CONFRONTING THE CIRCULARITY PROBLEM IN PRIVATE SECURITIES LITIGATION

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Many critics argue that private securities litigation fails effectively either to deter corporate misconduct or to compensate defrauded investors. In particular, commentators reason that damages reflect socially inefficient transfer payments—the so-called circularity problem. Fox and Mitchell address the circularity problem by identifying new reasons why private litigation is an effective deterrent, focusing on the role of disclosure in improving corporate governance.

The corporate governance rationale for securities regulation is more powerful than the authors recognize. By collecting and using corporate information in their trading decisions, informed investors play a critical role in enhancing market efficiency. This efficiency, in turn, allows the capital markets to discipline management, producing a governance externality that improves corporate decision-making and benefits non-trading shareholders. As this article shows, this governance externality justifies compensating informed traders for their fraud-based trading losses.

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INTRODUCTION

Private securities litigation has become increasingly controversial. The Republican Contract with America[1] criticized securities-fraud class-action lawsuits as abusive,[2] and Congress responded to these criticisms by enacting the extensive reforms of the Private Securities Litigation Reform Act of 1995 (PSLRA).[3] The reforms did not

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1. REPUBLICAN CONTRACT WITH AMERICA (1994), *available at* www.house.gov/house/contract/CONTRACT.html.

2. *See* Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 535 (1997) (describing claims of abusive private litigation).

3. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 77z–1).

eliminate the controversy, however. Recent academic commentaries—from scholars embracing a variety of political perspectives—raise serious questions about the efficacy of the private right of action.[4] Indeed, the academic literature reflects a general consensus that the traditional justifications for private litigation are deficient, and that the rationale for private litigation must be reconsidered.[5]

Professors Merritt Fox[6] and Lawrence Mitchell[7] have taken up this challenge. The authors have written two papers that offer new justifications for private litigation. In particular, both authors confront and reject the claim that private securities litigation is socially wasteful because it merely transfers funds from one set of shareholders to another. Some scholars have characterized this transfer as the "circularity problem."[8]

Fox and Mitchell each confront the circularity problem by focusing on the deterrent value of private litigation. Fox describes financial transparency as a tool for facilitating shareholder monitoring, and views private litigation as a means of making disclosure requirements effective.[9] Mitchell argues that shareholders are ultimately responsible for managerial malfeasance, and that private litigation deters

4. *See, e.g.*, ANJAN V. THAKOR ET AL., THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION 5 (2005), *available at* http://www.institute forlegalreform.com/index.php?option=com_ilr_docs&issue_code=SLI&doc_type=STU (stating that large institutional investors are systematically overcompensated by securities-fraud litigation); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545–50 (2006) (arguing that private litigation fails to achieve either compensation or deterrence objectives); Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 225–26 (2007) (identifying weaknesses in current litigation structure); 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, 650–52 (2007) (questioning whether enterprise liability should be pared back to increase the deterrent value of litigation).

5. *See* sources cited *supra* note 4.

6. Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WISC. L. REV. 297.

7. Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WISC. L. REV. 243.

8. Professor Coffee appears to have coined this specific phrase. *See* Coffee, *supra* note 4, at 1556. Professor Cox used similar terminology ten years earlier. *See* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509 (1997) ("A reason that the securities class action poorly serves both a compensatory and a deterrent objective is the circuity problem that arises when the source of a settlement is the corporation that commits the misrepresentation.").

9. *See generally* Fox, *supra* note 6.

shareholder passivity or shirking.[10] According to Mitchell, the need to maintain shareholder accountability for monitoring failures undercuts the argument that shareholders who pay fraud damages are "innocent shareholders."

Both papers reject the traditional divide between corporate governance and securities regulation, placing private securities-fraud litigation squarely within the realm of corporate governance. They do this by privatizing securities litigation—characterizing its objectives as the reduction of managerial agency costs and the improvement of corporate decision making. Thus, the authors move away from a conception of securities litigation in terms of investor protection, a conception at the core of the traditional compensation rationale. Neither Fox nor Mitchell seeks to protect investors who trade securities at prices tainted by fraud, and neither author takes seriously the claim that social harm is measured by the extent of that taint.

Yet in rejecting investor protection and its focus on compensation, the authors overlook a critical component of their own corporate-governance story. Capital-market discipline through the efficient incorporation and pricing of firm-specific information depends critically upon the existence of informed trading. Investors who seek out information, use that information to price securities, and then rely on that information in their trading decisions inject the economic significance of that information into the capital markets. Informed investing improves the efficiency of the markets and enables them to discipline managers.

