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The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective

*Steven A. Ramirez**

In the wake of the Great Depression, the federal securities laws operated to mandate disclosure of material facts to investors and extend broad private remedies to victims of securities fraudfeasors. The revelation of massive securities fraud underlying the Great Depression animated the federal securities laws as investment plunged after 1929 and failed to recover for years. For over sixty years after the enactment of the federal securities laws, no episode of massive securities fraud with significant macroeconomic harm occurred. The federal securities laws thereby operated to facilitate financial stability and prosperity, in addition to a superior allocation of capital. Unfortunately, as memories faded and inequality soared, corporate and financial elites (with the active aid of lawmakers) launched a sustained attack upon private enforcement of the securities laws. Soon thereafter the horrors of the Great Depression returned and massive securities fraud triggered the Great Recession of 2008 as economists predicted. This Article argues for a rollback of the war on private securities litigation to at least the 1980s based upon history and economic science. This would at least restore sensible pleading standards, impose liability on all participants in securities frauds (including aiders and abettors) and allow the states to impose more demanding standards of liability on wrongdoers in financial markets.

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* Professor, Loyola University Chicago School of Law and Director, Business and Corporate Governance Law Center. I dedicate this Article to the Loyola University Chicago School of Law students in my classes from 2006 to present. Their diverse experiences and perspectives constantly challenge me to refine and rethink my conclusions and ideas. Professors Mary Ramirez and June Carbone each made helpful suggestions on early drafts of this Article. Matthew Harrison provided helpful research assistance.

INTRODUCTION

Although securities fraud certainly inheres to modern financial markets, recent bouts of pervasive and systemic securities fraud seem unprecedented.[1] Indeed, compared to an extended golden era of financial stability[2] that lasted over six decades since the enactment of the Securities Act of 1933 ("Securities Act")[3] and the Securities Exchange Act of 1934 ("Exchange Act"),[4] the American financial system today operates with less transparency and more fraud than ever before.[5] This Article seeks to demonstrate that the U.S. suffers from a

1. For example, according to Massachusetts Institute of Technology Professor Andrew Lo the recent mega-scandal surrounding the manipulation of LIBOR, a key benchmark interest rate for trillions in securities and financial instruments, "dwarfs by orders of magnitude any financial scams in the history of markets." James O'Toole, *Explaining the Libor Interest Rate Mess*, CNNMONEY (July 10, 2010, 12:07 PM), http://money.cnn.com/2012/07/03/investing/libor-interest-rate-faq/index.htm.

2. I refer to the period beginning with the end of the Great Depression and ending with the Great Financial Crisis of 2008 (as defined in Part III). These two events mark the last two instances of a financial crisis triggering a major macroeconomic contraction in the U.S. In fact, between these two events experts can identify no other financial crisis of similar magnitude. *See* Greg Robb, *Bernanke: This may be Worse than Great Depression*, MARKETWATCH (July 26, 2009, 10:21 PM), http://www.marketwatch.com/story/bernanke-explains-crisis-to-average-americans-2009-07-26?siteid=rss&rss=1 ("'A lot of things happened, a lot came together, [and] created probably the worst financial crisis, certainly since the Great Depression and possibly even including the Great Depression."' (alteration in original) (quoting Federal Reserve Chairman Ben Bernanke)); *see also* Vivian Lou Chen, *Greenspan Says Lehman Unleashed 'Most Virulent' Crisis*, BLOOMBERG (May 7, 2010, 1:07 PM), http://www.bloomberg.com/news/2010-05-07/greenspan-says-lehman-failure-unleashed-most-virulent-crisis-in-history.html ("'The bankruptcy of Lehman Brothers in September 2008 precipitated what, in retrospect, is likely to be judged the most virulent global financial crisis ever."' (quoting former Federal Reserve Chairman Alan Greenspan)). As will be shown, each of these monumental events transpired upon a foundation of massive securities fraud.

3. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77zz).

4. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp).

