Reforming Securities Litigation Reform: A Proposal For Restructuring The Relationship Between Public And Private Enforcement Of Rule 10b-5

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Abstract:
For years, commentators have debated how to reform the controversial Rule 10b-5 class action, without pausing to ask whether the game is worth the candle. Is private enforcement of Rule 10b-5 worth preserving, or might we be better off with exclusive public enforcement? This fundamental and neglected question demands attention today more than ever. An academic consensus has now emerged that private enforcement of Rule 10b-5 cannot be defended on compensatory grounds, at least in its most common form (a fraud-on-the-market class action brought against a non-trading issuer). That leaves the oft-cited, but under-theorized, rationale that private enforcement is a “necessary supplement” to the securities fraud deterrence efforts of the SEC. When this justification is critically examined, however, it proves to be highly debatable. A rich body of law and economics scholarship teaches that “bounty hunter” enforcement of an overbroad law, like Rule 10b-5, may lead to over deterrence and stymie governmental efforts to set effective enforcement policy (even assuming away “strike suits” and the “agency costs” that attend class action litigation); if private enforcement is nevertheless desirable—a contestable proposition—it is because a world without it might result in even greater deviations from optimal deterrence, due to SEC budgetary constraints, inefficiency and/or capture.

By carefully explicating the relative advantages and disadvantages of private Rule 10b-5 enforcement versus exclusive public enforcement, this Article reveals a new and better way to remedy the shortcomings of the Rule 10b-5 class action. It proposes that policymakers adopt an “oversight approach” to securities litigation reform by, for example, granting the SEC the ability to screen which Rule 10b-5 class actions may be filed, and against whom. By muting the over deterrence threat of private litigation and placing the SEC back firmly at the helm of Rule 10b-5 enforcement policy, this approach would mitigate the primary disadvantages of private enforcement. Moreover, by preserving a private check on SEC inefficiency and capture and allowing the SEC to continue to supplement its budget with private enforcement resources, it would do so without eliminating the primary advantages of the current system. This approach stands in stark contrast to prior securities litigation reforms, which have responded to the over deterrence threat posed by Rule 10b-5 class actions by rigidly narrowing the scope of private liability. This Article argues that an “oversight approach” to securities litigation reform carries distinct advantages over this “narrowing approach,” and ought to receive serious consideration in the ongoing policy debate.
DRAFT 2/22/08

REFORMING SECURITIES LITIGATION REFORM:
A PROPOSAL FOR RESTRUCTURING THE RELATIONSHIP
BETWEEN PUBLIC AND PRIVATE ENFORCEMENT OF RULE 10b-5
Amanda M. Rose*

I. INTRODUCTION

Most commentators now agree that the private right of action implied under Rule 10b-5—that “judicial oak which has grown from little more than a legislative acorn”1—cannot be defended on compensatory grounds, at least in its most common incarnation: the fraud-on-the-market class action brought against a non-trading issuer. It has been severed, to continue the late Chief Justice’s metaphor, from the private law roots from which it sprang, and today finds defense, if at all, on deterrence grounds. Yet when it comes to deterrence, most observers also agree that Rule 10b-5 class actions perform poorly.

Beyond that, the consensus breaks down. Some proclaim that the specter of Rule 10b-5 class actions, and the massive liability they threaten, has led to overdeterrence—even to the extent of driving issuers away from the U.S. capital markets altogether, thus placing the United States at a competitive disadvantage relative to foreign markets. In the much anticipated Supreme Court decision in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., for example, a five-Justice majority recently warned that the Rule 10b-5 class action “may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets.”

Others, by contrast, charge that restrictions on the implied right imposed by the Private Securities Litigation Reform Act of 1995 (PSLRA) and decisions such as Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,3 recently reaff-

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firmed in *Stoneridge*, have led to underdeterrence, contributing to a climate of corporate permissiveness that led to scandals like Enron and WorldCom. Indeed, the *Stoneridge* dissent, authored by Justice Stevens, bemoaned “the Court’s continuing campaign to render the private cause of action under [Rule 10b-5] toothless.”4 Still others recognize that Rule 10b-5 class actions may both overdeter some actors (e.g., issuers, who face essentially strict enterprise liability for the frauds of their agents) and underdeter others (e.g., individual wrongdoers, who are rarely forced to contribute to settlements, and “gatekeepers”—like auditors and investment banks—who may escape liability under the rule of *Central Bank*).

Various reform proposals designed to remedy the perceived deterrent shortcomings of the Rule 10b-5 class action have been offered in recent years. These proposals, while diverse in their prescriptions, share a common theme: All proceed from the assumption that private Rule 10b-5 enforcement is a “necessary supplement”5 to the Rule 10b-5 enforcement efforts of the Securities and Exchange Commission. That assumption, however, is not self-evidently correct. To the contrary, once the notion that Rule 10b-5 class actions serve a meaningful compensatory function is cast aside, permitting “private attorneys general” to prosecute securities fraud cases reveals itself as a rather debatable proposition.

Law and economics scholarship teaches that it is especially difficult to achieve optimal deterrence when private parties are granted the right to enforce overbroad liability rules for financial reward, absent what has been called a “compensatory hedge.”6 Private rights may lead to overenforcement and, as a result, overdeterrence. They may also make for a relatively inflexible enforcement system: A monopolistic public enforcer can deal with the overdeterrent potential of an overbroad liability rule through use of discretionary nonenforcement, or by pursuing a cooperative approach to regulation, and it can adjust its approach if it appears to have gotten the deterrence calculus wrong (which will often be the case, in light of imperfect and changing information); private enforcement, however, nullifies the public enforcer’s ability to effectively utilize these tools by ensuring that the law will be enforced to its outermost limits, regardless of the public enforcer’s desires, so long as such enforce-

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4 128 S.Ct. at 779.
ment is profitable. Monopolistic public enforcement carries its own risks, of course. Its relative superiority as a means of achieving (or, more realistically, approximating) optimal deterrence will depend on several key factors specific to the particular law at issue and the character of the would-be enforcers.

When this learning is applied in the specific context of Rule 10b-5 enforcement, an interesting—though incomplete—picture emerges. As written, Rule 10b-5 is clearly overbroad, particularly when enterprise liability and hazy concepts such as materiality are considered. If Rule 10b-5 were enforced to its outermost limits, then, it would induce socially undesirable conduct, like an issuer’s excessive investment in precautions to protect against fraud by its agents (conduct that, like securities fraud itself, increases the cost of capital to no good end). Moreover, the plaintiffs’ securities bar is enticed to bring suit by the prospect of financial reward—an intuitive observation that is bolstered by evidence showing a correlation between an issuers’ market capitalization (which is, in turn, related to the size of the potential damage award and, in turn, the potential contingency fee) and the likelihood of being sued in a Rule 10b-5 class action. These two facts make it predictable that unrestricted private enforcement of Rule 10b-5 would, at least as it concerns companies with large market capitalizations, lead to overdeterrence and frustrate the Commission’s ability to set, and adjust, Rule 10b-5 enforcement policy.

These facts do not reveal, however, whether exclusive Commission enforcement would move us closer to optimal deterrence than the status quo. That leap requires one to accept the proposition that the interests of the Commission are better aligned with the public’s interest in achieving optimal deterrence than are the interests of the plaintiffs’ securities bar. Concerns about bureaucratic inefficiency and regulatory capture may lead some to predict that exclusive Commission enforcement would result in greater deviations from optimal deterrence than would private enforcement. So, too, may concerns about the Commission’s actual or potential budgetary constraints. Thus, it is not clear whether private Rule 10b-5 enforcement is desirable, or undesirable, relative to a system of exclusive Commission enforcement. Nor is the question readily subject to empirical testing.

Although it is unclear how they balance out, identifying the relative advantages and disadvantages of private Rule 10b-5 enforcement versus exclusive Commission enforcement is an important exercise. It allows one to conceptualize the deterrence shortcomings of the Rule 10b-5 class action, and how to remedy them, in a new and potentially superior way than has heretofore been sug-
gested. For the past twenty-five years, the securities litigation reform debate has centered on how to reduce the agency costs borne of the attorney-client relationship; more recently, substantial criticism has been heaped on the out-of-pocket measure of damages used in Rule 10b-5 class actions. But even if these agency costs were eliminated entirely (i.e., even if the interests of class members and their counsel were perfectly aligned), and even if the damages measure utilized in Rule 10b-5 class actions was substantially corrected (so that it better reflects the harm caused by securities fraud), the risk that private enforcement of Rule 10b-5 would lead to socially undesirable overdeterrence would remain. Such is the natural consequence of—and fundamental problem with—permitting profit-driven private enforcement of an overbroad law.

Short of eliminating private enforcement altogether, there are two very different ways that policymakers can approach this problem. First, they can narrow the scope of the private right—either directly, by altering the substantive liability rule, or indirectly, by altering the procedural law to disfavor the particular types of suits thought most undesirable (the “narrowing approach”). Second, they can grant the public enforcer some level of control over private litigation, so as to reintroduce the possibility of discretionary non-enforcement and cooperative regulation (the “oversight approach”).

The narrowing approach has been the mainstay of securities litigation reform efforts to date. Aspects of the PSLRA, key judicial decisions like Central Bank, and contemporary proposals to eliminate private enterprise liability can all be viewed as seeking to narrow Rule 10b-5’s overbreadth in an effort to mitigate the overdeterrence threatened by private enforcement. It is a costly approach—the flip side of an overbroad Rule 10b-5 is an underinclusive one. To the extent that the Commission is unable (or unwilling) to pick up the enforcement slack, narrowing the private right of action serves to replace the risk of overdeterrence with the risk of underdeterrence.

The oversight approach avoids this conundrum, but has been given very little attention as a potential mechanism for reform. If the Commission were authorized to prescreen all Rule 10b-5 class action complaints, for example, and decide which may be filed, there would be less need to rigidly narrow the implied right. Instead, we might rely on the Commission’s exercise of its expert discretion to protect against overdeterrence. This could have the added benefit of enabling the Commission to flexibly alter its enforcement strategies when new information or changed circumstances suggest it would lead closer to optimal deterrence.
If structured properly, a reform proposal grounded in increased Commission oversight of private Rule 10b-5 litigation has much to recommend it. Not only could it eliminate the core problem with Rule 10b-5 class actions without the tradeoffs required by the narrowing approach, but it could potentially do so without undermining the only two plausible bases for supplementing the Commission’s deterrence efforts with private enforcement—namely, the desire to harness additional enforcement resources, and the fear that if the Commission were left to its own devices, laxity or capture would mar its Rule 10b-5 enforcement efforts. With respect to the former, the prospect of recovery if the right to file is granted, combined with a right to reasonable recompense if the Commission chooses to take over the matter, might provide adequate incentives for private enforcers to investigate wrongdoing and otherwise participate in the system, thus ensuring, in conjunction with the Commission’s own efforts, a steady level of enforcement activity. With respect to the latter, requirements that the Commission promulgate principles guiding its decision with respect to whether to grant or deny the right to file, state in writing the reasons for its decision in a particular case, and report to Congress semi-annually on its track record of decisions, might serve as an antidote.

The intent of this Article is not to advocate a specific reform package, but rather to demonstrate that increased SEC oversight of private Rule 10b-5 litigation is a conceptual approach to reform deserving of further study and exploration. Although Commission oversight of private Rule 10b-5 class actions has not received attention in the securities litigation reform debate, government oversight is actually the norm in those rare cases where Congress has expressly granted private parties the right to sue to enforce the public interest absent a corresponding tort-like injury that can be meaningfully redressed through litigation. The False Claims Act, for example, authorizes the Department of Justice to intervene and to move to dismiss a qui tam action brought under that statute, regardless of whether the suit has merit, and notwithstanding that the government itself has not pursued relief against the defendant. And where the government has pursued relief, private enforcement is categorically barred. The fact that no comparable restrictions attend Rule 10b-5 class actions is a vestige of the implied right’s compensatory origins, which, as noted at the outset, no longer serve to justify private Rule 10b-5 enforcement via the class device. Policymakers should not allow the outdated form of private Rule 10b-5 litigation to dictate the substance of possible reforms any longer.
Part II traces the evolution of the private right of action under Rule 10b-5 from its compensatory beginnings to the present day, explaining that the modern Rule 10b-5 class action is justifiable, if at all, on deterrence grounds. Part III questions whether the Rule 10b-5 class action is truly a “necessary supplement” to the Commission’s deterrence efforts, applying law and economics scholarship to evaluate the relative advantages and disadvantages of private Rule 10b-5 enforcement versus exclusive Commission enforcement. Part IV then explains how enhanced Commission oversight of private Rule 10b-5 actions might minimize the disadvantages, and maximize the advantages, of both regimes, and answers some potential objections.

II. FROM KARDON TO BORAK: THE SHIFTING RAISON D’ÊTRE OF PRIVATE ENFORCEMENT

The story of private Rule 10b-5 enforcement begins with the advent of federal securities regulation itself. In the wake of the stock market crash of 1929 and the ensuing Great Depression, Congress enacted the Securities Exchange Act of 1934 as one in a series of statutes designed to promote “a philosophy of full disclosure”\(^7\) in the national securities markets. In Section 4 of the Act, Congress created the Securities and Exchange Commission as the expert agency with responsibility for the civil enforcement of these new statutes,\(^8\) and in Section 10(b) Congress granted the Commission broad authority to enact regulations banning manipulation or deception in connection with the purchase or sale of securities.\(^9\)

The Commission exercised the fullest extent of its delegated authority under Section 10(b) in 1942, when it enacted Rule 10b-5.\(^10\) The purpose of the Rule was to close a loophole in the Commission’s enforcement authority by prohibiting individuals or companies from buying securities if they engaged in fraud in their purchase; previously enacted rules prohibited only the fraudulent sale of

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The Rule’s primary drafter “never thought that twenty-odd years later it would be the biggest thing that ever happened” in the securities realm.

Although Rule 10b-5 “had no relation in the Commission’s contemplation to private proceedings”—and even less in Congress’s—just five years after its promulgation the United States District Court for the Eastern District of Pennsylvania implied a private right of action to sue for damages under the Rule in Kardon v. National Gypsum Co. The court did so despite the existence of several expressly enumerated private causes of action created by the 1934 Act and the Securities Act of 1933. The Kardon holding was adopted by “an overwhelming consensus of the District Courts and Courts of Appeals,” and by the Supreme Court a quarter century later in Superintendent of Ins. of N. Y. v. Bankers Life & Casualty Co. Although Kardon would not be decided the same way today, “the existence of a private cause of action for violations of the statute and the Rule is now well established” and has been repeatedly reaffirmed.

13 22 BUS. LAW. at 922
14 See Blue Chip Stamps, 421 U.S. at 729.
16 Id. at 514; see also Pamela H. Bucy, Private Justice, 76 S. CAL. L. REV. 1, 23-25 (2002) (cataloguing the express private rights of action in the 1933 and 1934 Acts).
18 404 U.S. 6 (1971).
20 Ernst & Ernst, 425 U.S. at 196; see also Herman & Maclean v. Huddleston, 459 U.S. 375, 380 (1983) (“The existence of this implied remedy is simply beyond peradventure”).

[Footnote continued on next page]
While the courts have not wavered in their recognition of the private right to sue for damages under Rule 10b-5, the justification for its existence has undergone significant transformation since 1946. Part II.A. explains that the right was originally implied to serve a compensatory function, but that the modern Rule 10b-5 class action that emerged in the late 1960s provides little if any meaningful compensation to investors, and instead finds its primary justification in its potential deterrent effect. Modern private enforcement via the class device therefore serves the same purpose as the Commission’s enforcement of Rule 10b-5. The wisdom of allowing “private attorneys general” to enforce Rule 10b-5 in this manner is not self-evident, but has been subject to surprisingly little challenge. Part II.B. explains why, describing how scholarship focused on the agency costs borne of the attorney-client relationship came to dominate the class action reform debate beginning in the 1980s, eclipsing more fundamental challenge to private enforcement of Rule 10b-5. Part II.C. situates the Private Securities Litigation Reform Act of 1995 (PSLRA) in this historical context. Part II.D. describes the problems that continue, even after the PSLRA, to frustrate the ability of Rule 10b-5 class actions to ensure optimal deterrence, and contemporary reform proposals designed to mitigate these lingering problems. Notably, these proposals continue to perpetuate the assumption that private enforcement is desirable. This Article tests that assumption in Part III.

A.