But informed trading is expensive. Acquiring information is costly, as is the reduced diversification necessary to reap the benefits of reliance-based trading. Fraud-based losses add to these costs, which are borne disproportionately by informed reliance-based traders. By compensating traders for fraud-based losses, private civil liability increases the incentive to engage in informed trading. This trading creates the positive externality of efficient pricing that in turn improves corporate governance. In effect, informed trading creates a positive corporate-governance externality. Other investors reap the benefit of informed trading and pay for it through litigation-based transfers in the form of damage awards.

Fox and Mitchell usefully cast securities regulation within the framework of corporate-governance regulation. With the deretailization of the securities markets, governance concerns, such as agency costs, offer a more compelling justification for mandatory disclosure than

10. Mitchell, *supra* note 7, at 287–90.

investor protection.[11] Under this framework, however, compensation is a critical component of enforcing mandatory-disclosure obligations through securities-fraud liability. This Paper argues that the governance framework provides an important justification for retaining the compensation objective in private securities-fraud litigation rather than jettisoning compensation in favor of focusing exclusively on deterrence.

This Paper proceeds as follows. First, the Paper briefly describes the critiques of private securities-fraud litigation. Second, the Paper identifies and analyzes the key insight of both papers: reformulating the goal of federal securities-fraud litigation in terms of a corporate-governance rationale rather than traditional investor protection. Finally, the Paper extends Professor Fox's and Professor Mitchell's analyses to identify a new defense of private litigation in terms of victim compensation—a defense that addresses the circularity problem.

I. PRIVATE SECURITIES LITIGATION: THE CRITIQUES

As both Fox and Mitchell explain, private securities litigation is typically described as serving two goals: compensation and deterrence.[12] A damage remedy compensates investors for losses suffered when those investors are misled in connection with purchasing or selling securities. Arguably, investors are damaged both by the decline in the value of their investment and by the impairment of their investment decision.[13] By causing defendants to pay for the costs of the harm caused by their actions, a damage award also deters wrongdoing. Corporate decision makers who anticipate bearing the costs of securities fraud will, ex ante, internalize those costs and engage in efficient levels of care to ensure that their disclosures are accurate.

11. *See, e.g.*, Brian G. Cartwright, Gen. Counsel, SEC, The Future of Securities Regulation, Speech at the University of Pennsylvania Law School Institute for Law and Economics (Oct. 24, 2007), *available at* http://sec.gov/news/speech/2007/spch102407bgc.htm (describing a reduction in the percentage of retail investors and exclusion of retail investors from some markets and asset classes as "deretailization"); *see also* Donald Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, U. VA. L. REV. (forthcoming 2009) (questioning whether increased institutionalization creates tension for the Commission's traditional approach to retail-investor protection).

12. *See* Fox, *supra* note 6, at 302 (identifying a compensation rationale, but describing it as "weak" and rejecting it in favor of a deterrence rationale); Mitchell, *supra* note 7, at 246 (describing "deterring managerial misconduct" as "a major purpose of class-action lawsuits").

13. *See* Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, IOWA L. REV. (forthcoming 2009) (identifying impairment of the investment decision as a distinct component of the fraud victim's harm).

In recent years, commentators have attacked both justifications. The central basis for this attack is the observation that, in reality, virtually all securities-fraud litigation is resolved by settlement. The settlements are paid by the issuer, usually through a combination of direct issuer payments and directors and officers (D&O) liability insurance.[14] The costs of the settlement are thus borne by the issuer's shareholders. Settlements rarely require individual corporate officials to pay damages, in part because it is more difficult to establish elements of the claim (such as scienter) against individual wrongdoers, and also because of the dynamics of the settlement process. In particular, plaintiffs may risk losing access to the issuer's insurance if their vigorous litigation provides a basis for the insurer to invoke the fraud exclusion of the D&O policy.[15]

The settlement of securities-fraud litigation through issuer-funded damage payments is the basis for the harshest criticism of the compensation objective: the circularity problem.[16] Because issuers are the ones who pay damages, directly or through insurance, the cost of the award is borne by current shareholders. A diversified investor is, on average, as likely to be on the paying end as on the receiving end and, over time, the sum of the damage awards paid and received should be a wash. For diversified investors, and the investor body as a whole then, litigation is largely a zero-sum game, net of transaction costs. These transaction costs are, however, substantial.[17]

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14. *See, e.g.*, Coffee, *supra* note 4, at 1550–54 (citing statistics showing that, in the overwhelming majority of cases, "the corporate defendant and its insurer typically advance the entire settlement amount").

