Securities Class Actions as Pragmatic Ex Post Regulation

Elizabeth Chamblee Burch
ARTICLES

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I. INTRODUCTION

Securities class actions are on the chopping block—again. Blue-ribbon commissions are claiming that increasing globalization requires a fresh, hard look at the relationship between the markets, the Securities and Exchange Commission (SEC), and private rights of action.\(^1\) Change is inevitable. But these changes may be disproportionate and ill-conceived, ignoring private securities class actions’ comparative institutional capability as a check against agency capture, selective enforcement, and secret settlements. For instance, these commissions recommend banning parallel private and SEC fair funds actions,\(^2\) increasing arbitration’s use,\(^3\) restricting private securities class actions to insider trading cases, and allowing only the SEC to pursue Rule 10b-5 violations.\(^4\) But these reforms miss the point: in the ongoing regulatory push and pull, corporations are winning the battle.\(^5\)

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\(^3\) See id. at 16–17 (summarizing proposal by Bloomberg-Schumer Report calling for strengthened arbitration).

\(^4\) See id. at 17–18 (discussing proposal by “Shadow Financial Regulatory Committee,” which called for federal legislation limiting securities class actions and SEC enforcement power).

It is true that the securities class action is not a perfect regulator. It is equally true, however, that its role in ex post regulation through litigation allows the United States to maintain its attractiveness as a relatively deregulated market with relaxed ex ante barriers and low market entry costs. Moreover, restricting the securities class action’s availability makes it the latest casualty in the ongoing trend toward winnowing public adjudication.

Arbitration, mediation, and administrative proceedings have replaced judicial hearings, trials, post-Enron, post-Sarbanes-Oxley debate over the United States’s seemingly dysfunctional system of corporate governance, Congress, the SEC, and the public at large suspect that, when sophisticated financial chicanery occurs, lawyers are typically present ‘at the scene of the crime.” For a corporate lawyer’s view of the current securities litigation environment, see Our Forbidding Litigation Environment Can Be Changed, METRO. CORP. COUNSEL, July 2007, at 6 (publishing interview with James C. Dugan, Partner, Willkie Farr & Gallagher LLP, regarding securities litigation system).

See Samuel Issacharoff, Regulating After the Fact, 56 DEPAUL L. REV. 375, 385 (2007) (“Ex post accountability is the prerequisite for ex ante liberalization.”); William B. Rubenstein, On What a “Private Attorney General” Is—and Why It Matters, 57 VAND. L. REV. 2129, 2149–50 (2004) (“Private attorneys may be better at [discerning or pursuing private wrongdoing] for a variety of reasons—because public attorneys may be fewer in number, underfunded, less skilled, or prone to political pressures.”); Catherine M. Sharkey, Preemption by Preamble: Federal Agencies and the Federalization of Tort Law, 56 DEPAUL L. REV. 227, 247–48 (2007) (“When so many agencies are understaffed and unable to enforce existing law, the private right of action is more important than ever in ensuring that unsafe practices and products are identified and kept out of the market.” (quoting Letter from Representative Jan Schakowsky to President George W. Bush (Feb. 16, 2006))).

See Judith Resnik, Many Doors? Closing Doors? Alternative Dispute Resolution and Adjudication, 10 OHIO ST. J. ON DISP. RESOL. 211, 212 (1995) (providing less optimistic forecast on array of state decision making options that will be available to future litigants); Judith Resnik, Procedural Innovations, Sloshing Over: A Comment on Deborah Hensler, A Glass Half Full, A Glass Half Empty: The Use of Alternative Dispute Resolution in Mass Personal Injury Litigation, 73 TEX. L. REV. 1627, 1633–34 (1995) (discussing willingness of judges to try mass tort cases as part of movement away from individual adjudication); Judith Resnik, Whither and Whether Adjudication?, 86 B.U. L. REV. 1101, 1102 (2006) [hereinafter Resnik, Whither and Whether] (“During the past thirty years, adjudication’s reach has been constrained—in part through requiring alternatives and in part by devolving much of the work of courts to administrative agencies and private providers.”). “Adjudication” has been defined in numerous ways. Geoffrey Hazard defined the term:

A procedure for determining a dispute involving a claim of legal or customary right in which a third party is invested with authority to make a decision that is recognized as binding, except that under some systems of adjudication the parties have a right to reach a different disposition by contract after an adjudication.

Geoffrey C. Hazard, Jr., Adjudication as a Private Good: A Comment, 8 J. LEGAL STUD. 319, 319 (1979). For purposes of this Article, I narrow this definition of “adjudication” by excluding processes that are not appealable to a state or federal court within the United States.
and open records. Transparency and accountability for public law matters has been lost in the shift.

Traditional litigation’s public function is so common as to be under-theorized: transparent adjudication through securities class actions holds both the government and corporations publicly responsible. But securities class actions do more than this. Their pursuit has spillover effects—positive externalities—including innovation, deterrence, information sharing, accountability, and transparency. These spillovers benefit more than parties to a lawsuit; they benefit the public.

Still, most commentators view class actions with suspicion; they see class suits as nonmeritorious byproducts of self-interest and the attorneys who bring them as rent-seekers. Yet the full picture and texture of securities class actions also necessitate a pragmatic positive account. This Article provides that account and thus fills a significant gap in the benefit side of cost-benefit literature. To do so, however, it self-consciously begins with a controversial assumption: securities class actions can be valuable. Naturally, I harbor no

\[8\] See infra Part III.D.

\[9\] See infra Part IV.A.

\[10\] On the notion of “spillovers,” Brett Frischmann and Mark Lemley explain:

Spillover benefits aren’t intentionally provided. . . . Instead, they are incidental “extras”—they spill over to others as a result of decisions you and we . . . made for our own purposes. While seemingly insignificant to us, spillovers turn out to be enormously significant to society. We are all incidental beneficiaries, each and every day. Spillovers “are a ubiquitous boon for society” because we share a common environment, live in communities, and interact with one another.


\[11\] E.g., Marilyn F. Johnson, Karen K. Nelson & A.C. Pritchard, In re Silicon Graphics Inc.: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act’s Pleading Standard, 73 S. CAL. L. REV. 773, 782–84 (2000) (arguing that plaintiffs’ lawyers have incentive to file frivolous lawsuits); Martin H. Redish, Class Actions and the Democratic Difficulty: Rethinking the Intersection of Private Litigation and Public Goals, 2003 U. CHI. LEGAL F. 71, 77 (2003) (contending that class litigation “amounts to little more than private attorneys acting as bounty hunters”); Charles W. Wolfram, Mass Torts—Messy Ethics, 80 CORNELL L. REV. 1228, 1231 (1995) (noting existence of “sell-out lawyers who, for millions in fees, are willing to sign away the rights of tens of thousands of faceless and lawyerless class members”); Adam C. Pritchard, Congress Should Not Repeal the Private Securities Litigation Reform Act, USA TODAY, Sept. 2003, at 18, 20 (arguing that increase in securities fraud class actions may be explained by fact that “plaintiffs’ lawyers simply are filing more suits in the hope that a few will ‘stick’ ”).
illusion that the securities class action always functions optimally. It doesn’t. I have written elsewhere about ways to optimize its public function and cabin its negative externalities, but leave those issues for another day. That allows me to focus here on the respective institutional capacities of private and public actors. To do so, I admittedly construct a false dichotomy between the two actors and between securities class actions as socially productive versus economically destructive. Politics drives that decision; it polarizes the debate. Thus, I frame this alternative account likewise.

Part II begins by explaining America’s response to the challenge of institutional design. America’s choice, using *ex post* regulation—consequence-based regulation—as opposed to heavy *ex ante* constraints on market entry, attracts new businesses, fosters competition, and supports economic growth. Still, engineering optimal enforcement requires an understanding and assessment of comparative institutional abilities. For instance, importing and adapting Oliver Williamson’s “Selective Intervention Puzzle” to enforcement design prompts questions such as, “Why can’t the SEC do everything that private attorneys general can and vice versa?” As this Article explores, the short answer is that public and private institutions have unique incentives, goals, and obstacles. Integrating both public and private actors into *ex post* enforcement diminishes collective action dilemmas, agency inaction, and private resolution of public law matters through arbitration. But regulation through litigation, particularly class litigation, has its share of critics. Consequently, after highlighting this regulatory scheme, I reevaluate quintessential criticisms that perpetuate standard rhetoric about class actions as both a species of aggregate


litigation—including allegations about frivolous lawsuits, ineffective attorney monitoring, and failure to pursue unattractive cases—and as a securities enforcement tool. Critics arguing the latter posit that securities class actions cause foreign firms to avoid United States listings\(^\text{14}\) and force diversified investors to pay high transaction costs to transfer wealth from one pocket to the other.\(^\text{15}\)

After addressing those concerns and finding many of them less problematic than critics claim, Part III assesses what is, for many, a counterfactual assertion: securities class actions benefit society. By supplementing \textit{ex post} enforcement, securities class actions produce positive externalities—spillover effects—that confer public advantages such as innovation, cost-reduction through information sharing, deterrence, transparent judicial process, and both corporate and enforcement accountability. Because any attempt to assign numerical values to these externalities is inherently artificial, I opt instead to weigh them in terms of fulfilling social objectives and democratic norms. These objectives and norms include: forming rules through adjudication, maintaining open fora for debating appropriate sanctions, facilitating access to the courts, and respecting litigants’ preference for traditional adversarial adjudication. Restricting the securities class action’s use undermines these objectives. Consequently, its worth is perhaps best gauged through indignation over the consequences following its departure. Part IV thus envisions the ramifications of eliminating securities class actions by imagining a world with government-centric securities enforcement. That world, I contend, is one steeped in bureaucracy, one failing to produce behavior-guiding precedent, one filled with closed-door arbitrations, one neglecting nonprioritized misconduct, and one ignoring litigant preference for judicial process.\(^\text{16}\) That world is one severe enough to outweigh my lingering doctrinal and jurisprudential concerns about securities class actions. In short, it is a world less preferable than our current system—flawed though it is.

\(^{14}\) \textit{See infra} note 98 and accompanying text.

\(^{15}\) \textit{See infra} note 108 and accompanying text.

\(^{16}\) This imagined world is not as far-fetched as it might seem. \textit{See infra} note 239 and accompanying text.
II. PRIVATIZING EX POST SECURITIES REGULATION

Flaws and all, securities regulation currently assumes that, left to their own devices, executives will lie about or conceal information to promote their own self-interest.¹⁷ Consequently, the pivotal regulatory question is not whether America should continue to regulate, but how: through ex ante barriers to market entry or ex post consequence-based regulation through litigation.

A AMERICAN SECURITIES REGULATION

Recent economic literature on productive economies, securities markets, and entry barriers favors the latter consequence-based approach.¹⁸ After analyzing bureaucratic entry hurdles in eighty-five countries and ranking the United States in the top quartile in terms of simple market entry for start-up businesses, economists established a correlation between monetary wealth and easy market entry.¹⁹ On the other hand, onerous ex ante regulation—the “tollbooth view” of extracting rents—coincided with greater corruption and an underground economy, but not with superior goods.²⁰ This high correlation between corruption, entry barriers, and mediocore products does little to commend a system centered on market entry.²¹

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¹⁷ See Harvey L. Pitt & Karen L. Shapiro, Securities Regulation by Enforcement: A Look Ahead at the Next Decade, 7 YALE J. ON REG. 149, 152–53 (1990) (arguing that “disturbing departure from ethical norms” in 1980s led to increased securities law enforcement and regulation).

¹⁸ See infra note 19 and accompanying text.

¹⁹ See Simeon Djankov et al., The Regulation of Entry, 117 Q. J. ECON. 1, 16–22 (2002) (ranking bureaucratic entry hurdles by number of procedures and days to obtain the requisite permits and ultimately concluding that “[r]ich countries . . . regulate entry relatively less than do all the other countries”); see also Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications 3 (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper No. 521, 2005), available at http://ssrn.com/abstract=839250 (arguing that contrary to expectations, common law countries such as United States have “markedly higher levels of regulatory intensity” than civil law regimes).

²⁰ Djankov et al., supra note 19, at 35.

²¹ See Simeon Djankov, Caralee McLiesh, & Rita Ramalho, Regulation and Growth 3 & n.4 (Mar. 17, 2006), available at http://ssrn.com/abstract=893321 (observing high correlation between corruption and business regulations index and noting that countries with less burdensome regulations experience faster economic growth); see, e.g., Bernard S. Black & Anna
This is why, as Sam Issacharoff observes, the United States “regulate[s] not entry but consequences.” Securities laws, as public laws, thus establish affirmative corporate disclosure obligations and delineate rules for enforcing them through litigation. These laws protect the investing public by maintaining the integrity of information about publicly traded companies and by insulating the American economy from insider abuse. The regulatory question thus becomes a structural one: which institutions—public, private, or some amalgamation of the two—should bear enforcement responsibilities?

Designing optimal enforcement requires both an understanding and assessment of various institutional capabilities. For example, consider Friedrich Hayek’s famous proposal that reporting first to a centralized authority before acting hinders societal adaptation, whereas decentralization ensures that the “man on the spot” can immediately use specific circumstantial knowledge to society’s
benefit. Private investors suffering the financial consequences of fraud often have superior knowledge about the injury, and their profit-seeking motive makes them more efficient than their bureaucratic counterpart. On the other hand, SEC experts cultivate information channels of their own. They can also readily discover more information through subpoenas and discovery by imposing sanctions or threatening to submit the case to the Department of Justice for criminal enforcement.

These relative institutional strengths spawned two divergent theories about what works best in securities regulation. Adherents to both agree that “law matters,” but they differ over design. One theory posits that by tailoring contract and tort law, securities law reduces the transaction costs of establishing private liability; the other views securities laws as creating and developing coercive obligations for producing information to a public authority, such as the SEC, plus constructing sanctions for noncompliance.

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28 See Segal & Whinston, supra note 13, at 4 (“Private individuals utilize their extensive knowledge of ‘specific circumstances of time and place,’ which would be impossible to communicate to a central authority.”).
29 See id. at 5 (“The public sector is generally less efficient than private, because it is not driven by the profit motive.”).
30 See id. (“A public enforcer has a lower cost of information discovery since it can use the power of the state.”); see also Rafael La Porta, Florencio Lopez De Silanes & Andrei Shleifer, What Works in Securities Laws? 4 (Tuck Sch. of Bus. at Dartmouth, Working Paper No. 03-22, 2003), available at http://ssrn.com/abstract=425880 (arguing that public enforcers can secure information more effectively than private plaintiffs).
31 La Porta, De Silanes & Shleifer, supra note 30, at 3.
simply, the divisive issue is who should enforce securities
laws—private market participants or public government actors.