When originally implied, the private right of action under Rule 10b-5 served a purpose distinct from the purpose served by Commission enforcement of the rule. Commission enforcement operated primarily to deter securities fraud in order to promote society’s collective interest in the integrity and efficiency of the capital markets; private enforcement, by contrast, operated primarily to compensate defrauded investors for their discrete losses—much like a common law claim for misrepresentation and deceit. Kardon was premised on the view that “[t]he disregard of the command of a statute is a

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wrongful act and a tort,” entitling the injured party to compensa-
tion.\textsuperscript{21} This private law paradigm premised on corrective justice
ideals fit the facts of \textit{Kardon} quite well: The defendants had person-
ally duped the plaintiffs into selling them stock at less than its true
value; forcing the defendants to compensate the plaintiffs for their
injuries would set right this wrong. Indeed, in \textit{Kardon} itself the
plaintiffs could have proceeded under either Rule 10b-5 or the com-
mon law; the real issue was whether they could take advantage of
the 1934 Act’s provision for nationwide service of process.\textsuperscript{22}

To be sure, there was overlap between SEC and private Rule
10b-5 enforcement even in the early days: The Commission would
sometimes return disgorged funds to investors, and the threat of a
private lawsuit might operate, incidentally, to deter. But public and
private Rule 10b-5 enforcement occupied analytically distinct
spheres. This distinction is reflected in the divergent remedies
available in private Rule 10b-5 actions and Commission enforce-
ment actions. Private actions permit only a singular tort remedy: the
recovery of compensatory damages, most often calculated using an
“out-of-pocket” measure.\textsuperscript{23} Commission actions, by contrast, permit
a panoply of remedies, enabling the Commission to perform its de-
terrent function in a finely calibrated manner, depending on the facts
and circumstances of the particular case before it.\textsuperscript{24}

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\textsuperscript{21} 69 F. Supp. at 513. The Supreme Court has since repudiated this approach to the im-
\textsuperscript{22} 69 F. Supp. at 514.
\textsuperscript{23} Jonathan C. Dickey, \textit{SECURITIES LITIGATION: A PRACTITIONER’S GUIDE} \textsuperscript{2}\textsuperscript{2} A\textsuperscript{2}(Practicing Law Institute 2006).
\textsuperscript{24} These remedies, the availability of which vary somewhat depending on whether the
Commission initiates an administrative proceeding or files suit directly in federal court,
today include civil money penalties, tiered in amount depending on the egregiousness of the
violation; officer and director bars; injunctive relief; cease and desist orders; disgorgement
of ill-gotten gains; and orders requiring corrective disclosures and corporate governance
changes, among other things. \textit{See} Vincent J. Badolato, \textit{SECURITIES LAW TECHNIQUES} \textsuperscript{3} §§
\textsuperscript{3} 87.06-87.07 (Matthew Bender 2006); Dickey, \textit{SECURITIES LITIGATION: A PRACTITIONER’S
GUIDE} \textsuperscript{4} §§ 15:3.2-15:3.3; James D. Cox & Randall S. Thomas, \textit{SEC Enforcement Heuristics:
An Empirical Inquiry}, 53 DUKE L.J. 737, 746-48 (2003); see also Securities Enforcement
Remedies And Penny Stock Reform Act of 1990, 101 P.L. 429, 104 Stat. 931 (Oct. 15,
1990). In addition, a Commission investigation may (and often does) lead to a negotiated
resolution prior to any formal charges ever being filed against the defendant. \textit{See} Dickey,
\textit{SECURITIES LITIGATION: A PRACTITIONER’S GUIDE} \textsuperscript{5} § 15:3.2. The Commission may also
refer violations to the Department of Justice for criminal prosecution. \textit{Id.} § 15:3.4.
Beginning in the 1960s, the distinction between public and private Rule 10b-5 enforcement began to blur. The emergence of the modern class action device in 1966, made widely applicable in securities cases by the fraud-on-the-market presumption of reliance, catalyzed the change. In common-law fraud cases, plaintiffs must prove that they actually read and relied upon the allegedly misleading disclosures, raising individualized issues that render class certification difficult. The fraud-on-the-market presumption of reliance available in Rule 10b-5 cases obviates that requirement, so long as the plaintiffs purchased their shares in an “efficient” market. It therefore “invites class certification (and a subsequent trial on the merits) by moving this one issue on which there will be substantial variation among the plaintiffs to a later stage of the proceeding, and then only if the defendant wishes to assume the burden of negating it.”

By vastly expanding the number of plaintiffs who may presumptively recover, and allowing them to pursue relief collectively via the class device, the fraud-on-the-market presumption dramatically raised the stakes of Rule 10b-5 litigation. Not surprisingly, the prototypical Rule 10b-5 case became a class action brought on

26 See Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (adopting the presumption); Paul G. Mahoney, Precaution Costs And The Law Of Fraud In Impersonal Markets, 78 Va. L. Rev. 623, 663 (1992) (reporting that “the rate at which securities fraud class action suits were filed nearly tripled between April 1988, just after Basic was decided, and June 1991”).
30 “Given the volume of trading in secondary trading markets, the damages recoverable in such suits can be a substantial percentage of the corporation’s total capitalization, reaching the tens or even hundreds of millions of dollars.” Pritchard, 85 Va. L. Rev. at 928.
behalf of thousands of investors, based on misstatements or omissions made in public disclosure documents that most class members never read, against a deep-pocketed corporate defendant that did not itself profit from the fraud.\textsuperscript{31} This type of case is “light years away” from the common law tort of misrepresentation and deceit.\textsuperscript{32}

Most notably for purposes of this Article, Rule 10b-5 class actions fail to provide meaningful compensation to the class members on whose behalf they are brought. The compensatory shortcomings of the modern Rule 10b-5 class action have been well-chronicled elsewhere and will only briefly be summarized here. First, many members of the plaintiff class will also be shareholders of the defendant corporation when suit is brought. For them, recovery will result largely in “pocket shifting.”\textsuperscript{33} Second, those class members who are well-diversified may not benefit from Rule 10b-5 litigation in the long run. This is because in a fraud-on-the-market case, “each loser—the buyer or seller disadvantaged by the fraud—is balanced by another winner: the person on the other side of the trade”\textsuperscript{34}; chances are that a well-diversified investor will be a winner as often as a loser, and will “perceive[] little good in a legal rule that forces

\textsuperscript{31} “Courts have largely assumed that when an executive speaks or acts fraudulently within the scope of his or her authority and in a manner at least partially meant to benefit the corporation, the corporation is jointly and severally liable.” See Donald C. Langevoort, On Leaving Corporate Executives “Naked, Homeless and Without Wheels”: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability, 42 WAKE FOREST L. REV. 627, 631 (2007). While insiders are regularly named as co-defendants, they rarely contribute to the settlement. See John C. Coffee, Jr., Reforming The Securities Class Action: An Essay On Deterrence And Its Implementation, 106 COLUM. L. REV. 1534, 1550-51 (2006). Instead, the vicariously liable corporate defendant almost always foots the bill. See Arlen & Carney, 1992 U. ILL. L. REV. at 695-96; A.C. Pritchard, Who Cares?, 80 WASH. U. L. Q. 883, 886-87 (2002). There have been, however, notable exceptions in recent years. See Shawn Young, Ex-WorldCom Directors Reach Pact, WALL STREET JOURNAL A6 (March 21, 2005).

\textsuperscript{32} Blue Chip Stamps, 421 U.S. at 744-745.

\textsuperscript{33} Coffee, 106 COLUM. L. REV. at 1558; Janet Cooper Alexander, Rethinking Damages In Securities Class Actions, 48 STAN. L. REV. 1487, 1503-04 (1996). Even when (as is often the case) insurance is available to fund the settlement, it is not costless for shareholders, who ultimately pay through increased insurance premiums. Langevoort, 38 ARIZ. L. REV. at 648-49; see also Baker & Griffith, 74 CHI. L. REV. at 489 (finding, based on interviews with insurance market participants, that “D&O insurers seek to price policies according to the risk posed by each corporate insured”).

\textsuperscript{34} Langevoort, 38 ARIZ. L. REV. at 646.
his winning half to compensate his losing half over and over.”

Third, there is the practical reality that Rule 10b-5 class actions recover only an insignificant share of investor losses at very high transaction costs. For these reasons, most commentators now agree that the prototypical Rule 10b-5 class action (i.e., one brought against a non-trading corporation for its officer’s “fraud-on-the-market”) cannot be defended on compensatory grounds.

As the original compensatory justification for private Rule 10b-5 enforcement grew less persuasive, a deterrence-based justification took on increased prominence. In 1964, the Supreme Court implied a private right of action to sue for damages under Section 14(a) of the 1934 Act in *J. I. Case Co. v. Borak*, based on the view that

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36 Coffee, 106 COLUM. L. REV. at 1545; Alexander, 48 STAN. L. REV. at 1500. Securities settlement values have risen in recent years, but not at a pace commensurate with investor losses. See *Trends In Shareholder Class Action Litigation: Filings Plummet, Settlements Soar* at 9, available at http://www.nera.com/publication.asp?p_ID=3028. To add insult to injury, revelation of the fraud also imposes a severe market penalty on the firm, further harming the corporation’s innocent shareholders. Jonathan M. Karpoff, D. Scott Lee, & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, available at http://ssrn.com/abstract=652121 (Dec. 31, 2006) (forthcoming JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS) (finding that a firm’s reputation losses as a result of financial fraud exceed the legal penalty by over 7.5 times, and exceed the amount by which the firm value was artificially inflated by more than 2.5 times).

37 See, e.g., Langevoort, 38 ARIZ. L. REV. at 651 (noting that the compensatory justification for private Rule 10b-5 class actions “has relatively few informed, non self-serving defenders”); Pritchard, 85 VA. L. REV. at 928 (arguing that “a rational investor would not willingly pay for the compensation provided by the class action regime if deterrence could be achieved at a lower cost through alternative means”); Coffee, 106 COLUM. L. REV. at 1545 (“From a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly”); Alexander, 48 STAN. L. REV. at 1507 (“the compensation rationale does not persuasively justify the present measure of damages”); Pritchard, 80 WASH. U. L. Q. at 884 (“Securities class actions cannot be justified as providing compensation”); cf. *Basic*, 485 U.S. at 263 (White, J., dissenting) (warning that adoption of the fraud-on-the-market presumption would “lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers”) (internal quotations omitted).
“[p]rivate enforcement of the proxy rules provides a necessary supplement to Commission action.”38 The same reasoning was subsequently invoked to explain private enforcement of Rule 10b-5.39 “In effect, Borak treats plaintiffs not as victims so much as ‘private attorneys general’ to whom damages are paid as a reward for bringing lawsuits that serve the public purpose of deterring securities violations”; it thus marked a significant departure from “the traditional compensatory rationale for implied rights of action.”40 Indeed, the purpose served by securities class actions today is more akin to the purpose served by qui tam actions41 than traditional private civil litigation.42

This revisionist justification for private Rule 10b-5 enforcement clearly begged the question: Why is it necessary to task private plaintiffs with a deterrence job already assigned to the Commission? That question, however, sparked little debate at the time. Perhaps the answer appeared too obvious to warrant serious discussion. After all, the 1960s and early 1970s were marked by a profound skepticism of the administrative state, as notions of “regulatory capture”

38 377 U.S. 426, 432 (1964).
41 “A qui tam statute permits a private citizen to bring an action on behalf of the government for recovery of a statutory penalty. The person who pursues the action—the ‘informer’ or ‘relator’—receives a portion of any amount recovered on the government’s behalf. Thus, qui tam statutes privatize government litigation, permitting the private informer to sue for the government on a contingent-fee basis.” J. Randy Beck, The False Claims Act And The English Eradication Of Qui Tam Legislation, 78 N.C.L. Rev. 539, 541 (2000) (footnotes omitted).
42 Jill E. Fisch, Class Action Reform, Qui Tam, And The Role Of The Plaintiff, 60 Law & Contemp. Probs. 167, 175 (1997); see also Alexander, 48 Stan. L. Rev. at 1508 (explaining that “[c]lass actions involving open-market transactions in the secondary market do not . . . fit the common law model” and that the “wrongful act in these open-market cases . . . is the violation of a regulatory statute enacted for the benefit of the public at large”); Matthew C. Stephenson, Public Regulation Of Private Enforcement: The Case For Expanding The Role Of Administrative Agencies, 91 Va. L. Rev. 93, 103-04 (2005) (“Many scholars have concluded that deterrence, rather than the need for private redress, has been the Court’s primary rationale for recognizing private causes of action under the securities and investor protection laws; private plaintiffs in these cases are seen by courts not so much as ‘victims’ in need of compensation but rather as private attorneys general”).
gained popular acceptance, along with an almost starry-eyed optimism about the possibilities for class litigation “to deter wrongdoers who previously were effectively insulated from responsibility by the economics of disputing.” Congress even began experimenting with direct citizen enforcement of environmental laws. As explained in Part III, there are important differences between enforcement of the environmental laws through citizen suits and enforcement of Rule 10b-5 through class action litigation, but such nuances were subsumed at the time by a trans-substantive belief in the efficacy of the “private attorney general.”

B.

In the 1970s, however, judicial and political attitudes changed. Disenchantment with the “private attorney general” concept began to manifest itself in varied ways. For example, the Supreme Court began limiting the standing of individuals to sue to enforce the public interest; by requiring that plaintiffs show some individualized injury traceable to the alleged violation, the Court effectively precluded Congress from pushing private enforcement of public law to its outermost limits. The Supreme Court also retreated from Borak, refusing to imply new private causes of action under the securities laws absent some indication of a Congressional intent to create such rights. Moreover, an expansive reading of Rule 23 came un-


46 Although some have tried to define the concept more precisely, see William B. Rubenstein, On What A “Private Attorney General” Is—And Why It Matters, 57 VAND. L. REV. 2129 (2004), “private attorney general” in this context simply means a private party who sues primarily to vindicate a public interest, rather than to redress a personal loss.

47 See Cox & Thomas, 53 DUKE L.J. at 740; Mahoney, 78 VA. L. REV. at 664 n.102.


49 See Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979); Piper, 430 U.S. 1; see also Frankel, 67 VA. L. REV. at 553; Grundfest, 107 HARV. L. REV. at 988; Roberta S. Karmel, REGULATION BY
deter sustained attack. Opponents of the class device “rallied around characterizations of the procedure as a form of ‘legalized blackmail’” and charged “widespread abuse of the rule by lawyers and litigants on both sides of the ‘v.’, including unprofessional practices related to attorneys’ fees, ‘sweetheart’ settlement deals, dilatory motion practice, harassing discovery, and misrepresentations to judges.”  

Rule 10b-5 class actions were singled out as presenting a particularly pernicious “danger of vexatiousness.”

Significantly, lawmakers chose to address the perceived abuses in private Rule 10b-5 litigation in a manner that did not challenge the assumption that private enforcement is a necessary supplement to the Commission’s deterrence efforts. Moreover, it was not seriously questioned that the best vehicle for private enforcement (assuming it is desirable) remained the class action device (as opposed to something more akin to a qui tam suit). It is, quite frankly, rather surprising that more pressure was not brought to bear on these assumptions, although the historic support of private enforcement by the Commission and an outdated belief that private Rule 10b-5 litigation serves a meaningful compensatory function likely goes part of the way to explain it.  

[Footnote continued from previous page]


51 Blue Chip Stamps, 421 U.S. at 739.


53 See Brief of the United States Securities & Exchange Commission at 4, S.E.C. v. Rind, 991 F.2d 1486 (9th Cir. 1993) (No. 91-55972) (noting that “enforcement actions are significantly different from private damage actions,” because the Commission seeks to “vindicate the public interest in the enforcement of the securities laws rather than the personal interests of private parties in obtaining compensation”); Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002 at 20, available at http://www.sec.gov/news/studies/sox308creport.pdf (“In contrast to Commission enforcement actions which have several aims, the aim of private litigation is solely to compensate injured investors”); 104 H. Rpt. 369 (“Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action”) (Joint Explanatory Statement of the Committee of Conference). And, of course, securities litigation is big
opment, however, that caused “[t]he social value of private enforce-
ment of the federal securities laws [to] become an article of faith in
the federal securities liturgy”54 was the scholarship of John Coffee.

Professor Coffee entered the fray in the early 1980s and framed
the terms of the class action debate in a way designed to “rescue”
rather than eliminate the besieged “private attorney general.”55 His
scholarship on the agency costs in class litigation posited that a mis-
alignment of incentives between class members and class counsel
was to blame for the “shortfall between the promise and the per-
formance of the private attorney general”56 and instructed that “the
basic goal of reform should be to reduce the agency costs incident
to this attorney-client relationship.”57 Professor Coffee’s work was
stunningly successful in shifting the focus of both the academy and
policymakers from the predicate question of the propriety of deter-
rence-focused class actions, like those brought under Rule 10b-5, to
the narrower question of how best to tweak the economic incentives
of class counsel in order to improve them.58 Indeed, “[s]cholars

business for plaintiffs’ and defendants’ lawyers alike. See Coffee, 106 COLUM. L. REV. at
1540-41. These powerful lobbies have a vested interest in maintaining private enforcement.
See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure & The Protection of
54 Grundfest, 107 HARV. L. REV. at 969.
55 John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the
56 Coffee, 42 MD. L. REV. at 220.
57 John C. Coffee, Jr., Understanding The Plaintiff’s Attorney: The Implications Of Eco-
nomic Theory For Private Enforcement Of Law Through Class And Derivative Actions, 86
58 Ironically, some class action defenders have recently charged that Professor Coffee’s
scholarship reflected a wrongheaded obsession with compensation. Observing that the true
purpose of the small claims class action is deterrence, they argue that it makes little sense to
talk of aligning the interests of class counsel with the interests of class members; it is soci-
ety’s interest in deterrence, not class members’ narrow interest in monetary recovery, that
matters, they explain. See, e.g., Myriam Gilles & Gary B. Friedman, Exploding The Class
REV. 103, 105 (2006); William B. Rubenstein, Why Enable Litigation?: A Positive Exter-
There is an easy answer to this argument, however, that fully reconciles the agency costs
approach with a dedication to deterrence-oriented class actions: In class action litigation,
the only proxy available for society’s interest is the class members’ money damages, as
defined by the substantive law. The “agency costs” approach can also, however, be recon-

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from various political viewpoints, who employ many methodologies beyond law and economics and who otherwise agree about very little, could all agree that the central problem in class action jurisprudence was the agency dilemma.”

C.

The agency costs scholarship pioneered by Professor Coffee clearly influenced the securities litigation reform debate in the 1990s. The Private Securities Litigation Reform Act of 1995 (PSLRA), enacted over President Clinton’s veto as part of the 104th Congress’s “Contract With America,” implicitly accepts private Rule 10b-5 enforcement as socially desirable. The Joint Explanatory Statement of the Conference Committee states that “private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.” The statute therefore attempts to improve, rather than eliminate, private enforcement by better aligning class counsel’s and class members’ interests. Most notably, the PSLRA’s “lead plaintiff” provision is designed to ensure that the party with the largest stake in the litigation selects and monitors class counsel, so that litigants with a perspective that values compensation as an end in itself, and the political debates surrounding class action reform tend to emphasize the latter view. Perhaps this versatility of the agency costs approach has helped dampen more fundamental challenge to the small claims class action.