15. *See, e.g.*, STEPHANIE PLANCICH ET AL., NERA ECON. CONSULTING, 2008 TRENDS: SUBPRIME AND AUCTION-RATE CASES CONTINUE TO DRIVE FILINGS, AND LARGE SETTLEMENTS KEEP AVERAGES HIGH 14 (July 29, 2008), *available at* http://www.nera.com/image/BRO_Recent_Trends_8.5x11_0808.pdf (explaining that settlements are typically covered by D&O insurance, but that an adverse trial judgment may result in an insurer invoking the fraud exclusion of the policy).

16. Critics also argue that investors' losses are largely uncompensated because securities-fraud cases settle for a very small percentage of the claimed damages. *See, e.g.*, Coffee, *supra* note 4, at 1545 (stating that the ratio of settlements to investor losses has never exceeded 7.2 percent). This claim ignores the potentially large differential between claimed damages and recoverable damages, a differential that may have increased in light of decisions like *Dura Pharma., Inc. v. Broudo*, 544 U.S. 336, 342–43 (2005), that have questioned the extent of the economic loss for which the defendants are legally responsible. *See* Fisch, *supra* note 13 (discussing *Dura* and its implications for the methodology of defining the harm effected by securities fraud).

17. *See* ANJAN V. THAKOR, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 4–6 (Oct. 2005), *available at* http://www.instituteforlegalreform.org/issues.php?option=com_ilr_docs&issue_code=SLI&doc_type=STU (describing the costs of securities litigation, including decreases in issuer market capitalization and plaintiffs' attorneys fees).

In light of these objections, commentators have turned to deterrence as an alternative justification for private litigation.[18] Deterrence has its critics as well, however. In particular, commentators observe that securities litigation does not deter individual wrongdoers because they do not pay damages. The corporate issuers that pay have not benefited from the fraud (unless they are issuing securities), and may often be victims themselves to the extent that disclosure violations, like financial-reporting manipulations, improperly increase management compensation or reduce the effectiveness of board and capital-market monitoring.[19] Excessive liability exposure and the resulting pressure to settle weak cases, as well as the risk that hindsight bias will lead to the erroneous imposition of liability, further reduce the deterrent effect of litigation because liability exposure that is not closely tied to the costs of the misconduct will not result in efficient levels of care by corporate decision makers.[20]

These concerns have led to suggestions for reevaluating the existing litigation structure. At the invitation of the United States Chamber of Commerce, Professor Fox and I, together with other securities-law professors with diverse perspectives about the value of private litigation, participated in a series of discussions about the current litigation system and the potential need for reform. As a result of these discussions, several members of the group wrote a letter urging Securities and Exchange Commission (SEC) Chairman Christopher Cox to convene a series of roundtables to gather additional information about the efficacy of private litigation.[21] As articulated in this letter (which I signed, but Professor Fox did not), the current litigation system results in "an immense amount of 'pocket-shifting' . . . . at a relatively high cost" and "does a bad job at deterrence."[22]

18. *See, e.g.*, *A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 929–30 (1999) (arguing that deterrence rather than compensation should be the primary goal in securities-fraud litigation).

19. Indeed, in other work Professor Fox argues that issuers not making a public offering of securities should not face civil damage liability; such liability should be reserved for individual wrongdoers and third-party actors, such as investment banks. *See* Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, COLUM. L. REV. (forthcoming 2009).

20. Fisch, *supra* note 13.

21. Letter from Six Law Professors to Christopher Cox, Chairman, SEC (Aug. 2, 2007) [hereinafter Law Professor Letter], *available at* http://www.the10b-5daily.com/archives/Chairman%20Cox%20SEC%20Letter.pdf; *see also* Jesse Westbrook, *SEC to Examine Effect of Investor Lawsuits on U.S. Competitiveness*, INT'L HERALD TRIB., Sept. 24, 2007, *available at* http://www.iht.com/articles/2007/09/23/bloomberg/bxinvest.php (describing the letter).

22. Law Professor Letter, *supra* note 21.

II. SECURITIES REGULATION AS CORPORATE GOVERNANCE

Fox and Mitchell address the criticisms about private litigation by reforming its objectives. Critical to both papers is a corporate-governance rationale for securities regulation. Rather than characterize the goal of the federal securities regulation as the protection of investors and the trading markets, Fox and Mitchell argue that securities regulation can better be understood as a mechanism for reducing managerial agency costs by enhancing shareholder monitoring. In effect, the authors envision modern securities regulation as a backdoor federalization of state corporation law.[23]

