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William W. Bratton

University of Pennsylvania Carey Law School

Michael L. Wachter

University of Pennsylvania Carey Law School

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ARTICLE

THE POLITICAL ECONOMY OF FRAUD ON THE MARKET

WILLIAM W. BRATTON[†] & MICHAEL L. WACHTER^{††}

The fraud-on-the-market class action no longer enjoys much academic support. The justifications traditionally advanced by its defenders—compensation for out-of-pocket loss and deterrence of fraud—are thought to have failed due to the action’s real world dependence on enterprise liability and issuer-funded settlements. The compensation justification collapses when considered from the point of view of different types of shareholders. Well-diversified shareholders’ receipts and payments of damages balance over time and amount to a wash before payment of litigation costs. The shareholders arguably in need of compensation—fundamental value investors who rely on published reports—are undercompensated due to pro rata distribution of settlement proceeds to all class members. The deterrence justification fails when enterprise liability is compared to alternative modes of enforcement, such as actions against individual perpetrators, which deter fraud more effectively. If, as the consensus view now has it, fraud on the market makes no policy sense, then its abolition would seem to be the next logical step. Yet most observers continue to accept the action on the same ground cited by the Supreme Court when it first implied a private right of

[†] Nicholas F. Gallicchio Professor of Law and Co-Director, Institute for Law and Economics, University of Pennsylvania Law School. For comments on earlier drafts, our thanks to Stephen Burbank, Cary Coglianesi, Jill Fisch, Gerard Hertig, Edmund Kitch, Adam Pritchard, Chester Spatt, Robert Thompson, Manuel Utset, David Zaring, and participants at the Penn/NYU Conference on Law & Finance, the Penn Law-Wharton Risk Regulation Seminar, and faculty workshops at Florida State and Florida International Law Schools. Thanks also to our research assistants, Joseph Nance and Mitchell Snow, members of the University of Pennsylvania Law School class of 2012.

^{††} William B. Johnson Professor of Law and Economics and Co-Director, Institute for Law and Economics, University of Pennsylvania Law School.

action under the Securities and Exchange Act of 1934 in 1964's J.I. Case v. Borak: a private enforcement supplement is needed in view of inadequate Securities and Exchange Commission (SEC) resources. In other words, even a private-enforcement supplement that makes no sense is better than no private-enforcement supplement at all.

This Article questions this backstop policy conclusion by highlighting the sticking points retarding movement toward fraud on the market's abolition and mapping a plausible route to a superior enforcement outcome. We recommend that private plaintiffs be required to meet an actual-reliance standard. We look to the SEC, rather than to Congress or to the courts, to initiate the change because the SEC is the lawmaking institution most responsible for the unsatisfactory status quo and best equipped to propose corrective action. Because an actual reliance requirement would substantially diminish the flow of private litigation, we also suggest a compensating increase in public-enforcement capability. More specifically, the SEC Division of Enforcement needs enough funding to redirect its efforts away from the enterprise and toward culpable individuals.

The Article addresses three barriers standing between here and there. First, there is a new justification for fraud on the market circulating in the wake of the failure of the original justifications: fraud-on-the-market litigation enhances the operation of the corporate governance system. We show that this line of reasoning, while well suited to justify the federal mandatory-disclosure system, does not support—and even detracts from—the case for fraud on the market. Second, we turn to politics to explain why fraud on the market retains political legitimacy despite the failure of its policy justifications. Third, we assess the contention that inadequacy of public enforcement resources justifies maintaining a fraud-on-the-market action. To that end, we show that circumstances have changed materially since the Supreme Court first invoked the justification in 1964. The SEC budget has grown elevenfold in real terms in the intervening forty-seven years, with much of the growth coming in the wake of the Enron fraud. The SEC's enforcement resources, like those of the plaintiffs' bar, ultimately are funded with dollars drawn from shareholder pockets, inviting direct comparison between the two. We show that public enforcement offers the shareholders more value than private enforcement. Private resources are tied to a low-deterrence, enterprise-liability framework. Public enforcement, even now, yields the shareholders comparable damage returns per dollar invested in enforcement. It can be deployed more flexibly, and it can be refocused against individual wrongdoers to enhance deterrence.

We conclude that increased public enforcement makes sense for shareholders even if it implies a diminished volume of private litigation and propose a political trade-off for the SEC to present to Congress: double the enforcement budget

in exchange for an SEC-promulgated regulation replacing fraud on the market with an actual-reliance requirement.

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INTRODUCTION

The fraud-on-the-market (FOTM) cause of action just doesn't work. At least that is the consensus view¹ among academics respecting the primary class action vehicle under the federal securities laws. FOTM came forth making two promises: (1) it would compensate present fraud victims, and (2) it would operate as a deterrent against future fraud. FOTM is now generally seen to have altogether failed to

¹ See Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Law: Resource-Based Evidence*, 93 J. FIN. ECON. 207, 209 (2009) (“[T]he conventional legal academic view . . . is that securities litigation . . . is seriously compromised.”).

This view coalesced relatively recently. For many years, James D. Cox and Joel Seligman were the leading defenders of the action's conceptual framework. See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 511-15 (1997) (defending securities class action litigation by analogizing its economics to that of insurance markets); Joel Seligman, Commentary, *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, 457 (1994) (providing a broad-based defense of securities class actions). Professor Cox later reduced his level of support. See, e.g., James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 449-52 (2005) (questioning FOTM's compensatory justification in the wake of empirical evidence showing that financial institutions tend not to collect available settlement money).

Merritt B. Fox's views have also changed over time. Compare Merritt B. Fox, *Understanding Dura*, 60 BUS. LAW. 1547, 1549-50 (2005) (criticizing judicial application of the loss causation requirement from a compensatory perspective), with Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 252 (2009) [hereinafter Fox, *Civil Liability*] (reconceiving FOTM as a corporate-governance device and FOTM damages as a restitutionary measure lacking the objective of compensating shareholders for market losses).

Significantly, the only across-the-board defense of FOTM to appear in recent years proceeds at an entirely theoretical level. See James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong About 10b-5?*, 13 AM. J.L. & ECON. 359, 359-62 (2011) (showing that enterprise liability has deterrent value in a world where management and selling shareholders have a unitary interest in fooling buyers). We have no quarrel with Professor Spindler's signaling model within its four corners. This Article, however, addresses FOTM in its institutional context.

deliver on the first promise. Real-world FOTM actions proceed on an enterprise-liability theory with corporate—as opposed to individual—defendants funding the compensation; investor “victims” are accordingly compensated from the pockets of other innocent investors. It follows that not only does FOTM fail as a compensatory mechanism, it doesn’t even make sense. As to the deterrent promise, FOTM is thought to deliver, but only a little. Enterprise liability causes the problem once again: if FOTM were serious about deterrence, the funding would come from individual miscreants.

FOTM is an artifact of history. It follows from two ideas, both bound up in the securities law concept of investor protection. The first dates to the 1960s and 1970s. It holds both that investor protections under the securities laws’ antifraud provisions, in particular section 10(b) of the Securities and Exchange Act of 1934² (1934 Act) and Securities and Exchange Commission (SEC) Rule 10b-5 thereunder,³ need a private enforcement mechanism⁴ and that the class action is the procedural mode best suited for that purpose.⁵ The second idea emerged as the courts elaborated the terms of the implied private right of action by reference to the common law of fraud.⁶

The common law fraudster compensates the victim by paying his out-of-pocket losses. Thus, the securities fraud defendant should pay the out-of-pocket losses of those who buy (or sell) a stock that is over- (or under-) priced due to a misrepresentation (or omission). But the common law template also threw up substantive hurdles. The tort of fraud presupposes parties dealing face-to-face and requires a showing of reliance on the misrepresentation,⁷ a showing that cannot be made as a practical matter in a class action. FOTM, which the Supreme Court

² 15 U.S.C. § 78j (2006).

³ 17 C.F.R. § 240.10b-5 (2011).

⁴ The private right of action under section 10(b) dates back to *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946), and was approved by the Supreme Court in *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). The Court’s decision was without substantive comment, but included a citation to *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964), which implied a private right of action under section 14 of the 1934 Act, reasoning that the SEC lacked the resources to review issuer proxy statements. *Id.* at 432.

⁵ See, e.g., Barbara Black, *Fraud on the Market: A Criticism of Dispensing with the Reliance Requirement in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 439-46 (1984) (explaining the interrelation between the FOTM presumption and class action enforcement).

⁶ See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-76 (1977) (requiring deception); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (requiring scienter).

⁷ RESTATEMENT (SECOND) OF TORTS § 310 (1965).

adopted in *Basic Inc. v. Levinson*,⁸ patched over the problem by relaxing the reliance requirement. With a famous citation to the Efficient Capital Market Hypothesis (ECMH), the court ruled that a showing of reliance on the integrity of the market price would suffice.⁹

It seemed like a good idea at the time. But FOTM simply did not work in practice. The consensus to that effect is notable in itself because big-ticket causes of action tend to have squads of academic cheerleaders.¹⁰ But that consensus fosters only a limited menu of policy alternatives. On the one hand, FOTM's opponents argue that FOTM and the entire mandatory-disclosure regime should be abolished together. On the other hand, FOTM's proponents strenuously try to make it work. They take two routes in this pursuit. The first route treats FOTM as a misunderstood cause of action in need of fresh policy justification: if FOTM makes no sense as a compensatory tort, then a conceptual framework that does make sense of it needs to be substituted.¹¹ Corporate governance and agency-cost reduction have been suggested as this conceptual curative.¹² The second approach focuses on FOTM's meager deterrent properties and then looks away from theory to focus on practice. Under this view, FOTM is a necessary enforcement supplement,¹³ despite its attendant conceptual problems: even if it doesn't work as promised, we are better off with it than without it. Meanwhile, we can try to make it work a little better.

⁸ 485 U.S. 224, 248-50 (1988).

⁹ *Id.* at 246 n.24. FOTM can be traced back to *Blackie v. Barrack*, 524 F.2d 891, 906-08 (9th Cir. 1975). The Supreme Court's explicit acceptance of FOTM was pre-*gaged* by *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970), and *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972), both of which presumed reliance in order to avert factual difficulties in other private actions brought under the securities laws. See also *Basic*, 485 U.S. at 243 (discussing with approval the lack of a reliance requirement in *Mills* and *Affiliated Ute Citizens*).

¹⁰ See, e.g., James A. Henderson, Jr. & Aaron D. Twerski, *The Politics of the Products Liability Restatement*, 26 HOFSTRA L. REV. 667, 668-69 & n.3 (listing academic defenses of the existing products liability regime).

¹¹ See *infra* Section III.A.

¹² See *infra* Section III.B.

¹³ See, e.g., Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 639, 642-43 (1996) [hereinafter Langevoort, *Capping Damages*] (recommending a shift from assessing out-of-pocket loss to levying individual fines, but not advocating for the termination of FOTM); Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 655-57 (2007) [hereinafter Langevoort, *Corporate Executives*] (noting FOTM's underdeterrence shortcoming and discussing potential reforms, but not recommending its immediate termination).

This Article takes a new look at FOTM and its conceptual and practical failures with a view toward expanding the list of policy alternatives. We reject the all-or-nothing connection that the opponents make between FOTM and the mandatory-disclosure system.¹⁴ In our view, disclosure mandates are necessary, but how best to enforce them is a separate question. We also reject FOTM proponents' conceptual strategy for the action's rehabilitation.¹⁵ As will be discussed below, the switch from compensation to corporate governance does solve a few problems, but in the end, it fails to break FOTM free from its original conceptual framework and attendant shortcomings. The practical defense is more compelling, even though it provides no theoretical cure and offers only the negative justification that although FOTM doesn't work, it's the best enforcement mechanism possible. This defense challenges FOTM opponents to make an affirmative case for disrupting the status quo.

The issue is more political and practical than theoretical. Accordingly, this Article addresses the political economy of FOTM, explaining why a cause of action that doesn't work continues to enjoy political legitimacy. After surveying the political landscape, this Article maps out a plausible route to a better policy outcome.

The prevailing policy analysis of securities fraud tells us two things: First, fraud is undeterred.¹⁶ Second, an enforcement system directed against individual perpetrators will deter fraud more effectively than a system based on enterprise liability.¹⁷ These conclusions hold out two routes to a better result. The first route would redirect class actions for corporate fraud away from the enterprise to individual defendants. This alternative has been explored in the literature.¹⁸ But, in our view, this path is more expedient than promising.¹⁹ The second route concludes that private class action enforcement is intractable and looks for alternatives. This Article pursues the second path.

Accordingly, we recommend a shift in emphasis from private to public enforcement.²⁰ FOTM should be abolished in cases where the

¹⁴ See *infra* Section III.D.

¹⁵ See *infra* notes 192-04, 213-15 & 214-30 and accompanying text.

¹⁶ See *infra* notes 132-40 and accompanying text.

¹⁷ See *infra* notes 136-44 and accompanying text.

¹⁸ See *infra* notes 140-47.

¹⁹ See *infra* text accompanying notes 148-55.

²⁰ Recent work by Professor Rose also stresses the importance of shifting emphasis to public enforcement. See generally Amanda M. Rose, *The Multienforcer Approach to Securities Law Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173 (2010) [hereinafter

issuer makes no trades. An actual-reliance requirement tailored to the circumstances of investors who do fundamental analysis should be substituted. As this requirement would reduce the flow of private-enforcement litigation, public enforcers should pick up the slack. We accordingly recommend that FOTM reform be accompanied by an increase in monetary support for the SEC Division of Enforcement sufficient to shift the division's focus from enterprise-liability settlement to holding individuals responsible for corporate wrongdoing. We look to the SEC, rather than Congress or the courts, to initiate the reform because it is the institution most responsible for the current unsatisfactory state of affairs and also the institution best equipped to fix it.

Part I describes FOTM and its failure to accomplish its victim-compensation objective. The presentation concentrates on the numbers, showing how plaintiffs' lawyers calculate out-of-pocket damages that support multibillion dollar claims,²¹ which, if pursued to judgment against actual fraudsters, would result in hit-the-jackpot compensation and crushing deterrence. Unfortunately—or perhaps fortunately—attorneys in real-world class actions look for settlement value, and those facing financial destruction are either disinclined to settle or already judgment-proof. Thus, corporate issuers of securities, hauled into court along with their employees on an enterprise liability theory, pick up the settlement tab in FOTM cases. With the corporation paying the settlement, the cost of compensating the shareholders in the plaintiff class falls on those holding the company's shares at the time of settlement. The shareholders in the class and the successful plaintiffs' attorney thus pick the pockets of the payor shareholders, which include the company's longer-term shareholders. Moreover, to the extent that the paying and receiving shareholders are fully diversified, cash inflows and outflows from FOTM settlements even out over time. This result makes FOTM a wash rather than a source of compensation, but a wash that ripens into a net loss once we account for attorneys' fees, liability insurance premiums, and other costs.

Compensation may benefit one set of shareholders: underdiversified information traders who research companies and invest based on reported information. These investors' gains and losses do not neces-

Rose, *The Multienforcer Approach*] (questioning the deterrent effect of relying on a trio of federal, state, and private enforcers); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1354-55 (2008) (suggesting that federal authorities be accorded the power to select private defendants).

²¹ See *infra* subsection I.A.2.

sarily equalize over time, and compensation could reduce injury. Unfortunately, FOTM does not work here either because returns on litigation do not come close to covering the losses from fraud. While class action complaints do claim losses in the hundreds of millions of dollars,²² settlement amounts are considerably smaller. From 1996 to 2010, median settlements returned only 2.8% of estimated plaintiff losses.²³

The misdirected compensation could be redirected to those who need it by removing the *Basic* presumption and imposing an actual-reliance requirement that is tailored to the circumstances of investors who research companies. But because the number of plaintiffs able to show actual reliance will likely be small, their aggregated damages might be too low to support class action enforcement. Thus, FOTM's already modest deterrent effect would diminish further.

Part II examines FOTM's impact on fraud deterrence and the justification for the action based thereon. We assume that fraud is a persistent problem and the current antifraud enforcement system, in the absence of FOTM, is an inadequate deterrent. Although FOTM gives the system a boost, its deterrent effect is significantly muted because the corporation and its insurance company make the payments rather than the corporation's culpable agents. FOTM proponents dismiss this objection as unpersuasive, arguing that an individual-liability system with penalties of sufficient magnitude to attract private enforcers would be draconian and would likely impair recruitment of talented managers.²⁴ In contrast, a system of individual liability lacking that draconian aspect would remove the deep pocket from the settlement table and reduce the incidence of private enforcement.²⁵ As a consequence, fraud, already underdeterred, would be deterred even less, and its deadweight social cost would increase. Finally, public enforcement is not an effective substitute due to incentive problems and political constraints.²⁶

²² See *infra* subsection I.A.2 for the calculation process. For a report on the recent filings, see CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2011 MID-YEAR ASSESSMENT 11 (2011), available at http://securities.stanford.edu/clearinghouse_research/2011_YIR/Cornerstone_Research_Filings_2011_Mid_Year_Assessment.pdf.

²³ ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2010 REVIEW AND ANALYSIS 10 fig.10 (2011), available at http://www.cornerstone.com/securities_settlements_2010 (follow "Securities Class Action Settlements—2010 Review and Analysis" hyperlink).

²⁴ See *infra* text accompanying note 139.

²⁵ See *infra* text accompanying note 139.

²⁶ See *infra* text accompanying notes 150-58.

We evaluate these assertions, concluding that any deterrent value-added is indeed modest. The economics of reputation does the heavy lifting respecting corporate-actor incentives. To the extent that fraud persists despite this economic constraint, FOTM has done almost nothing to solve the problem; hence the steady and material increase in public antifraud enforcement resources in recent years. We conclude that it is no longer necessary to view FOTM as an essential component in a viable antifraud enforcement system.

Part III analyzes governance and agency-cost reduction as substitute justifications for FOTM and shows that they fall short. At first, the governance justification seems to provide a viable framework because it solves the pocket-shifting problem that undermines the compensation justification. Once governance replaces tort as the framework justifying FOTM, shareholder funding is no longer objectionable because shareholders happily pay for everything related to corporate governance so long as the agency-cost reduction exceeds the expenditure. But do shareholders have cause to be happy in the case of FOTM actions?

In the securities context, reducing agency costs means enhancing corporate transparency. Federal securities laws require truthful disclosures in order to seek to make corporate strategies and financial results observable from the outside. This leads to two claims about agency costs. First, investors in an unscrupulous market will disregard reported earnings, effectively raising the market's cost of capital.²⁷ Second, transparency should lead to better business planning and execution because shareholder monitoring not only deters outright fraud, but also improves business policy.²⁸

This raises the question of whether FOTM actions enhance transparency. FOTM litigation, taken alone, adds little to nothing to the informational mix. The suits are *ex post* constructs activated not by the incorrect disclosure itself, but by its correction. The heavy lifting on transparency occurs *ex ante*, when the mandatory-disclosure system's rulebook instructs the corporation to make information public

²⁷ Cf. Fox, *Civil Liability*, *supra* note 1, at 253 (noting that disclosure is unlikely to have an effect on investor protection where shares are unfair on average).

²⁸ The end point is the same as with deterrence: more transparency means better governance and a lower cost of capital, and therefore it creates more value for each shareholder. Cf. *id.* at 252 (arguing that among the primary benefits of disclosure "are a more efficient allocation of resources in the economy as a result of improved corporate governance, increased capital market liquidity, and the consequent reduction in the cost of capital").

and to produce reliable financials. Any “governance” contribution, then, is simply a derivative of the contribution already made by the mandatory disclosure system. FOTM assists only by helping to keep the *ex ante* information base free of misrepresentations. We accordingly return to the deterrence justification. But we have already seen that FOTM comes up short as a means of deterrence.

There is an additional line of argument here: FOTM actions are used as federal proxies for litigation that could be brought under state corporate law’s duty of care, addressing management defalcations in business operations and giving shareholders a direct mode of intervention that bypasses the board of directors. This also doesn’t work because FOTM does not hold managers directly accountable for failure. Its consequences do not follow from the judgment of the shareholders acting as a group, as occurs when the franchise is exercised. And those who make the decisions—lawyers, pension funds serving as representative plaintiffs, and federal judges—are largely unaccountable from a governance perspective.

There is something to the point that FOTM overlaps with the territory covered by the state law duty of care, but we think the comparison has devastating implications for FOTM. The state law duty of care incorporated an opt-out possibility a quarter century ago,²⁹ and by now most companies have opted out with their shareholders’ approval.³⁰ In contrast, FOTM, like the rest of securities law, is mandatory. We do not question federal disclosure mandates, but we think a shareholder opt-out provision makes sense for FOTM, at least in lieu of outright abolition.

The Article, having suggested reform, turns to two barriers that block the path to a better result. The first is political: private securities litigation continues to enjoy political protection in Washington despite its failure in practice. The second barrier is fiscal: the SEC is assumed to be chronically underfunded, which would foreclose a shift to public enforcement.

Part IV takes up politics. FOTM endures as institutionally and economically salient as ever,³¹ despite layers of constraints and limita-

²⁹ See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2010) (stating that the certificate of incorporation may contain a provision that eliminates or limits the personal liability of a director to the corporation or stockholders for breach of fiduciary duty).

³⁰ See *infra* note 212.

³¹ Total annual settlement amounts for federal securities cases peaked at \$18.3 billion in 2006 as Enron-era litigation worked its way through the system. Annual settlement amounts in subsequent years were \$7.6 billion in 2007, \$2.8 billion in 2008,

tions imposed by congressional³² and judicial action³³ as well as erosion of support for its policy justification. Why? Political vulnerability does not necessarily follow when a legal institution makes no policy sense. Indeed, Congress considered eliminating FOTM before it enacted the Private Securities Litigation Reform Act of 1995 (PSLRA), but decided instead to advance a smaller-scale reform.³⁴ The business lobby has a follow-up package ready to be unwrapped in the right political climate.³⁵ If the past is any guide, an expanding economy and a bull market will be necessary conditions for such legislation's passage.³⁶ Accordingly, FOTM is safe for now.

In fact, it is better than safe. Part IV describes deeper political forces that legitimize private class action enforcement. FOTM suits are politically legitimate because managers are empowered actors in society and private anti-fraud litigation is a means with which to challenge their business decisions. Meanwhile, remaining questions about the incentives of those filing FOTM suits have diminished in volume: the PSLRA diminished the strike-suit problem³⁷ and brought in institutional investors as lead shareholders,³⁸ which made class actions more respectable. Even proponents of "light touch" financial regulation

\$3.8 billion in 2009, and \$3.1 billion in 2010. RYAN & SIMMONS, *supra* note 23, at 1 fig.1. New class action filings peaked in 1998 with 242 new filings, but 2008's 223 new cases came close. In 2010, new filings decreased to 176. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2010 YEAR IN REVIEW 3 fig.2 (2011), available at <http://www.cornerstone.com/securities-filings-2010-year-in-review> (follow "Securities Class Action Filings—2010 Year in Review" hyperlink).

³² See *infra* notes 229-44 & 298 and accompanying text.

³³ See, e.g., *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 153 (2008) (holding that customer/supplier companies cannot be brought within a securities suit because the investors did not rely on misrepresentations from those companies); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007) (holding that the "strong inference" standard in 15 U.S.C. § 78u-4(b)(2) meant that the "inference of scienter must be more than merely plausible or reasonable—it must be cogent"); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 347 (2005) (requiring plaintiff to show "some indication of the [economic] loss [suffered] and the causal connection that the plaintiff has in mind"); *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994) (holding that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)").

³⁴ See Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, sec. 101(b), § 21D(b)(3), (c), 109 Stat. 737, 747 (codified as amended at 15 U.S.C. § 78u-4 (2006)) (imposing barriers to litigation, such as sanctions for abusive litigation and discovery stays during pending motions to dismiss).

³⁵ See *infra* notes 292-14 and accompanying text.

³⁶ See *infra* notes 234-49 and accompanying text.

³⁷ See *infra* note 289 and accompanying text.

³⁸ See *infra* notes 278-284 and accompanying text.

balk at pulling the plug on FOTM because the specter of financial fraud looms large in the wake of the Enron and WorldCom scandals.³⁹

In addition, shareholders have emerged as a politically salient interest group. Decades ago, no one thought of a shareholder as a proxy for the median voter.⁴⁰ But things are different in our ownership society. Even though it makes little policy sense to pursue the shareholder interest in out-of-pocket loss compensation, invoking that interest could garner legislative results in the right political climate. That a different mode of enforcement might more effectively challenge management decisions, bring fraudsters to account, or protect the shareholder interest, makes FOTM contestable without denuding it of political legitimacy. The political barrier, then, is high.

Part V considers a core component of the FOTM defense: the argument that we have to live with this bad tort because public enforcement resources are inadequate. The SEC's enforcement capacity has changed substantially since the Supreme Court first implied a private right of action in 1964. Today's SEC deploys enforcement resources of materially greater magnitude than it did at that time. The SEC's 1964 budget was \$13.9 million compared to its 2010 budget of \$1.1 billion, which represents an inflation-adjusted increase factor of 11.2.⁴¹ A significant portion of the increases occurred in the recent post-Enron environment.⁴² While damage dollars yielded by private enforcement once dwarfed those brought in by SEC enforcers, that no longer is the case.⁴³ More to the point, there is reason to believe that the SEC offers shareholders a more efficient use of enforcement resources. There is an irony here—just as the shareholders pay the damages in FOTM actions, so do they fund the SEC through fees collected in connection with market trades and securities registrations. Part V shows that damages ordered in SEC proceedings cost the shareholders less than do those stipulated in private sector settlements.

We do not claim that today's SEC makes the private-enforcement supplement irrelevant. Nor do we contest the point that FOTM's re-

³⁹ Cf. MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 74-76 (2007), available at http://www.nyc.gov/html/om/pdf/ny_report_final.pdf (recognizing that many securities class action settlements are based on "legitimate" claims by investors with "warranted damages," but recognizing the negative perception of being a litigious society).

⁴⁰ See *infra* notes 245-72 and accompanying text.

⁴¹ See *infra* text accompanying note 311-31.

⁴² See *infra* Figure 1.

⁴³ See *infra* text accompanying note 324.

moval could result in lax enforcement. We do suggest that expanding and refocusing the SEC could more than make up for reduced private-sector enforcement at no additional cost to the shareholders. To that end, we propose a trade off: the SEC should ask for more money and refocus its enforcement operation on individual defendants and, in return, propose a rule that eliminates the FOTM presumption in private litigation.

I. FRAUD ON THE MARKET AS COMPENSATION

Fraud on the market under Rule 10b-5 takes the common law tort of misrepresentation from face-to-face dealings to faceless markets, remaking it into a vehicle for class action litigation against those who make false and misleading statements about publicly traded securities.⁴⁴ As at common law, the defendant must act with “scienter”—that is, recklessly, knowingly, or intentionally⁴⁵—and the plaintiff class members must be the purchasers or the sellers of the subject security.⁴⁶ But the defendant need not be a contract counterparty and, indeed, need not be trading at all.⁴⁷ Nor do the plaintiffs need to have relied on anything the defendant said. Under the Supreme Court’s *Basic* decision, class members benefit from a rebuttable presumption of reliance on the integrity of the market price,⁴⁸ which is grounded in the assumptions that the price of an actively traded stock reflects avail-

⁴⁴ See, e.g., *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 864 (2d Cir. 1968) (en banc) (holding that a press release was issued in a manner intended to affect stock prices and influence investors and remanding the case to determine whether the release was misleading to investors).

⁴⁵ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976) (defining scienter in terms of intentional conduct, but declining to decide whether recklessness falls within section 10(b) and Rule 10b-5).

⁴⁶ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 736 (1975) (noting that violations under the Securities Act of 1933 and the Securities Exchange Act of 1934 are “expressly limited to purchasers or sellers of securities”).

⁴⁷ See *Semerenco v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000) (noting that Rule 10b-5’s “‘in connection with’ element may be established by proof of the materiality of the misrepresentation and the means of its dissemination”).