Cf. John C. Coffee Jr., Rethinking the Class Action: A Policy Primer on Reform, 62 IND. L.J. 625, 644-45 (1987) (“My purpose is not to debunk any set of normative values—either those underlying a ‘public law’ approach or those espoused by adherents of individual justice—but to examine the likely consequences of proposed mechanisms for implementing normative visions”).

59 Rubenstein, 57 VAND. L. REV. at 2164; see also Bryant Garth, Ilene H. Nagel, and S. Jay Plager, The Institution Of The Private Attorney General: Perspectives From An Empirical Study Of Class Action Litigation, 61 S. CAL. L. REV. 353, 365 (1988) (observing that liberals and conservatives alike came “to define and promote their views almost exclusively in terms of whether there is enough or too much of a market incentive for individual attorneys to take particular lawsuits”).

60 104 Pub. L. 67.


gation decisions better reflect the interests of the plaintiff class.\footnote{Perino, 2003 U. ILL. L. REV. at 923-24.} The lack of client control had been identified in the agency costs literature as the source of all major shortcomings of class litigation, including the initiation of meritless suits and collusive settlements.\footnote{Coffee, 42 MD. L. REV. at 239-240 (explaining that the lack of client control leads to consequences that “weaken and potentially cripple private enforcement of law by means of the private attorney general”).}

In addition to these “client empowerment” reforms,\footnote{Fisch, 60 LAW & CONTEMP. PROBS. at 176.} the PSLRA also contains several substantive and procedural requirements for private Rule 10b-5 actions that, collectively, were designed to make it more difficult to bring certain categories of cases thought to be most troublesome. For example, disclosure of “soft” information (such as revenue forecasts) may render a company particularly susceptible to suits alleging “fraud-by-hindsight.”\footnote{See Ann Morales Olazabal, Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What’s Safe and What’s Not?, 105 DICK. L. REV. 1, 5-6 (2000).} The PSLRA therefore creates a safe harbor from liability for forward-looking statements either accompanied by meaningful cautionary language or made without actual knowledge of their falsity.\footnote{See generally id.} The safe-harbor is designed “to encourage issuers to disseminate relevant information to the market without fear of open-ended liability.”\footnote{104 H. Rpt. 369, at 32.}

The statute also heightens the pleading standards for stating a Rule 10b-5 claim with the aim of weeding out weak cases on a motion to dismiss.\footnote{Perino, 2003 U. ILL. L. REV. at 924.} Specifically, it requires that the complaint allege with specificity: the statement or omission that is false or misleading \footnote{15 U.S.C. § 78u-4(b)(1).} and why\footnote{Id. § 78u-4(b)(2); Tellabs, 2007 U.S. LEXIS 8270; Higginbotham v. Baxter Int’l, Inc., 495 F.3d 753 (2007); Central Laborers’ Pension Fund v. Integrated Elec. Servs., 2007 U.S. App. LEXIS 19917 (5th Cir. Aug. 21, 2007).}; if pleaded on information and belief, facts on which that belief is formed\footnote{Id.}; and facts giving rise to a strong inference that the defendant acted with the required state of mind.\footnote{Id. § 78u-4(b)(2)} The PSLRA also
requires plaintiffs to plead and prove loss causation,\textsuperscript{73} and precludes discovery pending decision on a motion to dismiss.\textsuperscript{74}

While designed to eliminate meritless cases early, specifically those based on a mere drop in a company’s stock price, some have warned that these reforms may also cut off meritorious suits and thus compromise the deterrent effect of the law.\textsuperscript{75} Indeed, some have suggested that the catastrophic corporate failures of the early 2000s, including Enron, WorldCom and others, may be attributable at least in part to the PSLRA.\textsuperscript{76}

By altering the substantive law and erecting procedural barriers to its enforcement based on concerns about securities class action “abuse,” Congress hardly broke with tradition: The judiciary had been doing the same for decades.\textsuperscript{77} The Supreme Court’s decision in \textit{Blue Chip Stamps v. Manor Drug Stores, Inc.}, denying standing to enforce Rule 10b-5 to non-purchasers and non-sellers of securities, for example, was explicitly motivated by a concern about “strike suits.”\textsuperscript{78} Other Supreme Court decisions restricting the scope of Rule 10b-5 were influenced by similar concerns, such as the 1994 decision in \textit{Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A} holding that Section 10(b) does not permit the imposition of aiding and abetting liability.\textsuperscript{79} Like the PSLRA, \textit{Central Bank} has been criticized as contributing to the spate of corporate failures earlier this decade.\textsuperscript{80}

\textsuperscript{75} Langevoort, 38 A\textit{RIZ}. L. REV. at 640-41; Pritchard, 85 VA. L. REV. at 961.
\textsuperscript{77} See Coffee, 42 Md. L. REV. 215, 228 (noting the tendency of courts “to narrow and limit substantive statutory rights, seemingly because of their distaste for the process by which such rights are enforced); Stephen Berry, \textit{Ending Substance’s Indenture To Procedure: The Imperative For Comprehensive Revision Of The Class Damage Action}, 80 COLUM. L. REV. 299 (1980).
\textsuperscript{78} 421 U.S. at 740.
\textsuperscript{79} 511 U.S. 164, 188-190 (1994).
\textsuperscript{80} Coffee, 84 B.U.L. REV. at 318-20 (observing that \textit{Central Bank} may have contributed to the “gatekeeper failure” that led to scandals like Enron). The Supreme Court interpreted the reach of \textit{Central Bank} broadly this Term in \textit{Stonerride}. See also Larry E. Ribstein, 10

[Footnote continued on next page]
D.

Whether the PSLRA has actually reduced the number of securities “strike suits” presents a difficult empirical question. Indeed, there is not even a consensus that “strike suits” were a problem in need of solving when the PSLRA was enacted. Most seem to agree, however, that the current system of Rule 10b-5 enforcement still does not result in optimal deterrence, and hence calls for reform continue. As noted, some believe that the PSLRA, like Central Bank

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82 Pritchard, 85 Va. L. Rev. at 958 (noting that “class actions offer, at best, a very imprecise and expensive form of deterrence”); Coffee, 106 COLUM. L. REV. at 1535-1536 (“As presently constituted, securities class actions produce wealth transfers among shareholders that neither compensate nor deter”); Richard A. Booth, Who Should Recover What For Securities Fraud? at 8 (2005), available at http://ssrn.com/abstract=883197 (securities fraud class actions “do no apparent good for anyone (other than lawyers), but they do considerable harm to defendant companies”). The SEC will hold a roundtable discussion in Spring 2008 to discuss securities litigation reform, at the behest of a diverse group of law professors. See Kara Scannel, SEC To Study Revamp On Shareholder Suits, WALL STREET JOURNAL C2 (Sept. 24, 2007).
before it, went too far to insulate misbehavior from liability, leading to underdeterrence. Others charge that excessive securities litigation has over deterred, harming the competitiveness of the U.S. capital markets by driving issuers abroad. Still others observe that private securities litigation both over deter and undeters, depending on the class of defendants.

Commentators on all sides have criticized the out-of-pocket damages measure employed in Rule 10b-5 class actions as not conducive to achieving optimal deterrence. In theory, optimal deterrence is achieved when the defendant is made to internalize the net social costs of the contemplated misbehavior—no more, no less. This requires that the sanction equal the net social costs of the conduct multiplied by the inverse of the probability of its imposition (or, rather, that the defendant perceives this to be the case). But the damages measure in private Rule 10b-5 litigation bears little relationship to the harm sought to be deterred. That harm is not the loss sustained by any discrete set of investors (which will be offset by the gain to investors on the other side of the transactions), but the more amorphous harm suffered by all investors—indeed, all members of society—when fraud raises the cost of capital and upsets the allocative efficiency of the economy. Another related critique is

85 “Thus, if the harm is 100 and the probability of sanctions is 50 percent, the sanction should be multiplied by 1/1.5 = 2, so the sanction should equal 200 (and thus the expected sanction would equal 100).” Steven Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW at 483 (2004).
86 See, e.g., Langevoort, 38 ARIZ. L. REV. at 646 (“full out-of-pocket compensation in open-market cases is systematically excessive and dysfunctional”); Alexander, 48 STAN. L. REV. at 1498 (“Aggregate class trading losses are probably greater than either the true cost of the violation or the benefits received by the violator, both of which are speculative in nature and difficult to calculate”).

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that it is most often the corporation (and, ultimately, its shareholders) that are forced to internalize these inaccurate damages, rather than the actual individual wrongdoers, who usually escape personal liability altogether.\textsuperscript{88}

Various solutions to these lingering problems have been offered. For example, Professor Coffee has suggested ways to cause culpable insiders to shoulder more of the liability, including most radically the elimination of enterprise liability in private fraud-on-the-market cases involving a non-trading issuer.\textsuperscript{89} He has also advocated imposing strict liability for Rule 10b-5 violations on auditors to prompt them to play a more robust gatekeeping role, with a cap on liability to avoid overdeterrence (and possible bankruptcy, with its attendant negative effects on the competitiveness of the market for auditing services).\textsuperscript{90} Professor Partnoy has made a similar proposal.\textsuperscript{91} Professor Langevoort has suggested capping compensatory damages in cases involving a non-trading issuer,\textsuperscript{92} and Professor Alexander has suggested replacing them with civil penalties tiered to distinguish

\textsuperscript{88} Almost without exception, Rule 10b-5 class actions that are not dismissed at the pleading stage result in settlement, and the individual wrongdoers allegedly responsible for the fraud rarely contribute. \textit{See} Arlen & Carney, 1992 U. ILL. L. REV. at 695-96; Coffee, 106 COLUM. L. REV. at 1566-1570 (explaining how a combination of agency costs, the legal rules regarding indemnification, and insurance practices lead the corporation, rather than insiders, to shoulder the brunt of Rule 10b-5 liability). Instead, the primary sources of settlement payments are issuers, their insurers, and ancillary defendants. \textit{See} Alexander, 48 STAN. L. REV. at 1506 & n. 81. Each of these sources of funds can be traced back to innocent investors: Payments by the issuer effect a direct transfer of wealth from the issuer’s current shareholders to the class members; payments by insurers are funded by premiums paid by the insurer’s policyholders (issuers and, indirectly, their innocent shareholders); and payments by ancillary defendants, like accountants and investment banks, are charged back to issuers (and, indirectly, their innocent shareholders) through increased fees due to litigation risk. \textit{See} Langevoort, 38 ARIZ. L. REV. at 649.

\textsuperscript{89} Coffee, 106 COLUM. L. REV. 1534.


\textsuperscript{92} Langevoort, 38 ARIZ. L. REV. 639.
between defendants with different states of mind. She would leave private parties to enforce the penalties, subject to limited Commission oversight. Professor Pritchard would similarly replace damages with penalties, but would leave it to the exchanges, rather than individuals, to enforce.

These proposals present interesting solutions to the deterrence shortcomings of Rule 10b-5 class actions. But each perpetuates the assumption that the Commission cannot or should not handle Rule 10b-5 deterrence efforts on its own. That assumption may be valid, but it ought to be seriously tested before further reform efforts are built on it. Part III undertakes this task, analyzing at a theoretical level the relative costs and benefits of a system of private Rule 10b-5 enforcement versus a system of exclusive Commission enforcement. Although a lack of empirical data precludes reaching a definitive conclusion as to the superior method of enforcement, the analysis nonetheless contributes considerably to the reform debate. It offers a different perspective on the perceived shortcomings of Rule 10b-5 class actions, and, as explained further in Part IV, sug-

93 Alexander, 48 STAN. L. REV. 1487.
94 Pritchard, 85 VA. L. REV. 925. The Commission had been rumored to be considering allowing companies to move shareholder disputes into arbitration, instead of courts; Chairman Cox, however, recently denied that there is pending before the Commission “‘any proposal or other mature rule’” on the subject. Kara Scannel, SEC Probes CDOs and Bear Funds, WALL STREET JOURNAL A3 (June 27, 2007).
95 See, e.g., Langevoort, 38 ARIZ. L. REV. at 652 (assuming that “the conventional view that private litigation is a necessary supplement to SEC enforcement is well-grounded” because of Commission resource constraints); Alexander, 48 STAN. L. REV. at 1490 (taking “as given” the “need for a private litigation remedy as a supplement to SEC enforcement”).
96 A few commentators have questioned the desirability of private enforcement of Rule 10b-5. Professor Grundfest urged the Commission to at least consider disimplying the private Rule 10b-5 cause of action prior to the enactment of the PLSRA, explaining that “the relationship between private and federal enforcement of the securities laws has not been subject to rigorous analysis.” 107 HARV. L. REV. at 969. In a more recent editorial, he has again questioned whether private enforcement should be retained. Joseph A. Grundfest, The Class-Action Market, WALL STREET JOURNAL, A15 (Feb. 7, 2007). Over a quarter century ago, Professor Frankel concluded that “[t]he experiment with deterrence-oriented private actions as a supplement to public enforcement of the securities acts has not been successful.” 67 VA. L. REV. at 557. Professors Stewart and Sunstein have also questioned the wisdom of private enforcement of the securities laws in cases alleging fraud-on-the-market. Stewart & Sunstein, 95 HARV. L. REV. at 1303-04; see also INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at 78 (2006) (“the public value of the securities class action is questionable”); Peter J. Wallison, Capital Complaints, WALL STREET JOURNAL, A19 (March 20, 2007).
gests a potentially superior way to approach securities class action reform than has previously been considered by policymakers.

III. IS PRIVATE ENFORCEMENT REALLY A “NECESSARY SUPPLEMENT” TO COMMISSION ACTION?

When private rights of action offer meaningful compensation to injured parties, they may be defended based on corrective justice grounds, separate and apart from utilitarian considerations of optimal deterrence. Moreover, truly compensatory private actions tend to promote the goal of deterrence: “The award of damages to those who actually incur the costs (assuming damages are properly computed) will provide incentives for defendants to maintain an efficient level of compliance,” and will do so without risking excessive enforcement given that a rational plaintiff will not sue unless “the social costs sought to be internalized (expected damage awards) . . . exceed the plaintiff’s expected litigation costs.”

As discussed in the previous section, however, most commentators now agree that the prototypical Rule 10b-5 class action does not provide meaningful compensation to investors. In contrast to a common law fraud case, a “fraud-on-the-market” Rule 10b-5 class action is less about correcting forced wealth transfers between the plaintiffs and the defendants than it is about protecting the integrity of the capital markets.

If one accepts this premise, then the desirability of retaining private Rule 10b-5 enforcement via the class device is, or ought to be, immediately called into question. There are few instances, at least since our Republic developed a mature public law enforcement capability, in which Congress has expressly granted private parties the right to sue to enforce public law norms absent a traditional tort-like injury that can be meaningfully redressed through litigation.

97 “American tort law recognizes the corrective justice ideal by providing a mechanism through which defendants who have wrongfully injured plaintiffs are required to compensate those plaintiffs for their injuries, and thereby make them whole insofar as this is practically possible.” Benjamin C. Zipursky, Civil Recourse, not Corrective Justice, 91 GEO. L.J. 695, 695 (2003).

98 Stewart & Sunstein, 95 HARV. L. REV. at 1298-99.

99 Redish, 2003 U. CHI. LEGAL at 108 (noting that only in “rare cases” has the government employed a “‘bounty hunter’ model, by providing non-compensatory reward to private individuals to encourage them to assist in enforcing legal regulation of behavior deemed harmful to the public interest”); Beck, 78 N.C.L. REV. at 548-49 (explaining that
few situations in which Congress has done so (e.g., the environmental “citizen suit,” the qui tam action under the False Claims Act, and the treble damages antitrust suit) have engendered much controversy—and for good reason. It is often more difficult to achieve optimal deterrence under a regime of private enforcement than under a regime of monopolistic public enforcement.\(^{100}\)

This Part explains why monopolistic public enforcement is often preferable, drawing on classic law and economics scholarship. It first describes, at an abstract level, why private enforcement may lead to overenforcement and how it can complicate efforts to approximate optimal deterrence. Next, it probes the assumptions on which the foregoing conclusions are based, and tests them in the specific context of Rule 10b-5 enforcement. The analysis casts doubt on the conventional wisdom that private Rule 10b-5 enforcement is obviously superior to the alternative of exclusive Commission enforcement.

A.

Private law enforcement for “bounty” is problematic for two overarching reasons. First, it may lead to overenforcement and, as a result, overdeterrence. Second, and relatedly, it tends to create a relatively inflexible system of enforcement that may be ill-suited to the goal of achieving optimal deterrence.

1. Optimal deterrence requires that the sanction imposed equal the net social costs of the misconduct multiplied by the inverse of the probability of the sanction’s imposition (or, more precisely, that the defendant perceives this to be the case).\(^{101}\) This inverse relationship makes it theoretically possible for a monopolistic public enforcer to save enforcement costs by reducing the probability of enforcement and increasing the magnitude of the sanction imposed on those against whom enforcement proceedings are brought. “A social savings in enforcement effort can be achieved by allowing sanctions to be imposed only with a low probability; and sanctions

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England moved away from qui tam enforcement of penal statutes in the nineteenth century as public law enforcement institutions developed).


\(^{101}\) See supra, note 85 and accompanying text.
can be raised to avoid dilution of deterrence from the low probability of sanctions.”

In a regime of profit-driven private enforcement, however, not only is such a cost-savings approach impossible, it also will be extremely difficult to reach an enforcement equilibrium—and hence a state of optimal deterrence. This is because, unlike with public enforcement, the magnitude of the sanction and the amount spent on enforcement cannot be set independently; rather “the level of the defendant’s liability determines the extent of enforcement (whether a suit will be brought and how much will be spent by the parties on litigation).” Thus, the higher the sanction, “the higher the payoff from suit; the higher the payoff, the more people will spend investigating and bringing suits.” This, in turn, leads to excessive enforcement and, as a predictable result, overdeterrence.

