# *Fighting Fraud on Faith: Federal Securities Regulation and the Limits of Disclosure*

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# ABSTRACT[**]

In the past ten years, Congress passed three major reform acts to address two diametrically opposed concerns: It first restrained what it believed was an excess of securities fraud *litigation*, then responded to an explosion of securities *fraud.* This Article contends that despite the competing provocations and ambitions of the reforms, they share an unwarranted adherence to the principle of disclosure as the best means to attack market malfeasance: The Article examines the basis for and consequences of that undeserved legislative fidelity. Applying behavioral economics and cultural theory to the recent legislation and its underpinnings, the Article concludes that a resilient faith in the integrity and possibilities of markets has displaced critical examination of market practices. Because Congress resists the more complex and irregular descriptions of markets that behavioral economists provide and instead relies ever more heavily on disclosure, legal models remain far too simple to capture much real world behavior – including the many possible permutations of fraud. This misplaced faith in the preventive power of disclosure impedes efforts to deter, detect and punish securities malfeasance. This Article suggests an alternative. Drawing on skeptical philosophy, it proposes a conceptual framework and practical reforms that avoid extremes and accommodate change. The skeptical approach advocated here acknowledges the benefits of disclosure, but contends that securities regulations also must recognize its limitations. The Article suggests that by questioning its assumptions, broadening its approach, and redirecting its resources toward a more diverse range of regulatory mechanisms, Congress could craft securities regulations that recognize the market's imperfections and better protect its participants from fraud.

[**] This Article is approximately 27,500 words long, including footnotes.

# Fighting Fraud on Faith:
# Federal Securities Regulation and the Limits of Disclosure

*Every individual necessarily labors to render the annual revenue of the society as great as he can. . . . He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.*
*Adam Smith*

*Faith is the substance of things hoped for, the evidence of things not seen.*
*The Epistle of Paul, 11:1*

In his recent book, Nobel Prize-winning economist Joseph Stiglitz describes the federal government's economic decision-making as an exercise of faith – "faith in words, in mystical notions of confidence, in the so-called wisdom of the financial markets."[1] He explains that although "everyone" involved in certain major decisions recognized that key assumptions about market behavior were unrealistic "there was a hope . . . that if the real world did not depart too much from such assumptions . . . Adam Smith's invisible hand theory would still provide a good description of the economy."[2] This, Stiglitz warns, "was a hope based more on faith – especially by those whom it served well – than on science."[3]

Faith in the "wisdom of the financial markets" is not merely a figure of speech, but a meaningful description of a frequent basis for federal

[1] JOSEPH E. STIGLITZ, THE ROARING NINETIES 151 (2003).
[2] *Id.*
[3] *Id.*

regulatory decisions. As Stiglitz intimates, traditional economic explanations are no longer accurate descriptions of the way financial markets function. Economists and behavioral psychologists have rejected traditional models of market behavior, having found that "[w]hile [they] have their place as illustrations of characterizations of an ideal world, we cannot maintain them in their pure form as accurate descriptors of actual markets."[4] Instead, behavioral economics cautions that "we have to distance ourselves from the presumption that financial markets always work well and that price changes always reflect genuine information."[5] Legislative reforms have failed to adapt to this altered assessment, however. While they appear to acknowledge, assess, and respond to instances of actual or purported market failure, the enacted reforms manifest a continued faith in presumptions of questionable validity.

This Article argues that trust in traditional assumptions regarding the prophylactic powers of information distribution continues to constrain government efforts to guard the integrity of the financial markets. It contends that although Congress attempts to respond to real or alleged market breakdowns, its adherence to suspect models prevents it from adequately understanding or responding to those malfunctions. Because they resist the more complex and irregular descriptions of markets that

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[4] Robert Shiller, *From Efficient Markets Theory to Behavioral Finance*, 17 J. ECON. PERSPECTIVES 83, 103 (2003) (discussing the efficient market hypothesis in particular).
[5] *Id.*

behavioral economists provide, legal models remain far too simple to capture much real world behavior – including the many possible permutations of fraud. Legislative reforms instead tend to affirm the integrity and legitimacy of markets with an insistence that resonates as faith: as the substance of things hoped for, but not seen. This Article suggests that by reasserting without reconsidering the integrity of the market, Congress misses opportunities to deter fraud and in fact may enact regulations poorly tailored to enhance market monitoring. Drawing on economic and cultural theory to examine securities regulation and litigation, the Article proposes that faith in markets has tainted law's responses to claims of securities fraud. It argues that congressional resistance to claims that the securities markets are incompletely efficient and consistently susceptible to fraud stems from entrenched belief, not from open evaluation of the validity of these challenges and, as a result, tends to err too much towards deference to and defense of market self-policing.

While it is necessary and appropriate for courts and Congress to limit nuisance suits and to regulate malfeasance, when monitors' responses rest on faith, they tend to rely too much on disclosure to prevent damages *ex ante* and too little on enforcement[6] to discover and compensate for them *ex poste*. Instead of designing a framework that encourages meritorious

[6] For ease of reference, I will use the term "enforcement" to refer to all forms of litigation – including SEC enforcement actions, state and federal criminal prosecutions and civil litigation.

litigation to play a monitoring and deterrence role, faith in markets has induced over-reliance on disclosure to deter and expose wrong-doing. Even the Sarbanes-Oxley Act,[7] which purported to respond to the massive financial frauds of the boom years by dramatically increasing measures designed to ensure market integrity, reflects this unwarranted faith. This Article proposes that Congress should replace faith with skepticism and be more willing to consider means of supplementing disclosure through increased enforcement and appropriately tailored regulation.

Although other commentators have examined the salutary role confidence plays in stabilizing and maintaining markets,[8] none have examined the dangers to markets of fundamentalist faith *per se*. This Article's contribution to the literature on securities regulation is unique: It contends that although recent major securities reforms purport to address diametrically opposed concerns – an excess of securities fraud *litigation* on the one hand,[9] and on the other an explosion of securities *fraud*[10] – they rely

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[7] Public Company Accounting Reform and Investor Protection Act of 2002, Sen. Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 107-205, 107th Cong. 2d. Sess. 2 (2002).

[8] *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 64-65 (2001); Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Law Isn't the Answer*, 45 WM & MARY L. REVIEW 1055, 1144 (2004); Lawrence M. Ausubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1023 (1990); *and* Lynn A. Stout, *The Unimportance of Being Efficient: an Economic Analysis of Stockmarket Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 668-74 (1988).

[9] The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, and the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227.

on common (and faulty) theoretical assumptions. Despite the different provocations and ambitions of each of the reform efforts, this Article argues that they share an unwarranted adherence to, and place an undeserved emphasis upon, disclosure as the means to attack market malfeasance. While other commentators have examined the disclosure principle as a foundation for securities regulation,[11] none have offered a cohesive critique of its role in contemporary efforts to address market malfeasance. This Article goes beyond the behavioral law and economics critiques of the legal principles,[12] to examine the way lawmakers' faith in those principles has affected their legislation. It suggests that in the wake of mounting challenges to received views, a resurgence of reverence for markets has prompted reflexive and poorly tailored legislation that is unduly hostile to adjudication. Applying behavioral economics and cultural studies to recent securities reform acts, it provides a theoretical analysis rooted in detailed examination of specific regulatory and litigation strategies. In particular, it elucidates the practical consequences for markets, courts, and litigants of rooting financial market regulation in faith, rather than skepticism.

The Article proceeds as follows. Part I begins by introducing the theoretical assumptions underlying the disclosure model of federal

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[10] The Sarbanes-Oxley Act of 2002, Public Company Accounting Reform and Investor Protection Act of 2002.
[11] Discussed *infra* at __.
[12] Discussed *infra* at __.

securities regulation. Disclosure – the voluntary or mandatory dissemination of information into the public realm – is purported to be the "disinfectant" that will purge the markets of malfeasance.[13] Disclosure is the primary defense against market malfeasance: It is to ensure that all material information is available to all, and information in turn ensures rational bargaining and accurate valuation. As the Supreme Court describes it, because "the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive," disclosure has long been considered the best antidote for fraud.[14] Part I.A. explores these concepts and provides an overview of the traditional legal and economic theory of the disclosure approach to market monitoring. As the securities laws reflect, in a disclosure regime, actors are posited to be not only self-interested, but also fully informed and rational. Since rational investors operate with access to all public information, they naturally will tend to negotiate prices that accurately reflect the asset's fundamental worth. The combination of rational actors and complete information creates a market system in which assets are accurately valued and efficiently exchanged. On this theory, regulation is rarely needed: If the material information is disclosed, the market will do the rest.

[13] Buckley v. Valeo, 424 U.S. 1, 67 (1976) ("[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.") (citation omitted).
[14] Securities & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200 (1972).

The efficient market and rational investor theories used to justify limited market monitoring have come under fire from innovative work in behavioral economics, however. Part I.B outlines the behavioral critique of the traditional assumptions. As Part I.B recounts, behavioral economists have challenged the basic underpinnings of the traditional model by examining the decision-making process and correlation *vel non* among price, value, and information. Their criticism of the economic model in turn has prompted legal academic questioning of the adequacy of securities regulations. If disclosure does not function as expected – if it does not disinfect because investors are not rational or markets are not efficient – then more regulation or more stringent enforcement of current rules may be needed to ensure market integrity. If the market and investors do not behave as assumed, they may not be as well-suited to police themselves.

Despite the behavioralists' questioning of the laws' premises, the assumptions that markets are in general resistant to fraud remain firmly entrenched in legislative approaches to monitoring malfeasance. Part I.C provides the theoretical and cultural explanation for this legislative fidelity. Drawing on recent works of cultural theory, it examines the powerful reverence for markets that came to dominance in the nineteen-nineties. It explores how exaltation of financial markets displaced critical examination of market practices – how faith in the integrity and possibilities of markets became the common anthem for market observers.

Part II elucidates how Congressional securities reform legislation incorporates that cultural leitmotif. Part II demonstrates that Congress's resistance to litigation can be explained in terms of misplaced faith in the preventive power of disclosure, and examines the consequences of that faith. Part II divides this analysis in decreasing order of particularity; ranging from the theoretical underpinnings through the regulatory framework to the concrete details of the *In re WorldCom, Inc. Securities Litigation*. At each level, the analysis reveals that the general theoretical trends and the individual consequences have been shaped by faith at the expense of market participants. Part II.A turns in detail to the legal framework established by congressional legislation. Analyzing lawmakers' responses in terms of faith, it identifies constraint of civil litigation and distrust of private litigants as resonating themes. The securities reform acts of 1995 and 1998 and the Sarbanes-Oxley Act of 2002 reflect an insistence on the primacy of disclosure that produced oscillating antagonism towards plaintiffs and possible corporate wrong-doers. By fluctuating between vigorous condemnation of plaintiffs and of corporations, between encouraging and discouraging lawsuits, and between extensively monitoring and trusting market participants, laws' responses have created uncertainty for litigants and for the subjects of regulation. While Congress consistently claims that it is responding to uniquely egregious conduct on the part of plaintiffs and corporate wrong-doers, its own fealty to ill-founded principles may in part be responsible for creating the conditions that give rise to the conduct it condemns. In addition to producing under- and over-regulation, the propensity for dramatic change encourages each side to lobby for frequent reform. Part II.A suggests that without a stable framework of expectation, securities monitoring is in danger of being distracted from the merits of particular claims in favor of broader defenses or condemnations of the background conditions. It contends that while some reforms strike an appropriately moderate tone, too often Congress responds disproportionately to the heresy of litigants and the betrayals of market malfeasors. As a result, reforms paradoxically produce both uncertainty and an undeserved confidence in the integrity and fairness of the market.

Having considered the reform acts in detail in Part II.A., Part II.B turns to their consequences for litigants. Part II.B employs a detailed study of the plaintiffs' strategies in the WorldCom securities litigation to identify precise ways in which legislative antagonism to litigation can backfire. Securities reforms designed to constrain frivolous litigation can create procedural conundrums that have the potential to drain resources from the merits of a case. As the WorldCom action reveals, plaintiffs who choose to do so can exploit the new reforms to advance their own interests at the expense of other wronged shareholders. By enacting legislation that responded to particular law firms and their strategies, rather than legislation that offered a clear, systemic vision of how to focus litigation on the merits of claims, Congress may have preserved plaintiffs' ability to bring exploitative litigation while missing an opportunity to encourage meritorious private monitoring of corporate malfeasance.

Having proposed in Part II that pervasive, dogmatic faith in the integrity and efficiency of the securities markets has produced undesirable trends in securities regulation, Part III turns to possible solutions. It draws on skeptical philosophy to suggest that market integrity would be better served by a regulatory approach that more thoroughly acknowledges – and even embraces – the uncertainty and challenges that it faces. While "in a time of faith" skepticism may be "the most intolerable of insults,"[15] the skepticism proposed here is skepticism in the service of faith. Skepticism advises that true understanding (and thus decision-making) can come only by acknowledging the impossibility of complete understanding. Following Montaigne's skepticism and Emerson's description of it, Part III argues that "since true fortitude of understanding consists in not letting what we know

[15] Randolph Bourne, *The War and the Intellectuals*, SEVEN ARTS (1917).

be embarrassed by what we do not know, we ought to secure those advantages which we can command, and not risk them by clutching after the airy and unattainable."[16] Perfectly efficient markets and wholly rational investors are unattainable, and behavioral law and economics has opened up a realm of uncertainty regarding market behavior. At the same time, within the existing legal framework plaintiffs often contest the legitimacy of market behavior through civil litigation. Rather than resist either challenge with reflexive reliance on discounted assumptions, courts and regulators ought to acknowledge the fragility of their assumptions and address the critiques on their merits. Remedying the procedural and jurisdictional intricacies created by the 1990s reforms in favor of procedural rules that more cohesively favor federal courts and consolidated litigation would be one such step. Acknowledging the limits of disclosure might also require renewed consideration of substantive regulations designed to protect investors who behavioral economics shows are unable to protect themselves. Exchanging fundamentalist faith for engaged skepticism in this fashion can shape markets that resist fraud and deserve confidence.

Describing Montaigne's skepticism, Emerson explains that "[s]kepticism is the attitude assumed by the student in relation to the particulars which society adores, but which he sees to be reverend only in

[16] Ralph Waldo Emerson, *Montaigne; Or, The Skeptic*, RALPH WALDO EMERSON, 312, 316 (Richard Poirier ed., 1990) (1850).

their tendency and spirit. The ground occupied by the skeptic is the vestibule of the temple." The skeptical approach offered here is one that contends that reverence for the spirit of efficient and fair markets is indeed desirable, but should be earned through works – questioning, reforming, regulating, litigating – not through "faith in words" or "mystical notions of confidence" alone.

## *I. The Theoretical Assumptions Underlying Securities Regulation*

### *A. The Disclosure Principle*

Federal securities regulation and litigation in the United States stand on a firm belief in the principle of disclosure. Since the first federal securities laws of the 1930s, the goal of federal financial market regulation has been to remedy information asymmetries, and the system of mandatory disclosure has been the primary means of achieving it.[17] Information – the constant, detailed, constrained, monitored, accumulated flow of information – in all its forms serves as the first line of defense against market malfeasance and the principal guarantor of the capital market regime. Regulations crafted by Congress and the SEC mandate and order the type,

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[17] Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 650 (1995). The conviction that disclosing information about securities and their issuers ensures the fair and efficient flow of capital is also the central premise of the Securities and Exchange Commission's approach to securities regulation. ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE 37 (1992). Like SEC enforcement actions, criminal prosecutions and private litigation frequently center on violations of disclosure obligations, claiming either that the disclosures were insufficient or that they were materially misleading.

form, and extent of issuers' disclosures.[18] The reliance on public dissemination of information to ensure the integrity of the securities markets is evident not only in the initial choice to enact a disclosure rather than merit-based regime of federal regulation, but also in the recent modifications of the securities laws. Increasingly, antifraud securities reforms have replaced a system in which disclosure serves as the baseline principle but litigation serves to enforce compliance with a regulatory framework that relies more exclusively on disclosure. This Section examines this orientation toward disclosure by providing a brief overview of its inception in the first two major federal securities laws.

The federal government was slow to enter the field of securities regulation. Until the New Deal, the states governed the exchange of securities through a patchwork of so-called "blue sky" laws.[19] The state statutes established comprehensive licensing schemes,[20] and focused on the "merits" of the proffered security by authorizing administrative authorities to prevent the offering of a security deemed to be "unfair, unjust,

[18] Pursuant to the Securities Exchange Act, firms that satisfy the governing criteria must file annual, quarterly, and sometimes monthly, reports. In addition to the disclosures mandated by law, issuers may also disclose information voluntarily – as when they seek to alert investors to their rising fortunes, projected earnings, or coming difficulties. The "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995 increased protection for companies disclosing forward-looking information. Those provisions and the disclosure requirements are discussed *infra* at ___.

[19] Michael A. Perino, *Fraud & Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 280 (1998).

[20] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 44 (rev. ed. 1995) (citation omitted); *see also id*.

inequitable, or oppressive."[21] With the stock market collapse of 1929 and subsequent Great Depression, demand for federal market regulation prompted congressional action.[22] The first federal law governing securities markets, the Securities Act of 1933 (the "Securities Act" or "1933 Act"), was part of the flood of legislation enacted during Franklin D. Roosevelt's first hundred days.[23] Since it was enacted so swiftly, there is limited legislative history to reveal the theory behind this major law; nonetheless, the Act and its interpretation reveal its orientation and intent.

