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(SELF-)POLICING THE MARKET:
CONGRESS’S FLAWED APPROACH TO SECURITIES LAW REFORM

Shannon Rose Selden*

ABSTRACT

In the past ten years, Congress tackled two concerns that appeared to be diametrically opposed: An excess of securities fraud litigation and an explosion of securities fraud. On the one hand, it sought to limit lawsuits against purportedly innocent corporations and on the other to stop greedy corporations from defrauding unsuspecting investors. Commentators have tended to analyze the two problems and the reforms they provoked as opposing or irreconcilable forces—one producing the other, or both as untempered congressional backlash. This Article takes a different approach. It contends that however different the problems appeared, the congressional reforms shared a single, flawed philosophy.

Despite the competing provocations and ambitions of the reforms, they share an unwarranted adherence to the principle of disclosure as the best means to attack market malfeasance. This Article examines the basis for and consequences of that unremarked regulatory consistency. Beneath the histrionics that provoked their passage, the reforms share a core faith in a dubious hypothesis: the ability of markets to self-policing through disclosure. Because Congress resists the more complex and irregular descriptions of markets that behavioral economists provide and instead relies ever more heavily on disclosure, legal models remain far too simple to capture much real world behavior—including the many possible permutations of fraud. This misplaced faith in the preventive power of disclosure impedes efforts to deter, detect and punish securities malfeasance. This Article suggests an alternative. It defends the merits of litigation, and proposes a conceptual framework and practical reforms that take advantage of third-party policing. The skeptical approach advocated here acknowledges the benefits of disclosure, but contends that securities regulations also must recognize its limitations. By questioning its assumptions, broadening its approach, and redirecting its resources toward a more diverse range of regulatory mechanisms, with greater reliance on enforcement and private litigation as the centerpiece, Congress could craft securities regulations that recognize the market’s imperfections and better protect its participants from fraud.

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(SELF-)POLICING THE MARKET: CONGRESS’S FLAWED APPROACH TO SECURITIES LAW REFORM

Over the past ten years, Congress has passed three major reform acts to address two diametrically opposed concerns: first, an excess of securities fraud litigation, then an explosion of securities fraud. In 1995 and 1998, Congress responded to the belief that corporations were plagued by litigious gadflies seeking a quick buck in early settlement, and enacted far-reaching procedural reforms to constrain private securities litigation. Then, in 2002, with the massive collapses of Enron, WorldCom, and their compatriots in corporate fraud, Congress turned its fury from greedy lawyers to greedy executives. Investors, it found, had been robbed blind by unmonitored corporations exuberantly manufacturing money through less-than-legal means. Congress again responded with a major reform of the securities laws, this time imposing extensive obligations on corporations and those associated with them.

To the extent these two crises and the reforms they provoked have been seen to have anything in common, it is generally (1) that both were overreactions and (2) that the second was a foreseeable consequence of the first. Rejecting the standard commentary, this Article offers a comprehensive analysis of the congressional "reforms" and argues that the legislation in fact derives from the same inadequate assumptions. Beneath the histrionics that provoked their passage, the reforms share a core faith in an imperfect hypothesis: the ability of markets to self-policing through disclosure.

This misplaced faith in the preventive power of disclosure impedes efforts to deter, detect and punish securities malfeasance. While publicizing material information is indeed a powerful regulatory tool, it works best when balanced with other policing mechanisms. Traditionally, congressional efforts to ensure market integrity and to eradicate fraud have recognized this and have used two devices to achieve the necessary equilibrium. One is the system of mandatory disclosure, which is designed to prevent and expose fraud before and as it happens by providing investors with the information they need to police the market from within. The other is litigation. In the form of enforcement actions, brought by the Securities and Exchange Commission, the Department of Justice, state attorneys general, and self-regulatory organizations, litigation polices the markets from without by bringing the investigative, prosecutorial, and injunctive powers of the state to bear against malfeasors. Private litigation—class and individual actions in state and federal court—adds yet another layer of policing, allowing investors not only to uncover fraud, but also to be compensated for their losses. Like wise investors, thoughtful legislators have been able to diversify their portfolios, choosing a balanced mix of options to hedge the risk that one will fail.

Unfortunately for participants in the securities markets, recent regulations are not well-hedged. Despite overwhelming evidence that markets are imperfect and increasing criticism of the economic hypotheses that support self-policing, Congress increasingly

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focuses almost exclusively on disclosure as the primary defense against market malfeasance. By reasserting without reconsidering the value of disclosure and the integrity of the market, Congress has missed opportunities to deter fraud and in fact may have enacted regulations that are poorly tailored to enhance market monitoring. Indeed, as economists have urged more complex and skeptical models of market behavior, Congress has retreated toward legal models that are far too simple to capture much real world behavior, including the many possible permutations of fraud. The misplaced congressional focus on self-policing, accompanied by a corresponding hostility toward litigation, has produced regulations with only limited capacity to deter and detect fraud.

This Article contends that although recent major securities laws purport to address diametrically opposed concerns, these laws rely on common (and faulty) theoretical assumptions and this Article offers a cohesive critique of the reform effort. While other commentators have examined the disclosure principle as a foundation for securities regulation, or the impact of the recent reforms, none have offered a cohesive critique of the role of either in contemporary efforts to address market malfeasance. This Article argues that the “reforms” simply repackaged the same theory in different guises and suggests that beneath congressional claims of reform lies a persistent reverence for markets that has prompted reflexive and poorly tailored legislation. The Article goes beyond the behavioral law-and-economics critiques of the legal principles to examine the way lawmakers’ faith in those principles has affected their legislation. Instead of designing a framework that encourages meritorious litigation to play a monitoring and deterrence role, faith in markets has produced reflexive legislation that is poorly tailored to attack market malfeasance. Even the Sarbanes-Oxley Act, which purported to respond to the massive financial frauds of the boom years by dramatically increasing measures designed to ensure market integrity, reflects this unwarranted faith and over-reliance on self-policing. It too imposes new burdens without producing a corresponding likelihood of preventing or discerning fraud. Rejecting the congressional method, this Article argues that true reform requires a more skeptical approach: An approach that uses rather than fears litigation.

The approach offered here is, therefore, a defense of litigation. Some may see this as a quaint or foolhardy position, but it is one worth defending—particularly in the face of renewed efforts to limit, if not eliminate, private securities fraud litigation. An approach to market regulation that preserves a role for litigation is an approach that is both skeptical and realistic. It requires recognition that no amount of regulation or disclosure will eliminate greed (litigant or corporate) or foil the impulse for fraud or exploitation, and that no amount of wishing or regulating can force markets to conform to highly idealized theoretical models. A skeptical and realistic approach seeks policing mechanisms that address the complex financial world as it is, not as we would like it to be.

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3. See infra Part I.A.
Adjudication requires immersion in the particular. It demands proof of particular claims and concrete losses. It deters, but also compensates when deterrence fails. It provides an opportunity for defendants to disprove ill-founded claims. It clarifies the obligations imposed by statutes and regulators. This skeptical approach to securities fraud recognizes that it is impossible to know whether and how much securities fraud occurs, how well disclosure works, or the full extent of malfeasors’ wrongdoing or validity of investors’ claims and suggests that litigation provides a means to find out. Efficient and fair markets are indeed desirable, but they cannot be expected to materialize on their own. The skeptical approach outlined here suggests that we compensate for disclosure’s limitations by employing diverse approaches to preventing, monitoring and compensating for market malfeasance. Like any good investor, Congress should hedge its bets.

Congressional caution and realism will be particularly important in response to what appears to be a renewed interest in containing private litigation. As this Article goes to press, key recommendations for legislative action are being developed and proposed by the Committee on Capital Markets Regulation, among others. Colloquially known as the Paulson Committee due to favorable comments about the non-partisan group by Treasury Secretary Henry M. Paulson, the Committee has just released its interim report. Although its recommendations do not appear to go as far as expected in favor of limiting private securities fraud actions, they do indicate a renewed interest in reshaping, and likely restraining, private civil litigation. While the implications of the Committee’s recommendations for litigants and the reform laws are too recent to be addressed in detail, perhaps the examination provided here of earlier reform efforts will offer some insight to those seeking to judge the Committee’s efforts. It is certainly not too soon to suggest that the full implications of any securities reform proposals should be considered carefully, with particular attention to their underlying assumptions and possible consequences.

Part I begins by providing an overview of the theoretical assumptions underlying the disclosure model of federal securities regulation. Disclosure—the voluntary or mandatory dissemination of information into the public realm—is purported to be the “disinfectant” that will purge the markets of malfeasance. Disclosure is the primary defense against market malfeasance: ensuring that all material information is available to all, and information in turn ensures rational bargaining and accurate valuation. As the Supreme Court describes it, because “the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive,” disclosure has long been considered the best antidote for fraud. As Part I.A. discusses, in a disclosure regime actors are posited to be self-interested, fully informed and rational. Since rational investors operate with access to all public information, they naturally will

7. See Labaton, supra note 6.
9. See id. at 90-99.
10. Buckley v. Valeo, 424 U.S. 1, 67 (1976) (“Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”) (quoting L. BRANDeIS, OTHER PEOPLE’S MONEY 62 (National Home Library Foundation ed., 1933)).
tend to negotiate prices that accurately reflect an asset's fundamental worth. The combination of rational actors and complete information creates a market system in which assets are accurately valued and efficiently exchanged. On this theory, regulation is rarely needed; if the material information is disclosed, the market will do the rest.

The efficient market and rational investor theories have come under fire from innovative work in behavioral economics, however. As Part I.B.1 recounts, behavioral economists have challenged the basic underpinnings of the traditional model by examining the decision-making process and correlation _vel non_ among price, value, and information. Their criticism of the economic model in turn has prompted legal academic questioning of the adequacy of securities regulations. If disclosure does not function as expected—if it does not disinfect because investors are not rational or markets are not efficient—then more regulation or more stringent enforcement of current rules may be needed to ensure market integrity. As the behavioralist critique will demonstrate, if the market and investors do not behave as assumed, they are not well-suited to police themselves.

Despite the behavioralists' questioning of the laws' premises, however, the assumption that markets are in general resistant to fraud remain firmly entrenched in legislative approaches to monitoring malfeasance. Part I.B.2 explains this legislative fidelity by drawing on recent works of cultural theory. It examines the powerful reverence for markets that came to dominance in the 1990's and explores how exaltation of financial markets displaced critical examination of market practices. As this section will show, faith in the integrity and possibilities of markets became the common anthem for market observers and a song that Congress could not resist.

Part II elucidates how congressional securities reform shares that misplaced faith. The securities reform acts of 1995 and 1998 and the Sarbanes-Oxley Act of 2002 all reflect an insistence on the primacy of disclosure and distrust of private litigants. Although Congress has fluctuated between vigorous condemnation of plaintiffs and of corporations, between encouraging and discouraging lawsuits, and between extensively monitoring and trusting market participants, it consistently turns to the same solution: self-policing. Part II develops this analysis from the theoretical underpinnings through the statutory framework to the concrete details of a representative civil action, the _In re WorldCom, Inc. Securities Litigation_. Part II suggests that congressional fealty to ill-founded principles may in part be responsible for creating the conditions that give rise to the very conduct it condemns.