Decoupling the sanction imposed against the wrongdoer from the bounty paid to the private enforcer is one solution to this quan-

102 Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW at 484. For example, the public enforcer could reduce the probability of enforcement in the example in note 85, supra, to 25 percent, in which case we would multiply the harm of 100 by $1/0.25 = 4$, for a sanction of 400 (and an expected sanction of 100). Id. at 483. There are practical limitations, however, to this approach. See id. at 483-84.

103 A. Mitchell Polinsky, AN INTRODUCTION TO LAW AND ECONOMICS (2d Ed. 1989) at 118.

104 Easterbrook & Fischel, 52 U. CHI. L. REV. at 621; see also William M. Landes & Richard A. Posner, The Private Enforcement of Law, 4 J. LEGAL STUD. 1, 32 (1975) (“in a case where substantial resources are necessary to generate a substantial probability of apprehension, those resources can be saved by setting a very high [fine], but the high [fine] induces private enforcers to expend resources on apprehension—the resources that the high [fine] was intended to conserve”).

105 “Overdeterrence depends on the probability that an individual attaches to a future scenario in which he suffers harm from overenforcement. Overenforcement accordingly translates into overdeterrence only to the extent that individuals take it into account ex ante.” Richard A. Bierschbach & Alex Stein, OVERENFORCEMENT, 93 GEO. L.J. 1743, 1745 (2005). This problem does not arise when the probability of enforcement is unity, because in that case “the optimum fine would be equal to the social costs of illegal activity, and if those costs rose the optimum fine would rise by the same amount. This would be (properly) perceived by [private] enforcers as an upward shift in the demand curve facing them, and would have the effect of increasing the resources devoted to [enforcement], as in the case of an ordinary product the demand for which increases. But where the probability of [enforcement] is less than one, the optimum fine is higher than the social costs of the illegal activity not as a signal that additional resources should be devoted to preventing the activity, but as a means of minimizing those resources.” Posner, ECONOMIC ANALYSIS OF LAW at 596-97.
It has been argued that the law effectively achieves such a decoupling in class litigation, by virtue of the fact that the plaintiffs’ lawyer—the true “enforcer” in small claims class actions—receives only a percentage of the total damages paid by the defendant in the form of a contingency fee. But the contingency fee typically increases, at least to an extent, in proportion to the size of the damages award, so the decoupling is incomplete and the basic problem may persist (albeit on a smaller scale).

Moreover, decoupling is not a perfect solution. Driving a wedge between the bounty paid to the enforcer and the sanction paid by the defendant creates attractive opportunities for collusion, given that the enforcer and the defendant would both be better off if they negotiated a settlement that is less than the expected sanction but greater than the expected bounty. Collusive settlements are thought to be one of the most intractable agency costs associated with small claims class actions; by fostering the perception that “the private watchdog can be bought off,” collusive settlements frustrate the ability of private enforcement to approximate optimal deterrence. The risk of collusive settlements cannot be eliminated by perfectly aligning the interests of class members and class counsel, as has been suggested in the agency costs literature, without essentially recoupling the bounty and the sanction—and thus reintroducing the problem of overenforcement.

At best, the contingency fee is a very rough approximation of the appropriate bounty. It is difficult to estimate the appropriate enforcement level even when there is a monopolistic public enforcer. Ambiguities abound as to the net social costs imposed by the misconduct, as well as the level of violations. Moreover, potential offenders may have imperfect perceptions of both the magnitude and probability of the sanction, and may not always act rationally. Private enforcement adds another layer for possible error by requiring that the law also estimate the bounty required to induce the desired rate of enforcement. In the context of securities fraud, for example, the system of rewards should induce private enforcers “to

\footnotesize{106 Posner, ECONOMIC ANALYSIS OF LAW at 597.}

\footnotesize{107 Coffee, 42 Md. L. Rev. at 220 n.14; see also Coffee, 86 COLUM. L. REV. at 694-95.}

\footnotesize{108 See Posner, ECONOMIC ANALYSIS OF LAW at 597.}

\footnotesize{109 Coffee, 42 Md. L. Rev. at 226. Collusion is possible in public enforcement, as well (in that context, we call it bribery). See Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW at 580 n.4; Posner, ECONOMIC ANALYSIS OF LAW at 597-98.}

\footnotesize{110 Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW at 481.}
expend resources finding and prosecuting violations until, at the margin, the last dollar of resources spent on enforcement reduces the social costs of nondisclosure by just one dollar”—something that “is almost impossible to achieve.”

2. The difficulties associated with calculating the optimal level of deterrence highlight what is perhaps the more salient disadvantage of private enforcement. In reality, a deterrence regime is constructed based on incomplete information and must be guided to some degree by intuition. Miscalculations will therefore be made, and adjustments will inevitably be necessary as additional information comes to light. In addition, changing circumstances will necessitate adjustment. It may be harder to make these adjustments in a regime of private enforcement.

If overdeterrence appears to be a problem, for example, the public enforcer can adjust by ratcheting down the enforcement level; conversely, if underdeterrence appears to be a problem, the public enforcer can ratchet it up. With private enforcement, by contrast, adjustment of the enforcement level would require altering the incentives held out to private enforcers—i.e., alteration of the sanction (or, in lawyer-driven litigation, the law governing the award of attorneys’ fees). This may be considerably more difficult to accomplish, at least in time to respond effectively to changed circumstances.

Another way in which a public enforcer may adjust the deterrence calculus is through alteration of its enforcement priorities. Laws are often overbroad, meaning that they capture within their literal terms conduct that, under a more perfectly tailored rule, society would choose not to sanction or prohibit. If such a law were enforced to its letter, the threat of liability would result in overdeterrence. A public enforcer can minimize this risk through credible use of “discretionary nonenforcement”—that is, the public enforcer can signal that it will not enforce the sanction against those who violate the prohibition in letter but not in spirit. Discretionary nonenforce-

111 Easterbrook & Fischel, 52 U. Chi. L. Rev. at 620.
112 Stephenson, 91 Va. L. Rev. at 139 (noting the “difficulty in predicting ex ante the overall effect of private citizen suits and the likelihood that relevant factual or political conditions will vary over time”).
113 While “private enforcement may be able to mobilize and reallocate its resources more quickly than the public enforcer, who is confined within a bureaucratic setting” (Coffee, 42 Md. L. Rev. at 227), it will not do so absent economic motivation.
ment allows society to avoid the costs of crafting more precisely tailored rules, and the loopholes such rules inevitably create.\textsuperscript{114} It also allows for ready adjustment by a public enforcer if beliefs change as to the type of conduct that warrants sanction. In a regime of unconstrained private enforcement, however, discretionary nonenforcement is a \textit{non sequitur}: If there is a violation of the rule and a reward worth the cost of pursuit, the case will be brought.\textsuperscript{115}

Relatedly, a public enforcer can adjust the deterrence calculus by adjusting its \textit{style} of enforcement, taking less of a coercive approach and more of a cooperative approach (or vice versa) if circumstances suggest it would lead to greater compliance. “The former approach is primarily concerned with detecting offenses and punishing violators—a legalistic, by-the-book approach that relies on formal legal process,” whereas “[t]he latter approach is primarily concerned with preventing violations and remedying underlying problems in a cooperative way, relying on the shadow of the law to induce that cooperation.”\textsuperscript{116} Private enforcement, however, is antithetical to a cooperative approach to regulation, for the obvious reason that private enforcers have little incentive to be cooperative. Private enforcement may therefore “engender an overemphasis on coercion and deterrence at the expense of negotiation and cooperation, regardless of the wishes of the government enforcement agency” and “may impede government efforts to persuade industries

\textsuperscript{114} Beck, 78 N.C.L. REV. at 627 (“The legislature cannot anticipate or express with precision all of the circumstances that might warrant an exception to a rule of general application, so it paints with a broader brush than the public interest requires”); Landes & Posner, 4 J. LEGAL STUD. at 38 (“The costs of precisely tailoring a rule to the conduct intended to be forbidden would be prohibitive given the limitations of human foresight and the inherent ambiguities of human language”).

\textsuperscript{115} See Landes & Posner, 4 J. LEGAL STUD. at 39 (“The existence of a public monopoly is a necessary . . . condition of discretionary nonenforcement”); William E. Kovacic, \textit{Private Monitoring And Antitrust Enforcement: Paying Informants To Reveal Cartels}, 69 GEO. WASH. L. REV. 766, 781 (2001) (“Robust private participation, especially independent rights of action that eliminate a public prosecutorial monopoly, reduce or eliminate the ability of government enforcement officials to use prosecutorial discretion as a nonlegislative tool for altering the law”).

to regulate themselves, since industry-generated guidelines may subsequently become the basis for private enforcement suits."

In short, it “can collide with agencies’ attempts to foster legitimate cooperation with regulatees.”

B.

The foregoing discussion would appear to support a preference for exclusive Commission enforcement of Rule 10b-5 to avoid the problems that inhere in private enforcement. But that preference rests on four key assumptions that must be identified and tested in the specific Rule 10b-5 context before any final conclusions can be reached. The efficacy of private law enforcement cannot properly be evaluated at a trans-substantive level. To the contrary, “[t]he desirability of private enforcement in a particular policy area will depend on context-specific information about the regulatory problem, the characteristics of the potential plaintiffs, and the effect of private enforcement on public enforcement efforts.” For this reason, recent attempts to defend the desirability of deterrence-oriented small claims class actions paint with too broad a brush.

117 91 Va. L. Rev. at 118.
118 21 Stan. Envtl. L.J. at 140. Private enforcement may also stymie the government’s efforts to send clear signals. “Levels of [public and private] enforcement may vary, carrying conflicting messages about the appropriate standard of conduct or the degree of corporate compliance.” Fisch, 60 Law & Contemp. Prob. at 199. It may also interfere with the government’s efforts to control the development of the law. Stephenson, 91 Va. L. Rev. at 119 (“judicial decisions rendered in citizen suits, brought piecemeal before nonexpert courts by citizen groups with particularized interests, may establish adverse or inconsistent precedents that complicate or disrupt government enforcement efforts”); Bucy, 76 S. Cal. L. Rev. at 66-67. 119 Stephenson, 91 Va. L. Rev. at 121; see also Steven Shavell, Foundations of Economic Analysis of Law (2004) at 578 (“Whether it is advantageous for legal intervention to come about through legal actions brought by private parties or through efforts of public enforcement agents depends on which method most economically results in identification and, if necessary, the apprehension of the parties to whom the law should apply”); Kovacic, 69 Geo. Wash. L. Rev. at 782 (“Decisions about how to expand private participation in implementing the law require an assessment of the quality of existing enforcement institutions, including the capability, intentions, and motivations of public prosecutors”); cf. Martin H. Redish, Class Actions and the Democratic Difficult: Rethinking The Intersection Of Private Litigation And Public Goals, 2003 U. Chi. Legal F. 71 (broadly attacking small claims class actions brought under Rule 23 based on democratic principles).

The four critical assumptions underlying a preference for exclusive public enforcement are: (1) that overdeterrence is a risk, (2) that the would-be private enforcers are profit-driven, (3) that the public enforcer’s interests are better aligned with the public’s interests than the private enforcer’s, and (4) that private enforcers do not otherwise enjoy some advantage that tips the scales in favor of private enforcement. As explained below, the first two assumptions are likely valid in the Rule 10b-5 context. Reasonable persons may differ, however, as to whether the third assumption is valid; one’s view will depend on the faith one places in the Commission, relative to the plaintiffs’ securities bar, to act in society’s best interest. With respect to the fourth assumption, the resources of the plaintiffs’ securities bar, given actual or potential budgetary constraints on the Commission, weigh in favor of private enforcement; whether they tip the scales in favor of private enforcement, however, is unclear.

1. The first key assumption underlying the preference for monopolistic public enforcement is that the optimal level of deterrence is less than the maximum level of deterrence. Were it otherwise, concerns about excessive enforcement by private plaintiffs, and the overdeterrence that results, would largely disappear; the law would be “designed to deter unconditionally—not to force the firm to compare costs and benefits, but to channel its conduct into approved forms.”  

Discretionary nonenforcement and cooperation with potential violators would be unnecessary—indeed, inappropriate.

This assumption appears valid in the context of Rule 10b-5. Congress delegated to the Commission the task of setting securities fraud enforcement policy in Section 10(b) because it recognized the limitations of a fixed rule of law to govern the dynamic capital markets, and the greater institutional competence of an expert agency to

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121 See Easterbrook & Fischel, 52 U. CHI. L. REV. at 621-22.
respond flexibly to changed circumstances. The Commission, in turn, promulgated Rule 10b-5, which itself is “as broad as almost any statute, a sort of long-arm provision in which the SEC forbids everything the statute gives it power to forbid.” It captures in its web a substantial amount of conduct that, under a more perfectly tailored rule, society would choose not to outlaw.

For example, by imposing what amounts to strict enterprise liability, Rule 10b-5 seeks to prompt the corporation to take adequate precautions to ensure that its officers do not engage in fraud. But the reach of the rule extends further, and captures cases where a corporation has taken appropriate care. After all, a corporation’s failure to prevent a Rule 10b-5 violation may or may not, in a particular case, be the result of negligent oversight. Indeed, it may be extremely difficult for a board of directors to detect or prevent an officer’s fraud, and the threat of massive Rule 10b-5 class damages

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122 Thel, 42 Stan. L. Rev. at 459-60. It is therefore not an obvious benefit that private Rule 10b-5 enforcement “contribute[s] to a consistent level of enforcement, recognizing that the SEC’s enforcement policies vary according to administration priorities at any given time.” Alexander, 48 Stan. L. Rev. at 1516; see Stephenson, 91 Va. L. Rev. at 142 (noting the value of flexibility “given the considerable uncertainty about the effects of different private enforcement schemes, the possibility of fairly rapid changes in underlying circumstances, and the fluidity of policy preferences regarding the rigor of enforcement of various statutes”); Sustaining New York’s and the US’ Global Financial Services Leadership at 74-75 (observing that private enforcement itself fluctuates depending on the volatility of stock prices). Moreover, the observation that “private enforcement . . . [may] prevent abrupt transitions in enforcement policy that have not been sanctioned by the legislature” (Coffee, 42 Md. L. Rev. at 227) is inapposite in the securities context, because Congress sanctioned the Commission to exercise its broad discretion in setting enforcement policy. Cf. Grundfest, 107 Harv. L. Rev. at 1019 (“In the sixty years since the Commission was created, Congress has repeatedly demonstrated its inability to resolve significant policy issues related to securities fraud litigation”).

123 Thel, 42 Stan. L. Rev. at 463 (footnote omitted).

124 These may include the “selection of managers, design of incentives, internal controls, etc.” Langevoort, 42 Wake Forest L. Rev. at 635; see also Cox, 39 Ariz. L. Rev. at 511; David Rosenberg, Decoupling Deterrence and Compensation Functions in Mass Tort Class Actions for Future Loss, 88 Va. L. Rev. 1871, 1889 (2002). In light of the significant market penalty that is imposed on a company if financial fraud is detected, it is unclear whether enterprise liability is necessary as a means of prompting investment in precautions. See Karpoff & Martin, The Cost to Firms of Cooking the Books; Langevoort, 42 Wake Forest L. Rev. at 636.

125 Professors Arlen and Carney have postulated that fraud-on-the-market is most often a consequence of “last period” agency costs. Arlen & Carney, 1992 U. Ill. L. Rev. at 701-03. They contend that under normal conditions, officers have strong incentives to act hon-
may prompt an unreasonably large investment in precautions that, at the end of the day, costs society more than it saves.126 Similarly, ambiguities in the legal standard mean that corporate officers may find it difficult to comply despite the best of intentions.127 The threat of liability may cause them to omit to disclose information that would benefit society (for fear that its disclosure will be deemed materially misleading), or to disclose information that costs more to produce than it is worth (for fear that its omission will be deemed materially misleading).128 In any event, they may spend too much time and too many resources trying to figure out what to do.129

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estly; when, however, officers fear that the corporation is facing insolvency, they may withhold disclosure of the bad news in order to buy time to turn the situation around. Id. Professor Langevoort has alternatively argued that fraud-on-the-market may be largely attributable to “corporate cultural biases,” particularly optimistic ones, that lead officers to filter out or underestimate the seriousness of bad news. BEHAVIORAL LAW & ECONOMICS at 144-67 (ed. Cass R. Sunstein 2000); see also Langevoort, 38 ARIZ. L. REV. at 655-56. Both phenomena may lead to actionable misstatements or omissions under Rule 10b-5, as much as an officer’s base desire to line his or her own pockets. See also Pritchard, 85 VA. L. REV. at 930-37 (explaining that fraud on the market is attributable to three “human frailties”: fear, greed, and pollyannism).

126 Langevoort, 38 ARIZ. L. REV. at 657 (“we want firms as a whole to adopt precautionary procedures up to a point where the investment exceeds the net social cost threatened by the fraud adjusted to reflect the less than perfect rate of detection and enforcement”).

127 See Pritchard, 85 VA. L. REV. at 936-37

128 See Ribstein, 10 LEWIS & CLARK L. REV. at 146 (observing that “insiders are particularly vulnerable to litigation risk since, even if the corporation or insurance pays the judgment, the insiders have a non-diversifiable risk of reputation loss”).