5. *E.g.*, Paul Krugman, *America the Tarnished*, N.Y. TIMES, Mar. 30, 2009, at A29 (bemoaning the lack of corporate transparency in causing the Great Financial Crisis of 2008 and suggesting that the American economy rested too much on fraud); Paul Krugman, *Enron's Second Coming*, N.Y. TIMES, Oct. 7, 2007, at A25 (stating that borrowers, mortgage investors and mortgage bank shareholders were misled about risky mortgages while senior managers hauled in

more corrupt financial sector, a more rigged financial marketplace and a more fraud-ridden business environment than at any time since the Great Depression.[6]

Securities fraud plays a central role in this reality and naturally arose from a failure of law to impose rational incentives and disincentives in the securities market.[7] Private securities litigation, in particular, suffered a series of irrational deviations from a pre-existing norm of broad remedies for victims of securities fraud at the hands of Congress[8] and the judiciary beginning in the 1990s.[9] These irrational deviations defy explanation on any basis other than the operation of raw economic and political power.[10] Massive securities fraud (and its close

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millions).

6. At the incipiency of the crisis, it was abundantly clear that investors in public firms did not receive adequate disclosure of risks at major financial firms. According to Nobel Laureate Joseph Stiglitz, firm Chief Executive Officers ("CEOs") "reported high profits, gave big bonuses, big stock options, but in fact there were huge risks buried off-balance sheet and those chickens have now come home to roost." *Talk of the Nation: Economists Explain How to Save Capitalism*, NAT'L PUB. RADIO (Oct. 20, 2008), http://www.npr.org/templates/story/story.php?storyId=95906243.

7. The Great Financial Crisis of 2008 arose from numerous causes, and this Article focuses on massive securities fraud as only one of many causes. *See, e.g.*, STEVEN A. RAMIREZ, LAWLESS CAPITALISM: THE SUBPRIME CRISIS AND THE CASE FOR AN ECONOMIC RULE OF LAW 1–16 (2013) (arguing that a failure of law to curb and constrain economic power productively explains each element of the financial crisis); Melissa B. Jacoby, *Home Ownership Risk Beyond a Subprime Crisis: The Role of Delinquency Management*, 76 FORDHAM L. REV. 2261, 2295 (2008) (arguing that the subprime mortgage crisis shows the need for a delinquency management regime as part of a unified housing policy); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1065 (2006) (arguing that rating agencies must be regulated to prevent them from facilitating the spread of subprime mortgages and predatory loans into global financial markets); Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 404 (2008) (arguing that conflicts, complacency and complexity each played a significant role in the subprime crisis and that these factors can be addressed through financial regulation on only a limited basis); Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 1 (2011) (attributing the crisis to the deregulation of derivatives).

8. *See* Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.); *see also* Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227 (codified at 15 U.S.C. § 78a).

9. *Compare* Herman & MacLean v. Huddleston, 459 U.S. 375, 386–87 (1983) ("[W]e have repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'" (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963)), *with* Merrill Lynch, Pierce, Fenner & Smith, Inc., v. Dabit, 547 U.S. 71, 80 (2006) ("'[L]itigation under Rule 10b–5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975))).

10. *E.g.*, Ann Reilly Dowd, *Look Who's Cashing in on Congress*, MONEY, Dec. 1997, at 128, 132 (listing the Private Securities Litigation Reform Act as the top example of how money drives

companion financial crises) predictably exploded thereafter.[11] The law simply failed to adequately deter fraud in the securities markets.

Part I of this Article will review the history of the federal securities laws. Prior to the enactment of the federal securities laws, the disclosure obligations of publicly traded firms defied any economic logic and instead operated to assure that ordinary investors could not possibly know the material facts regarding their investment.[12] After the Great Depression, the federal government imposed national disclosure standards and broad private remedies that repaired the manifest deficiencies in American capitalism.[13] This secured investor confidence and facilitated financial development and investment for over sixty years.[14] This era featured steady growth and remarkable financial stability to such an extent that in finance and economics it is frequently

legislation).

11. Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1080–81 (1999) [hereinafter *Arbitration and Reform*] (predicting "weaker enforcement of the federal securities laws and, therefore, less incentive for compliance" and concluding that "[d]espite its likely effects, the PSLRA was passed with little debate of the risks of returning to a pre-Depression regime of investors being relegated to state law remedies, or the dangers of deregulation in the financial services industry"). Even prior to the most recent subprime frauds, scholars showed how diluting private securities fraud remedies leads to more fraud. *See* Antonio E. Bernardo et al., *A Theory of Legal Presumptions*, 16 J.L. ECON. & ORG. 1, 31–32 (2000) (modeling how a more lax approach to securities fraud operates to increase the incidence of fraud and thus securities litigation); Ho Young Lee & Vivek Mande, *The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and Non-Big 6 Auditors*, 22 AUDITING: J. PRAC. & THEORY 93, 93 (2003) ("We find that after the PSLRA income-increasing discretionary accruals rise for auditees of Big 6 but not for auditees of non-Big 6 firms.").

12. *E.g.*, Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 53–56 (1983) [hereinafter Seligman, *Historical Need*] (demonstrating that neither state law nor stock exchanges adequately secured disclosure of material information).

13. *Id.* at 1–2, 9 ("[T]he failure of the critics to adequately take into account historical evidence concerning the need for a mandatory corporate disclosure system raises serious questions about the validity of their criticisms.").

14. Professor Steinberg raised the possibility that the securities law had turned too far in favor of management in early 2002: "the risk and irony of the tripartite action taken by Congress, the courts, and the SEC [is that] [i]n seeking to enhance capital formation and alleviating the burdens placed on business by the threat of vexatious litigation, the scales may be tipped disproportionately against investor protection" which may make raising capital more difficult for business. Marc I. Steinberg, *Curtailing Investor Protection Under the Securities Laws: Good for the Economy?*, 55 SMU L. REV. 347, 354 (2002). Similarly, Dean Seligman argued that while some parts of the PSLRA were defensible, "[t]here is a genuine risk that the 1995 Act will deter both non-meritorious and meritorious litigation. . . . A more balanced approach would preserve what is defensible in the Act, such as the lead plaintiff provision, and modulate the cruder provisions." Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. CIN. L. REV. 95, 117 (2004).

termed a dynamic era of American capitalism.[15] Unfortunately, the federal judiciary as well as Congress failed to remember the success of the federal securities laws and fell prey to the power of concentrated economic interests that insisted that full disclosure of material facts backed by broad private remedies was vexatious.[16] By the dawn of the twenty-first century, corporate and financial elites effectively diluted private securities litigation through their lobbying efforts in the halls of Congress and the federal courts.[17] Massive financial crises followed.[18]

Part II of this Article will show the historical association of constricted fraud remedies with financial instability. Prior to late 2001, when Enron infamously collapsed in an orgy of securities fraud, the federal securities laws operated to extinguish systemically and macroeconomically significant financial crises.[19] Of course the federal securities laws did not end fraud in the securities markets. That would be impossible. Instead the federal securities laws minimized securities fraud to such an extent that it no longer threatened the macroeconomy.[20]

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15. The performance of the U.S. economy since World War II has been termed "extraordinary" with growth interrupted by only two recessions caused by oil shocks—until the financial crisis triggered by the Enron frauds, discussed *infra* Part III. GEORGE KOZMETSKY & PIYU YUE, THE ECONOMIC TRANSFORMATION OF THE UNITED STATES 1950–2000, at 1–2 (2005). Others look globally at the age of high economic performance from 1970 to 2007. *See* Martin Wolf, *Risks and Rewards of the World Economy's Golden Era*, FIN. TIMES, May 1, 2007, http://www.ft.com/intl/cms/s/0/3b7736a4-f810-11db-baa1 000b5df10621.html?siteedition=intl#axzz2kxJVBJGd (describing period of 1970 to 2007 as a "golden era" of steady growth and low inflation for the global economy). I use the term to refer to the six decades of financial stability from the mid-1930s to the end of the twentieth century.