⁴⁸ 485 U.S. 224, 246-47 (1988). The Court interpolated the presumption for the express purpose of facilitating class action certification. *Id.* at 250. A predecessor case involving an omitted fact in a face-to-face transaction, *Affiliated Ute Citizens of Utah v. United States*, held that reliance can be presumed from the materiality of the facts omitted. 406 U.S. 128 153-54(1972). Subsequent cases have read the rule to apply only in cases of omission. See, e.g., *Binder v. Gillespie*, 184 F.3d 1059, 1064 (9th Cir. 1999) (relying on *Affiliated Ute Citizens* to find that the presumption of reliance is not properly applied unless the case “primarily alleges omissions”).

able public information and that misinformation can impair the price's accuracy. Finally, in a limiting adjustment, Rule 10b-5 requires the plaintiff to show that the misrepresentation caused the loss.⁴⁹

Under the Supreme Court's *Dura Pharmaceuticals, Inc. v. Broudo* decision, a price drop incident to a later disclosure of the truth will not be sufficient proof by itself of loss causation, for the reduced price "may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."⁵⁰ If the plaintiff class pleads and proves all of the above, it recovers out-of-pocket damages as at common law, which are calculated as the difference between the inflated price and the securities' intrinsic value.⁵¹

Several additional points about FOTM cases are worth noting. First, insider trading is not a necessary part of the fact pattern, even though it is sometimes alleged concurrently.⁵² Neither is corporate profit-taking through sales of newly issued, overpriced stock a necessary factor.⁵³ Accordingly, profit disgorgement is not central to FOTM's economic picture, even though it may show up in a given case. FOTM instead concerns the informational damage that company insiders inflict on stock traders. Unsurprisingly, the insiders are usually high-level managers at the stock issuer in question.⁵⁴ But as long as there is at least one human defendant who is an agent of the corporation that issued the pertinent securities, the issuer will be added

⁴⁹ The loss-causation requirement dates back to *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974). Congress later codified the requirement in the PSLRA. PSLRA Pub. L. No. 104-67, sec. 101(b), § 21D, 109 Stat. 737, 743 (1995) (codified at 15 U.S.C. § 78u-4(b)(4) (2006)).

⁵⁰ 544 U.S. 336, 343 (2005).

⁵¹ See, e.g., *Harris v. Amer. Inv. Co.*, 523 F.2d 220, 224-27 (8th Cir. 1975) (discussing possible methods of calculating damages).

⁵² Insider trading allegations have decreased steadily in recent years. They appeared in thirty-eight percent of securities class action complaints filed in 2006, but only in sixteen percent of complaints in 2010. See CORNERSTONE RESEARCH, *supra* note 31, at 31.

⁵³ Corporations that make material misstatements in connection with new issues can be sued under section 11 of the Securities Act of 1933 without a showing of corporate profit-taking. Securities Act of 1933 (1933 Act), ch. 38, 48 Stat. 82 (codified as amended at 15 U.S.C. § 77k).

⁵⁴ In 2004, chief executive officers and chief financial officers were named in ninety-six percent and eighty-three percent of securities class action lawsuits, respectively. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1549 tbl.4 (2006) (citing PRICEWATERHOUSE-COOPERS LLP, 2004 SECURITIES LITIGATION STUDY 11 (2004)).

as a defendant on an enterprise-liability theory.⁵⁵ This extension catches a deep pocket that will have insured itself against the loss, increasing the amount of recovery available to plaintiffs.

The cause of action, thus described, pursues federal securities laws' purpose of protecting investors in two ways: first, it compensates fraud victims for their losses, and, second, it deters fraud by imposing compensatory payment. This Part considers FOTM's performance of the first role. Section A shows how damages are calculated. Section B then shows both how damages are reduced in the course of settlement negotiations and how they are funded. Section C evaluates the results, illustrating that FOTM fails to realize its compensatory purpose in two ways. It cannot meaningfully compensate shareholders because most shareholders suffer no damages from fraud and only a subset of shareholders bears the settlement costs. At the same time, a shareholder who has actually sustained an economic loss receives no relief from small FOTM settlements. An actual reliance requirement would address these problems but would also result in a diminished flow of private litigation.

A. *Calculating Out-of-Pocket Damages under FOTM*

We begin our exploration of the meaning of "compensation" under FOTM with damage calculation.

1. The Price Drop

Settlement value stems from class damages, which begin with a sharp price drop in the wake of a corrective disclosure. While it is not true that a large drop in a company's stock inevitably leads to FOTM litigation,⁵⁶ it is true that plaintiffs investigate stock-price drops as pre-

⁵⁵ The defendant can incur liability under statutory or common law. Under "control person" liability, good faith is a defense. See 15 U.S.C. § 77(a) (providing that the controlling person is not liable if he had no "reasonable ground to believe in the existence of the facts" under which he would be liable); *id.* § 78t(a) (exempting controlling persons from liability if they acted in good faith). However, under agency law, employer liability follows as long as the employee is acting within the scope of employment. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 695-96 (noting that the good faith defense is "illusory" because courts apply agency law to securities fraud lawsuits).

⁵⁶ See Jennifer Francis et al., *Shareholder Litigation and Corporate Disclosures*, 32 J. ACCT. RES. 137, 138 (1994) (noting that of fifty-one firms that reported a twenty-percent or greater decline in earnings or sales, only one was subject to a shareholder lawsuit related to the announcement of that decline).

liminary indicators of FOTM actionability.⁵⁷ FOTM plaintiffs follow the money and look for big numbers, and they do so even more since the PSLRA raised litigation costs.⁵⁸ Unsurprisingly, FOTM defendants tend to be big companies—larger even than their industry peers.⁵⁹ The plaintiffs also need to find the basic elements of a FOTM claim, namely material misstatements made with scienter. Historically, these have tended to be statements made in advance of earnings declines.⁶⁰ While the PSLRA did not result in a decrease in the number of actions filed,⁶¹ its heightened pleading rule⁶² did cause plaintiffs to choose

⁵⁷ This is a function of the damage calculation practice detailed in subsection I.A.2, *infra*. Cornerstone Research periodically reports on the declines in FOTM defendants' stock prices during class periods. The numbers are part of a description of current plaintiffs' behavior patterns. Cornerstone reports that there were 176 class action filings in 2010 and 168 filings in 2009. CORNERSTONE RESEARCH, *supra* note 31, at 3. In 2010, the aggregate decline in market capitalization during the class periods for the subject companies was \$474 billion; in 2009, the decline was \$550 billion. *Id.* at 26 fig.25. Market capitalization losses during the two days flanking the last day of these actions' class periods—losses that make the companies good candidates to meet the loss causation requirement—were \$72 billion for the 2010 filings and \$84 billion for the 2009 filings. *Id.* at 24 fig.23.

⁵⁸ Steven J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1497-98 (2006).

⁵⁹ See Irene Kim & Douglas J. Skinner, *Measuring Securities Litigation Risk* 16 (June 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1632638> (noting that larger firms are sued at higher rates). Target industries, however, shift over time with market volatility. Technology companies were the lead targets a decade ago; in recent years, financial and health care companies have displaced them. See CORNERSTONE RESEARCH, *supra* note 31, at 18 fig.18 (finding that 18.2% of filings in 2001 targeted technology companies while financial and health care companies comprised 25.7% of new filings in 2010).

⁶⁰ Professors Thompson and Sale report a median earnings price drop of 54% as well as a focus on accounting and earnings management misstatements in 88% of the complaints filed in a one-year period. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 893, 897-98 (2003). The 2010 filings follow this pattern: 93% of the complaints alleged misrepresentations in financial documents; 45% alleged false forward-looking statements; and 26% alleged Generally Accepted Accounting Principles (GAAP) violations. The 2009 filings for the same categories were as follows: 87%, 45%, and 26%, respectively. CORNERSTONE RESEARCH, *supra* note 31, at 32. Interestingly, announced restatements are becoming less salient as triggers, implicated in 7% of 2010 complaints and 8% of 2009 complaints, as compared with 34% in 2006. *Id.*

⁶¹ See, e.g., Mukesh Bajaj et al., *Securities Class Action Settlements*, 43 SANTA CLARA L. REV. 1001, 1003 fig.1 (2003) (showing that the number of federal court filings returned to previous levels one year after Congress enacted the PSLRA); see also Choi & Thompson, *supra* note 58, at 1496-97 (noting that "the number of federal suits quickly returned to near its pre-PSLRA level" after Congress foreclosed such litigation in state courts). Bajaj and his colleagues also show that the settlement rate dropped substantially over the same time frame, while the time between filing and settlement has in-

their targets more carefully. Plaintiffs now look for “hard evidence,” typified by misstatements in company financials as well as SEC enforcement actions.⁶³

Thus briefed, let us hypothesize a typical fraud-on-the-market case. Assume that high-level actors at Ajax Corporation cause it to incorrectly apply Generally Accepted Accounting Principles (GAAP) with the result that Ajax overstates its earnings across seven fiscal quarters beginning on January 1, 201X and ending after the third quarter of 201Y. Ajax announces on January 2, 201Z that it will be restating its earnings for the preceding seven quarters, that its 201Y annual report will be delayed, and that the ex post quarterly earnings reductions will be between ten and thirty percent. Ajax’s stock, which has been trading upward during the two years in question, beginning at forty dollars and ending at sixty dollars, drops forty percent on the date of the restatement announcement, closing at thirty-six dollars. In this hypothetical, the January 2 corrective disclosure is the only possible cause of the price drop.

A plaintiffs’ law firm promptly files a class action complaint. The complaint defines the class as all purchasers of Ajax stock from January 1, 201X to December 31, 201Y, who continued to hold stock on January 2, 201Z, and claims out-of-pocket damages for each member

created. Bajaj et al., *supra*, at 1009 tbls.3 & 4, 1010. *But see* Choi & Thompson, *supra* note 58, at 1498 (reporting that the settlement rate is the same, but the time to reach settlement has increased). Evidence on the rate of dismissal is mixed. *See id.* at 1498 & nn. 54-56 (providing an overview of several studies that have reached different conclusions about dismissals).

⁶² PSLRA § 21D(b)(1)–(2), 15 U.S.C. § 78u-4(b)(1)–(2) (2006) (requiring plaintiff to specify each statement, the reasons why each statement is allegedly misleading, and to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”).

⁶³ *See* Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598, 601, 613-22 (2006) (defining “hard evidence” as a public announcement made before a filing in response to an accounting restatement or an SEC action, and finding support for these actions in an analysis of all initial public offerings between 1990 and 1999). Choi also suggests that the PSLRA disproportionately and negatively impacts non-nuisance litigation that lacks pre-filing hard evidence. *Id.* at 614-16; *see also* Marilyn F. Johnson, Karen K. Nelson & A.C. Pritchard, *Do the Merits Matter More? Class Actions Under the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627, 636 (2007) (finding a sharp increase in litigation grounded in accounting restatements following the introduction of the PSLRA); A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 146 (2005) (finding that revenue-related accounting violations and other GAAP allegations are negatively correlated with dismissals in the Second Circuit but not in the Ninth Circuit).

at the difference between the inflated price paid for the stock on the purchase date and its lower, intrinsic value on the date of filing.

2. The Value Line

One part of the damage calculation is easy. The class members' respective purchase prices are objectively determined by the record of market prices. In contrast, the lower intrinsic values on each purchase date are hidden. These values, like the market price itself, will have changed dynamically across the two-year period along with the fortunes of the company and the conditions in the wider economy. In theory, for any class member who purchased at a particular time, there is a "correct" per-share damages calculation based on the intrinsic value of Ajax at the moment of purchase. This would be the market price minus one share's allocation of the present value of Ajax's future net cash flows projected based on accurate public information about Ajax and discounted based on then-prevailing economic conditions.⁶⁴ But, unfortunately, this theoretically correct damages calculation does not facilitate the pleading and proof requirements of a class action lawsuit. Primary evidence of intrinsic value, such as one sees presented in an appraisal action, requires analysis of specific facts about the company, its prospects, and outside markets.⁶⁵ This evidence is expensive to generate and tends to be indeterminate.⁶⁶ Generating and marshalling such evidence day-by-day across a class period would be practically impossible and would chill class action antifraud enforcement, much as would an actual reliance requirement.⁶⁷

⁶⁴ Thus the intrinsic value of the stock will change dynamically across time, just as the market price does.

⁶⁵ See Lawrence A. Hamermesh & Michael L. Wachter, *Rationalizing Appraisal Standards in Compulsory Buyouts*, 50 B.C. L. REV. 1021, 1041-43 (2009) (describing the components of the going-concern value approach in appraisal, which includes the present value of earnings based on current assets and "the present value of the firm's growth opportunities").

⁶⁶ For additional information on indeterminacy, see *infra* note 69 and accompanying text.

⁶⁷ Commentators have dismissed the fundamental value approach as unduly speculative. See, e.g., Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 17 (1982) ("Attempting to appraise the value of the security by analyzing asset value, earnings data, and other information is inherently speculative."). Others contend that traditional fundamental-value evidence fails to meet the admissibility standard of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 592-95 (1993), which outlines reliability indicators a judge should use when determining whether to admit expert scientific testimony. See Esther Bruegger & Frederick C. Dunbar, *Estimating Financial Fraud Damages with Response Coef*

Happily for class action plaintiffs, they do not need to show fundamental value.⁶⁸ Instead, litigation experts use models that focus on market-price changes without an anchor in fundamental-value calculations. This exercise begins on the corrective disclosure date with the pre- and post-disclosure prices: here, sixty and thirty-six dollars. The latter is taken as Ajax's post-disclosure intrinsic value. The analysis then works backward, comparing the thirty-six-dollar figure against the stock market for the two-year class period to construct Ajax's per share intrinsic value at every date in the period. Two price lines emerge: a "market" line tracking Ajax's actual stock price and a constructed "value" line. The numbers on the constructed-value line purportedly determine the company's per share intrinsic value at all times during the class period. The difference between the stock-price line and the value line is the price inflation caused by the fraud.

The value line is created using an asset-pricing model, which is based on empirical stock-return data from a prior period during which the fraud did not impact Ajax's stock price. The model articulates risk and return relationships between the return on Ajax's stock and two other factors—the return on the stock market as a whole (the capital asset pricing model's beta factor) and the return on Ajax's industry group. The mathematical relationships, thus captured, provide a basis for inferring what the returns on Ajax stock would have been without the fraud. Ultimately, the exercise yields intrinsic values for each day in the class period.⁶⁹

More precisely, the model yields *proxies* for intrinsic values. It would take a huge leap of faith to support a stronger assertion about the accuracy of calculations generated by such a two-factor asset pricing model. Results vary greatly depending on the particular asset pricing model employed, and there are several such models.⁷⁰ Further, the

ficients, 35 J. CORP. L. 11, 12-13 (2009) (presenting the common perception that expert testimony not grounded in event studies is "junk science" that is appropriately "replaced with expert testimony based on the generally agreed-upon notion that a properly performed event study is an appropriate method for estimating damages in shareholder class action litigation").

⁶⁸ The practice dates back to Judge Sneed's concurring opinion in *Green v. Occidental Petroleum Corp.* See 541 F.2d 1335, 1344 (9th Cir. 1976) (discussing the creation of price and value lines to determine damages for each class member).

⁶⁹ See Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 897-98 (1990) (describing the steps used to calculate a value line using the comparable index approach discussed above).

⁷⁰ See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1491-92 (1996) (describing the value line approach and noting

evidence shows that one component of the model used in FOTM cases—the capital pricing model (CAPM)—is inaccurate for most time periods.⁷¹ CAPM is still used in empirical finance simply because it is the best model available. But we are left in an awkward evidentiary spot: even if it were safe to assume that the stock price accurately reflected Ajax’s fundamental value on the start and finish dates, confidence in the calculation for intermediate dates is very low.

Confidence respecting the start and end dates will be higher, but not necessarily by much. The Efficient Capital Markets Hypothesis (ECMH) that underlies *Basic’s*⁷² presumption of reliance on market-pricing integrity does not predict that the stock price reflects fundamental value. In its semi-strong state, it simply says that “no trading strategy based on public information can regularly outperform the market.”⁷³ Alternatively stated, ECMH stands for the principle that even if the stock is mispriced on any given date (based on any capital asset trading model), the misalignment may get worse before it finally is corrected in the future. In sum, FOTM damage calculations spin numbers based on a set of weak assumptions. And the problems with the damage calculation in our hypothetical case have only just started.

3. Complicating Factors

The hypothetical strives for simplicity by stipulating that the twenty-four-dollar price drop stems entirely from the corrective disclosure and reflects no other influences.⁷⁴ But there will be complications even with that stipulation. Direct application of the asset-pricing model does not always yield plausible day-to-day figures. For example, the price effect of the series of earnings misstatements may have cumulated over time, with the impact differing across class members depending on the time of stock purchase.⁷⁵ We will surmount this bar-

that “the value line calculations of the experts for the two sides can differ greatly, even when they are using the same methodology”).

⁷¹ See RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 196-99 (10th ed. 2011) (presenting a hypothetical scenario showing the model’s inaccuracy and concluding that “[t]here is no doubt that the evidence on the [model] is less convincing than scholars once thought”).

⁷² 485 U.S. 224 (1988).

⁷³ William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 692 (2010).

⁷⁴ See Cornell & Morgan, *supra* note 69, at 893-94 (describing the calculative problem presented by multiple risks and multiple disclosure dates).

⁷⁵ See Bruegger & Dunbar, *supra* note 67, at 14 (mentioning the difficulty associated with apportioning damages from securities class action lawsuits among multiple

rier with a further assumption: the average price inflation across the two-year period is twelve dollars, and it is normally distributed.

We may still be overstating the damages, however. When a company restates its financials, there may be collateral damage in the form of market reappraisal of its managers' capabilities.⁷⁶ Given this effect, the forty-percent decline in the stock price may outstrip the fundamental-value implications of the accounting adjustment taken alone.⁷⁷

Let us assume that no collateral damage exists and estimate a damage figure for the class. Assume that Ajax has twenty million shares outstanding, and that its market share turnover is one-hundred percent per year. How many shares are in the class? Things get tricky at this point. The class members are those who bought Ajax stock during the class period and continue to hold it at the period's end; in-and-out traders are excluded. If Ajax's one-hundred-percent turnover stems from activity respecting only ten percent of its shares, each of which is traded ten times annually, then the class will be comprised of the holders of ten percent of the stock. In contrast, if Ajax's share turnover involved a complete repopulation of its shareholder group across the two years, then one-hundred percent of Ajax's shares will be in the class. Unfortunately, because the connection between daily stock-trading volume figures and corporate stockholder lists is opaque, no verifiable figures are available.

co-defendants due to the challenge of assigning specific misrepresentations to individual co-defendants).

⁷⁶ Studies have provided empirical confirmation of this assertion. See, e.g., Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 582 (2008) (analyzing 585 enforcement actions brought between 1978 and 2002 and finding that reputational impairment accounted for approximately sixty-seven percent of the decline in a firm's stock price following the announcement of the misconduct); see also, e.g., Bradford Cornell & James C. Rutten, *Collateral Damage and Securities Litigation*, 2009 UTAH L. REV. 717, 723-27 (providing several examples of reputational harm as "collateral damage" from negative disclosures); Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of Dura Pharmaceuticals, Inc. v. Broudo*, 63 BUS. LAW. 163, 168-70 (2007) (identifying "confounding events" that cause a stock's intraday price drop following negative disclosure but are unrelated to the disclosure itself).

⁷⁷ It is not at all clear within *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), that the misstatements will be deemed to have caused this additional loss. See Cornell & Rutten, *supra* note 76, at 744-45 (noting the difficulty of considering collateral damages under a loss-causation framework); Ferrell & Saha, *supra* note 76, at 175-78 (discussing the impact postcorrective disclosure stock-price rebounds have on damages valuation).

Plaintiffs accordingly proceed inferentially and deploy experts who apply controversial models.⁷⁸ To surmount this problem in our hypothetical, we must add another assumption:⁷⁹ fifty percent of Ajax stockholders, holding a total of ten million shares, purchased of all their stock during the class period. Using the average loss, this yields a damage figure of \$120 million.

Our simple hypothetical thus turns out to be rather complicated. In the real world, the situation will be more complicated still, for factors unrelated to the fraud will also have an impact on the stock price

⁷⁸ The plaintiffs start with daily volume numbers and then differentiate between traded and untraded shares. Within the group of untraded shares, all buyers who sold the stock before the corrective disclosure date are eliminated. The models employed in this exercise are much disputed. See DANIEL R. FISCHER ET AL., NAT'L LEGAL CTR. FOR THE PUB. INTEREST, THE USE OF TRADING MODELS TO ESTIMATE AGGREGATE DAMAGES IN SECURITIES FRAUD LITIGATION: AN UPDATE 7-21 (2006) (criticizing the models and making an empirical showing of their tendency to overestimate damages); Linda Allen, *Meeting Daubert Standards in Calculating Damages for Shareholder Class Action Litigation*, 62 BUS. LAW. 955, 955 (2007) ("Current modeling practice by damages experts may fail to meet [*Daubert*] standards."); Linda Allen, *A New Theoretically-Grounded Microstructure Trading Model for Calculating Damages in Shareholder Class Action Litigation?*, 12 STAN. J.L. BUS. & FIN. 61, 62-65 (2006) (criticizing current models for using "aggregate trade volume" as their base and proposing a substitute based on "the net purchases of shares . . . on each day of the Class Period"); Michael Barclay & Frank C. Torchio, *A Comparison of Trading Models Used for Calculating Aggregate Damages in Securities Litigation*, LAW & CONTEMP. PROBS., Spring/Summer 2001, at 105, 117-18 (criticizing models in use as being highly inaccurate); John Finnerty & George Pushner, *An Improved Two-Trader Model for Measuring Damages in Securities Fraud Class Actions*, 8 STAN. J.L. BUS. & FIN. 213, 250-51 (2003) (finding fault with current models and proposing a more consistent substitute).

Damage calculation is in flux at all events. The "proportional trading" model that plaintiffs have long preferred has been rejected by one court for insufficient scientific support. See *Kaufman v. Motorola, Inc.*, No. 95-1069, 2000 WL 1506892, at *2 (N.D. Ill. Sept. 21, 2000) (finding that the proportional trading model fails to satisfy *Daubert* requirements). But see *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.*, No. 94-5587, 2000 WL 420548, at *2 (S.D.N.Y. Apr. 18, 2000) ("Surely, every stock pricing model will be subject to some form of statistical criticism or unwanted interpretation."). For criticism of the *Kaufman* opinion and a defense of the model, see Brian P. Murray & Eric J. Belfi, *The Proportionate Trading Model: Real Science or Junk Science?*, 52 CLEV. ST. L. REV. 391, 403-12 (2004). A newer replacement model has been questioned by another court. See *In re Broadcom Corp. Sec. Litig.*, No. 02-0030, 2005 WL 1403756, at *3 (C.D. Cal. June 3, 2005) (casting doubt on the two-trader model after an extensive evidentiary hearing but, because of the facts of the case, deciding not to rule on rejection). A third court has rejected the concept of aggregate damages entirely. See *Bell v. FORE Sys., Inc.*, No. 97-1265, 2002 WL 32097540, at *3-4 (W.D. Pa. Aug. 2, 2002) (theorizing that the PSLRA's limitation on damages contemplates individual plaintiffs with individual claims).

⁷⁹ See FISCHER ET AL., *supra* note 78, at 28-29 (suggesting that the question of damages be addressed during claims administration).

during the class period.⁸⁰ Such “confounding” information comes in different shapes and sizes.⁸¹ The corrective disclosure could have revealed additional bad news about Ajax’s prospects unrelated to its past financial reports. Thus, the stock price decline might stem both from the restatement and from the effect of additional bad news. Alternatively, Ajax might have bundled good news with its corrective disclosure. Or the market may have anticipated the accounting news over time, drawing inferences from past reported events.⁸² There are even cases where it is not at all clear that the corrective disclosure played any role in the stock-price decline, or so the defendants argue.⁸³ Defendants also argue that market prices can negatively overreact to disclosures of bad news, and that event studies do not filter out these effects.⁸⁴

Analysts agree that event-study methodology should be employed to sort out the different influences on the market price’s response to the corrective disclosure.⁸⁵ But, in line with the state of empirical finance theory,⁸⁶ there are wide differences in the methodology’s application. Indeed, these analysts debate matters as fundamental as choosing the appropriate event study models for the securities litigation context.⁸⁷ Moreover, as confounding information accumulates, it

⁸⁰ See Alexander, *supra* note 70, at 1491 (noting that variation among experts is common value-line calculation).

⁸¹ For a discussion of confounding events, see Ferrell & Saha, *supra* note 76, at 168-70.

⁸² This may, but need not, result from the company’s strategic conduct; the good news may be part and parcel of the corrective facts disclosed. See Cornell & Rutten, *supra* note 76, at 719-20 (providing a common example of a corrective disclosure—a merger announcement—that “over-discloses” the prior misstatement); see also Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1425-27 (1994) (noting that an announcement of new product opportunities over-disclosed a prior misstatement and arguing that using the disclosure as a measure of price effect is flawed because it ignores the fact that investors often have distinct reasons for paying less for stocks after the disclosure that are unrelated to the disclosure itself).

⁸³ See Alexander, *supra* note 70, at 1425-26 (describing the stark contrast between plaintiffs’ and defendants’ stated positions in securities class action litigations).

⁸⁴ See Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 180 (arguing that event studies fail to provide an accurate picture of a security’s value “because noise and sentiment can influence price”). A provision of the PSLRA that limits damages ameliorates this problem. PLSRA § 21D(e), 15 U.S.C. § 78u-4(e) (2006).

⁸⁵ For a description of the methodology, see Bruegger & Dunbar, *supra* note 67, at 16-24.

⁸⁶ See *supra* note 55 and accompanying text.

⁸⁷ See Jonah B. Gelbach et al., *Valid Inference in Single-Firm, Single-Event Studies 2* (Robert Day Sch., Working Paper No. 2009-17, 2009), available at <http://ssrn.com/>

becomes necessary to resort to old-fashioned financial analysis and make judgment calls about how investors would have responded to counterfactual scenarios:⁸⁸ it is one thing to confirm a corrective disclosure's pricing impact with an event study, but quite another to show the ex ante market value of the undisclosed information considered in isolation.⁸⁹ In the end, despite the apparently determinative character of the financial techniques brought to bear, we wind up in the well-known territory where lawyers in high stakes litigation make legal arguments based on uncertain information.⁹⁰

B. *Pocket Shifting*

On whom have the losses, thus calculated, fallen? The quantum of economic loss that Ajax stock purchasers experienced is much smaller than the foregoing damage calculation seems to indicate. And who funds the compensatory check? Shareholders supposedly protected by the cause of action. Therein lie policy problems for FOTM.

To return to the first question, note that every buyer in the Ajax class had a seller who benefitted from the price inflation, but who, having made no misstatement, may walk away with the inflated price in his pocket. Accordingly, within this group of buyers and sellers there is no net loss, only a wealth transfer between innocent parties.⁹¹ This scenario raises the question of whether FOTM litigation should function as an insurance scheme for buyers left holding the short end of the stick. The answer is no. The loss is not actually spread across a

abstract=1442222 (criticizing single-firm event studies as having an antiplaintiff bias and proposing a different methodology).

⁸⁸ See Cornell & Morgan, *supra* note 69, at 896-97, 911 (noting that finance theory requires estimating investor assessments). There are also numerous calculative questions arising from *Dura*. For a review, see Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS. L. REV. 199, 213-21 (2009).

⁸⁹ See Alexander, *supra* note 82, at 1427 (discussing the problems with using event studies to calculate damages, including the difficulty of separating a disclosure's market effect from the "litigation-related component").

⁹⁰ See *id.* at 1458 (arguing that damages calculated from event studies are uncertain, which has an impact on multiple levels of litigation proceedings); see also Abby F. Rudzin, *Loss Causation and Damage Defense Strategies* (describing the challenges of countering the "expert opinions" of plaintiffs' experts who do not rely on "mathematical or statistical analysis" in making those opinions at trial), in WILLIAM R. MAGUIRE ET AL., *MANAGING SECURITIES FRAUD CLAIMS* 45, 51-52 (2009).

⁹¹ See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 651 (1985) (describing how "trading in the aftermarket entails offsetting gains and losses").

larger class of insured actors, as it would be in the case of casualty insurance.⁹² With Ajax, we have a plaintiff class holding fifty percent of the shares seeking compensation from a corporation owned by the holders of one-hundred percent of the shares. To the extent that a shareholder in the class remains an Ajax shareholder at the time the compensation is paid, its pro rata contribution is a wash.⁹³ In effect, then, those Ajax shareholders who are not in the class pay the damages. The loss is shifted, but not really spread.⁹⁴

At this point, we need to sort out Ajax shareholders' pecuniary interests according to shareholder type. Drawing on basic financial economics for a model, we break them into two categories: (1) fully diversified portfolio shareholders and (2) underdiversified shareholders. The latter category in turn is broken into three subcategories: (a) uninformed traders, (b) long-term investors, and (c) information traders.