129 “‘Truth,’ like all good things, is costly to produce. The person selling securities must investigate the business venture at hand and package the information in a form that investors can understand. The process of acquiring and packaging information can be exceptionally expensive. Whole industries—accounting, investment banking, much of the bar, much of the financial press—are the embodiments of the costs of investigation and certification of information about firms and their securities. For any complex business, it is impossible to find and present ‘everything material’ in a space less than that of a decent-sized library.” Easterbrook & Fischel, 52 U. CHI. L. REV. at 615; see also Alexander, 48 STAN. L. REV. 1487, 1499-1500 (“The costs of taking care might include the measures the firm must take to discover and disclose information and to avoid misleading the public, the competitive disadvantage of making corporate information public, the risk that the firm will become overly cautious in providing information to investors or in conducting its business, and the possibility that firms will be reluctant to use the public equity markets at all”). Whether investors benefit by more information depends on whether the marginal benefits of incre-
Whereas the Commission might exercise its discretion and choose not to sanction a corporation for its agent’s violation when it has taken appropriate care, or when the challenged disclosure or omission presents a close question on liability, private enforcers lack the incentive to exercise similar restraint. The Commission might also exercise discretion in choosing which sanction to apply. It may impose any of a host of penalties (monetary and otherwise) that it deems appropriate in light of the specific misconduct at issue, and the particular defendant’s culpability and circumstances. Indeed, Congress expanded the Commission’s enforcement arsenal in the Securities Enforcement and Penny Stock Reform Act of 1990 precisely “to introduce greater flexibility into the SEC’s enforcement program with the objective of allowing the SEC ‘to achieve the appropriate level of deterrence in each case and thereby maximize the remedial effects of its enforcement actions.’”

Before deciding whether to impose penalties on a corporate issuer, for example, the Commission recently explained that it will consider the following nuanced factors:

- the presence or absence of a direct benefit to the corporation as a result of the violation;
- the degree to which the penalty will recompense or further harm the injured shareholders;

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130 In addition, “any enforcement system mistakenly treats some nonviolators as violators and subjects them to sanctions. The possibility of mistaken sanctions creates an error cost—the deterrence of useful conduct by the risk of liability.” Frankel, 67 VA. L. REV. at 573. “Error creates the possibility that innocent conduct will be held to violate the law and guilty conduct will be exonerated. As a result, undesirable conduct becomes less costly and desirable conduct becomes more costly. Consequently, the incentive structure generated by the system is impaired when persons subject to it anticipate the possibility of erroneous decisions.” Warren F. Schwartz, An Overview of the Economics of Antitrust Enforcement, 68 Geo. L.J. 1075, 1077 (1979). This article avoids wading into the debate over whether the “merits matter” in Rule 10b-5 class actions, but to the extent that they matter less than they would in a regime of monopolistic Commission enforcement, it would further support a preference for public enforcement. See Pritchard, 85 VA. L. REV. 925, 955 (“If both weak and strong cases lead to settlements, and if the settlements are not substantially greater in strong cases, the deterrent effect of class actions is diluted”).

131 See supra, note 24 and accompanying text.

the need to deter the particular type of offense;
the extent of the injury to innocent parties;
whether complicity in the violation is widespread throughout
the corporation;
the level of intent on the part of the perpetrators;
the degree of difficulty in detecting the particular type of off-
fense;
the presence or lack of remedial steps by the corporation;
and the extent of cooperation with the Commission and other
law enforcement.\footnote{See Statement of the Securities and Exchange Commission Concerning Financial Pen-
Commission staffers to receive approval by the full Commission before negotiating penal-
ties, which may lead to greater uniformity and predictability. See Speech by SEC Chair-
man: Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference

Private enforcers, by contrast, have only the blunderbuss remedy of
out-of-pocket damages in their toolkit.

Past securities litigation reform efforts, as well as contemporary
reform proposals calling for the elimination of enterprise liability,
can be understood as responding to the risk of overdeterrence posed
by Rule 10b-5 due to its overbreadth. The PSLRA, for example,
need not be viewed as reacting simply to the prevalence (real or
imagined) of non-meritorious securities fraud “strike suits.” By re-
stricting the scope of Rule 10b-5 liability (via the safe-harbor for
forward-looking statements) and making it more difficult to prove a
violation (via the heightened pleading requirements and discovery
stay), the PSLRA might also be viewed as an attempt to cut off suits
which could indeed have technical “merit” under the broad reach of
Rule 10b-5, but, if allowed to proceed, risk inducing an excessive
investment in precautions.\footnote{Bierschbach & Stein, Overenforcement, 93 Geo. L.J. at 1758 (theorizing that “the legal
system does its second-best by mitigating unavoidable overenforcement with heightened
evidentiary or procedural requirements that minimize overdeterrence”); Landes & Posner, 4
J. LEGAL STUD. at 40 (“An alternative to discretionary nonenforcement is to permit unlimited
private enforcement but rewrite the substantive rules of law to eliminate overinclusion”); Stephenson, 91 Va. L. REV. at 116-117 (“Because private citizens do not have the
same incentives to exercise discretion in deciding which violations of the law are worth
prosecuting, allowing private suits forces the government either to tolerate excessive en-
forcement of an overbroad rule or to narrow the rule in a way that allows many socially
undesirable activities to escape regulation”); see also Mahoney, 78 Va. L. REV. at 650 (ad-
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The Court explained that reading Section 10(b) broadly to create secondary liability for aiders and abettors would “exact costs that may disserve the goals of fair dealing and efficiency in the securities markets.” The Court declined to do so, based in part on a concern about “strike suits,” but based also on the fact that “the rules for determining aiding and abetting liability are unclear, in ‘an area that demands certainty and predictability.’” Uncertain risk of liability might cause securities professionals to refuse to provide services to some companies altogether, the Court explained, and might cause them to increase the prices charged to others (prices “in turn [paid] by the company’s investors, the intended beneficiaries of the statute”)—in other words, it might overdeter.

In Stoneridge, the Court again echoed these concerns, and observed that a broad reading of the implied right might shift securities offerings away from the domestic capital markets.

The specter of private Rule 10b-5 enforcement also might frustrate the Commission’s ability to pursue a cooperative approach to regulation. If it is to do more good than harm, Rule 10b-5 should encourage firms to adopt cost-effective internal controls to prevent

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vocating the adoption of a heightened intent standard in Rule 10b-5 cases as a means of protecting against overdeterrence).

135 511 U.S. at 188.

136 Id.

137 Id. A similar sentiment motivated the Court’s recent decision in Credit Suisse Securities (USA) LLC v. Billing, 127 S. Ct. 2383 (2007), 2007 U.S. LEXIS 7724, holding that the securities laws preclude the application of antitrust laws to the allegations of misconduct in the IPO underwriting process at issue in that case. The Court took as a given that the conduct alleged had been disapproved by the Commission, but nonetheless observed that serious harm could come of subjecting that conduct to private attack under the antitrust laws. The Court explained that “only a fine, complex, detailed line separates activity” that the Commission permits and forbids, and that “in light of the nuanced nature of the evidentiary evaluations necessary to separate the permissible from the impermissible, it will prove difficult for . . . different courts to reach consistent results.” 2007 U.S. LEXIS 7724, at *27 & *31. Thus, allowing private antitrust suits to proceed would likely “overly deter syndicate practices important in the marketing of new issues.” Id. at *37. The Court further noted that the Commission might in the future decide, in its expert judgment, to alter the line between what is permissible and what is impermissible; allowing private enforcement under the antitrust laws would “threaten to disrupt the full range of the Commission’s ability to exercise its regulatory authority.” Id. at *33.

138 128 S.Ct. at 772.
fraud by their agents and should encourage well-intentioned officers to make cost-effective disclosure calls. Cooperation with firms, rather than heavy-handed and overly technical enforcement, may be the best way to achieve this—enforcement flexibility, at a minimum, is likely necessary. This was the view at the time of the 1934 Act’s enactment. Section 10(b) received little criticism despite its extremely broad delegation of authority to the Commission precisely because “[m]any securities industry witnesses were particularly critical of rigid statutory regulation” and “business leaders generally favored cooperation between industry and government.”

The threat of follow-on class litigation may discourage companies from coming forward to the Commission when violations have occurred in order to seek a cooperative solution, since the class action “compensatory paradigm does not allow for damages reductions to encourage monitoring and reporting.” Moreover, “the volun-

139 42 STAN. L. REV. at 441-442. The Commission recently expressed a similar sentiment, noting that “the SEC’s first Chairman described the SEC’s role, and our relationship to business, as a partnership. We take that to mean, today just as back when Joe Kennedy was Chairman, that if a business is investor friendly, the SEC will be friendly to it.” Statement of the Securities and Exchange Commission before the House Financial Services Committee at 2 (June 26, 2007), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/sec_testimony_(6-26-07).pdf. This may have been in part responsive to recent criticisms that an overemphasis on coercion by U.S. regulators has placed the U.S. securities markets at a competitive disadvantage vis-à-vis the United Kingdom, where cooperation is the more prevalent approach to regulation. Id. at 2 (June 26, 2007). SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL SERVICES LEADERSHIP at 84; INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at 9 (noting the benefits of “more prudential regulation,” including “greater willingness of securities firms to step forward with self-identified problems, earlier identification and better understanding by regulators of high-risk issues, and generally greater cooperation between regulators and the regulated”); see also Coffee, 156 U. PENN. L. REV. at 272 (observing that “[b]y style and temperament, the U.S. punishes more severely” than the United Kingdom).

140 Pritchard, 85 VA. L. REV. at 993-94. Professor Arlen has argued that enterprise liability is justified only insofar as it induces corporations to adopt policing mechanisms that increase the probability that fraud is detected and individual wrongdoers are sanctioned—something it cannot do effectively if there is unrestricted private enforcement. Arlen, PUBLIC VERSUS PRIVATE ENFORCEMENT OF SECURITIES FRAUD at 46 (“Public enforcers cannot threaten a firm with sufficient liability to induce reporting . . . if it faces ruinous liability even if it does report, especially since reporting guarantees the imposition of such a sanction”); see also Richard Booth, WHO SHOULD RECOVER WHAT FOR SECURITIES FRAUD? at 31 (“it is not too strong to say that the current system of enforcement by the [securities fraud class action] effectively precludes any effective form of self-policing”).
tary disclosure of otherwise privileged information in securities enforcement matters may constitute waiver of the work product doctrine and attorney-client privilege” in subsequent class litigation.\textsuperscript{141}

2. Another key assumption underlying the preference for public enforcement is that private enforcers are motivated to prosecute claims primarily by the prospect of monetary reward.\textsuperscript{142} If, instead, the private enforcers’ motivations more naturally aligned with the public’s (\textit{i.e.}, to achieve optimal deterrence), it would be possible to keep the magnitude of the sanction independent from its probability and thus to avoid excessive enforcement. Stated another way, non-profit-driven private enforcers might in fact be motivated to engage in a form of discretionary nonenforcement.\textsuperscript{143}

The assumption that private enforcers are motivated by profit appears valid in the context of Rule 10b-5. Empirical studies demonstrate that historically Rule 10b-5 class actions have targeted companies with larger market capitalizations than the Commission targets.\textsuperscript{144} Moreover, the “conventional wisdom has long been that companies with small market capitalizations are less likely to be sued in securities class actions.”\textsuperscript{145} The larger a company’s market capitalization, “the larger the losses suffered by the putative class,

\begin{itemize}
  \item[\textsuperscript{141}] 1-1 \textsc{Securities Enforcement: Counseling and Defense} \textsection{} 1.02.
  \item[\textsuperscript{142}] Dayna Bowen Matthew, \textit{The Moral Hazard Problem With Privatization of Public Enforcement: The Case of Pharmaceutical Fraud}, 40 U. Mich. J.L. Reform 281, 332-33 (2007) (observing that where “large financial payoffs inure to the personal benefit of the private enforcer, there is a greater likelihood that private economic interests will lead plaintiffs to pursue claims that diverge from the public goals of a public statute”).
  \item[\textsuperscript{143}] This distinction has been captured using a variety of labels—entrepreneurial/ideological, bounty hunter/lone ranger, mercenary/social advocate. See also Rubenstein, 57 \textit{Vanderbilt L. Rev.} at 2156 (outlining a public/private spectrum of lawyering that takes into account the client, the fee arrangement, and the goal of the litigation).
  \item[\textsuperscript{144}] Cox & Thomas, 53 Duke L.J. at 764 (“In our sample, the SEC targeted companies with an average market capitalization $735 million less than those sued by the private plaintiffs’ bar alone”). The SEC has begun to target larger companies in recent years. See Cox & Thomas, 80 \textit{Notre Dame L. Rev.} at 901-02.
  \item[\textsuperscript{145}] Coffee, 106 Colum. L. Rev. at 1543; see also Stephen J. Choi, \textit{The Evidence on Securities Class Actions}, 57 \textit{Vanderbilt L. Rev.} 1465, 1480-1481 (“Plaintiffs’ attorneys will not wish to file even a meritorious suit against a small market capitalization firm with low stock market turnover to the extent the potential damages from such a suit are low and thus unlikely to compensate the plaintiffs' attorney for the relatively fixed costs of litigation”); Baker & Griffith, 74 U. Chi. L. Rev. at 503 n.72.
\end{itemize}
and the larger the potential settlement fund”—and contingency fee.  

This highlights a fundamental difference between private Rule 10b-5 enforcement and, for example, private enforcement of the environmental or civil rights laws. In the latter cases, the private enforcers may be incentivized to bring suit based on ideological beliefs. Assuming those beliefs reflect well the public sentiment regarding the optimal level of deterrence, private enforcement in such cases may be efficient. One (albeit dated) empirical study supports this distinction; it concludes, based on an evaluation of a sample of certified class actions in the Northern District of California over a five year period, that a profit-driven enforcer “is less likely to put together an innovative legal package, less likely to get a class certified, less likely to actively attempt to mobilize the class, and less likely to pursue injunctive relief, than a public interest or legal service lawyer focused on social advocacy.”

It was noted above that the PSLRA’s “lead plaintiff” provision is designed to ensure that the party with the largest stake in the litigation selects and monitors class counsel, so that litigation decisions better reflect the interests of the plaintiff class (thus reducing lawyer-client agency costs). Alternatively, that provision may be viewed as

146 Lisa L. Casey, Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging, 2003 B.Y.U.L. REV. 1239, 1241. The criminal indictment of Milberg Weiss on charges of paying kickbacks to clients to induce them to serve as lead plaintiffs in class-action lawsuits casts further doubt on the image of the plaintiffs’ securities bar as unmotivated by profit. See Peter Lattman, Closing Argument: Mr. Lerach Mulls Life Behind Bars, WALL STREET JOURNAL A1 (Feb. 12, 2008).

147 See Austin, 81 NW. U.L. REV. at 257 (noting that “[a]n environmental group’s incentives to bring suit resemble the incentives of public enforcers more closely than those of private plaintiffs who can recover damages”).

148 It might also be the case that Congress intended to make a “credible commitment” when it provided for private enforcement of the environmental laws. “In order to guarantee their intentions, governments, like parties to a contract generally, may take certain steps to restrict their freedom of action or at least to impose costs on themselves for violating their commitments. Granting private rights of action could be considered such a credible commitment: by taking the decision to enforce regulations out of the hands of government officials, the government signals that the laws being enforced by private parties will not be subject to uneven discretionary enforcement.” Trachtman & Moremon, 44 HARV. INTER’L L.J. at 241.

149 Garth, et al., 61 S. CAL. L. REV. at 396. Of course, “it remains true that what galvanizes environmental advocates may not accord with the most appropriate priorities from a public standpoint.” Rabkin, 61 LAW & CONTEMP. PROB. at 191.
an attempt to place institutional investors at the helm in order to
make litigation decisions better reflect the public’s interest in
achieving optimal deterrence. Institutional investors, at least relative
to non-diversified class members and unmonitored plaintiffs’ lawyers,
may be less likely to be motivated by a narrow desire to profit in
any particular case. While of course profit-driven, these repeat
players may be more likely to appreciate the greater economic con-
sequences of excessive litigation on the capital markets. In short,
their interests may be better aligned with the public’s.150 Institutional investors appear to be taking on the lead plaintiff role more
frequently since the enactment of the Sarbanes-Oxley Act of 2002;
PricewaterhouseCoopers reports that in 2006 large institutional in-
vestors acted as lead plaintiff in approximately 56% of cases, up
from 22% in 2002.151

3. A third, and critical, assumption underlying the preference
for monopolistic public enforcement is that the public enforcer’s in-
terests are better aligned with the public’s interest in achieving opti-
mal deterrence than are the private enforcer’s. Discretionary nonen-
forcement is a powerful tool, and the government’s use of it could

150 Matthew, 40 U. Mich. J.L. Reform at 331-332 (observing that the PSLRA’s “reforms more closely align the interests of private enforcers with the public goals of protecting the integrity of U.S. capital markets”).
151 2006 Securities Litigation Study at 38. NERA reports that “[c]ases with an institutional investor acting as lead plaintiff settle for approximately one-third more on average than cases involving other lead plaintiffs,” noting that it “is impossible to judge whether this correlation reflects the actions of the lead plaintiff or the nature of the cases in which institutions choose to be lead plaintiffs.” Recent Trends In Shareholder Class Action Litiga-
conceivably result in greater deviations from optimal deterrence than even profit-driven private enforcement. Indeed, “allowing regulators . . . broad discretion places great faith in their ability to recognize and represent the public interests,” and “capture can potentially result from the prosecutorial discretion that is essential to a cooperative approach to enforcement.” It is important to note that the inquiry here is a relative one. That private enforcement may “serve[] as a valuable check on government laxity and inefficiency” may be true, but it does not answer the binary question whether private or exclusive public enforcement will better approximate optimal deterrence.