The Securities Act of 1933 imposed registration and disclosure obligations on companies offering securities for sale to the public. Its disclosure philosophy followed the English Companies Act[24] while its antifraud provisions derived from the Martin Act of New York State.[25] As the Supreme Court has observed, the 1933 Act "was designed to provide

[21] Act of Mar. 10, 1911, ch. 133, 1911 Kan Sess. Laws 210, 212, *repealed by* Act of Mar. 16, 1929, ch. 140, 1929 Kan. Sess. Laws. 212 *quoted in* Seligman, *supra* n.__, at 673.
[22] *See* Seligman, *supra* n.__, at 673-75.
[23] JOSEPH P. LASH, DEALERS & DREAMERS 131 (1988).
[24] *See id*.
[25] *See* 1 LOSS & SELIGMAN, *supra* n.__ at 180. Although the role of the Martin Act in policing securities markets is beyond the scope of this article, it should be noted that due to the efforts of New York Attorney General Eliot Spitzer, the more senior Act recently has regained a prominent role in securities regulation and market reform. *See* Raymond Hennessy, *Spitzer Uses Old State Law to Target Insurers*, Oct. 19, 2004, WALL ST. J. at C1; Dennis C. Vacco, *Martin Act Martinet*, April 12, 2004, WALL ST. J. at A18; Tom Lauricella, *Fund Industry Faces Overhaul as Spitzer, SEC Fight for Turf*, WALL ST. J., Oct. 31, 2003, at A1; Riva D. Atlas, *SEC Chief Plays Down Clash with State Attorneys General*, NY TIMES, Sept. 15, 2003, at C2; Jerry Markon, *Obscure State Law Puts Heat on Executives*, WALL ST. J., Oct. 2, 2002, at C1; James Traub, *Eliot Spitzer Goes to War*, NY TIMES, June 16, 2002, at Sec. 6. The Martin Act has also played a significant role in criminal prosecution of high-profile white collar defendants. Former Tyco CEO Dennis Kozlowski, for example, was convicted in New York State court of charges arising under the Martin Act.

investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud, and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."[26] The 1933 Act established obligations in connection with the initial registration and offering of a security to the public and focuses on the responsibilities of issuers and those who aid them in this initial offering phase.[27] It requires issuers of securities to file a registration statement when they distribute securities to the public[28] and governs the form and content of statements and behavior related to the initial offering.

The following year, Congress addressed the need to regulate the secondary market for securities. The Securities Exchange Act of 1934 (the "Exchange Act" or "1934 Act") imposes ongoing disclosure obligations affecting the secondary market.[29] Like the 1933 Act, the Exchange Act responded to concerns emerging from the Depression and, like the earlier Act, it chose obligatory disclosures and accurate information as the best means to ensure the integrity of the securities markets. Where the 1933 Act is designed to address information asymmetries at the time of initial

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[26] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

[27] Compared to the Exchange Act, the Securities Act has been relatively unaffected by the recent reforms. Its strict liability, negligence and SEC enforcement provisions remain potent tools in efforts to fight securities malfeasance.

[28] *See* 15 U.S.C. § 77e.

[29] The obligation to file quarterly and annual reports (Forms 10-Q and 10-K), for example, arises pursuant to the 1934 Act.

offering, the 1934 Act imposes continuous disclosure obligations to prevent such asymmetries from reemerging in the secondary market. The SEC, the Department of Justice, and private litigants have all played significant roles in enforcing the provisions of the 1933 and 1934 Acts through investigation, prosecution, and/or litigation.[30]

The two New Deal Acts, and with them the emphasis on disclosure, have dominated the federal securities regulation regime since their inception.[31] The disclosure regime Congress adopted rests on two key

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[30] In securities fraud litigation, the most well-known provision of the 1934 Act is Section 10(b), the general antifraud provision, which in turn gave rise to the private cause of action for securities fraud created by Rule 10b-5.

[31] The securities markets are governed by a handful federal laws: The Securities Act, the Exchange Act, the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79, the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa, the Investment Company Act of 1940, 15 U.S.C. § 80a-1, the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1, the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa, and the Sarbanes-Oxley Act of 2002. The Securities Act and the Exchange Act remain the most significant, however, not only in their initial premises, but as they have evolved. Over the years the Acts have been streamlined– of particular relevance for purposes of this Article, by shifting toward integrated disclosure. As it became evident that the 1933 and 1934 Act requirements involved substantial duplication of information and compliance costs, the SEC embarked on an effort to integrate the disclosure requirements of the two Acts. *See Circumstances Affecting the Determination of What Constitutes Reasonable Investigation & Reasonable Grounds for Belief Under Section 11 of the Securities Act*, SEC Release No. 6335, 1981 WL 31062, at *1 (Aug. 6, 1981) ("SEC Release No. 6335"); *Reproposal of Comprehensive Revision to System for Registration of Securities Offerings*, SEC Release No. 6331, 1981 WL 30765, at *2 (Aug. 6, 1981) ("SEC Release No. 6331"). The integration effort proceeded "primarily by incorporating by reference Exchange Act reports into Securities Act registration statements." SEC Release No. 6335, at *3. Incorporation was implemented through the shortened registration Form S-3, which requires incorporation by reference of a registrant's Form 10-K from the previously concluded fiscal year and all interim Exchange Act filings from the end of that year through the end of the offering period. This "short-form registration" is for use by companies who have substantial equity floats or rated debt securities and are widely followed by professional analysts. *See Shelf Registration*, SEC Release No. 6499, 1983 WL 408321, at *2 (Nov. 17, 1983). Integrated disclosure was intended to "simplify disclosure and reduce unnecessary repetition and redelivery of information," not to modify the obligations imposed by the securities Acts themselves. *See* SEC Release 6335, *10 (discussing Rule 176 due diligence obligations). Integrated

assumptions regarding the nature of the interaction between markets and investors. First, it assumes that investors access, assess, and adapt to the information disclosed. In effect, the disclosure regime holds that informed investors are their own best defense against bad deals and flawed choices.[32] It says: Supply investors with the information they require, trust them to evaluate that information, and allow them to choose the path that best suits their needs. In order to conceive of investors in this mold, however, one must first assume that all (or most) investors have equal access, to complete information, which they rationally and thoroughly process to come to accurate conclusions. The adjectives are key to the theory: If investors truly are to be their own best defense, they must be assumed to function at a quite sophisticated level.

Second, the disclosure regime hypothesizes a thoroughly efficient market. The efficient market hypothesis ("EMH") "asserts that all financial prices accurately reflect all public information at all times."[33] Thus an efficient market is a market in which assets are correctly priced given

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disclosure operates on the assumption that once information has been disclosed, it need not be repeated – the market will absorb it initially and alter accordingly. Indeed, the integration of the two Acts again made explicit that the federal approach to securities regulation rests firmly on a belief in the efficacy of disclosure.

[32] KHADEMIAN, *supra* n.__, at 29.

[33] ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 171 (2000). Eugene Fama has been a leading advocate of this position. *See* Eugene Fama, *Market Efficiency, Long Term Returns and Behavioral Finance*, 33 J. FIN. ECON. 3 (1998); Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

publicly available information.[34] The EMH's model of market assessments draws from the presumed ability of investors to process information quickly, rationally, and accurately when deciding the price of their transactions. On the EMH, the price at which the market arrives reflects the assets' fundamentals – that is, it optimally predicts the present value of the entitlement to future benefits that is conferred by current ownership of the share.[35] According to the efficient market hypothesis, asset price changes are unpredictable because they occur only when truly new information enters the public sphere. This effect is described as the "random walk" theory: because the new information is unknown and impossible to anticipate, it produces a price movement the size and direction of which cannot be predicted with any accuracy.[36] Since the price in an efficient market either reflects all publicly available information or responds without warning to the disclosure of new information, efficient markets are also assumed to be equal-opportunity markets. That is, no matter how "smart" an investor is, on the EMH she cannot beat the Street.[37]

The two fundamental assumptions together place a great deal of faith in the evaluative capacity of individual decision makers and collective action. They trust that when given enough material and accurate

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[34] SHILLER, *id.* at 171; Fama, 25 J. FIN. at 383.
[35] PAUL ORMEROD, BUTTERFLY ECONOMICS 15 (2000).
[36] SHILLER , *supra* n.__, at 171.
[37] Shiller describes this assumption in terms of the equal results obtained by investors of differing aptitudes. *Id.* at 173.

information, investors individually and collectively can assess value, predict trends, and distinguish honesty from chicanery. The law in turn places its faith in these fundamental assumptions. By emphasizing disclosure as the primary means of ensuring market integrity, the law trusts that individuals will act according to the rational investor model to produce efficient markets. Federal rules require the disclosure of information prior to and at the time of a purchase or sale based on the belief that such disclosure will help to ensure that the assets are accurately valued and that investors are not penalized by information asymmetries.

When transactions "go wrong" and a displeased purchaser or seller pursues civil litigation, the legal standards reflect this underlying regulatory theory. In securities fraud litigation, market participants and background conditions are assumed to conform more or less to the theoretical rational investor and efficient market. Although securities enforcement litigation relies on the same models disclosure does, unlike the disclosure requirements it necessarily approaches the assumptions with skepticism, not faith. Where disclosure must trust that the dissemination of information will proceed according to the theoretical model, litigants must *prove* how a particular transaction transpired. The legal standard and adversary process preclude unquestioning adherence to a given hypothesis – where disclosure rules can rest on unconfirmed assumptions, litigated claims must be properly alleged and proven.

The different role the economic assumptions play in securities litigation can be seen in an examination of a typical Section 10(b) claim. Plaintiffs in a typical Section 10(b) securities fraud claim must prove "(a) *a material misrepresentation (or omission)*, (2) *scienter*, i.e., a wrongful state of mind, (3) *a connection with the purchase of sale of a security*, (4) *reliance*, often referred to in cases involving public securities markets . . . as "transaction causation," (5) *economic loss*, and (6) *loss causation*, *i.e.*, a causal connection between the material misrepresentation and the loss."[38] Each element reflects the presence of the underlying economic assumptions, assumptions that will be scrutinized during litigation. For example, a "material" statement is one that a reasonable person would consider important when deciding whether to buy or sell securities.[39] To assess the materiality of a statement or omission, a court must determine whether "defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a

[38] Dura Pharm., Inc. v. Broudo, 125 S. Ct. 1627, 1631 (2005) (citations omitted) (emphasis in original). *See also* Lawrence v. Cohn, 325 F.3d 141, 147 (2d Cir. 2003) (plaintiffs must show that "the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff's reliance on defendant's action caused injury to the plaintiff."). This representative standard discussed below is that of the Second Circuit, which tends to impose greater burdens on plaintiffs than other Circuits.

[39] Halperin v. eBankerUSA.com, Inc., 295 F.3d 352, 357 (2d Cir. 2002).

reasonable investor regarding the nature of the securities offered."[40] The securities fraud standard thus reflects the EMH belief that investors' decisions are based primarily on the "total mix" of information available in the marketplace.

Courts also must determine the likely effect on investors of cautionary language included in the total mix of information.[41] Under the "bespeaks caution" doctrine, misrepresentations are immaterial as a matter of law if "it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language set out in the same" document.[42] As with materiality, cautionary language is assessed in a specific factual context. The court is to consider "the allegedly fraudulent materials in their entirety to determine whether a reasonable investor would have been misled. The touchstone of the inquiry is not whether isolated statements within a document were true, but whether defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor regarding the nature of the securities offered."[43] Again, the bespeaks caution doctrine assumes investors will discern and rationally respond to cautionary language.

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[40] *Id.*; *see also* Basic v. Levinson, 485 U.S. 224, 231-32 (1988).
[41] Halperin, 295 F.3d at 357.
[42] *Id*.
[43] *Id.* at 356.

Plaintiffs also must establish both transaction and loss causation. As the Supreme Court affirmed last term, Congress has made clear its "intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss."[44] The Supreme Court rejected the Ninth Circuit standard that had permitted plaintiffs to recover even when they had only established that "the price on the date of purchase was inflated because of the misrepresentation."[45] In so holding, the Supreme Court reiterated the importance of proof in securities law cases: It noted that the securities statutes seek to maintain confidence in the markets by deterring fraud "in part through the availability of private securities fraud actions."[46] But it also cautioned that "the statutes make these [] actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."[47] Plaintiffs may not rely on theoretical models – they must established the extent and cause of their losses in concrete terms. In addition to loss causation, plaintiffs must prove transaction causation or reliance. The Second Circuit has explained that a plaintiff must allege that "*but for* the fraudulent statement or omission, the plaintiff would not have

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[44] Dura Pharm., Inc. v. Broudo, 125 S. Ct. 1627, 1633 (2005).
[45] *Id.* at 1631 (quoting the Ninth Circuit standard).
[46] *Id.* at 1633.
[47] *Id.*

entered into the transaction" and that "the subject of the fraudulent statement or omission was the cause of the actual loss suffered."[48] However, since direct reliance is extremely difficult to establish in the complex modern markets, at the pleading stage plaintiffs may rely on the "fraud-on-the-market" theory. Under this federal doctrine, they do not need to allege that they actually encountered the misrepresentation – instead, the court is to presume that plaintiffs relied on the market to "perform a substantial part of the valuation process performed by the investor in a face-to-face transaction."[49] The fraud-on-the-market theory explicitly incorporates the efficient market hypothesis: it assumes that "[t]he market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price."[50] Like the disclosure principle, therefore, at the pleading stage the legal presumptions trust in the accuracy of the economic theory. Unlike legislators crafting a disclosure rule, however, plaintiffs must earn the court's trust by proving the accuracy of the theory in each case.

As this overview shows, before, during, and after securities transactions, the relationships among the participants are governed by rules that assume the existence of the two key background conditions – rational

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[48] Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001).
[49] Basic, 485 U.S. at 244 (citation omitted).
[50] *Id.*

investors and efficient markets. How those assumptions are treated, however, drastically differs depending on the legal forum in which they are approached. When securities regulations are based on rational investor models and EMH, they trust in the accuracy of those descriptions – disclosure assumes that dissemination of accurate, material information ensures fair markets because it assumes that the information will be processed and used in conformity with economic theory. In enforcement litigation, the faith in rational investors and efficient markets must be earned by the concrete work of investigation, adjudication, and resolution. A balanced approach has faith that markets work well most of the time, but is not so trusting that it disdains the possibility that the models will fail. Enforcement catches those failures, providing an additional level of deterrence and protection for individual investors and for the markets as a whole. As the federal approach erodes enforcement mechanisms in favor of increasing dependence solely on disclosure, however, it becomes a system based ever more deeply on faith alone.

While the legal regime continues to stand on the assumptions that investors are rational and markets are efficient, economic theory has stepped away from them. Although many economists still strongly support the efficient market theory and continue to rebut its challengers, the efficient market theory and belief in investor rationality have been subjected to extensive scrutiny and criticism. The next section explores that economic theory to suggest that the law rests on a faulty foundation.

*B. Questioning Assumptions About Markets: Behavioral Economics*

Economists using innovative and interdisciplinary approaches have become increasingly convinced that orthodox economic theory cannot adequately explain market and investor behavior.[51] They challenge standard economic views regarding each of the above assumptions: Investors, they contend, are influenced by many factors and markets are rarely efficient. Offering a holistic criticism (although not a coherent alternative model), economists have identified critical irrationalities and inefficiencies in market and investor behavior. Indeed, while some economists continue to defend traditional approaches, contemporary economic theory largely rejects the models discussed thus far. Harvard President and former U.S. Treasury Secretary Lawrence Summers has even claimed that "[t]he efficient market hypothesis is the most remarkable error in the history of economic theory."[52]

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[51] The work in behavioral economics draws heavily on psychologists' insights into human decision-making and evaluative capabilities. The full breadth of this interdisciplinary project is beyond the scope of this Article, however. This Section will focus on the economic application of these insights. For a cohesive analysis of the diverse literature in this area, see ROBERT E. LANE, THE MARKET EXPERIENCE (1991).

[52] *Quoted in* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 74 (2000). Although Arrow's theorem provided remarkable guidance for many years, it appears to apply only in exceptionally rare circumstances. A glimpse of the effect of Arrow's work can be found in the papers collected in LANDMARK PAPERS IN GENERAL EQUILIBRIUM THEORY, SOCIAL CHOICE & WELFARE (selected by

As Paul Ormerod states, "orthodox economics cannot account for the sheer volatility of asset markets, and the paradoxes which arise" in market behavior.[53] Stock markets are simply far more volatile than efficient markets theory would imply.[54] Once economists allow for interaction between investors and for positive feedback, they generate models "in complete contradiction to the predictions of orthodox economic theory."[55] Behavioral models demonstrate that investors' decisions are influenced not only by market price and publicly available information, but also by their individual psychology and their interactions with others. Yale economist Robert Shiller describes these "amplification mechanisms" and "feedback

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Kenneth Arrow & Gérard Debreu) (2001) and in ARROW AND THE ASCENT OF MODERN ECONOMIC THEORY (George R. Feiwel ed., 1987).

[53] ORMEROD, *supra* n.__, at 19.

[54] *See* John Y. Campbell, *A Variance Decomposition for Stock Returns*, 101 ECON. J. 157 (1991); John Y. Campbell & Robert Shiller, *Stock Prices, Earnings and Expected Dividends*, 43 J. FIN. 661 (July 1988); Robert J. Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?*, 71 AM. ECON. REV. 420 (June 1981); Stephen F. LeRoy & Richard D. Porter, *The Present-Value Relation: Tests Based on Implied Variance Bounds*, 49 ECONOMETRICA 97 (May 1981). While recent research emphasizes that "the aggregate stock market appears to be wildly inefficient," it also emphasizes that *individual* stock prices may show some correspondence to efficient markets theory. Robert J. Shiller, *From Efficient Markets Theory to Behavioral Finance*, 17 J. ECON. PERSPECTIVES 83, 88 (2003).