16. Professor Miller situates the deformation of private securities litigation within a greater trend of powerful interests closing down access to the courts to the less powerful. Arthur Miller, *Simplified Pleading, Meaningful Days in Court, and Trials on the Merits: Reflections on the Deformation of Federal Procedure*, 88 N.Y.U. L. REV. 286, 301–05 (2013) [hereinafter Miller, *Simplified Pleading*] ("[A] backlash has set in against the private enforcement of public policies—a backlash that favors corporate and governmental interests against the claims of individual citizens. Politicians and special interests, sometimes aided, perhaps 'innocently,' by the media, vilify the plaintiffs' bar as fee-hawking ambulance chasers."). Professor Miller does not limit this development just to the more political branches; he impugns the judiciary as a more than willing participant. *Id.* at 304 ("[T]hese manifestations of the backlash have been given traction by the Supreme Court, which seems to have placed a thumb on the justice scale favoring corporate and government defendants. These manifestations have impaired both access to the federal courts for many citizens and the enforcement of various national policies.").

17. *See* Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598, 600 (2007) (finding that the PSLRA has deterred meritorious as well as meritless securities actions).

18. *See supra* notes 1, 2, 5.

19. Indeed, longtime observers routinely maintained that "U.S. securities markets are the best securities markets in the world." David L. Ratner, *The SEC at Sixty: A Reply to Professor Macey*, 16 CARDOZO L. REV. 1765, 1779 (1995); Steinberg, *supra* note 14, at 347.

20. Steve A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 564 n.377 (2003) [hereinafter Ramirez, *Law and Macroeconomics*] (citing ROBERT J.

After the evisceration of broad private remedies for securities fraud macroeconomically significant financial crises reappeared.[21] Once the law tilted away from deterrence and permitted more securities fraud under the constricted private securities remedies, fraud became pervasive (again) throughout securities markets, culminating in the subprime debacle.[22] The financial history of the U.S. since the turn of the century attests to the need for robust private remedies in the securities markets.

Part III will explain, based upon the history of financial markets and the federal securities laws, why private securities litigation operates as a key bulwark for securing investor confidence and thus financial stability. Private securities litigation offers powerful institutional advantages over mere government enforcement.[23] Only private securities litigation operates free of political influence.[24] Private attorneys will not likely operate in a politically partisan manner if they desire business success.[25] Private securities litigation imposes no material cost on the taxpayer.[26] Construing private securities remedies more broadly necessarily draws more enforcement and investigatory resources into the policing of financial markets on the broadest basis

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GORDON, MACROECONOMICS A1–A2 (9th ed. 2003)).

21. The New Deal consisted of many innovations that combined to secure financial stability and prosperity for decades. The point of this Article is not to argue that private securities litigation alone secured such benefits, but only to posit that it is crucial to transparency and investor confidence in financial markets. *See id.*

22. Even under the current legal regime some degree of deterrence remains, even if history shows deterrence to be inadequate. For example, a securities class action can be a catalyst for a hostile takeover, may harm a CEO's future prospects, lead to CEO turnover and trigger pay cuts. Mark L. Humphery-Jenner, *Internal and External Discipline Following Securities Class Actions*, 21 J. FIN. INTERMEDIATION 151, 151 (2012). If a securities fraud action results in disclosure of wrongdoing the firm's stock will decline by almost 40%—hurting an executive's stock portfolio including options held. *See* Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 582 (2008); *see also* Lynn Bai et al., *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. PA. L. REV. 1877, 1896–1904 (2010) (finding that firms that sued in securities class actions suffer inferior performance and a higher risk of bankruptcy).

23. Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic* ex post *Regulation*, 43 GA. L. REV. 63, 66 (2008) ("It is true that the securities class action is not a perfect regulator. It is equally true, however, that its role as *ex post* regulation through litigation allows the United States to maintain its attractiveness as a relatively deregulated market with relaxed *ex ante* barriers and low market entry costs.").

24. For example, Arthur Levitt, the Chairman of the Securities and Exchange Commission ("SEC") during the 1990s catalogued his efforts to quell CEO power. ARTHUR LEVITT, TAKE ON THE STREET 10–12, 106–15 (2002).