1. Modern Portfolio Investors

Many (and we would guess most) of Ajax's shareholders, both inside and outside of the class, will be modern portfolio investors.⁹⁵ These shareholders accept the tenets of finance theory, fully diversify their portfolios, measure returns based on the wider market, and avoid trading on company-specific information. These investors' trades are either liquidity-driven or incidental to their portfolio management.⁹⁶ Accordingly, they can be expected, on average, to be on the selling end of price-inflated stock trades fifty percent of the time and on the buying end fifty percent of the time.⁹⁷ Their gains and losses will net out over time as their diversified status, in effect, insures them

⁹² See Merritt B. Fox, *Why Civil Liability for Disclosure Violations when Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 304-05 ("[T]he persons who will ultimately bear these losses—the shareholders at the time the suit is brought—are unlikely to be any more diversified than the persons who initially incur [them]. . . . [T]hese losses are spread among the holders of all the issuer's shares, which . . . is a larger group.").

⁹³ See Coffee, *supra* note 54, at 1557 (illustrating that shareholders bear the burden of any judgment or settlement).

⁹⁴ See Fox, *supra* note 92, at 308 (arguing that shifting losses creates social costs).

⁹⁵ See generally BREALEY ET AL., *supra* note 71, at 186-88 (providing a basic background of modern portfolio theory).

⁹⁶ See *id.* at 188-90.

⁹⁷ See Alexander, *supra* note 70, at 1500-03 ("The chance of being on the losing or winning side of a transaction . . . can be assumed to be random.").

against price inflation.⁹⁸ It thus makes no sense for these shareholders to pay an additional insurance premium in the form of litigation costs.

These costs mount up. Plaintiffs' attorneys take an average of twenty-three percent of each settlement.⁹⁹ Corporate defense attorneys, whom companies pay directly, add an additional cost of at least twenty-five to thirty-five percent over and above the settlement costs.¹⁰⁰ In addition, there are the costs of directors' and officers' (D&O) insurance premiums and the ancillary costs of disrupted business.¹⁰¹ These factors imply that litigation costs may exceed the settlement proceeds directed to the class members. It is thus unsurprising that class action filings are associated with immediate declines in company stock prices.¹⁰²

To summarize, diversified portfolio investors emerge undamaged but for the litigation costs. It is still theoretically possible that a given investor institution could come out slightly ahead if its net proceeds from litigation settlements exceed its pro rata share of litigation costs, but that seems unlikely as a practical matter. Professors Cox and Thomas collected distribution data on 118 settlements and found

⁹⁸ See *id.* (noting that investors who make more trades are more likely to have their gains equal their losses).

⁹⁹ This is the mean percentage recovery in securities cases for the period 1993 to 2008 described in Theodore Eisenberg & Geoffrey P. Miller, *Attorneys' Fees and Expenses in Class Action Settlements: 1993–2008*, 7 J. EMPIRICAL LEGAL STUD. 245, 258 (2010). Figures for earlier periods tend to be higher. See, e.g., Denise N. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 121, 141 (1999) (showing a recovery of thirty-two percent from 1991 to 1998).

¹⁰⁰ Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1815 n.95 (2007).

¹⁰¹ See Fox, *supra* note 92, at 306-07 (discussing additional costs of securities litigation compensation, including lawyers' fees, expert costs, "the time and attention of issuers' executives required by litigation, the administrative costs associated with D&O insurance, and the use of scarce judicial resources"); cf. Langevoort, *Corporate Executives*, *supra* note 13, at 643-44 (asserting that a CEO is better suited to bear risk than the company, and thus, the CEO should be liable).

¹⁰² See ANJAN THAKOR, U.S. CHAMBER INST. FOR LEGAL REFORM, *THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION* 4-5 (2005), available at http://www.instituteforlegalreform.com/get_illr_doc.php?docid=857; Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 67-68 (1991). This picture has been confirmed empirically, but with a wrinkle. Thakor collected data documenting institutional investor positions in the stock of 755 companies that settled cases filed between 1995 and 2005 and tracking the investors' gains and losses on inflated stock. See ANJAN V. THAKOR WITH JEFFREY S. NIELSEN & DAVID A. GULLEY, U.S. CHAMBER INST. FOR LEGAL REFORM, *THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION* 8 (2005), available at http://www.instituteforlegalreform.com/get_illr_doc.php?docid=855 (accounting for a slight trading loss by reference to share issuance activity by the defendant companies).

that, on average, only twenty-eight percent of eligible institutional investors bothered to file claims.¹⁰³ They account for this behavior by referring both to some institutions' collective interest in maintaining a posture of loyalty to corporate managers and to informational breakdowns within the chain of market intermediaries.¹⁰⁴ Those institutions that do file claims direct the proceeds either to the particular portfolio that bore the loss or to their general fund. Accordingly, fund beneficiaries who exited during the (usually) long period between the corrective disclosure date and the settlement payment receive nothing from the settlement.¹⁰⁵

2. Underdiversified Investors

We now consider investors who buy and hold stocks in underdiversified portfolios. Because these investors forego diversification's insurance against price inflation damage, they are candidates for FOTM compensation. An objection to their compensation should be noted, however. *Basic Inc. v. Levinson* assumes the ECMH,¹⁰⁶ and the ECMH's primary advice to investors is to diversify fully.¹⁰⁷ Thus, an investor who chooses to forego diversification to pursue informational (or other) advantages is outside of the ECMH, and is thus arguably outside the class that the FOTM presumption protects.

We will waive this objection, however, and proceed by dividing the underdiversified investors into three groups: (a) uninformed traders, (b) long-term investors, and (c) information traders. It turns out that a clear policy case for compensation can be made only for the last group.

a. *Uninformed Traders*

Uninformed traders—also known as “noise traders”—buy and sell stocks at random; their trades lack an informational basis and are not

¹⁰³ Cox & Thomas, *supra* note 1, at 424.

¹⁰⁴ *See id.* at 427, 431-33 (stating that many large financial institutions refuse to file claims against their clients and noting that investors often do not receive notice of claims).

¹⁰⁵ *See id.* at 449.

¹⁰⁶ 485 U.S. 224, 246 & n.24 (1988).

¹⁰⁷ If one cannot make systematic profits trading on public information, and investors are compensated only for bearing systematic risk, there would be no other rational strategy. *See* WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 91-93 (6th ed. 2008); Bratton & Wachter, *supra* note 73, at 692 (“[N]o trading strategy based on public information . . . can outperform the market . . .”).

based on a system of portfolio management.¹⁰⁸ Because these noisy trades occur randomly as the traders buy and sell both under- and overpriced stocks, gains and losses cancel out over time, which undercuts the policy case for compensation.¹⁰⁹

b. *Long-term Investors*

Underdiversified investors who hold Ajax stock over the long term and who trade only rarely emerge in a different posture. Some of them could be outsiders saving for retirement. But most are probably Ajax insiders: officers and employees holding shares vested under equity-compensation schemes. Any shareholders from management who sold during the class period can be expected to be named as defendants with respect to their sales and can be put to one side. The rest are the clear losers in the federal securities litigation game.¹¹⁰ They pay their pro rata share of Ajax's litigation costs, but those who bought before the class date will be entirely on the defending side and will receive nothing from any settlement. Moreover, because long-term holders do not trade often, they receive little benefit from price-inflated stock. There is an irony here: this is the category containing any mom-and-pops in Ajax's shareholder group, and the system picks their pockets.

c. *Underdiversified Information Traders*

To the extent that FOTM can be defended as a compensatory mechanism, the basis lies with this group. These are the investment professionals (and, by extension, market intermediaries) who invest in analysis of publicly available information when making investment decisions.¹¹¹ Critically, this is also the only group whose members actually relied on Ajax's public statements.

These shareholders, although underdiversified, can buy and sell stocks very quickly. Accordingly, we situate most of them on the plaintiff side, as they have purchased and held Ajax stock within the class

¹⁰⁸ For a general discussion of noise trading as an alternative to the efficient markets approach, see Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP., Spring 1990, at 19, 19-31.

¹⁰⁹ Cf. ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* 3 (2000) (describing noise traders' gains and losses as portrayed in orthodox financial economics).

¹¹⁰ See Coffee, *supra* note 54, at 1560 (describing the underdiversified retirement savers as the "clearest losers").

¹¹¹ We put aside the question, raised by the ECMH, of whether these informational investments can yield a positive long-term return.

period but have since moved on. Of course, some shareholders may have held the stock through the disclosure date, thus creating an interest in both sides of the litigation. However, we find it hard to imagine that an appreciable number of these investors will be situated only on the payor side.

Note that this group includes a subset of investors who make additional investments in verifying the accuracy of public information.¹¹² Those who investigated Ajax stock during the class period and made the right call will have been amply rewarded by selling (whether from a long or short position) when the stock was overvalued. Those who investigated and made the wrong call will be in the plaintiff class, despite their skepticism.

This group has a strong claim for compensatory solicitude. These investors make a double investment: once in the cost of generating information and once in the foregone benefit of full diversification.¹¹³ At the same time, their informational investments yield a public benefit in the form of more accurate securities prices.¹¹⁴ In order to receive this public benefit, we arguably need to compensate the investors' reliance interest.¹¹⁵

Although this argument might be persuasive in a frictionless world where those who actually rely on public information could instantly and costlessly liquidate their fraud claims into the full amount of damages suffered, FOTM does not work that way. To illustrate this point, assume that 5% of the holders in the Ajax class (500,000 shares) fall into this category, and their average damages are \$12 per share, for a total of \$6 million. Assume further that the class action settles three years after filing, which has been the average settlement

¹¹² It is not clear whether this makes sense. Under FOTM, those who actually relied but did not investigate end up sharing the recovery with the skeptics and the liquidity traders who do not suffer any damages. For an analysis of the relative positions of the two types of informed investors under FOTM, see Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 636-41 (1992).

¹¹³ See Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 347 ("Informed traders . . . incur the costs of research. . . . And they incur, disproportionately, the costs of securities fraud because, relying on firm-specific disclosure to trade, they are more likely than diversified investors to be net losers.").

¹¹⁴ See *id.* at 342 ("Accurate share prices enable performance-based compensation structures to provide more precise incentives. They ensure that share buybacks and repurchases do not unfairly discriminate among shareholders, and that option grants do not dilute existing ownership interests. Finally, accurate share prices facilitate discipline through the takeover market.").

¹¹⁵ See *id.* at 348 (arguing in favor of the compensation of informed traders "because their reliance-based investment strategy provides a corporate-governance externality").

time since the passage of the PSLRA.¹¹⁶ The median settlement amount for FOTM actions in the \$50 to \$124 million range for the period 1996 to 2009 is 5.3% of estimated damages.¹¹⁷ The information traders accordingly recover \$318,000 before attorneys' fees.¹¹⁸ Of course, the number of information traders varies by company and over time. Even larger numbers result if 25% of the Ajax class falls into this category: \$30 million total damages claimed for a settlement return of \$1.59 million.

Either way, the returns are chump change. Many investors in this group are hedge funds. They will have reported this loss to their investors and reduced their returns three years earlier, possibly suffering consequences in the form of capital withdrawals.¹¹⁹ Recouping 5% three years later does nothing to backstop the funds' reliance or to encourage them to continue to invest in information.¹²⁰

¹¹⁶ See ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2009 REVIEW AND ANALYSIS 2 (2009), available at <http://www.cornerstone.com/Securities-class-action-settlements2009-review-and-analysis-03-24-2010> (follow "Securities Class Action Settlements: 2009 Review and Analysis" hyperlink under "Related Documents") ("[S]ettlements typically occur[] three years after filing."). Since 2006, the average settlement time has increased to three-and-a-half to four years. *Id.*

¹¹⁷ RYAN & SIMMONS, *supra* note 23, at 5.

¹¹⁸ *Id.* at 18 n.5.

¹¹⁹ See William W. Bratton, Hedge Funds and Governance Targets: Long Term Results 8-9 (Univ. Pa. Law Sch. Inst. for Law & Econ., Working Paper No. 10-17, 2010) available at <http://ssrn.com/abstract=1677517> (describing investor flight from the hedge fund, Pirate Capital, following portfolio reverses).

¹²⁰ The information traders do have a means of increasing their return. In recent years, a number of institutions have opted out of FOTM class actions and brought parallel direct actions in state courts. Historically such actions have been rare. See Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1550 (2004) (surveying consumer class actions filed between 1993 and 2003 and reporting an opt-out rate of less than 0.2%). The recent shift occurred after the PSLRA created a role for institutional investors in the selection of class attorneys. Public pension funds have emerged in the lead role, and these funds have developed loyalties to particular law firms. Opt-outs occur when the fund's preferred firm fails to win the counsel designation. The law firm then initiates a parallel action in a friendly state court, sometimes even waiting for the settlement to be announced before opting out. The defendant corporations tend to settle the parallel actions along with the action in chief. As a result, the institutional plaintiffs win larger settlement percentages than do the class plaintiffs. See John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 317-18 (2010) ("Possibly, the defendants recognize that large, well-financed opt-outs will simply not allow their counsel to settle cheaply and thus prefer to settle these cases outside the class action.").

C. Summary, Analysis, and Implications

Commentators have been making the central points in the foregoing discussion for many years.¹²¹ We know of no academic writer who controverts them. The resulting implications for FOTM are devastating.

1. The Failure of the Compensation Justification and Actual Reliance

FOTM is supposed to compensate shareholders for damages, but it fails in two ways. First, the shareholders bear the costs of the payments. Most cases settle within D&O insurance-policy limits, and the corporation, as opposed to the named individual defendants, still pays when the limits are exceeded.¹²² Nothing dictates this practice. Boards of directors could require contributions from individual defendants, or courts could reject settlements for lack of individual contributions. But the system continues to endorse collectivized funding in all but a handful of cases.¹²³

The second failure concerns the amounts paid. As we have seen, shareholders recover only a fraction of their losses. FOTM actions start with whopping price-inflation figures extrapolated by statistical experts. But the proceedings never yield the stated sums because litigation to final judgment is not cost effective from the lawyers' point of

¹²¹ The critique of FOTM reached maturity with Professors Arlen and Carney, as well as with Mahoney. See Arlen & Carney, *supra* note 55, at 730 (arguing that FOTM cases are not appropriate for the imposition of vicarious liability on offenders); Mahoney, *supra* note 112, at 656 (proposing FOTM's rejection based on the argument that FOTM will lead to underdeterrence of securities fraud and underenforcement of current laws); see also Easterbrook & Fischel, *supra* note 91, at 635 (originating elements of the analysis).

¹²² See FREDERICK C. DUNBAR ET AL., NAT'L ECON. RESEARCH ASSOCS., RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? 9 (1995) (showing that insurers pay an average of 68.2%, defendant companies 31.4%, and individuals 0.4% of settlement amounts).

¹²³ There have been a few spectacular cases in which top officers have made significant payments—Global Crossing, WorldCom, Adelphia—but they are exceptions. See Coffee, *supra* note 54, at 1551-53 (noting that officer payment cases tend to involve insolvent corporations, individual defendants who promise to make restitution to avoid indictment, or an inadequate or rescinded D&O policy). Outside directors have almost never been held liable. See Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1068 (2006) (finding thirteen settlements involving out-of-pocket payments by outside directors among the hundreds of settlements reached between 1991 and 2004). The famous exception involved the WorldCom board, whose members contributed twenty percent of their respective net worths. See Coffee, *supra* note 54, at 1552-53. Alan Hevesi, the former New York state comptroller, insisted on this result. See Gretchen Morgenson, *Ex-Directors at WorldCom Settle Anew*, N.Y. TIMES, Mar. 19, 2005, at C1.

view.¹²⁴ These large, complicated, and risky lawsuits provoke risk aversion on the part of those in charge.¹²⁵ If the action is dismissed, the law firm fronting the capital to develop the case loses its entire investment. The further the law firm goes in pursuing the claimed damages, the larger its investment in the suit, the less likely a settlement, and the greater the risk of loss in court due to evidentiary shortcomings or adverse findings of law. Indeed, one of the most striking features of FOTM jurisprudence is the absence of case law on damage calculations. Law is created only on issues that go to the complaint's threshold validity, resulting in a mountain of case law on loss causation, developed on motions to dismiss, and next to nothing on loss itself. As a result, "compensation" in the FOTM world comes down to numbers generated solely to provide parameters for settlement discussions.

There is a further irony. Suppose the securities litigation bar found it cost effective to go the distance. In the Ajax hypothetical, that would mean a judgment approaching \$120 million—one-sixth of the company's equity capitalization as of the corrective disclosure date. Such a payment presumably would have a material adverse impact on the current shareholders. Were such payments to be made by a large number of companies,¹²⁶ the resulting injuries to shareholders would make FOTM a pressing economic and political problem. The shareholder class itself would demand—and secure—its elimination.

In sum, FOTM's compensation justification makes no sense. Only a subset of shareholders arguably needs compensation, and private litigation is incapable of generating it. At the same time, even if FOTM

¹²⁴ Since the PSLRA's enactment, only twenty-two securities actions have gone to trial. Seven of those cases were settled before a verdict. Of the fifteen that went as far as a verdict, the defendants won ten and the plaintiffs five. Adam T. Savett, Risk-Metrics Grp., Securities Class Action Trials in the Post-PSLRA Era (Jan. 2010) (unpublished presentation), available at <http://blog.issgovernance.com/slw/SCAS%20Trials.pdf>.

¹²⁵ See Coffee, *supra* note 54, at 1543-44 (detailing the risk-conscious behavior of plaintiffs' attorneys and corporate actors before commencing securities class actions).

¹²⁶ Between 1996 and 2010, 2.4% of listed companies had a complaint filed against them. CORNERSTONE RESEARCH, *supra* note 31, at 12. But even this small percentage encompasses a large number of complaints: between 1996 and 2009, a total of 2372 complaints were filed against listed companies. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS—2009: A YEAR IN REVIEW 9 fig.8 (2010), available at http://www.cornerstone.com/Securities_filings_2009_yir (follow "Securities Class Action Filings—2009: A Year in Review" hyperlink). Actions cluster in certain industries in the wake of statement reversals. In 2002, for example, 22.7% of communications companies and 34.3% of utilities were sued. *Id.* at 12. In 2008, 32.6% of financial institutions were sued. *Id.*

makes a positive contribution as a fraud deterrent or as a governance supplement, it survives only because it undercompensates.

The logical conclusion of this analysis is FOTM's elimination. The only players with a strong case for compensation are the underdiversified information investors, who also happen to be the only players who can make out a case of actual reliance.

2. Litigation Incentives

Having suggested FOTM's elimination, we must confront the problem of litigation incentives. We have seen that limiting recovery to investors with reliance interests mitigates some policy problems, but it may create others. Our hypothetical FOTM action yields a \$6.36 million settlement, which implies an attorney's fee of \$1.46 million, or 23%. While not a jackpot, the figure is certainly large enough to incentivize litigation.

Cases with smaller out-of-pocket damages can also incentivize litigation. The proportion of claimed damages yielded in settlements goes up as the claimed damages amount gets smaller. In 2010, settlements of FOTM actions claiming less than \$50 million yielded a median of 9.9%, while settlements of cases in the \$1 to 5 billion range had an average yield of 1.7%.¹²⁷ As it turns out, there is such a thing as small-numbers securities litigation. Accordingly, there is no reason to think that private securities enforcement would disappear entirely in a reliance regime.

Still, at some point the projected yield is so low that the litigation incentive disappears. Let us reset the Ajax numbers for a reliance-based cause of action. If 5% of the shareholder population consists of information traders, the implied attorney's fee for a 5.3% settlement works out to \$73,140. If 25% are information traders, the fee becomes a more attractive \$365,700. In either case, a settlement will not create any appreciable decrease in the level of difficulty and expense confronting the lawyer as compared to the class action, which offers a fee of \$1.46 million. Indeed, the lawyer would need to prove reliance for each individual plaintiff, adding to the cost. Reliance could (and should) be defined liberally, with a focus on institutional research and analysis practices rather than on particular investment decisions based

¹²⁷ RYAN & SIMMONS, *supra* note 23, at 5 fig.5. Indeed, small-scale settlements commonly result from FOTM actions. From 1996 to 2009, the median settlement was approximately \$7.6 million. *Id.* at 2 fig.2.

on particular information. Even so, the hurdles for an investment-grade lawsuit do rise substantially.

Some investors may be willing to sue and pick up expenses. Here the activist hedge funds are the standout candidates. They accumulate large percentage stakes in their targets and, from a governance point of view, surmount the traditional collective-action problem.¹²⁸ Further, hedge funds have proven ready to sue.¹²⁹ But there remains the question whether the nexus of incentives that causes hedge funds to break the governance mold carries over to antifraud litigation. They are in the skeptical subset of informed investors. They look for quickly recoverable value positives and do their best to avoid companies with hidden value negatives.¹³⁰ Litigation would remain expensive and risky, even if reliance were easy to prove and the burden of class qualification were lifted. Moreover, the extended time to payment would discourage investment in litigation in this highly competitive sector.

We suspect that, given a liberal definition of reliance, there would be a steady stream of private 10b-5 litigation addressed to material misstatements. But it is clear that the volume of litigation would diminish. The issue is whether the diminution implies a welfare loss for shareholders or society in general. FOTM could still add value despite its failure as a compensatory tort.

There are two possible sources of value. First is fraud deterrence, which is the second pillar of FOTM's conceptual framework. FOTM proponents more recently proposed the second possible source, contribution to the corporate governance system, as a substitute justification. We discuss the second justification in Part III.

II. FRAUD ON THE MARKET AS DETERRENCE

Although the courts constructed FOTM as a compensatory tort, its very existence assumes that the SEC, the public enforcer of securities laws, needs assistance from the private sector. Thus, there is a possi-

¹²⁸ See William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1387-90 (2007) (describing the trend toward activist funds taking on more significant portions of target stock).

¹²⁹ See *id.* at 1403-05 (identifying examples that illustrate the willingness of activist funds to engage in proxy contests).

¹³⁰ See Christopher Faille, *How (Not) to Be an Investor Activist: Object Lessons*, HEDGE-WORLD DAILY NEWS, Mar. 6, 2006, available at LEXISNEXIS (search "HedgeWorld Daily News" database for "Object Lessons") (citing hedge fund manager Robert Chapman's advice that activist investors urging a corporate restructuring should ensure their stock "has the same characteristics that would make its passive ownership worthwhile").

bility that FOTM, even though it cannot be sustained as a compensatory measure, can still be justified on enforcement grounds. This shift in justificatory emphasis takes us from the private law side of the policy line to the public law side, where one must consider the social cost of fraud and ask whether FOTM reduces that cost by preventing fraud in the first place.¹³¹

¹³¹ A second mode of social cost justification could also be considered—FOTM could ameliorate the consequences of fraud by reducing investors' fraud-protection costs. This inquiry could also be characterized as externality identification. Either way, it roughly tracks the compensation analysis in Part I—any cost-reducing effect is a function of the yield of damage payments and thus a function of FOTM's performance as a compensatory vehicle.

This inquiry takes us to the economics of sanctions. It sets the base sanction at the net harm inflicted on others and then adjusts this figure upwards to reflect the probability of detection and enforcement. Easterbrook & Fischel, *supra* note 91, at 618; cf. Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 694 (1997) (advocating "several potentially optimal regimes," including one that would combine vicarious liability and positive corporate enforcement duties).

The threshold question for FOTM concerns the calculation of the net harm. An underdiversified informed trader who suffers a loss might take steps to avoid future loss by incurring information costs. This is a social cost, as it is cheaper for companies to tell the truth. See Easterbrook & Fischel, *supra* note 91, at 623; Mahoney, *supra* note 112, at 630-31; see also A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 939 (1999) (noting additional costs, such as those borne by nonfraudulent sellers to establish credibility and distinguish themselves from fraudulent sellers). Portfolio investors, by contrast, do not have an incentive to take precautions because they are as likely to be on the right side of the trade as on the wrong side. It could work differently with a noise trader. However, strictly speaking, a noise trader who responds to a loss by taking company-specific precautions leaves this category and becomes an informed trader. From a social-cost perspective, this would not necessarily be bad. Alternatively, the noise trader might shift to full diversification, which certainly would be good. Finally, a disappointed noise trader might quit the market altogether. This situation has the negative consequence of reducing market liquidity. But, significantly, the possibility of disappointed exit is part and parcel of noise trading. It happens all the time, whether or not company misstatements caused the price inflation.

For FOTM to make a positive contribution, it must result in an overall reduction in social costs. Based on the above analysis, these costs are primarily precautionary or monitoring expenditures by the informed subset of investors. See Mahoney, *supra* note 112, at 630-31. Let us now see how this works out. First we consider FOTM in a hypothetical world in which plaintiffs are incented (for whatever reason) to litigate every case to payment of the full amount of damages. Then we look at FOTM in the real world where cases settle for less than ten cents on the dollar.

In a high payout world, FOTM holds out an award approaching \$120 million to the Ajax purchasers in the class, which is a substantial sum even after subtracting attorneys' fees. An expectation of such a high payment presumably would lead to a reduction in precaution costs. But this remains a nonsensical approach to the problem. Paying the judgment to the entire class—both relying and nonrelying traders who will never invest

The exercise begins as a justification, but it soon sounds like a backstop defense. It starts with the assertion that fraud is a persistent problem because the motivations for fraud are difficult to extinguish. It follows that fraud is underdeterred in the present environment. At this point, an objection to FOTM arises: if greater deterrence is required, then the better option is to move away from enterprise liability to individual liability. But FOTM proponents dismiss the objection as unpersuasive. An individual liability system that handed out penalties of sufficient magnitude to attract private enforcers would be draconian and would likely impair the recruitment of talented managers. A more moderate system of individual liability would remove the deep pocket from the settlement table and so reduce the incidence of private enforcement, much as would a shift to an actual reliance requirement. As a consequence, fraud, already underdeterred, would be deterred even less, and its deadweight social cost would increase. Meanwhile, public enforcement fails to offer an alternative, as it is hobbled by incompatibility and political opposition.

This Part lays out the particulars of this defense of FOTM. Section A notes the persistence of fraud. Section B looks at the penalty alternative to enterprise liability and poses the overdeterrence question. Section C tells the standard story of SEC weakness. Section D de-

in precaution—is unnecessary. We emerge with a mix of under- and over-compensation: as long as the information traders get less than one hundred cents on the dollar, they still may invest in precaution, while the corporate defendant pays out a sum greater than the putatively efficient amount. Note also that to the extent that the corporate defendant is required to overpay, a perverse effect could follow—overdeterrence of discretionary disclosure. *Cf.* Bratton & Wachter, *supra* note 73, at 697-98 (noting that the mandatory-disclosure system makes no attempt to impose a full-disclosure regime); Jonathan L. Rogers et al., *Disclosure Tone and Shareholder Litigation* 3-5 (Univ. of Chi. Booth Sch. of Bus., Research Paper No. 09-01, 2011), available at <http://ssrn.com/abstract=1331608> (showing that more optimistic disclosures attract litigation).

There is an easy way to bring the numbers into an efficient alignment: discard FOTM and reshape the private right of action as a reliance tort. *See* Mahoney, *supra* note 112, at 636-40 (discussing the differences between a FOTM rule and a reliance rule and noting that a FOTM rule does little to change investor behavior). Social-cost analysis, then, takes us to the same spot as the analysis of FOTM as compensation.

We now shift to real world FOTM, where in Ajax's case the damage pool will be 5.3% of \$120 million, or \$6.36 million, distributed across the class as a whole. Since any given information trader's recovery will be minimal, it is clear that FOTM does nothing to promote reliance on companies' public disclosures or to discourage precautionary spending. To the extent that there are cash proceeds, most go to investors whose losses and gains net out over time, siphoning the recovery away from actors whose behavior could actually be influenced in welfare-enhancing ways. There is a compensating benefit—the reduced financial stakes mitigate the risk of perverse effects on disclosure policy. But that is not much of a commendation.

scribes empirical studies cited by proponents of FOTM as a means of deterrence, and shows that their defense comes down to a weak assertion: “Well, it still doesn’t make any sense, but it’s all we have.” Section E evaluates this assertion by pointing out that FOTM is not the only weapon in a growing arsenal of antifraud enforcement tools.

A. *Motivations for Fraud*

Fraud is indeed a persistent problem. The temptations are built into corporate capitalism, whether through concealment of bad news or overblown projection of future success. Managers conceal bad news to buy time. If an adverse business development leads to employment termination or reduces the value of stock options that are about to expire, then lying or nondisclosure staves off the day of reckoning. Delay also creates turn-around opportunities, despite the risk of enforcement action.¹³² Misstatements motivated by unchecked optimism are less rational in the face of adverse enforcement consequences, but still can be explained. We live in a shareholder-value era in which corporate reputation is tied to stock prices. Managers labor under pressure to talk to the market and tell investors what they want to hear.¹³³ Equity compensation schemes, another product of shareholder-value culture, add an additional element of self-interest to the motivational mix, whether the fraud stems from concealment or over-optimism.¹³⁴ Unsurprisingly, option compensation is positively associated with earnings manipulation and shareholder litigation.¹³⁵

¹³² See Arlen & Carney, *supra* note 55, at 701-03, 724-32 (showing most securities fraud cases can be described in terms of last-period optimism and that almost twenty-five percent of FOTM companies went into bankruptcy); see also Langevoort, *Corporate Executives*, *supra* note 13, at 635 (“The problem is that executives themselves will not be deterred from misconduct when their personal gain from perpetrating or concealing the fraud exceeds the impact they would suffer should the corporation have to pay”). There is evidence to support the proposition that, in accounting cases, defendant companies did indeed intentionally manage their earnings. See generally Dain C. Donelson et al., *Discontinuities and Earnings Management: Evidence from Restatements Related to Securities Litigation* 26 (Dec. 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1465029>.