An empirical study conducted in part by Rafael La Porta
answered this question by examining securities laws governing
initial public offerings in forty-nine countries.34 After evaluating
several hypotheses including doing nothing, using securities laws to
reduce transaction costs in private enforcement, or relying on public
enforcement to secure information and impose sanctions,35 the study
concluded that “efficient institutional choice takes the form of
private enforcement of public rules, which encourages private
recovery of damages.”36 In other words, private enforcement works
best in securities regulation because it is the most efficient
approach. Issuers, distributors, and accountants are the lowest cost
providers; securities laws make investor recovery less expensive
through mandatory disclosure requirements and liability rules.37
Consequently, broad, mandatory disclosure requirements and light
burdens of proof strongly correlated with more developed stock
markets.38

Evidence from other industries such as waste collection, electric
utilities, and mail services demonstrates that government-provided
services cost between 30% and 90% more than those the private
sector provides.39 This data, coupled with evidence that private
enforcement is more efficient, suggests that we have systematically
undervalued the advantages of coupling privatization with public

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mechanisms for efficient public enforcement of laws).
34 La Porta, De Silanes & Shleifer, supra note 30, at 4.
35 Id. at 2–4.
36 Id. at 22 (emphasis added).
37 Id. at 8.
38 Id. at 16–17.
39 MICHAEL J. TREBILCOCK, THE PROSPECTS FOR REINVENTING GOVERNMENT 21–22 (1994);
Michael J. Trebilcock & Edward M. Iacobucci, Privatization and Accountability, 116 HARV. L.
enforcement.\textsuperscript{40} Plus, private enforcement avoids the possibility of government failure.\textsuperscript{41}

Because private securities class actions are synonymous with private enforcement, these findings suggest that narrowing their function may handicap optimal enforcement. The findings also indicate that increasing government enforcement through the SEC is a second-best substitute.\textsuperscript{42} In short, securities class actions can provide a cost-effective, private procedural vehicle to vindicate substantive public rights within a society skeptical of centralized government.\textsuperscript{43}

Even though the notion of private attorneys supplementing public enforcement is hardly a fresh idea, its controversial nature has not diminished with time.\textsuperscript{44} The basic idea is this: private attorneys, working for private clients (often corporate shareholders or pension

\textsuperscript{40} See Glaeser & Shleifer, \textit{supra} note 33, at 421 (“\textit{S}ocieties with the highest levels of law and order should rely on private litigation rather than regulation. The reason for this is that the liability system—as long as it is not subverted—can achieve first best efficiency, whereas regulation alone never can.”). Of course, the crux of the question is whether innovation and creativity likewise creates perverse incentives such as undermining legislative policy or moving litigation to more hospitable foreign forums. One need only look to popular news accounts for this perspective. \textit{E.g.}, \textit{Shareholder Lawsuits: A Blazing Summer}, \textit{Economist}, Aug. 13, 2005, at 61 (“The \textit{P}rivate Securities \textit{L}itigation \textit{R}eform \textit{A}ct of 1995 was meant to curb frivolous class-action suits within the field of securities law. But in forcing class-action lawyers to raise their game, it has contributed to a new era of big lawsuits and even bigger settlements.”). I provide the alternative perspective in Part III and should note that not all accounts are anti-securities class action. \textit{E.g.}, Sandra Rubin, \textit{A New Haven for Class Acts}, \textit{Globe \& Mail}, June 13, 2007, at B10 (“While a certain amount of skepticism about class actions—particularly securities class actions—has been creeping into the American jurisprudence, in Canada, where we are still in the early part of our history in class actions, that’s not been a phenomenon.”); \textit{see also} \textit{R}obert A. \textit{K}agan, \textit{A}dversarial \textit{L}egalism: \textit{T}he \textit{A}merican \textit{W}ay of \textit{L}aw 100–04 (2001) (highlighting two faces of American legalism and providing both positive and negative account of private attorneys acting in quasi-governmental capacity).

\textsuperscript{41} See Burch, \textit{supra} note 25, at 2521 (noting that decentralized enforcement and private class actions free individuals from governmental dependence).

\textsuperscript{42} See \textit{id.} at 2541; Glaeser & Shleifer, \textit{supra} note 33, at 421 (“\textit{S}ocieties with the highest levels of law and order should rely on private litigation rather than regulation . . . . [because] the liability system . . . can achieve first best efficiency, whereas regulation alone never can.”).

\textsuperscript{43} \textit{K}agan, \textit{supra} note 40, at 125 (“\textit{A}dversarial legalism] persisted because of a political tradition that is mistrustful of bureaucratic authority—preferring to fragment authority and to hold it legally accountable through individually activated rights and adversarial litigation.”); Burch, \textit{supra} note 25, at 2522–23.

\textsuperscript{44} \textit{See, e.g.}, John H. Beisner et al., \textit{Class \textit{A}ction “Cops”: \textit{P}ublic \textit{S}ervants or \textit{P}rivate \textit{E}ntrepreneurs?}, 57 STAN. L. REV. 1441, 1444 (2005) (noting public’s increased disillusionment with class action practice).
funds), who pursue their own litigation also promote public interest and policy, thereby buttressing the government’s enforcement efforts.\textsuperscript{45} Granted, private interests may not perfectly align with public interests, but as this Article explores, a substantial overlap exists even in misaligned cases. Definitionally, although the private attorney general is ostensibly characterized in contrast with the government attorney, this archetypal dichotomy ignores the nuances of each.\textsuperscript{46} Rather, private attorneys general fluctuate along a continuum, serving both private and public functions at various times.\textsuperscript{47}

Private aggregation combined with contingency fees deputizes plaintiffs’ attorneys to initiate cases that the SEC and exchanges either overlook or lack the budget to bring.\textsuperscript{48} Conversely, the SEC and exchanges operate as failsafe enforcement for economically inefficient actions, \textit{i.e.}, actions where litigation costs exceed

\textsuperscript{45} See Rubenstein, supra note 6, at 2146.

\textsuperscript{46} See Burch, supra note 25, at 2524 (noting continuum between private attorneys general and government enforcement); Rubenstein, supra note 6, at 2132 (same).

\textsuperscript{47} Rubenstein, supra note 6, at 2132. Professor Rubenstein likens the private attorney general concept to Alfred Kinsey’s taxonomy of sexual orientations and points out that “[t]here are not just two pure forms—the private attorney on the one hand and the government attorney on the other—but rather an array of mixes of the public and private.” Id.


Contingency fees generally range from 20\% to 30\% of the class recovery through either settlement or trial. \textit{John C. Coffee, Jr., The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action}, 54 U. Chi. L. Rev. 877, 888–90 (1987). The court must, however, approve the fee under Rule 23. \textit{Fed. R. Civ. P. 23(h)(1).}
damages.\textsuperscript{49} Thus, there is a need for interdependence and overlap among private and public enforcement.\textsuperscript{50}

Despite this need, corporations are quick to criticize American litigation as abusive, dubbing securities class actions a form of legalized blackmail.\textsuperscript{51} So perceptions assume a reality of their own. There are, to be sure, occasional strike suits that settle for nuisance value.\textsuperscript{52} But perhaps we should expect this in an enforcement system relying primarily on decentralized, self-motivated private actors.\textsuperscript{53} Class actions, as compared with hundreds of individual claims or even fractional aggregation, are a cost-effective means for exploiting scale economies.\textsuperscript{54} Absent a certified class action, collective action problems would plague enforcement objectives and undermine the benefits achieved through the \textit{ex post} regulatory

\begin{footnotesize}
\textsuperscript{49} See Segal \& Whinston, \textit{supra} note 13, at 9 (suggesting that reducing socially wasteful litigation may be accomplished by not awarding damages for actions that are socially efficient).


\textsuperscript{51} See, e.g., Victor E. Schwartz, Mark A. Behrens \& Leah Lorber, \textit{Federal Courts Should Decide Interstate Class Actions: A Call For Federal Class Action Diversity Jurisdiction Reform}, 37 HARV. J. ON LEGIS. 483, 491 (2000) (noting that several courts have described class actions as form of blackmail); Charles Silver, “We’re Scared to Death”: \textit{Class Certification and Blackmail}, 78 N.Y.U. L. REV. 1357, 1363 (2003) (discussing view that class settlements are “legalized blackmail”); see also L. Elizabeth Chamblee, Note, Between “Merit Inquiry” and “Rigorous Analysis”: Using Daubert to Navigate the Gray Areas of Federal Class Action Certification, 31 FLA. ST. U. L. REV. 1041, 1084 (2004) (explaining that class actions can pressure defendants to settle even where plaintiffs’ cases are weak).

\textsuperscript{52} See Cox, Thomas \& Bai, \textit{supra} note 1, at 385 (observing that 20.5\% of settlements examined are below $2 million but theorizing that “[b]ecause this set represents only a distinct minority of the cases, . . . it hardly makes the case for wholesale reform of the securities class action”).

\textsuperscript{53} See Issacharoff, \textit{supra} note 6, at 384–85. Some commentators have called for reform of the plaintiffs’ bar in light of its role as a decentralized regulator. See, e.g., John Fabian Witt, \textit{Bureaucratic Legalism, American Style: Private Bureaucratic Legalism and the Governance of the Tort System}, 56 DEPAUL L. REV. 261, 262–63 (2007) (seeking ways to realize benefits of private enforcement while constraining plaintiffs’ bar’s discretionary authority and reducing associated agency costs).

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scheme, namely the value of \textit{ex ante} deterrence.\footnote{See David Rosenberg, \textit{The Regulatory Advantage of Class Action, in Regulation Through Litigation} 244, 246 (W. Kip Viscusi ed., 2002) (“Only class action aggravates all mass production tort claims to provide the opportunity for fully exploiting economies of litigation scale that ensure maximum regulatory, optimal deterrence benefit from mass production tort liability.”).} Forgetting the regulatory advantages is easy when corporations focus exclusively on the back-end. But the front-end picture boasts a robust economy unsaddled with bureaucratic barriers.\footnote{See Issacharoff, \textit{supra} note 6, at 385 (noting relative ease in United States of bringing new products to market and describing business environment as “a robust economy generating both opportunity and wealth”); Richard A. Epstein, \textit{Lessons from the Labor Markets, CHIEF EXECUTIVE MAG.}, July 1, 2007, at 59, \textit{available at} 2007 WLNR 16013780 (“U.S. capital markets . . . are freer now than they were 50 years ago.”).} It embraces the idea that minimal \textit{ex ante} interference enhances market freedom and innovation: in return for regulating consequences, we gain novel products, new businesses, competitive pricing, and employment opportunities, all generally unobstructed by \textit{ex ante} constraints.\footnote{Burch, \textit{supra} note 25, at 2523 (claiming that private enforcement mechanisms generate more innovation than government enforcers); \textit{see also} Epstein, \textit{supra} note 56, at 59 (“The great engine of U.S. economic productivity rests on the ability of employers and workers to set mutually agreeable terms on wages and conditions, largely without state intervention.”); Issacharoff, \textit{supra} note 6, at 385 (noting relative ease of doing business in United States because of minimal bureaucratic interference).} Both pictures—simple market entry and heavy litigation—accurately depict securities regulation, but only when viewed together.

\section*{B. REASSESSING NORMATIVE CRITICISMS}

Still, critics maintain that aggregation’s benefits do not outweigh its costs.\footnote{See, \textit{e.g.}, John C. Coffee, Jr., \textit{Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation}, 106 COLUM. L. REV. 1534, 1545 (2006) (“[T]he conclusion seems inescapable that the securities class action performs poorly.”).} Commentators, myself included, and recent commissions have fashioned securities class actions into the poster child for reform with maxims about strike suits and rent-seeking plaintiffs’ attorneys.\footnote{See, \textit{e.g.}, Burch, \textit{supra} note 25, at 2519 (admitting class actions are “not perfect regulators”); Dickey, \textit{supra} note 2, at 730, 736–39 (examining securities litigation reform proposals of several commissions).} Invoking these maxims, however, ignores securities class actions’ positive pragmatic side and may underestimate the effects of recent amendments to both securities laws and Rule 23.
Perhaps the traditional drawbacks are no longer as costly. Consequently, I reassess conventional understanding to discredit myths, direct debate toward persistent problems, and, in the remainder of the Article, couch these problems within the advantages of *ex post* regulation.

Normative criticism of securities regulation through the class action mechanism collapses into two principal categories: systemic assaults on the class action as a procedural joinder device and context-specific criticism of “securities” class actions. Reforms remedied some concerns in the former category. The problem now is this: those reforms overcorrected the securities class action and decreased both nonmeritorious and meritorious litigation. In a system relying heavily on *ex post* regulation, this weakens the regulatory bite and suggests that reformists proceed cautiously lest the law of unintended consequences reign.

1. **Species-Dependent Class Action Criticism.** Popular normative criticisms distill into three primary contentions: (1) frivolous claims exhort undue settlement pressure on innocent companies; (2) collective representation makes effective attorney monitoring unlikely; and (3) the plaintiffs’ bar is entrepreneurial and self-serving so it fails to pursue economically unattractive cases, leaving gaps in *ex post* enforcement. I address each argument in turn.

First, despite pervasive perceptions about corporate “blackmail” and frivolous claims, procedural devices weed out most securities-related nuisance suits, thereby alleviating settlement pressure. These devices include typical quality control procedures available in

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60 Redish, *supra* note 11, at 74.
63 See *infra* notes 67, 74, 85 and accompanying text.
every civil case: Rule 11 sanctions, Rule 12 motions to dismiss for failing to state a claim, and Rule 56 motions for summary judgment. Heightened pleading standards in securities fraud actions contribute to a 39.1% dismissal rate at this early litigation phase. Plus, the Private Securities Litigation Reform Act (PSLRA) stays discovery until courts resolve motions to dismiss, which further diminishes costs. The court must also assess whether to sanction plaintiffs’ counsel for bringing frivolous claims in every securities fraud case. Yet, curiously, this sanction is rarely used. In the ten-year period after the PSLRA’s enactment, courts sanctioned plaintiffs’ attorneys in only four reported cases—an average of one every two-and-a-half years nationwide. If widespread securities-related strike suits exist, one would expect heavier reliance on this provision. Similarly, research indicates

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64 See FED. R. CIV. P. 11(c) (authorizing courts to impose sanctions against parties or attorneys filing frivolous lawsuits).
65 FED. R. CIV. P. 12(b)(6).
66 FED. R. CIV. P. 56.
67 TODD FOSTER ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: FILINGS STAY LOW AND AVERAGE SETTLEMENTS STAY HIGH—BUT ARE THESE TRENDS REVERSING? 7 (Sept. 2007), available at http://www.nera.com/image/PUB_RecentTrends_Sep2007_2color_web-FINAL.pdf. This number reflects cases dismissed on a motion to dismiss between 2006 and 2007. Id. It has increased substantially from 19.4% of cases between 1991 and 1995. Id. Moreover, “the annual likelihood of a suit has fallen 27%.” Id.; see also Securities Exchange Act of 1934 § 21D(b)(1), 15 U.S.C. § 78u-4(b)(1) (2006) (requiring plaintiffs to “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, . . . [plaintiffs] shall state with particularity all facts on which that belief is formed”).
69 See id. § 77z-1(c) (requiring courts to record specific findings regarding parties’ and attorneys’ compliance under Rule 11); id. § 78u-4(c) (requiring mandatory imposition of sanctions on parties and attorneys in violation of Rule 11).
70 See Stephen J. Choi & Robert B. Thompson, Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA, 106 COLUM. L. REV. 1489, 1508 (2006) (“Despite the recurring use of adjectives like ‘mandatory’, ‘specific,’ and ‘each’ in the sanction provision and the hundreds of class actions brought since the Act was enacted, we find that the sanction provision has been little used as a weapon against possibly abusive class actions.”); see also Hartmarx Corp. v. Abboud, 326 F.3d 862, 872 (7th Cir. 2003) (reversing imposition of sanctions under PSLRA).
71 Choi & Thompson, supra note 70, at 1508–09.
72 It is true, however, that courts have interpreted this provision consistently with Rule 11 and, in so doing, have noted that “such sanctions are to be imposed sparingly, as they can have significant impact beyond the merits of the individual case” and can affect the reputation and creativity of counsel.” Hartmarx, 326 F.3d at 867 (quoting Pac. Dunlop Holdings, Inc. v.
that the settlement size of most claims closely correlates with evidence of fraud, such as insider trading and accounting restatements.73

Second, citing collective action and free rider problems, commentators allege that class litigation permits plaintiffs’ attorneys “to operate with nearly total freedom from traditional forms of client monitoring.”74 While traditional monitoring is absent in class litigation, Rule 23 supplies a surrogate: judicial oversight. Judges appoint class counsel, approve settlement terms, and authorize attorneys’ fees.75 Again, the PSLRA augments attorney monitoring in securities fraud class actions. It does so in two ways: (1) it entreats sophisticated institutional investors to serve as lead plaintiffs either in lieu of or alongside individual class representatives;76 and (2) it compels affirmative judicial vigilance in reviewing and sanctioning attorney misconduct.77

74 Macey & Miller, supra note 61, at 20. This is an age-old criticism. In 1941, Harry Kalven and Maurice Rosenfield noted the problem of settling before the suit reaches the court and observed, “as a practical matter this type of settlement may seriously impair the opportunities of the rest of the class to acquire knowledge of the wrong and to assert their rights effectively.” Harry Kalven, Jr. & Maurice Rosenfield, The Contemporary Function of the Class Suit, 8 U. CHI. L. REV. 684, 720 (1941).
75 FED. R. CIV. P. 23(e), (g)–(h).
76 See Choi & Thompson, supra note 70, at 1503–04 (noting significant increase in participation rate of institutional investors as lead plaintiffs since enactment of PSLRA). Stephen Choi notes that this provision may lead to “rational apathy” because of long-term relationships with public companies. Choi, supra note 54, at 1475. Moreover, institutional investors may get involved simply to “push the political agenda of those politicians with influence over the public pension fund.” Id. at 1476; see also Stephen J. Choi, Jill E. Fisch & A.C. Pritchard, Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act, 83 WASH. U. L.Q. 869, 872 (2005) (finding that increased involvement by public pension funds has had “no significant effect on attorneys’ fee awards”).
But these provisions can occasion new problems. For instance, the lead plaintiff provision may have recreated the collective action dilemma, thus compromising the class action’s purpose. Serving as a lead plaintiff costs institutions time and money and may expose them to costly discovery revealing their investment strategy.