25. *See* Samuel Issacharoff, *Regulating after the Fact*, 56 DEPAUL L. REV. 375, 379 (2007) (noting that "[p]rivate enforcement is a . . . safety valve against the potential capture of the [SEC] agency by industry").

26. *See* J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

possible—through the broad definition of securities themselves.[27] Private remedies depend upon market based incentives so that only the most meritorious and significant securities frauds warrant pursuit.[28] Attorneys taking on petty and weak claims will face economic failure. Finally, because only the most prosperous fraudfeasors will face private suits, frivolous suits and extortive litigation pose a very low level risk because the finest law firms in the nation will defend the most wealthy targets of private securities litigation.[29] Thus, judicial and legislative authorities, as well as the Securities and Exchange Commission ("SEC"), should revert to a more benign view of private securities litigation.

This Article concludes that diluting the sanctions and risks facing putative securities fraudfeasors in a material way creates greater incentives for securities fraud. Pervasive securities fraud destroys financial markets.[30] This truism now has been borne out in American financial markets.[31] Both an historic and macroeconomic view of financial markets supports this conclusion.[32] As Massachusetts Institute of Technology economist Charles Kindleberger stated: "Commercial

27. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

28. *See* Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1513–14 (2006) (finding that despite the mandated Rule 11 inquiry of the PSLRA, courts awarded sanctions in only four cases in the first ten years of the Act's existence).

29. *See id.*

30. *See* June Carbone, *Once and Future Financial Crises: How The Hellhound of Wall Street Sniffed Out Five Forgotten Factors Guaranteed to Produce Fiascoes*, 80 UMKC L. REV. 1021, 1035–1049 (2012) (reviewing the findings of the Pecora hearings after the market crash of 1929 and finding stunning failures in disclosure of risks, risk manipulation, excessive compensation and incentives for frauds); Enzo Incandela, *Recourse Under § 10(b) on Life Support: The Displacement of Liability and Private Securities Fraud Action after* Janus v. First Derivative, 43 LOY. U. CHI. L.J. 935, 935–39 (2012) (recounting investment disasters and massive misrepresentations in the run-up to the market crash of 1929).

31. In 1929, the stock market crashed under the weight of worthless securities; in 2008, it was bogus mortgage-backed securities. *Compare* H.R. REP. NO. 73-85, at 2 (1933) (stating that between 1920 and 1930 about one-half of the $50 billion of new securities issued were worthless), *with* Devlin Barrett & Dan Fitzpatrick, *J.P. Morgan is Haunted by Decision on Loans*, WALL ST. J., Nov. 20, 2013, at A6 (stating that a bank's agreement to pay a $13 billion settlement to the government for claims of mortgage-backed securities fraud occurred based upon revelations that the bank knowingly misrepresented risks of mortgages that were "so weak they likely would not even qualify as subprime").

32. The need to roll back limitations on private securities litigation constitutes only one of many maladies plaguing our financial system today. I have argued elsewhere (based upon macroeconomic and historic evidence) that the nation's largest banks must be fragmented, that derivatives regulation must be imposed to reduce non-transparent risk in the financial system, that corporate governance needs to be reformed to control CEO autonomy and that professionalization regimes must be expanded within the financial sector, among other reforms. RAMIREZ, *supra* note 7, at 47–73, 74–104.

and financial crises are intimately bound up with transactions that overstep the confines of law and morality."[33] Swindles fuel manias, signal panics and deepen financial distress.[34] History is replete with examples.[35] The U.S. therefore faces an urgent need to reimpose sanctions for securities fraud or face the inevitable fallout from laxity towards securities fraud: serial financial collapses.

A grand experiment in judicial and legislative encouragement of securities fraud now has failed.[36] Congress and the courts should reverse that experiment as promptly and thoroughly as possible and policymakers should seek to restore the private securities remedies to their historic policy underpinnings.[37] That means rolling back securities litigation restrictions.[38] Congress and the courts must restore deterrence

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33. CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES 73 (4th ed. 2000).