Reasonable minds may differ on whether the assumption that the Commission’s interests are better aligned with the public’s is valid in the context of Rule 10b-5 enforcement. The Commission clearly is not a perfect institution. While once touted as a model administrative agency, more recently it has been criticized as being too sympathetic to corporate interests. The Commission is

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152 Landes & Posner, 4 J. LEGAL STUD. at 41 (noting that a “major cost of discretionary nonenforcement arises from its converse, which is selective or discriminatory enforcement”).
153 Zinn, 21 STAN. ENVTL. L.J. at 102.
154 Trachtman & Moremon, 44 HARV. INT’L L.J. at 240. See Zinn, 21 STAN. ENVTL. L.J. at 107-111 (describing classic theory of regulatory capture); cf. Stephenson, 91 VA. L. REV. at 131 (noting that recent scholarship suggests capture concerns are overblown and “public interest” considerations play an important role in administrative decisionmaking).
155 Fisch, 60 LAW & CONTEMP. PROB. at 199; but see Matthews, 40 U. MICH. J.L. REFORM 281 (arguing that private enforcement may have a deleterious effect on public enforcement).
156 Professor Coffee has observed that “[a]lthough the public prosecutor lacks any profit motive that might lead him to bring weak or marginal cases for their nuisance value, a prosecution can be motivated by ideological, political, and careerist motives”; he views it as “an open question as to which set of perverse incentives is more dangerous.” Coffee, 42 Md. L. REV. at 227 n.25. Cf. Howard M. Erichson, Coattail Class Actions: Reflections On Microsoft, Tobacco, And The Mixing Of Public And Private Lawyerng In Mass Litigation, 34 U.C. DAVIS L. REV. 1, 43 (2000) (“Given the political checks on the actions of attorneys general and other government lawyers, and given that government lawyer compensation is not driven by litigation outcomes to the same extent as private lawyer compensation, one would expect government lawyers to be somewhat less likely than private litigators to pursue litigation without a reasonable basis”).
158 See, e.g., Jesse Westbrook, Cox Sets Off Alarms On Investor Rights With SEC Moves, BLOOMBERG.COM (May 24, 2007); Walt Bogdanich, Senate Report Says S.E.C. Botched

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subject to political whims (particularly with respect to its budget\textsuperscript{159}), and exhibits behavioral biases.\textsuperscript{160} That said, it is probably incorrect to assert that the Commission is a “captive” of the securities industry, if for no other reason than the fractious divisions within that industry.\textsuperscript{161} A leading historian on Wall Street has observed that “the ‘capture’ theory and its many variants, like the agency ‘life stage’ theory, are of relatively little use in explaining how any particular SEC decision is actually made.”\textsuperscript{162}

Moreover, if the Commission were to perform sub-optimally as a monopolistic enforcer of Rule 10b-5, it would be subject to political rebuke. Congress retains the ability to influence or override Commission policy with which it disagrees.\textsuperscript{163} Indeed, just recently Congress flexed its muscle by calling all five Commissioners to testify before the House Financial Services Committee to inquire about

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\textit{Hedge Fund Inquiry}, N.Y. TIMES C2 (Feb. 2, 2007). The Commission recently fired back, explaining in prepared testimony before the House Financial Services Committee that the issues it faces “are sometimes trivialized as disputes between business and investors—as if to be pro-investor is to be anti-business, or to be pro-business is to be anti-investor,” when the truth is that “when people invest in securities, they are risking their money on the success of the business. Only if the business succeeds will their investment prosper.” Statement of the Securities and Exchange Commission before the House Financial Services Committee at 1-2. \textit{See also} Kara Scannell, \textit{SEC Sides With Investors In 'Scheme Liability’ Case}, WALL STREET JOURNAL A3 (June 4, 2007).


\textsuperscript{161} Stephenson, 91 VA. L. REV. at 131 (“The risk of capture is . . . less acute when an agency has a broad jurisdiction, as such agencies respond to (and draw their personnel from) multiple constituencies with competing interests”).

\textsuperscript{162} Joel Seligman, \textit{The Transformation Of Wall Street} (3d ed. 2003) at xix.

\textsuperscript{163} “[T]he SEC is an independent, ‘legislative’ agency, with the powers it exercises delegated from Congress under Article I and its power flowing from its organic statutes, the 1933 and 1934 Acts. While the Chairman of the SEC is typically appointed by the then-incumbent President, he does not serve at the pleasure of the executive, nor do the other Commissioners.” Thad A. Davis, \textit{A New Model Of Securities Law Enforcement}, 32 CUMB. L. REV. 69, 127 (2002); \textit{see also} Joseph P. Bauer, \textit{Reflections On The Manifold Means Of Enforcing The Antitrust Laws: Too Much, Too Little, Or Just Right?}, 16 LOY. CONSUMER L. REV. 303, 321 (2004) (noting that the historically bipartisan nature of antitrust enforcement “may be the product of the fact that enforcement is not solely the responsibility of the executive branch”).
their efforts at investor protection. If anything, the Commission may be too responsive to Congress. The Commission’s actions also remain subject to judicial review, which “may be an antidote to agency capture.”

By contrast, private enforcers are not subject to electoral discipline. And, as explained above, their profit motive is inherently misaligned with the public’s interest in achieving optimal deterrence, given Rule 10b-5’s substantial overbreadth. Correcting for this misalignment may be more difficult than—or at least as difficult as—monitoring the Commission for capture or regulatory inefficiency.

165 Pritchard, 80 NOTRE DAME L. REV. at 1076-1077 (arguing that “the SEC’s status as an ‘independent’ agency leaves it vulnerable to the political whims of key legislators” which “fuels the cyclical pattern of neglect and hysterical overreaction that typifies securities regulation emanating from both the SEC and Congress,” and suggesting “[m]oving securities regulation to the executive branch” as a means to “help insulate the field from this destructive pattern”); cf. Radio Ass’n on Defending Airwave Rights v. United States DOT, 47 F.3d 794, 808 (6th Cir. 1995) (“Americans rightly expect their elected representatives to voice their grievances and preferences concerning the administration of our laws. We believe it entirely proper for Congressional representatives to represent the interests of their constituents before administrative agencies. . . . [A]dministrative agencies are expected to balance Congressional pressure with the pressures emanating from all other sources.”).
166 Trachtman & Moremon, 44 HARV. INT’L L.J. at 240; see also Landes & Posner, 4 J. LEGAL STUD. at 41 (“Although the danger of discriminatory enforcement is a serious one, it is somewhat mitigated by judicial doctrines that limit discretionary enforcement”)
167 This seems particularly likely given the additional layer of agency costs peculiar to class litigation. See Richard A. Nagareda, Class Actions In The Administrative State: Kalven And Rosen Revisited at 33 (forthcoming 75 U. Chi. L. REV. (Winter 2008)), available at http://ssrn.com/abstract=1014695 (drawing a parallel between the principal-agent problems that attend administrative agencies and those that attend class litigation: “for administration, the concern that agencies will drift from the preferences of their legislative creators and, for class actions, the fear that lawyers will serve themselves while diserving the members of the class”). Private enforcement also raises democratic concerns. See Stewart & Sunstein, 95 HARV. L. REV. at 1294 (“[T]he very origins of administrative agencies lay in dissatisfaction with private litigation as an undemocratic mechanism for social
4. Even taking the preceding assumptions as a given in the Rule 10b-5 context—i.e., (1) that overdeterrence is a risk, (2) that private enforcers are profit-driven, and (3) that their interests are not as well aligned with the goal of optimal deterrence as the public enforcer’s—private enforcement might still be justified if private enforcers enjoy some other advantage that tips the scales in their favor. For example, private enforcement might be justified if private parties naturally possess information about violations, information that is difficult for a public enforcer to obtain. In this scenario we might be more concerned about the underdeterrence that would result from monopolistic public enforcement than the overdeterrence that might result from private enforcement.

Qui tam actions brought under the False Claims Act may be defended on this basis, because a whistleblowing insider may have superior access to information than a government agency with which the company has contracted. Fraud-on-the-market Rule 10b-5 class actions, however, cannot be so readily defended on this ground. At least if followed by a stock price drop, securities fraud “is peculiarly susceptible to ultimate detection when committed by agents of publicly held corporations,” and the “identity of the wrongdoer is readily ascertainable.” This is because such cases “involve affirmative wrongful public acts that frequently are in writ-

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choice and control”); Stephenson, 91 VA. L. REV. at 119 (because “neither the citizens bringing private enforcement suits nor the judges who decide them are subject to electoral discipline, private enforcement may undermine a valuable democratic feature of American governance”); Garth, et al., 61 S. CAL. L. REV. at 395 (private enforcement “can mask a tremendous increase in regulation by suggesting that enforcement is separate from other activities of governmental bureaucracies”; conversely, it can “camouflage a dramatic decrease in such regulation by suggesting that private enforcement will somehow fill the gap”).

168 Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW at 578-88.

169 William E. Kovacic, Whistleblower Bounty Lawsuits As Monitoring Devices In Government Contracting, 29 LOY. L.A. L. REV. 1799, 1821-22 (1996) (“The chief efficiency advantage of qui tam bounty hunting is that it gives oversight and enforcement powers to those closest to the relevant information”); Rubenstein, 57 VAND. L. REV. at 2152 (noting that the qui tam realtor “is authorized, in the first place, precisely because it is believed that private parties (whistle blowers) will be in a better position to uncover fraud”); Matthew, 40 U. MICH. J.L. REFORM at 292.

Moreover, the Commission, as the repository for and reviewer of public company filings, stands in a better position to acquire information indicative of violations than the plaintiffs’ securities bar or diffuse shareholders. Indeed, a recent empirical study examining corporate frauds between 1996 and 2004 in companies with more than $750 million in assets found that “private securities litigation plays a minimal role (less than 2 percent) in the detection of fraud.” The Commission did better at 6%, though the prize for highest detection rate (19%) went to company insiders. Perversely, private enforcement of Rule 10b-5 operates to discourage this type of self-reporting.

Another, less compelling, factor that might tip the scales in favor of private enforcement is simple resource advantage. If the public enforcer lacks adequate resources to detect and prosecute violations, even if otherwise better positioned to do so, private enforcement may be justified. Again, we might be more concerned about the undeterrence that would result from monopolistic public enforcement in this situation than the overdeterrence that could result from private enforcement. Private enforcement of the securities

173 Id. at 2.
174 See supra, note 140 and accompanying text; see also Bucy, 76 S. CAL. L. REV. at 59-60 (explaining that the class action format “is designed to discourage knowledgeable insiders from coming forward” because “[a] class member who incurred the professional and personal risks to reveal inside information regarding the wrongdoing alleged by the class would receive nothing for incurring these risks; all the whistleblower would get is a pro rata share, based on the amount of stock held” (if they are a class member at all)). The Sarbanes-Oxley Act of 2002 contains provisions protecting whistleblowers to encourage insiders to report fraud, but its efficacy is in doubt. See Dyck, et. al, at 6 (finding that the “non-monetary incentives for employee whistleblowers introduced by SOX do not lead to an increased rate of detection by employees” and that, in the sample examined, “employee whistleblowing drops from 20.7% to 15.6% of cases after SOX”); Michael Delikat, Blowing The Whistle On Sarbox, WALL STREET JOURNAL A10 (Aug. 23, 2007) (suggesting that SOX’s whistleblower provisions have been abused by employees with axes to grind); see also Kovacic, 69 GEO. WASH. L. REV. at 777-78 (describing ways the law can encourage private monitoring short of granting private rights of action).
laws is often defended on this basis.\textsuperscript{175} It is a rather fragile defense, to be sure: Congress could simply increase appropriations to the Commission,\textsuperscript{176} and has in fact done so in recent years.\textsuperscript{177} But, taking it as valid, it extends only so far.

If a bounty is offered to private enforcers in order to entice them to detect and prosecute those Rule 10b-5 violations the Commission cannot afford to, the justification does not extend to violations that the Commission would choose not to pursue in a world of infinite resources. Nor does it extend to so-called “copycat” Rule 10b-5 class actions—\textit{i.e.}, class actions that allege violations that the Commission (or some other governmental agency) has \textit{already} detected and prosecuted.\textsuperscript{178} In 2006, fully 25\% of securities class actions filed in federal court also involved formal or informal Commission investigations or some form of Commission action.\textsuperscript{179} Such actions would appear to result purely in the generation of transaction costs.\textsuperscript{180}

\textsuperscript{175} Langevoort, 42 Wake Forest L. Rev. at 654 (“concern over the shortage of resources is the standard argument for supplementing SEC enforcement with private rights of action under the securities laws”).

\textsuperscript{176} Pritchard, 85 Va. L. Rev. 1017-18.

\textsuperscript{177} Pritchard, 80 Notre Dame L. Rev. at 1074 & n.6.

\textsuperscript{178} Redish, 2003 U. Chi. Legal F. at 89 (“coattail class actions obviously fail to perform the classic function of privately generated exposure of unlawful behavior traditionally facilitated by the private-attorney general concept”); Coffee, 42 Md. L. Rev. 215, 226 (“when the private attorney general becomes a ‘free rider,’ society loses the promise that . . . private resources would supplement public efforts in the detection of law violations by bringing actions that otherwise would not have been initiated”).

\textsuperscript{179} 2006 Securities Litigation Study at 24.

\textsuperscript{180} Bucy, 76 S. Cal. L. Rev. at 63 (observing that “[e]ven meritorious actions, if brought separately by public and private enforcers who have not coordinated their efforts, result in unnecessary costs and uncertainty for industry”). It appears that plaintiffs have every incentive to bring these suits, however. \textit{See Recent Trends In Shareholder Class Action Litigation: Filings Plummet, Settlements Soar} at 17, available at http://www.nera.com/image/PUB_RecentTrends_Sep2007-FINAL.pdf (finding, based on an analysis of securities fraud class actions filed in the first half of 2007, that cases “with any kind of official investigation, consent decree or penalty settles for, on average, approximately 20\% more than cases without any official action”); Cox & Thomas, 80 Notre Dame L. Rev. at 898-99 (finding, based on a sample of 389 securities fraud class actions, that those “without a parallel SEC action result in lower average (median) settlements, are brought against on average (but not median) smaller market capitalization companies, have shorter average (median) class periods, and take longer on average (median) to reach settlement”).
It has been suggested that copycat actions do aid in deterrence because administrative penalties alone may be insufficient to adequately deter,\textsuperscript{181} or because the government takes them into account in setting penalties.\textsuperscript{182} It is true that “even in major scandals where the SEC has brought its own action, the damages paid in securities class actions are usually (but not always) a multiple of those paid to the SEC.”\textsuperscript{183} It does not logically follow, however, that the penalties imposed by the Commission are inadequate to deter, or are set intentionally low in order to account for class litigation—or, if they are, that this is more efficient than simply authorizing and imposing greater administrative penalties.\textsuperscript{184} As indicated in Part II, the damages measure employed in Rule 10b-5 class actions is widely recognized as a poor proxy for the actual harm caused by securities fraud, so it makes little sense to use those damages as a benchmark. In addition, a bald comparison between Commission penalties and Rule 10b-5 class action recoveries fails to account for the fact that the Commission has in its enforcement arsenal non-monetary sanctions, like officer and director bars, that serve as potent deterrence weapons vis-à-vis individual wrongdoers. In any event, the penalties imposed by the Commission have been trending upward recently. The Commission “has imposed nearly as many issuer penalties through the first half of 2007 alone as in any full year in the Commission’s history,” including “eight penalties of $25 million or higher” since January 2006.\textsuperscript{185} Moreover, available data indicate that Commission penalties dwarf those imposed by financial regulators in other

\textsuperscript{181} Coffee, 42 Md. L. Rev. at 224-225.
\textsuperscript{182} Gilles, 155 U. Pa. L. Rev. at 155-56.
\textsuperscript{183} 106 Colum. L. Rev. at 1543; see also Howell E. Jackson, 24 Yale J. on Reg. 253, 280, Table 3 (2007).
\textsuperscript{185} Statement of the Securities and Exchange Commission before the House Financial Services Committee at 2-3; see also Carrie Johnson, SEC Shift May Lead to Lower Penalties, Washington Post D01 (Apr. 13, 2007) (noting that “[p]enalties reached record proportions after destructive scandals at Enron, Worldcom and Adelphia Communications, creating concern among some Commissioners that enforcement state members are over-reaching”).
jurisdictions (jurisdictions that do not utilize the securities fraud class action as a supplementary enforcement device). 186

Private enforcement of Rule 10b-5 also has been defended on the ground that plaintiffs’ securities lawyers enjoy a competitive advantage when it comes to large scale litigation, and thus “it often may be more efficient for public agencies to concentrate on detection (an area where they have the comparative advantage because of their superior investigative resources) and leave the actual litigation of the case to private enforcers.” 187 This assumes, however, a level of coordination that does not exist in the current Rule 10b-5 enforcement system: Private plaintiffs can and do bring actions that the Commission would not want litigated by private enforcers, either because it believes that it has already adequately penalized the defendant or because, in the exercise of its discretion, it would choose not to sanction the defendant. 188 Moreover, the vast majority of Rule 10b-5 class actions are either disposed of on a motion to dismiss or settle prior to trial, so the skills necessary to litigate these actions are limited to motions briefing and, perhaps, some limited discovery—important lawyering skills, to be sure, but ones unlikely to give rise to a distinct competitive advantage.