[55] ORMEROD, *id.* n.__ at 23. Robert Shiller was one of the earliest and remains one of the leading proponents of this work. *See* SHILLER at 148; Robert J. Shiller, *From Efficient Markets Theory to Behavioral Finance*, 17 J. ECON. PERSPECTIVES 83 (Winter 2003); Robert J. Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?*, 71 AM. ECON. REV. 420 (June 1981); Robert J. Shiller, *Bubbles, Human Judgment & Expert Opinion*, Cowles Foundation Discussion Paper No. 1303 (May 2001), *available at* http://cowles.econ.yale.edu (last visited July 10, 2005). *See also* HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING (2000); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000); PAUL ORMEROD, THE DEATH OF ECONOMICS (1994); RATIONAL CHOICE: THE CONTRAST BETWEEN ECONOMICS & PSYCHOLOGY, Princeton Conference on Behavioral Economics, report on the conference (Robin M. Hogarth & Melvin W. Reder, eds.) (Oct. 1984).

loops" as a "type of naturally occurring Ponzi process."[56] Typical investors, Shiller notes, do not normally behave like the ideal investors of traditional economic or legal models.[57] Instead, their emotional state and interactions with others are just as likely to influence their economic behavior as are "hard" factors like those posited by traditional theories.[58] In addition to these influences, investor behavior is determined in part by the fact that people may hold contradictory views simultaneously and may not be definitively attached to many of their views.[59] Because their commitments are weak, multiple, and often in tension with each other, investors do not make decisions based on a rational calculus.[60] They are human, and apt to be swayed by emotional and societal factors. Although the EMH has not

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[56] SHILLER, *supra* n.__, at 44.
[57] *Id.* at 55.
[58] *See* Daniel Kahneman, *New Challenges to the Rationality Assumption*, 3 LEGAL THEORY 105 (1997); Amos Tversky, Paul Slovic and Daniel Kahneman, *The Causes of Preference Reversal*, 80 AM. ECON. REV. 204 (1990); Roman Frydman, *Towards an Understanding of Market Processes: Individual Expectations, Learning, and Convergence to Rational Expectations Equilibrium*, 72 AM. ECON. REV. 652 (Sept. 1982) (discussing the importance of social norms in individual decision-making and impediments to the formation of rational expectations).
[59] *See*, *e.g.*, Robert P. Abelson, *Social Psychology's Rational Man*, in RATIONALITY AND THE SOCIAL SCIENCES (S.I. Benn & B.W. Mortimore, eds.) (London: Routledge & Kegan Paul, 1976) (discussing bounded rationality and process of "satisficing"); D.J. Butler, *Do Non-Expected Utility Choice Patterns Spring From Hazy Preferences? An Experimental Study of Choice 'Errors,'* 41 J. ECON. BEHAVIOR & ORG. 277 (2000); Yaw Nyarko, Michael Woodford, & Nicholas C. Yannelis, *Bounded Rationality and Learning*, 4 ECON. THEORY 811 (1994) (introducing symposium papers on sophistication and beliefs of decision-makers).
[60] *See* SHILLER, *supra* n.__, at 153, 57; *see also* Stephen J. Humphrey, *Feedback-Conditional Regret Theory and Testing Regret-Aversion in Risky Choice*, 25 J. ECON. PSYCH. 839 (2004) (discussing the role of expected rejoicing and regret in the decision-making process).

yet been completely supplanted, the behavioral finance critique is widely accepted in the economic literature.

Just as economists challenged the dominance of the efficient market theory, legal scholars have used behavioral economics to assess the laws that govern market activity. "Behavioral law and economics" scholars have applied the conclusions and the methodology of behavioral economics to identify inadequacies in the legal regime and to argue that legal approaches to market governance should adapt more complex (and more accurate) baseline assumptions regarding market and investor behavior. Donald Langevoort, for example, has offered extensive insight into the role behavioral economics might play in securities regulation, and has encouraged others to use behavioral approaches to "try to think through how best to formulate securities law in the face of [] increasing uncertainty."[61] Many have taken up the challenge.[62] For example, legal commentators have used behavioral economics to examine, *inter alia*, overconfidence and internet fraud,[63] the fraud-on-the-market presumption

[61] Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U.L. REV. 135, 138 (2002) (hereinafter "*Animal Spirits*"); *see also* Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992) (hereinafter "*Theories*").
[62] For overviews of this commentary, see BEHAVIORAL LAW AND ECONOMICS (Cass Sunstein ed., 2000); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); and Donald Langevoort, *Behavioral Theories of Judgment and Decisionmaking in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499 (1998).
[63] Langevoort, *Animal Spirits*, *supra* n.__, at 154-63.

and truth-on-the-market defense,[64] analyst biases,[65] judicial treatment of "puffery" and "materiality,"[66] the regulatory power of corporate law,[67] and firms' decisions to enter markets.[68]

Uncertainty regarding efficiency and rationality provides the basis to question not only the existing regulations, but also, perhaps even more importantly, the *absence* of regulation. As Langevoort notes, "aggressive deregulation" has been advocated on the grounds that market efficiency obviates the need for it.[69] Many argue that if markets "disinfect" themselves, there is no need to burden them with government or private monitoring.[70] As a result, the persistence of EMH may explain the lack of regulation in certain areas. If the premise of EMH is incorrect, and markets are not adequately self-policing, the logic of limited regulation and reliance chiefly on disclosure lacks coherence and credibility.[71]

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[64] *Id.* at 176-81.
[65] *Id.* at 163-75.
[66] Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99 (2005).
[67] Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as a Regulatory Tool*, 35 U.C. DAVIS L. REV. 581 (2002).
[68] Avishalom Tor, *The Fable of Entry: Bounded Rationality, Market Discipline, and Legal Policy*, 101 MICH. L. REV. 482 (2002).
[69] Langevoort, *Animal Spirits*, *supra* n.__, at 152.
[70] Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis,* 68 U. CIN. L. REV. 1023, 1033 (2000); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1939-40 (1996); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 682 (1984).
[71] For criticism of behavioral approaches, see Stephen J. Choi and A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003) (criticizing limited focus of behavioral economics, and examining the consequences of applying the theory to regulators as well as investors); Gregory Mitchell, *Taking Behavioralism Too Seriously?*

Some legal and economic commentators explain the persistence of the efficient market hypothesis by observing that although behavioral finance offers a powerful critique of traditional models, it has not conclusively established the inefficiency of markets.[72] They point to the "inefficiency" model's inability to account for all possible statistical variances as the reason the debate remains open in economics and, consequently, in law. Yet it is unlikely that the unresolved issues in statistical modeling alone are adequate to account for the full extent of the EMH's continued cultural valence. There is, however, another explanation.

*C. Faith in Markets*

If the insights of behavioral economics are correct, markets are not and cannot be governed not by fully informed, rational, self-interested actors. Instead, they "emerge[] from the internal relations of human and machinic agents whose knowledge is always mistaken and memories as well as expectations are inescapably incomplete."[73] In this strange new world, uncertainty and complexity are the only guarantees. The "invisible

*The Unwarranted Pessimism of the New Behavioral Analysis of Law*, 43 WM & MARY L. REV. 1907 (2002).

[72] *See, e.g.*, Robert J. Shiller, *From Efficient Markets Theory to Behavioral Finance*, 17 J. ECON. PERSPECTIVES 83 (2003) (noting that although the aggregate stock market appears to be inefficient, individual stock prices can show consistency with the EMH); Morris Altman, *The Nobel Prize in Behavioral & Experimental Economics: A Contextual & Critical Appraisal of the Contributions of Daniel Kahneman & Vernon Smith*, 16 REV. POLIT. ECON. 3 (2004) (discussing tension between two Nobel Prize winners' work showing on the one hand that agents are irrational, and on the other that economies are efficient).

[73] MARK C. TAYLOR, CONFIDENCE GAMES: MONEY & MARKETS IN A WORLD WITHOUT REDEMPTION 295 (2004).

hand" is no longer omniscient and omnipotent, but absent and/or unpredictable.

This loss of certainty provokes a return to faith, as Mark C. Taylor demonstrates in his compelling recent work, *Confidence Games: Money and Markets in a World Without Redemption*.[74] Taylor draws on philosophy, economics, religion and art to develop a cultural philosophy of markets. As he describes, when economic behavior is a complex, networked form of interaction among less-than-rational actors with incomplete (and often mistaken) knowledge, markets appear far more volatile and unstable than when economic behavior is construed as reasoned and informed. If one accepts that people process information not through rational assessments of their own economic self-interest, but in the complicated manner conjured by behavioral theorists, markets appear to be a more uncertain and insecure place.[75] Increasing recognition of this inevitable uncertainty leads to an "understandable desire for certainty, stability, and world order."[76] As in other realms, in the financial world, the desire for clarity in the face of inconsistency and uncertainty has lead to a resurgence of fundamentalist faith – in this case, faith in markets. That is, when they are faced with uncertainty, people often respond by acting on faith: They reiterate their commitments to contested ideas with a vigor that

[74] *Id*.
[75] *Id*. at 301.
[76] *Id*.

is proportional to the level of insecurity they experience and without validating those ideas based on testable evidence. As Taylor puts it, the desire to return to stability, "manifest[s] itself in a resurgence of market fundamentalism."[77]

In the nineties, the fundamentalists came to see markets in not just absolute, but exalted terms. The more entrenched the belief in the market became, the more marvelous were its attributes. As Thomas Frank has thoroughly documented, in the popular culture of the nineties, the market came to be revered as form of divine democracy. "[B]usiness and economic thinkers" told us that "[o]nly when people act within the marketplace . . . do they act rationally, choose rightly, and make their wishes known transparently. . . . Markets are where we are most fully human; markets are where we show that we have a soul. To protest *against* markets is to surrender one's very personhood, to put oneself outside the family of mankind."[78] As the sole spaces of true democracy, markets neither needed nor deserved extensive regulation. Instead, they must be allowed to function free from interference, so they in turn could allow investors to be free to realize their own aspirations. Frank casts this as a "deep and vicious" hostility toward government and academic critics of market populism characterized by the belief that "such figures [could] not possibly

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[77] *Id*.
[78] THOMAS FRANK, ONE MARKET UNDER GOD: EXTREME CAPITALISM, MARKET POPULISM AND THE END OF ECONOMIC DEMOCRACY xiii (2000).

understand the world of the market in all its mystery and complexity" and that "just by trying to figure things out they commit[ed] acts of hubris and arrogance, inexcusable offenses against democracy."[79] As Frank illuminates, the conceptualization of the market as democratic forum offered yet another reason to limit government interference – regulation was irreconcilable with the free interactions of the market *demos*. Like Taylor and Stiglitz, Frank identifies a persistent religiosity in the business commentators' demands for faith in the (redemptive) power of markets. Criticizing promoters of the new market ideology – from journalists to advertising executives to management theorists and stock market gurus – for selling a story of market democracy, Frank portrays their tale as a myth that succeeds primarily by inculcating a sense of awe in its audience. These "masters of the New Economy," he writes, "fancy themselves an exalted race of divinities, but they counsel the rest of us to become as little children before the market."[80] Whereas they have unique insight into the market, others are to trust in them and in the market itself. The "correct intellectual posture," demanded by market gurus was not doubt or distrust, but "the simple faith of childhood."[81] The conservative market populists argued, he says, "[t]hat democracy was closely related to the holy acts of buying and selling, and that those who try to control the market are therefore setting

[79] *Id.* at xvi.
[80] *Id*. at 87.
[81] *Id*.

themselves against nothing less than the almighty will of the people themselves."[82] Frank captures the sense that in the nineties, markets became the new religion, as well as the new democratic forum.[83]

*II. Law's Responses to the Contestation of Faith*

Despite the extensive criticism of rational investor and efficient market models, described in the preceding Part, disclosure remains the unthreatened basis of the securities regime. The market orthodoxy that dominated the business of investing also saturated the securities laws. Perversely, just as economists have moved *away* from faith in the purifying powers of information, the law has increased its emphasis on disclosure. Legislation, budget cuts, and priority shifting have skewed securities regulation against third-party policing through government enforcement and private litigation in favor of self-policing through disclosure.

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[82] *Id*. at 47.

[83] Although it is beyond the scope of this paper, the chiasmus that emerges from this understanding of market populism warrants further exploration. Frank's book is written for a broad audience, and does not delve into the theoretical underpinnings of conceptions of democracy. It is evokes, however, a chiastic relation between the Greek *polis* and modern market populism. Hannah Arendt's description of the space of public freedom sought by revolutionaries is eerily similar to Frank's rendering of the contemporary equation of markets with democratic possibility. For revolutionaries, Arendt says, freedom "could exist only in public; it was a tangible, worldly reality, something created by men to be enjoyed by men rather than a gift or a capacity, it was the man-made public space or market-place which antiquity had known as the area where freedom appears and becomes visible to all." HANNAH ARENDT, ON REVOLUTION 124 (1963). Though far-removed from the exuberance of IPOs and e-commerce, the conception of democracy in Greek political thought also centered on the publicity of the market place: "[f]reedom itself needed [] a place where people could come together – the agora, the market-place, or the *polis*, the political space proper." *Id.* at 31. The populists' conception that "free markets are by definition the same as democracy" and that "any effort to restrict them is an act of unpardonable pretentiousness, or arrogant disregard for the Will of the People" both inverts and returns to this original conception.

In the late 1980s and early 1990s, Congress came to believe that private securities litigation did not serve markets well.[84] As it grew increasingly critical of perceived abuses of the court system, it rejected the view that plaintiffs' actions exposed and deterred fraud, and sought to alleviate the burden created by private litigation. Where litigants had been encouraged to supplement government enforcement of the securities laws,[85] they came to be seen as gadflies. Corporations – frequent defendants in such suits – stepped up their pressure for congressional reforms that would reduce their exposure to class action litigation. At the same time, and despite strongly argued dissenting opinions, the Supreme Court accepted and reiterated the charge that frivolous and extortionate securities litigation

[84] The Supreme Court appeared to reach a similar conclusion in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994). In rejecting a form of liability recognized by hundreds of cases throughout the federal courts, the *Central Bank* majority expressed a clear desire to protect business against what it described as "decisions made on an ad hoc basis, offering little predictive value," based on highly fact-oriented assessments of the claims. In so deciding, the Court again discussed the unique "vexatiousness" of Rule 10b-5 litigation, and considered the far-reaching effects it feared such suits might have. It warned that "this uncertainty and excessive litigation can have ripple effects," making it difficult for emerging companies to obtain professional advice. It also posited that entities facing aider and abettor liability might find it "prudent and necessary as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." As the *Central Bank* dissent discussed at length, however, the federal courts had long interpreted Rule 10b-5 to include aiding and abetting liability, and had developed a substantial body of case law to govern such claims. On the dissent's view, aiding and abetting liability not only had proven manageable, but had played an important role in reducing fraud.

[85] The Supreme Court, for example, had stated that "implied private actions provide a most effective weapon in the enforcement of the securities laws and are a necessary supplement to Commission action." Bateman Eichler, Hill Richards Inc. v. Berner, 472 U.S. 299, 310 (1985) *quoting* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

was clogging the federal court system.[86] Whether those class action suits were indeed frivolous and extortionate, or instead legitimate efforts to recover losses suffered as a result of fraud, remains a matter of debate.[87] In all likelihood, the truth lies somewhere between the competing claims: The suits were neither as egregious as charged, nor as wholesome as their lawyers claimed. Nonetheless, the 1990s reform acts reflect and comprise a

[86] Like Congress, the courts have played a significant role in developing the scope and substance of the private cause of action for securities fraud and the resulting allocation of burdens among plaintiffs and defendants. Courts have played this unusually substantial role in the development of Section 10(b) claims due to the nature and origin of the private cause of action. Section 10(b) of the Exchange Act does not itself provide a private cause of action for securities fraud, nor did Congress explicitly consider creating such a cause of action. Instead, the private cause of action has been implied under Rule 10b-5. Like Congress, however, the Commission did not explicitly consider whether the provision it had drafted provided for private civil remedies. *See* SEC Securities Exchange Act Release No. 3230 (1942). Instead, Rule 10b-5 is a "judicial oak that has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 423 U.S. 723, 737 (1975). Relying on the unusual origin of the Section 10(b) private cause of action, the Court consistently has assumed broad responsibility in this area of the law. In *Blue Chip*, for example, it restricted Section 10(b) litigation, noting that "there has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Id.* at 739. Not long after *Blue Chip*, in *Chiarella v. United States*, 445 U.S. 222 (1980), the Court declined to extend Section 10(b) and Rule 10b-5 liability to the misappropriation of public information. Justice Blackmun, joined by Justice Marshall, dissented and cautioned that the Court's decision strayed from its principle of interpreting the securities laws flexibly. They warned that "the Court continues to pursue a course, charted in recent decisions, designed to transform Section 10(b) from an intentionally elastic 'catchall' provision to one that catches relatively little of the misbehavior that all too often makes investment in securities a needlessly risk business for the uninitiated investor." 445 U.S. at 246; *see also* Dirks v. SEC, 463 U.S. 646 (1983) (Blackmun, J., dissenting). As the Court continued to limit the scope of Section 10(b) and Rule 10b-5 actions in later cases, strong dissents repeatedly criticized the majority for failing to recognize and protect the important role private litigants played in policing the securities markets. *See, e.g.*, Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (holding Section 10(b) claims to the shorter statute of limitations period contained in other provisions of the securities laws, rather than the more generous period provided by the state statute of limitations for fraud claims); Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 189 (1994) (rejecting plaintiffs' claim that Section 10(b) liability extends to "aiders and abettors" of securities fraud).

[87] *See* Joel Seligman, *The Merits Still Do Matter: A Rejoinder to Professor Grundfest's Comment Why Dismply*, 108 HARV. L. REV. 748 (1995).

concerted effort to restrain civil securities litigation.[88] They can be best understood as a series of responses to plaintiffs' litigation strategies that Congress found to be unduly burdensome for corporations and capital markets and as an assertion of Congress' faith in markets in the face of mounting challenges.[89] This Part considers each of the major acts in turn, examining how they adhere to the belief that there is minimal need for civil litigants to aggressively police markets because disclosure can be relied upon to ensure their integrity. Under the most recent reforms, disclosure has broadened its dominance at the expense of litigation. That is, the relationship between disclosure and litigation has begun a strange conversion. Where adjudication and disclosure each had appeared to be necessary but not sufficient to market regulation, the recent reforms assume that when disclosure is sufficient, litigation is not necessary. This Part concludes that the law's emerging belief that disclosure is not just a necessary but a sufficient, means of policing markets is irreconcilable with contemporary economic theory and practical experience of securities fraud. It considers how each Act minimizes the enforcement function of private litigation and increases the work disclosure is expected to perform. With

[88] The Class Action Fairness Act of 2005 extended this trend to other areas of the law as well. *See* Elizabeth J. Cabraser, *The Class Action Counterreformation*, 57 STAN. L. REV. 1475, 1514-20 (2005); and *see infra* n.__.
[89] The Sarbanes-Oxley Act of 2002 departs from this trend, in that it responds to the corporate catastrophes of Enron, WorldCom and their ilk, and takes a much broader and more substantive approach to regulation than the procedure-oriented 1995 and 1998 Acts.

respect to each statute, the Part considers the underlying assumptions, the key provisions, and the theoretical commitments embedded therein.