¹³³ See Donald C. Langevoort, *Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 473 (2001) (discussing how the incentive structure can lead managers to make inappropriate disclosures).

¹³⁴ See Pritchard, *supra* note 131, at 931-37 (describing fraud as a product of fear, greed, and “Pollyannaism”).

¹³⁵ See Lin Peng & Ailsa Röell, *Executive Pay and Shareholder Litigation*, 12 REV. FIN. 141, 166, 170 (2008) (associating a high proportion of option payout with share-

B. *The Penalty Alternative*

If fraud is a persistent problem imposing deadweight social costs, then the antifraud enforcement system arguably needs greater deterrent punch. Redirecting enforcement away from companies and toward individual perpetrators presents an obvious means of improvement. This solution would also move the system away from compensatory damages and enterprise liability toward individual penalties. Unfortunately, no one seems able to chart a plausible course that takes us from here to there.

A line of commentary going back at least to the American Law Institute's Federal Securities Code of 1978¹³⁶ advocates substituting civil fines against individuals for out-of-pocket losses charged against corporations.¹³⁷ Depending on the size of the company and its level of executive pay, a fine capped at \$5, \$10, \$20, or \$30 million, or, alternatively, a fine set at a percentage of individual net worth, might be enough to rouse the scruples of a CEO or CFO.¹³⁸

price manipulation and showing upward manipulation of earnings reports during class periods).

¹³⁶ See FED. SEC. CODE § 1708(c) (1978) (proposing capped damages for both entity and managerial liability).

¹³⁷ See Langevoort, *Capping Damages*, *supra* note 13, at 657-60 (discussing the merits of a method of quantitative caps on damages and its advantages over the out-of-pocket standard).

¹³⁸ The shareholders derivative action has been suggested as a model that focuses on individual liability—it reverses enterprise liability by making the enterprise the plaintiff and restricts liability to culpable actors. See Richard A. Booth, *The Paulson Report Reconsidered: How to Fix Securities Litigation by Converting Class Actions into Issuer Actions*, 2 J. SEC. L. REG. & COMPLIANCE 244, 247 (2009) (rejecting civil fines and proposing derivative actions brought by shareholder plaintiffs to recover insiders' ill-gotten gains); Fox, *Civil Liability*, *supra* note 1, at 284 (making damages "payable to the issuer").

Other proposals for alternate damage calculation focus on the disgorgement of ill-gotten insider gains. See Adam C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2007-08 CATO SUP. CT. REV. 217, 219 (2008) (proposing that "damages . . . be measured by disgorgement of unlawful gains"); Booth, *supra*, at 249 (proposing a disgorgement regime). For a contrasting approach, see Fox, *Civil Liability*, *supra* note 1, at 284-86. Fox calculates damages using the company's newly acquired capital during a period of price inflation. *Id.* at 285. He would accordingly cap damages in any given year at the amount of capital invested by the company. *Id.* He would also eliminate enterprise liability and levy damages on officers, directors, and add an external certifier modeled on the underwriter of a new issue of securities. *Id.* at 286.

Specifically, assume that Corporation X had \$100 million in total assets at the beginning of the year, capitalized 50% with debt and 50% with equity. X's equity market capitalization was \$80 million, comprised of 2 million common shares trading at \$40 per share. Assume also that X invested \$10 million of newly acquired capital during the year, and that its stock price was inflated by \$10 due to material misstatements by

Even so, setting individual penalties poses a difficult, possibly intractable, trade-off in a system that relies on a private-enforcement supplement. On the one hand, the penalties must generate a damage pool large enough to attract plaintiffs' attorneys. On the other hand, if the increased fines generate sufficient funds to attract private enforcers, then there may be an inadvertent restriction of private enterprise. Draconian penalties could chill corporate recruitment and risk-taking.¹³⁹

Once the possibility of a chill is acknowledged, enterprise liability emerges in a more positive light.¹⁴⁰ It places the precautionary burden on the company¹⁴¹ and thus aligns incentives so as to minimize the possibility of a chill. The company is risk neutral, whereas its individual agents are risk averse. Excess caution due to the fear of securities

its officers. Fox would carve out the damage pool by dividing the amount invested, \$10 million, by the \$40 stock price. The quotient, here 250,000, is a block of "phantom shares." This number is multiplied by the stock-price inflation of \$10 to yield a damage pool of \$2.5 million.

Now compare FOTM damages for the hypothetical Corporation X. We can construct a figure by stipulating that investors who bought shares during the period held either 1 million or 500,000 shares at the end of the class period, yielding a price inflation of \$10 million or \$5 million. Using these numbers, Fox's damages are indeed lower. The question is whether the number remains too large to impose on individual defendants without a risk of overdeterrence. Given these numbers, this appears to be a problem.

We also question the assertion that earnings retained during a period of price inflation are actually ill-gotten gains. This capital emanates from the sale of goods and services or other assets, not from the pockets of capital providers. This capital certainly is not "free" with regard to calculation of the equity-capital cost. Further, price inflation could skew that calculation and cause the company to accept a suboptimal project. It does not follow that the capital is ill-gotten for purposes of a market-regulation regime.

¹³⁹ This is the same problem that besets the corporate law duty of care, a problem that has been resolved in favor of minimizing the penalty risk. See PRINCIPLES OF CORP. GOVERNANCE § 4.01(c), cmt. c-f (1994) (minimizing the risk of penalty by creating a Business Judgment Rule that provides a number of safe harbors for directors and officers).

¹⁴⁰ Some take the view that a tradeoff cannot be effected successfully. For example, Professor Coffee proposes that we retain enterprise liability but tweak FOTM to incent plaintiffs' lawyers to bring individual defendants to the settlement table as contributors. More particularly, he would offer a bounty in the form of a higher percentage of attorneys' fees to the extent of individual contributions and couple that with requirements of independent-director review of settlement fairness and full disclosure of settlement terms. See Coffee, *supra* note 54, at 1575-82 (proposing a form of attorneys' fees that varies based on the settlement source along with SEC-mandated independent-director review of any proposed settlement).

¹⁴¹ See Langevoort, *Corporate Executives*, *supra* note 13, at 635 ("The threat of enterprise liability essentially instructs the firm to take precautions . . . to reduce the system-wide fraud risk.").

law enforcement is more likely to be a problem where individuals are the primary enforcement targets.¹⁴²

We note an alternative possibility—substituting public enforcement. If the risk of a chill is serious, then setting fines arguably should not be a function of assuring an attractive rate of return on investment in private litigation. Instead, a public body pursuing a policy outcome should set fines. To the extent that these fines are too low to attract private enforcers, public enforcement should be the fallback option.

C. Institutional Constraints

Once the overdeterrence problem has improved the appearance of enterprise liability, the next phase of the argument puts a positive gloss on private enforcement by comparing the public alternative—in particular, SEC enforcement. In this story, the choice lies not between private and public enforcement, but between private enforcement and no enforcement at all.

The SEC does have an arsenal of enforcement weapons, including civil penalties, disgorgement of profits, bars on employment at public companies,¹⁴³ and, under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley),¹⁴⁴ freezes on extraordinary payments from issuers¹⁴⁵ and a

¹⁴² See Easterbrook & Fischel, *supra* note 91, at 643-44 (stating that if private losses were not compensable, people would have an incentive to take too many precautions); Langevoort, *Corporate Executives*, *supra* note 13, at 635 (explaining how “risk-fearing individual executives . . . might . . . be excessively cautious,” and therefore the risk-neutral firm should undertake the task of implementing precautionary measures). To put this a different way, targeting the firm rather than the individuals spreads the risk from managers to investors, who, given diversification, are better able to bear it. Easterbrook & Fischel, *supra* note 91, at 640-41.

It has also been argued that enterprise liability has a hidden positive incentive. Even though it deflects the blame from the culpable, it encourages monitoring by the outside directors and third-party gatekeepers. These actors are in need of incentives to engage in stricter monitoring. See Langevoort, *Corporate Executives*, *supra* note 13, at 636 (discussing how outside directors will not be subject to temptation or cognitive bias and therefore “will insist on rigorous monitoring and internal controls to avoid large-scale enterprise liability”). By contrast, note that one possible gatekeeper, the liability insurer, has no place at this incentive table. See Baker & Griffith, *supra* note 100, at 1808 (showing, empirically, that D&O insurers invest little in monitoring management and that their risk assessment and pricing structures send a weak deterrence signal).

¹⁴³ Langevoort, *Corporate Executives*, *supra* note 13, at 652-54.

¹⁴⁴ Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

¹⁴⁵ Sarbanes-Oxley Act § 1103, 15 U.S.C. § 78-u3(c) (2006); see also SEC v. Gemstar-TV Guide Int’l, Inc., 401 F.3d 1031, 1036 (9th Cir. 2005) (noting that section 1103 “would allow the SEC, during an investigation, to seek an order in Federal court im-

compensation clawback triggered by accounting restatements.¹⁴⁶ But, historically, the agency has not vigorously deployed these weapons against individual defendants.

Indeed, SEC enforcement actions bear a more than passing resemblance to FOTM actions—the agency tends to settle with the enterprise funding the penalty rather than with the culpable individuals.¹⁴⁷ Actors at the SEC are aware of the problem. Since Enron, the regulators have been targeting more individuals,¹⁴⁸ but the agency continues to face internal disagreement regarding individuals versus corporate contributions to settlements.¹⁴⁹

posing a 45-day freeze on extraordinary payments to corporate executives”) (quoting 148 CONG. REC. S6545 (daily ed. July 10, 2002) (statement of Sen. Trent Lott)).

¹⁴⁶ Sarbanes-Oxley Act § 304, 15 U.S.C. § 7243 (providing a statutory enforcement mechanism for asset-forfeiture proceedings against noncompliant officers). The SEC recently initiated the first clawback case in which the targeted executive did not act culpably. See *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1073 (D. Ariz. 2010) (“Section 304 requires a CEO to reimburse an issuer even where the CEO committed no personal wrongdoing”).

¹⁴⁷ See Langevoort, *Corporate Executives*, *supra* note 13, at 654 (explaining that the SEC’s limited resources restrain the agency from pursuing more contentious enforcement actions against individual executives). Historically, even when individual fines are imposed, the settlements often permit the operation of indemnification agreements between corporations and managers. Chester S. Spatt, Chief Economist, U.S. Sec. & Exch. Comm’n, Speech by SEC Staff: “Penalties and Sanctions for Securities Fraud”: Remarks Before the American Economic Association (Jan. 6, 2007), available at <http://www.sec.gov/news/speech/2007/spch010607css.htm>. But SEC practice has changed, and individual defendants now must pay themselves. See *infra* text accompanying note 361.

¹⁴⁸ See Langevoort, *Corporate Executives*, *supra* note 13, at 628 (“Since 2002 especially, the SEC has clearly been more aggressive in seeking remedies against individual executives, and even companies themselves appear more willing to try to recoup payments they have made to dishonest managers.”). The SEC has also taken steps to articulate its standards for determining when to target the enterprise rather than the individuals. See, e.g., Press Release, U.S. Sec. & Exch. Comm’n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), available at <http://www.sec.gov/news/press/2006-4.htm>. This initiative did not, however, contribute to more vigorous enforcement. See *infra* notes 264-87 and accompanying text.

¹⁴⁹ Those pushing for individual liability have been in the minority. See Kara Scannell, *Clawbacks Divide SEC*, WALL ST. J., Aug. 7-8, 2010, at B3 (describing Commissioner Aguilar’s “threat not to vote on cases where he thinks the agency is too lax”). Meanwhile, a few courts have recently displayed dissatisfaction with lowball SEC enforcement settlements and the agency’s failure to pursue individuals. See Jonathan Weil, *Citigroup’s Sweetheart Deal Flunks Smell Test*, BLOOMBERG (Aug. 18, 2010, 9:00 PM), <http://www.bloomberg.com/news/2010-08-19/citigroup-s-sweetheart-deal-flunks-smell-test-jonathan-weil.html> (describing district judge’s demand for a brief from the SEC regarding the agency’s questionable treatment of Citibank).

More generally, the agency is described as chronically underfunded and understaffed, and its existing staff is described as subject to high turnover.¹⁵⁰ It is also seen as politically vulnerable. If the SEC rouses itself and directs its enforcement power against culpable executives, management can use its influence in Congress to reduce the agency's budget, thereby choking off the initiative.¹⁵¹ Some see private enforcement as a way around this problem, with the promise of high settlement payments assuring a continuous enforcement incentive. Plaintiffs' law firms, moreover, are seen to possess superior economies of scale and scope along with a significant financial incentive.¹⁵² This is, in short, a classic "public versus private" debate in which private incentives trump clumsy, compromised public administration.

D. Empirical Results

A stack of empirical studies confirms that FOTM actions have some deterrent impact. These studies show that private securities litigation magnifies the negative impact of bad news disclosures by adding costs for both the enterprise and individual managers, implying a deterrent effect. For example, FOTM defendants are more likely to replace their CEOs than are companies that suffer financial reversals but no lawsuits.¹⁵³ It follows that a CEO interested in holding onto his

¹⁵⁰ See Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILLANOVA L. REV. 1139, 1140, 1156 (2003) ("The United States has under-funded the hard work of investor protection, holding back from the system the resources it would take to substantially lessen the expectations gap, even if it can never be eliminated.").

¹⁵¹ See Fox, *supra* note 92, at 328 (describing the "fear that administrative officials might fail to prosecute apparently worthwhile individual cases because of pressure from wealthy or powerful individuals who would be negatively affected").

¹⁵² *Id.* at 329-30.

¹⁵³ See, e.g., Greg Niehaus & Greg Roth, *Insider Trading, Equity Issues, and CEO Turnover in Firms Subject to Securities Class Action*, 28 FIN. MGMT. 52, 53 (1999) ("[D]efendant firms experience a higher CEO turnover rate relative to matched firms that also experienced large stock price drops . . . [and] meritorious cases are more likely to result in CEO turnover."); Philip Strahan, *Securities Class Actions, Corporate Governance and Managerial Agency Problems* 3-4 (Fed. Reserve Bank of N.Y., Paper No. 9816, 1998), available at http://www.newyorkfed.org/research/staff_reports/research_papers/9816.pdf ("While ownership structure and broad composition do not change after securities class actions, the likelihood of CEO turnover nearly doubles, and the increase is statistically significant."). Results in this literature, however, are mixed. See Anup Agrawal, et al., *Management Turnover and Governance Changes Following the Revelation of Fraud*, 42 J.L. & ECON. 309, 332 (1999) (finding little systematic evidence that firms suspected of or charged with fraud have unusually high turnover of senior managers or directors).

job should avoid involvement with fraud, and that enterprise liability is not necessarily without individual consequences.

Let us accept the point that FOTM actions have negative consequences. A follow-up question arises: how salient is FOTM's consequential contribution? The closer one looks, the less salient its profile.

Ex ante, the primary deterrence mechanism for corporate managers is the market—bad things happen to those who perform badly. CEO turnover is in the first instance associated with poor corporate performance,¹⁵⁴ and poor performance by itself generates antifraud litigation. As between the two, we suspect the performance incentive looms larger as a motivator for corporate decisionmakers. Note that in many cases where an executive is fired following a FOTM complaint, the board is also faced with the discovery of culpable fraud (in some cases accompanied by insider trading), an occurrence that should result in termination quite apart from the presence or absence of private litigation. Culpability and termination go together. When firms are faced with enforcement action by the SEC or the Department of Justice, the termination statistics are overwhelming: Karpoff, Lee, and Martin find that 93.4% of managers identified as culpable by government enforcers lose their jobs.¹⁵⁵

We accordingly look to FOTM for an incremental impact. To get a better handle on this, consider a finding on reputational effects.¹⁵⁶ By hypothesis, if private lawsuits target badly governed companies, reputational damage to the defendant companies' independent directors should follow. But Eric Helland's study, which substitutes numbers of directorships as a measure of reputation, shows no such effect—to the contrary, numbers of directorships increase for directors of companies accused of fraud.¹⁵⁷ There is an important caveat:

¹⁵⁴ Cf. Jerold B. Warner et al., *Stock Prices and Top Management Changes*, 20 J. FIN. ECON. 461, 487-88 (1988) (investigating the "relation between a firm's stock price performance and subsequent changes in its top management"); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 453 (1988) (examining relationship between board composition and frequency of performance-based CEO turnover).

¹⁵⁵ Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193, 201 tbl.3 (2008).

¹⁵⁶ See Eric Helland, *A Secondary Market Test of the Merits of Class Action Securities Litigation: Evidence from the Reputation of Corporate Directors* 18 (Contracting & Orgs. Research Inst., Working Paper No. 2004-05, 2004), available at <http://ssrn.com/abstract=517183> (examining the correlation between reputational penalties for directors and shareholder class actions).

¹⁵⁷ *Id.* at 18.

directors of companies in the top quartile of the sample in terms of settlement amount appear to incur reputational damage.¹⁵⁸

There are two implications. First, private actions do not in themselves signal governance defalcation to the markets. Second, big settlement numbers do signal governance defalcation. It seems, once again, that performance matters most, with litigation positioned in a secondary, follow-up role so far as negative consequences and the associated deterrent effect are concerned.

Finally, consider a finding on stock prices. Professors Ferris and Pritchard took a sample of defendant firms and found an average negative stock price reaction of approximately 25% on the corrective disclosure date.¹⁵⁹ The prospect of FOTM litigation is one factor in the negative mix. Realization of that prospect in the form of a complaint being filed causes a further average stock price reduction of 3.33%.¹⁶⁰ And so we have another FOTM consequence, but not necessarily one that adds to the case for its defense. These figures show how enterprise liability worsens a bad corporate situation and injures innocent parties, even as it fails to focus on the responsible actors.

FOTM actions also have positive effects. There is evidence that defendant companies are more poorly governed—accounting fraud is associated with fewer outside directors,¹⁶¹ and better governance is associated with more informative disclosure practices.¹⁶² Litigation, in turn, is associated with governance improvement. CEO turnover can

¹⁵⁸ *Id.* at 4. Evidence is mixed with respect to directors of companies subject to SEC enforcement actions. See *id.* at 21-22 (showing a strong negative impact with respect to the largest companies).

¹⁵⁹ Stephen P. Ferris & A.C. Pritchard, *Stock Price Reactions to Securities Fraud Class Actions Under the Private Securities Litigation Reform Act 3* (Univ. of Mich. Law Sch., John M. Olin Ctr. for Law & Econ., Paper No. 01-009, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=288216.

¹⁶⁰ *Id.* at 7.

¹⁶¹ See generally Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Directors Composition and Financial Statement Fraud*, 71 ACCT. REV. 443, 445 (1996) (“[N]o-fraud firms have significantly . . . higher percentages of outside directors than fraud firms.”); Patricia M. Dechow et al., *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEMP. ACCT. RES. 1, 21 (1996) (investigating the motives and consequences of earnings manipulation in a sample of firms subject to SEC enforcement actions).

¹⁶² See Saumya Mohan, *Disclosure Quality and Its Effect on Litigation Risk 11* (Sept. 1, 2006) (unpublished manuscript), available at http://ssrn.com/abstract_id=956499 (“[I]ndependent banks . . . are associated with more informative disclosure levels.”).

herald improved management at a defendant company. Defendant companies also tend to increase numbers of independent directors.¹⁶³

But an endogeneity question arises: why might a defendant company add independent directors? Litigation might have prompted it to see the benefits of following the good-governance playbook. Alternatively, litigation itself might make it more convenient to bring in new outsiders lacking ties to the events in question who can take the lead in approving a settlement.¹⁶⁴

Consider another positive finding: a company subject to securities litigation is highly unlikely to be subject to further securities litigation for the three years following the suit.¹⁶⁵ Learning is implied—the company now takes compliance more seriously. But other inferences can also be drawn. Perhaps securities fraud tends to be one-off because the market learns from the experience. Companies that analysts follow will find it difficult to sustain optimism in the face of disappointments, and a single misstatement followed by a correction will alert the analysts to scrutinize future claims of success closely.

Finally, if companies and executives do learn from their experiences with FOTM, what exactly is the lesson? Companies subject to shareholder litigation reduce the amount of information they reveal to the markets, particularly about future-earnings expectations.¹⁶⁶ Managers, it seems, learn that plaintiffs' lawyers can base accusations of misconduct on management's own voluntary disclosures.¹⁶⁷ It follows that it is better to say less to avoid another lawsuit. More generally, the higher the firms' litigation-risk profile, the lower the level of voluntary disclosure.¹⁶⁸

¹⁶³ See Stephen P. Ferris et al., *Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings*, 42 J. FIN. & QUANTITATIVE ANALYSIS 143, 161 (2007) (finding that with derivative lawsuits "the proportion of outside representation on the board of directors increases").

¹⁶⁴ Cf. Helland, *supra* note 156, at 3-4 (pointing out that increased board diversity in the face of litigation is not always demonstrative of better corporate governance because independent directors may be brought on simply to inoculate the board from allegations of poor governance at trial).

¹⁶⁵ Kim & Skinner, *supra* note 59, at 23-24.

¹⁶⁶ Jonathan L. Rogers & Andrew Van Buskirk, *Shareholder Litigation and Changes in Disclosure Behavior*, 47 J. ACCT. & ECON. 136, 154 (2009).

¹⁶⁷ *Id.*

¹⁶⁸ See Stephen P. Baginski et al., *The Effect of Legal Environment on Voluntary Disclosure: Evidence from Management Earnings Forecasts Issued in U.S. and Canadian Markets*, 77 ACCT. REV. 25, 48 (2002) (arguing that lower legal liability leads to more consistent voluntary disclosure of management earnings forecasts and noting this finding's consistency with earlier studies). See generally Carol A. Frost & Grace Pownall, *Accounting*

E. Evaluation

The case for FOTM, thus stated, is more than a little contradictory. It holds that FOTM's effectiveness stems not from its own deterrent power, but rather from the SEC's lack thereof. Further, FOTM is considered a success because an enforcement regime that actually had deterrent power would have the perverse effect of chilling risk taking.¹⁶⁹ Empirical studies confirm this view. Thus, FOTM is desirable because a serious deterrent regime is unlikely and undesirable. This is an odd argument for a case that begins with the proposition that fraud is underdeterred.

If fraud is underdeterred, FOTM does little to solve the problem. So little, it seems, that the system has begun to evolve around FOTM. Consider three developments during the decade since Enron. First, public antifraud enforcement has become a growth industry. Criminal enforcement of the securities laws, once rare, is now institutionalized in specialized corporate fraud task forces organized by the Justice Department.¹⁷⁰ The Bush Administration's team reported that it obtained almost 1300 convictions (including those of 200 CEOs) and

Disclosure Practices in the United States and the United Kingdom, 32 J. ACCT. RES. 75, 76 (1994) (comparing statement disclosure rates). For a game theory model confirming the result of distorted incentives, see Joshua Ronen & Varda (Lewinstein) Yaari, *Incentives for Voluntary Disclosure*, 5 J. FIN. MARKETS 349, 373 (2002).

There is a related question: when there is bad news, should it be disclosed immediately, and, if so, does that preempt litigation? There is a large and somewhat contradictory body of work addressing the timeliness of negative disclosures. See Laura Field et al., *Does Disclosure Deter or Trigger Litigation?*, 39 J. ACCT. & ECON. 487, 506 (2005) (finding that firms with higher litigation risks are more likely to disclose earnings warnings and that disclosure deters rather than triggers litigation); Douglas J. Skinner, *Why Firms Voluntarily Disclose Bad News?*, 32 J. ACCT. RES. 38, 57 (1994) (arguing that managers have incentives to disclose negative earnings statements as a way to preempt bad quarterly earnings news due to litigation risk and to maintain goodwill within the investment community); see also Dain C. Donelson et al., *The Timeliness of Earnings News and Litigation Risk* 11-12 (McCombs Research Paper Series, Research Paper No. IROM-08-10, 2010), available at <http://ssrn.com/abstract=1641342> (showing an association between timely disclosure and litigation reduction).

¹⁶⁹ See *infra* note 175.

¹⁷⁰ Anton R. Valukas et al., *Enforcement Actions in the Post-Enron World: Zero Tolerance in the White-Collar Arena*, 37 REV. SEC. & COMMODITIES REG. 133, 141 (2004), available at http://www.jenner.com/files/tbl_s18News/RelatedDocuments147/1246/Valukas_Staoffer_Travis.pdf.

levied hundreds of millions of dollars in fines and restitution between 2002 and 2008.¹⁷¹

Second, corporations themselves have been deputized as antifraud enforcers. Mandatory internal-compliance systems were added to the enforcement regime, imposed first by the Foreign Corrupt Practices Act of 1977 (FCPA)¹⁷² and then more emphatically by the Sarbanes Oxley Act of 2002.¹⁷³ These statutes take federal antifraud enforcement deep inside corporations, mandating reports and management systems that assure companies' legal compliance.¹⁷⁴ These internal compliance systems require planning and design, staffing and execution, and monitoring and auditing.¹⁷⁵

Third, corporate employees (and others) are being rewarded for giving tips to the SEC about potential violations. Section 922 of the Dodd-Frank Act charges the SEC with developing a new whistleblower program to enhance the agency's capacity to detect fraud in advance.¹⁷⁶ The program, which is up and running,¹⁷⁷ holds out substantial financial compensation for high quality tips.¹⁷⁸

¹⁷¹ PRESIDENT'S CORPORATE FRAUD TASK FORCE, U.S. DEP'T OF JUST., REPORT TO THE PRESIDENT, at iii-iv (2008), available at <http://www.justice.gov/archive/dag/cftf/corporate-fraud2008.pdf>.

¹⁷² Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended in scattered sections of 15 U.S.C.).

¹⁷³ Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

¹⁷⁴ See, e.g., Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262 (2006) (requiring internal compliance systems and an annual audit by outside auditors).

¹⁷⁵ These systems are thought to be costly. See Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems,"* 31 J. CORP. L. 949, 959-60 (2006) (describing some of the costs of internal compliance systems, ranging from audit fees to less tangible costs, such as less employee risk taking); Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404,* 29 CARDOZO L. REV. 703, 734 (2007) (attributing a decrease in small companies' IPOs at least in part to the high costs of Sarbanes-Oxley compliance).

¹⁷⁶ See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), § 21D(a)(3), (b)(1), 15 U.S.C.A. § 78u-6(a)(3), (b)(1) (West 2011) (directing the SEC to reward original information leading to a successful enforcement action with an amount between ten and thirty percent of the sanctions exacted).

¹⁷⁷ An Office of the Whistleblower has been established. Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34300, 34363 (June 13, 2011) (to be codified at 17 C.F.R. pt. 240); see also *Welcome to the Office of the Whistleblower*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/whistleblower> (last visited Oct. 15, 2011).

¹⁷⁸ Participants in compliance programs are not eligible. See 17 C.F.R. 240.21F-4(b)(4)(iii)(B) (2011) (excluding employees responsible for compliance and audits). But eligible employees are encouraged to work with the compliance office. See 17 C.F.R. § 240.21F-6(a)(3), (b)(3) (2011) (requiring the SEC to take into account coop-

These developments occurred at the extremes—at one end we see high-intensity deterrence through criminalization and, at the other, enforced and rewarded cooperation outside of the litigation system. One wonders whether a long-term reduction in the incidence of securities fraud will result, but it is too early to tell. Scholars have written about the costs of Sarbanes-Oxley's new regime,¹⁷⁹ but we are aware of no significant scholarship on the benefits of increased compliance. Interestingly, however, accounting restatements, the bedrock evidence for FOTM actions during most of the past decade, started to decline in 2007. In 2006, a total of 1564 companies filed restatements whereas in 2009 the number was down to 630.¹⁸⁰ Maybe something is working.

Fraud deterrence is thought to reduce social costs because it protects the securities markets. These markets—and, in particular, their liquidity—depend on a core of confidence that companies fairly disclose basic information about themselves. Today's markets are more liquid than ever, despite the ups, downs, and scandals of the last decade.¹⁸¹ So, even if we still must say that fraud is underdeterred, an adequate confidence level appears to have been maintained. Meanwhile, our legal system for the most part (the exception being the recent stepped-up threat of criminal liability) avoids imposing penalties on individual miscreants. What, then, makes the system work?