Having considered the reform acts in detail in Part II.A., Part II.B turns to their consequences for litigants. When litigation works well, it provides an opportunity for resolution of concrete claims and either compensation or exoneration. When the legislative reforms are poorly conceived, however, they can distract from the merits of a claim. Part II.B employs a detailed study of the plaintiffs' strategies in the WorldCom securities litigation to identify precise ways in which legislative antagonism to litigation can succeed or backfire. As the WorldCom action reveals, plaintiffs who choose to do so can exploit the new reforms to advance their own interests at the expense of other wronged shareholders. By enacting legislation that responded to particular law firms and their strategies, rather than legislation that offered a clear, systemic vision of how to focus litigation on the merits of claims, Congress may have preserved plaintiffs' ability to bring exploitative litigation while missing an opportunity to encourage meritorious
private monitoring of corporate malfeasance.

Having proposed in Part II that persistent faith in the integrity and efficiency of the securities markets and a backlash hostility toward litigation produced undesirable trends in securities regulation, Part III turns to possible solutions. It suggests that market integrity would be better served by a regulatory approach that more thoroughly acknowledges, and even embraces, the uncertainty and challenges that it faces. Like the sophisticated investor, legislators should diversify: instead of relying solely on disclosure and self-policing, they should acknowledge that fraud will continue to exist and design a legal regime that allows private litigants and government enforcement actions to uncover, curtail, and compensate for it. Remediying the procedural and jurisdictional intricacies created by the 1990's reforms in favor of procedural rules that more cohesively favor federal courts and consolidated litigation would be one such step. Acknowledging the limits of disclosure might require not only increased support for enforcement actions and private litigation, but also renewed consideration of substantive regulations designed to protect investors who are unable to protect themselves. Exchanging fundamentalist faith for engaged skepticism in this fashion can shape markets that resist fraud and deserve confidence.

I. THE THEORETICAL ASSUMPTIONS UNDERLYING SECURITIES REGULATION

A. The Disclosure Principle

Federal securities regulation and litigation in the United States stand on a firm belief in the principle of disclosure. Since the first federal securities laws of the 1930s, the goal of federal financial market regulation has been to remedy information asymmetries, and the system of mandatory disclosure has been the primary means of achieving it. Information—the constant, detailed, constrained, monitored, accumulated flow of information—in all its forms serves as the first line of defense against market malfeasance and the principal guarantor of the capital market regime. Regulations crafted by Congress and the SEC mandate and order the type, form, and extent of issuers' disclosures. The reliance on public dissemination of information to ensure the integrity of the securities markets is evident not only in the initial choice to enact a disclosure rather than merit-based regime of federal regulation, but also in the recent modifications of the securities laws. Increasingly, antifraud securities reforms have replaced a system in which disclosure serves as the baseline principle but litigation serves to enforce compliance, with a regulatory framework that relies more exclusively on disclosure. As this Section shows, this disclosure-oriented regime had its inception in the first two major federal securities laws.


13. Pursuant to the Securities Exchange Act, firms that satisfy the governing criteria must file annual, quarterly, and sometimes monthly, reports. In addition to the disclosures mandated by law, issuers may also disclose information voluntarily. The "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995 increased protection for companies disclosing forward-looking information. See infra Part II.A.1.
The federal government was slow to enter the field of securities regulation. Until the New Deal, the states governed the exchange of securities through a patchwork of so-called "blue sky" laws. The state statutes established comprehensive licensing schemes, and focused on the "merits" of the proffered security by authorizing administrative authorities to prevent the offering of a security deemed to be "unfair, unjust, inequitable, or oppressive." With the stock market collapse of 1929 and the subsequent Great Depression, demand for federal market regulation prompted congressional action. The first federal law governing securities markets, the Securities Act of 1933 (the "Securities Act" or "1933 Act"), was part of the flood of legislation enacted during Franklin D. Roosevelt's first hundred days.

The Securities Act of 1933 imposed registration and disclosure obligations on companies offering securities for sale to the public. Its disclosure philosophy followed the British Companies Act while its antifraud provisions derived from the Martin Act of New York State. As the Supreme Court has observed, the 1933 Act "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud, and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." The 1933 Act established obligations in connection with the initial registration and offering of a security to the public and focuses on the responsibilities of issuers and those who aid them in this initial offering phase. It requires issuers of securities to file a registration statement when they

17. See SELIGMAN, supra note 15, at 6-7.
19. JOSEPH P. LASH, DEALERS & DREAMERS 131-136 (1988). Since the Securities Act of 1933 was enacted so swiftly, there is limited legislative history to reveal the theory behind this major law - the Act speaks for itself, however.
21. LASH, supra note 19, at 131.
23. See 1 LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATIONS 180 (3d ed. 2004). Although the role of the Martin Act in policing securities markets is beyond the scope of this Article, it should be noted that due to the efforts of New York Attorney General Eliot Spitzer, the more senior Act recently has regained a prominent role in securities regulation and market reform. See Raymond Hennessy & Phyllis Plicht, Spitzer Uses Old State Law to Target Insurers, WALL ST. J., Oct. 19, 2004, at Cl; Dennis C. Vacco, Martin Act Slammed, WALL ST. J., Apr. 12, 2004, at A18; Tom Lauricella, Deborah Solomon & Gregory Zuckerman, Mutual Funds Face Overhaul As Spitzer and SEC Fight for Turf, WALL ST. J., Oct. 12, 2003, at A1; Riva D. Atlas, S.E.C. Chief Plays Down Clash With State Attorneys General, N.Y. TIMES, Sept. 23, 2003, at C2; Jerry Markon & Charles Gasparino, For Corporate-Crime Fighters, No Law Is Old - New York Prosecutors Are Scoring As They Use the Martin Act, WALL ST. J., Oct. 2, 2002, at Cl; James Traub, The Attorney General Goes to War, N.Y. TIMES, June 16, 2002, at Sec. 6. The Martin Act has also played a significant role in criminal prosecution of high-profile white collar defendants: former Tyco CEO Dennis Kozlowski, for example, was convicted in New York State court of charges arising under the Martin Act. Markon & Gasparino, supra at Cl.
25. 15 U.S.C. §§ 77k, 77f. Compared to the Exchange Act, the Securities Act has been relatively unaffected by the recent reforms. The Securities Act's strict liability, negligence and SEC enforcement
distribute securities to the public and governs the form and content of statements and behavior related to the initial offering.\textsuperscript{26}

The following year, Congress addressed the need to regulate the secondary market for securities. The Securities Exchange Act of 1934 (the "Exchange Act" or "1934 Act") imposes ongoing disclosure obligations affecting the secondary market.\textsuperscript{27} Like the 1933 Act, the Exchange Act responded to concerns emerging from the Depression and chose obligatory disclosures and accurate information as the best means to ensure the integrity of the securities markets. Where the 1933 Act is designed to address information asymmetries at the time of initial offering, the 1934 Act imposes continuous disclosure obligations to prevent such asymmetries from reemerging in the secondary market. The SEC, the Department of Justice, and private litigants have all played significant roles in enforcing the provisions of the 1933 and 1934 Acts through investigation, prosecution, and/or litigation.\textsuperscript{28}

The two New Deal Acts, and with them the emphasis on disclosure, have dominated the federal securities regulation regime since their inception.\textsuperscript{29} The disclosure regime Congress adopted rests on two key assumptions regarding the nature of the interaction between markets and investors. First, it assumes that investors access, provisions remain potent tools in efforts to fight securities malfeasance.

\textsuperscript{26} 15 U.S.C. §§ 77e-77g.


\textsuperscript{28} In securities fraud litigation, for example, the most well-known provision of the 1934 Act is Section 10(b), 15 U.S.C. § 78j, the general antifraud provision, which in turn gave rise to the private cause of action for securities fraud created by Rule 10b-5. 17 C.F.R. § 240.10b-5 (2005).

assess, and adapt to the information disclosed. In effect, the disclosure regime holds that informed investors are their own best defense against bad deals and flawed choices.\textsuperscript{30} It says: supply investors with the information they require, trust them to evaluate that information, and allow them to choose the path that best suits their needs. In order to conceive of investors in this mold, however, one must first assume that all (or most) investors have equal access to complete information, which they rationally and thoroughly process to come to accurate conclusions. The adjectives are key to the theory; if investors truly are to be their own best defense, they must be assumed to function at a quite sophisticated level.

Second, the disclosure regime hypothesizes a thoroughly efficient market. The efficient market hypothesis ("EMH") "asserts that all financial prices accurately reflect all public information at all times."\textsuperscript{31} Thus an efficient market is a market in which assets are correctly priced given publicly available information.\textsuperscript{32} The EMH’s model of market assessments draws from the presumed ability of investors to process information quickly, rationally, and accurately when deciding the price of their transactions. On the EMH, the price at which the market arrives reflects assets’ fundamentals—that is, it optimally predicts the present value of the entitlement to future benefits that is conferred by current ownership of the share.\textsuperscript{33} According to the efficient market hypothesis, asset price changes are unpredictable because they occur only when truly new information enters the public sphere. This effect is described as the “random walk” theory: because the new information is unknown and impossible to anticipate, it produces a price movement the size and direction of which cannot be predicted with any accuracy.\textsuperscript{34} Since the price in an efficient market either reflects all publicly available information or responds without warning to the disclosure of new information, efficient markets are also assumed to be equal-opportunity markets. That is, no matter how “smart” an investor is, on the EMH she cannot beat the Street.\textsuperscript{35}

The two fundamental assumptions together place a great deal of faith in the evaluative capacity of individual decision makers and collective action. They trust that when given enough material and accurate information, investors individually and collectively can assess value, predict trends, and distinguish honesty from chicanery. The law in turn places its faith in these fundamental assumptions. By emphasizing disclosure as the primary means of ensuring market integrity, the law trusts that participants will act according to the rational investor model to produce efficient markets. Federal rules require the disclosure of information prior to and at the time of a purchase or sale based on the belief that such disclosure will help to ensure that the assets are accurately valued and that investors are not penalized by information asymmetries.

\textsuperscript{30} KHADEMian, supra note 12, at 29.


\textsuperscript{32} SHILLER, supra note 31, at 177; Efficient Capital Markets, supra note 31, at 383.


\textsuperscript{34} SHILLER, supra note 31, at 177.

\textsuperscript{35} Id. at 179. Shiller describes this assumption in terms of the equal results obtained by investors of differing aptitudes. Id.
While the regulatory regime stands on the assumptions that investors are rational and markets are efficient, economic theory has stepped away from them. Although many economists still strongly support the efficient market theory and continue to rebut its challengers, the efficient market theory and belief in investor rationality have been subjected to extensive scrutiny and criticism. The next section explores that economic theory to suggest that the law rests on a faulty foundation.

B. Questioning Assumptions About Markets

1. Behavioral Economics

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

As Paul Ormerod states, “orthodox economics cannot account for the sheer volatility of asset markets, and the paradoxes which arise” in market behavior. Stock markets are simply far more volatile than efficient markets theory would imply. Once economists allow for interaction between investors and positive feedback, they generate models “in complete contradiction to the predictions of orthodox economic theory.”

36. The work in behavioral economics draws heavily on psychologists’ insights into human decision-making and evaluative capabilities. For a cohesive analysis of the diverse literature in this area, see ROBERT E. LANE, THE MARKET EXPERIENCE (1991).