### *A. The Reform Acts*

#### *1. The Private Securities Litigation Reform Act of 1995*

A chorus of critics emerged in the early nineties, charging that securities fraud class action suits were driven by lawyers, not clients; based on stock price movement, not genuine fear of fraud; seeking quick settlement, not resolution on the merits; and were unjustly hampering capital formation, not legitimately policing market malfeasance.[90] When the Republicans assumed control of Congress in 1994, they acted swiftly to translate the corporate and judicial criticisms of plaintiffs' use of federal courts into securities reform legislation.[91] The Private Securities Litigation Reform Act of 1995 (the "PSLRA")[92] was the first major reform act to

[90] As one *New York Times* article described it, during the Congressional debates, the issues were "dominated by caricature. Congressional critics [] vilified lawyers who file securities class-action cases as fee-hungry extortionists who do nothing to help investors. Corporate executives dismiss the plaintiffs in those suits as cynical opportunists who buy stock only to gain suing rights. Class-action lawyers condemn their corporate critics as greedy hucksters seeking a license to steal." Diana B. Henriques, *Investing It: Making It Harder for Investors to Sue*, N.Y. TIMES, Sept. 10, 1995 at Sec. 3, 1. Henriques's article goes on to offer an alternative, balanced portrayal of numerous individuals on both sides of the issue. Other discussions of these tensions can be found in, e.g., *Suits or Straitjackets?*, ECONOMIST, Dec. 2, 1995, at 20; Benjamin Weiser, *High-Tech Firms Decry Frivolous Suits; America Online Chairman Says Laws Stacked Against Companies*, WASH. POST, March 7, 1995, at D3; *Shareholder Suits; Class Acts*, ECONOMIST, Mar. 19, 1994, at 95; Bruce Rubenstein, *Cease & Desist*, CORP. LEG. TIMES, Sept. 1994, at 1.

[91] Some claimed that the haste to legislate during the first 100 days of Republican control of the House of Representatives led to poorly crafted legislation. *See*, *e.g.*, Jeff Gerth, *Overhaul of Securities Laws: A Fast Track to Change or a Hasty Decision?*, N.Y. TIMES, May 26, 1995, at A19 (reporting on discussion regarding the speed and possible shortsightedness of the PSLRA legislative process).

[92] Pub. L. No. 104-67, 109 Stat. 737 (codified in 15 U.S.C. §§ 77k-1, 77z-1 to z-2, 78u-4 to 78u-5, 78j-1 (Supp. II. 1996)).

emerge out of the harsh and sustained criticism of private class action securities litigation. As demonstrated in this section, the PSLRA's response to these concerns reveals the congressional commitment to disclosure as the primary means of preventing and exposing malfeasance. Congress's faith in the disclosure principle is manifested by (a) the general distrust of private litigation which was the motivating force behind the PSLRA's enactment and (b) the specific reforms it adopted.

*(a) Distrust of Litigation*

The PSLRA arose directly from key underlying beliefs about the dangers of private securities litigation. First, Congress was persuaded that there was a significant gap between the amount of securities fraud and the amount of securities litigation. It accepted the view that profligate plaintiffs' attorneys were filing a crippling amount of meritless lawsuits.[93] The Senate Report, for example, observed that "[a]lthough private securities class actions can complement SEC enforcement actions, the evils flowing from abusive securities litigation start with the filing of the complaint and continue through to the final disposition."[94] Critics of private securities litigation persuasively argued that many suits were based on shifts in stock prices that naturally resulted from legitimate business and market practices,

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[93] S. REP. 104-98, at 4-9, *reprinted in* 1995 U.S.C.C.A.N. 679; H.R. REP. 104-50(I), at 15, 14-20 (1995), (adopting the view of the "many executives of companies in the accounting, securities, and manufacturing industries" who "believe that the civil liability system has been twisted and is operating against them.").

[94] S. REP. 104-98, at 8.

not from fraud.[95] The breadth of Section 10(b) allowed plaintiffs to bring a seemingly endless range of complaints. Section 10(b)[96] has been described as "a catchall antifraud provision."[97] It reaches a virtually limitless range of fraudulent conduct, as it makes it unlawful to use "*any* manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security.[98] In addition, unlike certain provisions of the 1933 Act, which specifically limit the range of potential defendants,[99] *any* defendant who engages in fraud in connection with the purchase or sale of a security may be liable for Section 10(b) and Rule 10b-5 violations.[100]

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[95] *See* S. REP. 104-98, at 4 (discussing strike suits); H.R. REP. 104-50(I), at 15 (same).

[96] *See* Section 27, 15 U.S.C. § 78aa. Section 10(b) provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange - . . .
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5, the parallel regulation, gives rise to the private cause of action. It provides that it is unlawful for any person, directly or indirectly,

> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

[97] Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983).

[98] 15 U.S.C. 78j(b) (emphasis added).

[99] *See*, *e.g.* Section 11, 15 U.S.C. § 77k (establishing liability for specified individuals and entities in connection with registration statements); Section 12(a)(2), 15 U.S.C. § 77l(a)(2) (establishing liability for sellers of securities in connection with prospectus statements).

[100] *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; *see also* Affiliated Ute Citizens of Utah v. Untied States, 406 U.S. 128, 151-52 (1972). Section 10(b) also provides more extensive

Congress also pointed to the generous federal pleading standards of the federal courts as particularly susceptible to exploitation by plaintiffs and their attorneys. Although Rule 9 provided that plaintiffs must plead fraud claims with particularity,[101] all non-fraud claims in the same action needed to meet only the far more lenient notice pleading standards of Rule 8.[102] In addition, even the burdensome Rule 9 requirements were mitigated by federal securities fraud doctrines.[103] Third, plaintiffs were able to invoke

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damages for successful plaintiffs than do the 1933 Act causes of action. *Compare* 15 U.S.C. § 78j(b) *and* 17 C.F.R. § 240.10b-5 (which do not specify damages rules) *with* 15 U.S.C. § 77l(a)(2) (providing for damages limited to rescission or its equivalent) *and* 15 U.S.C. § 77k (limiting damages based on purchase price, sale price, and of sale). *See also* LOSS & SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION at 1287-94 (discussing general rules for Section 10(b) and Rule 10b-5 damages and their "voracious exceptions").

[101] Rule 9(b), FED. R. CIV. P. (requiring allegations of fraud to be stated with particularity).

[102] Rule 8, FED. R. CIV. P. (requiring a complaint to contain "a short and plain statement of the claim showing that the pleader is entitled to relief).

[103] Applied literally, Rule 9 appears to require specific pleadings with respect to each element of the Section 10(b) claim, including that plaintiffs' relied on defendants' material misrepresentation or omission. In the Second Circuit, for example, an allegation of fraud must specify "(1) those statements the plaintiff thinks were fraudulent, (2) the speaker, (3) where and when they were made, and (4) why the plaintiff believes the statements to be fraudulent." Koehler v. Bank of Bermuda (New York) Ltd., 209 F.3d 130, 136 (2d Cir. 2000). The requisite scienter may, however, be pleaded generally. *See* Rule 9(b), FED. R. CIV. P.; Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001). The Private Securities Litigation Act of 1995 raised the pleading standard for federal securities fraud cases by adopting the language of the Second Circuit standard. *See* 15 U.S.C. § 78ub-4. Although many – including President Clinton – feared that Congress intended to impose a pleading standard higher than the Second Circuit's, see *President's Message to the House of Representatives Returning Without Approval the Private Securities Litigation Reform Act*, 31 Weekly Comp. Pres. Doc. 2210 (Dec. 19, 1995), *reprinted in* 141 CONG. REC. S19034 (Dec. 21, 1995), courts have since reached a variety of interpretations. *Compare* GSC Partners CDO Fund v. Washington, 368 F.3d 228, 236-67 (3d Cir. 2004); Southland Sec. Corp. v. Inspire Ins. Solutions, 365 F.3d 353, 361-65 (5th Cir. 2004); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 682-83 (6th Cir. 2004); Ronconi v. Larkin, 253 F.3d 423, 429 (9th Cir. 2001); Kalnit, 264 F.3d at 138; and Koehler, 209 F.3d at 136. *See also* Christopher M. Fairman, *Heightened Pleading*, 81 TEX. L. REV. 551, 600-12 (2002); Gregory P. Joseph, *How to Prepare for and Successfully Try a Securities Class Action in the Post-Reform Era*, 1190 PRAC. L. INST./CORP. 89, 102-03 (2000); Michael Dunn, Note, *Pleading Scienter After the Private Securities Litigation Reform Act: Or, A Textualist Revenge*, 84 CORNELL L. REV. 193 (1998).

the statutory provisions enabling federal courts to exercise jurisdiction over pendent and ancillary state law claims.[104] Thus, plaintiffs did not need to forgo any of their state law claims in order to pursue their Section 10(b) claims in federal court. Instead, they were able to pursue their state law claims using the more favorable discovery tools and notice pleading standards of the federal courts.

Congress also accepted the charge that a significant proportion of securities class actions were brought not to recover losses for deserving investors, but to obtain enormous fees for greedy lawyers.[105] Extensive testimony before Congress supported these views.[106] Class actions were

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Plaintiffs are able to avoid such specific and difficult pleadings in securities fraud cases, however, because the federal courts had adopted the fraud-on-the-market hypothesis. *See* Basic v. Levinson*,* 485 U.S. 224, 244 (1988). For a discussion of the fraud-on-the-market theory and a consideration of how it is affected by the PSLRA, see Jeffrey L. Oldham, Comment, *Taking "Efficient Markets" out of the Fraud-on the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U.L. REV. 995 (2003); and see *supra* at ___.

[104] 28 U.S.C. § 1367.

[105] *See* S. REP. 104-98, at 12-13; H.R. REP. 104-50(I), at 18-19. Striking disparities between lawyers' fees and plaintiffs' awards were widely reported. *See* Saundra Torry, *Going to the Head of the Class Action Settlement*, WASH. POST, April 8, 1996, at F7 (discussing cases in which class members received awards of stickers and coupons while their lawyers sought millions of dollars in fees); Kurt Eichenwald, *Millions for Us, Pennies for You*, NY TIMES, Dec. 19, 1993, at Sec. 3, 1 (discussing case in which investor received pennies on the dollar for her losses while the law firm representing the class received six million dollars in fees, plus expenses); Nancy Rutter, *Bill Lerach Thinks of Himself as Robin Hood in a Class-Action Suit*, FORBES 116 (Oct. 9, 1995); Barry Meir, *Math of A Class-Action Suit: "Winning" $2.19 Costs $ 91.33*, N.Y. TIMES, Nov. 21, 1995, at A1.

[106] *See, e.g.*, Concerning H.R. 10 and Securities Litigation Reform, Testimony Before the Subcomm. On Telecommunications & Finance of the Senate Comm. on Commerce, (1995), 1995 WL 57112 (F.D.C.H.) (testimony of Richard C. Breeden, Chairman, International Financial Services, Coopers & Lybrand LLP); Private Securities Litigation Revision, Prepared Statement, submitted to the Subcomm on Telecommunications & Finance of the Senate Comm. on Commerce (1995) (statement of Daniel R. Fischel, University of Chicago Professor of Law); Common Sense Legal Reforms Act, Hearing Before the Subcomm. on Telecommunications & Finance of the House Comm. on Comm.,

also seen as a major (and unwarranted) impediment to business and to the capital formation process.[107] Where courts and commentators in the past had recognized the important public role private litigation could play in policing market malfeasance, the new Congress rejected this possibility. It found that class actions placed enormous burdens on corporate defendants, and gave little consideration to any countervailing benefits such actions might provide.

Tales of discovery abuses by class action plaintiffs also provided an impetus for reform. In particular, criticism focused on the fact that plaintiffs and defendants in federal securities litigation faced asymmetrical discovery burdens. While defendants often were required to produce voluminous records and numerous deponents,[108] plaintiffs faced few discovery obligations at this early stage of the litigation. Critics contended that plaintiffs abused the discovery rules in two ways. First, because they

(Jan. 19, 1995) (statement of Dennis W. Bakke, President & CEO, The AES Corporation); Concerning Securities Litigation Reform, Hearing Before the Subcomm. On Securities of the Senate Banking, Housing and Urban Affairs Comm., (April 6, 1995) (statement of Charles C. Cox, Senior Vice President of Lexecon, Inc.).

[107] S. REP. 104-98, at 16-17; H.R. REP 104-50(I), at 14-15; Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. On Banking, Housing & Urban Affairs, 103d Cong., 1st Sess. 280, at 2 (1993) (statement of Senator Dodd); id. at 3 (statement of Senator Riegle); *id*. at 12 (statement of Edward R. McCracken, President, Silicon Graphics, Inc.); *id*. at 37 (statement of William R. McLucas, Director, SEC Division of Enforcement).

[108] Securities fraud cases were subject to the same discovery rules as other civil actions in federal court. For the relevant discovery rules, see FED. R. CIV. P. 26-35. By contrast, discovery in state court practice is often stayed during the pendency of a motion to dismiss. *See, e.g.*, New York Civil Practice Law and Rules, § 3214(b) (providing that service of notice of a motion to dismiss stays the defendant's disclosure obligations until the motion is decided).

could take extensive discovery early in the litigation, they were able to file complaints based on little if any information and then to attempt to unearth evidence of fraud later.[109] Second, because discovery is disruptive, expensive and time-consuming for defendants, the threat – or reality – of extensive discovery obligations forced defendants to settle regardless of the merit of the claims.[110] Indeed, some critics even charged that defendants and plaintiffs' lawyers settled *too* early in many legitimate cases. They contended that plaintiffs' lawyers were willing to take early settlements that provided substantial attorneys fees but little investor compensation when they should have expended additional time and resources to aggressively pursue more appropriate recovery for the members of the class.[111]

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[109] The Senate Report, for example, concluded that plaintiffs "sometimes filed frivolous lawsuits" in the hopes that discovery would provide a basis for their claims. S. REP. 104-98, at 14. It relied on testimony from one executive who stated that "once the suit is filed, the plaintiff's law firm proceeds to search through all of the company's documents and take endless depositions for the slightest positive comment which they can claim induced the plaintiff to invest and any shred of evidence that the company knew a downturn was coming." *Id.* (citation omitted). According to general counsel of an investment bank, "discovery costs account for roughly 80% of total litigation costs in securities fraud cases." *Id.* (citation omitted).

[110] S. REP. 104-98, at 14. *See also* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) (contending that class action settlements in securities litigation are often neither voluntary nor accurate reflections of the merits of the claims). For criticism of Alexander's analysis, see Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 453 (1994).

[111] SEC Chairman Arthur Levitt testified that "counsel may have a greater incentive than the members of the class to accept a settlement that provides a significant fee and eliminates any risk of failure to recoup funds already invested in the case." Securities Litigation Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Congr. 2d Sess., 35-36 (1994). He also noted that if the defendant does not prevail on an early motion to dismiss, "the economics

In addition, the mere existence of unresolved fraud allegations also was alleged to have prompted defendants to settle spurious claims. Critics of securities fraud class actions contended that merely by bringing fraud allegations plaintiffs were able to cast a pall over a defendant corporation, and that corporations thus targeted were willing to settle meritless claims simply in order to remove the cloud of suspicion.[112] Plaintiffs – and in particular, plaintiffs' class action lawyers – were believed to be exploiting this side effect of litigation to extort settlements far greater than the likely and appropriate value of a recovery at trial.[113]

The PSLRA reveals the congressional commitment to disclosure as the primary means of preventing and exposing malfeasance. Congress's faith in disclosure appears in two forms: First, in its general distrust of private litigation, and second, in the type of reforms it adopted. The PSLRA reflects deep suspicion towards private litigation as a legitimate means of deterring and revealing securities fraud. Each of the driving assumptions of the Act stems from a belief that the amount of securities *litigation* far exceeded the amount of securities *fraud*. Condemnation of the frequency of suits, the extensive use of federal discovery mechanisms, and

of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial." *Id.* at 36.

112 S. REP. 104-98, at 21. For a reporter's overview of the argument, see Kathleen Day, *When Shareholders Sue Is It a Matter of Justice for Aggrieved Investors or "Legal Extortion"?*, WASH. POST, Jan. 31, 2004, at F1.

113 S. Rep. 104-98, at 21-22.

large settlements all amounts to condemnation of the process of litigation itself. When Congress enacted the PSLRA, it codified the belief that litigation was much less necessary and less useful than plaintiffs had claimed.

This suspicion of litigation is the complement of faith in disclosure. Assuming that Congress seeks to ensure market integrity and to eradicate fraud, it traditionally has used two tools. One is the system of mandatory disclosure, which is designed to prevent and expose fraud before and as it happens. The other is enforcement – both public and private. The use of enforcement recognizes that markets cannot be entirely self-policing: some malfeasance will occur that participants will not be able to avoid or recover from. Enforcment actions – brought by the SEC, the Department of Justice, private litigants, State Attorneys-General, self-regulatory organizations – provide an added layer of security, policing the markets from without as disclosure allows them to be judged from within. The PSLRA strongly favors the first of these tools (disclosure) over the second (enforcement). This favoritism emerges both ideologically and practically. Leading up to the passage of the PSLRA and throughout the congressional hearings, extensive testimony attacked litigation as a blight on the market system, a scourge that served no one but greedy plaintiffs' attorneys. This conceptual antipathy toward private litigation created the impetus for the significant procedural reforms of the PSLRA. The faith that disclosure, rather than private enforcement, could ensure market integrity then provided the basis for the nature of those reforms.

*(b) The PSLRA Reforms*

Each of four significant PSLRA provisions reflects and codifies a faith in disclosure as the primary means of preventing and exposing securities fraud. The key reforms of the PSLRA included (a) a heightened pleading standard, requiring plaintiffs to include allegations giving rise to a strong inference of fraudulent intent on the part of defendants[114]; (b) an automatic stay of discovery upon the filing of a motion to dismiss[115]; (c) lead plaintiff provisions designed to wrest control of the litigation from lawyers and return it to their clients – the class and its representatives[116]; and (d) a statutory safe-harbor for forward-looking statements.[117]

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[114] *See* PSLRA § 101(b), 15 U.S.C. § 78u-4(b) (amending Section 21D of the 1934 Act).

[115] *See* PSLRA § 10, 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B) (amending Section 27(b) of the 1933 Act and Section 21D(b) of the 1934 Act).