We return to basic market assumptions: the reputation market and private governance both punish financial failure, whether or not accompanied by fraud, and can be expected to punish more severely when thus accompanied. In addition, as financial markets are quick to learn, misrepresentations are costly even without enforcement penalties. Optimistic reporting or hiding bad news in the hopes of rescue in better times is a risky strategy in an efficient market. While a company can control its own information flow, it cannot control news coverage of market trends or information from competitors who correctly inform the market.

eration or interference with the operation of the compliance system in determining the amount of the award).

¹⁷⁹ See, e.g., Prentice, *supra* note 175, at 734 (noting Sarbanes-Oxley's negative effect on small-company IPOs).

¹⁸⁰ MARK CHEFFERS ET AL., AUDIT ANALYTICS, 2009 FINANCIAL RESTATEMENTS: A NINE YEAR COMPARISON 1 (2010).

¹⁸¹ See James Angel et al., *Equity Trading in the 21st Century* 7-26 (Univ. of S. Cal. Marshall Sch. of Bus., Working Paper No. FBE 09-10, 2010), available at <http://ssrn.com/abstract=1584026> (identifying a variety of metrics for analyzing recent volatility in equity trading).

None of this makes legal enforcement irrelevant. But between criminal enforcement initiatives, internal compliance regimes, liberal rewards to whistleblowers, and market controls, we emerge skeptical about the backstop case for FOTM. If, despite all of the above, fraud remains underdeterred, then perhaps it is time to seek more potent enforcement alternatives. The specter of overdeterrence rises in response. We offer two rejoinders. First, despite the continued refrain of underdeterrence, increased criminal prosecution in the post-Enron era already creates an overdeterrence risk. Second, civil enforcement only implies this risk if left to private plaintiffs. Fines must increase to entice the plaintiffs' lawyers to court, but public enforcement creates no such risk.

In sum, FOTM's deterrent value is so uncertain and the individual enforcement alternatives so clearly superior that "deterrence" cannot be an adequate standalone justification. Reviewing the deterrence case does not close the book in FOTM's favor, but rather keeps it open for further inquiry. If the best that can be said about FOTM is "it still doesn't make any sense, but it's all we have," then something has gone very wrong.

We undertake the inquiry into what went wrong in Part IV. There, we account for FOTM's politically protected status, noting in particular shareholder interest's rise to political salience. Having thus diagnosed the political pathology that gives FOTM its aura of inevitability, we make a reform suggestion in Part V. Using shareholder protection for policy grounding, we show that the SEC's civil enforcement arm is a more formidable operation than it once was and make a case for stepped-up SEC enforcement capability as a cost-effective substitute for FOTM. But before we embark on those discussions, we must evaluate one final line of justification for FOTM. FOTM advocates have repackaged their causes of action as a means of improving corporate governance. Part III considers this claim.

III. FRAUD ON THE MARKET AS GOVERNANCE

FOTM proponents, presumably reeling in the wake of the compensation critique and apparently not content to rest their case on deterrence, pursue a new path to justification. They claim that FOTM makes a positive governance contribution. This Part evaluates that position, which rests on the idea that the governance system works well only if shareholders have the information needed to evaluate management. While this is a fair point, it seems more to underscore

the importance of the mandatory-disclosure system than to support FOTM. Indeed, the more closely we look at FOTM as a mechanism within the governance system, the more anomalous and dysfunctional it looks. FOTM does not result in direct accountability for managerial failure; its consequences do not follow from the judgment of the shareholders as a group; and it causes stock prices to go down. Other corporate-governance institutions admit of significant contractual inputs and hew to productivity concerns as they evolve over time. Federal judges applying self-referential case law and members of Congress responding to interest groups shaped FOTM several stages removed from the productivity margin.

Section A points out substantive implications of the shift in conceptual framework from compensation and deterrence to corporate governance. Section B lays out the governance case for FOTM and points out its shortcomings. Section C shifts course and draws on a comparison to state fiduciary law to make a governance case against FOTM. Section D summarizes.

A. *The Governance Framework*

The governance defense of FOTM has roots in Professor Romano's early empirical study of shareholder litigation. She found, as have subsequent studies, that shareholder litigation tends to affect weakly governed companies and concluded that litigation complements shareholder monitoring to align the interests of managers and shareholders.¹⁸² But she also concluded that shareholder litigation is mostly ineffective.¹⁸³ Subsequent writers reversed her conclusion, pointing to better governance not just as an incidental consequence of shareholder litigation, but as a self-standing justification for it.¹⁸⁴

¹⁸² Romano, *supra* note 102, at 85 (finding that firms who are sued are more likely to have weak governance structures and noting that shareholder litigation has consequences that help to align the interests of shareholders and managers).

¹⁸³ *Id.* at 84-85 ("The data support the conclusion that shareholder litigation is a weak, if not ineffective, instrument of corporate governance."). Note that this beginning point establishes a functional connection without reference to federal securities case law. There one encounters *Santa Fe Industries, Inc. v. Green*, in which the Supreme Court ruled that fraud within the meaning of section 10(b) of the 1934 Act does not include unfair transactions that violate state fiduciary duties. 430 U.S. 462, 479 (1977),

¹⁸⁴ See Fox, *supra* note 92, at 325-30 (defending the present system on a governance theory while also proposing a substitute litigation framework directed at individual actors); Pritchard, *supra* note 131, at 937 (describing governance enhancement as central to the purpose of some antifraud litigation).

The transition from deterrence to governance necessarily brings a shift of perspective. Where deterrence seeks accurate market prices to promote liquidity, governance redirects the view to the individual corporate issuer and seeks transparency as a means to achieve agency-cost reduction.¹⁸⁵ More particularly, transparency leads to better business planning and execution because shareholder inputs are meaningful only if business-policy issues can be accurately appraised from the outside. The shift from market accuracy to agency-cost reduction also means a shift from one body of law and economics to another—from the economics of sanctions and public law to agency-cost economics and private law. Finally, we shift from seeking social-cost reduction and social-welfare maximization to maximizing individual firm value.

Despite these shifts, the governance and deterrence frameworks converge at the bottom line. We are still talking about deterring fraud, even as the end in view shifts to better governance. Transparency, the governance objective, presupposes accurate market prices, which in turn are the objective of the deterrence justification. At the same time, accurately priced markets tend to be liquid markets, and these two factors together lower the cost of capital for securities issuers. The public goal of protecting the markets thus, in the end, seeks the same corporate-value maximization as the private-governance framework.

There is no such convergence between “FOTM as governance” and “FOTM as compensation,” even though the theories share some conceptual affinities. Shifting from deterrence to governance returns us to the private side of the public-private divide. This is the same side

Implications from a line of empirical analysis may have added traction to the governance analysis. These are multicountry studies that compare public enforcement, measured in terms of government agencies' legal empowerment, against private enforcement, measured in terms of disclosure mandates and private liability standards. The private factors are associated with deep trading markets, dispersed ownership and numbers of initial public offerings (IPOs). See Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 23, 25 (2006) (examining the nexus between IPOs and securities-fraud liability). Any traction has dissipated in the wake of Jackson and Roe's paper, *supra* note 1, at 207, which substitutes and compares the results of a test based on resource allocations to public enforcers. Unsurprisingly, the association between market robustness and public-enforcement resources is stronger than that based on the private factors. See *id.* (noting that public-enforcement resources are as closely associated with strong capital markets as is private disclosure and are more associated with strong markets than are other markers of private enforcement).

¹⁸⁵ See Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1049 (1995) (discussing how mandatory disclosure has its origins in common law devices for agency-cost reduction). The SEC went on to transform mandatory disclosure to enhance accuracy in the markets such that the system now pursues both objectives. *Id.* at 1048-50.

as the compensation justification, which also emphasizes the shareholder interest. But the presuppositions that motivate FOTM as compensation are otherwise discarded. The compensation theory's goal is to get money into the pockets of particular shareholders, but a debilitating internal inconsistency results when FOTM allows other shareholders to fund the payments. The shift to governance largely solves this problem.¹⁸⁶ Shareholders are expected to pay for corporate governance because it reduces agency costs and makes them better off. Of course, FOTM does not spread its costs evenly. But where the distributional imbalance inherent in pocket shifting is an adverse result within the compensation framework, it is irrelevant within the governance framework so long as FOTM's beneficial effects imply net positives across the board.

B. *The Governance Case for FOTM*

What benefits does FOTM bring to the corporate governance system? The literature puts forward a two-part answer: (1) FOTM forces transparency and facilitates monitoring to foster good governance, and (2) FOTM helps shareholders surmount the legal and collective-action barriers to fulfill their role as principals in an agency relationship with managers. We consider each claim in turn.

1. FOTM and Transparency

Proponents of FOTM as governance point out that the governance system—and in particular the shareholders' roles therein—depends on transparency to function properly.¹⁸⁷ They then rest their case, implicitly relying on a crucial assumption—that FOTM is necessary to achieve transparency.¹⁸⁸ This assumption in turn follows from the deterrence case, namely that FOTM enhances transparency by deterring fraud. Thus does the governance case collapse back into the deterrence case, shifting the emphasis without adding anything.

In order to strengthen the case for FOTM, the governance justification requires additional support. Because the justificatory claim

¹⁸⁶ See Fox, *supra* note 92, at 327 (describing the cost of shareholder litigation as a “user fee” for investors).

¹⁸⁷ Fox, *Civil Liability*, *supra* note 1, at 253-57.

¹⁸⁸ See *id.* at 273 (noting that foreign governments concerned with transparency have increasingly adopted civil liability for corporate noncompliance).

concerns transparency, then, by hypothesis, FOTM actions must add something to the information available about the target company.

We are hard pressed to detect a positive informational contribution. FOTM actions are backward looking. Attorneys construct them by connecting a corporate announcement that causes a decline in the stock price with a material anterior disclosure that has since been deemed inaccurate. The lawsuit's chance of success depends largely on the strength of the connection and the financial impact of the connected events, which is established by a statistical analysis of past stock prices. Any prospective informational input comes from the signal the lawsuit sends about management quality.

But how much information does a FOTM suit add? The bad business news is already on the table, as is the anterior disclosure. Depending on the facts, the action may or may not highlight that the anterior disclosure amounted to a misstatement. Often, as with accounting restatements, the existence of a prior misstatement will be part and parcel of the bad news. In cases with a parallel SEC proceeding, the private action may have no informational role to play at all. Finally, although some cases will highlight or add facts, cases without merit will also generate noise on the screen.

As noted, any information developed in connection with a FOTM action will relate primarily to management quality, and this information will presumably bear negatively on individual managers' reputations. But we have seen that it is not safe to assume that FOTM actions have negative reputational consequences for all implicated managers, but rather follow only for outside directors of the companies with the biggest losses.¹⁸⁹ Given a significant loss, we wonder whether the negative message would register in the marketplace with or without a FOTM action.

Overall we see little in the way of a supplemental informational contribution. This thin benefit must be weighed against the informational cost. We have seen that companies experiencing a FOTM action seek to avoid future confrontations by decreasing their discretionary disclosures.¹⁹⁰ Overall, then, we see no positive contribution to transparency.

This is not a surprise. When problems arise concerning the quantum and quality of information flowing to the markets, attention turns to the mandatory-disclosure system. When an adjustment seems necessary, rulemaking processes go forward at the SEC and the Financial

¹⁸⁹ See *supra* notes 156-66 and accompanying text.

¹⁹⁰ See *supra* notes 166-74 and accompanying text.

Accounting Standards Board.¹⁹¹ These processes include inputs of information and expertise from interested parties. Now compare FOTM as a source of disclosure mandates. It yields case law on particular questions of truth, falsity, and materiality. That case law results from encounters between litigating attorneys (plaintiffs', defendants', the SEC's, and amici's) and courts whose judges, for the most part, are composed of former government attorneys.¹⁹² While such encounters certainly may benefit from considered policy analysis, the decisionmakers have no duty to consider or seek out such inputs. Nor do they necessarily possess expertise respecting either the policy or the mechanics of future application by reporting companies.

It is fortunate, then, that FOTM plays only a minor role in generating the terms of the mandatory-disclosure system.

2. FOTM and the Shareholder-Manager Agency Relationship

Professors Thompson and Sale describe a governance role for FOTM independent of its role as a mandatory-disclosure backstop.¹⁹³ They suggest that federal securities litigation occupies governance territory that overlaps with the state law duty of care.¹⁹⁴ They look to specific provisions of the mandatory-disclosure system to establish the overlap and show how its directives probe deeply into corporate decisionmaking and risk-management processes.¹⁹⁵ They then extend the overlap to shareholder antifraud litigation, making a series of characterizations, all of which are fair: (1) a shareholder action prompted by an accounting restatement involving earnings is an action based on a loss in corporate value stemming from mismanagement, and thus such an action is a proxy for a state law duty of care action;¹⁹⁶ (2) a federal antifraud shareholder action, like a state law care action, ad-

¹⁹¹ William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5, 13-15, 22-24 (2007).

¹⁹² See RUSSELL WHEELER, BROOKINGS INST., *THE CHANGING FACE OF THE FEDERAL JUDICIARY* 6-8 (2009) (noting a trend toward appointing lawyers from the public sector as judges).

¹⁹³ Thompson & Sale, *supra* note 60, at 872.

¹⁹⁴ See *id.* at 872-73 ("The [SEC] regulations are extensive and provide for disclosures arguably designed to enforce what are basic state law fiduciary duties.").

¹⁹⁵ See *id.* at 873-75 (explaining how, for example, one such regulation describes in detail what should be included in a company's financial report).

¹⁹⁶ See *id.* at 887.

dresses the officers' conduct of the business;¹⁹⁷ and (3) a federal shareholder action implies that the officers' stewardship of the company is not what the shareholders would want it to be.¹⁹⁸

The overlap, thus established, is descriptive and does not advance a justification for FOTM. But Thompson and Sale go further, asserting that federal litigation enhances opportunities for shareholders to perform a direct "governance role"¹⁹⁹ and hold officers accountable, in effect letting the shareholders assume the board of directors's monitoring role.²⁰⁰ These stronger claims, if sustainable, carry normative traction.

We think Thompson and Sale carry their point a step too far when they suggest that FOTM litigation lets shareholders realize untapped potential as agency principals who may bypass the board of directors and directly hold managers accountable. A FOTM complaint by definition names at least one corporate director or officer. But FOTM in practice almost never holds anyone to an individual admission of liability, much less individual accountability, because doing so decreases the action's economic value to the plaintiffs' attorneys.²⁰¹ Any real accountability, such as a CEO firing, is an incidental effect. Whether the termination follows from the business failure itself, the board's reaction to the executive's defalcation, the violation of the securities laws taken alone, or the violation taken together with the FOTM action, will depend on the case. Our sense is that when boards remove CEOs, business failures loom larger than compliance defalcations.

Suppose for a moment that FOTM actually works as Thompson and Sale describe and does provide a direct channel for shareholder participation in business decisions. We doubt that it would be tolerated for long in that role. Under FOTM, it is not the shareholders acting as a group who make decisions, as occurs when they exercise the franchise, but a plaintiffs' lawyer subject to oversight by a named plaintiff (or group of named plaintiffs)²⁰² and a federal judge. This,

¹⁹⁷ See *id.* at 897 ("The federal cases focus on the failure of managers, principally officers, to fulfill their management obligations.").

¹⁹⁸ See *id.* at 907 (asserting that shareholders institute a securities action "by complaining about the difference in the price at which they bought . . . and the lower, actual value of the stock with which they are stuck").

¹⁹⁹ *Id.* at 871.

²⁰⁰ See *id.* at 888 (stating that in state-law fiduciary suits, shareholders often respond to managers' decisions by "suing to limit the directors' freedom to act or not to act").

²⁰¹ See *supra* notes 121-31.

²⁰² For a discussion of governance questions arising within the class action context, see Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337, 340. See also Richard Nagareda, *Class Actions in the Administrative State*:

quite simply, is not an appropriate context for business decisionmaking, including decisions on CEO tenure. There is a lack of accountability. When shareholder litigation is meritless or otherwise has perverse effects on the defendant corporation's business, neither the named plaintiff, nor its attorneys, nor the judge need take responsibility. Further, the informational environment is not conducive to business decisionmaking. Litigators and judges have forensic expertise and focus on the past. Value, in contrast, concerns the future.

Finally, FOTM actions can result in new internal governance regulations. Settling defendants often implement governance improvements, but these nonpecuniary settlement items can be distinguished from the effects of the lawsuit itself.²⁰³ These items operate prospectively and presumably have the approval of a board of directors that is itself forward looking. Even if named plaintiffs, their lawyers, and federal judges are not the ideal actors to generate corporate legislation, and even if a settlement table trading governance improvements for damages and attorneys' fees is far from an ideal negotiating environment, positive contributions can nonetheless be made.

For us, the question presented concerns the place that nonpecuniary settlement terms take in the overall cost-benefit balance. We suspect they carried greater weight thirty years ago when good-governance practices were only setting out on the long road to institutionalization. It is different today. Best practices are the subject of ongoing engagement between managers, directors, market intermediaries, institutional shareholders, and regulators. The curve of self-regulatory responsiveness has been sloping upward.²⁰⁴ There certainly is room for governance improvement incident to litigation shocks at poorly governed firms. But an institution as costly as FOTM cannot

Kalven and Rosenfeld Revisited, 75 U. CHI. L. REV. 603, 604 (2008) (discussing the challenges of class action settlement in the regulatory state). The PSLRA supposes that size of shareholding should be the lead factor in determining the selection of an appropriate lead plaintiff. See PSLRA § 101(b), 15 U.S.C. § 78u-4(a)(3)(B)(iii) (2006) (“[T]he court shall adopt a presumption that the most adequate plaintiff in any private action arising under this chapter is the person or group of persons that . . . has the largest financial interest in the relief sought by the class.”); see also Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1155 (2011) (challenging the supposition on legitimacy grounds and advocating formation of broadly based groups of named plaintiffs).

²⁰³ See Ferris et al., *supra* note 163, at 163 (discussing corporate governance improvements in the wake of litigation and settlement).

²⁰⁴ See Bratton & Wachter, *supra* note 73, at 675-88 (challenging the notion that shareholder empowerment will result in the reduction of agency costs).

possibly make sense as a generalized mechanism for the dispersion of best practices.

C. *The Governance Case Against FOTM*

We noted above that nobody goes to court to procure disclosure rules that enhance transparency and hence improve governance. But the corporate governance system does remit shareholders to court to enforce management fiduciary duties. It follows that the state law fiduciary enforcement apparatus, which also involves going to court, provides a reference point from which to appraise FOTM's role in corporate governance.

State fiduciary law and the federal securities laws have numerous interconnections. For example, history's first disclosure mandates were targeted at conflict-of-interest transactions and were promulgated to facilitate private enforcement of fiduciary law.²⁰⁵ Today, section 10(b)'s insider trading cases create a zone of prohibited self-dealing where state law hesitated to intervene.²⁰⁶ But insider trading is a zone of individual rather than enterprise liability, so it does not implicate FOTM's policy problems. The fiduciary territory closest to FOTM is the state law duty of care, as Thompson and Sale correctly point out.²⁰⁷ We differ from them, however, with respect to the comparison's policy implications.

The state law duty of care could easily be a venue for big-ticket litigation, just like FOTM. For that to be the case, business judgments gone wrong would need to be actionable on a *res ipsa loquitur* basis, with damages set as the economic loss to the corporation from the carelessly undertaken action. Accountability would follow—state fiduciary duties are enforceable through derivative actions and so directly target board members. Thus hypothesized, the state law duty of care would be considerably more threatening to business people than is FOTM.

But, of course, the duty of care is anything but threatening because state law has sought to ensure that business judgments gone

²⁰⁵ See Mahoney, *supra* note 185, at 1089 (arguing that "the alleviation of agency problems . . . [was] identified as an *indirect* benefit of the 'full disclosure' philosophy").

²⁰⁶ See Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1321-30 (1999) (describing the Supreme Court's insider trading jurisprudence in fiduciary terms); *cf.* *Santa Fe Indus. v. Green*, 430 U.S. 462, 479-80 (1977) (cutting off access to section 10(b) as an avenue for direct enforcement of the state law duty of loyalty).

²⁰⁷ See *supra* notes 194-08 and accompanying text.

wrong do not become actionable as a function of hindsight.²⁰⁸ So narrow is the duty of care's formulation that it was once fashionable to propose its abolition on the ground of sheer irrelevance.²⁰⁹ But that was before the Delaware Supreme Court departed from tradition in *Smith v. Van Gorkom* to use the duty's traditional formulation to hold a board of directors liable for a hastily approved merger.²¹⁰ *Van Gorkom*, by signaling that the duty of care could be plaintiff-friendly, led to its de facto abolition. The Delaware legislature responded to dissatisfaction with the decision by adding section 102(b)(7) to Delaware's corporate code, permitting corporations to opt out of the duty of care in their charters (but not the duties of loyalty and good faith).²¹¹ By now, most large corporations have done so.²¹²

The comparison to FOTM is telling. Where federal courts parroting the phrase "investor protection" expand liability without much concern for the impact on business decisionmaking and operations, state courts do concern themselves with business operations and shape fiduciary law accordingly. Their scrupulousness follows from charter competition: any state that fails to be scrupulous loses its large incorporations,²¹³ with Delaware being the only state with large stakes in the game. An element of contractual consent thereby enters into the relationship of the regulator and the regulated,²¹⁴ an element

²⁰⁸ See *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982) (explaining that "liability is rarely imposed upon corporate directors or officers simply for bad judgment").

²⁰⁹ See Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 937 (1983) ("[V]ery little of any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit."); Elliott J. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 14-15 (1984) (arguing against the duty of care on the grounds that individual directors are assumed to give considerable thought to each business decision, thus rendering them invulnerable to suit).

²¹⁰ See 488 A.2d 858, 872 (Del. 1985) (holding that "[i]n carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders" and that the board of directors had failed to uphold such duty).

²¹¹ DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2010).

²¹² See Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 692 (2009) ("After section 102(b)(7) was enacted, the shareholders of almost all Delaware corporations approved charter amendments containing these exculpatory provisions . . .").

²¹³ See, e.g., William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 626-31 (2006) (outlining New Jersey's fall from being the jurisdiction of choice for American corporations).

²¹⁴ See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 130 (1993) ("[T]he powerful dynamic of state competition ensures that provisions perceived to increase share value are enacted over time.").

largely absent in the federal securities context. With the 102(b)(7) opt-out, explicit consent enters the state law picture, and corporations—with their shareholders' approval—have decided that the benefits of care-based litigation are not worth the costs.

The state law comparison thus raises the question of opting out of FOTM. The issue follows inevitably from the invocation of corporate governance as an evaluative framework. Governance, as we noted above, moves the discussion to the private side of the public-private divide to focus on agency-cost reduction. Agency-cost reduction, in turn, is predominantly a contractual exercise. In their classic work, Professors Jensen and Meckling depicted agency-cost reduction as a dynamic contracting process in which both managers and shareholders address agency costs over time, in the managers' case by bonding their fidelity, and in the shareholders' case by monitoring their investments.²¹⁵ If agency costs remain unaddressed, it is because it is too costly for the parties to remove themselves. The result that follows for corporate governance is that, as new agency costs appear, the system will find ways to reduce them, even as residual agency costs will persist in the wake of the system's adjustments.²¹⁶ If the actors in the governance system do not find FOTM costs beneficial, then they should be free to contract around FOTM, just as they contract around the duty of care and into lower agency costs.

The objection to this line of reasoning is that fraud is different. The agency model depicts endogenous contractual adjustments within a system to which fraud is exogenous. In the model, agency-cost reduction follows from management bonding and shareholder monitoring.²¹⁷ When managers do not tell the truth, it disables the shareholders' monitoring function (even as nothing prevents a manager from bonding himself to tell the truth). Thus, agency-cost reduction presupposes disclosure mandates and fraud enforcers.

Assume that this argument is correct, and that fraud is exogenous to the agency model and requires mandatory suppression. It does not necessarily follow that FOTM also must be mandatory, for with-

²¹⁵ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-30 (1976).

²¹⁶ We have argued elsewhere that the corporate governance system has indeed evolved dynamically over the past several decades to reduce agency costs substantially, making a series of endogenous adjustments to agency-cost control both in boardrooms and in financial markets. See Bratton & Wachter, *supra* note 73, at 675-88.

²¹⁷ Jensen & Meckling, *supra* note 215, at 308-09.

out it, we would still have an extensive public apparatus to enforce disclosure mandates.

Let us then go forward to a thought experiment in opting out. Suppose Congress enacted a statute (or the SEC promulgated a rule) that put FOTM up for a yea-or-nay vote at every publicly traded company.²¹⁸ A nay would mean that in any future section 10(b) action respecting a disclosure or failure to disclose by a nontrading company or company actor, the plaintiff would be required to show actual reliance. Because FOTM is a creature of federal law, a federal law presumably could give effect to a shareholder opt-out resolution without ancillary complications concerning placement in corporate charters or bylaws.²¹⁹

We would structure this company-by-company plebiscite to precipitate maximum focus within the shareholder community on the cost-benefit question presented. We would thus delay a vote until the second proxy season after enactment to allow institutional investors adequate time to formulate their policy views. To minimize the risk of perverse effects, no company would be locked into the result reached.²²⁰ Prospectively, all companies would be free to opt in or out of FOTM in the future, with shared agenda control—either a shareholder proposal under Rule 14a-8 or a management proposal would put the issue to the shareholders.

It is hard to see what objections could be raised against this arrangement, given the assumption that FOTM is a corporate-governance device on the private side of the public-private divide. The best objection we can conceive is the one we have raised else-

²¹⁸ We are not the first to discuss opting out in connection with FOTM. Pritchard argued that shareholders should make a partial waiver of the FOTM reliance presumption to deprive wrongdoers of any benefit under Rule 10b-5. See Pritchard, *supra* note 138, at 247-55. However, our thought experiment puts the matter in a framework that advances the policy discussion.

Meanwhile, Professor Pritchard has put forward opting out of FOTM as a shareholder proposal proponent at Alaska Air. Alaska Air sought permission to exclude the proposal, and the SEC staff responded with a no-action letter. See Alaska Air Group, Inc., SEC No-Action Letter, 2011 WL 916161, at *2 (Mar. 11, 2011) (stating that the SEC's Division of Corporate Finance would not recommend enforcement against Alaska Air for omitting the proposal from its proxy materials).

²¹⁹ A shareholder resolution that the board of directors did not first approve would not conform to Delaware's requirements for a charter amendment. DEL. CODE ANN. tit.8, § 242 (Supp. 2010). It could, if necessary, be characterized as a shareholder bylaw.

²²⁰ Cf. Fox, *supra* note 92, at 316 (noting that a contractual disclosure regime established at the time of an IPO could not guarantee credible disclosure for the life of a firm).

where against shareholder empowerment with respect to business policymaking—that the shareholders, due to information asymmetries, are incapable of competently exercising the franchise.²²¹ But we think the cases are distinguishable. A shareholder power to opt into control over business policy would have immediate negative consequences. The very threat of intervention would cause management to cater to the stock's market price in formulating and executing the business plan. Perverse effects could follow.²²² With FOTM, any connection to business policymaking is indirect, and information asymmetries present less of a problem. It is true that shareholders at a particular company could vote against FOTM, only to discover later that fraud had been brewing even as they took a fraud-enforcement device off the table. But we would expect them to anticipate that possibility when voting. To the extent they deem FOTM to have robust compensatory, deterrent, or governance properties, they should vote yea. If not, they should vote nay, whether or not a fraud was brewing.

Mandating an across-the-board vote at every company could be controversial. The section 102(b)(7) precedent, by vesting the opt out in the corporate charter, puts the decision in management's hands, subject to a ratifying shareholder vote. It can be argued that the same should be done here. If a given management is happy to remain subject to FOTM actions, why should we disturb the status quo? There are three answers.

First, an economy-wide referendum only becomes possible once we shift from the state to the federal context. Any state law precedent is indirect. Second, because the policy questions surrounding FOTM concern the trading market and implicate shareholder interests across the board, it follows that solicitation of an across-the-board response is an appropriate reaction to the problem. Third, an across-the-board approach keeps the informational screen as clear of noise as possible. Leaving the motion to management muddies the water with questions about positive or negative signals of the particular managers' fidelity

²²¹ See Bratton & Wachter, *supra* note 73, at 696-705 (discussing the importance of managers due to the information asymmetries of shareholders). For a strange twist on FOTM and shareholder empowerment, see COMM. ON CAP. MARKETS REG., INTERIM REPORT 16 (2006), available at http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf, which suggests that greater shareholder empowerment means stronger market discipline and diminished reliance on litigation as a governance supplement.