Despite extra effort and added headaches, lead plaintiffs receive only their pro-rata share of recovered funds. Other investors collect the same proportional benefit minus the burden. This generates an incentive to free ride on others’ efforts and recreates the quintessential collective action dilemma.

Stephen Choi and Robert Thompson expand this point by observing, “[i]n a world where investment manager performance is regularly measured by relative returns, the possibility of competing managers free riding on your efforts, or the comparative option of your free riding on other investors, operates as a disincentive to participate as a lead plaintiff.”

In short, the lesson is that manipulating variables within class practice without considering perverse and unintended consequences may inhibit enforcement.

Finally, critics contend that plaintiffs’ attorneys fail to pursue economically unattractive cases—cases involving companies with
less market capitalization—and thus leave enforcement gaps. But if securities class actions supplement regulation, it should come as no surprise that cost-benefit analysis—a concept quite familiar to public regulation—also influences the private sphere. This skepticism may belie a deeper belief that every misdeed warrants enforcement to the letter—a belief negated by prosecutorial discretion and agency priority setting. Besides, larger settlements should correlate with greater expertise and meritorious actions. That is, merit-based claims—claims with significant economic value—produce higher monetary settlements than those settling for nuisance value. Simply put, private actors have enforcement discretion too, but they weigh factors differently than an administrative agency might.

Moreover, class actions are easy targets for arbitrary enforcement allegations. Dispersed actors initiate them for any number of selfish or altruistic reasons. The hard point is why concern falls disproportionately on private enforcement rather than agency inaction. SEC inaction is political and nonreviewable, but class actions against corporate defendants are saddled with an implicit assumption that plaintiffs’ attorneys simply sought the deepest pockets.

These assumptions seep into class certification considerations, tainting consequence-based regulation. Theoretically, courts cannot consider a class action’s merits in determining whether to certify it.

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81 See, e.g., Coffee, supra note 58, at 1564 (arguing that reducing damages decreases incentives of plaintiffs’ attorneys to seek out and prosecute securities fraud).


83 Choi & Thompson, supra note 70, at 1516 (“Firms with greater ability at identifying and prosecuting more meritorious litigation, all other things being equal, will tend to have a greater market share of the total settlement amount compared with plaintiff law firms focusing more on nuisance litigation.”).


Yet recent federal appellate decisions, notably the Second Circuit’s *In re Initial Public Offering Securities Litigation* opinion⁹⁰ and the Fifth Circuit’s *Oscar Private Equity Investments v. Allegiance Telecom, Inc.* opinion,⁹¹ have whittled away at *Eisen’s* sweeping prohibition against considering the merits.⁹¹ This ban has evolved antithetically: judges must now resolve factual disputes relevant to certification prerequisites.⁹² But the case’s merits are inextricably intertwined with certification inquiries; the Supreme Court recognized as much in permitting a “probe behind the pleadings.”⁹³ The jurisprudential concern is that judges’ assumptions will influence their certification decisions. Agency litigation, on the other hand, suffers no such bias. As contrasted with class litigation, SEC enforcement actions enjoy presumed legitimacy and, because they aren’t class actions, need not overcome Rule 23’s certification criteria.⁹⁴

In short, agency discretion is free from the cynicism confronting private enforcement. Yet, my point is not to exonerate private attorneys’ decisional basis; rather, it is to observe that agencies also use a cost-benefit analysis to determine which actions to pursue. The class certification battle, as compared with agency ease in

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⁹⁰ See 471 F.3d 24, 41 (2d Cir. 2006) (holding that judge can make Rule 23 determination even if certification overlaps with merit issues).

⁹¹ See 487 F.3d 261, 268 (5th Cir. 2007) (asserting that it is misreading of *Eisen* to assume that merits questions may never be addressed at certification stage); see also Recent Case, *Fifth Circuit Holds that Plaintiffs Must Prove Loss Causation Before Being Certified as a Class*, 121 HARV. L. REV. 890, 896 (2008) (arguing that *Oscar* decision restricts fraud-on-the-market presumption by allowing courts to examine merits at certification stage).

⁹² See *Eisen*, 417 U.S. at 177 (“We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action.”); see also Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251, 1277–80 (2002) (proposing alternative to *Eisen* rule which would permit preliminary inquiry into merits).

⁹³ See, e.g., *Oscar Private Equity Invs.*, 487 F.3d at 266–69 (inquiring into merits of plaintiffs' fraud-on-the-market theory at certification and holding that “loss causation must be established at the class certification stage by a preponderance of all admissible evidence”). Certification requirements come from FED. R. CIV. P. 23(a) and 23(b)(3).

⁹⁴ Cf. Nagareda, *supra* note 85, at 18–19 (comparing legitimacy of EEOC employment actions to private employment class actions).
initiating cases, is a sticking point when contemplating the complementary regulatory roles of the SEC and private actions.

2. Context Specific Criticism of Securities Class Actions. Although generalized class action critiques are less vexatious in the securities context, two objections leveled specifically at securities class actions cause both pragmatic and deontological concerns. The pragmatic concern, put forth by several high-profile commissions, charges that securities class actions deter foreign firms from listing in the United States. The deontological, and thus more troubling, criticism is the so-called “circularity problem.” That is, the notion that class actions simply shift wealth from one diversified shareholder’s pocket to another, minus significant transaction costs.

Consider first the claim that the securities class action’s availability threatens the attractiveness of the United States’ markets to foreign firms. For example, the report commissioned by Michael Bloomberg and Charles Schumer asserts, “the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors.” Similarly, the Committee on Capital Markets Regulation reported that transactions, listings, and trading volume are gravitating toward London and Hong Kong. Both

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95 See infra notes 98–101 and accompanying text.
96 See Coffee, supra note 58, at 1556–66 (arguing that fundamental problem of securities class actions is pocket-shifting wealth transfers among shareholders).
97 See infra notes 108–14 and accompanying text.

New York underwriting fees are so high because investment bankers are the Prada of American financial-services workers. . . . To ensure that things go smoothly, they hire New York’s best (read: most expensive) lawyers, accountants and flacks. In its report, Oxera noted that there was a “perception among some of the companies consulted” that such ancillary costs were highest in the United States.

99 COMM. ON CAP. MKTS. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 31 (2006), available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; see also BLOOMBERG & SCHUMER, supra note 98, at i (noting that American financial services industry is increasingly competing with Dubai, Hong Kong, and Tokyo).
countries regulate their markets less intensely. While the shift is real, the cure does not hinge upon eliminating securities class actions, particularly when the premise rests on the frivolous litigation myth. Put simply, empirical studies confirm that widespread frivolous litigation no longer exists even though the perception of a “litigation explosion” remains. Consequently, to the extent that this myth negatively influences foreign firms, education and anchoring—not elimination—are better solutions.

Additionally, foreign countries have increasingly adopted their own forms of collective litigation. For instance, French President Nicolas Sarkozy, Deutsche Telekom AG shareholders, and American lawyers are campaigning for aggregate litigation in Europe; Germany recently adopted the Capital Markets Model Case Act, or “KapMuG,” to facilitate collective litigation on behalf of injured investors; and Canada, Australia, China, and Taiwan, among others, have all enacted various aggregate litigation procedures for securities cases. This movement toward globalizing class actions

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100 COMM. ON CAP. MKTS. REG., supra note 99, at 40–41 (explaining that Hong Kong ranks high in terms of regulatory intensity and that financial services prefer more flexible regulatory philosophy of Britain’s Financial Services Authority over SEC).

101 See supra notes 67–73 and accompanying text.


suggests that these countries are grappling with similar trade-offs: to what extent is society willing to fund and trust centralized government enforcement in lieu of privatization and direct access to justice?\textsuperscript{106} Granted, some countries may be reacting to expansionist tendencies by the United States courts to include—or some may say to discriminate against—foreign plaintiffs in allocating settlement proceeds. Yet the class action’s increasing appeal makes sense: why use public funding for enforcement when privatization can reduce taxpayer expenses?\textsuperscript{107} 

Even reducing public costs, however, does not avoid the most damning securities class action criticism: that it simply redistributes wealth among diversified shareholders minus significant transaction costs.\textsuperscript{108} The argument is that shareholders and former shareholders sue the corporation for a misstatement or omission, even though the corporation itself has not purchased or sold its securities,\textsuperscript{109} upon settlement, “the corporation and thus, indirectly, its shareholders, bear the costs.”\textsuperscript{110} Diversification exacerbates this problem by making it more likely that, on any given day, an investor will be in both the plaintiff-class suing a corporation and in the shareholder group funding a settlement.\textsuperscript{111} Professor Coffee labels this a “circularity problem” and argues that these

\textsuperscript{106} We will see more of what this trade-off might entail in Part IV.

\textsuperscript{107} See, e.g., Glaeser & Shleifer, supra note 32, at 431–32 (using private enforcement of “blue laws” as example).

\textsuperscript{108} See COMM. ON CAP. MKTS REG., supra note 99, at 72 (“Fines and damages imposed on corporations are borne by innocent shareholders, thus reducing their returns.”); A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 VA. L. REV. 925, 957–58 (1999) (“The transaction costs of litigation leading to settlements that merely transfer wealth among shareholders are a pure social waste, unless class actions provide a substantial deterrent effect.”).

\textsuperscript{109} See Coffee, supra note 58, at 1556 (describing “secondary market” case).

\textsuperscript{110} Burch, supra note 12, at 374.

\textsuperscript{111} Id. at 374–75; see also Coffee, supra note 58, at 1538, 1558 (noting that diversified shareholders are often on both sides of wealth transfer). For an interesting illustration of this redistribution principle using Dobby—Harry Potter’s house elf—see Richard A. Booth, The End of the Securities Fraud Class Action As We Know It, 4 BERKELEY BUS. L.J. 1, 4–5 (2007).
transaction costs fall disproportionately on innocent shareholders—the fraud victims.112 This is most likely true. And his solution, targeting the wrongdoers—corporate officers and directors who commit fraud—rather than the corporation,113 may cut down on these costs.114

But it is equally true that any regulatory system generates transaction costs.115 For example, the American Enterprise Institute estimates that complying with the Sarbanes-Oxley Act (Sarbanes-Oxley) has cost businesses approximately $1.1 trillion;116 RAND Corporation adds that Sarbanes-Oxley increased the costs of “being public” from roughly $900,000 to $1,954,000.117 Yet, the United States still has lower entry costs and barriers than most other countries, which ex post regulation makes possible.118 Litigation

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112 See John C. Coffee, Jr., Law and the Market: The Impact of Enforcement 76–77 (Columbia Law Sch. Ctr. for Law and Econ. Stud., Working Paper No. 304, 2007), available at http://ssrn.com/abstract_id=967482 (“[A] system of enterprise liability is at work that resembles punishing the victim of a burglary because the victim negligently suffered a burglary. Such punishment may deter, but among those likely deterred are foreign firms considering cross-listing in the U.S.”); see also COMM. ON CAP. MKTS., supra note 99, at 72 (“Fines and damages imposed on corporations are borne by innocent shareholders, thus reducing their returns.”); Coffee, supra note 58, at 1556 (describing “circularity problem”); Pritchard, supra note 108, at 958 (noting that misstatements by corporate managers are often motivated by benefits to managers rather than corporations).

113 Coffee, supra note 58, at 1538.

114 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, 630, 661 (2007) (arguing that shift from enterprise liability would reduce costs of security fraud enforcement, and proposing increased use of equitable remedies such as recession and restitution).

115 See Donald Wittman, Prior Regulation Versus Post Liability: The Choice Between Input and Output Monitoring, 6 J. LEGAL STUD. 193, 196 (1977) (stating that both ex post and ex ante monitoring involves transaction costs). Economists, for example, have demonstrated that private enforcement can actually reduce the overall costs of identifying violations and can enhance efficiency. Glaeser & Shleifer, supra note 32, at 431–32. Transaction costs are, however, ubiquitous. See KAGAN, supra note 40, at 104–08 (concluding that American legal costs are high because of redundancy, episodic trials, dueling experts, pretrial discovery, and lawyer-centered as opposed to judge-centered system).


118 See Issacharoff, supra note 6, at 377 (“What really sets the United States apart is the fact that its basic regulatory model is ex post rather than ex ante . . . .”).
costs time and money regardless of who is sued. Shareholders necessarily bear those expenses.\textsuperscript{119} Even if plaintiffs’ attorneys target officers and directors, determining, and perhaps litigating, directors’ and officers’ insurance coverage generates secondary costs, costs that might be reduced or reallocated if insurers were better loss prevention suppliers and defense cost managers.\textsuperscript{120} This is the bottom line: both \textit{ex ante} and \textit{ex post} regulation costs shareholders money. The key, however, is not in eradicating private litigation, which simply shifts regulatory costs elsewhere, but in using class litigation judiciously, limiting damage awards appropriately, and weighing these costs against securities class actions’ benefits.\textsuperscript{121} This Article advances the latter point by developing previously under-theorized benefits accruing from securities class actions’ ability to provide a public good: regulation. This good, in turn, creates positive spillovers that cannot be achieved through alternative enforcement regimes.

III. SECURITIES CLASS ACTIONS’ POSITIVE EXTERNALITIES

Although it may contradict our intuitions and is undoubtedly controversial, class actions are Janus-faced: they supply a public good, too. Economists typically define a “public good” as one that the government must furnish because private organizations lack market incentives to do so.\textsuperscript{122} Public goods thus suffer from a collective

\begin{itemize}
\item \textsuperscript{119} Burch, \textit{supra} note 12, at 374.
\item \textsuperscript{120} See Coffee, \textit{supra} note 58, at 1570 (noting difficulties in differentiation of insurance for corporation, corporate directors and officers); see also Tom Baker & Sean J. Griffith, \textit{The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer}, 95 GEO. L.J. 1795, 1808–17 (2007) (stating that D&O insurers do not provide loss prevention services or manage litigation defense costs). Because the corporation pays for insurance, shareholders effectively pay for insurance. Coffee, \textit{supra} note 58, at 1553; Pritchard, \textit{supra} note 108, at 957. A strong argument exists that D&O insurance undermines securities class action deterrence. See Baker & Griffith, \textit{supra}, at 1818–21 (arguing D&O insurance undermines deterrent effect of securities liability). I largely agree with and briefly address that argument in the latter portion of Part III.A.
\item \textsuperscript{121} For more on limiting damage awards in securities fraud class actions, see Burch, \textit{supra} note 12, at 385–94.
\end{itemize}
action problem; there is no incentive to provide a product or service that benefits everyone equally. 123 Two dilemmas explain this disincentive: “non-rivalry of consumption”—that consumption by one does not diminish the good’s availability for others—and “impossibility of exclusion”—that limiting the good’s use to paying consumers is not possible. 124 The textbook example is a lighthouse. Although there is a need for the lighthouse, building it benefits everyone equally (invoking the collective action problem) and, once built, there is no way to exclude certain ships from enjoying its benefits. 125 A less typical example is deterring wrongdoing through litigation. 126 Like the lighthouse, deterrence benefits everyone, not just litigants. And there is a collective action problem since potential plaintiffs with minimal damages may do nothing in hopes of free riding on the future deterrence benefit of others’ actions. 127

The securities class action overcomes this problem by permitting investors to pool their claims and allowing plaintiffs’ attorneys to request court approval for fees based on the entire recovery. 128 It privatizes, or some might say subsidizes, the typical governmental function of regulating and deterring. 129 In this manner, class actions help produce a public good: regulation, which, in turn, creates positive externalities such as fostering corporate accountability, promoting deterrence, enforcing public norms, and circumnavigating

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123 Rubenstein, supra note 122, at 711; see also David Luban, Settlements and the Erosion of the Public Realm, 83 GEO. L.J. 2619, 2623 (1995) (“Economists define a public good as a beneficial product that cannot be provided to one consumer without making it available to all (or at least many others). The textbook example is a lighthouse . . . .”).