[116] *See* PSLRA § 101, 15 U.S.C. §§ 77z-1(a)(3), 78u-4(a)(3) (amending Section 27(b) of the 1933 Act and Section 21D(b) of the 1934 Act). The lead plaintiff provision creates a presumption that the plaintiff who has the largest financial interest in the case and who otherwise satisfies the class representatives of Rule 23 should serve as lead plaintiff. *See* 15 U.S.C. § 77z-1(a)(3)(B)(iii)(I); FED. R. CIV. P. 23. The PSLRA reform was crafted to "increase the likelihood that institutional investors will serve as lead plaintiffs." S. REP. 104-98, at 11 (1995); *see also* H.R. CONF. REP. NO. 104-369, at 6 (1995). The lead plaintiff in turn is to select and retain lead counsel, subject to the approval of the district court. *See* 15 U.S.C. § 77z-1(a)(3)(B). The appointment process for lead plaintiff is designed to be competitive in the hopes that competition will ensure that the best plaintiff guides the class. A final provision to ensure plaintiffs are not mere puppets of their lawyers requires the lead plaintiff to file a sworn statement certifying that they have reviewed and authorized the complaint, that they did not purchase securities at the direction of counsel or for the purpose of pursuing litigation. *See id.*

[117] *See* PSLRA § 102, 15 U.S.C. §§ 77z-2, 78u-5 (amending the 1933 and 1934 Acts).

First, the heightened pleading standard requires plaintiffs to make allegations giving rise to a strong inference of fraudulent intent. Because plaintiffs must make these allegations in the complaint – at the very commencement of litigation, prior to any initial disclosures or discovery – such allegations can only be possible if one assumes that sufficient evidence of the defendants' fraudulent intent will be publicly available. Although it may be easily established in some cases, fraudulent intent – or the scienter necessary to sustain a Section 10(b) claim – can be difficult to plead in detail prior to discovery. Indeed, Rule 9 of the Federal Rules of Civil Procedure, which governs the pleading of fraud claims, recognizes this difficulty by permitting scienter to be pleaded generally, rather than with the particularity required of other fraud allegations.[118] The PSLRA heightened pleading standard instead assumes that in meritorious fraud cases, disclosure and public information will provide sufficient evidence of intent to enable plaintiffs to meet this high threshold.

Second, the PSLRA requirement that discovery be automatically stayed upon the filing of a motion to dismiss securities fraud claims also reflects a belief that all of the information required to plead the fraud claims will be publicly available. Again, the legislation trusts in disclosure – in the public availability of all relevant information – to provide the basis for

[118] Under Rule 9(b), "[m]alice, intent, knowledge and other conditions of mind of a person may be averred generally." Rule 9(b), FED. R. CIV. P.

enforcement. This kind of legislation *limits* the investigative power of litigation. On this approach, litigation has no independent expositive purpose: instead, it primarily forces it instead to seek redress for fraud that is already evident. Here, litigation must serve to process claims, not monitor markets. The true monitoring is to be done through public disclosure.

Third, the adoption of a safe-harbor for forward-looking information again reflects a faith in disclosure to process and evaluate issuer information. Unlike the pleading and discovery provisions, the statutory safe-harbor does not directly address the litigation process. Under certain conditions it does, however, respond to pressure from public companies to insulate predictive statements from liability. In this sense, it again reflects a belief that if the information is publicly disclosed, in the appropriate context, with the correct disclaimers, then the market will be able to process the information and appropriately value the related securities. Like the other two provisions, it distances litigation from the process of checking the accuracy of such statements or to expose misrepresentations. Again, the burden is mainly on the market – the disclosure system – to evaluate and monitor the statements.

A fourth noteworthy provision of the PSLRA, the lead plaintiff provision, is unique. Unlike the other three, it addresses directly what was alleged to be the primary evil of private securities class action litigation: its domination by self-interested, over-zealous plaintiffs' attorneys, who sued on their own behalves, and cared little, if anything, for the interests of the class (and indeed, were alleged to have "created" the class by employing so-called professional plaintiffs).[119] The lead plaintiff provision does not turn on the availability of information in the public sphere. Rather, it uses procedural mechanisms and prerequisites to increase the likelihood that class litigation will be driven by plaintiffs who are highly motivated and legitimately concerned in the outcome of the case, and that those plaintiffs will direct their lawyers, not vice versa. It does so by amending Section 27 of the Securities Act to provide for appointment of a lead plaintiff "the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members" and institutes a rebuttable presumption that the most adequate person is the person that "has the largest financial interest in the

[119] Milberg Weiss was singled out for particular castigation during the legislative process. Recently, news reports have stated that federal prosecutors have been investigating Milberg Weiss for four years in connection with the firm's practices in civil securities class actions. One of the "professional plaintiffs" has been indicted, and three partners of the former firm – including William Lerach, their lead lawyer for the WorldCom litigation – have been told that they face possible criminal indictment. *See Prosecutors Step Up Probe of Milberg Weiss Law Firm*, WALL ST. J., Aug. 8, 2005, at A1; Timothy L. O'Brien & Jonathan D. Glater, *Robin Hoods or Legal Hoods? The Government Takes Aim at a Class Action Powerhouse*, NY TIMES, July 17, 2005, at B1.

relief sought by the class" who otherwise satisfies the Rule 23 requirements.[120]

In sum, of four main PSLRA reforms, three rest on a faith in disclosure to prevent and expose fraud *ex ante*, and reduce litigants' ability to investigate, uncover, prosecute and hence deter fraud.

After the PSLRA's adoption, commentators and corporate defendants closely followed class action plaintiffs' responses. Many securities class actions continued to be filed in federal court, but it appeared that the number filed in state courts had increased significantly.[121] It seemed that the PSLRA had shifted the balance in favor of state litigation:

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[120] 15 U.S.C. § 77z-1(a) (3)(b). By preferring the appointment of the person or persons with the largest financial interest in the action, the lead-plaintiff provisions adopted a preference for large institutions over individual investors.

[121] Claims brought under state law, for example, might be eligible for punitive damages awards. Although moving to state court made it more difficult for plaintiffs to pursue nationwide class actions, they could compensate by bringing statewide class actions in multiple states. Plaintiffs in state court could not avail themselves of the fraud on the market theory, as they had in federal court, but they also did not have to meet the heightened pleading standard imposed by the PSLRA. In sum, plaintiffs were quick to interpret the new law and to identify its weaknesses. They saw that although the PSLRA foreclosed some options, it left others open and adapted their approaches accordingly. *See* Michael A. Perino, Legislative Forward, *Fraud & Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 302-03 (1998); Office of General Counsel, SEC, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 68-69 (Apr. 1997); Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience* at 9 (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 140, Feb. 1997); Denise M. Martin, Vinita M. Juneja, Todd S. Foster & Frederick C. Dunbar, *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions?* 8 (National Economic Research Associates, Nov. 1996). *But see* Richard W. Painter, *Responding to A False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 42-45 (1998).

post-PSLRA, the benefits of state court compensated for having to forgo some of the advantages of federal court. [122]

Only a few years after its implementation, many proponents of the securities reforms concluded that the PSLRA had failed. They returned to Congress with new complaints about exploitative plaintiffs' strategies, and sought additional legislation designed to further constrain class action litigation and to effectuate the PSLRA requirements.[123]

*2. The Securities Litigation Uniform Standards Act of 1998*

Congress responded to the plaintiffs' adaptations to the PSRLA by enacting a second major securities litigation reform act. Passed in 1998, the Securities Litigation Uniform Standards Act ("SLUSA")[124] contained procedural requirements designed to return securities fraud class actions to federal court in order to give effect to the litigation restrictions of the PSLRA. SLUSA's main achievement in this regard was its approach to preemption and removal of the offending class actions. SLUSA preempted securities fraud claims under state law, when alleged in "covered class actions."[125] Its preemption provision provides:

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[122] *See* LOUIS LOSS & JOEL SELIGMAN, IX SECURITIES REGULATION at 4424-46 (3d Ed. 1992).

[123] *See, e.g.*, David Segal, *Cases Contingent on Bad News; Lawyers in Shareholder Suits Drawing Big Fees – and Strong Criticism*, WASH. POST, Nov. 15, 1997, at G1 (discussing lobbying efforts).

[124] Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.).

[125] "Covered class actions" are defined in reference to the "covered securities" that Congress defined and subjected to exclusive federal regulatory authority in Section 18 of the National Securities Markets Improvement Act of 1996. *See* 15 U.S.C. §§ 77r(a) &

> No covered class action based upon the statutory or common law of any State . . . may be maintained in any State or Federal court by any private party alleging – (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.[126]

SLUSA's narrow focus is evident on its face. It does not preempt state law securities fraud *causes of action*: Instead, it preempts state securities fraud claims *only when they are alleged by a "covered class action*." SLUSA's approach reflects its underlying assumptions and motive: that class actions (not state securities laws) are threatening, and that federal law must rein them in.[127]

SLUSA ensures a particularly aggressive form of preemption. Typically, when a state law claim is preempted by federal law, the motion to dismiss would be brought in and decided by the state court: where federal law preempts, the state court is required to dismiss. SLUSA, by contrast,

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77r(b)(1)-(4). The covered class action provision includes a "carve out" designed to exclude from preemption state lawsuits brought as shareholder derivative suits. 15 U.S.C. § 77p(d)(1); *see also* David M. Levine & Adam C. Prichard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 24 (1998).

[126] 15 U.S.C. § 77p(b).

[127] On the uniqueness and constitutionality of the SLUSA preemption and removal provisions, see A.C. Pritchard, *Constitutional Federalism, Individual Liberty, & the Securities Litigation Uniform Standards Act of 1998*, 78 WASH. U.L.Q. 435 (2000). Despite its facially narrow focus, SLUSA's place in the accumulation of federal securities law reforms may have caused it to have a more significant effect on the basic federal/state divide over corporate governance than one might expect. Robert B. Thompson has argued that SLUSA's enactment shifted this balance and increased the importance of shareholders' voting role relative to other shareholder functions. *See* Robert B. Thompson, *Preemption & Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, & Sue*, 62 LAW & CONTEMP. PROBS. 215 (1999).

requires the action *first* to be removed to federal court, then, when appropriate, to be dismissed by the federal court as preempted by the federal law.[128]

The removal provision is designed to prevent securities fraud class action plaintiffs from circumventing the reforms of the PSLRA through tactical use of state court procedures and, more broadly, from using the state courts to their advantage at all. Congress (and the corporate lobby) feared that if class actions alleging state fraud claims were preempted but not removed, extensive litigation over whether or not the claims were covered could still continue in state court.[129]

SLUSA's removal provision helps to render the PSLRA effective in two ways. First, removal triggers the federal PSLRA discovery stay, thus preventing plaintiffs' from evading that restriction and burdening defendants with discovery requests that the PLSRA sought to limit.[130] Second, because the question of preemption will be decided by federal, rather than state, courts, Congress expected the SLUSA removal provision to provide greater uniformity in interpretation of the scope of preemption.[131] By targeting the form, rather than the content, of securities actions, SLUSA

[128] *See* Pritchard, *supra*, n.__, at 490-91.
[129] H.R. Rep. No. 105-640, at 16 (1998) ("This provision is designed to prevent a State court from inadvertently, improperly, or otherwise maintaining jurisdiction over an action that is preempted . . . .").
[130] Pritchard, *supra*, n.__, at 491.
[131] *Id.*

has achieved its stated goal: Federal courts are now, with limited exception, the sole fora in which class actions involving covered securities may be pursued.[132]

Like the PSLRA before it, SLUSA was driven by key underlying assumptions regarding private securities litigation. First, it responded to concerns that the PSLRA had not constrained securities litigation, but merely had shifted it from federal to state court.[133] How Congress –

[132] In February 2005, Congress passed and the President signed into law, legislation that applies a SLUSA-like approach to all major, national class action litigation. Like SLUSA, the Class Action Fairness Act of 2005 ("CAFA"), Public Law 109-2, 119 Stat. 4 (Feb. 18, 2005), was motivated by concerns about the merits and extortionate effects of class action litigation, and the over-zealous and allegedly self-interested role played by plaintiffs' attorneys. CAFA amends the federal diversity jurisdiction statute to extend the jurisdiction of the federal courts to a broad range of class action litigation. It eliminates the requirement of complete diversity as among defendants and class representatives by permitting jurisdiction where *any* class *member* is diverse from *any* defendant. *See* 28 U.S.C. § 1332 (d)(2)(A). In addition, CAFA amends the amount-in-controversy requirement for class actions to provide that "the claims of the individual class members shall be aggregated" to meet the requirement, rather than considered individually, as under the prior law. *See* 28 U.S.C. § 1332(d)(6). CAFA does include certain limitations on federal jurisdiction over such interstate class actions, however. Like SLUSA, it includes what amounts to a Delaware carve-out by excluding class actions that relate to the internal affairs or governance of a corporation and that arise under the law of the state of incorporation or organization. *See* 28 U.S.C. § 1332(d)(9). Also, since SLUSA already preempts and removes class actions regarding covered securities, they are excluded from CAFA's purview. CAFA also includes exceptions regarding the number and/or type of plaintiffs and defendants who are citizens of the state, the total number of class members, the involvement of States of State officials as defendants. *See* 28 U.S.C. §§ 1332(d)(2)-(5).

[133] Senator Christopher Dodd, for example, explained that new legislation was needed in part because the PSLRA was "working so well on the Federal level that weaker claims have migrated from Federal courts to State courts . . . a development that threatens . . . the success that we have achieved to date in this general area." The Securities Litigation Uniform Standards Act of 1997 – S-1260: Hearings on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. On Banking, Housing, & Urban Affairs, 105th Cong. at 15 (opening statement of Senator Christopher J. Dodd) (Oct. 29, 1997). This sentiment was reflected in the language of the statute itself. Securities Litigation Uniform Standards Act of 1998, § 2(2), 112 Stat. 3227, 3227, 15 U.S.C. § 78(a) ("The Congress finds that . . . (2) since enactment of [the PSLRA], considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts . . . "). *See also* H.R. Conf. Rep. No. 105-803, at 13, *reprinted in* 144 Cong. Rec. H11, 021

influenced heavily by anti-class action commentators and the corporate lobby – perceived this shift determined its response. It appeared to many that the shift from federal to state court simply indicated how far the greedy plaintiffs' bar was willing to go to extort settlements (and their exorbitant attorneys' fees) from corporate targets.[134] Few, if any, suggested that the suits had shifted because investors continued to be defrauded and to need fora in which to pursue their claims. Few, if any, contested the assumptions that the shift had indeed occurred and that it was undermining the PSLRA reforms.[135] In addition to concerns about the ways in which plaintiffs' adaptations had rendered the PSLRA ineffective, Congress responded to concerns that an increase in state claims and state litigation would in turn produce an increase in state legislation. Citing reforms proposed by the plaintiffs' bar in California,[136] many warned that securities regulation was

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(Oct. 15, 1998); Painter, *supra* n.__, at 42-45 (describing this claim and questioning its empirical support). For studies assessing the migration, see *supra* n.__.

[134] *See generally*, David Segal, *Cases Contingent on Bad News; Lawyers in Shareholder Suits Drawing Big Fees – and Strong Criticism*, WASH. POST, Nov. 15, 1997, at G1 (reporting on claims that plaintiffs had "made an end-run" around PSLRA reforms); Bruce Rubenstein, *Fraud Failsafe or License to Lie*, CORP. LEG. TIMES, Nov. 1997, at 1 (discussing post-PSLRA plaintiffs' tactics).

[135] Noteworthy among the exceptions were Richard Painter and Joel Seligman – Seligman's cautionary analysis coming even before the passage of the PSLRA. *See generally* Painter, *Responding to a False Alarm*, *supra* n.__; Seligman, *supra* n.__.

[136] A November referendum ballot in California included Proposition 211, a law proposed and drafted primarily by plaintiffs' attorneys and designed to make it easier for investors to sue companies and their executives. *See* Retirement Savings & Consumer Protection Act, Prop. 211, 1995-96 Reg. Sess., 1996 Cal. Legis. Serv. No. 10, at A-20 (West); *see also* Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641, 683 (1997); Elizabeth Corcoran, *A Contentious Proposition: California Firms Fight Move to Make it Easier for Investors to Sue*, WASH. POST, Sept. 24, 1996, at C1. The measure was defeated.

on the verge of a "race-to-the-bottom," in which states would enact laws in a competition to be generous to plaintiffs and hostile to nationally traded public companies.[137]

SLUSA also reiterates suspicion of private litigation as a legitimate means of monitoring markets. Instead of considering whether plaintiffs had moved to state court because the federal restrictions were burdening meritorious claims, Congress saw the purported migration as further evidence of attorneys' exploitative tactics. SLUSA was designed primarily to ensure the effectiveness of the PSLRA reforms and it consequently shares the same concerns and motivation as the PSLRA: distrust of plaintiffs and a desire to minimize and constrain private securities litigation.

*3. The Sarbanes-Oxley Act of 2002*

In 2002, Congress again undertook major reform of the securities laws. The Public Accounting Reform and Investor Protection Act of 2002, commonly known as the Sarbanes-Oxley Act, responded to a new set of concerns, using a different set of tools.[138] Where the PSLRA and SLUSA addressed the perceived excesses of the plaintiffs' bar, the Sarbanes-Oxley Act responded to a flood of revelations of massive corporate fraud.

[137] Of course, whether this is a race to the top or to the bottom depends on one's perspective. But many considered the possible consequences of a "Delawarization" of state securities fraud laws. *See* Painter, *Responding to a False Alarm*, *supra* n.___, at 71-75 (discussing this debate); Perino, *Fraud & Federalism*, *supra* n.__, at 322-29.

[138] *See* Joel Seligman, *No One Can Serve Two Masters: Corporate & Securities Law After Enron*, 80 WASH. U.L.Q. 449 (2002).

Although in 2002 the tide had turned from condemnation of plaintiffs' lawyers to that of corporate malfeasants, Congress's response to the flood of fraud was largely an emphatic reaffirmation of faith in the disclosure principle. The Senate Report described the Act's purpose as "to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years. . . . The bill [] requires steps to enhance the direct responsibility of senior corporate management for financial reporting and for the quality of financial disclosures made by public companies."[139] As this statement of purpose indicates, the Sarbanes-Oxley Act focuses on personal and entity responsibility for the integrity of public issuers' financial disclosures. Unlike the PSLRA and SLUSA, the Sarbanes-Oxley Act concentrates on creating structural remedies for the information asymmetries in initial and secondary markets, not on managing securities litigation. The Sarbanes-Oxley Act entrusts disclosure and gatekeeper monitoring – not government or private litigation – with primary responsibility for averting fraud. As discussed below, in addition to the new disclosure requirements, some of the most wide-ranging and much-discussed provisions of the Act are those that impose new monitoring and reporting responsibilities on companies'

[139] Public Company Accounting Reform and Investor Protection Act of 2002, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 107-205, 107th Cong. 2d Sess. 2 (2002).

executives and directors and on their outside accounting and legal experts.[140]

The Sarbanes-Oxley Act responded to revelations of fraud by imposing additional disclosure requirements on public companies. In particular, the new obligations were designed to heighten transparency with respect to executive compensation and off-balance sheet arrangements.[141] The Sarbanes-Oxley Act also required the SEC to adopt rules regarding disclosure of off-balance sheet transactions in quarterly and annual reports,

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[140] For an analysis of the role of corporate gatekeepers and the use of expertise generally, see Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735 (2004). Prior to the passage of the Sarbanes-Oxley Act, Frank Partnoy had argued that investment banking, accounting and law firms can play a key role as gatekeepers, and proposed a modified strict liability regime to enhance their effectiveness in that role. Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U.L.Q. 491 (2001).