²²² See Bratton & Wachter, *supra* note 73, at 698-703 (arguing that information asymmetries may negatively affect IPO pricing, financing choices, and corporate investment policy).

to the mandatory-disclosure regime.²²³ Alternatively, a given management might hesitate to present the question for fear that a negative shareholder response might destabilize its position. In this regard, note that the grounds for contractual modification of FOTM already may exist. The strongest such case applies to contractually mandated arbitration, which has been validated elsewhere under the 1934 Act by the Supreme Court.²²⁴ Alternatively, companies may have the power to waive their shareholders' right to bring class actions.²²⁵ Yet we are not aware, under either alternative, of any management generated opt-out experiments indicating hesitation on management's part.

We see no ancillary process or informational problems. If the shareholder community, on reflection, concludes that FOTM is beneficial, it can be expected to vote yea, just as it does year after year on the nay side with respect to the vast majority of shareholder proposals.²²⁶ A question arises: might the shareholders vote nay, expecting public enforcers to pick up any resulting slack and thereby externalizing the

²²³ See Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 954-56 (1991) (providing a default rule analysis of mandatory disclosure and FOTM, highlighting the range of possible corporate preferences).

²²⁴ See *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 485-86 (1989) (holding claims under the 1933 Act to be arbitrable); *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 242 (1987) (holding 1934 Act claims to be arbitrable and not barred by section 29's invalidation of waivers of compliance); see also John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 954 (1988) (suggesting that some 10b-5 actions could be precluded by an agreement to arbitrate set out in the charter). An SEC rule barring arbitration of class action claims stands in the way, however. Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, 57 Fed. Reg. 52,659, 52,660 (Nov. 4, 1992). For an extended discussion, see Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607, 635 (2010).

²²⁵ See Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 424 (2005) (exploring possibilities for preclusion of class actions through collective-action waivers). Professor Pritchard extends the point, suggesting that companies include a partial waiver of the FOTM reliance presumption in their charters. See Pritchard, *supra* note 138, at 248-51 (suggesting changes to the damages provision). Under this theory, reliance on FOTM would limit recoverable damages to profit disgorgement; a party establishing actual reliance could request out-of-pocket losses. *Id.* Pritchard acknowledges that a bar to waivers of compliance in section 29 of the 1934 Act might amount to a barrier. *Id.* at 252.

²²⁶ See Doron Levit & Nadya Malenko, *Non-Binding Voting for Shareholder Proposals*, 66 J. FIN. 1579, 1579-80 (2011) (reporting that even despite a recent increase in support for shareholder proposals, the percentage of proposals receiving a majority vote stood at only 21.2% in 2006).

cost of enforcement to the taxpayers?²⁷ The answer is no. We will see in Part V that the shareholders also pay for public enforcement.

Should the shareholders vote nay, we would go forward with a conditional experiment on antifraud enforcement. Say, for example, that the shareholders vote nay, but then have second thoughts after public enforcement capability is cut back. Today's institutional shareholders are coordinated enough to bring back FOTM in a single proxy season. At the same time, we note that voting nay might jolt the SEC and Congress into a beneficial reassessment of the resources devoted to public enforcement.

If the plebiscite yielded a separating equilibrium, with some companies or some industries opting in and while others opted out, creating dynamic change over time, we presumably would benefit from an information-enriched environment that teaches us something about the benefits and costs of different modes of fraud enforcement. Shareholder confusion would not be problem; FOTM status would be easily ascertained, alongside the *P/E* ratio and the state of incorporation, on shareholder information services like Bloomberg, Yahoo, or Hoover's.

If our thought experiment is reasonable, there is little basis on which to defend FOTM in its present, mandatory posture as a corporate governance institution.

D. *Fraud on the Market and the Mandatory-Disclosure System*

Our opting-out discussion avoids the approach to mandatory-enabling issues that prevails in the securities regulation literature. In the securities context, contractual choice tends to be seen as a monolithic proposition with mandatory disclosure and a private right of action on the one hand, and a complete absence of federal mandates on the other. We suspect that FOTM incidentally benefits from this either/or situation. The minority of commentators who would eliminate FOTM advocate a broader rollback of federal securities laws and the existing mandatory-disclosure system. They project a contractual big bang, with regulation of disclosure remitted to market intermediaries²²⁷ toward the end of dynamic, responsive, contractual governance.

²²⁷ See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 315-18 (2000) (arguing for a deregulation of securities markets that could lead to the elimination of most significant federal regulation); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1457-62 (1997) (providing arguments in favor of regulatory competition); see also Pritchard, *supra* note 138, at 247-49 (advocating that shareholders at least partially opt out of the FOTM presumption).

Recent defenses of FOTM give us a mirror-image view. FOTM proponents frame their case as a follow-up to a defense of the mandatory-disclosure system.²²⁸

The either/or is not useful and is a sticking point; the issues are layered and separable. The narrowest question, the one we address here, is whether FOTM makes sense as the formulation of the reliance requirement in private antifraud suits, assuming a judicially implied private right of action exists. Addressing this question requires taking up a related question regarding the role private litigation plays in securities law enforcement. But it does not require us to confront the desirability of the mandatory-disclosure regime. We here assume a positive answer to that question, leaving the global question of contract versus mandate to another day.

IV. POLITICS AND LEGITIMACY

We have pursued three policy justifications for FOTM without getting a favorable result. Policy vacuity does not necessarily imply political vulnerability, however. Indeed, Congress once considered eliminating FOTM and decided against it. One of the PSLRA's predecessor bills, the Securities Litigation Reform Act,²²⁹ would have imposed an actual reliance requirement on private securities plaintiffs, along with a "loser pays" rule for attorneys' fees²³⁰ and elimination of liability for recklessness.²³¹ The provisions were dropped before the bill was reported out of committee, apparently in response to objections raised by Arthur Levitt, then the chairman of the SEC.²³² An inference arises: FOTM enjoys a shield of legitimacy even in adverse political climates. This Part looks into the sources of this political credibility and identifies residual problems that could, given a conducive political climate, occasion further legislative constraints.

Section A connects FOTM to the politics of management accountability. FOTM has political legitimacy because managers are empo-

²²⁸ See Fox, *Civil Liability*, *supra* note 1, at 252-68 (advocating continued mandatory disclosure and addressing civil liability in the mandatory regime); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Litigation*, 55 DUKE L.J. 711, 719, 766-71 (2006) (voicing support for FOTM theory, even in inefficient markets).

²²⁹ See H.R. 10, 104th Cong. (1995) (proposing amendments to several federal liability laws).

²³⁰ *Id.* § 203.

²³¹ *Id.* § 204.

²³² John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 348-49 (1996).

wered actors in society and in the economy, and FOTM holds out a means by which to challenge business decisions gone wrong. Its promise to enforce the law against fraudsters strengthens the case. Section B shows how FOTM, with its putative goal of shareholder compensation, also benefits from shareholders' emergence as a politically salient interest group. That a different enforcement mode might more effectively challenge management decisions, hold fraudsters accountable, or protect the shareholder interest makes FOTM contestable without denuding it of political legitimacy. Section C turns to the contrary political agenda. Management went to Congress to make class action lawyers' lives harder with the PSLRA and stands ready to lobby again for further constraints. Outright abolition of FOTM, however, is not on any of the current wish lists. This suggests a curious alignment of interests between management and the plaintiffs' bar. For managers, an inconvenient but ineffectual enforcement tool may be better suited than any politically plausible alternative regime, particularly a regime directed to enforcement against individuals rather than companies.

A. *Management Accountability*

Corporate law, ever since Berle and Means, has depicted managers as private actors who wield considerable social and economic power in society without being subject to accountability constraints comparable to those imposed on public actors.²³³ Policy debates have focused ever since on appropriate modes of public and private constraint.

The intensity of the debates waxes and wanes with the health of the economy. When companies produce successfully, and the economy grows, so does management's legitimacy. Thus a buoyant stock market cleared the way for the PSLRA.²³⁴ On the other hand, economic reversals trigger new demands for accountability.²³⁵ The FCPA, Sarbanes-Oxley, and, most recently, the Dodd-Frank Act each ad-

²³³ See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 249 (1933); see also William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 J. CORP. L. 99, 118-22, 147-50 (2008) (summarizing Berle's theories and the evolution of those theories today).

²³⁴ See Bratton & McCahery, *supra* note 213, at 672 fig.VII (illustrating the correlation between the growth of the stock market and the enactment of the PLSRA and other related statutes).

²³⁵ See *id.* at 661-69 (describing the new legislation passed as a result of the Watergate and Enron scandals).

dressed such downside demands. The federal securities laws did also; according to a “creation story” told at the SEC, the 1933 and 1934 Acts responded to market failure and the need to defuse “public resentment of economic privilege” in the midst of the Depression.²³⁶ Note that the story asserts a common interest between managers and securities law enforcers: when enforcers hold managers accountable, they do so for the sake of preserving a system that empowers the managers in the first place.

The SEC creation story, with its emphasis on the social settlement and its overtones of class warfare, is nicely suited to the plaintiffs’ bar. Securities class actions allow upstart lawyers to pursue and bring down the social structure’s top dogs. The class warfare story is dated, but it still resonates, if only because a subgroup of corporate actors abuses its position and perpetrates fraud, while its members line their own pockets.²³⁷ The abuse of position account also circulated at the time the securities laws were enacted, but as a point of criticism. William Douglas, then a Yale law professor, described the shortcomings of the about-to-be-enacted federal securities statute in an article in the *Harvard Law Review*.²³⁸ He described the scandals that had come to light in the aftermath of the Great Crash of 1929, variously involving secret loans, undisclosed profit-sharing plans, self-dealing contracts, and insider trading.²³⁹ Mandatory-disclosure rules, he argued, would not be enough to prevent the repeat of such sorry spectacles in the next cyclical market rise.²⁴⁰ Justice Douglas has been proven correct again and again, and the securities law regime has been adjusted repeatedly to deal with the problem. FOTM is one of those adjustments.

More generally, even in our market-oriented, deregulatory age, private economic and social empowerment generates demands for rec-

²³⁶ Langevoort, *supra* note 206, at 1329.

²³⁷ See Cary Coglianese, *Legitimacy and Corporate Governance*, 32 DEL. J. CORP. L. 159, 160 (2007) (“[C]orporate managerial power . . . can be used to satiate the self-interested thirst of greedy CEOs at the expense of shareholders.”). Management greed and manipulation are standard themes in the literature of FOTM defense. See, e.g., James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After Dura Pharmaceuticals*, 95 GEO. L.J. 653, 691 (2007) (showing how defendants can circumvent the loss-causation requirement to cover up fraud by simultaneously disclosing positive results).

²³⁸ See William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1329-34 (1934) (noting that the upcoming legislation was a step in the right direction but that it was still a “task half done”).

²³⁹ *Id.* at 1306.

²⁴⁰ *Id.*

titude and accountability.²⁴¹ Private antifraud litigation addresses this demand. That its upstart private attack dogs never go for the top dogs' jugulars does not seem to matter; the performative value is there.²⁴²

All of this teaches an important lesson: it is corporate managers themselves who keep the game going for FOTM. They do so partly by virtue of their structural position, and, to this extent, they are not to blame. But they also do so partly by virtue of the actions of the subset of miscreants in their group. To this extent, FOTM is their own fault.

Ironically, managers also can be seen as incidental beneficiaries of FOTM. When fraud and misuse of corporate authority trigger policy questions, progressives look for ex ante regulatory responses that disempower managers generally by constraining business judgments and reducing rents.²⁴³ Conservative politicians and administrators, in contrast, prefer to redirect political demands against management to tougher enforcement of existing regulations. The redirection averts substantive regulation that would constrain discretion in business policymaking.²⁴⁴ FOTM, by combining a show of enforcement and a limited threat of disruption, contributes to the deregulatory equilibrium.

B. *Shareholder Solicitude*

Shareholder solicitude occupies the other side of FOTM's political coin. It is wrought into the structure of antifraud litigation as the "right" in the private right of action. Then-SEC Chairman Harold Williams described the private enforcement function in 1979: "Private actions, brought by aggrieved individuals to protect their own rights, supplement the Commission's own enforcement program, and significantly increase the likelihood that securities law violations will be chal-

²⁴¹ See also Coglianese, *supra* note 237, at 160-61 (questioning corporations' legitimacy, namely, their integrity and trustworthiness, in the face of the immense power they wield); cf. Douglas, *supra* note 238, at 1327-28 (outlining potential reforms that would better protect investors).

²⁴² For a contrasting discussion of private securities litigation and management accountability, which looks to justification rather than description, see Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 99-106 (2008).

²⁴³ See Langevoort, *supra* note 150, at 1142 ("To the progressive, Enron is a story about arrogance and abuse, and a call for wide-ranging reforms designed to reduce the rents from corporate stewardship."); see also Coglianese, *supra* note 237, at 161-62 (distinguishing between corporate regulation, which is imposed by the government, and corporate governance, which includes internal board procedures).

²⁴⁴ See Langevoort, *supra* note 150, at 1141-42 (describing the viewpoints of both conservatives and progressives).

lenged and corrected.”²⁴⁵ Here the “right” is not merely the means to the end of a policy goal—it is a substantive entitlement in itself.

Shareholder solicitude, thus embedded in the tort, only recently began gaining political traction. Before then, the shareholder interest was seen as distinct from the public interest. Another look at Adolf Berle illustrates this viewpoint. Berle believed that management power should be contained to promote the public interest. He simultaneously promoted a model of corporate governance built around a shareholder trust,²⁴⁶ which was calculated to limit management self-dealing. But Berle also drew a sharp distinction between the shareholder interest and the public interest: shareholder welfare could be a proxy for social welfare only when shares were equitably distributed among the public as a whole.²⁴⁷ That was not the case then, nor is it the case now.

The FCPA, enacted in 1977,²⁴⁸ holds out a legislative (and political) example of separation between shareholder and public interests. The FCPA, like Sarbanes-Oxley, responded to political demands for management accountability following a series of high-profile scandals. In the FCPA’s case, the scandals were “questionable foreign payments” made by corporations to actors abroad in connection with the sale of big-ticket American products—payments discovered incidentally in the course of the Watergate investigation.²⁴⁹ The public response cast managers as irresponsible public actors: corporate corruption was

²⁴⁵ 44 SEC ANN. REP., at vii (1978), available at http://www.sec.gov/about/annual_report/1978.pdf.

²⁴⁶ See BERLE & MEANS, *supra* note 233, at 248 (paraphrasing an underlying thesis of corporate law, namely that “all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears”).

²⁴⁷ See Bratton & Wachter, *supra* note 233, at 142-43.

²⁴⁸ Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended in scattered sections of 15 U.S.C.).

²⁴⁹ See generally Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 86-87 (2005) (chronicling the history of the FCPA). During the Watergate investigations of 1973–1974, the special prosecutor discovered corporate political slush funds that evaded normal accounting controls. See GEORGE C. GREANIAS & DUANE WINDSOR, *THE FOREIGN CORRUPT PRACTICES ACT* 63 (1982). The SEC announced a voluntary disclosure program, and admissions by over 300 companies resulted. See Daniel Pines, *Amending the Foreign Corrupt Practices Act to Include a Private Right of Action*, 82 CALIF. L. REV. 185, 187-188 (1994). It was the Watergate era, and the public demanded a cleanup of corporate corruption. See, e.g., DONALD R. CRUVER, *COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT* 5 (1999).

unacceptable, even if it occurred abroad in pursuit of shareholder value at home. Given a public willing to impose new ethical standards on managers at the expense of shareholders, Congress imposed responsibility by law.²⁵⁰

Sarbanes-Oxley admits of a similar reading. Professor Langevoort points out that even as Sarbanes-Oxley is nominally investor protective, it accords the shareholders no new powers. Instead, it imposes good-governance constraints on businesses with an eye toward dulling overly sharp incentives and keeping corporate risk taking within socially acceptable limits.²⁵¹ Viewed this way, Sarbanes-Oxley is no more about shareholder value maximization than was the FCPA. Like the FCPA, it imposes public accountability on large corporations to create public legitimacy.²⁵²

But, unlike the FCPA, Sarbanes-Oxley was prompted by scandals unrelated to elected officials, scandals instead tied to spectacular losses at a number of large enterprises.²⁵³ These shareholder losses figured into the political motivation. Stock ownership had become more widespread between 1977 and 2002, albeit collectivized in the form of pension and mutual fund interests. Politicians, moreover, had begun to cater to the “Investor Class”²⁵⁴ and to promote an “ownership society”²⁵⁵ in which individually vested pension savings figured importantly. So when Congress enacted Sarbanes-Oxley, even though retail investors viewed as an interest group continued to have little influence,²⁵⁶ the shareholder qua shareholder had edged much closer to

²⁵⁰ See Andrei Shleifer, *Does Competition Destroy Ethical Behavior?*, 94 AM. ECON. REV. 414, 418 (2004) (noting that as societies grow rich they prove more willing to pay for ethical behavior through enforcement).

²⁵¹ See Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1828-29 (2007) (“SOX is less about redistributing private power as diffusing it through more checks, balances, and sunlight.”).

²⁵² See *id.* at 1820 (“SOX’s most important effects may be less about investor protection than about renegotiating the boundary between the public and private spaces in big corporations, a much deeper ideological issue.”).

²⁵³ Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005).

²⁵⁴ In 2004, one third of American voters described themselves as “investors,” and national politicians now cater to the so-called “Investor Class.” Richard S. Dunham & Ann Therese Palmer, *Just Who’s in the ‘Investor Class?’*, BUS. WK., Sept. 6, 2004, at 42-43.

²⁵⁵ See Press Release, The White House, Fact Sheet: America’s Ownership Society: Expanding Opportunities (Aug. 9, 2004), available at <http://georgewbush-whitehouse.archives.gov/news/releases/2004/08/20040809-9.html> (outlining President George W. Bush’s policies favoring an “Ownership Society”).

²⁵⁶ See Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience* (explaining that retail investors have had little political

the median voter and loomed large politically. Shareholder empowerment, missing in Sarbanes-Oxley, would follow in the next round—the Dodd-Frank Act, which enables the placement of shareholder board nominees in management proxy statements and accords the shareholders “say on pay” rights, among other things.²⁵⁷

The Congress that enacted Sarbanes-Oxley, while granting no new powers to shareholders, did find other, innovative ways to cater to their interests. Consider in this regard the Investor and Capital Markets Fee Relief Act of 2002 (Fee Relief Act), a tax relief measure for the investor class.²⁵⁸ The fees in question were those that fund the SEC—fees collected from exchange transactions and in connection with SEC registrations. Fee revenues had been in excess of the SEC’s annual budget for many years,²⁵⁹ and the excess had disappeared into the Treasury. Congress enacted the Fee Relief Act to align the fee revenues and the cost of running the SEC with the goal of reducing fees. The Fair Funds provision in Sarbanes-Oxley was similarly motivated.²⁶⁰ Historically, the SEC had endeavored to return profits disgorged by defendants in its enforcement actions to victimized investors. When a defendant paid a penalty, in contrast, the SEC remitted the amount to the Treasury. Sarbanes-Oxley’s Fair Funds provision charges the SEC to endeavor to return penalty monies to injured investors,²⁶¹ elevating the interests of shareholder victims over those of the public fisc.

Significantly, Fair Funds disbursements mimic FOTM economics. As we have seen, SEC penalties tend to be paid by corporate defendants, as are FOTM settlements. A Fair Funds distribution to a subset of shareholders is every bit as much an exercise in pocket shifting as is payment of a FOTM settlement. The political implication is as power-

clout, except during times of perceived scandal), *in* INVESTOR PROTECTION IN EUROPE 489, 491 (Guido Ferrarini & Eddy Wymeersch eds., 2006).

²⁵⁷ Dodd-Frank Act §§ 951, 953–55, 971, 15 U.S.C.A. §§ 78j-4, 78n-a, 78n-1 (West Supp. 2 2011).

²⁵⁸ Pub. L. No. 107-123, 115 Stat. 2390 (codified at 15 U.S.C.).

²⁵⁹ See *infra* text accompanying notes 346-67.

²⁶⁰ See 15 U.S.C. § 7246(a)–(b) (2006) (requiring that civil judgment penalties be added to associated disgorgement requirements).

²⁶¹ The charge is conditioned on a concomitant disgorgement order, and the decision to remit is left to the agency’s discretion in any given case. See *id.* § 7246(a) (“[T]he amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.”).

ful as the underlying policy analysis is faulty: the Fair Funds legislation, by tracking FOTM, implicitly endorses it.

So long as catering to shareholder interests appears advantageous to Congress, it is difficult to imagine a political coalition forming to eliminate FOTM. Dodd-Frank, although it does nothing to enhance the present position of securities plaintiffs, signals a tilt in their position. Among the many studies commissioned by the statute, two concern private securities litigation and look into the possibility of overruling Supreme Court decisions that restrict the scope of FOTM actions.²⁶²

We close with a caveat respecting the politics of shareholder solicitude. Even as we think that current politics protect FOTM from frontal attack, concern for the shareholder interest means different things to different people and holds out a range of policy implications. These concerns can be deployed to undermine securities law enforcement activity. For example, management advocates who propose new measures to limit FOTM invoke pocket shifting and solicitude for the payor shareholders.²⁶³

Consider in this regard an enforcement scenario acted out at the SEC post-Sarbanes-Oxley. In 2006, the SEC articulated a set of guidelines to govern the imposition of fines against corporations, specifying nine factors to use in assessing an appropriate penalty.²⁶⁴ Most of the items on the list were standard enforcement concerns such as culpability, cooperation, detection, and injury inflicted.²⁶⁵ But the SEC singled out two concerns as paramount, one tending to support a penalty and the other tending to oppose it: (1) in favor of a penalty, the presence (or absence) of a “direct and material benefit” to the corporation from the offense, such as through reduced expenses or increased revenues; and (2) against a penalty, whether a penalty will cause addi-

²⁶² One study, commissioned by the Government Accountability Office, will consider liability for aiders and abettors as well as secondary actors, implicitly questioning the Supreme Courts’ rulings in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), and *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). See Dodd-Frank Act § 929Z, 124 Stat. 1375, 1871 (requiring the Comptroller General of the United States to conduct a study analyzing aiding and abetting liability in securities laws).

²⁶³ See, e.g., U.S. CHAMBER INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION: THE PROBLEM, ITS IMPACT AND THE PATH TO REFORM 41 (2008), available at http://www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213 (“Congress also should address the fact that payments by defendant companies punish innocent existing shareholders, while investors (often large, diversified investors) who sold their shares at an inflated price before the disclosure of the fraud reap windfall gains.”).

²⁶⁴ See Press Release, *supra* note 148.

²⁶⁵ *Id.*

tional harm to shareholders who have committed no violation.²⁶⁶ Shareholder solicitude motivates both of these factors. The first factor attaches penalties to cases where the payor shareholders benefitted from the fraud, while the second weighs against penalties in cases where the payor shareholders neither participated nor benefitted.²⁶⁷

The two factors quickly came to dominate SEC enforcement policy. At the Commission's insistence, the enforcement staff had to qualify a penalty with an affirmative showing of tangible benefits to the company, usually based on an event study.²⁶⁸ The result, unsurprisingly, was that it became more difficult to impose fines in pure market-fraud situations. The policy also discouraged the SEC staff from undertaking complex cases, inhibited the imposition of penalties for egregious conduct, and blurred the distinction between penalties and disgorgements.²⁶⁹ Chairman Christopher Cox followed up in 2007 with a second internal requirement: Commission approval of a penalty range in certain cases in advance of the staff's commencement of settlement discussions.²⁷⁰ This operated as a wedge with which the Commission could delay disfavored proceedings and effect penalty reductions.²⁷¹

The SEC's penalty-qualification requirements could have been lifted straight out of the policy playbook of a management lobbyist.²⁷² Both requirements were criticized in a 2009 Government Accountabil-

²⁶⁶ *Id.*

²⁶⁷ For a discussion of the tradeoff, see Chester S. Spatt, *An Informal Perspective on the Economics and Regulation of Securities Markets*, 2 ANN. REV. FIN. ECON. 127, 138 (2010).

²⁶⁸ See U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 41 (2009), available at <http://www.gao.gov/new.items/d09358.pdf> (reporting the heavy burden placed on the Enforcement Division to show corporate benefit when seeking to impose a penalty).

²⁶⁹ See *id.* at 42-43 (relating the reported effects of the two factors on enforcement incentives and success rates).

²⁷⁰ See Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), available at <http://www.sec.gov/news/speech/2007/spch041207cc.htm> ("So in a handful of cases where the need for national consistency is greatest, we're reviving what had been a long standing policy of the SEC for all cases for many years—that Commission approval be obtained before settlement discussions are commenced.").

²⁷¹ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 39-43 (reporting that SEC investigators and enforcement attorneys had incentives not to seek penalties due to the obstacles to their approval).

²⁷² See U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 263, at 41 (urging Congress, on behalf of the business community, to impose penalties only very cautiously).

ity Office Report.²⁷³ The present SEC Chair, Mary Schapiro, lifted the advance notice requirement upon taking office in 2009.²⁷⁴ Since then, the SEC's Enforcement Division has been reorganizing itself, reporting enhanced efficiency and results, including stepped-up amounts of both penalties and disgorgements.²⁷⁵ It is not clear what, if anything, this change implies about the continuing application of the 2006 penalty guidelines. We have discovered no public statement regarding their present status.

C. Agency Problems

Two different groups of private agents populate the FOTM fact pattern: plaintiffs' lawyers and corporate managers. This section brings them into our political economy. These two groups stare at each other across a field of combat. Plaintiffs' lawyers favor FOTM as it is (or was), while managers would like to pick up where the PSLRA left off and constrain it still further. At the same time, neither group of agents would want Congress to eliminate FOTM completely.

We start with the plaintiffs' bar, which has its own legitimacy problem. Those in charge of an enforcement institution founded on concerns about management accountability must be accountable in turn. Unfortunately, the class action lawsuit is not an institution well suited to this end. Plaintiffs' attorneys—in theory the shareholders' agents—in practice make litigation decisions in a zone of discretion. When they seem to abuse their discretion and impose deadweight costs on defendant companies without corresponding benefits to shareholders, discretion-constraining legislation may follow in the right political climate. For example, a bull stock market²⁷⁶ and a class of favored companies in the technology sector combined in 1995 to focus con-

²⁷³ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 41 (“[S]ome investigative attorneys came to see the Commission as less of an ally in bringing enforcement actions and more of a barrier.”)

²⁷⁴ *Id.* at 36.

²⁷⁵ See Robert Khuzami, Director, Div. of Enforcements, U.S. Sec. & Exch. Comm'n, Speech to the Society of American Business Editors and Writers (Mar. 19, 2010), *available at* <http://www.sec.gov/news/speech/2010/spch031910rsk.htm> (“[F]ast-forward one year, and the Division of Enforcement, and the Commission as a whole, are in a very different place.”).

²⁷⁶ See Bratton & McCahery, *supra* note 213, at 671-72 (charting the value of the Dow Jones Industrial Average alongside the political maneuvers that led to the PLSRA's passage).

gressional attention on abusive practices of securities plaintiffs—in particular, the strike suit.²⁷⁷

The PSLRA resulted, and with it an experiment in attorney agency-cost control in the form of the lead plaintiff provision.²⁷⁸ This provision takes the selection of the class action’s named plaintiff out of the plaintiffs’ lawyers’ hands, makes it contestable, and vests the decision in a court charged to presume that good litigation governance follows from “the largest financial interest in the relief sought.”²⁷⁹ Thus constructed, the PSLRA operates on the assumption that a financial interest in the stock in itself imports incentives to control litigation agency costs.²⁸⁰ Experience has taught a different lesson, which follows from the economics of institutional investing. Mutual funds have competitive reasons to avoid investing time and resources in shareholder activism and have business reasons to keep friendly channels open to the corporate sector.²⁸¹ They accordingly have refrained from stepping forward as lead plaintiffs.²⁸² Public pension funds, in contrast, are managed by public servants who have incentives to build reputations as governance activists.²⁸³ Unsurprisingly, lead plaintiffs have often come from this sector,²⁸⁴ even though they lack the pure financial incentives contemplated by the PSLRA.

Problems can arise when selective, rather than financial, incentives prompt a principal to monitor an agent. The lead plaintiff provision held out just such an invitation, and the plaintiffs’ law firms readily ac-

²⁷⁷ Thompson & Sale, *supra* note 60, at 884-85.

²⁷⁸ 15 U.S.C. § 78u-4(a)(3) (2006).