124 Russell Hardin, Collective Action 17 (1982); Rubenstein, supra note 122, at 711; see also Tracey E. George & Chris Guthrie, Induced Litigation, 98 NW. U. L. REV. 545, 552–53 (2004) (asserting that defining features of public goods are “nonrivalry of consumption” and “infeasibility of excluding other consumers”). George and Guthrie label courts impure public goods because “[t]he individualized use . . . is inherently divisible and rival, as one person’s presence [i.e., a complaint] precludes others from using the same part of the good during that period.” Id. at 555–56.

125 Luban, supra note 123, at 2623.

126 See Burch, supra note 25, at 2523 (“Through fostering accountability, enforcing public norms, and circumnavigating the possibility that an attorney general could abuse her discretionary authority, class litigation itself becomes a public good.”).

127 Rubenstein, supra note 122, at 711.

128 Id. at 712.

129 See Burch, supra note 25, at 2522–23 (suggesting that shifting enforcement to private sector generates more innovation than government enforcement produces).
potential SEC and exchange inaction. As Bill Rubenstein explains, “[t]he class action mechanism is important not just because it enables a group of litigants to conquer a collective action problem and secure relief, but also—perhaps more so—because the litigation it engenders produces external benefits for society.” Like marketplace transactions, ex post regulation through securities class actions has spillover effects reaching more than just lawsuit litigants. These spillovers—externalities—occur when one person’s activity benefits another without payment. Externalities theory relies on economic insights to broaden the traditional two-dimensional view of class litigation and counter paradigm paralysis. In short, externalities theory counters orthodox beliefs that envision class actions as sterile outlays producing nothing and extracting rents.

Regulating through securities class actions generates a catalog of positive externalities (some of which would qualify as public goods themselves): innovation, deterrence, information sharing, accountability, and transparency, to name but a few. Admittedly, these actions may also create negative spillovers such as the circularity problem. Or, one might find innovation in this setting problematic and align with those promoting agency justice and...

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131 Rubenstein, supra note 122, at 710.

132 See id. at 723 (“The class action takes the spillover effect—the burden of scarce resources—and shares that burden among all . . . ”).

133 See Frischmann & Lemley, supra note 10, at 262, 268 (“[A] wealth of economic evidence teaches us that spillovers are good for society.”).

134 See JOEL ARTHUR BARKER, DISCOVERING THE FUTURE: THE BUSINESS OF PARADIGMS 68–70 (3d ed. 1989) (defining “paradigm paralysis” as recognition that every individual possesses core set of beliefs through which individual filters new information and arguments).

135 See Rubenstein, supra note 122, at 723–25 (identifying these positive externalities as benefits of class action litigation generally); see also Luban, supra note 123, at 2623–24 (identifying development of advocacy skills as positive externality).
urging alternative resolution. But in my view—one embracing a consequentialist cost-benefit analysis and tending toward Kaldor-Hicks efficiency—these positive externalities outweigh persistent doctrinal concerns.

As a simple initial example, consider innovation. Private rights of action conjoined with claim pooling create self-funded supplemental regulators who can afford to pioneer legal theories, hire cutting-edge experts, design sophisticated damage models, conduct electronic discovery, monitor the market, and engineer fraud detection techniques. Private attorneys are risk takers, not bureaucrats. Moreover, private actors counter agency “ossification”—the agency’s tendency to maintain the status quo since it accumulates administrative doctrine and judicial precedent. Explaining these benefits, Brett Frischmann and Mark Lemley observe, “[i]ndustries with significant spillovers generally experience more and faster innovation than industries with fewer spillovers,” perhaps because they evoke opportunities for entrepreneurial exploitation. They further suggest that private entrepreneurs “are part of a virtuous circle because they are in turn

136 E.g., KAGAN, supra note 40, at 128 (“No other country comes close to matching the organizational and political energy of American personal injury lawyers, who aggressively seek out cases, disseminate litigation technologies, dream up new causes of action, and fiercely resist litigation-reducing reforms.”).

137 See Jonathan Klick & Robert H. Sitkoff, Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey’s Kiss-off, 108 Colum. L. Rev. 749, 826 n.346 (2008) (“The Kaldor-Hicks efficiency criterion holds that an action is efficient if those who gain from the action benefit, in the aggregate, more than those who lose from the action, in the aggregate.”).


139 See Nagareda, supra note 85, at 38 (noting agencies’ “disinclination to pursue ambitious, cutting-edge initiatives . . . due to the demands of process and judicial review accumulated in administrative law doctrine over the years”); see also William S. Jordan, III, Ossification Revisited: Does Arbitrary and Capricious Review Significantly Interfere with Agency Ability to Achieve Regulatory Goals Through Informal Rulemaking?, 94 Nw. U. L. Rev. 393, 394 (2000) (explaining ossification hypothesis); Mark Seidenfeld, Demystifying Deossification: Rethinking Recent Proposals to Modify Judicial Review of Notice and Comment Rulemaking, 75 Tex. L. Rev. 483, 483 (1997) (“[O]ssification refers to the inefficiencies that plague regulatory programs because of analytic hurdles that agencies must clear in order to adopt new rules.”).

140 Frischmann & Lemley, supra note 10, at 268–69.
creating new knowledge spillovers that support still more entrepreneurial activity.”

A. DETERRENCE

This entrepreneurial exploitation engenders deterrence. The prospect that litigation deters fraud animates the ex ante incentive—maximizing total social welfare—of our ex post regulatory system. Yet, I opt not to dwell extensively on deterrence for two reasons. First, its evidence is largely anecdotal and mired in controversy. Empirical analysis cannot, for example, quantify the amount of fraudulent conduct deterred by litigation, nor can it measure litigation’s benefits. Empirical data can, however, identify private litigation’s costs through fee requests and nonconfidential settlements, which results in a one-sided analysis. Second, securities class actions’ paramount spillovers—accountability and transparency—surpass and strengthen deterrence.

The impossibility of precisely measuring potential class litigation’s ex ante incentives on a corporate agent contemplating wrongdoing may make it a fool’s errand, but we can at least think about deterrence logically. Studies about why officers and

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141 Id. at 269.
142 See Blackie v. Barrack, 524 F.2d 891, 903 (9th Cir. 1975) (“The availability of the class action to redress [securities fraud] has been consistently upheld, in large part because of the substantial role that the deterrent effect of class actions plays in accomplishing the objectives of the securities laws.” (citation omitted)); Johnson, Nelson & Pritchard, supra note 11, at 777 (“Insofar as securities fraud class actions provide an efficient enforcement device, stock prices generally should reflect the effectiveness of those suits in deterring fraud.”).
144 See Segal & Whinston, supra note 13, at 14 (“A key problem with the empirical direction is that the benefits of private litigation are difficult to observe.”).
145 One study argues that the increased role of institutional investors in class litigation increases deterrence. Keith L. Johnson, Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors, 60 LAW & CONTEMP. PROBS. 155, 165 (1997).
directors lie often cite chronic conditions such as greed, fear, pressure, opportunity, “ethical plasticity,” and pollyannaism. These conditions suggest that if managers rationally engage in a cognitive cost-benefit analysis before outwardly exhibiting false optimism (lying), then knowing that they will personally suffer some penalty could combat and lessen these tendencies. Still, these same conditions also imply, perhaps with equal force, that misrepresentations are impulsive, not deliberate. Deterrence is thus paradigm dependent. Some facets of contemporary cognitive psychology research challenge this duality’s efficacy, suggesting instead that both impulsive and deliberative behavior fail because people are irrational. But social learning theorists believe the opposite; they claim that “human behavior can best be explained by an interaction of cognitive, behavioral, and environmental factors.”

On the use of class actions, Richard Posner noted that “the most important point, on an economic analysis, is that the violator be confronted with the costs of his violation—this achieves the allocative purpose of the suit—not that he pay them to his victims.” RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 349–50 (1972); see also Kenneth W. Dam, Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest, 4 J. LEGAL STUD. 47, 54 (1975) (noting deterrent effect of class actions).


See Daniel W. Shuman, The Psychology of Deterrence in Tort Law, 42 U. KAN. L. REV. 115, 116 (1993) (“Deterrence theory assumes that the psychological linkage between tort law and safer behavior is that people are cognizant of the likelihood of tort sanctions for proscribed behavior and choose safer alternatives to avoid those sanctions.”). See id. at 128–29 (suggesting that impulsive behavior involves little time to consider tort consequences, and thus “paradigms” of impulsive and deliberative behavior fall at either end of behavior continuum).

Id. at 157; see also ALBERT BANDURA, SOCIAL LEARNING THEORY 13 (1977) (“A comprehensive theory of behavior must explain how patterns of behavior are acquired and their expression is continuously regulated by the interplay of self-generated and external sources of influence.”); ROBERT L. HEATH & JENNINGS BRYANT, HUMAN COMMUNICATION THEORY AND RESEARCH: CONCEPTS, CONTEXTS AND CHALLENGES 351 (2d ed. 2000) (“Social learning theory emphasizes the interaction of cognitive, behavioral, and environmental factors in determining behavior.”).
These theorists suggest that securities class action judgments, as a form of civil liability or civil “punishment,” effectively shape behavior so long as they are accurately and fully publicly communicated.\textsuperscript{150} In other words, judgments that lack transparency, those kept confidential, do not deter.

Social learning theory thus seems to support practical observations about behavioral tendencies. We know, for example, that securities class actions cause CEO turnover.\textsuperscript{151} One empirical study by Greg Niehaus and Greg Roth found that defendant corporations experience a higher CEO turnover rate when compared with those suffering significant stock price decreases but no lawsuit.\textsuperscript{152} Using a sample of 612 securities class actions, Niehaus and Roth found that CEOs who lose their jobs in the midst of securities class actions do not acquire comparable positions within three years.\textsuperscript{153} They conclude, “[g]iven that the average age of the departing defendant managers is 54, this evidence suggests that the management turnover associated with [securities class actions] does

\textsuperscript{150} See Shuman, supra note 147, at 158 (“Social learning theory, however, is based on the premise that people observe that inappropriate (i.e. tortious) behavior is punished, and that appropriate (i.e. nontortious) behavior produces valued outcomes.”); see also Bandura, supra note 149, at 121 (arguing that observing exemplary punishment can deter behavior, although punishment observed to occur infrequently has weak restraining effect). Similarly, in the criminal context, Joan Heminway argues that “perceptions of leniency, more than the reality that plea bargains may lead to enhanced criminal justice, limit the retributive and deterrent force of criminal prosecutions under Rule 10b-5.” Joan MacLeod Heminway, Hell Hath No Fury Like an Investor Scorned: Retribution, Deterrence, Restoration, and the Criminalization of Securities Fraud under Rule 10b-5, 2 J. BUS. & TECH. L. 3, 9 (2007).

\textsuperscript{151} Coffee, supra note 58, at 1554 (“For example, some research has found that securities class actions tend to result in CEO turnovers in their wake. In one study, the filing of a securities class action was found to more than double the likelihood of a CEO turnover, increasing it from 9.8% before the filing to 23.4% afterwards.” (footnotes omitted)); Charles M. Yablon, A Dangerous Supplement? Longshot Claims and Private Securities Litigation, 94 NW. U. L. REV. 567, 595–96 (2000) (describing correlation between securities class actions and “top management turnover”). But see Anup Agrawal et al., Management Turnover and Governance Changes Following the Revelation of Fraud, 42 J.L. & ECON. 309, 311 (1999) (finding that fraud alone was not correlated to unusually high management turnover).

\textsuperscript{152} Greg Niehaus & Greg Roth, Insider Trading, Equity Issues, and CEO Turnover in Firms Subject to Securities Class Actions, 28 FIN. MANAGEMENT 52, 53 (1999) (“[D]efendant firms experience a higher CEO turnover rate relative to matched firms that also experienced large stock price drops. . . . [and] meritorious cases are more likely to result in CEO turnover.”).

\textsuperscript{153} Id. at 68 (noting that study “yielded no instances of a departing defendant CEO gaining a new and comparable position . . . within three years after leaving the defendant firm”).
impose personal costs on defendant managers.”

While reducing the availability of directors’ and officers’ insurance—or making insurers more effective monitors—and increasing agent liability—as Professor Coffee proposes—will likely enhance deterrence, Niehaus and Roth’s evidence demonstrates that even current form securities class actions cause personal negative consequences. These personal consequences may also include emotional, reputational, financial, and social ramifications, so long as the litigation process is transparent.

Given this finding, class action litigation’s theoretical behavioral influence is two-fold. First, amassing similar claims through Rule 23 mounts a notable litigation threat that figures into any conscious cost-benefit analysis. Social learning theory predicts that this “threat effect” deters risky behaviors taken without due care and increases candor among corporate managers. Put differently, deterrence enhances public welfare by preventing

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154 Id.; see also Agrawal et al., supra note 151, at 311 n.6 (suggesting that job loss due to fraud implies large personal penalties for managers); Robert D. Cooter, Three Effects of Social Norms on Law: Expression, Deterrence, and Internalization, 79 OR. L. REV. 1, 15 (2000) (examining how legal sanctions supplement social sanctions in order to encourage compliance with social norms). This result was linked to two measures of meritorious class actions: “the extent of insider selling during the class period and the settlement amount.” Niehaus & Roth, supra note 152, at 53.

155 See Coffee, supra note 58, at 1555–56 (proposing that insurance companies rescind policies applicable to insiders for fraud or assert traditional coverage exclusions); see also Tom Baker & Sean J. Griffith, Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market, 74 U. CHI. L. REV. 487, 488–89 (2007) (arguing that D&O insurance achieves deterrence goals only indirectly, if at all); Baker & Griffith, supra note 120, at 1799 (arguing that D&O insurance may actually increase shareholder losses).

156 See Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 95 (1991) (“Managers also face scrutiny in labor markets. If sacked today, they may have trouble matching their income elsewhere.”); Baker & Griffith, supra note 155, at 489 n.7 (noting emotional impact of shareholder litigation on officers and directors); infra notes 215–17 and accompanying text.

157 Burch, supra note 25, at 2550; see also Rosenberg, supra note 138, at 908 (“By aggregating mass exposure claims, class actions could enable mass exposure victims to litigate both in the numbers and with the adversarial strength necessary to achieve the tort system’s . . . deterrence objectives . . . .”).

unreasonable risks that cost more to incur than to prevent.\textsuperscript{159} Meritorious class suits also catalyze policy and management changes, the effects of which benefit the public.\textsuperscript{160} Second, class actions curtail the need for future litigation by developing the law, translating legal jargon into standards of conduct, and thus clarifying and delineating boundaries for acceptable behavior.\textsuperscript{161}

Of course, nobody claims that securities class actions perfectly produce or promote optimal deterrence. Proposals across the board, including some of my own, contend that class actions may over- or under-deter\textsuperscript{162} or may fail to promote an appropriate level of compliance.\textsuperscript{163} Reforms recommend optimizing fraud deterrence by targeting the wrongdoers—i.e., corporate officers and directors—rather than the corporation,\textsuperscript{164} pushing D&O insurers to monitor corporate behavior and litigation costs,\textsuperscript{165} clarifying the scienter standard,\textsuperscript{166} and limiting damages to out-of-pocket losses.\textsuperscript{167}
Yet each of these proposals relies on a single, pivotal assumption: warts and all, securities class actions can deter wrongdoing.\textsuperscript{168}

\textbf{B. INFORMATION SHARING}

In addition to securities class actions' potential deterrent effects, consider also their potential to reduce enforcement costs through information sharing. Contrary to the notion that plaintiffs piggyback purely on the SEC’s efforts, the SEC and the plaintiffs' bar target companies with different capital.\textsuperscript{169} But for the roughly 15% of overlapping cases where both the SEC and plaintiffs' attorneys file suit,\textsuperscript{170} both regulators profit from increased information.\textsuperscript{171} Ideally, within this overlap, they would exchange

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\textsuperscript{168} See, e.g., Coffee, \textit{supra} note 58, at 1547 ("[T]he securities class action . . . can still perform admirably as a form of deterrence.").