[141] In support of increased financial disclosure, former SEC Chairman Richard Breeden testified before the Senate committee that:

> Some of Enron's financing vehicles appear to have been structured to let the company report income that had never occurred, and that might never occur, while essentially arming a neutron bomb in its financial structure. That this was not clearly disclosed, and that nearly 50% of Enron's assets could have been held off balance sheet, demonstrates that both GAAP and SEC disclosure standards need an expedited review and some fast co rrective action to increase transparency. The SEC and FASB should work together to structure an appropriate combination of policies, with more on balance sheet treatment and vastly more disclosure.

Senate Committee on Banking, Housing & Urban Affairs, *Oversight Hearing on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies* (Feb. 12, 2002) (prepared statement of Richard C. Breeden, former Chairman of the Securities & Exchange Commission). In interpreting the new requirements, the SEC broadened the scope of the material companies should consider and discuss in detail in the Management's Discussion and Analysis ("MD&A") portion of public companies' required Forms 10-K and 10-Q disclosures. The Commission focused in particular on discussion of liquidity and capital resources, trading activities that induce non-exchange traded contracts, and the effects of transactions with related parties. *See* David S. Ruder, Yuji Sun, & Arek Sycz, *The Securities & Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis & Evaluation*, 80 NOTRE DAME L. REV. 1103, 1124 (2005).

in order to prevent Enron-esque obfuscation of off-balance sheet transactions through the use of special purpose entities.[142]

Because the Sarbanes-Oxley Act was a response to the massive accounting frauds at companies like Enron and WorldCom, it focused extensively on improving the accounting oversight of publicly traded companies. The Act established the Public Company Accounting Oversight Board, a private organization charged with registering, inspecting, investigating, disciplining and setting audit standards for public accounting firms that provide audit reports for issuers covered by certain of the securities laws.[143] The Act's other provisions also focused on financial accounting and sought to ensure the integrity of the auditing process. Among other things, it prohibited accounting firms from providing certain delineated nonaudit services to their claims,[144] regulated public company audit committees and reliance on corporate audits,[145] and imposed responsibility for financial reporting on executive officers.[146]

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[142] *Id.* at 1127. In general, "the SEC rules implementing section 401(b) establish comprehensive and detailed disclosure standards for using non-GAAP financial measures, while preserving antifraud measures." *Id.* at 1137.

[143] LOSS & SELIGMAN, *supra* n.__, at 61-62

[144] Sarbanes-Oxley Act § 201, 15 U.S.C. § 78jA. The Section is designed to eliminate the conflicts of interest that arose when accounting firms provided both auditing and consulting services for their clients.

[145] Title III of the Act adds Section 10A(m) to the Exchange Act. It directs that:

> The audit committee of each issuer, in its capacity as a committee of the issuer, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each

The Sarbanes-Oxley Acts also placed additional responsibility on corporate executives. First, it sought to reduce executive fraud and mismanagement by limiting various opportunities for executives to abuse compensation mechanisms.[147] Second, the Act made executives explicitly and publicly responsible for the accuracy of financial reports filed with the SEC. Three separate provisions required certification of the accuracy of reports filed with the SEC: Sections 302, 404, and 906 (and the rules promulgated thereunder) use certification requirements to encourage corporate management to control and evaluate internal disclosure controls and procedures.[148] The SEC's implementation of the reforms also focused heavily on disclosure. Pursuant to the Act, the Commission accelerated the filing deadlines for quarterly and annual reports, expanded the range of

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> registered public accounting firm shall report directly to the audit committee. The audit committee is required to be comprised entirely of independent directors and be authorized to engage independent counsel and other advisors.

Sarbanes-Oxley Act, Section 301, 15 U.S.C. § 78jA(m)(2).

[146] Section 302 requires extensive certifications to be made by the principal executive officer(s) and the principal financial officer(s) for each quarterly and annual report filed pursuant to Sections 13(a) and 15(d) of the Exchange Act. Sarbanes-Oxley Act, § 302(a), 15 U.S.C. § 7241(a); *see also* 17 C.F.R. §§ 240.13(a)-14, 13(a)-15 (implementing Section 302). For an analysis of the certification requirements, see Roberta S. Karmel, *Realizing the Dream of William O. Douglas – The Securities & Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 101-03 (2005).

[147] Key provisions required the CEO and CFO to return any bonus, incentive, equity-based compensation or profits from the sale of issuers' securities in the event the issuer was required to file an accounting restatement due to misconduct, Sarbanes-Oxley Act, § 304, 15 U.S.C. § 7243; prohibited directors and executives from trading in the issuers' securities during any employee fund blackout period, Sarbanes-Oxley Act, § 306, 15 U.S.C. § 7244; and banned companies from extending credit (in various forms) to any director or CEO. Sarbanes-Oxley Act, § 406(k), 15 U.S.C. § 78m(k).

[148] *See* Sarbanes-Oxley Act of 2002, §§ 302, 404, 906, 15 U.S.C. §§ 7241, 7262, 18 U.S.C. § 1350; *see also* 17 C.F.R. § 240.13a-15 (Rule 13a-15).

events that triggers the requirement of filing a current report, mandated detailed discussions in the MD&A sections, imposed executive certification requirements, and adopted pro forma disclosure regulations.[149]

In addition, the Sarbanes-Oxley Act imposed rigorous rules of professional responsibility for attorneys.[150] In particular, the rules governing attorneys require them to report evidence of material violations of securities laws or breaches of fiduciary duty to the chief legal officer or CEO of the company, and, if the reportee "does not appropriately respond," to report the evidence to the audit committee or to the board of directors directly.[151]

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[149] LOSS & SELIGMAN, *supra* n.__, at 61-63. In addition to the detailed provisions regarding financial information and material changes in issuers' prospects, disclosure is used as the means to encourage improvements in corporate ethics. Section 406 of the Sarbanes-Oxley Act requires issuers to disclose annually whether the company has adopted a code of ethics for key executive and financial officers. § 406, 15 U.S.C. § 7264; *see* Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253 (2005). Although the Sarbanes-Oxley Act casts such obligations in terms of disclosure, some have seen its provisions as an unusual federal incursion into the substantive law of corporate governance. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

[150] ABA Center for Continuing Legal Education, *Sarbanes-Oxley Revolution in Disclosure and Corporate Governance: Complying with the New Requirements* (2003); Symposium, *The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002*, 52 AM. U. L. REV. 613, 617 (2003).

[151] Sarbanes-Oxley Act, § 307, 15 U.S.C. § 7241. For analysis and discussion of this provision, see William H. Simon, *Wrongs of Ignorance & Ambiguity: Lawyer Responsibility for Collective Misconduct*, 22 YALE J. REG. 1 (2005) (assessing Section 307 and the Bar's response); Lawrence Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915 (2003) (suggesting that many of the Section 307 provisions are redundant of pre-existing legal obligations). *See also* Tom D. Snyder, Jr., *A Requiem for Client Confidentiality?: An Examination of Recent Foreign & Domestic Events & Their Impact on the Attorney-Client Privilege*, 50 LOY. L. REV. 439, 439 (2004); Larry Cata Becker, *The Duty to Monitor: Emerging Obligations of Outside Lawyers & Auditors to Detect & Report Corporate Wrongdoing Beyond the Federal Securities Laws*, 77 ST. JOHN'S L. REV. 919 (2003);

In yet another provision designed to encourage and protect revelations of wrongdoing, the Sarbanes-Oxley Act included provisions designed to protect corporate whistleblowers.[152] Just as other provisions discussed above enlist professional gatekeepers to monitor corporate behavior, the whistleblower protection provision is designed to enlist corporate employees in monitoring and disclosing malfeasance.

In sum, the most significant securities legislation since the initial 1933 and 1934 acts relies on auditors, independent directors, attorneys, and employee whistleblowers to aid regulators in monitoring corporations and to prevent, detect, and report wrongdoing. With limited exceptions, such as the extension of the statute of limitations for securities fraud claims,[153] and increased criminal penalties,[154] it does not rely on or empower private litigants or government agencies to police or prosecute malfeasance.[155] Instead, the Sarbanes-Oxley Act operates on the presumption that disclosure itself will deter wrongdoing.

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Stuart H. Coleman, *Issues Facing Lawyers as Chief Compliance Officers & Gatekeepers*, Practicing Law Institute, PLI Order No. 6369, The Investment Management Institute 2005: Meeting the Challenge of a New Regulatory Regime (April 2005).

[152] 18 U.S.C. § 1514A. For a detailed examination of the whistleblower provision, see Robert G. Vaughn, *America's First Comprehensive Statute Protecting Corporate Whistleblowers*, 57 ADMIN. L. REV. 1 (2005).

[153] Section 804 of the Sarbanes-Oxley Act, 18 U.S.C. § 1658, provides that private causes of action involving claims of fraud, deceit, manipulation or contrivance may be brought within two years of the discovery of the violation or five years of the violation. Section 804, therefore, legislatively overrides the Supreme Court's *Lampf Pleva* 1-year/3-year statute of limitations for Section 10(b) and Rule 10b-5 claims.

[154] Sarbanes-Oxley Act, §§ 807, 903, 904-06, 1106, 18 U.S.C. §§ 78ff(a), 1348, 1341, 1343, 1350, 29 U.S.C. § 1131.

[155] *See* Ribstein, 28 J. Corp. L. 1, *supra*, n.__.

Taken together, the PSLRA, SLUSA and the Sarbanes-Oxley Act reflect a deepened commitment to using disclosure and monitoring as the primary means to ensure the integrity of the securities markets. The PSLRA and SLUSA disarmed plaintiffs and reduced the possibility for deterrence of fraud through litigation, while the Sarbanes-Oxley Act responded to massive fraud by increasing disclosure requirements and gatekeepers' monitoring obligations. The combined effect of the three major reform acts is to shift the burden of regulation and deterrence to favor more heavily *ex ante* prevention through disclosure while reducing the role of litigation as a means of *ex poste* exposure and deterrence. Given disclosure's shortcomings, such extensive reliance can be seen as an act of faith.

*B. Reform Acts in Action: The* In re WorldCom Securities Litigation

Just as plaintiffs responded to the PSLRA by relocating securities actions to state courts, they responded to SLUSA by pleading their claims to avoid the reform's procedural constraints. Since SLUSA targeted the form of the civil action, plaintiffs transformed to avoid it. Although many plaintiffs and their counsel have chosen to pursue traditional class actions in the federal fora required by SLUSA, others have explored alternative litigation strategies that they believe have the potential to increase their recovery and provide positions of greater strength for settlement negotiations. The litigation arising from the collapse of WorldCom illustrates both the stark contrast between these approaches and the dangers of focusing securities reforms on plaintiffs' strategies. As the WorldCom litigation demonstrates, it is the particular choices made by individual plaintiffs and their counsel, not the fact of litigation *per se* that can cause problems of waste, extortion and duplication in securities litigation. The two strategies employed by major plaintiffs in the WorldCom litigation reveal how securities litigation can both advance the law of market regulation and unduly burden defendants and the courts. Those strategies are analyzed in detail below.

WorldCom, Inc. had emerged from the obscurity of life as Long Distance Discount Services of Clinton, Mississippi to become one of the world's largest telecommunications companies. In the frenzied days of the telecomm bubble, WorldCom stock traded at a peak of sixty-four dollars, and was enthusiastically lauded by analysts. In the summer of 2002, as the aftershock of Enron's bankruptcy continued to resound, WorldCom topped the toppled energy giant by filing the largest bankruptcy in U.S. history. In late June, WorldCom announced that it had improperly treated more than $3.8 billion in violation of generally accepted accounting principles and would have to restate its publicly reported financial results. As it announced ever-greater restatements, the company, its executives, directors and those associated with them became the subject of extensive civil litigation, SEC investigation, Department of Justice prosecution, state and industry enforcement action and public castigation.[156] While the full scope of the WorldCom collapse and subsequent legal action is worthy of its own exegesis, elucidating the effects of the federal securities reform acts requires a more narrow focus on the civil litigation.

The civil actions arising from WorldCom's collapse offer a unique opportunity to examine plaintiffs' role in securities litigation.[157] The two largest pension funds in the United States both filed civil suits, but pursued very different strategies: the two approaches illuminate both the successes and failures of the nineties reform acts, and the dangers and issues in securities litigation reform more generally. The routes chosen by the New York State Civil Retirement Fund and the California Public Employees Retirement System are considered below.

The New York State Civil Retirement Fund ("NYSCRF"), the second-largest pension fund in the country, was one of the largest institutional investors in WorldCom: It claimed to have lost $300 million in the company's collapse. Like numerous other defrauded investors,

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[156] *See* In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 394 (S.D.N.Y. 2003).

[157] Although the analysis that follows examines two of the most significant approaches to litigating claims arising from the WorldCom fraud, others also pursued distinctive strategies. Attorneys in Mississippi, for example, filed numerous actions on behalf of small groups of individuals alleging state claims, in hopes of avoiding SLUSA's class action removal provisions.

including countless pension funds, NYSCRF brought suit soon after the restatement announcement. As one of the largest institutional investors, NYSCRF sought appointment as lead counsel pursuant to the PSLRA lead plaintiff provisions.[158] The district court consolidated NYSCRF's suit and the many other class actions that had been filed in the Southern District of New York and granted NYSCRF's motion for appointment as lead plaintiff for the consolidated class action. NYSCRF's counsel were appointed as lead counsel for the consolidated class. On behalf of the consolidated class actions (now captioned the *In re WorldCom, Inc. Securities Litigation*) NYSCRF filed a consolidated amended complaint on behalf of the class in October of 2002.

The Consolidated Complaint asserted a wide range of claims against a lengthy list of defendants.[159] WorldCom itself, however, was not among those named. Because WorldCom had filed for Chapter 11 bankruptcy, the automatic stay provisions of the bankruptcy laws protected it from litigation.[160] The bankruptcy stay did not protect the numerous others implicated in the company's collapse, however. The Lead Plaintiff's class action complaint pleaded extensive allegations against former WorldCom

[158] *See supra* at ____.

[159] The corrected, amended consolidated complaint filed after disposition of the motions to dismiss and to certify the class can be found as In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 23671651 (S.D.N.Y. Dec. 1, 2003).

[160] In re WorldCom, Inc. Sec. Litig., 293 B.R. 308, 313 (S.D.N.Y. 2003).

executives,[161] underwriters of WorldCom's two major bond offerings, directors and former directors, accountants,[162] and those responsible for issuing financial analyst reports regarding the company.[163] The complaint alleged that the defendants had violated Sections 11, 12 and 15 of the 1933 Act, which provide liability in connection with material misstatements in registration statements and prospectuses filed in connection with an initial offering for control person liability in connection with these underlying violations;[164] and that they had violated Sections 10(b) and 20(a) of the

[161] The complaint named four of WorldCom's former executives as defendants: Bernard J. Ebbers, the President, CEO and a director; Scott D. Sullivan, the Chief Financial Officer and a director; David F. Myers, the Controller and Senior Vice President; Buford Yates, Jr., the Director of General Accounting. Before the class complaint was filed, Yates and Myers had pleaded guilty to securities fraud and conspiracy, and Myers had pleaded guilty to filing false documents with the SEC. On [date] Sullivan pleaded guilty to [charges]; he then testified against Ebbers, who was convicted of [charges]. Both men have been sentenced to federal prison terms, Ebbers for a twenty-five year sentence.

[162] Arthur Andersen LLP, Andersen UK, Andersen Worldwide SC, and two Andersen partners. Arthur Andersen LLP had also been Enron's accountant and auditor.

[163] The complaint included claims against Salomon Smith Barney in its role as an underwriter for the bond offerings, and against it and its parent Citigroup and analyst Jack Grubman in connection with Grubman's analyst reports. The complaint alleged Section 10(b) fraud claims against Grubman and Salomon and control person claims against Salomon and Citigroup. The plaintiffs alleged that in a quid pro quo relationship, the defendants issued unduly favorable analyst reports, provide WorldCom executives with valuable IPO shares and loan Ebbers hundreds of millions of dollars in exchange for receiving extensive investment banking business from the company. In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 400-06 (S.D.N.Y. 2003).

[164] Section 11 provides that any signer, director of the issuer, preparing or certifying accountant, or underwriter may be liable if "any part of the registration statement . .. contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ." 15 U.S.C. § 77k(a). Purchasers have standing to sue pursuant to Section 11 whether they bought the securities at the initial offering or in the aftermarket. Those who purchase more than twelve months after the issuance of the statement do not need to prove reliance in order to recover. *Id.* Section 11 also provides an affirmative defense. If defendants can prove that the security's loss in value is due to something other than the alleged misrepresentation or omission on which the claim is based, defendants need not pay damages. 15 U.S.C. § 77k(e). Section 12(a)(2) allows a purchaser of a security to bring a

1934 Act, which create the private cause of action for securities fraud and liability for those who "control" those who committed the underlying fraud.[165] In sum, the plaintiffs brought both securities fraud claims and strict liability and negligence claims against a wide spectrum of those they believed responsible for the fraud and their resulting losses.