The Fox and Mitchell papers differ in their view of the relationship between securities regulation and shareholder monitoring. Mitchell emphasizes the key role of the shareholder in effective corporate governance. As Mitchell explains, shareholders are ultimately responsible for corporate decisions through their election of the board of directors.[24] Because of this responsibility, shareholders cannot fairly be characterized as innocent victims when their agents engage in fraud. Mitchell observes that, historically, corporate (enterprise) liability served as a vehicle for ensuring that shareholders, as well as corporate officials, bore collective responsibility for corporate actions.[25] Modern developments, including the institutionalization of the U.S. equity markets, coupled with growing sophistication and activism on the part of institutional investors, have increased the ability of shareholders to serve as effective monitors.[26]

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23. Congress rejected the explicit adoption of a federal corporation law when it adopted the federal securities law. *See, e.g.*, JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 208–10 (1982) (describing the consideration of a federal corporation law); Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1180–83 (1993) (describing reasons why Congress did not federalize corporate law). Nonetheless, as some authors have observed, federal securities litigation has largely supplanted state law as a mechanism for enforcing some traditional corporate-law principles such as fiduciary duties. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 860 (2003).

24. Mitchell, *supra* note 7, at 290.

25. Indeed, a few vestiges of this responsibility remain. The New York Business Corporation Law, for example, imposes personal liability on the ten largest shareholders of a corporation for unpaid wages. *See* N.Y. BUS. CORP. LAW § 630(a) (2003). The provision does not apply to publicly traded corporations. *Id.*

26. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 830–49 (1992) (describing the potential for increased monitoring by institutional investors). *But see* Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1025

Potential securities-fraud liability creates an additional incentive for shareholders to pay attention to the actions of their corporate agents. By requiring shareholders to pay when corporate officials commit fraud, private litigation enhances shareholder responsibility for the actions of those officials. As Mitchell argues, shareholders themselves "have the power and thus the responsibility to protect the integrity of our financial markets through their voting and trading."[27]

There are some difficulties with Mitchell's analysis. Under current law and practice, shareholders have little power to control the composition of the board of directors.[28] The federal proxy rules do not allow shareholders to nominate directors directly without mounting an independent proxy contest, and recent amendments to the federal proxy rules limit shareholder ability to introduce issuer-specific bylaw amendments aimed at increasing shareholder nomination power.[29] Many corporations have charter and bylaw provisions such as advance-notice requirements that further limit shareholder voting rights, as well as provisions that limit shareholder removal of directors.[30] Even with the widespread adoption of majority-voting provisions, shareholder election of directors is more accurately understood as the power to ratify a slate of directors chosen by the current board rather than the power of selection.[31]

More troubling is the fact that, even at its best, the power to elect the board of directors is an attenuated way to exercise control over corporate management. Under state law, director authority to manage the corporation is extremely broad. Shareholders have little or no right to make operational decisions or to take measures that limit the board's discretionary authority.[32] Indeed, some commentators have argued that, under Delaware law, a shareholder-initiated bylaw to limit or prohibit

(1994) (questioning whether institutional investors have the appropriate incentives to engage in activism).

27. Mitchell, *supra* note 7, at 292.

28. *See, e.g.*, Jill E. Fisch, *The Transamerica Case*, *in* THE ICONIC CASES IN CORPORATE LAW 46, 63–67 (Jonathan R. Macey ed., 2008) (describing shareholders' limited power to nominate directors).

29. *Id.* at 67.

30. *See, e.g.*, *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 344 (Del. Ch. 2008) (describing courts' experience with advance-notice bylaws), *aff'd sub nom.*, *CNET Networks, Inc. v. Jana Master Fund, Ltd.*, 947 A.2d 1120 (Del. 2008).

31. *See* Fisch, *supra* note 28, at 69–70 (describing majority-voting provisions).

32. The classic case setting forth this principle, which corporations casebooks continue to include, is *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85, 86 (1880) (rejecting a shareholder attempt to interfere with director decision making).

the board from adopting a poison pill would be invalid as an interference with the board's statutory authority.[33]

Moreover, although the board of directors technically exercises supervisory authority over corporate management, in practice the balance of power often tilts in the other direction. This is evidenced in the recent debate over excessive executive compensation.[34] Despite the board's statutory authority to determine executive compensation and the creation of processes, such as compensation committees, that are designed to facilitate the independent exercise of that authority, pay levels suggest that corporate executives continue to enjoy greater bargaining power than the board.[35] Concededly, the increased importance and independence of audit committees have increased board oversight of financial reporting, but ultimately boards are poorly positioned to supervise corporate disclosures in a detailed manner.[36]

Fox's paper goes further in developing the role of securities regulation in reducing managerial agency costs. Fox argues that the core component of federal securities regulation—mandatory issuer disclosure—can properly be understood as a corporate-governance mechanism designed to enhance operational decision making through increased transparency.[37] In addition to increasing the allocational

33. *See, e.g.*, Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 419 (1998) ("[S]tatutes creating general authority to adopt by-laws may not be construed to permit stockholders to adopt by-laws directly limiting the managerial power of the board of directors.").

34. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (criticizing structure and amount of executive compensation); Stephen Labaton, *Four Years Later, Enron's Shadow Lingers as Change Comes Slowly*, N.Y. TIMES, Jan. 5, 2006, at C2 (observing that, despite criticisms and reform proposals, executive compensation is poorly linked to performance).

35. *See* BEBCHUK & FRIED, *supra* note 34, at 121.

36. *See, e.g.*, Adriaen M. Morse, Jr., *Breaking the Circle: The Problem of Independent Directors Policing Public Company Financial Disclosure Under the SEC's New Rules Governing Public Company Audit Committees*, 23 ANN. REV. BANKING & FIN. L. 673, 717 (2004) (observing that, despite the new rules, including Sarbanes-Oxley, "[a]udit committees will still lack sufficient means to adequately look over management's shoulder").

37. In other work, Professor Fox has described the governance effects of mandatory disclosure. *See, e.g.*, Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113, 114 (1999). He has also identified reasons why it may be necessary to mandate disclosure beyond the level voluntarily provided by issuers. *See, e.g.*, Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1394–95 (1999). These reasons include the positive externality of improved share-price accuracy. Mandated disclosure also enhances the ability of the issuer and its managers to credibly commit to continued transparency.

efficiency of the capital markets, Fox explains that transparency improves the functioning of existing corporate-governance structures by enabling shareholder monitoring devices, such as voting and derivative litigation, to operate more effectively.[38] Similarly, disclosure requirements applicable to transactions involving a possible conflict of interest reduce the likelihood of self-dealing by making it easier to detect.

Professor Jeffrey Gordon's recent insights into independent directors complement and extend Fox's analysis.[39] Gordon claims that transparent financial markets have facilitated the growth of the independent board because they facilitate monitoring by outside directors. According to Gordon, outside directors receive critical information on managerial decisions through stock prices and related sources of public market information, such as analyst and media reports; this information allows the directors to monitor effectively, despite the time and information constraints associated with their positions.[40]

The value of transparency in enhancing corporate governance goes further. 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.

The key step in Fox's analysis is his identification of this governance rationale for regulation, a rationale that extends beyond investor decisions to trade—which play a role in allocational efficiency—to the mechanisms that govern internal operational decisions. Under his view, transparency does not merely improve investor ability to choose among competing investment opportunities, it increases the likelihood that those opportunities will be profitable. Importantly, this governance externality extends beyond secondary-market trading.

Fox thus transforms securities regulation from public law into private law,[41] viewing disclosure provisions as the efficient terms to

38. Fox, *supra* note 6, at 114.

39. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1541 (2007) ("[T]he rise of independent directors is partly explained by the increasing informativeness of stock prices over the 1950–2005 period.").

40. *Id.* at 1561–62.

41. *See, e.g.*, Randy E. Barnett, *Foreword: Four Senses of the Public Law-Private Law Distinction*, 9 HARV. J.L. & PUB. POL'Y 267, 267–72 (1986) (explaining the distinction between public law and private law); Amir N. Licht, *International*

which investors and issuers would have voluntarily agreed in the absence of limitations in the contracting process. In this world, civil enforcement is analogous to the standard private right of action for breach of contract. Private civil enforcement is therefore the norm, rather than the exception. When they bring a claim, securities-fraud plaintiffs are not acting as private attorney generals enforcing an obligation to the general public, they are enforcing a disclosure obligation that is personal to them. According to Fox, public enforcement, rather than private, is the phenomenon that requires justification.[42]

Fox's analysis provides a fit between the disclosure components of securities regulation and those aspects of federal law that intrude more explicitly into corporate governance—the SEC's extensive regulation of shareholder voting under the federal proxy rules;[43] the board composition and committee requirements adopted by the self-regulatory organizations (SROs), at the behest of the SEC;[44] and the short-swing trading restrictions of section 16(b), which Professor Steve Thel demonstrates are more properly viewed as restraints on management manipulation of operational decisions than restrictions on the use of nonpublic information.[45] Fox's explanation also fits nicely with the evolution of private securities-fraud litigation. It is consistent with Professors Robert Thompson and Hillary Sale's assessment that securities-fraud litigation has served to federalize state-law fiduciary principles, enabling shareholders to expand a traditional governance claim beyond the existing limits of state law.[46] It even offers a plausible rationale for the Supreme Court of the United States's recent decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[47] to limit the scope of fraud claims against nonissuer defendants; such claims could not be predicated upon the implicit contractual disclosure

Diversity in Securities Regulation: Roadblocks on the Way to Convergence, 20 CARDOZO L. REV. 227, 258 (1998) (explaining that, although the borders are not clear, the "public law/private law distinction between securities regulation and corporate law generally holds").