37. See, id.


39. ORMEROD, supra note 33, at 23. Robert Shiller was one of the earliest, and remains one of the leading, proponents of this work. See SHILLER, supra note 31, at 148; Efficient Markets, supra note 40; Changes in Dividends, supra note 40; Robert J. Shiller, Bubbles, Human Judgment & Expert Opinion (Cowles
Behavioral models demonstrate that investors' decisions are influenced not only by market price and publicly available information, but also by their individual psychology and their interactions with others. Yale economist Robert Shiller describes these "amplification mechanisms" and "feedback loops" as a "type of naturally occurring Ponzi process." Typical investors, Shiller notes, do not normally behave like the ideal investors of traditional economic or legal models. Instead, their emotional state and interactions with others are just as likely to influence their economic behavior as are "hard" factors like those posited by traditional theories. In addition to these influences, investor behavior is determined in part by the fact that people may hold contradictory views simultaneously and may not be definitively attached to many of their views. Because their commitments are weak, multiple, and often in tension with each other, investors do not make decisions based on a rational calculus. They are human, and apt to be swayed by emotional and societal factors. Although the EMH has not yet been completely supplanted, the behavioral finance critique is widely accepted in the economic literature.

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


42. SHILLER, supra note 31, at 56.
43. Id. at 55.
44. See Daniel Kahneman, New Challenges to the Rationality Assumption, 3 LEGAL THEORY 105, 114 (1997); Amos Tversky et al., The Causes of Preference Reversal, 80 AM. ECON. REV. 204, 214-15 (1990); Roman Frydman, Towards an Understanding of Market Processes: Individual Expectations, Learning, and Convergence to Rational Expectations Equilibrium, 72 AM. ECON. REV. 652, 664 (1982)(discussing the importance of social norms in individual decision-making and impediments to the formation of rational expectations).
example, legal commentators have used behavioral economics to examine, *inter alia*, overconfidence and internet fraud,\(^4\) the fraud-on-the-market presumption and truth-on-the-market defense,\(^5\) analyst biases,\(^6\) judicial treatment of "puffery" and "materiality,"\(^7\) the regulatory power of corporate law,\(^8\) and firms' decisions to enter markets.\(^9\)

Uncertainty regarding efficiency and rationality provides the basis to question not only the existing regulations, but also, perhaps even more importantly, the absence of regulation. As Langevoort notes, "aggressive deregulation" has been advocated on the grounds that market efficiency obviates the need for it.\(^10\) Many argue that if markets "disinfect" themselves, there is no need to burden them with government or private monitoring.\(^11\) As a result, the persistence of EMH may explain the lack of regulation in certain areas. If the premise of EMH is incorrect, and markets are not adequately self-policing, the logic of limited regulation and reliance chiefly on disclosure lacks coherence and credibility.\(^12\)

Some legal and economic commentators explain the persistence of the efficient market hypothesis by observing that although behavioral finance offers a powerful critique of traditional models, it does not conclusively establish the inefficiency of markets,\(^13\) and in fact, the "inefficiency" model's inability to account for all possible statistical variances may be one reason the debate remains open in economics and, consequently, in law. Yet it is unlikely that the unresolved issues in statistical modeling alone are adequate to account for the full extent of the EMH's continued cultural valence. There is, however, another explanation.

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50. Id. at 176-81.

51. Id. at 163-75.


58. See, e.g., Efficient Markets, supra note 40, at 89 (noting that although the aggregate stock market appears to be inefficient, individual stock prices can show consistency with the EMH); Morris Altman, The Nobel Prize in Behavioral & Experimental Economics: A Contextual & Critical Appraisal of the Contributions of Daniel Kahneman & Vernon Smith, 16 Rev. Pol. Econ. 3, 4, 6 (2004) (discussing tension between two Nobel Prize winners' work showing on the one hand that agents are irrational, and on the other that economies are efficient).
2. Faith in Markets

If the insights of behavioral economics are correct, markets are not and cannot be governed by fully informed, rational, self-interested actors. Instead, they “emerge... from the internal relations of human and machinic agents whose knowledge is always mistaken and memories as well as expectations are inescapably incomplete.”59 In this strange new world, uncertainty and complexity are the only guarantees. The “invisible hand” is no longer omniscient and omnipotent, but absent and/or unpredictable.60

This loss of certainty provokes a return to faith.61 Drawing on philosophy, economics, religion and art, Mark C. Taylor has developed a cultural philosophy of markets explaining that restoration of faith. As he describes, when economic behavior is a complex, networked form of interaction among less-than-rational actors with incomplete (and often mistaken) knowledge, markets appear far more volatile and unstable than when economic behavior is construed as reasoned and informed.62 If one accepts that people process information not through rational assessments of their own economic self-interest, but in the complicated manner conjured by behavioral theorists, markets appear to be a more uncertain and insecure place.63 Increasing recognition of this inevitable uncertainty leads to an “understandable desire for certainty, stability, and world order.”64 As in other realms, in the financial world, the desire for clarity in the face of inconsistency and uncertainty has led to a resurgence of fundamentalist faith—in this case, faith in markets. That is, when they are faced with uncertainty, people often respond by acting on faith: they reiterate their commitments to contested ideas with a vigor that is proportional to the level of insecurity they experience and without validating those ideas based on testable evidence. As Taylor puts it, the desire to return to stability, “manifest[s] itself in a resurgence of market fundamentalism.”65

In the nineties, the fundamentalists came to see markets in not just absolute, but exalted terms. The more entrenched the belief in the market became, the more marvelous were its attributes. As Thomas Frank thoroughly documents, in the popular culture of the nineties, the market came to be revered as form of divine democracy:

[B]usiness and economic thinkers [told us that] [o]nly when people act within the marketplace... do they act rationally, choose rightly, and make their wishes known transparently.... Markets are where we are most fully human; markets are where we show that we have a soul. To protest against markets is to surrender one’s very personhood, to put oneself outside the family of mankind.66

As the sole spaces of true democracy, markets neither needed nor deserved

60. Id.
61. Id. at 286.
62. Id. at 320.
63. Id. at 301.
64. TAYLOR, supra note 59, at 301.
65. Id.
extensive regulation. Instead, they must be allowed to function free from interference, so they in turn could allow investors to be free to realize their own aspirations. Frank casts this as a “deep and vicious” hostility toward government and academic critics of market populism characterized by the belief that “[s]uch figures... [could not] possibly understand the world of the market in all its mystery and complexity” and that “just by trying to figure things out they commit[ed] acts of hubris and arrogance, inexcusable offenses against democracy.”67 As Frank illuminates, the conceptualization of the market as a democratic forum offered yet another reason to limit government interference; regulation was irreconcilable with the free interactions of the market demos. Like Taylor and Stiglitz, Frank identifies a persistent religiosity in the business commentators’ demands for faith in the (redemptive) power of markets. Criticizing promoters of the new market ideology, from journalists to advertising executives to management theorists and stock market gurus, for selling a story of market democracy, Frank portrays their tale as a myth that succeeds primarily by inculcating a sense of awe in its audience. These “masters of the New Economy,” he writes, “fancy themselves an exalted race of divinities, but they counsel the rest of us to become as little children before the market.”68 Whereas they have unique insight into the market, others are to trust in them and in the market itself. The “correct intellectual posture,” demanded by market gurus was not doubt or distrust, but “the simple faith of childhood.”69 The conservative market populists argued, “[t]hat democracy was closely related to the holy acts of buying and selling, and that those who try to control the market are therefore setting themselves against nothing less than the almighty will of the people themselves.”70 Frank captures the sense that in the nineties, markets became the new religion, as well as the new democratic forum.71

II. REGULATORY ENTRENCHMENT

The major securities law reforms of the past ten years reflect precisely this type of market adulation, despite their claims to the contrary. At the same time legislators railed against corporate exploitation of market conditions and/or attorney manipulation of the legal presumptions, they enacted legislation that adheres to precisely the principles they decry. As this section shows, the market orthodoxy that dominated the business of investing also saturated the securities laws. Perversely, as economists

67. Id. at xvi.
68. FRANK, supra note 66, at 87.
69. Id.
70. Id. at 47.
71. Hannah Arendt’s description of the space of public freedom sought by revolutionaries is eerily similar to Frank’s rendering of the contemporary equation of markets with democratic possibility. For revolutionaries, Arendt says, freedom:

could exist only in public; it was a tangible, worldly reality, something created by men to be enjoyed by men rather than a gift or a capacity, it was the man-made public space or market-place which antiquity had known as the area where freedom appears and becomes visible to all.
HANNAH ARENDT, ON REVOLUTION 120 (1963). Though far-removed from the exuberance of IPOs and e-commerce, the conception of democracy in Greek political thought also centered on the publicity of the market place: “[f]reedom itself needed... a place where people could come together – the agora, the market-place, or the polis, the political space proper.” Id. at 31. The populists’ conception that “free markets are by definition the same as democracy” and that “any effort to restrict them is an act of unpardonable pretentiousness, or arrogant disregard for the Will of the People” both inverts and returns to this original conception. FRANK, supra note 66, at 47.
moved away from faith in the purifying powers of information, legislators increased the regulatory emphasis on disclosure. Instead of grasping and addressing the uncertainties identified by contemporary economics, Congress turned its back. Like the market fundamentalists Taylor and Frank discuss, Congress experienced an unlikely, and overlooked, resurgence of market fundamentalism. Legislation, budget cuts, and priority-shifting skewed securities regulation against third-party policing through litigation in favor of self-policing through disclosure.

This Part considers each of the major acts in turn, examining how they adhere to the belief that there is minimal need for civil litigants to aggressively police markets because disclosure can be relied upon to ensure their integrity. Under the most recent reforms, the relationship between disclosure and litigation has begun a strange conversion. Where adjudication and disclosure each had appeared to be necessary but not sufficient to market regulation, the recent reforms assume that when disclosure is sufficient, litigation is not necessary. This Part concludes that the law’s emerging belief that disclosure is not just a necessary, but a sufficient, means of policing markets is irreconcilable with contemporary economic theory and practical experience of securities fraud. It considers how each Act minimizes the enforcement function of private litigation and increases the work that disclosure is expected to perform. With respect to each statute, this Part considers the underlying assumptions, key provisions, and theoretical commitments embedded therein.  

A. The Reform Acts

1. The Private Securities Litigation Reform Act of 1995

In the late 1980s and early 1990s, Congress came to believe that private securities litigation did not serve markets well. At the same time, and despite strongly argued dissenting opinions, the Supreme Court accepted and reiterated the notion that frivolous and extortionate securities litigation was clogging the federal court system. Both

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73. The Supreme Court appeared to reach a similar conclusion in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 188 (1994). In rejecting a form of liability recognized by hundreds of federal cases, the Central Bank majority expressed a clear desire to protect business against what it described as “decisions made on an ad hoc basis, offering little predictive value.” Id. In so deciding, the Court warned that “this uncertainty and excessive litigation can have ripple effects,” making it difficult for emerging companies to obtain professional advice. Id. It also posited that entities facing aider and abettor liability might find it “prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial.” Id. On the dissent’s view, aiding and abetting liability not only had proven manageable, but had played an important role in reducing fraud. Id. at 197-98 (Stevens, J., dissenting).

74. Like Congress, the courts have played a significant role in developing the scope and substance of the private cause of action for securities fraud and the resulting allocation of burdens among plaintiffs and defendants. As the Supreme Court stated in Blue Chip Stamps, given the unusually limited parameters Congress and the SEC provided when they created § 10(b) and Rule 10b-5, respectively, the Court has found it “proper [to] consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.” Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975). The judiciary has played this unusually substantial role in the development of Section 10(b) claims due to the
Congress and the Court may have been listening to the chorus of critics who had emerged charging that securities fraud class action suits were driven by lawyers, not clients; based on stock price movement, not genuine fear of fraud; seeking quick settlement, not resolution on the merits; and were unjustly hampering capital formation, not legitimately policing market malfeasance.\textsuperscript{75} When the Republicans assumed control of Congress in 1994, they acted swiftly.\textsuperscript{76} The Private Securities Litigation Reform Act of 1995 ("PSLRA") was the first major reform act to emerge out of the harsh and sustained criticism of private class action securities litigation.\textsuperscript{77} While its legislative history emphasizes the perils of litigation, the specific provisions of this "reform" act reveal the congressional commitment to disclosure.