\textsuperscript{170} James D. Cox & Randall S. Thomas, \textit{Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?}, 80 NOTRE DAME L. REV. 893, 897 (2005); Cox & Thomas, \textit{supra} note 169, at 777; \textit{see also} Cox, Thomas & Bai, \textit{supra} note 1, at 361 (finding 17% overlap between SEC investigations and private enforcement actions). Some economists posit strategies where the violator faces “double jeopardy,” i.e., enforcement from a regulator discovering the violation and from a victim suffering injury from the violation, “often work better.” Glaeser & Shleifer, \textit{supra} note 33, at 411.

\textsuperscript{171} See Howard M. Ericson, \textit{Coattail Class Actions: Reflections on Microsoft, Tobacco, and the Mixing of Public and Private Lawyering in Mass Litigation}, 34 U.C. DAVIS L. REV. 1, 30 (2000) ("Government documentary discovery, especially, can facilitate the pursuit of claims by private plaintiffs. Not only does the government action provide plaintiffs with valuable information, but access to that information greatly reduces plaintiffs' costs."). In addition to private-public information sharing, the SEC and DOJ also share information. See 15 U.S.C. § 77t(b) (2000) (providing for sharing of evidence between SEC and DOJ).
information and ideas. Cooperating could reduce discovery and processing costs, lessen SEC penalties for defendants, minimize litigation time, and preserve judicial resources.

Yet the real information-sharing rewards flow from plaintiffs’ attorney to plaintiffs’ attorney rather than from plaintiffs’ attorney to the SEC. The former relationship creates symmetry between plaintiffs and defendants in settlement negotiations and levels the playing field. For example, in a typical mass tort case, repeat-player defendants typically know more than plaintiffs do about previous settlements, expert evidence, and discovery materials. Informational asymmetries disadvantage those claimants in both picking their attorney and accepting settlement agreements. Unlike one-shot claimants, institutional lead plaintiffs in securities class actions—repeat players—reduce informational asymmetry. The PSLRA hoped for as much, as demonstrated by Elliott Weiss and John Beckerman’s influential article proposing that institutions serve as lead plaintiffs. In fact, one study shows that having a public pension fund as a lead plaintiff positively correlates with a higher settlement size. After winning the initial battle for lead plaintiff, in theory, former competitors will then join forces rather
than opt-out, share information and expertise, and thus bolster the litigation’s threat effects.\textsuperscript{177}

C. ACCOUNTABILITY

Considering information sharing as a class action spillover reveals a glimpse of class actions’ positive, pragmatic side. Yet, securities class actions also guard against selective enforcement and inaction by the SEC, the Department of Justice, and the self-regulatory organizations (the exchanges). They hold both corporations and the entities that regulate them publicly accountable.\textsuperscript{178} Roughly defined, “accountability” is one actor’s power to demand explanations or justifications for another’s decisions.\textsuperscript{179} Jurisdictional overlap between public and private regulatory institutions thus functions as a stopgap measure countering selective agency enforcement. Decentralizing enforcement enhances corporate and agency accountability by creating profit objectives (contingency fees) for private attorneys. It also overcomes lackluster governmental incentives; unlike deficient government performance, inadequate private attorney performance causes personal financial and reputational repercussions.\textsuperscript{180} Moreover, unlike public actors with governmental immunity, market-based accountability, discipline, and sanctions hold private attorneys externally accountable.\textsuperscript{181}

\begin{flushright}
\textsuperscript{177} Anecdotal evidence suggests that institutions serving as lead plaintiffs do develop effective litigation and fee supervision skills. Choi & Thompson, supra note 70, at 1506; see also Johnson, supra note 145, at 156 (noting that investors can benefit from increased participation of institutions in securities litigation). Choi and Thompson report, for example, “the New York State Comptroller’s Office . . . [has] three year contracts with about fifteen firms.” Choi & Thompson, supra note 70, at 1506.
\textsuperscript{178} For information on accountability as a public good, see Anita L. Allen, Privacy Isn’t Everything: Accountability as a Personal and Social Good, 54 ALA. L. REV. 1375, 1387 (2003) (“Accountability chills, deters, punishes, prompts, pressures, and exposes.”).
\textsuperscript{180} See Trebilcock & Iacobucci, supra note 39, at 1436 (“[P]rivate corporations may not survive in the face of poor performance, while government enterprises generally do not face such a risk.”).
\textsuperscript{181} See supra notes 69–71 and accompanying text; see also Trebilcock & Iacobucci, supra note 39, at 1423, 1448 (“Private actors face discipline that public actors do not. Moreover, there is a danger that public actors, even if potentially more successful at pursuing a
Despite these hurdles for the private sector, the numbers verify that private class actions exert substantially more leverage than the exchanges and the SEC. For example, from 2000 to 2002, plaintiffs initiated an average of only 205 securities class actions versus some 5,000 actions by the SEC, States, National Association of Securities Dealers, and the New York Stock Exchange.¹⁸² Yet, these class action settlements and trials totaled awards of over $1.9 billion, whereas the entire public enforcement effort, not including arbitrations by the NASD or NYSE, resulted in sanctions of $1.86 billion.¹⁸³ The class action’s monetary sanctions comprise roughly 52% of total monetary sanctions for both public and private enforcement actions.¹⁸⁴ It is little wonder that these numbers are manipulated by context; depending on the pundit, they show either that private actions cost shareholders substantially more than public enforcement actions or that private actions are more effective.¹⁸⁵

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Cases with Accompanying SEC Settlements

<table>
<thead>
<tr>
<th>Company</th>
<th>Settlement Fund in SEC Action</th>
<th>Settlement Fund in Related Class Action</th>
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¹⁸² See infra APPENDIX.
¹⁸³ See Jackson, supra note 19, at 27.
¹⁸⁴ COMM. ON CAP. MKTS. REG., supra note 99, at 71. Cornerstone Research’s 2005 data shows the overwhelming private civil penalties compared with SEC actions for some of the most recent securities class actions:

³⁸⁵ One study found that “the expected costs required to deter an adversary vary as a function of the stakes it seeks, and that this relationship between expected costs and stakes is convex: Deterrence gets ‘easier’ as the stakes and threatened sanction increase.” Gary Schaub, Jr., Deterrence, Compellence, and Prospect Theory, 25 Pol. Psychol. 389, 405 (2004) (commenting on C. Arthur Williams, Jr., Attitudes Toward Speculative Risks as an Indicator of Attitudes Toward Pure Risks, 35 J. Risk & Ins. 577, 577–86 (1966)); see also Erichson, supra note 171, at 42 (“Private class actions, more than government litigation, compel defendants
Regardless of your own reading, no one can deny private actions’ centrality in enforcement, for better or worse.

Critics contend that securities class actions are unnecessary, that the SEC and the exchanges, through the Financial Industry Regulatory Authority (FINRA), have adequate means and incentives to ensure market integrity. See Pritchard, supra note 108, at 963–66 (arguing that exchanges have several advantages over class actions as monitoring devices); see also Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453, 1459 (1997) (“The necessity of attracting investors who have ample alternatives should lead exchanges to choose rules and listing standards that produce benefits to investors until the value investors attach to further benefits is outweighed by the cost of providing them.”). But see Stephen Craig Pirrong, The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation, 38 J.L. & ECON. 141, 143 (1995) (arguing that there is no evidence that self-regulating exchanges are efficient).

Consider first how limited resources tax enforcement. While testifying before the Appropriations Committee, SEC Chairman Christopher Cox lamented the agency’s enormous task in light of its scant resources:

About 3,600 staff at the SEC are responsible for overseeing more than 10,000 publicly traded companies, investment advisers that manage more than $32 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the $44 trillion worth of trading conducted each year on America’s stock and options exchanges. These daunting numbers make it clear that, even if the SEC budget were to double or triple, the agency would have to carefully set priorities.

185 See Pritchard, supra note 108, at 963–66 (arguing that exchanges have several advantages over class actions as monitoring devices); see also Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453, 1459 (1997) (“The necessity of attracting investors who have ample alternatives should lead exchanges to choose rules and listing standards that produce benefits to investors until the value investors attach to further benefits is outweighed by the cost of providing them.”). But see Stephen Craig Pirrong, The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation, 38 J.L. & ECON. 141, 143 (1995) (arguing that there is no evidence that self-regulating exchanges are efficient).


188 Testimony Concerning Fiscal 2008 Appropriations Request: Hearing Before the H. Subcomm. on Financial Services and General Government and the Comm. on...
But priorities have a dark side. The very word implies that wrongdoers under the political radar may avoid penalties. Corporate officers monitor the SEC’s priorities and tailor their own activities to avoid the SEC spotlight.\(^{189}\) Of course, they also know that surreptitious behavior at the margins will be ignored. Although SEC priorities change periodically, the reality is that without private enforcement as a shotgun in the closet, nonprioritized wrongful practices may not be sanctioned.\(^{190}\) Thus, social learning theorists would predict that corporate agents who observe inappropriate behavior-evading sanctions may be less reticent about engaging in that behavior themselves.\(^{191}\)

Positive political theory further explains the effects of prioritizing in agency capture terms.\(^{192}\) Legislators design administrative processes to serve political choices and bend to policy objectives.\(^{193}\)
Because Congress oversees the SEC and the President appoints its chairman, its budget and enforcement priorities are necessarily products of the political process. Preying on its bureaucratic infrastructure is an easy way to extend political victories. Moreover, the SEC, perhaps out of necessity, capitulates to special interest groups. For example, consider the SEC’s initial willingness to exempt small business from Section 404 of Sarbanes-Oxley and the small business lobby’s strength. Some have even pinpointed the agency’s capture by special interests—with congressional acquiescence—as causing the meltdown of several major corporations.

Although SEC enforcement suffers from scarce resources and agency capture, it complements private actions with tools that are
unavailable to private plaintiffs. For instance, the SEC need not prove damage, injury, or reliance to sue, nor must it meet class certification criteria.\(^{200}\) Under federal securities laws, it can choose from an array of sanctions including administrative cease-and-desist orders and orders barring or suspending individuals from acting as reporting companies’ officers or directors.\(^{201}\) Further, to the extent that criminal sanctions deter individuals from committing fraud,\(^{202}\) the SEC transmits evidence and refers cases both formally and informally to the Department of Justice.\(^{203}\) In short, my claim is not

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\(^{200}\) See Sec. & Exch. Comm’n v. Rana Research, Inc., 8 F.3d 1358, 1364 (9th Cir. 1993) (holding that reliance is not element of 106-S violation and thus SEC need not prove reliance); Sec. & Exch. Comm’n v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993) ("[A] district court may grant the Commission’s request for disgorgement even where no injured investors can be identified."). See also ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD § 9:1 (2d ed. 2003) (noting minimum standards required for SEC proceedings as opposed to private actions).

\(^{201}\) See 15 U.S.C. § 77h-1(a) (2000) (cease and desist orders); id. § 78u(d)(2) (judicial orders barring individuals from serving as officers or directors); id. § 78u-3(a) (cease and desist orders).

\(^{202}\) As Jennifer Arlen observed, criminal sanctions may have perverse effects if imposed on corporations. See Jennifer Arlen, The Potentially Perverse Effects of Corporate Criminal Liability, 23 J. LEGAL STUD. 833, 836 (1994) ("Previous analysis suggests that increased corporate liability necessarily reduces crime. Introducing corporate enforcement costs, however, reveals that increased corporate liability does not necessarily reduce corporate crime and, indeed, may result in increased crime.").

that the SEC is defunct, but that private class actions foster corporate accountability by supplementing the SEC’s efforts.

On this efficacious relationship, James Cox and Randall Thomas observe, “the SEC cannot and does not prosecute all violations and the private suit picks up the slack,” thus “even when there is a SEC enforcement action, the private suit provides a more encompassing remedy for the injured investors.”204 Although private class actions produce larger settlements with a parallel SEC action, the SEC and private attorneys tend to earmark different sized companies.205 The SEC targets companies with a market capitalization of $735 million less than companies that the plaintiffs’ bar pursues.206 One explanation is that smaller corporations have fewer auditing resources.207 Naturally, the contingent fee also plays a role. Low capitalization and trading volume may render any damage recovery too small to justify the cost and time required for mounting an effective securities class action.208 In sum, these data suggest that the interrelationship between private and public enforcement is beneficial: it increases corporate and regulatory accountability, a positive spillover for the investing public.

D. TRANSPARENCY

Securities class actions yield yet another advantage: when filed in public courts with predominately open records, they also create a transparent process.209 Transparent judicial process generates three

204 Cox & Thomas, supra note 169, at 779.
205 Id. at 763.
206 Id. at 764; see also Beasley et al., supra note 169, at 41–42 (noting that certain regulatory provisions may fail to target even smaller companies).
207 Cox & Thomas, supra note 169, at 766; see also Beasley et al., supra note 169, at 41 (suggesting that smaller companies lack resources to implement effective internal controls).
208 See Pritchard, supra note 108, at 951–52 (“[C]ompanies with small capitalizations or trading volume may be effectively immune from the threat of a class action suit.”).
209 A lawsuit’s existence is likely to be public, based on both the First Amendment and common law’s approach to the right of access to court records. See Hartford Courant Co. v. Pellegrino, 380 F.3d 83, 93–94 (2d Cir. 2004) (discussing media’s and public’s qualified right
notable spillovers all positive: (1) it educates the public sector about legal obligations and remedies and thereby begets two additional accountability and norm producing measures—marketplace and social accountability;\textsuperscript{210} (2) it increases judicial legitimacy; (3) it augments and promotes deterrence by permitting corporate decision makers and the public to observe sanctions of inappropriate behavior.

First, open proceedings shed light on how laws are enforced and what they mean.\textsuperscript{211} Through openness, the media can publicize facts and unearth pertinent information buried in court documents and the SEC’s EDGAR filing system.\textsuperscript{212} Even though securities class action complaints are notoriously dense, once filed, reporters further siphon relevant facts into an easily digestible format; they use “headline-grabbing” messages to communicate frankly with the public and overcome the inherent “maze-like rules” involved in regulatory issues.\textsuperscript{213} Lawsuits decrease public information costs.\textsuperscript{214}

\textsuperscript{210} See Allen, supra note 178, at 1378 (“Social norms of every category—religious, ethical, moral, legal, and customary—foster accountability.”); Burch, supra note 25, at 2547–49 (describing benefits of transparent process); infra notes 215–22 and accompanying text; see also Resnik, With and Whether, supra note 7, at 1102 (“Adjudication’s public dimensions also enable a diverse audience to see the effects of the application of law in many specific situations.”).

\textsuperscript{211} See Judith Resnik, Uncovering, Disclosing, and Discovering How the Public Dimensions of Court-Based Processes Are at Risk, 81 CHI.-KENT L. REV. 521, 536–37 (2006) (arguing that open court proceedings permit understanding of law and how it is made).

\textsuperscript{212} See Luban, supra note 123, at 2625 (“[T]he discovery and publicizing of facts, which may subsequently be used by political actors, ordinary citizens, or other agents in the legal system (litigants as well as lawyers), is a public good created by adjudication.”). EDGAR is the filing system used by the SEC. For more information, visit the SEC’s website at http://www.sec.gov/edgar.shtml. Stanford’s Securities Class Action Clearinghouse also provides abundant information and is available at http://securities.stanford.edu/.