42. *See* Fox, *supra* note 6, at 132 ("Public enforcement is only needed when there is some kind of enforcement-market failure.").

43. *See* Fisch, *supra* note 28, at 46–47.

44. *See, e.g.*, Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE. L.J. 517, 553–55 (2003) (describing the New York Stock Exchange and Nasdaq adoption of rules governing independent audit committees).

45. Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 393 (1991).

46. *See* Thompson & Sale, *supra* note 23.

47. 128 S. Ct. 761 (2008).

obligation and might require the more traditional common-law predicates.

Perhaps the most challenging part of Fox's analysis lies in the structure of the private enforcement mechanism. Current law denies standing to shareholders who have not traded[48]—those shareholders who, under Fox's view, are the true victims of the fraud by being deprived of information that would have enabled them to monitor and/or discipline management. More significantly, those holders will wind up paying damages. Private securities-fraud litigation instead consists of contractual-disclosure claims that are enforced by traders for the benefit of, but at the cost of, current holders. There is little reason to believe that the social cost of the harm to current holders—the impact of the fraud on the operation of the firm's governance structure—is correlated with the recoverable damages, defined as the effect of the revelation of the fraud upon market prices. More problematically, the interests of traders, many of whom are no longer shareholders, need not be aligned with the interests of current holders. This agency problem is magnified by the class-action mechanism, which places a premium upon factors such as the issuer's market capitalization, trading volume, and insurance coverage, because of the significance of those factors in increasing the predicted fee award available to plaintiffs' counsel.

Another challenge for the corporate-governance rationale is the mandatory nature of the enforcement remedy. Commentators have suggested that shareholders should be able to modify the private-litigation remedy or choose an alternative enforcement mechanism, such as arbitration, on an issuer-specific basis,[49] but this suggestion is complicated by the fact that current shareholders, in adopting such a provision, would be limiting the rights of future shareholders.[50]

48. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 725, 754–55 (1975).

49. *See, e.g.*, 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) ("Arguably, both the derivative action and some actions based on Rule 10b-5 could be either preempted or precluded by an agreement to arbitrate set forth in the corporation's certificate of incorporation and, in theory, accepted by shareholders when they acquired their shares."); Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 424 (2005) (arguing that companies could opt out of securities class-action lawsuits through collective-action waivers); A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta: *The Political Economy of Securities Class Action Reform*, 2007–2008 CATO SUP. CT. REV. 217, 248 (suggesting that shareholders could modify the damage remedy in an SEC Rule 10b-5 claim through an appropriate charter provision).

50. *See* REPORT OF ROUNDTABLE DISCUSSIONS ON CLASS ACTION REFORM AT DUKE UNIVERSITY 13 (Feb. 2, 2007), *available at* http://ilep.info/pdf/Roundtable_

Although one might argue that shareholders implicitly accept the terms of the corporate charter—including a waiver of litigation rights—when they purchase stock, this argument is weakened if the interests of current shareholders are directly adverse to those of future shareholders. Because Fox's argument conceptualizes private litigation in terms of protecting the interests of current shareholders, it strengthens the argument that, like other governance provisions, it should be subject to modification by those shareholders.[51]

A final concern is the calculation of damages. Fox acknowledges that current damage analysis does not capture the extent of governance harm caused by securities fraud, creating the risk of a mismatch between the private and social value of litigation.[52] A complete analysis of this problem is beyond the scope of this Paper, but Fox elsewhere addresses the challenge of designing a system of civil liability in which damages are tied more closely to social harm.[53]

III. USING THE GOVERNANCE STORY TO REINSTATE THE COMPENSATION OBJECTIVE

A. The Corporate-Governance Response to Circularity

Mitchell and Fox offer persuasive reasons to reconceptualize private securities litigation as a corporate-governance mechanism. Their arguments can, however, be extended to provide a broader response to the critics of private litigation. In addition to providing a deterrence-based rationale for securities-fraud litigation, the corporate-governance rationale adds a new justification for compensation, and, at the same time, offers an answer to the circularity problem.

The role of informed traders in promoting capital-market efficiency is the key to this solution. If securities regulation is about increasing issuer transparency to improve corporate governance, then effective securities regulation requires not just ex post enforcement of disclosure violations, but ex ante incorporation of mandated disclosure into the securities markets. Transparency alone is not enough to improve corporate governance. For shareholders and directors to use

200702_Final_Report.pdf (identifying the question of whether such provisions would be enforceable against newly purchasing shareholders); Gilles, *supra* note 49, at 423–25 (noting concern about the enforceability of unilaterally adopted waivers against strangers who purchase on the secondary market).