A. Distrust of Litigation

The PSLRA arose directly from key underlying beliefs about the dangers of private

\textsuperscript{75} As one \textit{New York Times} article described it, the Congressional debates were dominated by caricature. Congressional critics... vilified lawyers who file securities class-action cases as fee-hungry extortionists who do nothing to help investors. Corporate executives dismiss the plaintiffs in those suits as cynical opportunists who buy stock only to gain suing rights. Class-action lawyers condemn their corporate critics as greedy hucksters seeking a license to steal. Diana B. Henriques, \textit{Investing It: Making It Harder for Investors to Sue}, \textit{N.Y. TIMES}, Sept. 10, 1995 at § 3, 1. Henriques's article offered an alternative, balanced portrayal of both sides of the issue. \textit{Id. See also}, e.g., \textit{Suits or Straitjackets?}, \textit{ECONOMIST}, Dec. 2, 1995, at 20; Benjamin Weiser, \textit{High-Tech Firms Decry Frivolous Suits: America Online Chairman Says Laws Stacked Against Companies}, \textit{WASH. POST}, Mar. 7, 1995, at D3; \textit{Shareholder Suits; Class Acts}, \textit{ECONOMIST}, Mar. 19, 1994, at 95; Bruce Rubenstein, \textit{Cease & Desist}, \textit{CORP. LEGAL TIMES}, Sept. 1994, at 1.

\textsuperscript{76} Some blamed the haste to legislate during the first 100 days of Republican control for poorly crafted legislation. See, e.g., Jeff Gerth, \textit{Overhaul of Securities Laws: A Fast Track to Change or a Hasty Decision?}, \textit{N.Y. TIMES}, May 26, 1995, at A19 (reporting on discussion regarding the speed and possible shortsightedness of the PSLRA legislative process).

securities litigation. First, Congress was persuaded that there was a significant gap between the amount of securities fraud and the amount of securities litigation. It accepted the view that profligate plaintiffs' attorneys were filing a crippling amount of meritless lawsuits. The Senate Report, for example, observed that "although private securities class actions can complement SEC enforcement actions, the evils flowing from abusive securities litigation start with the filing of the complaint and continue through to the final disposition." Critics of private securities litigation persuasively argued that many suits were based on shifts in stock prices that naturally resulted from legitimate business and market practices, not from fraud. The breadth of § 10(b) allowed plaintiffs to bring a seemingly endless range of complaints. Section 10(b) has been described as "a catchall antifraud provision." It reaches a virtually limitless range of fraudulent conduct, as it makes unlawful the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security. In addition, unlike certain provisions of the 1933 Act, which specifically limit the range of potential defendants, any defendant who engages in fraud in connection with the purchase or sale of a security may be liable for Section 10(b) and Rule 10b-5 violations.

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78. S. REP. NO. 104-98, at 4-9 (1995), as reprinted in 1995 U.S.C.C.A.N. 679; H.R. REP. NO. 104-50(I), at 15 (1995) (adopting the view of the "many executives" who "believe that the civil liability system has been twisted and is operating against them.").


80. See id., at 4 (discussing strike suits); H.R. REP. NO. 104-50(I), at 15 (discussing strike suits).


- It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
- To employ any device, scheme, or artifice to defraud,
- To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


Congress also pointed to the generous federal pleading standards of the federal courts as particularly susceptible to exploitation by plaintiffs and their attorneys. Although Rule 9 provided that plaintiffs must plead fraud claims with particularity,86 all non-fraud claims in the same action needed to meet only the far more lenient notice pleading standards of Rule 8.87 In addition, even the burdensome Rule 9 requirements were mitigated by federal securities fraud doctrines.88 In addition, plaintiffs were able to invoke the statutory provisions enabling federal courts to exercise jurisdiction over pendent and ancillary state law claims.89 Thus, plaintiffs could pursue their state law claims using the more favorable discovery tools and notice pleading standards of the federal courts.

Congress also accepted the charge that a significant proportion of securities class actions were brought not to recover losses for deserving investors, but to obtain enormous fees for greedy lawyers.90 Extensive testimony before Congress supported these views.91 Class actions were also seen as a major (and unwarranted) impediment

86. FED. R. CIV. P. 9(b) (requiring allegations of fraud to be stated with particularity).
87. FED. R. CIV. P. 8 (requiring a complaint to contain "a short and plain statement of the claim showing that the pleader is entitled to relief.").
88. Applied literally, Rule 9 appears to require specific pleadings with respect to each element of the Section 10(b) claim, including plaintiffs' reliance on defendants' material misrepresentation or omission. In the Second Circuit, for example, an allegation of fraud must specify "](1) those statements the plaintiff thinks were fraudulent, (2) the speaker, (3) where and when they were made, and (4) why the plaintiff believes the statements fraudulent." Koehler v. Bank of Berm. (N.Y.) Ltd., 209 F.3d 130, 136 (2d Cir. 2000). The requisite scien ter may, however, be pleaded generally. FED. R. CIV. P. 9(b); Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001). The Private Securities Litigation Act of 1995 raised the pleading standard for federal securities fraud cases by adopting the language of the Second Circuit standard. See 15 U.S.C. § 78u-4(b) (2000). Although many -- including President Clinton -- feared that Congress intended to impose a pleading standard higher than the Second Circuit's, see 141 CONG. REC. S19034 (1995), courts have since reached a variety of interpretations. See also GSC Partners CDO Fund v. Washington, 368 F.3d 228, 236-67 (3d Cir. 2004); Southland Sec. Corp. v. Inspire Ins. Solutions, 365 F.3d 353, 361-65 (5th Cir. 2004); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 682-83 (6th Cir. 2004); Ronconi v. Larkin, 253 F.3d 423, 429 (9th Cir. 2001); Kalnit, 264 F.3d at 138; Koehler, 209 F.3d at 136; Christopher M. Fairman, Heightened Pleading, 81 TEX. L. REV. 551, 600-12 (2002); Gregory P. Joseph, How to Prepare for and Successfully Try a Securities Class Action in the Post-Reform Era, 1190 P. L./CORP. 89, 102-03 (2000); Michael R. Dunn, Note, Pleading Scien ter After the Private Securities Litigation Reform Act: Or, A Textualist Revenge, 84 CORNELL L. REV. 193 (1998).

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


to business and to the capital formation process. The new Congress found that class actions placed enormous burdens on corporate defendants, and gave little consideration to any countervailing benefits such actions might provide.

Tales of discovery abuses by class action plaintiffs provided an additional impetus for reform. In particular, criticism focused on the fact that plaintiffs and defendants in federal securities litigation faced asymmetrical discovery burdens. While defendants often were required to produce voluminous records and numerous deponents, plaintiffs faced few discovery obligations at this early stage of the litigation. Critics contended that plaintiffs abused the discovery rules in two ways. First, because they could take extensive discovery early in the litigation, they were able to file complaints based on little, if any, information and then attempt to unearth evidence of fraud later. Second, because discovery is disruptive, expensive and time-consuming for defendants, the threat—or reality—of extensive discovery obligations forced defendants to settle regardless of the merit of the claims. Indeed, some critics even charged that defendants and plaintiffs’ lawyers settled too early in many legitimate cases. They contended that plaintiffs’ lawyers were willing to take early settlements that provided substantial attorneys fees when they should have aggressively pursued more appropriate recovery for the members of the class.

In addition, the mere existence of unresolved allegations was alleged to have imposed undue burdens on defendants. Critics contended that merely by bringing fraud allegations plaintiffs were able to cast a pall over a defendant corporation, and that

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93. Securities fraud cases were subject to the same discovery rules as other civil actions in federal court. See Fed. R. Civ. P. 26-35. By contrast, discovery in state court practice is often stayed during the pendency of a motion to dismiss. E.g., N. Y. C.P.L.R. 3214(b) (2006) (providing that service of notice of a motion to dismiss stays the defendant’s disclosure obligations until the motion is decided).

94. The Senate Report, for example, concluded that plaintiffs “sometimes filed frivolous lawsuits” in the hopes that discovery would provide a basis for their claims. S. REP. NO. 104-98, at 14. It relied on testimony from one executive who stated that “once the suit is filed, the plaintiff’s law firm proceeds to search through all of the company’s documents and take endless depositions for the slightest positive comment which they can claim induced the plaintiff to invest and any shred of evidence that the company knew a downturn was coming.” Id. (citation omitted). According to general counsel of an investment bank, “discovery costs account for roughly 80% of total litigation costs in securities fraud cases.” Id. (citation omitted).


96. SEC Chairman Arthur Levitt testified that “counsel may have a greater incentive than the members of the class to accept a settlement that provides a significant fee and eliminates any risk of failure to recoup funds already invested in the case.” Securities Litigation Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Energy and Commerce, 103d Cong. 35-36 (1994) (statement of Arthur Levitt, S.E.C. Chairman). He also noted that if the defendant does not prevail on an early motion to dismiss, “the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.” Id. at 36.
corporations thus settled meritless claims simply in order to remove the cloud of suspicion.\textsuperscript{97} Plaintiffs—and in particular, plaintiffs’ class action lawyers—were believed to be exploiting this side effect of litigation to extort settlements far greater than the likely and appropriate value of a recovery at trial.\textsuperscript{98}

The PSLRA reflects deep suspicion towards private litigation as a legitimate means of addressing securities fraud. Each of the driving assumptions of the Act stems from a belief that the amount of securities litigation far exceeded the amount of securities fraud. Condemnation of the frequency of suits, the extensive use of federal discovery mechanisms, and large settlements all amount to condemnation of the process of litigation itself. When Congress enacted the PSLRA, it codified the belief that litigation was much less necessary and less useful than plaintiffs had claimed.

\textbf{B. The PSLRA Reforms}

To describe the PSLRA merely as an anti-litigation statute is to miss its second, equally important, philosophy, however. Significant PSLRA provisions not only limit lawsuits, but also reflect and codify an on-going faith in disclosure as the primary means of preventing and exposing securities fraud. These key reforms of the PSLRA include (a) a heightened pleading standard, requiring plaintiffs to include allegations giving rise to a strong inference of fraudulent intent on the part of defendants;\textsuperscript{99} (b) an automatic stay of discovery upon the filing of a motion to dismiss;\textsuperscript{100} (c) lead plaintiff provisions designed to wrest control of the litigation from lawyers and return it to their clients—the class and its representatives,\textsuperscript{101} and, (d) a statutory safe-harbor for forward-looking statements.\textsuperscript{102}

First, the heightened pleading standard requires allegations that give rise to a strong inference of fraudulent intent. Because plaintiffs must make these allegations in the complaint—at the very commencement of litigation, prior to any initial disclosures or discovery—such allegations can only be possible if sufficient evidence of the defendants’ fraudulent intent is publicly available. Although it may be easily established in some cases, the scienter necessary to sustain a Section 10(b) claim can be difficult to plead in detail prior to discovery. Indeed, Rule 9 of the Federal Rules of


\textsuperscript{98} S. REP. No. 104-98, at 21-22.


\textsuperscript{100} See 15 U.S.C. § 77z-1(b) (2000); § 78u-4(b)(3)(B) (amending Section 27(b) of the 1933 Act and Section 21D(b) of the 1934 Act).