\textsuperscript{213} Wendy Wagner, When All Else Fails: Regulating Risky Products Through Tort Litigation, 95 GEO. L.J. 693, 704 (2007). Many lawsuits also follow on the heels of media releases or academic commentaries. For example, Erik Lie, a professor of finance at the University of Iowa, and Randall A. Heron, a professor of finance at Indiana University, recently published a study indicating that more than 2,000 companies used backdated stock options to enhance executive pay packages. See Randall A. Heron & Erik Lie, Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?, 83 J. FIN. ECON. 272, 294 (2007) (concluding that either backdating occurs or that executives can predict market with reasonable certainty). Professor Lie notified SEC investigators of the reporting problems as early as 2004. Jonathan Macey, Regulation and Scholarship: Constant Companions or Occasional Bedfellows?, 25 YALE J. ON REG. 305, 307 (2008). The investigation and talk of indictments escalated, however, only after the Wall Street Journal and New York Times began reporting the study’s early results. E.g., Charles Forelle & James Bandler, The Perfect
Moreover, access to reliable information subjects companies to marketplace and social accountability—that is, socially pressuring corporate actors to conform with community and cultural norms. These norms are often more stringent than securities laws, requiring compliance with the spirit of the law, not just the letter. Securities class actions’ transparent nature also exposes CEOs to discipline and accountability within the managerial labor market, namely losing their job without the possibility of other prospects. Thus, open proceedings as opposed to private arbitration, for example, foster social and marketplace accountability.

214 Wagner, supra note 213, at 704. This is true for both repeat player institutional investors and individual investors.

215 See Dan M. Kahan, What Do Alternative Sanctions Mean?, 63 U. CHI. L. REV. 591, 630–42 (1996) (examining deterrent effect of shaming penalties); Jerry L. Mashaw, Accountability and Institutional Design: Some Thoughts on the Grammar of Governance, in PUBLIC ACCOUNTABILITY: DESIGNS, DILEMMAS AND EXPERIENCES 125–26 (Michael W. Dowdle, ed., 2006) (examining accountability regimes generated by social networks). One study investigating reputational effects of financial fraud on outside directors found that “fraud is followed by a large and significant decline in the number of other board appointments held by outside directors.” Eliezer M. Fich & Anil Shivdasani, Financial Fraud, Director Reputation, and Shareholder Wealth 27 (Oct. 19, 2005) (unpublished manuscript), available at http://www.olin.wustl.edu/jfi/pdf/financial.fraud.pdf. Moreover, “[t]his decline is consistent with both a reputational penalty being borne by outside directors as well as an endogenous adjustment of monitoring expertise, where the expertise is reallocated to firms that are revealed to be more fraud-prone than previously expected.” Id. at 27–28. Some social accountability may also come from information gleaned through the grapevine as opposed to more formal reports.

216 See Cooter, supra note 154, at 15 (explaining that aligning law with social norms supplements sanctions); Kahan, supra note 158, at 349 (positing that social sanctions are cost-effective crime deterrent); Cass R. Sunstein, Social Norms and Social Roles, 96 COLUM. L. REV. 903, 944–47 (1996) (discussing “shame” in function of social norms).

217 See Niehaus & Roth, supra note 152, at 67 (“Thus, the managerial labor market appears to be the mechanism that is used for disciplining managers of firms subject to [securities class actions].”). But see Eric Helland, Reputational Penalties and the Merits of Class-Action Securities Litigation, 49 J.L. & ECON. 365, 366 (2006) (assuming that reputational penalties to officers and directors subject to securities class actions are proxy for meritorious lawsuits and concluding that fraud accusations had no negative reputational effect).
Second, transparency strengthens institutional legitimacy. When litigants submit disputes to the court, they reinforce the court’s reputation as an authoritative body. On this reflexive character, David Luban comments, “the more authority adjudication by courts carries, the more authority it will earn, both because it casts a longer and more firmly contoured shadow on out-of-court negotiations, and because its authority inspires more litigants to use it, further enhancing its authority.” Judicial legitimacy’s desirability must surely come down, at least in one respect, to producing norms and authority. That is, judges elaborate, refine, and explain public values. Both private and public actors reinforce these values through litigation, relying again on the judiciary to sanction breaches and clarify legislative ambiguities.

Thus, this translation process provides the foundation for a normative framework that guides future behavior. Put differently,

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218 See Tom R. Tyler, Does the American Public Accept the Rule of Law? The Findings of Psychological Research on Deference to Authority, 56 DePaul L. Rev. 661, 664 (2006) (“Transparency and openness foster the belief that decisionmaking procedures are neutral.”); see also Owen M. Fiss, The Social and Political Foundations of Adjudication, 6 Law & Hum. Behav. 121, 125 (1982) (“In America, the legitimacy of the courts, and the power they exercise in structural reform or for that matter in any type of constitutional litigation, is founded on the unique competence of the judiciary to perform their distinctive social function, which is . . . to give concrete meaning and application to the public values embodied in the Constitution.”).

219 See Luban, supra note 123, at 2625 (contrasting judicial resolution with other means of dispute resolution and noting that “when disputants turn elsewhere for resolution—private arbitration, nonjudicial government agencies, or private bargaining—the salience of adjudication fades and the authority of courts weakens”).

220 Id. Similarly, Judith Resnik observes, “through access, the public is educated, the judges and litigants and lawyers are supervised, and knowledge of legal requirements is disseminated.” Resnik, Wither and Whether, supra note 7, at 1114; see also Judith Resnik, Due Process: A Public Dimension, 39 U. Fla. L. Rev. 405, 405–27 (1987) (arguing that public’s role in decision making process is important component of due process).

221 See Planned Parenthood of Se. Pa. v. Casey, 505 U.S. 833, 865 (1992) (“The Court’s power lies, rather, in its legitimacy, a product of substance and perception that shows itself in the people’s acceptance of the Judiciary as fit to determine what the Nation’s law means and to declare what it demands.”).

222 See Luban, supra note 123, at 2626 (“[A]djudication, which produces rules and precedents, is instrumentally useful because these provide a normative framework for future transactions.”); Shuman, supra note 147, at 158 (“Social learning theory, however, is based on the premise that people observe that inappropriate (i.e. tortious) behavior is punished, and that appropriate (i.e. nontortious) behavior produces valued outcomes.”). I have argued elsewhere that nonclass settlements, in addition to arbitration and mediation, undermine the development of this framework. Burch, supra note 25, at 2545–46, 2550. That critique is not as widely applicable to putative securities fraud class actions since courts have decided that
litigation produces external societal norms that, in turn, can resolve matters without legal coercion. Take, for example, the recent class actions against Enron\textsuperscript{223} and Worldcom.\textsuperscript{224} Without exception, these class actions and the scandals that prompted them generated controversy, news, and debate.\textsuperscript{225} But they also reinforced norms and broadcasted judicial sanctioning of inappropriate behavior. They educated the public, and public outrage demanded legislative action. For better or worse, Congress responded with Sarbanes-Oxley.\textsuperscript{226} Thus, in a roundabout way, these public suits contributed to structural transformation.\textsuperscript{227} Even though litigants reached a settlement, it required court approval, which was published in a written opinion.\textsuperscript{228} Rule 23(e) fairness hearings, conducted in public courthouses, fostered public access.\textsuperscript{229} The average passerby could

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\textsuperscript{223} \textit{In re Enron Corp. Sec., Derivative & ERISA Litig.}, 228 F.R.D. 541, 567 (S.D. Tex. 2005) (approving partial settlement as being fair, reasonable, and adequate).

\textsuperscript{224} \textit{In re WorldCom, Inc. Sec. Litig.}, 388 F. Supp. 2d 319, 360 (S.D.N.Y. 2005) (considering and approving settlements in WorldCom litigation).

\textsuperscript{225} \textit{E.g., Ex-Enron Executive Sentenced to Prison}, N.Y. TIMES, June 19, 2007, at C8 (detailing former Enron executive Kenneth D. Rice’s plea and sentencing).

\textsuperscript{226} See Macey, supra note 193, at 957–58 (discussing proposal and enactment of Sarbanes-Oxley).

\textsuperscript{227} Burch, supra note 25, at 2550. Owen Fiss argues that transformation through litigation identifies a set of values that “stand as the core of a public morality and serve as the substantive foundations of structural litigation.” Fiss, supra note 218, at 124. He continues, asserting that “[t]he social function of contemporary litigation is not to resolve disputes, but rather to give concrete meaning to that morality within the context of the bureaucratic state.” Id.

\textsuperscript{228} \textit{E.g., In re WorldCom}, 388 F. Supp. 2d at 333 (“[C]lass notice] set a deadline of August 12, 2003 for any objections to the settlements and announced a September 9, 2005 fairness hearing . . . .”). \textit{In re Enron}, 228 F.R.D. at 544 (“A fairness hearing on the proposed settlement was held on August 19, 2004.”).

\textsuperscript{229} See FED. R. CIV. P. 23(e)(2) (requiring fairness hearing before proposed class action
wander in; the nation could watch on television or read about it in newspapers. In short, open process generated opportunities for public insight into how judges apply substantive laws and judicial procedures.230

What if, in lieu of public adjudication, disputes about Enron and WorldCom were privately arbitrated? Wouldn’t suits with such vastly public dimensions seem inherently suspicious, even Kafkaesque, if they took place behind closed doors? What are they doing in there? How did “they”—whoever they are—come up with that decision?231 As Immanuel Kant once observed, “[a]ll actions relating to the rights of other human beings are wrong if their maxim is not compatible with their being made public.”232 This is not to say that all private resolutions are suspect by nature. Rather, public law controversies, such as securities fraud cases, should be open for public scrutiny.233 As Justice Brandeis famously observed,


230 See Resnik, Whither and Whether, supra note 7, at 1103 (“The literal and material presence of adjudication stems in part from its performative qualities: much of the activity occurs in buildings open to the public.”); Jean R. Sternlight, Creeping Mandatory Arbitration: Is It Just?, 57 STAN. L. REV. 1631, 1662 (2005) (“[O]ur public court hearings educate the public and potential wrongdoers as to how the law is being interpreted, thereby deterring potential wrongdoers from violating the law, educating victims as to their rights, and inviting the public to take action to help reform the law should it not be satisfied with the public results.”).

231 One might level similar criticism at the jury deliberation process. That process, however, is subject to judicial checks through motions for new trial and motions for renewed judgment as a matter of law. FED. R. CIV. P. 50.


233 See Harry T. Edwards, Where Are We Heading with Mandatory Arbitration of Statutory Claims in Employment?, 16 GA. ST. U. L. REV. 293, 295 (1999) (“When public laws are enforced in the private fora, however, we have no assurance that the underlying public interests are fully satisfied.”); see also Harry T. Edwards, Alternative Dispute Resolution: Panacea or Anathema?, 99 HARV. L. REV. 668, 671 (1986) (suggesting that distinction between public and private law cases is not easily identifiable); Wagner, supra note 213, at 709 (“Litigation also may not serve the general public interest if the proceedings of a case are concealed. For example, if the litigants agree to seal damaging documents as a condition to settlement, then the courts can do little to dislodge this stubborn, privately held information.”). Although openness is important in national matters, such as securities fraud class actions, arbitration can function well in other areas of securities litigation. As Carrie Menkel-Meadow has argued, nonpublic settlements may serve some alternative interests such as “consent, participation, empowerment, dignity, respect, empathy and emotional catharsis, privacy, efficiency, quality solutions, equity, access, and yes, even justice.” Carrie Menkel-Meadow, Whose Dispute Is It
“Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”

Securities class actions affect the economy, the public, and investors worldwide; public access in these actions matters. Open hearings enable the public to observe state and federal actors generating social norms and enforcing ethical constraints on corporations that frequently appear untouchable. Class litigation thus levels and alters the typical dynamic’s respective power: individual versus the corporation.

IV. RECONCEIVING CLASS ADJUDICATION

But the securities class action and its leveling function are under attack. In her provocatively titled article, Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action, Myriam Gilles predicts the death of Rule 10b-5 class actions:

So if I am right—if we are entering a world where the requisite “agreement” to arbitrate is satisfied by notice-plus-acceptance of the product—then the door may be open just wide enough to impose collective action waivers in the classic 10b-5 fraud-on-the-market context, provided that there is sufficiently clear notice. . . . I can imagine, for example, a NASDAQ website listing companies who have elected to “opt out” of class action exposure.

We are not there yet, but we have reached a crossroads; even the Committee on Capital Markets Regulation recommends that the
SEC allow public companies to “opt out” of traditional securities litigation against an issuer and into arbitration by contracting with their investors.236 And Gilles is right: without a countervailing interest in public image and accountability, without some legislative or judicial stops, collective waivers “[m]ay [c]ome to [r]ule the [e]arth.”237 This section envisions what a world with government-centric enforcement might look like. The thought experiment that follows exposes the fundamental nature of process—made possible through public class litigation—that we take for granted.

A. DIS-IMPLYING A PRIVATE RIGHT OF ACTION—THROUGH THE LOOKING-GLASS238

Imagine that the SEC has abolished the private right of action under Rule 10b-5. What would enforcement entail? The simple answer is that private securities class actions would no longer complement the work of the exchanges or the SEC. Arbitration would assume a central and expanded role in exchange enforcement.239 Of course, the SEC could pursue fraud and insider trading. But imagine further that limited resources still hinder the SEC. Its regulatory role would evolve into one primarily of oversight and delegation, requiring it to outsource most enforcement actions to the exchanges, rely on administrative proceedings, and pursue only a limited federal court caseload. Granted, the thorny “circularity problem” about wealth transfers among diversified

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236 COMM. ON CAP. MKTS. REG., supra note 99, at 111 (recommending that SEC permit shareholders to adopt alternative procedures for dispute resolution, including arbitration).

237 Gilles, supra note 5, at 425.

238 This refers to Lewis Carroll’s children’s book, Through the Looking-Glass and What Alice Found There (1871). The full text is available at http://www.cs.indiana.edu/metastuff/looking/lookingdir.html. Here, I use the looking-glass as a two-fold metaphor: (1) to represent what the future might look like and (2) to demonstrate that removing the securities class action, when held up to the looking-glass, is not the remedy that some would like it to be.

239 Such a system is not so far-fetched. In fact, several commentators have called for all securities disputes to be submitted to arbitrators. See, e.g., Steven A. Ramirez, Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious As Well As the Frivolous, 40 Wm. & Mary L. Rev. 1055, 1063 (1999) (suggesting that arbitration could permit proper functioning of private enforcement). For a brief history of arbitration’s use in the securities industry, see Jennifer J. Johnson, Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration, 84 N.C. L. Rev. 123, 127–33 (2005).
investors minus transaction costs would be tidied up with the class action’s demise. And according to recent commission reports, national and foreign investors alike may again flock to American markets.

To be sure, this is an oversimplified picture and, in some ways, a strawman. Yet the point of this thought experiment is not to propose an alternative enforcement regime, such as expanding the SEC’s bounty model, but to suggest that securities class actions are a cornerstone in our system of democratic enforcement. This section envisions the absence of securities class actions and hypothesizes that, under the current system, the SEC would have to rely heavily on administrative proceedings and exchange-based arbitration to fill the enforcement deficit.

Notice that traditional securities law literature speaks of private rights of action as if they reduce market freedoms in a negative manner. But our very conception of this freedom includes the fruits of ex post regulation through private litigation. When we go through the looking-glass, we discover what is wrong: class action litigation emerges as a lynchpin preventing regulation from devolving further into bureaucracy and secrecy. As compared with

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240 See supra notes 108–14 and accompanying text.

241 The reports contain a variety of recommendations, only a few of which relate to securities class actions. See, e.g., COMM. ON CAP. MKTS. REG., supra note 99, at 11–13 (discussing reasons why businesses consider U.S. class action enforcement system so tough and recommending ways to improve private enforcement).

242 Joseph A. Grundfest has written a widely influential article explaining that “[t]he implied Rule 10b-5 private right, although well established under current law, is not immutable, and congressional action is not required to change its contours.” Joseph A. Grundfest, Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority, 107 HARV. L. REV. 961, 965 (1994).


245 See Burch, supra note 25, at 2519 (discussing positive externalities of class action litigation).

246 Granted, class litigation, conducted initially through plaintiffs’ consortiums and concluded through settlement fund administrators, comprises its own bureaucratic microcosm. See id. at 2545–46 (describing “new kind of system” created by class litigation). But trading
individual autonomy here is less troubling; without class litigation, it is economically inefficient to vindicate substantive rights. Moreover, class actions preserve intra-class transparency and participation opportunities for claimants during significant decisions such as whether to opt-out, to object to settlement terms, and to object to attorneys' fees.