51. *See, e.g.*, Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1396 (1989) (summarizing the literature arguing "that corporations should largely be free to opt out of corporate law rules").

52. Fox, *supra* note 6, at 123.

53. Fox, *supra* note 19.

the disclosed information to monitor, it must be incorporated into equity prices. For securities that are traded in efficient markets, this incorporation occurs through informed secondary trading. Informed traders must research and analyze firm-specific information, use that information to adjust their expectations about firm value, and act on that information by trading.

The theory behind the circularity argument is that the market consists primarily of diversified investors for whom the gains and losses from securities fraud net out.[54] The objective of diversification is to achieve a market rate of return by eliminating firm-specific risk.[55] Because a diversified portfolio largely eliminates firm-specific rewards as well, it reduces the incentive for investors to engage in costly information gathering. At the extreme, for the indexed investor, whose investments are completely independent of firm-specific information, the cost of research is wholly irrational.[56]

Passive diversified investing may be a rational strategy for a particular investor, but this strategy is devastating for the market as a whole. Investors will not acquire information unless they have the opportunity to profit on that information by trading. More specifically, for an investor to benefit from firm-specific research, the potential profit from that research must exceed the costs of research and analysis.[57] Thus, informed trading requires investors to limit their diversification and concentrate their holdings in a limited number of

54. Coffee, *supra* note 4, at 1558 ("[A]t least in the aggregate, diversified investors are largely making wealth transfers among themselves as the result of contemporary securities litigation.").

55. *See, e.g.*, Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 936 (1994) (explaining that investors can eliminate firm-specific risk through diversification).

56. *See, e.g.*, Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 836 (2003) (explaining that indexing "eliminates the need for expensive research on individual corporations").

57. Although one might argue that, with mandated disclosure, the cost of acquiring firm-specific information is very low, the analysis of that information is more costly. Moreover, such analysis is fundamental to the corporate-governance story. For stock prices to facilitate monitoring through the mechanisms described above, they must be efficient, not merely in an information sense, but in terms of fundamental value—that is, information must be incorporated into stock prices properly. *See, e.g.*, Jill E. Fisch, *Picking A Winner*, 20 J. CORP. L. 451, 464 (1995) (reviewing ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993)) (explaining the difference between informational efficiency and fundamental-value efficiency). *But see* Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591, 592 (1986) (citing evidence that the markets are not fundamentally efficient).

issuers.[58] Indexed investors, in contrast, seriously threaten market efficiency.

As a result, informed traders are a critical component of the market that enables mandated disclosure to serve as a corporate-governance mechanism. Yet, informed traders incur costs that are not borne by other investors. They incur the costs of research.[59] They incur the reduced liquidity and increased risk associated with limiting their diversification.[60] 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.

Informed traders are more likely to suffer net losses from securities fraud precisely because they trade on information, including fraudulent information. For example, when an issuer releases false information about the United States Food and Drug Administration testing of its new pharmaceutical product, informed traders are likely to buy. Uninformed traders, lacking that information, are more likely to be on the opposite side of those trades. Indeed, when the price increases as a result of the fraud, some uninformed traders, such as index funds, are particularly likely to sell because the price increase triggers the need to rebalance their portfolios.[61]

The governance rationale therefore suggests that compensation is both desirable and noncircular. For informed traders, the gains and losses from securities fraud are unlikely to net out. Even if they did, informed traders incur disproportionate costs because of their trading activity. Rather than viewing these costs as an indication that informed traders have failed to diversify sufficiently, policy makers should recognize that the costs produce a positive governance externality. If

58. *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069–70 (2007) (explaining that a shareholder-activism strategy is feasible for hedge funds that take concentrated stakes in portfolio companies but not for diversified institutional investors).

59. It is a separate issue whether informed traders incur excessive information costs, either individually or collectively. *See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 290–91 (2003) (considering the possibility that investors engage in excessive research).

60. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 568 (1990) ("Large stakes reduce liquidity . . . .").

61. *See, e.g.*, Morris Mendelson & Junius W. Peake, *Intermediaries' or Investors': Whose Market is it Anyway?*, 19 J. CORP. L. 443, 458 (1994) ("Those who index do not buy or sell on news. Instead, they execute transactions to invest newly-received funds, to rebalance their portfolio keeping it closely weighted to track the particular index being followed, or to make changes in asset allocation formulas . . . .").

fraud increases the cost of providing this externality, holders should compensate traders for the resulting losses.