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

\textsuperscript{102} See § 77z-2; § 78u-5 (amending the 1933 and 1934 Acts).
Civil Procedure, which governs the pleading of fraud claims, recognizes this difficulty by permitting scienter to be pleaded generally, rather than with the particularity required of other fraud allegations. The PSLRA’s heightened pleading standard instead assumes that in meritorious fraud cases, public information will provide sufficient evidence of intent to enable plaintiffs to meet this high threshold.

Second, the PSLRA requirement that discovery be automatically stayed upon the filing of a motion to dismiss securities fraud claims also reflects a belief that all of the information required to plead the fraud claims will be publicly available. Again, the legislation trusts in disclosure to provide the basis for enforcement. This kind of legislation limits the investigative power of litigation. On this approach, litigation has no independent expositive purpose: it is primarily forced to seek redress for fraud that is already evident. Here, litigation must serve to process claims, not monitor markets. The true monitoring is to be done through public disclosure.

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

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

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103. Under Rule 9(b), “[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally.” FED. R. CIV. P. 9(b).
104. Milberg Weiss was singled out for particular castigation during the legislative process. See John R. Wilke & Scott J. Paltrow, Prosecutors Step Up Probe of Milberg Weiss Law Firm, WALL ST. J., Aug. 8, 2005, at A1. Recently, news reports have stated that federal prosecutors have been investigating Milberg Weiss for four years in connection with the firm’s practices in civil securities class actions. Id. One of the “professional plaintiffs” has been indicted, and three partners of the former firm — including William Lerach, their lead lawyer for the WorldCom litigation — have been told that they face possible criminal indictment. Id. See also Timothy L. O’Brien & Jonathan D. Glater, Robin Hoods or Legal Hoods? The Government Takes Aim at a Class Action Powerhouse, N.Y. TIMES, July 17, 2005, BU, at 1.
person that “has the largest financial interest in the relief sought by the class” who otherwise satisfies Rule 23.105

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

After the PSLRA’s adoption, commentators and corporate defendants closely followed class action plaintiffs’ responses. Many securities class actions continued to be filed in federal court, but it appeared that the number filed in state courts had increased significantly.106 It seemed that the PSLRA had shifted the balance in favor of state litigation: post-PSLRA, the benefits of state court compensated for having to forego some of the advantages of federal court.107 Only a few years after its implementation, many proponents of the securities reforms concluded that the PSLRA had failed.108 They returned to Congress with new complaints about exploitative plaintiffs’ strategies, and sought additional legislation designed to further constrain class action litigation and to effectuate the PSLRA requirements.109


Congress responded to the plaintiffs’ adaptations to the PSRLA by enacting a second major securities litigation reform act. Passed in 1998, the Securities Litigation Uniform Standards Act (“SLUSA”)110 contains procedural requirements designed to return securities fraud class actions to federal court in order to give effect to the litigation restrictions of the PSLRA. SLUSA’s main achievement in this regard is its approach to preemption and removal of the offending class actions. SLUSA preempts securities fraud claims under state law, when alleged in “covered class actions.”111 Its

105. § 77z-1(a)(3)(b). By preferring the appointment of the person or persons with the largest financial interest in the action, the lead-plaintiff provisions adopted a preference for large institutions over individual investors.


107. See Loss & Seligman, supra note 19, at 424-46.

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

109. Id.


111. “Covered class actions” are defined in reference to the “covered securities” that Congress defined and subjected to exclusive federal regulatory authority in Section 18 of the National Securities Markets Improvement Act of 1996. See 15 U.S.C. § 77r(a) (1997); 15 U.S.C. § 77r(b)(1)-(4) (1997 & Supp. 2006). The covered class action provision includes a “carve out” designed to exclude from preemption state lawsuits
preemption provision provides:

No covered class action based upon the statutory or common law of any State... may be maintained in any State or Federal court by any private party alleging – (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security. 112

SLUSA’s narrow focus is evident on its face. It does not preempt state law securities fraud causes of action; instead, it preempts state securities fraud claims only when they are alleged by a “covered class action.” 113 SLUSA’s approach reflects its underlying assumptions: that class actions (not state securities laws) are dangerous and federal law must rein them in. 114

SLUSA ensures a particularly aggressive form of preemption. Typically, when a state law claim is preempted by federal law, the motion to dismiss would be decided by the state court: where federal law preempts, the state court is required to dismiss. SLUSA, by contrast, requires the action first to be removed to federal court, then, when appropriate, to be dismissed by the federal court as preempted by the federal law. 115

The removal provision is designed to prevent securities fraud class action plaintiffs from circumventing the reforms of the PSLRA through tactical use of state court procedures and, more broadly, from using the state courts to their advantage at all. Congress (and the corporate lobby) feared that if class actions alleging state fraud claims were preempted but not removed, extensive litigation over whether or not the claims were covered could still continue in state court. 116

SLUSA’s removal provision helps render the PSLRA effective in two ways. First, removal triggers the federal PSLRA discovery stay, thus preventing plaintiffs from evading that restriction and burdening defendants with discovery requests that the PLSRA sought to limit. 117 Second, because the question of preemption will be decided by federal, rather than state, courts, Congress expected the SLUSA removal provision to provide greater uniformity in interpretation of the scope of preemption. 118 By targeting


113. Id.

114. A.C. Pritchard, Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998, 78 WASH. U. L.Q. 345, 437 (2000) (discussing also the uniqueness and constitutionality of the SLUSA preemption and removal provisions). Despite its facially narrow focus, SLUSA’s place in the accumulation of federal securities law reforms may have caused it to have a more significant effect on the basic federal/state divide over corporate governance than one might expect. See Robert B. Thompson, Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue, 62 LAW & CONTEMP. PROBS. 215, 215 (1999). Thompson has argued that SLUSA’s enactment shifted this balance and increased the importance of shareholders’ voting role relative to other shareholder functions. Id. at 215-16.

115. See Pritchard, supra note 114, at 490-91.

116. H.R. REP. NO. 105-640, at 16 (1998) (“This provision is designed to prevent a State court from inadvertently, improperly, or otherwise maintaining jurisdiction over an action that is preempted . . . .”).

117. Pritchard, supra note 114, at 491.

118. Id.
the form, rather than the content, of securities actions, SLUSA has achieved its stated goal: federal courts are now, with limited exception, the sole fora in which class actions involving covered securities may be pursued.  

Like the PSLRA before it, SLUSA was driven by key underlying assumptions regarding private securities litigation. First, it responded to concerns that the PSLRA had not constrained securities litigation, but merely had shifted it from federal to state court. How Congress— influenced heavily by anti-class action commentators and the corporate lobby—perceived this shift determined its response. It appeared to many that the shift from federal to state court simply indicated how far the greedy plaintiffs’ bar was willing to go to extort settlements (and their exorbitant attorneys’ fees) from corporate targets. Few, if any, suggested that the suits had shifted because investors continued to be defrauded and to need fora in which to pursue their claims. Few, if any, contested the assumptions that the shift had indeed occurred and that it was undermining the PSLRA reforms. In addition to concerns about the ways in which

119. In February 2005, Congress passed and the President signed into law legislation that applies a SLUSA-like approach to all major, national class action litigation. Class Action Fairness Act of 2005, Public Law 109-2, 119 Stat. 4 (2005). Like SLUSA, the Class Action Fairness Act of 2005 (“CAFA”) was motivated by concerns about the merits and extortorate effects of class action litigation, and the over-zealous and allegedly self-interested role played by plaintiffs’ attorneys. See H.R. 1115, 108th Cong. § 2(a)(4)(A) (2003) (finding that “through the use of artful pleading, plaintiffs are able to avoid litigating class actions in Federal court, forcing businesses and other organizations to defend interstate class action lawsuits in county and State courts where . . . less scrutiny may be given to the merits of the case.”). Other have noted that “Congress appears to have been motivated by state courts’ purported inability or unwillingness to control class action settlements or curtail attorneys’ fees.” Elizabeth J. Cabraser, The Class Action Counterreformation, 57 STAN. L. REV. 1475, 1515 (2005). CAFA amends the federal diversity jurisdiction statute to extend the jurisdiction of the federal courts to a broad range of class action litigation. 28 U.S.C.A. § 1332(d)(2)(A) (West 2006). It eliminates the requirement of complete diversity among defendants and class representatives by permitting jurisdiction where any class member is diverse from any defendant. In addition, CAFA amends the amount-in-controversy requirement for class actions to provide that “the claims of the individual class members shall be aggregated” to meet the requirement, rather than considered individually, as under the prior law. See 28 U.S.C.A. § 1332(d)(6) (West 2006). CAFA does include certain limitations on federal jurisdiction over such interstate class actions, however. See 28 U.S.C.A. § 1332(d)(9) (West 2006). Like SLUSA, it includes what amounts to a Delaware carve-out by excluding class actions that relate to the internal affairs or governance of a corporation and that arise under the law of the state of incorporation or organization. § 1332(d)(9)(B). Also, since SLUSA already preempts and removes class actions regarding covered securities, they are excluded from CAFA’s purview. § 1332(d)(9)(A). CAFA also includes exceptions regarding the number and/or type of plaintiffs and defendants who are citizens of the state, the total number of class members, and the involvement of States or State officials as defendants. See 28 U.S.C.A. §§ 1332(d)(2)-(5) (West 2006).

120. For example, Senator Christopher Dodd explained that new legislation was needed in part because the PSLRA was “working so well on the Federal level that weaker claims have migrated from Federal courts to State courts . . . a development that threatens . . . the success that we have achieved to date in this general area.” The Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs, 105th Cong. 15 (1997) (statement of Christopher J. Dodd, member, S. Comm. on Banking, Housing & Urban Affairs). This sentiment was reflected in the language of the statute itself. Securities Litigation Uniform Standards Act of 1998, § 2(2), Pub. L. No. 105-353, 112 Stat. 3227, 3227 (1998) (codified in section 15 U.S.C. § 78(a)) (“The Congress finds that . . . since enactment of [the PSLRA], considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts . . .”). See also H.R. CONF. REP. NO. 105-403, at 13 (1998); Painter, supra note 106, at 42-45 (describing this claim and questioning its empirical support). For studies assessing the migration, see generally supra note 126.

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

122. Noteworthy among the exceptions were Richard Painter and Joel Seligman—Seligman’s cautionary analysis coming even before the passage of the PSLRA. See generally Painter, supra note 106; Seligman,
plaintiffs' adaptations had rendered the PSLRA ineffective, Congress responded to concerns that an increase in state claims and state litigation would in turn produce an increase in state legislation. Citing reforms proposed by the plaintiffs' bar in California, many warned that securities regulation was on the verge of a "race-to-the-bottom," in which states would enact laws in a competition to be generous to plaintiffs and hostile to nationally traded public companies.

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

3. The Sarbanes-Oxley Act of 2002

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

Although in 2002 the tide had turned from condemnation of plaintiffs' lawyers to that of corporate malfeasant, the congressional response to the flood of fraud was largely an emphatic reaffirmation of faith in the disclosure principle. The Senate Report described the Act's purpose as

...to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years.... The bill... requires steps to enhance the direct responsibility of senior corporate management for financial reporting and for the quality of financial disclosures made by public companies.

supra note 12.


124. Of course, whether this is a race to the top or to the bottom depends on one's perspective. But many considered the possible consequences of a "Delawarization" of state securities fraud laws. See Painter, supra note 106, at 71-75 (discussing this debate); Perino, supra note 14, at 322-29.