²⁷⁹ *Id.*

²⁸⁰ Institutional investors commonly have the largest financial stakes in the largest securities class action settlements. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2088-94 (1995).

²⁸¹ See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 474 (1991) (noting that incurring the costs associated with attempting to check and control corporate governance is inimical to the end goal of a passive indexed portfolio—being the least-cost producer).

²⁸² Choi & Thompson, *supra* note 58, at 1504.

²⁸³ See William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1914-18 (1995) (describing the “financial and selective incentives” for public and private institutions).

²⁸⁴ See Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 330 (2008) (“With the adoption of the PSLRA and the creation of the lead plaintiff provision, institutional investors and public pension funds in particular have become increasingly active, serving as lead plaintiffs in a higher percentage of cases every year . . .”).

cepted it. As a result, different pension funds have developed long-term ties with different law firms. The law firms, looking to maintain these ties, make strategic political contributions in the pension funds' states.²⁸⁵ This "pay to play" practice has spurred a new round of corruption allegations from FOTM opponents.²⁸⁶ High-profile criminal proceedings against prominent plaintiffs' lawyers alleging improper payments to named plaintiffs add to the aura of corruption.²⁸⁷

Let us assume that any pay-to-play practices are brought under control (legislation has been introduced²⁸⁸). Given that assumption, FOTM may very well emerge from the long process of congressional containment with its legitimacy enhanced. Strike suits do not appear to be as salient a problem in the wake of the PSLRA.²⁸⁹ Without a basis

²⁸⁵ See Stephen J. Choi, Drew T. Johnson-Skinner & Adam C. Pritchard, *The Price of Pay to Play in Securities Class Actions*, J. EMPIRICAL LEGAL STUD. (forthcoming) (manuscript at 13), available at <http://ssrn.com/abstract=1527047> (showing that while pension fund supervision implies lower attorneys' fees, the differential disappears when one controls for campaign contributions made to officials with influence over state pension funds). For a skeptical approach to pay-to-play allegations, see David H. Webber, *Is "Pay-to-Play" Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study* (NYU Law Sch., Ctr. for Law, Econ & Org., Research Paper No. 09-28, 2010), available at <http://papers.ssrn.com/abstract=1432497>.

²⁸⁶ See, e.g., U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 263, at 30-34 (describing the corruption that emerges in a pay-to-play legal culture); RICHARD M. KOVACEVICH ET AL., THE FIN. SERVS. ROUNDTABLE, THE BLUEPRINT FOR U.S. FINANCIAL COMPETITIVENESS 69 (2007), available at <http://www.fsround.org/cec/pdfs/FINALCompetitivenessReport.pdf> (recommending that Congress should amend the PSLRA to eliminate pay to play).

²⁸⁷ See Jonathan D. Glater, *High-Profile Trial Lawyer Agrees to Plead Guilty*, N.Y. TIMES, Mar. 21, 2008, at C1 (reporting that Melvyn I. Weiss, a well-known attorney, agreed to plead guilty "to [making] hidden side payments to plaintiffs in class-action lawsuits filed by his firm"); Michael Parrish, *Leading Class-Action Lawyer is Sentenced to Two Years in Kickback Scheme*, N.Y. TIMES, Feb. 12, 2008, at C1 ("William S. Lerach . . . was sentenced Monday two years in prison and ordered to forfeit \$7.75 million for concealing illegal payments to a plaintiff in the class-action lawsuits . . .").

²⁸⁸ Legislation has been proposed that would require disclosure of all payments, fees, and contributions between law firms and lead plaintiffs. In addition, a competitive bidding process would be added as an alternative means of choosing lead counsel. Securities Litigation Attorney Accountability and Transparency Act, H.R. 5463, 110th Cong. §§ 3-4 (2008).

²⁸⁹ See Choi, *supra* note 63, at 616 (comparing matched sets of firms that were sued and not sued pre- and post-PSLRA to suggest that "plaintiffs' attorneys post-PSLRA shifted away from cases requiring lengthy and costly investigation prior to the filing of suit toward cases with more obvious indicia of fraud"); Eric Talley & Gudrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation* 25 (Univ. of S. Cal. Law & Econ. Research Paper Series, Research Paper No. 04-7, 2004), available at <http://ssrn.com/abstract=536963> (finding that the PSLRA deters both frivolous and meritorious litigation).

for credible allegations of corruption, antiplaintiff politics would lose impetus. Litigation would fall back into the more nebulous politics of deregulation, taking a place on long legislative agendas as one of a number of regulatory costs businesses would prefer to do without.

Indeed, current proposals concerning securities litigation appear as items on lengthy corporate legislative wish lists.²⁹⁰ National competitiveness, particularly in light of international securities listings, is the across-the-board policy imperative of choice.²⁹¹ A string of proposals regarding securities litigation awaits the light of day. The number-one agenda item is an arbitration opt-in.²⁹² Also on the wishlist are credit in damages calculations for Fair Funds paid out,²⁹³ tighter controls on parallel actions in state courts,²⁹⁴ a defendant's interlocutory appeal on

²⁹⁰ See, e.g., BLOOMBERG & SCHUMER, *supra* note 39, at 19-25 (recommending national priorities, methods for leveling the international playing field, and ways to preserve financial preeminence); COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 16 (2006), available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (recommending policy changes in shareholder rights); U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 263, at 42 (advocating greater transparency in the settlement process and more widespread use of arbitration).

²⁹¹ See, e.g., BLOOMBERG & SCHUMER, *supra* note 39, at 100 ("Congress should bolster America's long-term competitiveness by enacting legislative reforms to securities law that will eliminate inappropriate lawsuits without undermining relevant substantive rights."); COMM. ON CAPITAL MKTS. REGULATION, *supra* note 290, at 109-12 (recommending an opt-in to arbitration in the context of across-the-board reform proposals designed to make U.S. capital markets more attractive to foreign companies).

²⁹² Management would like the privilege to amend corporate charters to opt into arbitration of securities fraud claims. Alternatively, companies should be able to opt into nonjury trials. See COMM. ON CAPITAL MKTS. REGULATION, *supra* note 290, at 110 (recommending that "shareholders should be able to choose their remedies . . . including providing for arbitration (with or without class action procedures)").

²⁹³ Management argues that a double recovery results when a company makes a payment to the SEC and also makes a settlement payment in a parallel class action. The argument is that corporate defendants should receive a damages credit equal to any Fair Funds paid out. See COMM. ON CAPITAL MKTS. REGULATION, *supra* note 290, at 80 (recommending that the SEC "limit the amount of damages recoverable through class actions when the SEC provides victim compensation with funds obtained through a Fair Funds remedy"); COMM'N ON THE REGULATION OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 89 (2007) ("The Commission recommends that the SEC adopt a formal policy that prohibits duplicate payments from Fair Funds and private litigation on similar claims. Specifically, any amount investors receive from a Fair Fund should offset the amount that they are allowed to collect as damages in private securities litigation on similar claims."); U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 263, at 43 ("[P]rivate damages awards should be offset in the first instance by any Fair Funds collected by the SEC for compensating shareholders.").

²⁹⁴ Management has also been watching institutional investors opt out of federal class actions only to bring parallel actions in state court. See *supra* note 120 and ac-

denial of motion to dismiss,²⁹⁵ pleading particularity for loss causation,²⁹⁶ and damages limitations.²⁹⁷

These proposals lie dormant, ready for enactment in a favorable political environment. If the past is any guide, such an environment presupposes an expanding economy and a rising stock market.²⁹⁸ It follows that the proposals may be gathering dust for some time. Indeed, none found their way into the Dodd-Frank Act.

D. *Summary and Analysis*

FOTM's political economy also has undergone changes in recent years as a result of developments in the political economy of shareholding. FOTM continues to enjoy the protection of the management-accountability imperative that brought securities regulation into existence during the Depression. Because the shareholder interest now registers politically, FOTM's superficial qualities of shareholder friendliness enhance its stature—congressional gestures in the shareholders' direction validate FOTM by mimicking its economics. But shareholder solicitude is a two-sided coin: FOTM's opponents point out that innocent shareholders pay the compensation.

We emerge in a political equipoise with a narrow stretch of contestable territory. The plaintiffs' side has had the upper hand recently, convincing Congress to commission studies under Dodd-Frank that look to roll back inconvenient Supreme Court opinions. The management interest bides its time, looking for opportunities to

companioning text. It asks Congress to close off the state court route altogether, or, failing that, to stay state court actions until final resolution of a federal class action. See U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 263, at 39 (noting the harmful effect of state-law claims filed in state court that are not class action, which circumvent federal regulation).

²⁹⁵ Management argues that it is unfair that a dismissed plaintiff can appeal when a defendant losing on a dismissal motion cannot. See BLOOMBERG & SCHUMER, *supra* note 39, at 104 (arguing that litigating parties should be able to appeal interlocutory judgments immediately to the circuit courts); U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 263, at 35 (advocating equal access to interlocutory appeals). This doubtless has less to do with fairness than settlement value.

²⁹⁶ See U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 263, at 37 (stating that Congress should "mandat[e] that plaintiffs plead loss causation with the same level of specificity currently reserved for scienter").

²⁹⁷ Management would abolish aggregated damages in favor of a regime based on actual submission and verification by class members with any undistributed settlement funds returned to the defendant. *Id.* at 34, 41. The pocket-shifting argument is also invoked.

²⁹⁸ See *supra* text accompanying notes 234-50.

reduce FOTM's scope and salience without creating new public enforcement initiatives.

Interestingly, outright abolition of FOTM is not on any current management wishlist. No doubt political expediency has something to do with this. However, there may also be a juncture at which management's interest intersects with that of the plaintiffs' bar. Suppose that FOTM's termination was a possibility and gave rise to a perception of an enforcement gap. This in turn might lead to pressure for stepped-up public enforcement. Given this scenario, management might prefer FOTM constraint to FOTM termination. As between a private action safely nested in enterprise liability and a public enforcement resource that could move in the direction of direct actions against individuals, management's interest clearly lies with the former. More generally, FOTM increases managers' legitimacy by disempowering them, even as it presents little threat to individual malefactors. Anti-FOTM activists in the business lobby should be careful what they wish for.

Our account has only mentioned the SEC in passing. As the agency responsible for enforcing the securities laws, it occupies a central position in the political economy of FOTM. We turn to it in the next Part, first taking an historical look at the SEC's funding and then considering its role as a political actor in the battle over FOTM.

V. THE SEC AND REFORM

We have seen that FOTM survives and prospers even though it doesn't work from a public policy perspective. It prevails in the courts by virtue of *stare decisis*. Outside, in the world of political contestability, it occupies a safe spot amid opposing forces in equipoise. Whatever its actual policy shortcomings, FOTM retains associations with powerful justificatory concepts, such as management accountability and shareholder protection. Its opponents, with a political wind at their backs, have proved able to delimit but not eliminate it. Meanwhile, law reform proponents focus on superior alternative modes of private enforcement,²⁹⁹ with few mentioning the simpler expedient of doing away with FOTM's reliance presumption.³⁰⁰ This hesitance stems from

²⁹⁹ See *supra* note 121.

³⁰⁰ Professors Langevoort and Pritchard are exceptions. See Langevoort, *Corporate Executives*, *supra* note 13, at 656 (imagining abandonment of the presumption of reliance "[w]ithout necessarily endorsing it as a reform"); Pritchard, *supra* note 138, at 248 (suggesting a shareholder opt-out); see also Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25, 54 (2007) (suggesting

the assumption that public enforcement resources are inadequate to contain fraud, a situation deemed natural and inevitable. Given the limited public apparatus, it follows that any private enforcement is better than none at all.³⁰¹

The inadequate resources claim sounded as loudly as ever in 2011. The Dodd-Frank Act directed the engagement of a consultant to review the SEC's structure and operations.³⁰² The consultant confirmed the inadequacy of the agency's resources.³⁰³ The report posed a stark choice to Congress: either provide the agency with funds sufficient to support its required capabilities or cut back on its responsibilities to fit the available funds.³⁰⁴ Any hopes that Congress would choose the former option were dashed during the budget fracas of 2011.³⁰⁵

This Part reconsiders the inadequate resources assertion, despite the consultant's recent confirmation. The objective is not to controvert the assertion but rather to reframe the question, inquiring into the degree of resource deficiency instead of asking a yes or no ques-

abandonment of the presumption respecting third parties); *cf.* Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 591-98 (1997) (recommending no change in the reliance presumption, but suggesting stricter scienter and materiality standards for the largest issuers).

³⁰¹ In an empirical multicountry comparison, La Porta asserts that a combination of disclosure mandates taken together with private enforcement remedies better predicts market robustness than public-enforcer empowerment. *See* La Porta et al., *supra* note 184, at 20 (hypothesizing that "public enforcement plays a modest role at best" in structuring stock markets, while, "in contrast, the development of stock markets is strongly associated with extensive disclosure requirements and a relatively low burden of proof on investors seeking to recover damages"). Jackson and Roe rebut this by showing a stronger connection between market robustness and public enforcement resources. More to the point, Jackson and Roe show that disclosure has a significant relationship to market capitalization where private liability does not. Jackson & Roe, *supra* note 1, at 217-19.

³⁰² Dodd-Frank Act § 967(a)(1), 15 U.S.C.A. § 78d-4 (West Supp. 2 2011). The directive was incidental to Dodd-Frank's imposition of new administrative burdens on the agency.

³⁰³ BOS. CONSULTING GRP., U.S. SECURITIES AND EXCHANGE COMMISSION: ORGANIZATIONAL STUDY AND REFORM 165-69 (2011), available at www.sec.gov/news/studies/2011/967study.pdf.

³⁰⁴ *Id.* at 9. Boston Consulting examined the SEC from an organizational perspective, recommending numerous infrastructural improvements. The report estimates that the SEC would require an additional \$200 to \$300 million to implement the first phase of improvements. *Id.* at 147. If new funding is not forthcoming, the report recommends that the SEC delegate certain rulemaking and enforcement functions to self-regulatory organizations. *Id.* at 150-53. This would mean, for example, devolution of broker-dealer and investment advisor examinations. The report recommends no changes respecting antifraud enforcement.

³⁰⁵ *See infra* note 312.

tion. The policy literature on antifraud takes the yes-or-no approach and makes a strong-form inadequacy assertion: the public glass is empty, period. This was indeed the situation when the Supreme Court first implied a private right of action under the federal securities laws in 1964. But public resources have increased greatly since then—particularly during the last decade³⁰⁶—so much so as to again raise the question about relative reliance on public and private enforcement. Here is that question: is it plausible to suggest that the SEC could pick up any enforcement slack occasioned by the removal of the FOTM presumption? This Part answers in the affirmative, suggesting that FOTM's elimination could be paired with an increase in public enforcement funding for a net improvement in deterrence at no added cost to shareholders.

Section A conducts an historical survey of the SEC budget and shows that the agency has emerged in recent years as an expansive and powerful enforcement apparatus. To the extent additional agency resources would be needed to make up for diminished reliance on private enforcement, funding would be readily available from the SEC's dedicated income sources at no cost to the taxpayers. As with private enforcement, the funding ultimately comes from shareholder pockets, provoking an intriguing comparative question: which enforcement mode, public or private, makes better dollar-for-dollar use of the shareholders' money? This Part suggests that shareholders would be better served if they funded greater SEC enforcement in a system without a private side FOTM presumption available against nontrading issuers. Inadequate public enforcement is neither natural nor inevitable.

Section B explores the institutional implications of this analysis. A shift to a well-equipped public enforcer presupposes an administrative commitment at the SEC and a political commitment in Congress. As between the two, primary responsibility falls on the SEC as the agency charged with the federal securities laws' articulation, administration, and enforcement. Although the SEC arguably has the power to eliminate FOTM through rulemaking, it certainly does not have the power

³⁰⁶ Precedent inquiries into SEC enforcement resources have found an increase in the SEC's resources. However, that increase has been accompanied by an even greater increase in the number of enforcement actions filed. See Burch, *supra* note 242, at 129-31 (looking at the years 2000–2002 and 2005); James D. Cox & Randall Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 757-60 (2004) (describing the SEC's resource limitations in the mid to late 1990s and early 2000s and noting that, since approximately 2002, many of those limitations have decreased).

to set its own budget, so an enforcement initiative would require congressional support. We suggest that such cooperation could be secured through a tradeoff of more money for enforcement in exchange for FOTM's removal, with a net benefit for the shareholders. Unfortunately, it is not at all clear that the initiative we suggest aligns well with present interests, either of actors at the SEC or in Congress. We pose it as a structural possibility rather than as fruit on the tree for immediate harvest.

Before proceeding, we pause to note what this Part does *not* contend. We do not claim that public enforcement is categorically superior to private enforcement, whether as regards securities law³⁰⁷ or any other legal regime. Nor do we argue for across-the-board withdrawal of private rights of action. We address only the shortcomings of FOTM.

A. Enforcement Resources

It is a truism that FOTM, despite its flaws, passes cost-benefit testing because the SEC needs a private enforcement supplement. Indeed, the SEC itself has long viewed the private supplement as essential to the accomplishment of its mission. In 1979, then-Chairman Harold Williams, described the private enforcement role as follows:

[O]ur resources are inadequate to police all securities law violations which may take place. As a result, our enforcement activities are designed not only to address specific wrongdoings, but also to alert the private sector as to the kinds of activities which we believe violate the securities laws.

Private actions . . . supplement the Commission's own enforcement program, and significantly increase the likelihood that securities law violations will be challenged and corrected.³⁰⁸

Things have changed since 1979. The story that depicted private plaintiffs as robust enforcers has imploded under sustained inspection. Perhaps public enforcement conditions also have changed since 1979, or, more to the point, since 1964, the year the Supreme Court approved the first securities law private-enforcement supplement.³⁰⁹ It accordingly is time to take another look at SEC enforcement capability.

³⁰⁷ For this line of argument, see Rose, *The Multienforcer Approach*, *supra* note 20, at 2175-78.

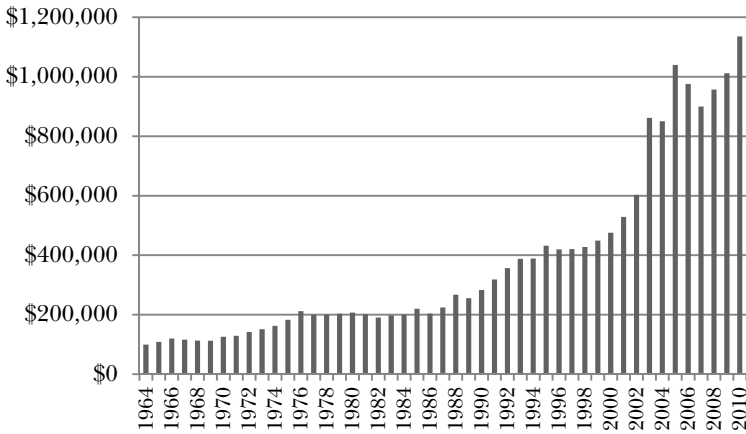
³⁰⁸ 44 SEC ANN. REP., *supra* note 245, at vii.

³⁰⁹ See *supra* note 4.

1. The SEC’s Budget

In 1964, the SEC’s budget was \$13.9 million; in 2010, its budget was \$1.12 billion.³¹⁰ Adjusting the 1964 number for inflation yields a directly comparable 1964 budget figure of \$99.2 million.³¹¹ This in turn yields a multiple of increase of 11.4. Figure 1 shows the SEC’s budgets from 1964 to 2011 in 2011 dollars. Although large increases do not occur annually, there is only one extended period of real decline, the period from 1976 to 1985, during which high inflation was followed by the first Reagan administration’s political disfavor. At no time has an anti-enforcement Congress or executive used budget cuts to eviscerate the agency.³¹²

Figure 1: SEC Budgets (Inflation Adjusted), 1964–2010³¹³



³¹⁰ The calculation was performed using the Bureau of Labor Statistics calculator to yield dollars in 2011. *Databases, Tables & Calculators by Subject*, BUREAU LAB. STAT., <http://data.bls.gov>.

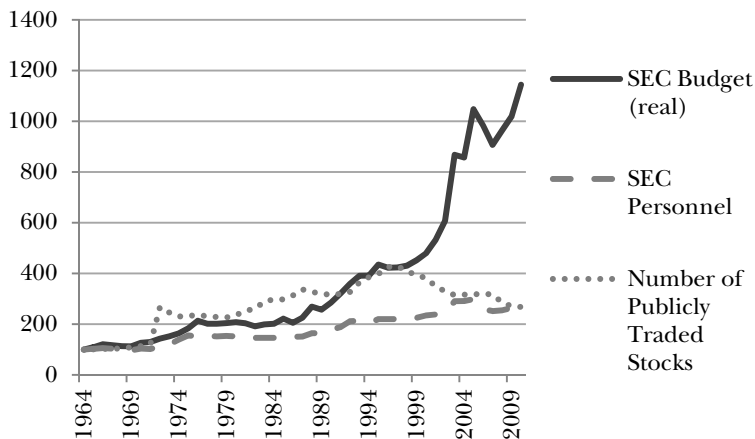
³¹¹ See *supra* note 310.

³¹² SEC partisans recently made just this allegation, when Congress rejected the agency’s 2012 budget request and some House members threatened cuts. See John J. Curran & Jesse Hamilton, *Schapiro SEC Seen Ineffectual Amid Dodd-Frank Funding Curbs*, BLOOMBERG MARKETS MAG. (Mar. 30, 2011, 11:01 PM), <http://www.bloomberg.com/news/2011-03-31/schapiro-sec-seen-ineffectual-amid-dodd-frank-funding-curbs.html>. But cuts have not been forthcoming. Under the present Continuing Resolution, the SEC comes away with a \$74 million increase. See Melanie Waddell, *Congress Moves Budget Vote to Thursday; SEC, CFTC See Budget Boost*, ADVISOR ONE (Apr. 12, 2011), <http://www.advisorone.com/article/congress-moves-budget-vote-thursday-sec-cftc-see-budget-boost>.

³¹³ SEC budget data were collected from the SEC’s annual reports for the years 1964–2010. See SEC ANN. REPS., available at <http://www.sec.gov/about/annrep.shtml> (compiling the SEC’s annual reports).

There are three instances of significant increase, all contemporaneous with high profile enforcement activity: the first in the mid 1970s, coincident with the foreign payment scandals; the second in the early 1990s, after the Drexel Burnham action and the savings and loan crisis; and the third in 2001 after Enron. Of the three, the post-Enron budget increase is the most notable, amounting to a historic upward jump in the amount of public resources devoted to securities law enforcement.

Figure 2: SEC Resources to Publicly Traded Stocks, 1964–2010³¹⁴



Some claim that no matter what budget increases the SEC receives, its available staff always lags behind market growth.³¹⁵ There is something to this,³¹⁶ but not as much as once was the case. Figure 2 takes the SEC budget, expressed in real terms, and compares it to the number of personnel employed by the agency as well as the number of publicly traded stocks. In 1964, the SEC had budget lines for 1379 personnel; in 2010, it had lines for 3748 personnel. In 1964, there were 2127 publicly traded stocks; in 2010, the number was 5701.

³¹⁴ *Id.* The stock data were taken from the Center for Research in Securities Prices's US Stock & Index Databases, which collect data from the last business day of each year. Access to the database is available for purchase at <http://www.csrp.com/documentation/product/stkind>.

³¹⁵ See Cox & Thomas, *supra* note 306, at 757-58 (detailing staff shortages at the SEC notwithstanding budget increases).

³¹⁶ The Boston Consulting Group opines that the SEC presently needs 375 to 425 additional full-time employees. BOS. CONSULTING GRP., *supra* note 302, at 196-97. Enforcement was not one of the divisions singled out as needing additional staff. *Id.*

Prior to Enron, the three figures increase at relatively similar rates with the SEC personnel figure lagging. Personnel finally returned to parity with the number of stocks traded in 2009. In contrast, the budget, once stoked in the wake of Enron, breaks out of the band with a sharp increase.

Figure 3 tracks annual SEC personnel and budget figures, here expressed in nominal terms, across the same period against the market value of publicly traded equities, which increased from \$490,134,900,000 to \$17,526,408,500,000, also expressed in nominal terms. The budget roughly tracks increases in equity market capitalization until the mid 1990s, when the stock market’s sudden rise outstripped budget increases. The pattern reverses after 2000, when the market entered a period of backing and filling while the SEC enjoyed more robust financing in the wake of Enron and Sarbanes-Oxley.

Figure 3: SEC Resources to Equity Market Capitalization, 1964–2010³¹⁷

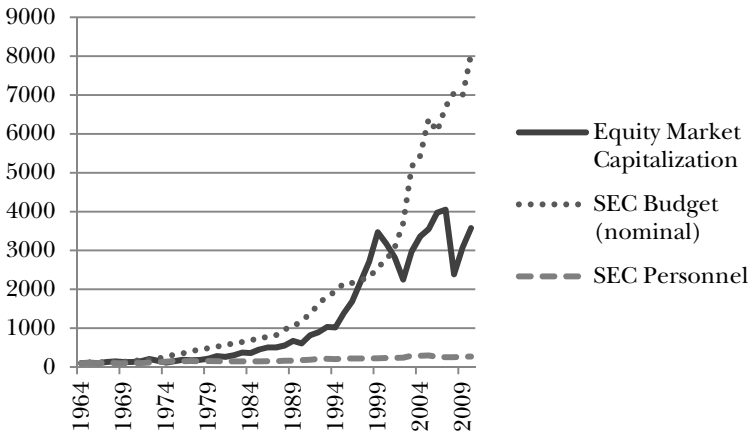


Figure 4 fleshes out the picture, using SEC-initiated enforcement actions as a yardstick for agency productivity. These enforcement actions increased from forty-three per year in 1964 to 681 in 2010. The numbers impress when compared to the personnel numbers, and stay ahead of inflation-adjusted budget increases.³¹⁸ At the same time,

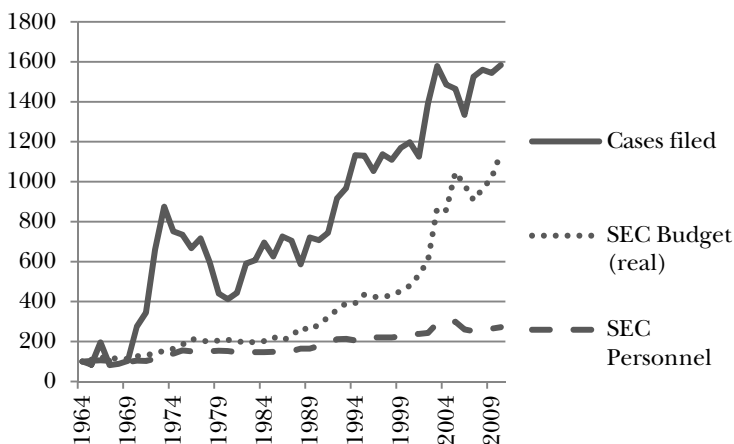
³¹⁷ *Id.*

³¹⁸ If the nominal budget numbers were used, the budget increases would outstrip increases in enforcement activity.

numbers of enforcement actions per dollar of resources never returned to the level achieved in the early 1970s—the complexity and magnitude of the cases doubtless has something to do with this.

The numbers show a burst of activity in the wake of the collapse of the 1960s bull market, followed by more moderate and steady increases with notable upticks after 1990 and again after Enron. The early 1990s increases may reflect a legislative adjustment, as Congress materially added to the SEC's stock of enforcement weapons in the Securities Enforcement and Penny Stock Reform Act of 1990.³¹⁹ Before 1990,

Figure 4: SEC Resources to Enforcement Activity, 1964–2010³²⁰



the agency had only two choices in addressing violations of mandatory-disclosure rules outside of the public offering context—either going to court for an injunction or proceeding administratively to request a corrective filing. The 1990 legislation added the administrative cease-and-desist order with an express provision for profit disgorgement³²¹ and opened doors for the agency to seek civil monetary penalties outside of the insider-trading context.³²²

³¹⁹ Pub. L. No. 101-429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C.). The previous step-up in legislative authority, the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.), addressed insider trading. For further discussion, see Cox & Thomas, *supra* note 306, at 746-48.

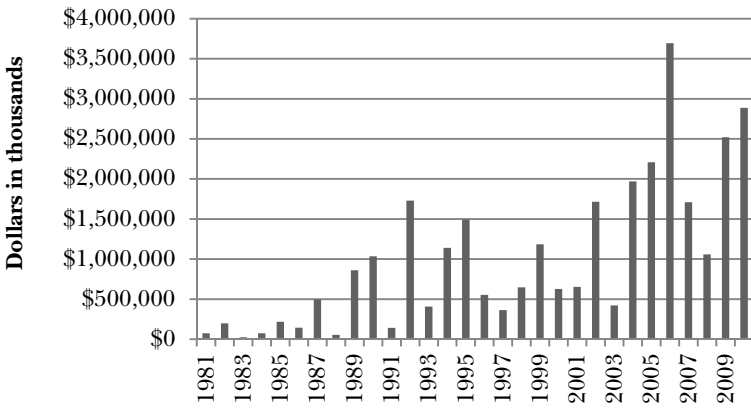
³²⁰ See *supra* note 313.