186 Based on conservative estimates, Professor Coffee calculates that “the SEC imposes financial penalties that exceed those of the FSA by a nearly ten to one margin (at least in 2004 and 2005).” Coffee, 156 U. PENN. L. REV. at 272. Professor Jackson has reported that, even when adjusted for market size, the United States has substantially more enforcement actions and imposes substantially more public monetary sanctions than either the United Kingdom or Germany—comparisons that “do not factor in private securities litigation, which accounts for more than a third of monetary sanctions imposed U.S. securities markets and which lack any counterpart in either Britain or Germany.” Jackson, 24 YALE J. ON REG. at 283 (emphasis added).
187 Coffee, 42 Md. L. REV. at 224.
188 See Stephenson, 91 V.A. L. REV. at 115 (noting that “government regulatory agencies (it is often claimed) are better at screening out enforcement actions that are either nonmeritorious or not worth the costs of prosecution”); cf. U.S. Securities and Exchange Commission 2006 Performance and Accountability Report at 2 (reporting that the Commission “had a 10-0 record of trial court victories in fiscal 2006, its first perfect year in memory—a strong indication that the agency is bringing the right cases and getting solid results for investors and for taxpayers”), available at http://www.sec.gov/about/secpar/secpar2006.pdf It has also been suggested that private enforcement may lead to greater innovations in the development of the law. Barton H. Thompson, Jr., The Continuing Innovation of Citizen Enforcement, 2000 U. ILL. L. REV. 185, 206. But profit-driven private enforcers “naturally look[] for the easy victories.” Garth, et al., 61 S. CAL. L. REV. at 376-377. Therefore, “creativity and innovation in the generation of the lawsuit are unlikely.” Id.
Borak’s mantra that private enforcement is a “necessary supplement” to Commission action merely states a conclusion, and the foregoing analysis demonstrates that it is hardly a self-evident one. To the contrary, profit-driven private enforcement of an overbroad law like Rule 10b-5 comes with significant downside risks. Private Rule 10b-5 enforcement may lead to overdeterrence, frustrate the Commission’s ability to engage in discretionary nonenforcement, and complicate efforts to take a cooperative approach to regulation. These risks are unrelated to the agency costs borne of the attorney-client relationship or the out-of-pocket measure of damages. Ironically, eradicating agency costs could actually increase the risk of overdeterrence, by serving to “recouple” the sanction and the bounty. Improving the damages measure in Rule 10b-5 class actions so it better reflects the actual net social harm caused by securities fraud is a laudable goal and ought to be pursued, but it alone is an insufficient answer to the dilemma posed by private Rule 10b-5 enforcement: Assuming that the sanction remains sufficient to induce private enforcers to bring claims, Rule 10b-5’s overbreadth and ambiguity will continue to present the risks identified above.

If the current system of private enforcement is superior to exclusive Commission enforcement, it is because actual or potential budgetary constraints on the Commission would lead to a level of underdeterrence that would impose greater costs than allowing private enforcement (a rationale that would not support allowing copycat Rule 10b-5 class actions), or because the Commission is so inefficient and/or captured that allowing it to exclusively control enforcement would result in greater deviations from optimal deterrence than private enforcement. Whether the current system of private enforcement is in fact superior is difficult if not impossible to determine empirically. It would be immensely challenging to quantify the costs and benefits of the Rule 10b-5 enforcement system as it exists today,\(^\text{189}\) let alone to quantify the costs and benefits of a counter-factual system of exclusive Commission enforcement. Recent comparative empirical research on enforcement intensity, however, might give one pause before charging that private Rule 10b-5 enforcement is clearly necessary because the SEC is underfunded or undermotivated.\(^\text{190}\) This research not only suggests that the SEC

\[^{189}\text{See Jackson, 24 Yale J. on Reg. at 257-63 (describing the difficulties of applying cost-benefit analysis to the financial services industry).}\]

\[^{190}\text{See supra, note 186.}\]
enforces securities laws more intensely than financial regulators in other jurisdictions, it also casts doubt on the conclusion of prior studies that private enforcement is more important than public enforcement in promoting financial development.\textsuperscript{191}

The foregoing analysis is nevertheless relevant to the reform debate. As explained in the next Part, identifying and understanding the downsides and potential upsides of private Rule 10b-5 enforcement relative to a system of exclusive Commission enforcement broadens the scope of that debate in an important way.

\section*{IV. Improving Deterrence By Restructuring The Relationship Between Commission And Private Enforcement}

As explained above, it is possible—though by no means clear—that the risks that attend private Rule 10b-5 enforcement are more tolerable than the risks that would attend exclusive Commission enforcement. If policymakers were faced with a binary choice between the current Rule 10b-5 enforcement system and exclusive Commission enforcement, this uncertainty might favor maintaining the status quo. But policymakers are not so constrained in how they approach enforcement of the antifraud provisions of the securities laws. Assuming that it is otherwise cost-effective, any incremental reform to the current system that serves to minimize the risks that attend private enforcement, while continuing to guard against the risks that would attend exclusive Commission enforcement, should result in a net improvement to the Rule 10b-5 enforcement regime and, ultimately, social welfare.

Short of eliminating private enforcement altogether, there are two very different approaches policymakers can take to mitigating the risks that attend private enforcement of an overbroad law. First, policymakers can narrow the scope of private liability—either directly, by altering the substantive liability rule, or indirectly, by altering the procedural law to disfavor the particular types of suits

thought most undesirable (the “narrowing approach”). Second, policymakers can grant the public enforcer some level of control over private litigation, so as to reintroduce the possibility of discretionary nonenforcement and cooperative regulation (the “oversight approach”).

Securities class action reform efforts to date have tended to follow the narrowing approach. As explained in Part III.B.1, aspects of the PSLRA, key judicial decisions like Central Bank and Stoneridge, and contemporary proposals to eliminate enterprise liability can all be viewed as seeking to narrow Rule 10b-5’s overbreadth.

Little serious attention, however, has been paid to the oversight approach. This is perhaps unsurprising: Rule 10-5 class actions do continue to “take[] the form of compensatory proceedings, i.e., traditional tort suits,” and requiring an individual who has been harmed to seek the government’s approval or consent before being entitled to pursue relief against the wrongdoer is inconsistent with the corrective justice ideals that underlay tort law.

As detailed in Part II, however, the compensatory justification for Rule 10b-5 class actions today “has relatively few informed, non self-serving defenders,” at least in relation to suits alleging after-

192 Supra, note 134.
193 Frankel, 67 VA. L. REV. at 570.
194 See supra, note 97. The tides may be changing, however. Professor Arlen, for example, is working on a proposal that would grant the Commission some ability to prevent private litigation against firms that fulfill their policing duties. Arlen, Public Versus Private Enforcement Of Securities Fraud (working paper on file with author). In addition, Professor Fisch has previously argued the benefits of providing for greater government oversight of small claims class actions generally. Fisch, 60 LAW & CONTEMP. PROBS. at 198-202; see also id. at 200 (“Although the plaintiffs’ bar presumably would balk at the prospect of a government approval requirement, the obligation to submit a securities fraud complaint to the SEC or an antitrust suit to the Federal Trade Commission prior to filing might be less onerous than legislative restrictions on private rights of action”). Professor Alexander’s proposal to shift to a regime of civil penalties under Rule 10b-5 also contemplates some level of government oversight. Alexander, 48 STAN. L. REV. at 1517 (“Plaintiffs would also be required to give notice of the action to the SEC, which would have the option to take over the action and, in any event, appear at any settlement hearing”). Professor Bucy has also argued that the qui tam model of the False Claims Act should be expanded to cover the national financial markets because it attracts valuable inside information and “allows for government monitoring and control of private actions and for cooperation between public and private regulators.” 76 S. CAL. L. REV. at 80. See also Coffee, 156 U. PENN. L. REV. at 304-05 (noting that “it makes sense to place greater reliance on public enforcement” in light of the failure of private enforcement to impose penalties on culpable insiders).
195 Langevoort, 38 ARIZ. L. REV. at 651
market fraud against non-trading issuers. Moreover, to the extent there is any residual compensatory function for Rule 10-5 class actions, the “Fair Funds” provision of the Sarbanes-Oxley Act of 2002 now permits the Commission to perform that function by expressly authorizing the payment of substantial penalties recovered in administrative proceedings to injured investors. There is therefore no compelling reason to allow the outdated form of private Rule 10b-5 litigation to preclude consideration of oversight reforms going forward.

In substance, the modern Rule 10b-5 class action is more like the express “private attorney general” statutes that Congress has adopted than a traditional tort suit. Notably, those statutes typically do provide for some level of government control over private litigation. The False Claims Act, for example, expressly authorizes the Department of Justice to intervene and to move to dismiss a qui tam action brought under that statute, regardless of whether the suit has merit, and notwithstanding that the government itself has not pursued relief against the defendant. The government’s motion will be sustained so long as the decision survives rational basis review.

196 Cases involving insider trading are different. “Diversification provides complete protection only in a simple securities fraud case. In a case of fraud with insider trading, the perpetrators extract some of the gain that would otherwise go to innocent traders.” Booth, Who Should Recover What For Securities Fraud? at 13. Suits against trading issuers, such as those involving allegations of fraud in an IPO, also result in more meaningful wealth transfers. But the securities laws provide express private remedies to cover the most common of these situations. See 15 U.S.C. §§ 77k, 77l(a)(2); 78p(b); 78t-1.

197 “Prior to the Sarbanes-Oxley Act, when the Commission received payment of a penalty, it was required to transmit such money to the U.S. Treasury. Section 308(c) changed the law to permit penalty sums collected to be added to disgorgement funds in certain circumstances.” Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002 at 5. See 15 U.S.C. § 7246; 17 C.F.R. §§ 201.1100-201.1106. The Commission recently reported that it has returned over $1 billion to investors through Fair Funds since 2005, and that several additional large disbursements are pending and will be announced shortly. Statement of the Securities and Exchange Commission before the House Financial Services Committee at 3; see also U.S. Securities and Exchange Commission 2006 Performance and Accountability Report at 23 (“In FY 2007, the SEC expects to distribute a significant amount of the approximately $3.3 billion dollars collected for distribution in . . . 26 mutual fund cases”).


predicated on fraud that is already being pursued by the government,200 or which has already been publicly disclosed (unless the qui tam plaintiff is the “original source” of the information),201 thus ensuring that private enforcement truly supplements—rather than merely duplicates—public enforcement efforts. Even citizen suits brought under the environmental laws (which, as noted above, may do better at achieving deterrence than Rule 10b-5 class actions202) are precluded if the government has already taken remedial action.203 Plaintiffs under both regimes must notify the responsible government agency of their intent to sue prior to filing, so as to allow that agency to first address the matter itself.204

In addition, an analogue to the oversight approach may be found in derivative litigation. Just as allowing unrestricted private enforcement of Rule 10b-5 can interfere with the Commission’s ability to effectively set enforcement policy in order to protect the capital markets, allowing unrestricted derivative litigation can interfere with a board of directors’ ability to effectively manage the affairs of a corporation. The law does not grant the derivative plaintiff carte blanche to sue to vindicate the corporation’s interests. To the contrary, like the government under the False Claims Act, the board of directors (or a special litigation committee) is generally entitled by law to notice of the derivative plaintiff’s intent to sue, an opportunity to pursue or settle the matter itself, and significant authority to block the litigation, even if it chooses to take no action; moreover, the board’s (or committee’s) judgment must be respected by the courts if it comports with the deferential business judgment rule.205 These requirements prevent the derivative plaintiff from usurping the discretion of the board or its designees, and from pursuing cases that are in the derivative plaintiff’s—but not the corporation’s—best in-

202 See supra note 149 and accompanying text.
203 See Zinn, 21 STAN. ENVTL. L.J. at 154-55.
204 31 U.S.C. § 3730(b)(2); Zinn, 21 STAN. ENVTL. L.J. at 152. Even “Title VII of the Civil Rights Act prioritizes public over private enforcement in the sense of conditioning the later on the issuance by the EEOC of a right to sue letter.” Nagareda, Class Actions in the Administrative State: Kalven and Rosenfield Revisited at 19.
terests. By the same token, they allow derivative litigation to proceed when it is demonstrated that the board lacks independence or has acted without a rational basis.\textsuperscript{206}

That no comparable restrictions attend private Rule 10b-5 litigation is a byproduct of the private right’s compensatory origins. The modern securities class action has so far departed from those common-law origins, however, that the concerns with overdeterrence set forth above suggest that policymakers ought to broaden the securities litigation debate and at least consider the benefits of an oversight approach to reform.\textsuperscript{207} As explained below, an oversight approach offers some significant advantages over the narrowing approach as a mechanism for improving the deterrence function of Rule 10b-5 litigation, and is worthy of further exploration.

1. The narrowing approach places policymaking control in the hands of Congress and, ultimately, the courts. Both institutions are constrained to exercise such authority relatively rigidly, by (respectively) enacting and interpreting static rules defining the scope of private Rule 10b-5 liability, even as the dynamics of the marketplace continue to change over time.\textsuperscript{208} The upshot is that a narrowing approach risks replacing overinclusion with underinclusion.\textsuperscript{209} Indeed, it risks creating precisely the “loopholes” overbroad laws seek to avoid. Eliminating enterprise liability in private Rule 10b-5 litigation, for example, could ensure that corporations do not excessively invest in precautions to protect against fraud by their agents, but it might also lead to an inadequate investment in precautions. “As with [enterprise] liability, secondary liability may have an important role to play in deterring securities fraud”—if properly controlled rather than eliminated entirely.\textsuperscript{210} Similarly, the PSLRA’s

\textsuperscript{206} See Principles of Corporate Governance: Analysis and Recommendations §§ 7.03.

\textsuperscript{207} So, too, should European policymakers, as they consider adoption of private enforcement mechanisms to strengthen investor protections abroad. See Stefano M. Grace, Strengthening Investor Confidence In Europe: U.S.-Style Securities Class Actions And the Acquis Communautaire, 15 J. TRANSNAT’L L. & POL’Y 281 (2006).

\textsuperscript{208} As Justice Scalia recently observed, courts “must apply judgment” when deciding cases—“[b]ut judgment is not discretion.” Tellabs, 2007 U.S. LEXIS 8270, at *44 (Scalia, J., concurring); cf. James M. Landis, The Administrative Process at 147-48 (Yale Univ. Press 1938).

\textsuperscript{209} Landes & Posner, 4 J. LEGAL STUD. at 38 (“The more particularity the legislature tried to describe the forbidden conduct, the more loopholes it would open up”); supra note 112.

\textsuperscript{210} Pritchard, 85 VA. L. REV. at 996.
“heavy pleading requirements . . . [and] excessively deep harbor for forward-looking disclosure . . . raise the risk that too many meritorious claims will . . . be barred.” 211

While theoretically the Commission could pursue cases where sanction is warranted but private relief precluded, 212 the very resource limitations that are said to justify private enforcement in the first instance may render this option illusory. Inefficiency or capture might also prevent the Commission from policing in that gap. Moreover, despite legislative and judicial attempts to narrow the private right of action under Rule 10b-5, substantial overbreadth does and will remain. Enterprise liability is but one example. The bipartisan Committee on Capital Markets Regulation recently advised that “there needs to be greater clarity to private litigation under Rule 10b-5.” 213 It recommended that the SEC provide more guidance on such things as materiality, scienter, and reliance, to help ensure that the U.S. capital markets stay competitive in the global economy. 214 The narrowing approach is thus at best an incomplete guard against the risk of overdeterrence, and where it does guard against that risk, it introduces a non-trivial risk of underdeterrence. 215

2. The oversight approach, by contrast, places policymaking control back in the hands of public enforcers, thus reintroducing the possibility of discretionary nonenforcement and cooperative regulation. As discussed more fully below, it can therefore avoid the conundrum between over- and under-deterrence presented by the narrowing approach, assuming that the oversight regime is properly structured so as to guard against inefficiency and capture on the part of the public enforcer.

211 Langevoort, 38 ARIZ. L. REV. at 640-41.
212 The PSLRA does not limit the Commission’s authority to bring enforcement actions under Rule 10b-5, and it restored the Commission’s ability to bring civil aiding and abetting claims. 15 U.S.C. § 78t(e); 104 S. Rpt. 98, at 19 (1995).
213 INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at xii.
214 Supra at 80-82.
215 Judicial retrenchment of modern antitrust doctrine can similarly be viewed as an example of a narrowing approach to reform. Kovacic, 69 GEO. WASH. L. REV. at 782-83 (discussing court rulings imposing restrictive standing and injury tests for private plaintiffs in antitrust cases and observing that “[r]elying on judicial interpretation to limit private enforcement of overly broad statutory commands presents risks,” as “[c]ourts might try to curb private enforcement through distorted constructions that forestall the prosecution of socially counterproductive private claims but also impede the pursuit of valid private cases”).
What might oversight reform look like in the context of private Rule 10b-5 enforcement? The putative private enforcer (i.e., the class representative and its counsel) could be required, prior to filing a Rule 10b-5 class action complaint in federal court, to submit it to the Commission for review. Based on such review, the Commission could be required to either grant or deny the right to file. It might deny the right based either on a determination to pursue the matter itself, or because it does not view the litigation as necessary or appropriate in the public interest, taking into account the protection of investors, efficiency, competition, and capital formation. Conversely, a decision to grant the right to file might be based on a determination that allowing suit is consistent with the public interest and the protection of investors, taking into account the same considerations.\footnote{Oversight reform could target a more limited category of Rule 10b-5 cases. For example, Professor Arlen has suggested that the SEC be given some level of oversight authority over those subset of securities fraud cases targeting a corporation based on principles of respondeat superior liability. She would not limit private suits against individual defendants. Arlen, Public Versus Private Enforcement Of Securities Fraud (working paper on file with author). The procedural details of oversight reform could also vary widely regarding such things as, for example, the timing of agency intervention and the scope and nature of judicial review. See, e.g., infra note 230. The purpose of the example provided here is to demonstrate the advantages of oversight as a conceptual approach to reform, not to provide the details of an optimal oversight reform package. The author intends to explore the latter in a future project.}

Authorizing the Commission to pre-screen Rule 10b-5 class action complaints in this manner would return to it full control over, and thus ultimate responsibility for, Rule 10b-5 enforcement policy.\footnote{Technically this type of proposal could be implemented through use of the Commission’s exemptive authority under Section 36 of the 1934 Act. See 15 U.S.C. § 78mm(a) (“the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors”); see also Coffee, 106 COLUM. L. REV. 1583-84 & n.177.} By controlling which class actions are filed—and, importantly, against whom—the Commission could once again engage in discretionary nonenforcement, as well as make full use of its nuanced and flexible remedies, allowing private enforcers to pursue out-of-pocket class damages only when it believes such relief is ap-
This would ensure that private enforcement efforts truly “supplement” the Commission’s efforts, rather than duplicate or frustrate them. It might also justify reconsideration of the most onerous provisions of the PSLRA, and perhaps even lead to the legislative repeal or modification of Central Bank. Neither the PSLRA nor Central Bank limits the Commission’s discretion to pursue enforcement actions. If the Commission is able to apply that discretion to screen Rule 10b-5 class complaints, there would be less reason to continue imposing those limitations in private litigation.