126. Id. at 516.

As this statement of purpose indicates, the Sarbanes-Oxley Act focuses on personal and entity responsibility for the integrity of public issuers' financial disclosures. Unlike the PSLRA and SLUSA, the Sarbanes-Oxley Act concentrates on creating structural remedies for the information asymmetries in initial and secondary markets, not on managing securities litigation. The Sarbanes-Oxley Act entrusts disclosure and gatekeeper monitoring—not government or private litigation—with primary responsibility for averting fraud. As discussed below, in addition to the new disclosure requirements, some of the most wide-ranging and much-discussed provisions of the Act are those that impose new monitoring and reporting responsibilities on companies' executives and directors and on their outside accounting and legal experts.

The Sarbanes-Oxley Act is a response to revelations of fraud by imposing additional disclosure requirements on public companies. In particular, the new obligations are designed to heighten transparency with respect to executive compensation and off-balance sheet arrangements. The Sarbanes-Oxley Act also requires the SEC to adopt rules regarding disclosure of off-balance sheet transactions in quarterly and annual reports, in order to prevent Enron-esque obfuscation of off-balance sheet transactions through the use of special purpose entities.

Because the Sarbanes-Oxley Act is a response to the massive accounting frauds at companies like Enron and WorldCom, it focuses extensively on improving the accounting oversight of publicly traded companies. The Act established the Public Company Accounting Oversight Board, a private organization charged with registering, inspecting, investigating, disciplining and setting audit standards for public accounting firms that provide audit reports for issuers covered by certain of the securities laws.

130. In support of increased financial disclosure, former SEC Chairman Richard Breeden testified before the Senate committee that:
Some of Enron’s financing vehicles appear to have been structured to let the company report income that had never occurred, and that might never occur, while essentially arming a neutron bomb in its financial structure. That this was not clearly disclosed, and that nearly 50 percent of Enron’s assets could have been held off balance sheet, demonstrates that both GAAP and SEC disclosure standards need an expedited review and some fast corrective action to increase transparency. The SEC and FASB should work together to structure an appropriate combination of policies, with more on balance sheet treatment and vastly more disclosure.
131. Ruder, supra note 130, at 1127. In general, "the SEC rules implementing section 401(b) establish comprehensive and detailed disclosure standards for using non-GAAP financial measures, while preserving antifraud remedies." Id. at 1137.
The Act's other provisions also focused on financial accounting and sought to ensure the integrity of the auditing process. Among other things, it prohibits accounting firms from providing certain delineated nonaudit services to their clients, regulated public company audit committees and reliance on corporate audits, and imposed responsibility for financial reporting on executive officers.

The Sarbanes-Oxley Act also placed additional responsibility on corporate executives. First, it sought to reduce executive fraud and mismanagement by limiting various opportunities for executives to abuse compensation mechanisms. Second, the Act made executives explicitly and publicly responsible for the accuracy of financial reports filed with the SEC. Three separate provisions required certification of the accuracy of reports filed with the SEC: Sections 302, 404, and 906 (and the rules promulgated thereunder) use certification requirements to encourage corporate management to control and evaluate internal disclosure controls and procedures. The SEC's implementation of the reforms also focused heavily on disclosure. Pursuant to the Act, the Commission accelerated the filing deadlines for quarterly and annual reports, expanded the range of events that triggers the requirement of filing a current report, mandated detailed discussions in the MD&A sections, imposed executive certification requirements, and adopted pro forma disclosure regulations.

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

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

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

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

Just as plaintiffs responded to the PSLRA by relocating securities actions to state courts, they responded to SLUSA by pleading their claims to avoid the reform’s procedural constraints. Since SLUSA targeted the form of the civil action, plaintiffs transformed to avoid it. Although many plaintiffs and their counsel have chosen to pursue traditional class actions in the federal fora required by SLUSA, others have explored alternative litigation strategies that they believe have the potential to increase their recovery and provide positions of greater strength for settlement negotiations. The litigation arising from the collapse of WorldCom illustrates both the stark contrast between these approaches and the dangers of focusing securities reforms on plaintiffs’ strategies.145 As the WorldCom litigation demonstrates, it is the particular choices made by individual plaintiffs and their counsel, not the fact of litigation per se that can cause problems of waste, extortion and duplication in securities litigation. The two strategies employed by major plaintiffs in the WorldCom litigation reveal how securities litigation can both advance the law of market regulation and unduly burden defendants and the courts. Those strategies are analyzed in detail below.

WorldCom, Inc. had emerged from the obscurity of life as Long Distance Discount Services of Clinton, Mississippi, to become one of the world’s largest telecommunications companies: in the frenzied days of the telecom bubble, WorldCom stock traded at a peak of sixty-four dollars, and was enthusiastically lauded by analysts.146 In the summer of 2002, as the aftershock of Enron’s bankruptcy continued to resound, WorldCom topped the toppled energy giant by filing the largest bankruptcy in U.S. history.147 In late June, WorldCom announced that it had improperly treated more than $3.8 billion in violation of generally accepted accounting principles and would have to restate its publicly reported financial results.148 As it announced ever-greater restatements, the company, its executives, directors and those associated with them became the subject of extensive civil litigation, SEC investigation, Department of Justice prosecution, state and industry enforcement action and public castigation.149 While the full scope of the WorldCom collapse and subsequent legal action is worthy of its own exegesis, elucidating the effects of the federal securities reform acts requires a more narrow focus on the civil litigation.

The civil actions arising from WorldCom’s collapse offer a unique opportunity to examine the role of a plaintiff in securities litigation.150 The two largest pension funds in the United States both filed civil suits, but pursued very different strategies: the two approaches illuminate both the successes and failures of the nineties reform acts, and the dangers and issues in securities litigation reform more generally. The routes chosen

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145. Speaking of disclosure, the author was a law clerk to the Hon. Denise Cote during 2003. The views expressed herein are mine alone.
147. Id. at 392.
148. Id. at 401.
149. See id. at 392-406.
150. Although the analysis that follows examines two of the most significant approaches to litigating claims arising from the WorldCom fraud, others also pursued distinctive strategies. Attorneys in Mississippi, for example, filed numerous state actions on behalf of small groups of individuals, in hopes of avoiding SLUSA’s removal provisions. See also, Jeffrey T. Cook, Recrafting the Jurisdictional Framework for Private Rights of Action Under the Federal Securities Laws, 55 Am. U. L. R. 621, 624 (2006).
by the New York State Civil Retirement Fund and the California Public Employees Retirement System are considered below.

The New York State Civil Retirement Fund ("NYSCRF"), the second-largest pension fund in the country, was one of the largest institutional investors in WorldCom: it claimed to have lost $300 million in the company's collapse.\(^1\) Like numerous other defrauded investors, including countless pension funds, NYSCRF brought suit soon after the restatement announcement.\(^5\) As one of the largest institutional investors, NYSCRF sought appointment as lead plaintiff pursuant to the PSLRA lead plaintiff provisions.\(^15\) The district court consolidated NYSCRF's suit and the many other class actions that had been filed in the Southern District of New York and granted NYSCRF's motion for appointment as lead plaintiff for the consolidated class action.\(^154\) NYSCRF's counsel was appointed as lead counsel for the consolidated class. On behalf of the consolidated class actions (now captioned the In re WorldCom, Inc. Securities Litigation) NYSCRF filed a consolidated amended complaint on behalf of the class in October of 2002.\(^155\)

The Consolidated Complaint asserted a wide range of claims against a lengthy list of defendants.\(^156\) WorldCom itself, however, was not among those named. Because WorldCom had filed for Chapter 11 bankruptcy, the automatic stay provisions of the bankruptcy laws protected it from litigation.\(^157\) The bankruptcy stay did not protect the numerous others implicated in the company's collapse, however. The lead plaintiff's class action complaint pleaded extensive allegations against former WorldCom executives,\(^158\) underwriters of WorldCom's two major bond offerings, directors and former directors, accountants,\(^159\) and those responsible for issuing financial analyst reports regarding the company.\(^160\) The complaint alleged that the defendants had

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152. See id. at 400-01.  
153. Id. at 397-98.  
155. The corrected, amended consolidated complaint filed after disposition of the motions to dismiss and to certify the class can be found as Complaint, In re WorldCom, Inc. Sec. Litig., 2003 WL 23671651, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Dec. 1, 2003).  
156. Id.  
158. The complaint named four of WorldCom's former executives as defendants: Bernard J. Ebbers, the President, CEO and a director; Scott D. Sullivan, the Chief Financial Officer and a director; David F. Myers, the Controller and Senior Vice President; Buford Yates, Jr., the Director of General Accounting. Complaint, In re WorldCom, Inc. Sec. Litig., 2003 WL 23671651, No. 02 Civ. 3288 (DLC) (S.D.N.Y. Dec. 1, 2003). Before the class complaint was filed, Yates and Myers had pleaded guilty to securities fraud and conspiracy, and Myers had pleaded guilty to filing false documents with the SEC. Id. On March 2, 2004, Sullivan pleaded guilty to criminal violations of the federal securities laws. In re WorldCom, Inc. Sec. Litig., 336 F. Supp. 2d 310, 314 n.11 (S.D.N.Y 2004) (Nos. 02 Civ. 3288 DLC, 03 Civ. 2841). Sullivan then testified against Ebbers, who was convicted on nine counts of conspiracy, securities fraud, and related crimes. United States v. Ebbers, 458 F.3d 110, 112 (2006). Both men have been sentenced to federal prison terms, Ebbers for a twenty-five year sentence. Id. at 117.  
159. Arthur Andersen LLP, Andersen UK, Andersen Worldwide SC, and two Andersen partners. Arthur Andersen LLP had also been Enron's accountant and auditor. Complaint, supra note 168.  
160. Id. The complaint included claims against Salomon Smith Barney in its role as an underwriter for the bond offerings, and against it and its parent Citigroup and analyst Jack Grubman in connection with Grubman's analyst reports. Id.; In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d at 400, 404. The complaint
violated Sections 11, 12 and 15 of the 1933 Act, which provide liability in connection with material misstatements in registration statements and prospectuses filed in connection with an initial offering and for control person liability in connection with these underlying violations; and also that they had violated Sections 10(b) and 20(a) of the 1934 Act, which create the private cause of action for securities fraud and liability for those who "control" those who committed the underlying fraud. In sum, the plaintiffs brought both securities fraud claims and strict liability and negligence claims against a wide spectrum of those they believed responsible for the fraud and their resulting losses.

The California Public Employees Retirement System ("CalPERS"), by contrast, pursued an individual action in California state court. It did not join in the class action; much less seek appointment as lead counsel. Although it also named former WorldCom executives, directors and former directors, and many of the same underwriter defendants, its allegations were much more limited. CalPERS pleaded a single cause of action—a Section 11 claim based on one of WorldCom’s two major bond offerings.

161. Complaint, In re WorldCom, Inc. Sec. Litig., 2003 WL 23671651, No. 02 Civ. 3288 (DLC). Section 11 provides that any signer, director of the issuer, preparing or certifying accountant, or underwriter may be liable if "any part of the registration statement... contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . ." 15 U.S.C. § 77k(a) (2000). Purchasers have standing to sue pursuant to Section 11 whether they bought the securities at the initial offering or in the aftermarket. Id. Those who purchase more than twelve months after the issuance of the statement do not need to prove reliance in order to recover. Id. Section 11 also provides an affirmative defense. If defendants can prove that the security's loss in value is due to something other than the alleged misrepresentation or omission on which the claim is based, defendants need not pay damages. 15 U.S.C. § 77k(e) (2000). Section 12(a)(2) allows a purchaser of a security to bring a claim against a seller who "offers or sells a security... by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements... not misleading." 15 U.S.C. § 77k(a)(2) (2000). Section 12 does not require a showing of scienter: a seller may be liable without "proof of either fraud or reliance." Gustafson v. Alloyd Co., 513 U.S. 43 (1995). Like Section 11, Section 12 contains an affirmative defense. 15 U.S.C. § 77k(a)(2). Section 15 provides that "every person who, by or through stock ownership, agency, or otherwise... controls any person liable" under Sections 11 or 12 shall be liable. 15 U.S.C. § 77o (2000). Sections 11 and 12, and Section 15 which derives from them, provided the bases for claims against a limited array of potential defendants, for more limited damages than those available under Section 10(b) and Rule 10b-5. They are in effect, however, strict liability and negligence provisions in which proof is relatively easy to establish and the defendants bear heavy burdens to rebut.