34. *Id.* at 73, 77.

35. *Id.* at 73–90.

36. The PSLRA rested on a weak evidentiary foundation from the beginning. GARY W. SHORTER, CONG. RESEARCH SERV., SECURITIES LITIGATION REFORM: HAVE FRIVOLOUS SHAREHOLDER SUITS EXPLODED? CRS-34 (1995) ("On balance the evidence does not appear to be compelling enough for one to conclude that warrantless class action suits have exploded . . . ."); John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 339–40 (1996) ("At Senate hearings . . . much of the testimony focused on the perception of a securities litigation crisis. Many of the witnesses gave anecdotal evidence of widespread abuses in the private litigation system, but the empirical evidence was inconclusive."). It is noteworthy that the attack on private securities litigation coincided with soaring economic inequality in the U.S. *See* RAMIREZ, *supra* note 7, at 36.

37. Congress acted specifically with the intent of averting "national emergencies" that produced unemployment and macroeconomic dislocation arising from chicanery in the securities markets. 15 U.S.C. §78b (2012).

38. The irrational indulgences granted to securities fraudfeasors have been critiqued by a number of scholars. This is the only Article that advocates a return to the broad private remedies of decades past in response to compelling evidence of the macroeconomic costs of massive securities fraud implicit in recurring financial crises. *See, e.g.*, Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, 2009 COLUM. BUS. L. REV. 802, 816 (arguing that the PSLRA results in under-deterrence of fraud); Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 583 (1998) (advocating against the stay of discovery under the PSLRA); Elliott J. Weiss & Janet E. Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 that the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457, 472 (1998) (arguing that the pleading demands are unduly burdensome on shareholders when they are denied discovery); *see also* John C. Coffee Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1403 (2002) (suggesting that the PSLRA's protection of auditors from liability for their errors was one factor contributing to the Enron-era scandals); Andre Douglas Pond Cummings, *Still "Ain't No Glory in Pain": How the Telecommunications Act of 1996 and Other 1990s Deregulation Facilitated the Market Crash of 2002*, 12 FORDHAM J. CORP. & FIN. L. 467, 471–72 (2007) ("Studies have shown that the PSLRA, SLUSA and other deregulatory initiatives in the mid-1990s enabled an environment that almost invited the fraud that spun out of control in the corporate fiascos of Enron, WorldCom, Tyco, Adelphia, ImClone and Global Crossing."). For the most part, commentators neglect the

before our nation suffers yet another macroeconomic catastrophe rooted in massive securities fraud.[39]

I. A Short History of the Federal Securities Laws

Prior to the 1930s, state law primarily governed disclosure of material facts in connection with securities transactions.[40] In this regard state law proved woefully deficient.[41] For example, state law did not mandate that publicly traded firms disclose any facts to shareholders, not even essential information such as audited financial statements.[42] Instead, shareholders needed to press claims for information through individual lawsuits.[43] Fraud claims faced severe restrictions because (among other problems), in an impersonal market, transaction participants generally owe no duty of disclosure.[44] State Blue Sky laws failed to effectively enforce disclosure requirements across state lines, a measure which became increasingly necessary as a result of the nationwide character of the securities business.[45] Securities sales literature was "too often deliberately misleading."[46] This all meant that market participants lacked access to even basic material facts.[47]

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role that securities fraud (and other associated misconduct) plays in financial crises and macroeconomic disruptions. *See* Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2184 (2010) (discussing the costs of violations of the securities laws but failing to discuss financial instability and macroeconomic disruptions).

39. Private actions likely deter more than SEC actions as private claims are associated with greater sanctions. Stephen J. Choi & Adam C. Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison* 12 (Univ. of Mich. Law & Econ. Research Paper Series, Paper No. 12-022, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739.

40. Dean Seligman shows that the rules of stock exchanges prior to the federal securities laws also failed to secure adequate disclosure for investors due to limited enforcement. Seligman, *Historical Need*, *supra* note 12, at 54–57.