1. Litigation as an Intermediate Good—Norm Production and Behavioral Conformity. Public litigation has two primary functions: (1) resolving disputes; and (2) defining, shaping, and clarifying the law to make behavioral modification and compliance possible. In this sense, judicial services are not “final goods” but “intermediate” goods supplying behavioral standards. As an outgrowth of the first function—dispute resolution—courts interpret and apply rules and laws. Particularly, when reduced to written opinions, these byproducts, these translations, map the outcome of future suits, sometimes permitting us to avoid suit altogether.

arbitration and administrative opinions' relative obscurity, the publicity that class litigation generates filters vital information. Moreover, public adjudication creates behavior-guiding precedent, which bolsters deterrence theory. And it fulfills litigants' preference for process. Just imagine. As you do, you may notice that as these sticking points develop, class litigation concerns lessen.

See Andrew D. Goldstein, Sealing and Revealing: Rethinking the Rules Governing Public Access to Information Generated Through Litigation, 81 CHI.-KENT L. REV. 375, 381–82 (2006) (suggesting that public access to judicial information advances several social goals, including enabling public to monitor judicial behavior, educating public, and informing citizens of opportunities for participation in system).

Burch, supra note 25, at 2519 (“[C]lass litigation] establishes rules of conduct that both delineate boundaries for acceptable social behavior and decrease the need for future lawsuits.”); see also Goldstein, supra note 247, at 383 (noting that broad public access to judicial information forms and shapes societal norms).


Id.

Id. at 236. Larry Solum contends, “[f]or adjudicative procedure to perform its action-guiding function well, procedures and their outcomes must be regarded as legitimate sources of authority for officials, third parties, and litigants…. If the system is seen as illegitimate or without authority, then the system may fail.” Lawrence B. Solum, Procedural Justice, 78 S. CAL. L. REV. 181, 189 (2004).
William Landes and Richard Posner describe rule formation’s social function as “a means of particularizing the standards of socially desired behavior in order to promote compliance [with rules].”254 Put simply, judicial precedent gives corporate managers a behavioral guide and hopes that, if followed, many litigants will avoid the process entirely. Arbitration does no such thing.255 Rather, it is biased against creating binding precedent or rules of any sort. A party who knew it would lose because of an arbitrator’s previous decisions would refuse to use that arbitrator.256

Posner and Landes thus liken adjudication to a public good. They reason that arbitration might perform the dispute resolution function well enough, but to explain the result in behavior guiding ways “would be to confer an external, an uncompensated, benefit not only on future parties but also on competing judges.”257 To this idea, David Luban adds, “[a]lthough the original litigants of the cases ‘purchase’ the rules, future litigants use these rules without paying,” which thus creates a free rider problem.258 Precedent created through adjudication, like other public goods, thus requires governmental and litigant subsidies.259 Litigants, understandably,

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254 Landes & Posner, supra note 251, at 236; see also Luban, supra note 123, at 2622–23 ("Rules and precedents, in turn, have obvious importance for guiding future behavior and imposing order and certainty on a transactional world that would otherwise be in flux and chaos.").

255 Some commentators argue that even traditional judicial process does not create a behavioral guide because so many cases settle. See, e.g., RALPH C. FERRARA & DANNY ERTEL, BEYOND ARBITRATION: DESIGNING ALTERNATIVES TO SECURITIES LITIGATION § 2.25 (1991) (noting that frequent objection to use of arbitration interferes with common law process of refining and specifying law). This argument, however, ignores the potential for judges to clarify the law through motions to dismiss for failure to state a claim, motions for class certification, and motions for summary judgment. Moreover, any certified class settlement is subject to a judicial fairness hearing evaluating the settlement’s adequacy. Fed. R. Civ. P. 23(e).

256 See Richard H. McAdams, The Expressive Power of Adjudication, 2005 U. ILL. L. REV. 1043, 1111–12 (describing impact of perceived bias on arbitrator selection); see also Landes & Posner, supra note 251, at 239–40 (“Any rule that clearly indicates how a judge is likely to decide a case will assure that no disputes subject to the rule are submitted to that judge since one party will know that it will lose.”).

257 Landes & Posner, supra note 251, at 238; see also McAdams, supra note 256, at 1114 ("[A] private market will supply an optimal amount of dispute resolution, but not an optimal amount of dispute avoidance.”).

258 Luban, supra note 123, at 2623.

259 See McAdams, supra note 256, at 1114–16 (observing that government-paid fixed salaries “avoids motivating selfish adjudicators to maximize future disputes”).
have little desire to subsidize precedent when they do not foresee themselves becoming involved in similar future litigation. This problem is ubiquitous in public goods. But recall that both defendant corporations and institutional lead plaintiffs are often repeat players. Thus, unlike most litigants, these players have some incentive to invest in precedent and adjudicative clarification and less motivation to opt-out of public adjudication.

NYSE arbitral decisions confirm the theory that arbitration stymies precedent production. Although the exchanges make the win-loss decision public, the decision is simply a cursory summary. Decisions have no precedential value. They contain little more than the litigants’ names, filing date, hearing dates, decision dates, a one sentence case summary, a two to three sentence decision, and the award amount. There is no way to standardize legal principles from case to case. This makes impossible any hope of treating

260 Id.
261 Id. ("[D]isputants will invest only to the point where the marginal private costs equal their marginal private benefits.").
262 See infra notes 313–16 and accompanying text.
263 See KAREN KUPERSMITH, PLI, A GUIDE TO ARBITRATION AT THE NEW YORK STOCK EXCHANGE 16 (2006), http://www.nyse.com/pdfs/arb_usersguide.pdf (last updated Jan. 2006) ("Generally, arbitration awards simply state whether a party succeeded in proving its claim and, if so, the amount of any monetary award or other relief, or whether the claim was dismissed; there is usually no explanation as to how the arbitrators reached their decision.").
265 Moreover, the NYSE rules explicitly refuse to entertain class actions. NYSE, Inc., Arbitration Rules, Rule 600(d), available at http://wallstreet.cch.com/NYSE/Search (search for “600(d)”; then follow “Rule 600.Arbitation” hyperlink) (prohibiting class arbitration); id. at 627(f), available at http://wallstreet.cch.com/NYSE/Search (search for “627(f)”; then follow “Rule 627.Awards” hyperlink) (“The awards shall be made publicly available, provided however, that the name of the customer party to the arbitration will not be publicly available if he or she so requests in writing."
similarly situated people or corporations similarly.\textsuperscript{266} Arbitration thus creates an overriding concern that is more problematic than the neglected behavior-guiding function. It creates a problem with transparency.

Expanding arbitration and eliminating class actions’ part in \textit{ex post} regulation prompts two deterrence-based critiques. First, arbitration’s opaque, private nature keeps decisions in the shadows; decisions are subject to neither public scrutiny nor traditional appellate review.\textsuperscript{267} In fact, arbitration advertises confidentiality and privacy as hallmark features.\textsuperscript{268} Confidentiality shields pleadings, testimony, and documents from the investing public.\textsuperscript{269} Granted, this is less problematic in disputes that involve the public indirectly, such as broker-customer quarrels, but when the public cannot observe the administration of justice on a matter directly affecting investors and stock prices, such as securities fraud, the public might rightly conclude that there is something to hide, something like agency inaction, industry bias, or self-interest.\textsuperscript{270}

\textsuperscript{266} See Sternlight, supra note 230, at 1662 ("The fundamental premises of the ‘rule of law’ are that similarly situated persons should be treated similarly under the law and that persons of privilege or influence should not receive special treatment.").


\textsuperscript{268} E.g., KUPERSMITH, supra note 263, at 1 ("[T]he hearings all share one common element—they are generally not open to anyone who is not a named party, a corporate representative of a named party, or an attorney of a party. Since privacy and confidentiality are two of the hallmarks of arbitration, those not directly involved may only observe the proceedings with the consent and permission of all the parties and arbitrators.").


\textsuperscript{270} See supra notes 209–33 and accompanying text. Perceptions of bias are prevalent in securities arbitration. See, e.g., Sung J. Lim, \textit{Mandatory Arbitration in the Securities Industry: Efficiency at the Cost of Justice for All?}, 26 J. CORP. L. 771, 801 (2001) (arguing that swift justice through arbitration “is not always fair”); Cheryl Nichols, \textit{Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias}, 15 OHIO ST. J. ON DISP. RESOL. 63, 127 (1999) ("There is likely to remain an appearance of impropriety in the arbitrator selection process because of ambiguity, under-inclusiveness, and over-inclusiveness in the arbitrator classification system combined with too much securities industry discretion in the appointment process of a securities industry sponsored and administered arbitral forum."); Marc I. Steinberg, \textit{Securities Arbitration: Better for Investors than the Courts?}, 62 BROOK. L. REV. 1503, 1531 (1996) (arguing that most investors would likely prefer jury trial to arbitration); see also Steven B. Caruso, \textit{Ethical Standards for Securities Arbitrators: A
Second, arbitration opinions fail to articulate decisions in ways that instruct behavior. This creates future disputes that litigants could have avoided. While this benefits arbitrators by generating more business, it burdens officers and directors with additional disputes. Conversely, because class action litigation elicits opportunities for judges to construe and explain securities laws, standards, rules, and procedures, it enables corporate actors to adhere to public values. Arbitration thus erodes opportunities to give force to and interpret these values. Moreover, in class action litigation, even when it ends in a certified settlement subject to an open fairness hearing, litigants can see conflict patterns and sanction or settlement variations. This knowledge shapes underlying norms and opens a forum for debating appropriate penalties. For instance, debates over penalties, procedures, and fora led Congress to enact the PSLRA, SLUSA, and Sarbanes-Oxley. Regardless of whether these Acts were positive or negative developments, the public dialog leading to their enactment furthered fundamental democratic notions.


271 See Luban, supra note 123, at 2622–23 (“Rules and precedents, in turn, have obvious importance for guiding future behavior and imposing order and certainty on a transactional world that would otherwise be in flux and chaos.”); Shuman, supra note 147, at 123 (contending that need for certainty in deterrence theory requires that tort law have clear, understandable behavioral standard).

272 See McAdams, supra note 256, at 1112–14 (arguing that arbitration and other forms of private adjudication do not supply optimal amount of dispute avoidance); see also Owen M. Fiss, Against Settlement, 93 YALE L.J. 1073, 1089 (1984) (“Civil litigation is an institutional arrangement for using state power to bring a recalcitrant reality closer to our chosen ideals.”).

273 Resnik, supra note 211, at 536.

274 See id. (“By knowing and seeing many claims of right, the judgments made, and the forms of sanctions imposed, a range of individuals and of groups can debate what sanctions are appropriate and, more basically, what the underlying norms ought to be.”).

Arbitration stops this norm-producing function. Using deterrence and social learning theory, we can also hypothesize that arbitration results in suboptimal deterrence since officers and directors will be less certain about which behaviors might result in a penalty. Overall then, a world without securities class litigation would be one with less guiding precedent, less transparency, less public conversation, more uncertainty and fraud, and with cases that correspond to one another only coincidentally.

Moreover, arbitrations make marketplace justice impossible. The public has little insight into corporate misdeeds affecting the American economy and thus can express neither outrage over an “unfair” decision for a market favorite nor boycott products or services produced by corporate miscreants. But achieving this accountability is impossible when the information needed for consumers to self-select is kept private. Judith Resnik observes on this point, “[t]he public as an audience has an important role in witnessing, in interpreting, in owning, and in disowning what has

276 See Burch, supra note 12, at 380–83 (arguing that “until would-be violators can approximate the cost of a penalty, they will be unable to adjust their behavior accordingly”); Cooter, supra note 154, at 21 (“Law and social norms have complementary strengths as means of social control. . . . The promulgation of a law often transforms a vague principle with an imprecise sanction into an explicit obligation with a definite sanction.”); Shuman, supra note 147, at 158 (“Social learning theory, however, is based on the premise that people observe that inappropriate (i.e. tortious) behavior is punished, and that appropriate (i.e. nontortious) behavior produces valued outcomes.”). But see FERRARA & ERTEL, supra note 255, at 53 (challenging argument that private resolution of securities disputes will undermine disclosure and deterrence goals of securities laws).

277 See Luban, supra note 123, at 2641 (hypothesizing existence of world without adjudication); Sternlight, supra note 230, at 1664 (“Clearly, when disputes are resolved in private settings, such as binding arbitration, typically neither public access nor public precedent are assured.” (footnote omitted)).

278 See generally MICHAEL D. BAYLES, PROCEDURAL JUSTICE: ALLOCATING TO INDIVIDUALS 42 (1990) (“Public rules and principles allow people to plan their activities to conform to them, and this reason applies whether the rules impose burdens or confer benefits.”). Bayles recounts a story of a female shoplifter who received a harsher sentence than usual. After the newspaper ran the story, public outrage prevented a continued crack down on other shoplifters. Id. at 42–43. These “social effects” include reputational losses, business losses, and emotions such as shame and guilt. Many academics consider these substantial nonlegal sanctions. See, e.g., Robert Cooter & Ariel Porat, Should Courts Deduct Nonlegal Sanctions from Damages?, 30 J. LEGAL STUD. 401, 405–10 (2001) (discussing consequences of nonlegal sanctions); see also Mashaw, supra note 215, at 122 (comparing market accountability to public law accountability).
occurred.”

2. Bureaucracy and Privatization. Increased arbitrations will not be the only hallmark feature of a system that shelves private class actions; the SEC will have to rely extensively on administrative law judges. Recall that there are only 3,600 SEC staff to oversee some 10,000 publicly traded companies, investment advisers managing approximately $32 trillion in assets, 1,000 fund complexes, 6,000 broker-dealers, and $44 trillion worth of trading per year. Without private litigation complementing SEC efforts, increased bureaucratization is inevitable. Even now, with private class litigation, the SEC initiated only 218 civil proceedings as compared to 356 administrative law proceedings.

But what is undesirable about expanding bureaucracy through administrative agencies if it sustains—and even advances—enforcement of securities laws? True, bureaucratization is a pragmatic solution, and it has existed since the class action’s inception. On the positive side, administrative agencies dealing daily with securities cases develop specialized knowledge and consistently interpret statutes. Moreover, administrative bodies
oversee the network of securities laws and can thus uniformly apply law to divergent facts. But at some point, administrative agencies become wedded to their own precedent—cherishing outmoded interpretations and eschewing creative approaches. Thus, specialization can become myopic and self-serving, eliminating the laboratory value of polycentric litigation.

Further, bureaucratization responds to a perception that litigants are less satisfied with process causing cost and delay. And while extreme cost and delay is troubling, there is no correlation between public perception of procedural justice and litigant cost or case duration. Rather, litigants value participation opportunities, neutral arbiters, and the formality and ritual of court process. Dignified procedures associated with judicial proceedings cloak them in legitimacy, enhance authority, and suggest to litigants that the justice system takes them and their dispute quite seriously. Administrative bureaucracies often lack these characteristics.

interpretive questions in an ideologically consistent manner within a given time period.

287 Kalven & Rosenfield, supra note 74, at 719.
288 But see Coates, supra note 196, at 543 (arguing SEC has not “suffered from bureaucratic inertia”).
291 See LIND ET AL., supra note 290, at 66–67 (finding that perception of fairness can be enhanced by improving perceptions of dignity and procedural care); Deborah R. Hensler, Suppose It’s Not True: Challenging Mediation Ideology, 2002 J. DISP. RESOL. 81, 95 (listing factors important to perceptions of procedural fairness, including lack of bias, thoroughness, and “dignitary values”); Lind et al., supra note 290, at 981 (“Apparently, what has been overlooked in previous analyses of the likely reactions of litigants to traditional trial procedures is the considerable importance that litigants attach to being treated with respect and dignity. . . . Given our findings, it seems likely that these very features of trial enhance, rather than diminish, the apparent fairness of the procedure.”).
292 Lind et al., supra note 290, at 981 (“[T]hat their case was deemed important enough to receive so respectful a hearing was probably quite flattering. After all, the trial was in all likelihood one of the most meticulous, most individualized interactions that the litigant had ever experienced in the course of his or her contacts with government agencies.”).
Bureaucracy diffuses responsibility and distances litigants from the decision maker, erecting participation barriers and prompting concerns about legitimacy and authority.\(^{293}\) This distance suggests just the opposite of judicial process to litigants: their dispute appears less important. Legitimate process—process giving force to public values—relies on judges to infuse these values with meaning.\(^{294}\) This translation process requires judicial independence, separation from politics, and insulation from economic pressures.\(^{295}\) As children of the political process, administrative agencies such as the SEC have far less independence than Article III judges.\(^{296}\)

In addition to lacking independence, bureaucracies alienate litigants. Because they separate the judge from the participants, critics label bureaucracies “rule by nobody.”\(^{297}\) Moreover, diffusing process into multifaceted organizational structures causes a loss of control, sometimes even to those administering the organization.\(^{298}\) This loss then contributes to biases such as turf protection, risk aversion, and routine, rather than innovation and reassessment.\(^{299}\)

\(^{293}\) See Freeman, supra note 50, at 545 (“Since the New Deal explosion of government agencies, administrative law has been defined by the crisis of legitimacy and the problem of agency discretion.”). But see Rubin, supra note 179, at 2074 (arguing that hostility to bureaucracy is based on nostalgia).