162. Complaint, In re WorldCom, Inc. Sec. Litig., 2003 WL 23671651, No. 02 Civ. 3288 (DLC). See also, supra, note 84 (discussing Section 10(b) and Rule 10b-5). As discussed above, Section 10(b) and Rule 10b-5 provide more extensive liability than the 1933 Act provisions, but are more difficult for plaintiffs to establish. Section 20(a) provides that "every person who, directly or indirectly, controls any person liable under any provision of this chapter... shall also be liable joint and several with and to the same extent as such controlled person... unless the controlling person acted in good faith..." 15 U.S.C. § 78t(a) (2000). As its text indicates, Section 20(a) broadens the range of defendants who may be liable for damages for the underlying fraud.


CalPERS's strategy was straightforward: it limited its claims in order to remain in state court. If it had pleaded claims pursuant to Section 10(b) and Rule 10b-5, its action would have had to be removed to federal court, which has exclusive jurisdiction over those claims.\textsuperscript{166} If it had pleaded class, rather than individual, claims, it would have been removable pursuant to the class action removal provision of SLUSA. Aside from the home court advantage, it may not be immediately apparent why CalPERS pursued such a narrow suit in a case involving such massive losses and near-certain fraud. In fact, the true advantage to CalPERS's strategy was not to be unique, but to be nearly identical to other actions.

CalPERS's strategy was designed to succeed as part of a larger conglomerate of purportedly individual actions. CalPERS's attorneys, from the San Diego office of Milberg Weiss Bershad Hynes & Lerach LLP,\textsuperscript{167} represented approximately one hundred and twenty other public and private pension funds.\textsuperscript{168} Milberg Weiss persuaded their numerous pension fund clients to pursue individual actions in each of their home state courts. On behalf of these "independent" but like-minded plaintiffs, Milberg Weiss crafted a narrow complaint that it filed in each action in state courts across the country, with only minor changes to accommodate the factual circumstances of each action.\textsuperscript{169}

By filing individual yet coordinated actions, the pension funds represented by Milberg Weiss (referred to in the district courts' opinions and hereinafter as the "Milberg Weiss Actions") sought to achieve the benefits of coordinated litigation without the constraints of class action. Milberg Weiss represented that it would negotiate and litigate on behalf of all of its individual clients; thus bringing to bear the full force of their joint claims while ensuring that they avoided the federal removal and consolidation that would follow had they filed suit as a class.\textsuperscript{170}

Milberg Weiss' tactics in the WorldCom securities litigation are exemplary of the type of "plaintiffs' attorney" conduct that so outraged Congress when it passed the 1995 and 1998 reform acts.\textsuperscript{171} As the district courts' opinions and orders repeatedly found, the claims alleged by CalPERS and the other Milberg Weiss Actions were precisely the same as those raised by the class.\textsuperscript{172} The court found that the claims raised by the individual Milberg Weiss Actions

all arise from the same underlying course of conduct that serves as the basis for the

\textsuperscript{166}. \textit{In re WorldCom, Inc.} Sec. Litig., 293 B.R. at 315.
\textsuperscript{167}. According to some, the WorldCom litigation was partially to blame for Milberg Weiss' final decision to split into two firms—and East and West Coast branches. \textit{See} Timothy L. O'Brien, \textit{Behind the Breakup of the Kings of Tort}, N.Y. TIMES, JULY 11, 2004, § 3 at 1. In particular, the May 23 letter to potential plaintiffs (discussed below) was said to have "infuriated" Melvyn Weiss and to have been the final provocation for the dissolution of his partnership with William Lerach. \textit{Id.}
\textsuperscript{168}. \textit{In re WorldCom, Inc.}, 294 F. Supp. 2d. at 435.
\textsuperscript{169}. \textit{Id.}
\textsuperscript{170}. \textit{In re WorldCom, Inc.}, Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 22701241, at *5 n.1 (S.D.N.Y. Nov. 17, 2003).
\textsuperscript{171}. Indeed, the district court found that Milberg Weiss had failed to include critical information in its letters soliciting clients, and that it had failed to adequately advise its clients regarding key aspects of the litigation. It found that "Milberg Weiss does not appear to have presented a forthright description of the advantages and disadvantages of both the individual action and class action options," and described in detail key failings of Milberg's representations. \textit{Id.} at *7.
\textsuperscript{172}. \textit{Id.}
claims addressed to the May 2000 and May 2001 bond offerings, and indeed, for the claims in the Securities Litigation addressed to the trading in WorldCom's equity securities... They do not rely on any issue, such as an accounting irregularity, not set forth fully in the complaint in the Securities Litigation. 173

In addition, the Section 11 and 12 claims brought by the Milberg Weiss Actions were among the most straightforward to establish. Unlike Section 10(b) claims, they required no scienter showing and had a much lower threshold with respect to causation. CalPERS and the plaintiffs in the other Milberg Weiss Actions had purchased securities in the same bond offerings, in reliance on the same statements, and with the same consequences as plaintiffs in the class action—there simply was very little (if anything) that was unique about the so-called “individual actions.” 174

Instead, the sole benefit to be gained by pursuing separate, state court claims was leverage in settlement. By pursuing coordinated (but not class) actions in over twenty-five states, the Milberg Weiss plaintiffs sought to spread the defendants' resources thin. 175 Although the federal class action litigation was automatically subject to the discovery stay of the PSLRA, discovery in the state court actions could proceed. Had discovery proceeded in all actions, the number of discovery demands and motions seeking identical information and alleging identical claims would have multiplied exponentially. Such duplication adds nothing to the adjudication of the underlying merits of the claims. The spreading of resources and competing actions does, however, greatly increase the pressure to settle due to the sheer cost of litigation for defendants and the uncertainty of multiple actions and potentially inconsistent decisions.

In the WorldCom litigation, such burdens were to some extent avoided due to WorldCom's bankruptcy, despite Milberg Weiss' unceasing efforts to separate its actions from the quickly moving class litigation. The bankruptcy laws not only prevent litigation against a bankrupt issuer, but also permit removal to federal court of all actions related to the bankruptcy. 176 Defendants successfully argued in the vast majority of the individual actions that the claims were sufficiently related to WorldCom's bankruptcy to fall within the purview of the bankruptcy removal


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


176. Section 1334(b) of the Judicial Code, 28 U.S.C. § 1334 (2000), provides for federal jurisdiction over cases having to do with bankruptcy proceedings. It states that “the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.” Id. (emphasis added). Section 1452(a) provides for removal to federal court of cases over which the federal courts have original jurisdiction. 28 U.S.C. § 1452 (2000).
provision. The defendants succeeded in removing the cases to federal court, and in keeping them there.\textsuperscript{177} As each of the cases was removed to federal court, it fell within the MDL transfer order and was sent to the Southern District of New York to be handled with the class action.\textsuperscript{178}

What are the lessons of WorldCom? First, plaintiffs (and their lawyers) are not indistinguishable. They pursue different strategies, for their own purposes, with varying degrees of success. As a result, the PSLRA and SLUSA were both under- and over-inclusive. Second, Congress was correct to believe that plaintiffs’ litigation is sometimes designed solely for unfair strategic advantage—employing tactics designed to expand the scope of their clients’ recovery due not to an expansive view of the merits, but solely to unwarranted stretching of defendants’ resources and the resulting “edge” gained in settlement negotiations. The Milberg Weiss Actions starkly demonstrate this: they added nothing to the determination of the merits, but came close to achieving a massive advantage in settlement solely through their procedural posture. Third, however, litigation can and does serve a purpose. There can be no question that executives at WorldCom engaged in extensive fraud that resulted in massive losses for millions of investors: While those investors cannot hope to recover in full the nearly twenty billion dollars they claimed to have lost, the class litigation was able to achieve some degree of remuneration for them.\textsuperscript{179} The class action not only provided some remedy for its constituents, but also served to expose numerous dubious practices and to force the court, defendants, and commentators to consider a wide range of important but rarely scrutinized legal issues. Among other things, the litigation raised the question of


\textsuperscript{178} See \textit{In re WorldCom, Inc.}, 2003 WL 21219037. See also \textit{In re WorldCom, Inc. Sec. Litig.}, No. 02 Civ. 3288(DLC), 2003 WL 21242882 (S.D.N.Y. May 28, 2003) (consolidation order); \textit{In re WorldCom, Inc. Sec. Litig.}, No. 02 Civ. 3288(DLC), 02 Civ. 8981(DLC), 2003 WL 31867720 (S.D.N.Y. Dec. 23, 2002) (addressing consolidation of the individual actions with the class actions); Albert Fadem Trust v. WorldCom, Inc., No. 01 Civ. 3299(DLC), 2002 WL 1880530 (S.D.N.Y. Aug. 15, 2002) (consolidation of the class actions and appointment of lead plaintiff).

analysts’ liability pursuant to Section 10(b) and Rule 10b-5,\textsuperscript{180} the extent and appropriateness of quid pro quo relationships between issuers, underwriters and their analysts,\textsuperscript{181} the competing jurisdictional provisions of the Bankruptcy Act and the Securities Act,\textsuperscript{182} underwriters’ due diligence obligations under the 1933 Act,\textsuperscript{183} directors’ responsibility (even before Sarbanes-Oxley) for their certification of documents,\textsuperscript{184} the availability of directors’ personal assets for settlement,\textsuperscript{185} and the statute of limitations bars to individual actions when a class action is pending.\textsuperscript{186} Many of these issues had not been considered extensively by courts or commentators,\textsuperscript{187} and many have implications that will range far beyond the WorldCom litigation. The fact that the class actions were consolidated, coordinated and held to an intense and extraordinarily fast-paced litigation schedule forced focus on the merits of the litigation and revealed the unanticipated consequences of the evolution of the securities laws.

The microcosm of the WorldCom litigation offers some insight into the benefits of litigation more generally. Although securities litigation relies on the same models of rational investors and efficient markets that disclosure does, unlike the disclosure requirements it necessarily approaches the assumptions with skepticism, not faith. Where disclosure must trust that the dissemination of information will proceed according to the theoretical model, litigants must prove how a particular transaction transpired. The legal standard and adversary process preclude unquestioning adherence to a given hypothesis—where disclosure rules can rest on unconfirmed assumptions, litigated claims must be properly alleged and proven.

The different role the economic assumptions play in securities litigation can be seen in an examination of a typical Section 10(b) claim, one of the key claims in the WorldCom litigation and one of the motivating factors behind the historic Citigroup settlement. Plaintiffs in a typical Section 10(b) securities fraud claim must prove

(a) a material misrepresentation (or omission), (2) scienter, i.e., a wrongful state of mind, (3) a connection with the purchase or sale of a security, (4) reliance, often referred to in cases involving public securities markets... as “transaction causation,” (5) economic loss, and (6) loss causation, i.e., a causal connection between the material misrepresentation and the loss.\textsuperscript{188}
Each element reflects the presence of the underlying economic assumptions, assumptions that will be scrutinized during litigation. For example, a "material" statement is one that a reasonable person would consider important when deciding whether to buy or sell securities. To assess the materiality of a statement or omission, a court must determine whether "defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor regarding the nature of the securities offered." Thus, the elements and pleading standard reflect the assumption that disclosure (or its lack) is crucial, but require specific attention to its effect in a particular instance.