41. SAMUEL ELIOT MORISON, THE OXFORD HISTORY OF THE AMERICAN PEOPLE 282 (2d ed. 1972) ("Certain states such as Delaware and New Jersey allowed anyone paying a registration fee to incorporate a company, leaving its directors free to issue new stock, and with no obligation to make an annual report or an accounting."). Delaware still does not mandate disclosure of any information to shareholders. Other than the federal securities laws, disclosure obligations of corporations are "narrow to non-existent." MELVIN ARON EISENBERG & JAMES D. COX, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 363 (10th ed. unabr. 2011).

42. LOUIS LOSS ET AL., SECURITIES REGULATION 288 (4th ed. 2006).

43. EISENBERG & COX, *supra* note 41, at 362.

44. *E.g.*, Goodwin v. Agassiz, 186 N.E. 659, 660 (Mass. 1933) (holding that mere silence does not amount to a breach of duty).

45. LOSS ET AL., *supra* note 42, at 233–38.

46. H.R. REP. NO. 73-85, at 2–3 (1933).

47. *See* DAVID M. KENNEDY, FREEDOM FROM FEAR 368 (1999) (concluding that while the federal securities laws imposed new disclosure obligations on businesses, the enhanced flow of information improves economic efficiency of financial markets and thereby rationalizes the

Consequently, investment rested on guesses and gambles.[48] Modern capitalism (as well as market efficiency theory) demanded a superior informational foundation to drive investment.[49]

Such a reality creates fertile ground for panics, and the U.S. suffered major financial panics in 1873, 1893 and 1907.[50] The greatest financial collapse of all occurred in 1929, when the U.S. suffered an historic stock market crash.[51] The aggregate value of all stocks listed on the New York Stock Exchange fell from $89 billion in the fall of 1929 to $15 billion in 1932.[52] Subsequent Congressional inquiries implicated, in the words of Joseph P. Kennedy, "practically all the important names in the financial community in practices which, to say the least, were highly unethical."[53] Economist John Kenneth Galbraith echoed that conclusion: "American enterprise in the twenties had opened its

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securities laws in accordance with free-market theory).

48. ARTHUR M. SCHLESINGER, JR., THE COMING OF THE NEW DEAL 470 (1958). "Virtually none of the critics of the SEC's mandatory corporate disclosure system during the New Deal questioned the need for a compulsory corporate disclosure system." Seligman, *Historical Need*, *supra* note 12, at 2.

49. *See* Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. L. 225, 269–270, 271–72 (2001) (reviewing the underlying assumptions of market efficiency and concluding that the federal securities laws facilitate efficiency by assuring a minimum level of disclosure).

50. MORISON, *supra* note 41, at 37, 111–13, 151–52 (stock speculation contributed to the Panic of 1873; bank failures and a panic in the London securities market for American shares triggered the Panic of 1893; and, stock speculation and the overextension of credit led to the Panic of 1907).

51. *See* H.R. REP. NO. 73-85, at 2 (stating that between 1920 and 1930 about one-half of the $50 billion of new securities issued were worthless). Additionally, the subprime mortgages of the 2008 crisis harken back to massive investments in foreign bonds during the run up to the crash in the late 1920s. SCHLESINGER, *supra* note 48, at 437–38 (recounting how Wall Street bankers peddled foreign bonds to American investors despite expert opinions that the bonds would default and without disclosure of bribes paid to foreign officials). Indeed, National City Company went forward with an offering of foreign bonds issued by a Brazilian state that was fantastically lax and borrowed in "complete ignorance, carelessness and negligence" of the long term financial consequences. *Id.* at 438. One fraudfeasor simply forged Italian bonds to deceive investors. MORISON, *supra* note 41, at 285. National City and Chase Bank continued to sell foreign bonds at pre-default prices even after the governments involved disclosed to the banks that no further interest would be paid on the debt. KINDLEBERGER, *supra* note 33, at 80