\(^{294}\) Fiss, supra note 218, at 125; see also Owen M. Fiss, The Bureaucratization of the Judiciary, 92 YALE L.J. 1442, 1443 (1983) (“Bureaucratization poses a unique challenge to the legitimacy of governmental power.”).

\(^{295}\) See Fiss, supra note 218, at 125 (“The judiciary’s competence and thus its legitimacy depends upon adherence to these two qualities of process—dialogue and independence—not on the willingness of the people to consent to particular outcomes or on people’s capacity to appoint or remove the individuals who hold the public office.”); McAdams, supra note 256, at 1112 (“The traditional justification for impartiality is legitimacy—that individuals comply with an adjudicative outcome because they perceive it to be legitimate, and they will only perceive it to be legitimate if it is unbiased.”).

\(^{296}\) See supra notes 192–98 and accompanying text.

\(^{297}\) See Alexandra D. Lahav, The Law and Large Numbers: Preserving Adjudication in Complex Litigation, 59 FLA. L. REV. 383, 393 (2007) (“The alienation argument is based on the criticism that bureaucracy is a rule by nobody.”); see also Fiss, supra note 294, at 1458 (commenting that where “[r]esponsibility is shared with the multitude of other judges and with the impersonal forces and inanimate mechanisms that so pervade complex organizations [then] the Rule of Nobody becomes triumphant”).


\(^{299}\) Id.; see also Elena Kagan, Presidential Administration, 114 HARV. L. REV. 2245, 2354 (2001) (“A given agency decision (or nondecision) might derive instead from congressional pressure, interest group lobbying, bureaucratic (but nonexpertise-based) policy views, or
There is less internal accountability.\textsuperscript{300} Bureaucratic hierarchy is, in reality, amorphous.\textsuperscript{301} All of this suggests that substituting agency justice—justice administered, pursued, and developed by the SEC through administrative law judges—and exchange arbitrations may dilute legitimacy and constitute a second best substitute.\textsuperscript{302}

Still, the pivotal question, as posed by Adam Pritchard, is “who cares”?\textsuperscript{303} Aren’t class members oblivious to proceedings on their behalf? After all, most investors cannot even be bothered to collect their settlement funds.\textsuperscript{304} The answer goes beyond the lawsuit’s litigants and even beyond class members bound by the settlement. It is true that process is crucial for defining and notifying class members and for determining a settlement’s preclusive effect. But the real answer is this: without access to courts and without procedural legitimacy, the system may fail.\textsuperscript{305} So law fails. And deterrence falters. Actors are less likely to be deterred by—or to

\textsuperscript{300} See Mashaw, supra note 215, at 124 (suggesting that bureaucratic authority systems lack authority-based accountability, as superiors must negotiate for authority rather than command it).

\textsuperscript{301} See Bruce Ackerman, The New Separation of Powers, 113Harv. L. Rev. 633, 696 (2000) (“[I]n fact there are tons of bureaucratic documents produced each year throughout the world that reveal an appalling ignorance of the complex social and economic relationships they purport to regulate.”).


\textsuperscript{304} See Solm, supra note 253, at 189 (“If a system is seen as illegitimate or without authority, then the system may fail.”); see also McAdams, supra note 256, at 1110–15 (discussing trade-off between dispute resolution and dispute avoidance); Judith Resnik, Failing Faith: Adjudicatory Procedure in Decline, 53 U. Chi. L. Rev. 494, 545 (1986) (“Adjudication is far from perfect. But what it offers is decisionmaking by government-empowered individuals who have some accountability both to the immediate recipients of the decisions and to the public at large.”). Bureaucracy undermines the fundamental right of access to the courts, a “right conservative of all other rights, and [one that] lies at the foundation of orderly government.” Chambers v. Baltimore & Ohio R.R., 207 U.S. 142, 148 (1907); see also Byland v. Shapiro, 708 F.2d 967, 971 (5th Cir. 1983) (reaffirming fundamental importance of right of access to courts).
comply with—sanctions rendered through an illegitimate, concealed process. Thus, transparent, legitimate procedures matter a great deal.

Bureaucratic enforcement of securities laws, on the other hand, begs the question: to what extent are we willing to accept second-best practices for claims that strengthen the *ex post* regulatory system? Absent a private right of action, the SEC must forge an elaborate infrastructure featuring exchange arbitration and administrative law just to function. But this alternative “process” is sterile, estranged, and secretive. And that is the crux of the trade-off.

3. Litigant Preference for Adversarial Litigation. Of course, what is traded is no longer the trial. A recent study indicated that “federal courts actually tried fewer cases in 2002 than they did in 1962, despite a fivefold increase in the number of civil filings.” The rise of administrative proceedings and arbitration in both our hypothetical world and in the real world contributes to a growing trend toward privatization, confidentiality, and settlement. And still, litigants report a preference for adversarial litigation. While one

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307 See Lahav, *supra* note 297, at 431 (“Transparency is critical to a humanized bureaucracy . . . .”).


309 See Refo, *supra* note 289, at 2 (emphasis omitted); see also id. (“Total civil jury trials went from 2,765 in 1962, to 3,361 in 1972, to 4,771 in 1982, and then dropped to 4,279 in 1992, down to 3,006 in 2002.”).

310 See Hensler, *supra* note 291, at 81–95 (discussing findings that litigants prefer adversarial trial procedures to alternatives such as mediation); John Lande, *How Much Justice Can We Afford?: Defining the Courts’ Roles and Deciding the Appropriate Number of Trials, Settlement Signals, and Other Elements Needed to Administer Justice*, 2006 J. Disp. Resol. 213, 223 (2006) (“The vast majority of litigants value courts as legitimate institutions to assume jurisdiction, administer paperwork, adjudicate pretrial disputes, manage the dispute resolution process in an orderly way, and enforce decisions.”); Judith Resnik, *Mediating Preferences: Litigant Preferences for Process and Judicial Preferences for Settlement*, 2002 J. Disp. Resol. 155, 155–56 (2002) (finding that litigants were more satisfied when they were able to participate in court-based processes).
early study in the 1980s revealed satisfaction with any trial-like procedure in which litigants could participate,\footnote{Lind et al., supra note 290, at 980–82; see also Lind et al., supra note 290, at 65 (suggesting link between notions of procedural fairness and preference for dispute resolution method).} that preference may be narrowing to judicial adjudication.

More recently, a study by Theodore Eisenberg and Geoffrey Miller demonstrated this narrowed preference.\footnote{Eisenberg & Miller, supra note 263, at 335.} It reached a stark finding: out of 2,800 contracts filed with the SEC, only 11% opted for arbitration in lieu of the judicial system.\footnote{Id. at 345. These results were contrasted with nonrelational contracts such as “asset sales, bond indentures, mergers, securities purchase agreements, and underwritings.” Id. at 345.} Eisenberg and Miller concluded that “[t]he infrequency of arbitration clauses . . . suggests that sophisticated contracting parties may not, in fact, believe in the purported benefits of arbitration over litigation.”\footnote{Id. at 350; see also Theodore Eisenberg, Geoffrey P. Miller & Emily L. Sherwin, Arbitration’s Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts 6 (Cornell Law Sch. Legal Studies Research, Working Paper No. 08-017, 2007), available at http://ssrn.com/abstract=1076968 (concluding that companies prefer litigation as means of dispute resolution).} Naturally, corporate actors may change their minds if they believe that an arbitration agreement could include a collective action waiver allowing them to opt out of class action exposure.\footnote{See Gilles, supra note 5, at 427 (suggesting that proliferation of collective action waivers provides incentives for inclusion of arbitration agreements).} Still, this study suggests that litigants may no longer be satisfied with arbitration; rather, there is a distinct preference for traditional judicial process.\footnote{See Eisenberg & Miller, supra note 263, at 374 (“In the simple economic view, our results suggest that corporate representatives believe that litigation can add value over arbitration.”.)} And without a private right of action—that is, without a securities class action—exchange arbitrations and SEC administrative proceedings will eclipse and extinguish traditional process.

B. REMEMBERING THE CLASS ACTION SUIT’S “CONTEMPORARY” FUNCTION
This desire for adversarial litigation partially explains why the class action’s contemporary enforcement function is neither outdated nor inept. But the principal reason is synonymous with the historical rationale for Rule 23. A 1937 SEC report captured it perfectly:

The wide diffusion of securities has created a situation where the single and isolated security holder usually is helpless in protecting his own interests or pleading his own cause. The plight of the individual investor is accentuated where he is uninformed and unskilled in the intricacies of finance. It is likewise accentuated where his investment is so small that it becomes either impossible or improvident for him to expend the funds necessary to prosecute his claims or defend his position. Absent securities class actions, vindicating rights is not economically feasible. So what could be securities enforcement’s future is merely historical repetition.

Fifty years ago, Harry Kalven and Maurice Rosenfield recognized the truth behind the SEC’s 1937 report in their legendary article, *The Contemporary Function of the Class Suit*. Without the private class action as a supplemental tool in securities regulation and with its strict ban in exchange arbitration, it is easy to imagine a return to their view of institutional incapacity: “If each is left to assert his rights alone if and when he can, there will at best be a random and fragmentary enforcement, if there is any at all.” They theorized

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317 Granted, class litigation has become less adversarial in the traditional sense. See *generally* William B. Rubenstein, *A Transactional Model of Adjudication*, 89 GEO. L.J. 371 (2001) (arguing that class action lawsuits have more in common with business deals than with traditional adversarial litigation).


that private actors pursing class litigation and public institutions, such as the SEC, should work “side by side to check and complement each other.”

While envisioning this joint endeavor, contrast the private class action’s easy elegance with administrative agencies’ institutional awkwardness. By “awkwardness,” I mean that agencies in particular are constrained by politics and their own bureaucracy. This is not to say that class certification is streamlined—the certification process is unwieldy—but that the securities class action plaintiffs’ bar is generally unhindered, at least on the front end, by funding issues and authorization requests. Moreover, the private right of action harnesses the class action bar’s inventiveness and capacity to serve ostensibly public goals.

The bottom line is this: laws and practices designed to reign in class actions do more than that. They change the dynamic between (primarily) complementary sources of ex post regulation through litigation. They weaken or eclipse class litigation’s positive spillover effects, thereby narrowing public educational opportunities and increasing bureaucracy. To be sure, there is some tension between public and private regulators. But integrated regulation—mixing public and private—also enriches discussions about longstanding questions over legitimacy and transparency.


321 Kalven & Rosenfield, supra note 74, at 721.

322 See David Marcus, Erie, The Class Action Fairness Act, and Some Federalism Implications of Diversity Jurisdiction, 48 WM. & MARY L. REV. 1247, 1286 (2007) (“Lawyers and commentators have long recognized that class actions play significant roles as instruments of economic regulation.”); see also Freeman, supra note 50, at 548–49 (suggesting that private actors are capable of contributing to efficacy of administration and serving public goals).

323 See Jackson & Roe, supra note 194, at 2 (“The data here do not, however, have public enforcement uniformly trumping private enforcement.”).
rhetoric—rhetoric recognizing class actions only as byproducts of attorney self-interest—must change.

V. CONCLUSION

If we consider that layering private regulation atop SEC and exchange enforcement enhances legitimacy, accountability, transparency, and deterrence, then we must surely appreciate the external benefits that outer stratum provides. But this securities class action defense—this claim that it furnishes a public good with beneficial spillovers—does not purport to end debates over *ex post* regulation.

Nobody denies that there are lingering doctrinal and jurisprudential concerns over litigation’s transaction costs and excessive back-end regulation. These concerns are, perhaps, a battleground best defended by securities class action critics. And yet, any debate over securities regulation’s future should recognize private class litigation’s comparative institutional capability to make transparent an increasingly opaque process, craft decisional rules and interpretations that guide future behavior, cultivate innovation, deter fraud, and hold corporations, exchanges, and the SEC publicly accountable. Still, much research and debate are needed to clarify the point at which *ex post* regulation through litigation crosses the threshold from socially productive to economically destructive. Even then we must contemplate the bigger picture of institutional design. The lesson for institutional reformists is this: to be cognizant of what awaits securities regulation at the crossroads; reconsider what is at stake. It just might be that the securities class action’s awkward operation may seem elegant and admirable in comparison.
VI. APPENDIX

PUBLIC ENFORCEMENT EFFORT

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<thead>
<tr>
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<th>2000–2002</th>
<th>2005</th>
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<tr>
<td>SEC Actions</td>
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<td>DOJ Prosecutions</td>
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PUBLIC SANCTIONS\textsuperscript{328}

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<tr>
<td>SEC Monetary Sanctions</td>
<td>$801,333,333\textsuperscript{329}</td>
<td>$3.1 billion (ordered)\textsuperscript{330}</td>
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\textsuperscript{324} Jackson, supra note 19, at 27.
\textsuperscript{328} During this period the SEC was also responsible for 358 non-monetary civil sanctions, which include suspensions, expulsions, and censures. Jackson, supra note 19, at 27.
\textsuperscript{329} Id.
\textsuperscript{330} U.S. SEC. & EXCH. COMM’N, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT, supra note 325, at 47. This figure inaccurately compares with the 2000–2002 average because the Sarbanes-Oxley Act was passed in 2002. The “fair funds” provision in this Act permits the SEC to use disgorgement funds to compensate injured parties, so the SEC has been more inclined to order disgorgement as a penalty. Id.
EXCHANGE ENFORCEMENT EFFORT

Annual Averages

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<th>2000–2002</th>
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<td>Total Exchange Enforcement</td>
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EXCHANGE SANCTIONS

Annual Averages

Monetary Sanctions

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331 Jackson, supra note 19, at 27.
333 Jackson, supra note 19, at 27.
334 NYSE, Inc., NYSE Regulation, How Regulation Works, Enforcement, http://web.archive.org/web/20060615084337/http://www.nyse.com/regulation/howregworks/1022221394131.html (last visited Oct. 9, 2008). The NYSE reports that of the 196 cases it prosecuted, 58 were against member firms and 138 were against individuals. Id.
336 Id.
337 Id. The figure for 2000 could not be located.
338 Id.
339 Jackson, supra note 19, at 27.
340 Id. In 2005, the NYSE awarded $27.7 million in disciplinary sanctions. NYSE, Inc., supra note 334.
341 Jackson, supra note 19, at 27.
Non-Monetary Civil Sanctions\textsuperscript{343}

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**PRIVATE ENFORCEMENT ACTIONS**

**Annual Averages**

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**PRIVATE MONETARY SANCTIONS**

**Annual Averages**

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\textsuperscript{343} All of the Non-Monetary Civil Sanctions figures were adopted from Jackson, supra note 19, at 27.

\textsuperscript{344} Id.


\textsuperscript{346} Id.

\textsuperscript{347} Id. at 5 (providing that in 2000, settlement amount was $16 million; in 2001, settlement amount was $14 million; in 2002, settlement amount was $24 million). Class action trial awards accounted for another $17,626,000. Jackson, supra note 19, at 27.

\textsuperscript{348} MILLER, FOSTER & BUCKBERG, supra note 345, at 5.