Courts also must determine the likely effect on investors of cautionary language included in the total mix of information presented to the market. Under the "bespeaks caution" doctrine, misrepresentations are immaterial as a matter of law if "it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language set out in the same" document. As with materiality, cautionary language is assessed in a specific factual context. The court is to consider:

the allegedly fraudulent materials in their entirety to determine whether a reasonable investor would have been misled. The touchstone of the inquiry is not whether isolated statements within a document were true, but whether defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor regarding the nature of the securities offered.

Plaintiffs also must establish a causal relationship between the fraud and their losses. As the Supreme Court affirmed last term in Dura Pharmaceuticals, Inc. v. Broudo, Congress has made clear its "intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss." The Supreme Court rejected the Ninth Circuit standard that had permitted plaintiffs to recover even when they had only established that "the price on the date of purchase was inflated because of the misrepresentation." In so holding, the Supreme Court reiterated the importance of proof in securities law cases; the Court noted that the securities statutes seek to maintain confidence in the markets by deterring fraud "in part, through the availability of private securities fraud actions." But it also cautioned that "the statutes make these... actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." Plaintiffs may not rely on theoretical models—they must establish the extent and cause

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190. Id. (citing McMahan & Co. v. Wherehouse Entm't, Inc., 900 F.2d 576, 579 (2d Cir. 1990)). See also Basic v. Levinson, 485 U.S. 224, 231-32 (1988).
191. Halperin, 295 F.3d at 357.
192. Id.
193. Id.
194. Dura Pharm., Inc., 544 U.S. at 346.
195. Id. at 340 (emphasis omitted) (quoting the Ninth Circuit standard).
196. Id. at 345.
197. Id. (emphasis added).
of their losses in concrete terms.

Before, during, and after securities transactions, the relationships among the participants are governed by rules that assume the existence of the two key background conditions: rational investors and efficient markets. How those assumptions are treated, however, drastically differs depending on whether they are the basis for legislation or litigation. Securities regulations based on rational investor models and EMH must trust the accuracy of those descriptions; the dissemination of accurate, material information helps to ensure fair markets if the information will be processed and used in conformity with economic theory. In litigation, whether an investor acted rationally or a market efficiently must be established through the concrete work of investigation and adjudication. A balanced approach has faith that markets work well most of the time, but is not so trusting that it disdains the possibility that the models will fail. Litigation catches those failures, providing an additional level of deterrence and protection for individual investors and for the markets as a whole.

These basic precepts of securities litigation are familiar, but they seem to get overlooked in the tumult of legislative reform. It is worth pausing, then, to point out that in actual securities fraud litigation, judges are charged with evaluating the merits of specific allegations and must do so according to well-developed standards. While disclosure rests on the hope that information will be carefully evaluated and fraud exposed, the concrete particularity of litigation requires it. It is not intended "to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." Its precision and concreteness thus make it a necessary complement to the broader insurance that disclosure is intended to provide.

III. A Skeptical Approach to Securities Regulation

A. In Defense of Litigation

As the previous parts demonstrate, markets are messier than the law describes. Behavioral economics, cultural theory, and recent history remind us of a few key realities. First, as a practical and theoretical matter, markets cannot and do not exist independently of the individuals and entities that comprise them. They are and must be susceptible to the all-too-human traits of inconsistency, unpredictability, irrationality, logic, loyalty, and betrayal. Second, they are vulnerable to fraud. Because information asymmetries must always exist between those who have initial responsibility for gathering, processing, and presenting a company’s financial information and those who use that information to make investment decisions, a gap in knowledge and control will always create an opportunity for malfeasance. And, because the information will be used by less-than-rational investors in incompletely efficient markets, disclosure is an imperfect tool for preventing and detecting fraud. Although disclosure does much to minimize the size and duration of the disparity in information and consequent opportunity for malfeasance, contemporary economics reveals that it rests on

198. Id.
questionable assumptions. Fourth and finally, recent legislative reforms addressing serious questions about the adequacy of federal market regulation have failed to take these realities into adequate consideration.

This Article does not contend that the disclosure model is undesirable or that it should be abolished. Despite mounting challenges to the economic assumptions underlying the disclosure framework, disclosure continues to provide a crucial foundation for American securities markets. Disclosure provides the surest way of narrowing the asymmetries in information that create opportunities for malfeasance and the means most likely to push markets toward greater openness and efficiency. This Article does argue, however, that disclosure should not function as the sole tool of securities regulators and disclosure regulations should be based on accurate assessments of its limitations as well as its advantages. Disclosure alone is not sufficient to prevent fraud, to punish those who commit it, to remunerate those who suffer from it, or to clarify the law that addresses each of those issues. Faith in a disclosure system without regard to extensive evidence that its assumptions are flawed and despite the difficulty of predicting or measuring its effects is indeed faith in a "mystical notion." 

This part proposes an attitudinal shift and suggests particular reforms that such a shift might inspire. It suggests that securities regulation should embrace the complexity and uncertainty of markets and acknowledge the impossibility of designing legislation that will perfectly police malfeasance. It advocates a skeptical approach as the conceptual basis for supplementing the disclosure regime and addressing some of its significant shortcomings in order to create a regulatory regime that better deters, detects, and punishes fraud.

The skeptical approach proposed here does not reject the reigning faith. Disclosure is likely the best means of balancing the interests of investors and issuers, and of ensuring fair and functional markets. While it accepts the notion that disclosure may be the most advantageous premise for federal securities regulation, the skeptical approach recognizes and seeks to address its imperfections. What then would a skeptical argument about securities regulation look like? Does a shift in the theoretical framework provide any practical advantage in terms of debating and drafting legislation?

B. Skeptical Securities Regulation

First, the skepticism advocated here, properly understood, can provide a principled basis for assessing proposed regulations. It need not do so explicitly (that is, for the approach to be effective, no one need stand on the Senate floor and declare herself a Pyrrhonian or quote Montaigne), but it can work by requiring arguments and laws to be structured according to a more appropriate framework. A skeptical assessment begins with questioning, with doubt about even the most commonplace of beliefs. Thus a skeptical approach to securities regulation might begin by questioning how markets function. It might ask whether they are efficient, and if so, how and in what ways? It might query how investors make decisions. Are they logical? Emotional? Consistent? Predictable? Do they use information? If so, what information and how? The

199. SHILLER, supra note 31, at 103.
information required by law to be disclosed? Or other types of information and the means of accessing it? Adopting a skeptical approach is a way of returning to first principles, and thus creating a space to consider evolving understandings of market functioning. Ironically, a more philosophical approach would require consideration of more hard evidence and concrete detail regarding market behavior. Skepticism makes room for economics; by questioning legal certainties and presumptions, a skeptical approach to legislation forces the law to take the discoveries of other disciplines into account.

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

A skeptical approach would shift not only the methodology of legislation, but also its content. The skeptic rejects extremes. She resists the temptation to veer too far in any one direction, but rather seeks a philosophy that fits like "some coat woven of elastic steel." Emerson's metaphor captures the adaptive stability of skepticism. The skeptic is consistent yet flexible, steady yet limber. A skeptical approach is willing to consider new evidence—of plaintiffs' abuses or pervasive fraud, for example—and adapt accordingly, but it resists oscillating dramatically between extreme conflicting positions. The skeptic recognizes that such shifts might be unjustified on the facts (that is, that the basic levels or existence of malfeasance or manipulation are likely to have changed as drastically as claimed), and, as importantly, that they might be undesirable in and of themselves. In seeking elastic consistency, the skeptic recognizes that it is not just extremes that are to be avoided, but radical or frequent shifts between them. Such an approach would help to avoid the inconsistency and uncertainty for litigants, courts, and market participants that arise from too frequent or too drastic changes in perspective. A skeptical approach would advise against undue antagonism towards plaintiffs on the one hand, and towards the subjects of regulation on the other. It would moderate the extreme positions taken toward plaintiffs by the PSLRA and toward subjects of regulation by the Sarbanes-Oxley Act.

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

In answering these questions, skepticism is uniquely suited not only to frame how lawmakers might approach new legislation, but also to describe legislation's normative aspirations. On a skeptical approach to securities regulation, the law itself should reflect a skeptical attitude. Like the skeptic, securities market regulation should also "register... everything but bestow... its assent on nothing." It should take into...
account the probability of fraud and other forms of malfeasance, as well as the possibility that plaintiffs can and do sue when no fraud has been committed; it should take into account the possibility that investors are irrational and unpredictable, as well as the likelihood that thorough dissemination of material and accurate information can and does play a role in investors' decisions. Regulation should be designed to provide the framework for securities markets and to govern behavior within those markets in a manner most likely to ensure fairness, openness, and efficiency, but it should not also seek to judge the efficacy of its approach. By aggressively restricting enforcement, whether by limiting civil litigation or cutting SEC budgets, or some other method, Congress in effect pre-judges the success of its regulations. A skeptical approach rejects this conclusion and this role for Congress. It holds that while disclosure may be desirable and may indeed satisfy legislative goals, the legislator-as-skeptic is not in a position to decide.

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

Instead of trying to discourage private litigation, reforms should strive to make it work. By encouraging legislators to reconsider the value of litigation, skepticism requires thinking practically about how to focus litigation on the merits of complex securities fraud cases and should decrease the opportunities for exploitative and meritless procedural maneuvering. Practical changes that would allow adjudication to achieve these goals could include, for example, a series of reforms designed to concentrate and streamline complex securities actions that are filed when alleged malfeasance affects investors nationwide. Reforms could consider creating exclusive federal jurisdiction for Securities Act claims (as already required for Exchange Act claims) simplifying the procedures for, and expanding the reach of, multi-district transfer, consolidation, and coordination, and tailoring federal procedural rules for discovery and motion practice in consolidated MDL cases. At the same time, reforms that seek to improve securities litigation and enhance its role in market monitoring must focus on public, as well as private, actions. For example, the enforcement office of the SEC and prosecutorial power of the Department of Justice can be potent tools for uncovering and deterring fraud, but both must ensure that white-collar crime remains a top priority, even when it fades from the headlines, and both must receive adequate funding and support from Congress.
In brief, skeptical responses to securities fraud recognize that it is impossible to know whether and how much securities fraud has occurred, how well disclosure is working, or the full extent of malfeasors’ wrongdoing and investors’ losses, and seek to provide the means to find out. Litigation, with its focus on specific facts and legal claims, can be a powerful tool for testing the efficacy of the laws, assessing the extent of the losses, and gauging the degree of malfeasance. It is an important and necessary means for deterring malfeasors and compensating defrauded investors, bringing clarity to the law that benefits defendants and plaintiffs alike. Litigation’s strengths—its focus on concrete facts and claims—also make it an imperfect tool for addressing some of the problems identified by behavioral economics, however. If investors truly act irrationally, a claim for securities fraud might not succeed: an irrational investor might be unable to establish the loss or transaction causation required to recover. Although SEC enforcement actions and Department of Justice criminal prosecutions have principles, objectives, tools and standards that do not apply to private plaintiffs, even they might be unable to bring their full weight to bear in such cases. Litigation, then, cannot be the only answer.

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

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

IV. CONCLUSION

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