An oversight approach would also allow for a more cooperative style of regulation. For example, if particular conduct falls within a gray area of Rule 10-5 liability, the Commission could preclude class action claims based on such conduct. If, after a dialogue with industry participants, it determines that such conduct ought to be held a violation, it could issue a clarifying release and permit class action claims based on such conduct only on a going-forward basis. In addition, such a regime might encourage corporations to work with the Commission to improve internal controls, and to promptly disclose failures in those controls when they occur, by eliminating the constant threat of class action litigation that may deter such cooperation today.

An oversight approach to securities litigation reform might also beneficially affect the manner in which corporations defend against

218 If more than one defendant were named in a complaint, a decision to grant the right to file would need not extend to all defendants; rather, the Commission could specify the defendants against whom class relief can be pursued, and explain why relief against the other named defendants is denied. For example, the Commission could choose to grant the right to file against individual wrongdoers, but not against the corporate defendant, or vice versa; or it could grant the right to file against the corporate defendant but not the auditor. In such cases, the Commission could choose to itself pursue some form of relief (monetary or otherwise) against the defendant(s) it has spared from class litigation.

219 See supra, note 212.

220 Grundfest, 107 HARV. L. REV. at 1015 (explaining that “there can be substantial good faith confusion over the question whether disclosures are adequate to comply with complex rules that have received little Commission interpretation and with which practitioners have little experience,” and suggesting that “[t]he Commission could therefore determine that it is imprudent to subject registrants to the risk of private party liability if there is still room for confusion over novel and complex disclosure requirements, and the Commission could use its disimplication authority to shelter issuers from Rule 10b-5 private liability until it determines that the standards for compliance are sufficiently clear to support such exposure”).

221 See supra, note 140.
Commission action. Under the current system, the Commission enjoys considerable power to coerce settlement. Corporations tend to settle with the Commission for fear of the *res judicata* effect of an adjudicated loss in a subsequent Rule 10b-5 class action, and they tend to do so early and at a substantial premium in order to avoid being asked to produce documents (including privileged documents) that may be discoverable in subsequent class action litigation. If a Commission enforcement action precluded subsequent class action litigation, however, corporations would have greater incentive to fight back when they believe the Commission is overreaching, and to settle fully and finally when actual wrongs are discovered. This would not only be more fair, it would also serve to clarify the scope of Rule 10b-5 by adding to the body of precedent interpreting it—a positive externality.

Reform based on enhanced Commission oversight of private class actions would also go a long way toward rehabilitating the public image of the securities fraud class action, thus enhancing its strength as a deterrent. Today, it is too easy for officers to discount the importance of fraud allegations made in the context of class litigation, because the plaintiffs’ class action bar has been so demonized in the popular media. If securities class actions bore the imprimatur of the Commission, however, it would be much more difficult for officers to dismiss them as mere nuisance filings.

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222 Coffee, 42 Md. L. Rev. at 225 (citing Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979)).
223 *Supra*, note 141; Dickey, *Securities Litigation: A Practitioner’s Guide* §§ 15:3.1; see also Erichson, 34 U.C. Davis L. Rev. at 28-29.
224 It has been suggested that private enforcement “is potentially ‘fairer’ because the private plaintiff does not have the same built-in advantage as the public prosecutor or regulatory agency, to whom courts have a tendency to defer.” Coffee, 42 Md. L. Rev. at 226. However, much of the Commission’s “unfair” advantage is the product of private enforcement.
225 See Rubenstein, 74 U.M.K.C. L. Rev. at 723-24. The threat of criminal prosecution raises a host of additional issues which are beyond the scope of this Article. See e.g., The Rise Of Deferred Prosecution Agreements, N.Y. L.J. p.1 (Dec. 18, 2006).
227 See Pritchard, 85 Va. L. Rev. at 1016. The reform could also be designed to temper the risk of collusive settlements by requiring that the Commission be notified of and comment on the adequacy and fairness of Rule 10b-5 class action settlements. The Class Action Fairness Act of 2005 contains a comparable provision, requiring in diversity class actions that notification of any proposed settlement be given to an appropriate government official prior to its approval. 28 U.S.C. § 1715. That provision “is intended to combat the
While an oversight approach could significantly mitigate the risks that attend private enforcement, it admittedly raises some of the same concerns that are associated with exclusive Commission enforcement—in particular, the possibility that inadequate enforcement resources and bureaucratic inefficiency or regulatory capture might lead to greater deviations from optimal deterrence than unrestricted private enforcement. As noted above, however, the narrowing approach raises these concerns, as well, at least with respect to the conduct that approach immunizes from private enforcement. Moreover, safeguards could be built into an oversight reform package to minimize these risks.

For example, the prospect of the Commission’s vetoing (or commandeering) a Rule 10b-5 class action might dissuade some private enforcers from participating in the system, thus reducing the amount of private resources available to supplement the Commission’s enforcement efforts (although it is unlikely that private enforcers would disappear entirely, given the possibility of substantial recovery if the right to file is granted). This disincentive could be offset, however, by granting a putative private enforcer the right to reasonable recompense if the Commission were to choose to take over the matter. 228

Oversight reform could similarly be designed to guard against the risks of capture and regulatory inertia. To guide and cabin its discretion, the Commission could be required to promulgate factors for determining when class action litigation is necessary or appropriate in the public interest. Those factors the Commission considers in

[Footnote continued from previous page]

‘clientless litigation’ problem by adding a layer of independent oversight to prohibit inequitable settlements,” S. Rpt. 109-14, at 34 (2005), as well as to afford the government an opportunity to take action if the settlement is “inconsistent with applicable regulatory policies.” Id. at 32. With similar objective, the FTC has urged the adoption of an amendment to Federal Rule of Civil Procedure 23 that would require plaintiffs to notify government agencies involved in related actions or investigations of the pendency of a class action lawsuit. Letter to the Judicial Conference on Proposed Amendments to Rule 23 of the Federal Rules of Civil Procedure (Feb. 15, 2002), available at http://www.ftc.gov/os/2002/02/rule23letter.pdf.

deciding whether to impose penalties on a corporation provide an obvious starting point for class action complaints against corporate defendants, for example. Moreover, the Commission could be required to articulate in writing the basis for its decision denying or granting the right to file in a particular case. It could also be required to prepare a report for Congress semi-annually detailing its decisions granting and denying the right to file, and tracking the status of its Rule 10b-5 enforcement efforts as well as the Rule 10b-5 class actions which it has permitted to proceed. Those reports could allow for comparison between the penalties, disgorgement and other relief imposed by the Commission and the money recovered by private enforcers. This transparency and accountability might reduce the likelihood that the Commission would too often deny the right to file, and too often decline to pursue matters itself (or pursue them vigorously enough).

3. An oversight approach to securities litigation reform, such as the one sketched out above, begs some obvious questions—important questions that deserve the attention of commentators and policymakers. A few of these are identified, and addressed, in this subpart. The purpose of this discussion is not to provide an exhaustive analysis of the pros and cons of oversight reform, since the precise questions (and answers) would depend on the contours of any particular reform proposal. Rather, the goal of this subpart—and, indeed, the proposal as a whole—is to begin a dialogue among academics, market participants, and ultimately policymakers regarding the relative advantages and disadvantages of using Commission

229 See supra, note 133 and accompanying text.
230 In qui tam suits under the False Claims Act, the government is not required to take an affirmative position on the suit at the outset, although it can intervene and move to dismiss at any point. This creates structural incentives for the government to sit back and allow the suits to proceed, without truly exercising any oversight function. Matthew, 40 Mich. J.L. Reform at 297-98; see also Kovacic, 29 Loy. L.A. L. Rev. at 1848-49 (arguing for more vigorous screening of qui tam suits by the DOJ). The approach suggested here avoids that problem. Compare Alexander, 48 Stan. L. Rev. at 1523.
231 “Although the Commission carefully documents its own enforcement activities for the public record, it [currently] makes no effort to analyze its enforcement program in the larger context of a litigation system that also permits private enforcement of the securities laws.” Grundfest, 107 Harv. L. Rev. at 971 n.24. If the putative private enforcer were granted the right to file, it could be required to provide copies of all subsequent pleadings in the litigation to the Commission, so that the Commission could stay abreast of developments (and, if so inclined, weigh in as an amicus).
oversight as an additional tool to enhance the efficiency of our capital markets by mitigating the risks inherent in private Rule 10b-5 litigation.\textsuperscript{232}

\textbf{Why maintain the Rule 10b-5 class action at all, dressed as it is in its outdated compensationalist clothing—instead, why not abolish it entirely and replace it with a pure bounty system akin to the False Claims Act?}

The answer to this question is threefold. First and most practically, maintaining the Rule 10b-5 class action, while subjecting it to Commission screening, is less extreme and thus should stand a better chance of actual adoption or, at least, serious consideration. Abolishing private securities class actions could well be viewed as politically infeasible, and thus an unhelpful beginning to a serious debate on securities litigation reform. Expanded Commission oversight, by contrast, is—or ought to be—a real possibility that should garner both adherents and detractors, thus ensuring a meaningful dialogue. Second, adopting a pure bounty system would raise difficult constitutional questions on standing that an oversight-based approach avoids.\textsuperscript{233} Third, while Rule 10b-5 class actions do not serve a compensatory function that is meaningful enough to justify unconstrained private enforcement, investor compensation \textit{is} (or potentially could be) a residual benefit. Some class members, at least, will have sustained actual, net losses as a result of securities fraud and, in any event, it makes sense to return the money recovered to the pockets of investors (rather than to, for instance, the U.S. Treasury). Securities fraud increases the cost of raising capital in part by discouraging participation in the capital markets; if investors use their damage awards to reinvest in securities, the increased demand would work to offset that harm. Moreover, there may be a benefit to making investors \textit{feel} as if they have a means of redress, even if it is not a truly meaningful one in the economic sense—it may serve to increase investor confidence and willingness to participate in the capital markets which, again, would work to offset the harm caused by securities fraud.

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{232} See supra note 216.
\item \textsuperscript{233} See Fisch, \textit{60 LAW \& CONTEMP. PROBS.} at 186-94; Alexander, \textit{48 STAN. L. REV.} at 1517-19.
\end{enumerate}
\end{footnotesize}
If it is true that some class members, at least, will have sustained actual, net losses as a result of securities fraud, isn’t it unfair to allow the Commission to deny them their right to relief?

The short answer is that the proposal outlined above does not authorize the Commission to deny any individual of any substantive right; it merely authorizes the Commission to deny an individual the opportunity to represent a class under Federal Rule of Civil Procedure 23. Individual Rule 10b-5 suits would remain available without restriction. To be sure, investors with small stakes may find it uneconomical to bring such a suit, whereas large investors may not. Although this may seem unfair, in reality most “mom and pop” investors own mutual fund shares rather than direct equity stakes in corporations and must rely on their mutual fund managers to sue in any event.234 Other small investors are likely to trade infrequently, which means that they are the most burdened by Rule 10b-5 class actions. This is because, under the transacting-plaintiff requirement of Blue Chip Stamps,235 they will more often be on the paying end of a Rule 10b-5 class action than a member of the class. Moreover, in cases involving serious allegations of fraud, one would expect the Commission to deny the right to file only if it has determined to pursue the matter itself. In such a case, investors may very well receive compensation through a Fair Funds distribution.

If individual Rule 10b-5 suits would remain available without restriction, isn’t it possible that large institutional investors would bring such suits and upset the deterrence calculus in the same way class actions do now?

The answer is that this is possible,236 particularly given the growing trend of institutional investor “opt outs” in Rule 10b-5 class actions.237 It remains true, however, that most institutional inves-

235 421 U.S. 723.
236 Alexander, 48 Stan. L. Rev. 1487, 1524-1525 (noting that “the existence of large-stakes claimants could reintroduce the problems of excessive damages even if class actions were prohibited” and that “[r]etaining an individual right to compensatory damages would thus throw the deterrence calculation underlying the statute out of kilter”).
tors do not bring individual Rule 10b-5 actions today, nor do they participate in class action litigation as lead plaintiffs or, in many cases, even make claims on class settlement funds. Moreover, as noted in Part III.B.2, institutional investors’ interests are more likely to align naturally with the public’s interest in achieving optimal deterrence than unmonitored plaintiffs’ lawyers, so institutional investor suits present less cause for concern than class actions. That said, if this were perceived as a significant risk, the scope of the Commission’s screening authority could be defined in such a way as to extend to all representational actions on behalf of a certain number of investors, and institutional investors could be counted by reference to their beneficial owners.

Is this proposal otherwise cost-effective?

This is a question that can and should be studied in greater detail. Compensating putative private enforcers for their efforts in the event the Commission takes over the action would require the expenditure of real resources. Moreover, requiring the Commission to screen and monitor the universe of Rule 10b-5 class actions is obviously not costless. But the total number of Rule 10b-5 class actions filed in any given year is not that high when considered on a per occurrence, post-MDL, basis. And the added costs to the Commission in this regard must be offset by the improved deterrence and savings to the judiciary expected to result from the implementation of such a proposal. Even Rule 10b-5 class actions that are destined to be dismissed for pleading defects under the PSLRA must first go through a time consuming lead plaintiff battle, and “copycat” class actions often are not amenable to dismissal at the pleadings stage—even if it appears that the damages claimed will, at the end of the day, be fully offset by a Fair Funds distribution. The oversight pro-


239 Empirical studies place the number at less than 150 in 2006, although this does represent a decline from previous years. See Trends In Shareholder Class Action Litigation: Filings Plummet, Settlements Soar at 1-2; 2006: A Year in Review at 1; 2006 Securities Litigation Study at ii. If multiple complaints were submitted concerning the same allegations against one or more of the same defendants, the Commission could consolidate its consideration of those complaints and issue only a single decision. If the putative private enforcers intended to file in different judicial districts, a decision granting the right to file could specify the single judicial district in which relief can be pursued (thus obviating the need to engage the multi-district litigation machinery).
positional outlined above would ensure that fewer of these suits ever see
the inside of a courtroom, providing much warranted relief to the
federal docket.

V. CONCLUSION

For the past twenty-five years, policymakers and commentators
have struggled to find ways to improve Rule 10b-5 class actions,
without pausing to ask whether the game is worth the candle—is
private enforcement of Rule 10b-5 preferable to monopolistic Com-
mission enforcement? The time to begin answering that question
has arrived. The original compensatory justification for private Rule
10b-5 enforcement has been jettisoned by most knowledgeable ob-
servers, and the Fair Funds provision in the Sarbanes Oxley Act of
2002 today permits the Commission to deliver compensation to in-
vestors in any event. If the Rule 10b-5 class action finds warrant, it
is as a supplement to the Commission’s deterrence efforts.

Classic law and economics scholarship, however, casts consid-
erable doubt on the desirability of utilizing Rule 10b-5 class actions
as an additional deterrent. Rule 10b-5 class actions threaten to over-
deter and they frustrate the Commission’s ability to effectively en-
gage in discretionary nonenforcement and cooperative regulation.
These risks are inherent to profit-driven private enforcement of an
overbroad law like Rule 10b-5, and would persist even if the agency
costs borne of the attorney-client relationship were eradicated and
the damages measure employed in Rule 10b-5 class actions cor-
corrected. This is not to say that Rule 10-5 class actions should there-
fore be eliminated. It remains possible that exclusive Commission
enforcement would result in even more damaging underdeterrence,
due to the Commission’s budgetary constraints and the risk of bu-
reaucratic inefficiency or regulatory capture. There is simply inade-
quate empirical evidence to know for sure.

Identifying the relative advantages and disadvantages of private
versus exclusive Commission enforcement of Rule 10b-5 is helpful
in its own right, however, even if it is unclear how they balance out.
It serves to frame the problems associated with Rule 10b-5 class ac-

tions in a different way—one that suggests a new, and potentially
superior, approach to reform that has heretofore received little seri-
sous consideration from either academics or policymakers.

Several of the most controversial private securities litigation re-
forms to date can be viewed as seeking to narrow Rule 10b-5’s
overbreadth in order to mitigate the risks that naturally attend private
enforcement of an overbroad law. This narrowing approach to re-
form carries significant costs—viz., it risks replacing overinclusion
and overdeterrence with underinclusion and underdeterrence. The resource limitations and risks of inefficiency and capture that are thought to justify private enforcement in the first instance may prevent the Commission from adequately policing the gaps created by these types of reforms.

An oversight approach to reform offers a possible solution to this conundrum. For example, if the Commission were granted the authority to screen, and approve or reject, Rule 10b-5 class action complaints before filing, it would be unnecessary to rigidly narrow the private right of action to protect against overdeterrence. Instead, we might rely on the Commission to offer that protection in the exercise of its expert discretion. This type of reform carries significant additional benefits, and would not necessarily introduce the dangers of exclusive Commission enforcement. To the contrary, it might be designed to preserve adequate incentives for private enforcers to participate in the system, thus ensuring a consistent level of enforcement resources, and it could build in protections against capture and shirking.

This proposal obviously raises many questions, which are worth exploring. While Commission control over Rule 10b-5 class actions might seem radical, in reality it is the total absence of such control that is peculiar in this context. In cases where Congress has expressly granted private parties the right to enforce the law for profit, rather than to redress a tort-like injury, it has frequently provided for a level of government oversight. That no comparable restrictions attend private Rule 10b-5 enforcement is an outdated vestige of the implied right’s compensatory origins.

Policymakers ought to expand the scope of the contemporary securities litigation reform debate and seriously consider the virtues of an oversight approach to reform. Giving the Commission an enhanced role in monitoring and supervising private Rule 10b-5 class actions has the potential to mitigate the risks of private enforcement—particularly the concern that the current regime may lead to overdeterrence and inflexibility—while avoiding the concomitant risks of monopolistic public enforcement.