Significantly, the compensation justification addresses one of the difficulties posed by Fox's analysis—the mismatch between the damage calculation and the social harm caused by the fraud. The informed-trader analysis demonstrates that securities fraud does not simply harm society through a loss of efficiency, but harms the specific traders whose reliance-based investment decisions have been distorted. To the extent that damages compensate traders for this harm, the traditional calculation of damages based on trading volume and price distortions is reasonably well correlated with that harm.

B. Possible Objections to the Governance Story

The governance story is not immune from criticism. Perhaps the greatest concern is that a system that requires passive investors, like pension funds, to compensate informed traders, such as hedge funds, is unlikely to be well received by the public. This rationale for compensation is quite different from the justification of protecting small, unsophisticated retail investors—widowers and orphans. Even if retail investors—who are disproportionately holders—ultimately benefit from a system of securities regulation that improves corporate governance, their benefits are less visible and less easily quantifiable than the losses they bear through damage awards.

More problematic is the lack of fit between the governance analysis and the existing structure of securities-fraud litigation—specifically, the *Basic Inc. v. Levinson*[62] fraud-on-the-market class-action lawsuit. I have laid out a justification for compensating informed traders because their reliance-based investment strategy provides a corporate-governance externality. Fraud-on-the-market cases, on the other hand, compensate investors without regard to their individualized reliance. Thus, under my reasoning, such class-action lawsuits substantially overcompensate a large class of investors. At the same time, because the damage award is shared among the entire trading class, informed traders are likely to be undercompensated in the sense that they recover merely a fraction of their actual losses.

Accordingly, one possible implication of the governance story suggests that *Basic* should be cut back. The *Basic* decision has, of course, been subject to criticism,[63] and, although I have questioned the

62. 485 U.S. 224 (1988).

63. *See, e.g.*, Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson, 77 VA. L. REV. 1017 (1991).

rationale of *Basic* elsewhere,[64] an extensive analysis of the case is beyond the scope of this Paper.[65] This Paper, however, supports a reformulation of *Basic*, rather than a reversal. In particular, the Supreme Court could expand *reliance* to include those who acquire information from market intermediaries, such as analysts and the news media, while rejecting a cause of action for investors who relied solely on the market price.[66] A broader conception of reliance would more accurately reflect the information environment in which investors trade while retaining the critical causal link between the fraud and the trading decision.

A final concern is the extent to which the agency costs of institutional investors interfere with the theoretical operation of the informed trading model. The institutionalization of the securities markets has led to a system in which individual portfolio managers make trading decisions on behalf of their institutional employers, yet those portfolio managers may be compensated in ways that distort their incentives, creating problems such as short-term bias, herding, and excessive risk taking.[67] Any such distortion will disrupt market efficiency, in a fundamental sense, and reduce capital-market discipline.

CONCLUSION

The extensive criticisms of private securities-fraud litigation warrant a careful reexamination of the pros and cons of the existing structure. Fox and Mitchell respond to these criticisms by focusing on the deterrence objective. Both authors ground their analysis in a broader conception of deterrence, in which securities regulation improves the corporate governance of public issuers by enabling shareholders, outside directors and the capital markets to monitor

64. *See generally* Fisch, *supra* note 13.

65. For a more extensive analysis of *Basic* and its legacy, see Donald Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151.

66. *See, e.g.*, Fisch, *supra* note 13 (arguing that *Basic* could have extended *reliance*, consistent with common-law fraud principles, to incorporate investors who relied on third-party intermediaries who were themselves defrauded). Information flow in today's markets suggests that such intermediaries play a critical role in informing investors. *See, e.g.*, *In re Merck & Co., Inc. Sec. Litig.*, 432 F.3d 261 (3d Cir. 2005) (involving significant stock-price reaction to a *Wall Street Journal* analysis of the issuer's disclosure, despite absence of a reaction to the prior securities filing containing that information).

67. *See, e.g.*, John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1326–27 (1991) (describing regulatory restrictions on investment-adviser compensation and resulting incentive problems).

corporate decision making. Under this model, protection of shareholders, rather than investors, is a primary goal of securities regulation.

Yet, the corporate-governance model requires more than disclosure; it requires market participants to acquire, evaluate and use the information disclosed by issuers. As such, the model identifies a key role for informed traders who, through their market behavior, incorporate information into securities prices. This process produces a corporate-governance externality that inures to the benefit of nontrading shareholders. Both the value of this externality and the costs borne by informed traders in producing it offer a rationale for compensating informed traders for their fraud-based losses. Ultimately, the governance story has more powerful implications than those articulated by Fox and Mitchell, because in addition to its import for deterrence, it provides a compelling answer to the circularity problem.