The California Public Employees Retirement System ("CalPERS"), by contrast, pursued an individual action. It did not join in the class action, much less seek appointment as lead counsel.[166] Instead, it filed an individual, narrowly tailored complaint in California state court. Like NYSCRF, it named former WorldCom executives, directors and former

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claim against a seller who "offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements not misleading." 15 U.S.C. § 77l(a)(2). Section 12 does not require a showing of scienter: a seller may be liable without "proof of either fraud or reliance." Gustafson v. Alloyd Co., 513 U.S. 561, 582 (1995). Like Section 11, Section 12 contains an affirmative defense. Section 15 provides that "every person who, by or through stock ownership, agency, or otherwise, . .. controls any person liable" under Sections 11 or 12 shall be liable. 15 U.S.C. § 77o. Sections 11 and 12, and Section 15 which derives from them, provided the bases for claims against a limited array of potential defendants, for more limited damages than those available under Section 10(b) and Rule 10b-5. They are in effect, however, strict liability and negligence provisions in which proof is relatively easy to establish and the defendants bear heavy burdens to rebut.

[165] Section 10(b) and Rule 10b-5 are discussed *supra* at __. As discussed above, Section 10(b) and Rule 10b-5 provide more extensive liability than the 1933 Act provisions, but are more difficult for plaintiffs to establish. Section 20(a) provides that "every person who, directly or indirectly, controls any person liable under any provision of this chapter . . . shall also be liable jointly and severally with and to the same extent as such controlled person . . . unless the controlling person acted in good faith . . . ." 15 U.S.C. § 78t(a). As its text indicates, Section 20(a) broadens the range of defendants who may be liable for damages for the underlying fraud.

[166] *See* 293 B.R. at 315 (discussing CalPERS complaint).

directors, and many of the same underwriter defendants.[167] Its allegations were much more limited, however. Instead of bringing fraud, negligence and strict liability claims, CalPERS pleaded a single cause of action – a Section 11 claim based on one of WorldCom's two major bond offerings.

CalPERS's strategy was straightforward: It limited its claims in order to remain in state court. If it had pleaded securities fraud claims pursuant to Section 10(b) and Rule 10b-5, its action would have had to be removed to federal court, which has exclusive jurisdiction over those claims. If it had pleaded class, rather than individual, claims, it would have been removable pursuant to the class action removal provision of SLUSA. Aside from the home court advantage of maintaining its action in California state court, it may not be immediately apparent why CalPERS pursued such a narrow suit in a case involving such massive losses and near-certain fraud. In fact, the true advantage to CalPERS's strategy was not to be *unique*, but to be nearly *identical* to other actions.

CalPERS strategy was designed to succeed as part of a larger conglomerate of purportedly individual actions. CalPERs' attorneys, from the San Diego office of Milberg Weiss Bershad Hynes & Lerach LLP,[168]

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[167] In re WorldCom Inc. Sec. Litig., 294 F. Supp. 2d 431, 437 & 437 nn.10-11 (S.D.N.Y. 2003) (describing a similar complaint filed in a Milberg Weiss Action on behalf of pension funds from Alaska).

[168] According to some, the WorldCom litigation was in part to blame for Milberg Weiss's final decision to split into two firms – and East and West Coast branches. *See* Timothy L. O'Brien, *Behind the Breakup of the Kings of Tort*, NY TIMES, JULY 11, 2003, at 31. In

represented approximately one hundred and twenty other public and private pension funds.[169] Milberg Weiss persuaded their numerous pension fund clients to pursue individual action in each of *their* home state courts. In a letter to clients and potential clients, it described its goal as being "to assemble a coalition of public and private pension funds with $2 to $3 billion in losses and to pursue coordinated litigation throughout the United States apart from whatever happens in the class action."[170] On behalf of these "independent" but like-minded plaintiffs, Milberg Weiss crafted a narrow complaint that it filed in each action in state courts across the country, with only minor changes to accommodate the factual circumstances of each action.[171]

By filing individual yet coordinated actions, the pension funds represented by Milberg Weiss (referred to in the District Court's opinions and hereafter as the "Milberg Weiss Actions") sought to achieve the benefits of coordinated litigation without the detriments of class action. Milberg Weiss represented that it would negotiate and litigate on behalf of all of its individual clients – thus bringing to bear the full force of their joint claims – while ensuring that they avoided the federal removal and

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particular, the May 23 letter to potential plaintiffs (discussed below) was said to have "infuriated" Melvyn Weiss and to have been the final provocation for the dissolution of his partnership with William Lerach. *Id.*

[169] In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 435 (S.D.N.Y. 2003).

[170] In re WorldCom, Inc. Sec. Litig., 2003 WL 22701241, at *4, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Nov. 17, 2003).

[171] *Id.*

consolidation that would follow had they filed suit as a class.[172] Milberg Weiss represented to potential clients that it would conduct the pension funds' actions in a "coordinated cooperative manner" so that all funds would "share the benefits of our investigatory efforts, discovery and other information, as well as experts, thus achieving economies of scale."[173] The District Court found that Milberg Weiss solicited potential clients by urging that "the advantages of coordinated litigation activity against common defendants would also include the leverage derived from the value of the aggregated claims." [174] The Court also found that the firm had sought to persuade clients to participate in its conglomerate by representing that pursuing an individual action would "permit[] the individual fund to retain control of its own claims and to be in a position to settle or try its claims as it chooses."[175]

The Milberg Weiss Actions sought to maintain this independence and establish settlement leverage by avoiding federal jurisdiction and the certain transfer and consolidation that would follow from its exercise. Indeed, the District Court found that,

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[172] In re WorldCom, Inc. Sec. Litig., 2003 WL 22701241, at *5, n.1, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Nov. 17, 2003).
[173] In re WorldCom, Inc. Sec. Litig., 2003 WL 22701241, at *4, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Nov. 17, 2003) (quoting May 23, 2003 letter from Milberg Weiss to prospective clients).
[174] *Id.* (summarizing letter).
[175] *Id.* (summarizing letter).

> [i]t would appear that Milberg Weiss has chosen a strategy to file as many cases as possible for its pension fund clients in different states and to resist removal of those cases to federal court and their subsequent transfer to a single federal court by the MDL Panel. It has eschewed the filing of Exchange Act claims even if such claims would increase a plaintiff's leverage, since the presence of Exchange Act claims would provide an independent basis for removal of the cases to federal court.[176]

By limiting their claims in this fashion, CalPERS and the other Milberg Weiss Actions hoped both to avoid the inevitable removal under these sections and to take advantage of the bar to removal contained in the 1933 Act.[177] The individual actions resisted federal jurisdiction in order to maintain their independence from the consolidated class and individual actions. As the court observed,

> The existence of a plethora of Individual Actions filed in state courts appears to be driven at least in part by the desire of counsel to escape the consolidation or coordination of their actions with other related WorldCom litigation, a coordination facilitated by the filing of an action in federal court and by the MDL process. In an apparent effort to avoid such coordination, the Individual Actions were filed in state courts across the nation and were drafted around the removal and class action provisions of the current federal securities statutes.[178]

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[176] In re WorldCom, Inc. Sec. Litig., 2003 WL 22701241, at *5, n.1, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Nov. 17, 2003); In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288(DLC), 2003 WL 21219037, at *1 (S.D.N.Y. May 22, 2003).

[177] Section 22(a) of the 1933 Act bars removal from state to federal court of claims arising under that Act. 15 U.S.C. § 77v(a).

[178] In re WorldCom, Inc. Sec. Litig., 2003 WL 21219037, at *1, No. 02 Civ. 3288 (DLC), (S.D.N.Y. May 22, 2003).

Despite the carefully planned strategy, the pension funds' actions were removed to federal court as "related to" the WorldCom bankruptcy. Pursuant to the order of the Judicial Panel on Multi-District Litigation ("MDL"), they were then transferred to the Southern District of New York for joint pre-trial treatment with the other WorldCom-related securities actions.[179] Upon arriving in the Southern District of New York, the transferred cases were consolidated with the class action by order of the District Court.[180] The Court had found that

> [g]iven the prolixity of litigation regarding WorldCom, the similarity of the claims, and the magnitude of the losses, the District Court had found that "consolidation of these actions for pretrial proceedings is necessary to achieve economies for the parties and the Court and to achieve substantial justice for the parties."[181]

Thus, in the end, due in part to the defendants' diligent removal and transfer litigation and the District Court's consistent emphasis that the litigation must be efficient and focused on the merits of the claims, the strategy failed.

Milberg Weiss's tactics in the WorldCom securities litigation are exemplary of the type of "plaintiffs' attorney" conduct that so outraged

[179] *See* In re WorldCom, Inc. Sec. Litig., 293 B.R. 308, 312 (S.D.N.Y. 2003). MDL transfer is authorized pursuant to 28 U.S.C. § 1407.
[180] In re WorldCom, Inc. Sec. Litig., 2003 WL 21219037, at *4, No. 02 Civ. 3288 (DLC), (S.D.N.Y. May 22, 2003).
[181] In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), Order, Dec. 22, 2002.

Congress when it passed the 1995 and 1998 reform acts.[182] As the District Courts opinions and orders repeatedly found, the claims alleged by CalPERS and the other Milberg Weiss Actions were precisely the same as those raised by the class. The court found that the claims raised by the individual Milberg Weiss Actions "all arise from the same underlying course of conduct that serves as the basis for the claims addressed to the May 2000 and May 2001 bond offerings, and indeed, for the claims in the Securities Litigation addressed to the trading in WorldCom's equity securities. The complaints in the Individual Actions make this point emphatically. They do not rely on any issue, such as an accounting irregularity, not set forth fully in the complaint in the Securities Litigation."[183] In addition the Section 11 and 12 claims brought by the Milberg Weiss Actions were among the most straightforward to establish. Unlike Section 10(b) claims, they required no scienter showing and had a much lower threshold with respect to causation. They were indeed negligence and strict liability claims: claims that, although intensely litigated, were not uniquely difficult for plaintiffs to pursue. CalPERS and the plaintiffs in the other Milberg Weiss Actions had purchased securities in

[182] Indeed, the district court found that Milberg Weiss had failed to include critical information in its letters soliciting clients, and that it had failed to adequately advise its clients regarding key aspects of the litigation. It found that "Milberg Weiss does not appear to have presented a forthright description of the advantages and disadvantages of both the individual action and class action options," and described in detail key failings of Milberg's representations. *Id.* at *7.

[183] In re WorldCom, Inc. Sec. Litig., 2003 WL 21219037, at *4, No. 02 Civ. 3288 (DLC), (S.D.N.Y. May 22, 2003).

the same bond offerings, in reliance on the same statements, and with the same consequences as plaintiffs in the class action: there simply was very little (if anything) that was unique about the so-called "individual actions."[184]

Instead, the sole benefit to be gained by pursuing separate, state court claims was leverage in settlement. By pursuing coordinated (but not class) actions in over twenty-five states, the Milberg Weiss plaintiffs sought to spread the defendants' resources thin.[185] Although the federal class action litigation was automatically subject to the discovery stay of the PSLRA, discovery in the state court actions could proceed. Had discovery proceeded in all actions, the number of discovery demands and motions

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[184] *See id.* This was true of other individual actions as well. As the District Court explained:

> The May 22 Opinion identified several significant case management considerations, not least of which was the preservation of assets for distribution to plaintiffs. Equally important was the need to heighten efficiency and decrease costs while ensuring a full and fair opportunity for all plaintiffs and defendants to conduct the discovery and motion practice necessary to their actions and defenses. In this case, such efficiencies are particularly appropriate since the Individual Actions and the class action all stem from the same course of conduct and involve common questions of law and fact. . . .
>
> The reasoning and purpose behind the stay was that each of the plaintiffs in Individual Actions would be on sufficient notice of the defendants' answers to their own complaints by referring to the answers filed to the class action complaint. The similarities between the individual and class actions are so great as to render separate filings of answers in each Individual Action unnecessarily duplicative and wasteful.

In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 23095478, at *3 (S.D.N.Y. Dec. 30, 2003).

[185] In re WorldCom, Inc. Sec. Litig., 2003 WL 22701241, at *4, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Nov. 17, 2003).

seeking identical information and alleging identical claims would have multiplied exponentially. Such duplication adds nothing to the adjudication of the underlying merits of the claims. The spreading of resources and competing actions do, however, greatly increase the pressure to settle due to the sheer cost of litigation for defendants and the uncertainty of multiple actions and potentially inconsistent decisions.

In the WorldCom litigation, such burdens were to some extent avoided due to WorldCom's bankruptcy, despite Milberg Weiss's unceasing efforts to separate its actions from the quickly moving class litigation. The bankruptcy laws not only prevent litigation against a bankrupt issuer, but permit removal to federal court of all actions related to the bankruptcy.[186] Defendants successfully argued in the vast majority of the individual actions that the claims were sufficiently related to WorldCom's bankruptcy to fall within the purview of the bankruptcy removal provision. The defendants succeeded in removing the cases to federal court, and in keeping them there.[187] As each of the cases was removed to federal court, it fell

[186] Section 1334(b) of the Judicial Code, 28 U.S.C. § 1334(b), provides for federal jurisdiction over cases having to do with bankruptcy proceedings. It states that "the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or *related to* cases under title 11." *Id*. (emphasis supplied). Section 1452(a) provides for removal to federal court of cases over which the federal courts have original jurisdiction. *See* 28 U.S.C. § 1452(a).

[187] The removal and remand issues were extensively litigated. *See, e.g.*, In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 22533398 (S.D.N.Y. Nov.7, 2003) (motion for interlocutory appeal); In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 22383090 (S.D.N.Y. Oct. 20, 2003) (unanimity and removal); In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 22299350 (S.D.N.Y. Oct.

within the MDL transfer order and was sent to the Southern District of New York to be handled with the class action.[188]

What are the lessons of WorldCom? First, plaintiffs (and their lawyers) are not indistinguishable. They pursue different strategies, for their own purposes, with varying degrees of success.[189] Second, Congress was correct to believe that plaintiffs' litigation is sometimes designed *solely* for unfair strategic advantage – employing tactics designed to expand the scope of their clients' recovery due *not* to an expansive view of the merits, but solely to unwarranted stretching of defendants's resources and the resulting "edge" gained in settlement negotiations. The Milberg Weiss Actions starkly demonstrate this: they added nothing to the determination of

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7, 2003) (Rule 41(a) clarification); In re WorldCom, Inc. Sec. Litig., Nos. 03 Civ. 1283, 03 Civ. 3860, 03 Civ. 2839, 03 Civ. 4499, 03 Civ. 3859, 03 Civ. 4500 (DLC), 2003 WL 21702284 (S.D.N.Y. Jul. 23, 2003) (remand); In re WorldCom, Inc. Sec. Litig., Nos. 02 Civ. 3288, 03 Civ. 3593, 03 Civ. 3597, 03 Civ. 2840, 03 Civ. 3594, 03 Civ. 3298, 03 Civ. 3591, 03 Civ. 3595, 03 Civ. 3599 (DLC), 2003 WL 21705229 (S.D.N.Y. Jul. 23, 2003) (remand); In re WorldCom, Inc. Sec. Litig., 294 B.R. 553 (S.D.N.Y. 2003) (remand & bankruptcy reorganization); In re WorldCom, Inc. Sec. Litig., Nos. 02 Civ. 3288, 03 Civ. 167, 03 Civ. 338, 03 Civ. 998 (DLC), 2003 WL 21031974 (S.D.N.Y. May 5, 2003) (remand); In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 1563412 (S.D.N.Y. Mar. 25, 2003) (severance); In re WorldCom, Inc. Sec. Litig., Nos. 02 Civ. 3288, 02 Civ. 8981(DLC), 293 B.R. 308, 2003 WL 716243 (S.D.N.Y. Mar. 3, 2003) (remand); In re WorldCom, Inc. Sec. Litig., Nos. 02 Civ. 3288, 02 Civ. 8981, 02 Civ. 9520 (DLC), 2002 WL 31867720 (S.D.N.Y. Dec. 23, 2002) (individual actions); In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2002 WL 31729501 (S.D.N.Y. Dec.5, 2002) (stays).

[188] *See* In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 21219037 (S.D.N.Y. May 22, 2003). *See also* In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288(DLC), 2003 WL 21242882 (S.D.N.Y. May 28, 2003) (consolidation order); In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 31867720 (S.D.N.Y. Dec. 23, 2002) (addressing consolidation of the individual actions with the class actions); Albert Fadem Trust v. WorldCom, Inc., No. 02 Civ. 3288 (DLC), 2002 WL 1880530 (S.D.N.Y. Aug. 15, 2002) (consolidation of the class actions and appointment of lead plaintiff).

[189] Although not related to the WorldCom litigation,

the merits, but came close to achieving a massive advantage in settlement solely through their procedural posture. Third, however, litigation can and does serve a purpose. There can be no question that executives at WorldCom engaged in extensive fraud that resulted in massive losses for millions of investors. While those investors cannot hope to recover in full the nearly twenty billion dollars they claimed to have lost, the class litigation was able to achieve some degree of remuneration for them.[190] The class action not only provided some remedy for its constituents, but also served to expose numerous dubious practices and to force the court, defendants, and commentators to consider a wide range of important but rarely scrutinized legal issues. For example, the litigation raised the question of analysts' liability pursuant to Section 10(b) and Rule 10b-5;[191] the extent and appropriateness of quid pro quo relationships between issuers, underwriters and their analysts;[192] the competing jurisdictional

[190] Several of the Citigroup defendants settled the claims against them with the Lead Plaintiff in May 2004 for $2.575 billion (the "Citigroup Settlement"). *See* In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288(DLC), 2004 WL 2591402 (S.D.N.Y. Nov. 12, 2004); *see also* Gretchen Morgenson, *Citigroup Agrees to a Settlement over WorldCom*, NY TIMES, May 11, 2004, at A1. Numerous underwriter defendants who were all non-lead syndicate members paid nearly $866 million in settlements. In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2005 WL 613107, at *2 (S.D.N.Y. Mar. 15, 2005); *see also* Gretchen Morgenson, *Investment Banks to Settle WorldCom Bond Suit*, NY TIMES, March 5, 2005, at C4; Gretchen Morgenson, *Bank of America Settles Lawsuit over WorldCom*, NY TIMES, March 4, 2005, at C1. J.P. Morgan, the last to settle, then reached a $2 billion agreement with the plaintiffs. Gretchen Morgenson, *Morgan Accord over WorldCom Costs $2 Billion*, NY TIMES , March 17, 2005, at A1.

[191] In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d at 424-30.