³²¹ 15 U.S.C. §§ 77h-1(a), 78u-3(e) (2006).

³²² 15 U.S.C. § 78u(d)(3).

Figure 5 offers another view of enforcement beginning in 1981, when the SEC’s annual report first included the penalties and profit disgorgements ordered in connection with its enforcement actions.³²³ The sequence begins with \$30 million in 1980, picks up magnitude after the 1990 legislation, and ends at \$2.85 billion in 2010.³²⁴ On an inflation-adjusted basis, the average annual number of fines and disgorgements ordered during the last five years of the sequence increased 20.2 times over the average amount during the first five years.

Figure 5: Fines and Disgorgements Ordered in SEC Enforcement Actions (Inflation Adjusted), 1981–2010³²⁵



2. Comparing the Public and Private Sectors

The figures tell us that the SEC’s enforcement reach has been extended materially since 1964. But they tell us nothing about the “adequacy” of the resulting enforcement operation.

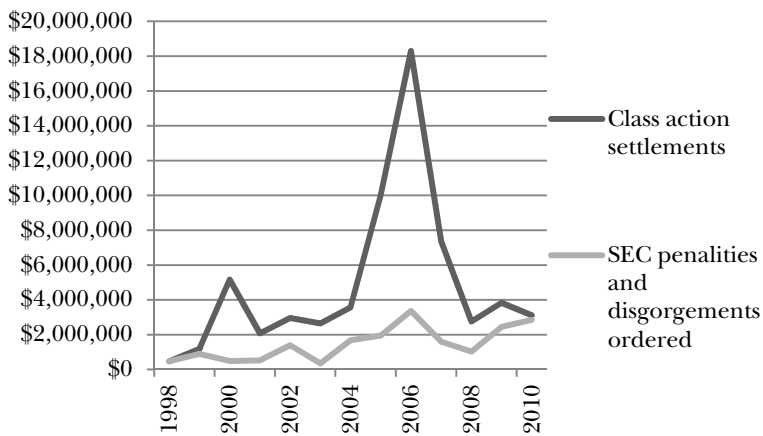
³²³ Penalties and disgorgements are regulated under sections 21B and 32 of the 1934 Act. *Id.* § 78u-2, 78ff.

³²⁴ Amounts ordered are often greater than amounts actually collected, as the SEC has difficulty collecting awards from judgment-proof defendants. *See, e.g.*, 2004 SEC PERFORMANCE AND ACCOUNTABILITY REPORT 48 (2004), *available at* <http://www.sec.gov/about/secpar/secpar04.pdf> (reporting a balance sheet allowance for doubtful accounts of 81.02%). The problem presumably stems from the fact that securities violations tend to occur at companies experiencing financial difficulty. *See Arlen & Carney, supra* note 55, at 724-26 (confirming empirically that securities fraud tends to be an end-period problem).

³²⁵ *See supra* note 313.

Figure 6 offers some information respecting magnitude and salience by comparing annual amounts of penalties and disgorgements reported by the SEC with total annual class action settlement dollars. The private sector certainly extracts larger sums, especially given big ticket cases like those settled in the wake of Enron and WorldCom. However, in recent years the SEC has pulled itself up to parity. Indeed, apart from the spike in private returns in 2006, the divergence between the lines is surprisingly small. Figure 7 offers a contrasting view, comparing annual numbers of initiated class actions to the annual number of initiated SEC enforcement actions. By this case-by-case measure, the SEC has the larger volume.

Figure 6: SEC v. Private Actions, Dollar Amounts, 1998–2010³²⁶



³²⁶ For SEC data, see, SEC ANN. REPS., *supra* note 313. For class action settlement data see RYAN & SIMMONS, *supra* note 23, at 1, fig. 1, and ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2008 REVIEW AND ANALYSIS 1 fig.1 (2009), available at http://securities.stanford.edu/Settlements/REVIEW_1995-2008/Settlements_Through_12_2008.pdf.

Figure 7: SEC v. Private Actions, Numbers Initiated, 1996–2010³²⁷

Not too much should be made of either comparison. The larger private-sector dollar amounts reflect different incentives and objectives. Lawyers in the private sector are motivated by the possibility of personal financial gain, while those working at the agency pursue reputational gain in addition to whatever motivation public service imparts. Plaintiffs' attorneys evaluate potential class actions by settlement value. The SEC is more interested in the magnitude and character of the violation and the proceeding's deterrent pay off.³²⁸ It also seeks to innovate by bringing new fact patterns within the ambit of the antifraud regime.³²⁹ Finally, its enforcers cover a much broader range of subject matter,³³⁰ dealing with the defalcations of broker-dealers, investment companies, and investment advisors in addition to the narrow antifraud subject matter covered by private class actions.

³²⁷ For SEC data, see *supra* note 313. For class action filing data see CORNERSTONE RESEARCH, *supra* note 31, at 3 fig.2.

³²⁸ See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-02-662T, MAJOR HUMAN CAPITAL CHALLENGES AT SEC AND KEY TRADE AGENCIES 6 (2002) (statements of Richard J. Hillman, Director, Fin. Markets and Cmty. Inv., & Loren Yager, Director, Int'l Affairs and Trade); see also Cox & Thomas, *supra* note 306, at 777 (arguing that SEC enforcement actions focus on small companies, thus diminishing the overall deterrent effect of SEC enforcement).

³²⁹ See Cox & Thomas, *supra* note 306, at 752 (describing communication to market participants as the foremost metric that SEC uses in prioritization); *supra* text accompanying note 308.

³³⁰ See 2009 SEC PERFORMANCE AND ACCOUNTABILITY REP.: PUTTING INVESTORS FIRST 9-11 (2009), available at <http://www.sec.gov/about/secpar/secpar2009.pdf> (describing the range of enforcement initiatives used by the SEC).

The antifraud overlap segment makes up fifty percent of enforcement volume at the SEC.³³¹ The SEC still emerges as the higher volume enforcer, but less than Figure 7 indicates.³³²

Finally, we compare the number of lawyers deployed in the public and private sectors. From 2009 to 2010, five law firms were responsible for 61% of all payouts from class action settlements.³³³ The law firms in question employed a total of 453 lawyers in mid-2010.³³⁴ Extrapolating, it took around 743 attorneys to produce the 2009–2010 settlement yield. In 2009, the SEC enforcement division had a total of 1223 personnel. Based on a rough estimation, 782 of those were attorneys.³³⁵ The SEC thus matches the private sector in per capita human resources.

But there are significant differences in focus as well as subject matter coverage. The SEC spends most of its enforcement resources on primary investigation.³³⁶ If there is a front line in fraud enforcement, it is here. In recent years, the number of investigations initiated by the Enforcement Division has ranged from 3500 to 4500 annually.³³⁷ Eighty percent of the Division's nonsupervisory lawyers work on

³³¹ In 2008, twenty-three percent of SEC actions concerned issuer reporting problems. Adding actions concerning securities offerings (eighteen percent) and insider trading (nine percent) brings the total to fifty percent. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 23. The SEC also initiated significant numbers of actions against investment advisors, broker-dealers, and market manipulators. *Id.*; see also Cox & Thomas, *supra* note 306, at 750 (calculating that half of SEC enforcement actions could have a parallel private class action claim and noting that the subclass is split fifty-fifty between actions respecting public offerings and those respecting other reporting violations).

³³² Simi Kedia and co-authors compare SEC enforcement actions to private class action litigation respecting GAAP violations, respectively, during the period 1996–2006. Simi Kedia et al., *The Deterrence Effects of SEC Enforcement and Class Action Litigation* (June 2011) (manuscript at 3) (unpublished manuscript), available at <http://ssrn.com/abstract=1868578>. The SEC initiated 474 proceedings; there were 1111 private class actions. *Id.* By this measure, private class actions show the higher volume.

³³³ See RYAN & SIMMONS, *supra* note 23, at 14 (showing Robbins, Geller, Rudman, & Dowd (30%); Bernstein, Litowitz, Berger, & Grossman (10%); Barroway, Topaz, Kessler, Meltzer, & Check (7%); Labaton Sucharow (7%); and Milberg (7%)).

³³⁴ The numbers were counted on the law firms' web sites on July 24, 2010.

³³⁵ We arrived at this number using percentages for 2008 detailed in the 2009 GAO report. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 18. According to the report, 54% of non-supervisory positions in the Enforcement Division are taken by investigative attorneys and 10.3% by trial attorneys. Our estimate assumes that these percentages hold for supervisory personnel as well.

³³⁶ Extrapolating from the numbers reported in *supra* note 335, 80% of the Division's lawyers do investigation and 20% do trial work.

³³⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 22.

the investigative side, while only twenty percent are trial lawyers.³³⁸ This investigative investment spills over to the private sector where plaintiffs' law firms file complaints against companies already subjected to SEC investigations. Thirty percent of the class actions settled in 2010 followed the settlement of an SEC action in the same case.³³⁹ The average class action settlement in this SEC overlap subset was \$13 million from 1996 to 2010; the average settlement in cases without the overlap was \$5.8 million.³⁴⁰

Finally, we again note that the Enforcement Division is reputed to be a troubled operation.³⁴¹ It suffers problems of morale and a high personnel turnover rate, although improvements have been noted in recent years.³⁴² Agency staff also operate under cumbersome internal review and approval procedures.³⁴³ Moreover, overall enforcement capacity is subject to political controls because the Division can grow only to the extent that Congress allocates the necessary funds.³⁴⁴

3. Sources of Funds

If Congress decided to make a stronger commitment to enforcement, the necessary monies would be available at no cost to the taxpayers. As noted above, the SEC is funded by fees it collects from exchange transactions and registrations. Figure 8 compares the agency's fee revenues to its operating costs from 1964 to 2010. Fee revenues have exceeded costs since 1983.

³³⁸ See CORNERSTONE RESEARCH, *supra* note 31, at 3 fig.2.

³³⁹ RYAN & SIMMONS, *supra* note 22, at 11. Kedia and co-authors find in their sample comparing the SEC to class actions, that sixty percent of SEC investigations are accompanied by class action litigation. Kedia et al., *supra* note 332, at 2.

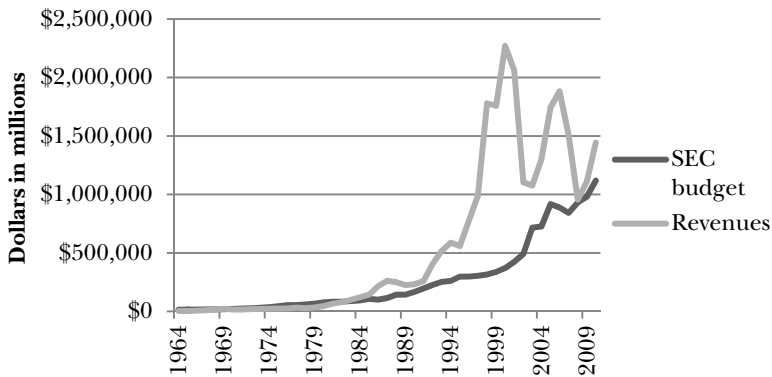
³⁴⁰ *Id.*; see also Cox & Thomas, *supra* note 306, at 763-77 (studying a dataset of cases of private-SEC overlap and finding also that the SEC is more likely to target an issuer with a lower market capitalization or an issuer in financial distress than are private plaintiffs).

³⁴¹ See BOS. CONSULTING GRP., *supra* note 302, at 211 (reporting a low level of staff engagement "exacerbated" by a structure "which leaves middle managers feeling disempowered"); Cox & Thomas, *supra* note 306, at 757-59 (discussing staffing problems at the SEC).

³⁴² See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 19-20 (showing that the turnover rate has decreased significantly in recent years); see also BOS. CONSULTING GRP., *supra* note 302, at 42-43 (describing recent administrative initiatives at the Enforcement Division to improve morale and reduce turnover).

³⁴³ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 27-30 (stating that "the process for supervisory review of enforcement cases is burdensome and unnecessarily redundant" and calling for a more efficient use of SEC resources).

³⁴⁴ See 2009 SEC PERFORMANCE AND ACCOUNTABILITY REP., *supra* note 330, at 73-74 (describing the SEC budgeting process and its dependence on congressional approval).

Figure 8: SEC Budget and Revenues, 1964–2010³⁴⁵

The sharp decrease in revenues that begins in 2007 results less from decreased market volume than from Congress's enactment of the Fee Relief Act in 2002.³⁴⁶ The Fee Relief Act achieved its objective of aligning the agency's revenues and costs in 2008. Previously, excess revenues were remitted to the Treasury, but under the Fee Relief Act, they are saved in a separate account for the SEC's future use.³⁴⁷ The bottom line is that procuring funding for stepped-up enforcement would be as simple as resetting the fees.

There is yet another potential source of funds. The SEC historically endeavored to return profits disgorged by defendants to victimized investors; penalties were remitted to the Treasury. Sarbanes-Oxley's Fair Funds provision³⁴⁸ changed that, charging the SEC to endeavor to return penalty monies to injured investors. The decision to remit is left to the agency's discretion in any given case.³⁴⁹ The agency has followed the course indicated by the statute and remits the funds to investors. Indeed, the agency has created a new Office of Collections and Distributions to administer these funds.³⁵⁰ The SEC distri-

³⁴⁵ SEC ANN. REPS., *supra* note 313.

³⁴⁶ See *supra* text accompanying notes 258-75.

³⁴⁷ 2009 SEC PERFORMANCE AND ACCOUNTABILITY REP., *supra* note 330, at 73.

³⁴⁸ 15 U.S.C. § 7246(a)-(b) (2006).

³⁴⁹ See *id.* § 7246(a) (“[T]he amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.”).

³⁵⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 268, at 4. The action came at the instance of a GAO recommendation. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-830, SECURITIES AND EXCHANGE COMMISSION: ADDITIONAL ACTIONS NEEDED

buted \$6.6 billion from 2002 to 2009, of which \$2.1 billion flowed out in 2009 alone.³⁵¹

Congress, having elevated the shareholders' interest in these funds in 2002, redirected a portion to cover the costs of stepped-up enforcement under the Dodd-Frank Act.³⁵² This provides that 10-30% of penalties and disgorgements ordered in SEC proceedings be made available to pay any whistleblowers who provided the agency with essential information in the case. The SEC is directed to set aside a fund for this purpose, drawing on disgorgement and penalty fees.³⁵³ The SEC duly set aside \$452 million in 2010.³⁵⁴

The whistleblower fund is a step in the right direction. From a policy point of view, it correctly elevates the deterrence objective over shareholders' interest in compensation. From a practical point of view, it confirms this Article's fiscal point: should a future Congress again decide to invest in stepped-up antifraud deterrence, funding concerns do not present a barrier.

Recall that some criticize FOTM because shareholders ultimately pay the settlements. We now add a countervailing point: it makes no difference who does the enforcing, as the shareholders always end up picking up the tab. The costs, however, fall differentially within the shareholder class under each regime. Private costs fall hardest on un-diversified long-term holders; public costs fall hardest on those who do the most trading.

4. Bang for the Buck

Given that the shareholders pay under either scheme, the question remains as to comparative costs and results between the private and public sector enforcement.

TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS 25-31 (2007), *available at* <http://www.gao.gov/new.items/d07930.pdf> (discussing the SEC's plans to establish a centralized Fair Fund office).

³⁵¹ 2004 SEC PERFORMANCE AND ACCOUNTABILITY REP., *supra* note 330, at 11.

³⁵² Dodd-Frank § 922, 15 U.S.C.A. § 78-d (West Supp. 2 2011).

³⁵³ *Id.*

³⁵⁴ 2010 SEC PERFORMANCE AND ACCOUNTABILITY REP. 21, *available at* <http://www.sec.gov/about/secpar/secpar2010.pdf>.

**Figure 9: Judgment or Settlement Amounts
per Dollar Invested in Litigation³⁵⁵**



Figure 9 sets out the results of an eleven-year (1999–2009) comparison between class action attorneys’ fees calculated assuming a payout of 23% of the settlement³⁵⁶ and the cost of the SEC Enforcement Division calculated on the assumption that the Division receives 34% of the agency’s annual budget.³⁵⁷ A 23% average class action attorneys’ fees award implies a damage payout of \$4.35 per enforcement dollar invested. The SEC enforcement payout, taken as the average annual quotient of announced disgorgements and penalties divided by the cost of running the Enforcement Division, is \$6.20 per dollar invested. On this comparison, then, private enforcement emerges as relatively more expensive than public enforcement.³⁵⁸

Next comes the question of which sector, public or private, provides the shareholders with more bang for their buck? Standard policy analysis in corporate law strongly favors the private side. Private en-

³⁵⁵ RYAN & SIMMONS, *supra* note 23, at 11 fig.11.

³⁵⁶ See *supra* note 99 and accompanying text (studying the period 1993–2008).

³⁵⁷ The 34% figure is derived by comparing the Enforcement Division budget for the years 2004 to 2008, U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 268, at 19, to the SEC’s overall budget for each year, SEC ANN. REPS., *supra* note 313. It is an average of the five years’ figures.

³⁵⁸ The result reverses conventional wisdom regarding the respective costs of public and private enforcement. See Michael J. Trebilcock & Edward M. Iacobucci, *Privatization and Accountability*, 116 HARV. L. REV. 1422, 1429 (2003) (citing studies on airlines, waste collection, electric utilities, and postal services that found a public sector approach to cost between 30% and 90% more than a private sector approach).

forcement benefits from the sharp prod of financial incentives, while public enforcers are civil servants working within burdensome administrative constraints. The numbers here suggest a stronger case for the public side than generally assumed.³⁵⁹ High-powered private incentives come at a cash price, and maintaining the cash machine builds a dependence on enterprise liability, a suboptimal result from an enforcement point of view. An administrative framework could work better here, given the chance. An adequately funded agency could redirect its efforts to individual perpetrators as a matter of policy choice, while the private bar is locked in by its own private economics.

Now consider a follow-up question. Suppose that shareholders were offered a choice: maintain the status quo or double the SEC enforcement budget and abolish FOTM, leaving the door open for private actions against nontrading issuers where actual reliance can be shown. The case for doubling resources on the public side is quite plausible, but so is indifference between the two choices. The only result that these numbers preclude is a hands-down preference for FOTM.

B. *The SEC as Agent for Reform*

1. A Quid Pro Quo

The plaintiffs' bar looks for settlement value, but the SEC has other incentives and can thus pursue law enforcement objectives. Where the plaintiffs' bar is driven by the economics of settlement and locked into enterprise liability, the SEC is limited by its budget. The SEC also settles and, in so doing, often pursues the path of least resistance by accepting a payment from the corporation rather than pursuing individual miscreants.³⁶⁰ Given additional funds and personnel, the SEC could push harder to target individual defendants and force them to pay, adding deterrent effect. Indeed, the SEC has already taken a step in this direction in its settlements with individual defendants, using the settlement agreement to block resort to D&O insurance policies.³⁶¹

³⁵⁹ The Kedia study reports a roughly equal deterrent effect for SEC enforcement actions and private class actions directed against GAAP violations that use reversal of income-increasing accruals in the industry in question as a measure of deterrent impact. Kedia et al., *supra* note 332, at 3. It follows that the SEC is not as ineffective as it is usually portrayed.

³⁶⁰ See *supra* note 147 and accompanying text.

³⁶¹ See DAN BAILEY & TOM GEYER, SEC'S DIM VIEW OF INDEMNIFICATION DARKENS 1 (2005), available at http://www.baileycavalieri.com/68-SECs_View_Indemnification.pdf (describing the SEC's actions as motivated by public policy).

A stronger push need not implicate overdeterrence. Administrative intelligence can seek out the sweet spot where a private incentive to maximize returns holds out risks.

We have no answer as to how much additional funding and how much time would be required to build the needed organizational infrastructure. We only point out that the money is available, whether from increased fees or further diversion of penalty and disgorgement proceeds to deterrent use. If Congress doubled the SEC's budget, and the SEC devoted the entire increase to enforcement, funding for enforcement would increase 300% over its present level.

But why would the SEC make such a request? Although calls for large SEC budget increases have been commonplace in the wake of Sarbanes-Oxley and Dodd-Frank,³⁶² a one-time, precedent-breaking request for enforcement funding could hold out negative political implications. Professor Langevoort describes the politics of the SEC's budget as a balancing act.³⁶³ On the one hand, the agency needs to depict the markets as investor friendly, for otherwise it has failed in its mission. On the other hand, it also needs to depict a continuing threat from miscreant executives. Historically, both sides of the balance have signaled moderate increases in enforcement resources, even as the balance has inhibited the agency from seeking a large enforcement increase.

Further, even assuming the SEC made the request, why would Congress agree? While it has often increased the SEC's budget, it has done so incrementally and never by leaps and bounds. Unusual increases tend to come in the wake of scandals and legislative overhauls. In addition, strong opposition from the business lobby can be safely predicted.³⁶⁴

Within the present political economy of securities law enforcement, then, there is neither a reason for the SEC to request an extraordinary budget increase directed to enforcement nor for Congress to grant one. But political equilibriums can be disrupted.

³⁶² For example, in 2011, the SEC sought a fifteen percent increase at a time of budget austerity. It found itself forced to drum up support to stave off a freeze. See Andrew Ross Sorkin, *Wall St. Aids S.E.C. Case For Budget*, N.Y. TIMES, Feb. 8, 2011, at B1 (reporting that former SEC lawyers now on Wall Street have lobbied for increased funding for the SEC).

³⁶³ See Langevoort, *supra* note 150, at 1143-44.

³⁶⁴ See *id.* at 1144-45 (discussing opposition to SEC budget increases from institutional investors, broker-dealers, accountants, and the securities bar).

We think Congress would view increases in the SEC enforcement budget more favorably if a political giveback came in tandem. More particularly, we propose a quid pro quo: stepped-up public enforcement in exchange for reduced reliance on private enforcement; increased enforcement funding in exchange for the elimination of the FOTM presumption. The objective is to achieve a more effective enforcement regime geared against individual defendants while avoiding an overall increase in costs borne by shareholders.

2. Rulemaking Power, Job Opportunities, and the Management Interest

Our proposition is simple, and its objectives have solid grounding in two decades of policy analysis. The party best situated to effectuate the proposal is the SEC, which recently has been reorganizing, reforming, and expanding its enforcement operation.³⁶⁵

In our view, the SEC has the power to remove the FOTM presumption via rulemaking. The authority follows from the words of section 10(b), which delegates authority to make such antifraud “rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”³⁶⁶ It has been argued, plausibly in our view, that the resulting envelope of authority is capacious enough to allow the SEC to disimply the 10b-5 private right of action.³⁶⁷ Even if that were not the case and judicial implication of a private action were somehow deemed to limit the SEC’s rulemaking authority,³⁶⁸ many of the terms of the private right of action remain open to clarification, modification, or reversal by rule.

The matter is not entirely clear, however. It can be argued that ex post statutory modifications of a private right of action imply congressional ratification of the action’s basic terms, including the FOTM

³⁶⁵ See *supra* note 275.

³⁶⁶ 1934 Act § 10(b), 15 U.S.C. § 78j(b) (2006).

³⁶⁷ See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority*, 107 HARV. L. REV. 961, 976-79 (1994) (failing to see any legal obstacle to the Commission’s ability to disimply private rights of action).

³⁶⁸ We think that result is unlikely. Our view would be different if the statute itself created the private right of action. See *Kelley v. EPA*, 15 F.3d 1100, 1107-08 (D.C. Cir. 1994) (reading express private right of action to block administrative rulemaking over the scope of substantive rights).

presumption.³⁶⁹ Were this interpretation to prevail, our proposal would have to be remitted to Congress in its entirety.

Either way, we look to the SEC to take the initiative. The SEC should assume primary responsibility for antifraud enforcement, along with all accompanying management and planning problems, and step away from a longstanding, ad hoc public-private arrangement. The public-private back and forth presents career opportunities. Many members of the SEC's senior staff come from elite law firms, and they use their agency experience to return to the private sector with enhanced prestige.³⁷⁰ Upon return, they tend to do corporate defense work, which does not necessarily exist absent plaintiffs with plausible causes of action. Even assuming more SEC enforcement actions, and hence more SEC defense work, eliminating FOTM could shrink billable hours across the sector. Thus might our proposal excite opposition on both the plaintiffs' and defendants' sides of the bar.

To the extent that the plaintiffs' bar and its allies may exert their influence against our proposal, we could offer a modification. Instead of striking FOTM from the books directly, the SEC (or Congress) could turn the matter over to the shareholder community and orchestrate the across-the-board opt-in/opt-out referendum we hypothesized in Part III.³⁷¹ To the extent the FOTM interest thereupon persuaded its putative beneficiaries (and financial underwriters) of the value of its services, the shareholders would opt to stay in, and FOTM would emerge with its legitimacy much enhanced.

³⁶⁹ This occurred with the enactment of the PSLRA. PSLRA § 21D, 15 U.S.C. § 78u-4. The theory would be that recognition implies the reception of the basic judicial outlines of the action into the statutory scheme, so as to shield the action from alteration by agency rulemaking. The Supreme Court brought congressional ratification to the fore in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 165 (2008), concluding that congressional recognition tied the Court's hands and blocked an expansion of the action's scope.

³⁷⁰ Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1604-05 (2006) (scrutinizing the revolving door of SEC lawyers and private practice and its connection to new regulations).

³⁷¹ There are incidental questions concerning the SEC's institutional disposition. Respecting antifraud, the agency has always followed a regulation-by-litigation strategy and expressed a preference for standards over rules. *See id.* at 1619-20 (noting the formation of policy more often through enforcement than through rulemaking); Langevoort, *supra* note 206, at 1337 (referring to William L. Cary's comment that rules are a "blueprint for fraud" because of unintended loopholes and barely legal schemes). Our proposal does not traverse these preferences, but it simply relegates private plaintiffs' lawyers to a diminished role in the creation of law.

We also acknowledge a risk of unintended effects. The management interest could seize the occasion to effect a net reduction in enforcement resources. This result would follow if, say, the SEC were to present a plan to Congress, and Congress then decided to eliminate the FOTM presumption legislatively without approving a compensating increase to the SEC's enforcement budget.

This is possible, but in our view unlikely. We have seen that the politics tilt in favor of enforcement with the less attractive aspects of the private action providing the political point of engagement for management opposition. Any residual chance of political disruption can be minimized if the SEC took the lead and eliminated FOTM by rule. Congress would be called on only to assent to budgetary expansion,³⁷² which could precede a FOTM rulemaking, which could be conditioned on the budget initiative's success. Alternatively, an opt-in/opt-out approach holding open a door for company-by-company reentry would minimize the risk of an unintended decrease in overall enforcement resources.

C. *Summary*

We hold out no hopes for early adoption of either of our reform proposals—this Part's quid pro quo, or the national shareholder FOTM referendum proposed in Part III. We propose them as possibilities to make a point about federal securities laws' reliance on a mix of private and public enforcement. Private class actions continue to be endorsed solely on the assumption that public enforcement is crippled by budgetary and incentive constraints, but that assumption went out of date in the post-Enron era. Meanwhile, substantive criticisms of FOTM formerly made by a minority of observers have risen to the status of a consensus view. It is time to conjoin these two developments and rethink the whole.

CONCLUSION

The question is not whether FOTM as we know it should go. The closer one looks at FOTM's doctrinal and economic supports, the

³⁷² Statutory limits on penalties might also need to be considered. Under sections 21(d)(3) and 21B(b) of the 1934 Act, penalties max out at \$100,000 "for each act or omission." 15 U.S.C. §§ 78u(d)(3)(B), 78u-2(b). These penalties are subject to periodic upward inflation adjustment under the Federal Civil Penalties Inflation Adjustment Act of 1990, 28 U.S.C. § 2461 note.

harder it is to defend. Rather, the questions are how and when FOTM will go. These are tougher, for FOTM's institutional and political supports stand up to inspection much better than its substantive supports.

We expect the questioning to intensify in coming years. Management is ready to hand the Congress another PSLRA whenever a favorable political window opens. At the same time, the SEC is slowly pointing its growing enforcement operation toward individual miscreants. These oppositional forces could over time precipitate a root-and-branch reconsideration of securities law enforcement policy, with FOTM being eclipsed as the SEC accepts more responsibility.