[192] *Id.*; In re WorldCom, Inc. Sec. Litig., 2003 WL 22533398, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Nov. 7, 2003).

provisions of the Bankruptcy Act and the Securities Act;[193] underwriters due diligence obligations under the 1933 Act;[194] directors' responsibility (even before Sarbanes-Oxley) for their certification of documents;[195] the availability of directors' personal assets for settlement;[196] and the statute of limitations bars to individual actions when a class action is pending,[197] among other things. Many of these issues had not been considered extensively by courts or commentators,[198] and many have implications that will range far beyond the WorldCom litigation. The fact that the class actions were consolidated, coordinated and held to an intense and extraordinarily fast-paced litigation schedule forced focus on the merits of the litigation and revealed the unanticipated consequences of the evolution of the securities laws.

*III. A Skeptical Approach to Securities Regulation*

As the previous Parts demonstrate, markets are messier than the law describes. Behavioral economics, cultural theory, and recent history remind us of a few key realities: First, as a practical and theoretical matter, markets cannot and do not exist independently of the individuals and entities that

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[193] California Public Employees' Retirement Sys. v. WorldCom, Inc., 368 F.3d 86 (2004).
[194] In re WorldCom, Inc. Sec. Litig., 346 F.Supp.2d 628 (S.D.N.Y.2004).
[195] 294 F. Supp. 2d at 419-420.
[196] In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288, 2005 WL 335201, at *4-*5 (S.D.N.Y. Feb. 14, 2005); In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288, 2005 WL 613107 (S.D.N.Y. Mar. 15, 2005).
[197] 294 F. Supp. 2d at 450-53.
[198] *See* In re WorldCom, Inc. Sec. Litig., 315 F. Supp. 2d 527, 545 (S.D.N.Y. 2004) (noting issues of first impression).

comprise them: They are and must be susceptible to the all-too-human traits of inconsistency, unpredictability, irrationality, logic, loyalty, and betrayal. Second, they are vulnerable to fraud. Because information asymmetries must always exist between those who have initial responsibility for gathering, processing, and presenting a company's financial information and those who use that information to make investment decisions, a gap in knowledge and control will always create an opportunity for malfeasance. And, because the information will be used by less-than-rational investors in incompletely efficient markets, disclosure is an imperfect tool for preventing and detecting fraud. Although disclosure does much to minimize the size and duration of the disparity in information and consequent opportunity for malfeasance, contemporary economics reveals that it rests on questionable assumptions.[199] Fourth and finally, recent legislative reforms addressing serious questions about the adequacy of federal market regulation have failed to take these realities into adequate consideration.

This Article does not contend that the disclosure model is undesirable or that it should be abolished. Despite mounting challenges to the economic assumptions underlying the disclosure framework, disclosure continues to provide a crucial foundation for American securities markets.

[199] Shiller, *supra* n.4, at 103.

It provides the surest way of narrowing the asymmetries in information that create opportunities for malfeasance and the means most likely to push markets toward greater openness and efficiency. This Article does argue, however, that disclosure should not function as the sole tool of securities regulators and disclosure regulations should be based on accurate assessments of its limitations as well as it advantages. Disclosure alone is not sufficient to prevent fraud, to punish those who commit it, to remunerate those who suffer from it, and to clarify the law that addresses each of those issues. Faith in a disclosure system regardless of extensive evidence that its assumptions are flawed and despite the difficulty of predicting or measuring its effects is indeed faith in a "mystical notion."[200]

This Part proposes an attitudinal shift and suggests particular reforms that such a shift might inspire. It suggests that securities regulation should embrace the complexity and uncertainty of markets and acknowledge the impossibility of designing legislation that will perfectly police malfeasance. It draws on Montaigne's philosophical skepticism to provide a conceptual basis for supplementing the disclosure regime and addressing some of its significant shortcomings in order to create a regulatory regime that better deters, detects, and punishes fraud.

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[200] STIGLITZ, *supra* n.1, at 151.

*A. Skepticism*

The skeptical philosophic tradition[201] advises that "to determine the limits of our powers and to know and judge the difficulty of anything whatsoever constitutes great, even the highest knowledge . . . ."[202] At the same time, skepticism doubts whether man is capable of such determinations.[203] As Michel de Montaigne elucidates in his seminal essay, *An Apology for Raymond Sebond*,[204] the Pyrrhonian skeptics aimed to "shake all convictions, to hold nothing as certain, to vouch for nothing" and thus to "make their faculty of judgment so unbending and upright that it registers everything but bestows its assent on nothing."[205] The refusal to bestow assent is not a dissolution into "unbelief" or "universal doubting," however, but is a means to embrace the habits of "consideration, of self-containing," and of rejection of extremes.[206] Writing on Montaigne, Emerson explains that the skeptic is not the ingénue of caricature, who "doubts even that he doubts," but "the considerer, the prudent, taking in

[201] The skeptical philosophy discussed here is in the Pyrrhonian tradition. Although Cartesian skepticism has been the focus of much discussion, that vein is characterized by its criticism of skepticism more than its embrace (even Descarte attacked skepticism). Pyrrhonian skepticism, as found in the works of Sextus Empiricus, Montaigne, David Hume, and Ludwig Wittengstein, has been described as "the only actual skeptical tradition" after ancient times, and is the tradition of skepticism referred to here. This Part will focus on skepticism as it appears in Montaigne's work and Emerson's exegesis of it. For recent work on Pyrrhonian skepticism generally, see PYRRHONIAN SKEPTICISM (Walter Sinnot-Armstrong ed., 2004).

[202] Michel de Montaigne, *An Apology for Raymond Sebond*, in MICHEL DE MONTAIGNE: THE COMPLETE ESSAYS 489, 560 (M.A. Screech ed., 2003).

[203] *Id*.

[204] *Id*.

[205] *Id*.

[206] Emerson, *supra* n.__, at 316.

sail, counting stock, husbanding his means . . . . ."[207] The skeptic "know[s] that human strength is not in extremes, but in avoiding extremes."[208] Rejecting excesses, he "labors to plant his feet, to be the beam of the balance . . . . he stands for the intellectual faculties, a cool head, and whatever serves to keep it cool."[209] For Emerson, skepticism in the Pyhrronian tradition rejects certainty in favor not of ignorance or blind doubt, but to create space for reflection and adaptation. He celebrates Montaigne as the embodiment of this engaged detachment – as someone who was a thinker of "golden averages, volitant stabilities, compensated or periodic errors, houses founded on the sea."[210]

By describing the skeptic in terms of paired opposites – *volitant* stabilities, *compensated* errors – Emerson captures the paradoxical nature of skepticism. The skeptic simultaneously operates within the existing paradigm and questions its premises – he lives in a house not *near* the sea, but "*founded on*" it. Emerson's imagery reveals the true nature of Montaigne's skepticism – he does not reject the possibility of knowledge, but is able to question even the most apparently stable of beliefs without losing his grounding. Emerson locates the skeptic as someone both within and without a given tradition by identifying his place as being in the

[207] *Id.*
[208] *Id.* at 314.
[209] *Id.*
[210] *Id.* at 317.

"*vestibule* of the temple."[211] Skepticism is not heresy – the skeptic does not forsake the temple, nor does he proclaim unorthodoxies. Instead, he enters only partway; he is there, but not committed. Thus skepticism "is the attitude assumed by the student in relation to the particulars which society adores, but which he sees to be reverend only in their tendency and spirit."[212] The skeptic venerates the principle, even as he questions it.

Montaigne, like Emerson after him, finds that skepticism is not a rejection of faith, but the philosophy that makes faith possible. For Montaigne, the true heretic is one who "dares to presume that he knows anything."[213] To be "convinced of certainty," for Montaigne, "is certain evidence of madness and of extreme unsureness."[214] The skeptical tradition, on the other hand, rejects the follies and limitations of human judgment and prevents them from serving as bases for certainty, thus clearing the path for true faith. Describing Pyrrhonian skepticism, Montaigne concludes

> No system discovered by Man has greater usefulness nor a greater appearance of truth which shows us Man naked, empty, aware of his natural weakness, fit to accept outside help from on high: Man stripped of all human learning and so all the more able to lodge the divine within him, annihilating his intellect to make room for faith.[215]

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[211] *Id.* at 322.
[212] *Id.*
[213] Montaigne, *Apology*, *supra* n.__, at 502.
[214] *Id.* at 607.
[215] *Id.* at 564.

Only by acknowledging his lack of certainty can man find faith. And when he does, he is able to truly embrace faith as such – as an act of trust without reason.

The skeptical philosophy elucidated by Montaigne and Emerson provides both a theoretical model and an illuminating metaphor for future securities reform legislation. Their work can provide the basis for a conceptual framework that permits continued adherence to a disclosure model while encouraging acceptance of its shortcomings and inducing more creative approaches to deterring malfeasance. Like Emerson's "student in the vestibule of the temple," the skeptical approach proposed here does not reject the reigning faith: Disclosure is likely the best means of balancing the interests of investors and issuers, and of ensuring fair and functional markets. While it accepts the notion that disclosure may be the most advantageous premise for federal securities regulation, the skeptical approach recognizes and seeks to address its imperfections. What then, would a skeptical argument about securities regulation look like? Does a shift in the theoretical framework provide any practical advantage in terms of debating and drafting legislation?

*B. Skeptical Securities Regulation*

First, the skepticism advocated here, properly understood, can provide a principled basis for assessing proposed regulations. It need not do so explicitly (that is, for the approach to be effective, no one need stand on the Senate floor and declare herself a Pyhrronian or quote Montaigne), but it can work by requiring arguments and laws to be structured according to a more appropriate framework. A skeptical assessment begins with questioning – with doubt about even the most commonplace of beliefs. Thus a skeptical approach to securities regulation might begin by questioning how markets function. It might ask whether they are efficient, and if so, how and in what ways? It might query how investors make decisions. Are they logical? Emotional? Consistent? Predictable? Do they use information? If so, what information and how? The information required by law to be disclosed? Or other types of information and means of accessing it? Adopting a skeptical approach is a way of returning to first principles, and thus creating a space to consider evolving understandings of market functioning. Ironically, a more philosophical approach would require consideration of more hard evidence and concrete detail regarding market behavior. Skepticism makes room for economics: By questioning legal certainties and presumptions, a skeptical approach to legislation forces the law to take the discoveries of other disciplines into account.

A skeptical approach thus might avert the continued reliance on controverted theoretical assumptions evidenced in the legislative reasoning of the PSLRA, SLUSA and the Sarbanes-Oxley Act. Although Congress had the opportunity to consider the most recent work in economics when it enacted each law, it instead adopted existing assumptions about how markets, litigants, and malfeasors operate. A skeptical approach encourages legislators to work within the existing framework, but to doubt and refuse to act on unproven assumptions.

A skeptical approach would shift not only the methodology of legislation, but its content. As Emerson recommends, the skeptic seeks to be the "beam of the balance," the cool head, or the intellectual. The skeptic rejects extremes. She resists the temptation to veer too far in any one direction, but rather seeks a philosophy that fits like "a coat woven of elastic steel."[216] Again, Emerson's metaphor captures the adaptive stability of skepticism. The skeptic is consistent yet flexible, steady yet limber. A skeptical approach is willing to consider new evidence – of plaintiffs' abuses or pervasive fraud, for example – and adapt accordingly, but it resists oscillating dramatically between extreme conflicting positions. The skeptic recognizes that such shifts might be unjustified on the facts (that is, that the basic levels or existence of malfeasance or manipulation are likely to have changed as drastically as claimed), and, as importantly, that they might be undesirable in and of themselves. In seeking elastic consistency, the skeptic recognizes that it is not just extremes that are to be avoided, but

[216] Emerson, *supra* n.__, at 317.

radical or frequent shifts between them. Such an approach would help to avoid the inconsistency and uncertainty for litigants, courts, and market participants that arise from too frequent or too drastic changes in perspective. A skeptical approach would advise against undue antagonism towards plaintiffs on the one hand, and towards the subjects of regulation on the other. It would moderate the extreme positions taken toward plaintiffs by the PSLRA and toward subjects of regulation by the Sarbanes-Oxley Act.

Skepticism also would affect the substantive content of securities regulation by altering *how* a lawmaker might view her role and approach the problem of translating new information or new problems into laws. That is, the lawmaker must ask, what is my role in this process? And, more specifically, what is the role of the regulation we are trying to design?

In answering these questions, skepticism is uniquely suited not only to frame how lawmakers might approach new legislation, but also to describe legislation's normative aspirations. On a skeptical approach to securities regulation, the law itself should reflect a skeptical attitude. Like the skeptic, securities market regulation should also "register[] everything but bestow[] its assent on nothing."[217] It should take into account the probability of fraud and other forms of malfeasance, as well as the

[217] Montaigne, *Apology*, *supra* n.__, at 560.

possibility that plaintiffs can and do sue when no fraud has been committed; it should take into account the possibility that investors are irrational and unpredictable, as well as the likelihood that thorough dissemination of material and accurate information can and does play a role in investors' decisions. Regulation should be designed to provide the framework for securities markets and *to govern* behavior within those markets in a manner most likely to ensure fairness, openness, and efficiency, but it should not also seek *to judge* the efficacy of its approach. By aggressively restricting enforcement – whether by limiting civil litigation or cutting SEC budgets, or some other method – Congress in effect pre-judges the success of its regulations. A skeptical approach rejects this conclusion and this role for Congress. It holds that while disclosure may be desirable and may indeed satisfy legislative goals, the legislator-as-skeptic is not in a position to decide.

What is the practical effect of this theoretical approach? It reassigns responsibility for regulating to Congress and for adjudicating to courts; it reasserts a role for enforcement litigation. Enforcement – civil or criminal, private or public – provides an opportunity to gain the knowledge that Congress lacks. It can determine how rationally or irrationally investors behaved in a given situation, how useful or irrelevant information was, how honest or misleading defendants were, how efficiently or inefficiently the market functioned. Adjudication is designed to resolve those remaining doubts, and should be allowed and encouraged to do so. Thus skeptical legislation would not only focus on creating an unbiased framework, but on ensuring that enforcement actions can focus on providing a fair and focused hearing. As discussed with respect to WorldCom, litigation can not only provide resolution for the parties, but can serve to clarify the law as well. Enforcement litigation thus further serves the goal of creating a regulatory regime in which litigants, investors, and market participants have a clear picture of their rights, risks, and obligations.

Instead of trying to discourage private litigation, reforms should strive to make it *work*. By encouraging legislators to reconsider the value of litigation, skepticism requires thinking practically about how to focus litigation on the merits of complex securities fraud cases and should decrease the opportunities for exploitative and meritless procedural maneuvering. Practical changes that would allow adjudication to achieve these goals could include, for example, a series of reforms designed to concentrate and streamline complex securities actions that are filed when alleged malfeasance affects investors nationwide. Reforms could consider creating exclusive federal jurisdiction for Securities Act claims (as already required for Exchange Act claims); simplifying the procedures for, and expanding the reach of, multi-district transfer, consolidation, and coordination; and tailoring federal procedural rules for discovery and motion practice in consolidated MDL cases. At the same time, reforms that seek to improve securities litigation and enhance its role in market monitoring must focus on public, as well as private, actions. For example, the enforcement office of the SEC and prosecutorial power of the Department of Justice can be potent tools for uncovering and deterring fraud, but both must ensure that white-collar crime remains a top priority, even when it fades from the headlines, and both must receive adequate funding and support from Congress.

In brief, skeptical responses to securities fraud recognize that it is impossible to know whether, and how much, securities fraud occurs, how well disclosure works, or the full extent of malfeasors' wrongdoing and investors' losses, *and seek to find out*. Litigation can be a powerful tool for doing so, and an important means for deterring malfeasors and compensating defrauded investors. Litigation's strengths – its focus on concrete facts and claims – also make it an imperfect tool for addressing some of the problems identified by behavioral economics, however. If investors truly act irrationally, a claim for securities fraud might not succeed: an irrational investor might be unable to establish the loss or transaction causation required to recover. Although SEC enforcement actions and Department of Justice criminal prosecutions have principles, objectives, tools and standards that do not apply to private plaintiffs, even they might be unable to bring their full weight to bear in such cases. Litigation, then, cannot be the only answer.

Like disclosure, litigation has the advantage of limiting its impositions on the decisions issuers and investors make. If behavioral economics is correct, however, some imposition might be necessary in circumstances where it is clear that investors are likely to make irrational choices that endanger their self-interest. For example, employees of WorldCom and Enron were not only permitted, but strongly encouraged, to invest heavily in their employers' stock. When those companies collapsed the employees lost not only their immediate income, but also their retirement savings. Substantive regulations based on a behavioral critique and a skeptical approach might recognize the irrationality and danger of such concentrated investments, and limit the percentage of their pensions that employees can commit to company stock. Substantive regulations might also recognize that merely requiring companies or executives to disclose conflicts of interest may not prevent such conflicts from tainting transactions. A skeptical approach would think seriously about identifying and prohibiting conflicts that are irremediable, with special attention to analysts, consultants, auditors, and investment banks. The Sarbanes-Oxley

Act has already taken significant steps in this direction, but it may be time to evaluate and, if necessary, expand or redirect its efforts.

The reforms outlined here are intended merely as examples of directions skeptical legislation might pursue. While they reach an assortment of issues through a variety of means, they all emerge from the recognition of disclosure's limits and of the impossibility of knowing how markets and individuals will behave. Together, they seek to replace the orthodoxy of faith in disclosure with the heterodoxy of skepticism.

*IV. Conclusion*

Despite economists' widespread recognition of significant flaws in the its underlying assumptions, the ideology of disclosure continues to serve as a foundational principle for federal securities regulation. This Article has shown that misplaced faith in markets drives federal market regulation toward greater reliance on disclosure and continued hostility to litigation and substantive regulation; and it has suggested that legislators substitute skepticism for this unwarranted fidelity. Like the skeptics, securities regulation should strive to accommodate uncertainty and to avoid extremes by seeking to craft a "coat woven of elastic steel" – to enact regulations that are simultaneously stable and mobile. A skeptical response would compensate for disclosure's limitations and help to achieve the promise of open and efficient market by using adjudication and substantive regulation to prevent, monitor, and compensate for market malfeasance. Then, when a skeptical lawmaker has faith in disclosure, her faith can be like Montaigne's – trust born of recognition of uncertainty, not unwarranted insistence or fear of change. It is an open-eyed faith; one that acknowledges and responds to uncertainty with a combination of trust and reasoned reflection. In sum, a skeptical lawmaker knows that she does not know and begins with basic questions, then seeks to develop legislation that avoids extremes but accommodates change, and, finally, leaves the work of assessing the efficacy of that legislation to the efforts of courts and litigants.