52. LOSS ET AL., *supra* note 42, at 255–56. Additionally, one-half of all the foreign securities purchased by the American public defaulted. *Id.* The total loss in all securities amounted to $93 billion between 1929 and 1931. *Id.*

53. SCHLESINGER, *supra* note 48, at 423. For example, the House of Morgan maintained a preferred list of highly connected customers that qualified to buy stock at a deep discount to the price available to the public customers. *The New York Times* termed this practice a "gross impropriety," and the Governor of Kansas called it "bribery." *Id.* at 436. The Chairman of Chase National Bank, the previously highly regarded Andrew Wiggin, further exemplifies Kennedy's point. He sold massive securities in his own firm while simultaneously knowing that the firm embarked on a repurchase campaign to the tune of $800 million. Steve Thel, *The Original Conception of Section 10(b)*, 42 STAN. L. REV. 385, 413 n.118 (1990).

hospitable arms to an exceptional number of promoters, grafters, swindlers, imposters and frauds. This, in the long history of such activities, was a kind of flood tide of corporate larceny."[54] By the mid-1930s the economy suffered from crippling declines in investor confidence and investment collapsed, leading to the Great Depression.[55]

A modern industrial economy requires an advanced financial system to provide sufficient capital flows and investment to fund growth.[56] Deep and liquid financial markets do the job.[57] However, "the public must have confidence in the integrity of our financial markets in order to insure a stable and inexpensive source of capital for American business growth."[58] When that confidence flags and investors head for

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54. JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929, at 178 (1954); *see also* 3 MORISON, *supra* note 41, at 281–86 (describing and detailing the nefarious activities underlying the "greatest orgy of speculation and over-optimism since the South Sea Bubble of 1720"). Historian Morison's account of financial markets before the Depression illustrates well the problem with markets infected by massive securities fraud. Between the bear raids, the insider dealing and manipulative stock pools described by Morison, one must conclude that it was simply impossible to invest intelligently in securities. *Id.* at 282–85. The simple thread in all of these nefarious devices is that stock prices move in accordance with information not available to an ordinary securities investor. We will see this historic fact repeated in 2008.

55. "[I]nvestor confidence was so low before the enactment of the federal securities laws that the issuance of new corporate securities had plummeted from $9.4 billion in 1929 to $380 million in 1933." Ramirez, *Arbitration and Reform*, *supra* note 11, at 1066 n.35 (citing I LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 216 (3d ed. 1998)). The term "panic" captures the notion of irrational and indiscriminate selling of financial assets. For example, in the early 1930s, there was a run on German Banks after the failure of Creditanstalt in Vienna that was partly fueled by a failure of speculators to understand the difference between Germany and Austria. KINDLEBERGER, *supra* note 33, at 77. Panics simply operate as the inevitable flipside of manias, which fuel bubbles. Disclosure of material facts stems both psychological states; therefore, investor confidence is inherently tied to reality through full disclosure of truthful information.

56. *E.g.*, Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537, 538 (1998) (relating economic growth to financial development); Maurice Obstfeld, *Risk-Taking, Global Diversification and Growth*, 84 AM. ECON. REV. 1310, 1326–27 (1994) (finding that the ability of investors to diversify through markets encourages growth).

57. *E.g.*, Asli Demirgüç-Kunt & Vojislav Maksimovic, *Law, Finance and Firm Growth*, 53 J. FIN. 2107, 2134 (1998) (finding that firms in countries with active stock markets were able to obtain greater funds to finance growth); Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559, 584 (1998) (finding that industries dependent on external finance are more developed in countries with better protection of external investors).

58. Ramirez, *Arbitration and Reform*, *supra* note 11, at 1057 ("[I]ncreasing investor confidence . . . may have important economic consequences. By reducing the perceived risk of corporate securities, compulsory disclosure would tend to reduce the risk premia that issuers . . . would have to pay, thus increasing the funds available for economic growth." (citing LOSS & SELIGMAN, *supra* note 55, at 217–18)). Empirical studies have shown that more robust investor protection and securities regulation laws—including stricter enforcement of disclosure mandates—support a lower cost of capital for firms. Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. ACCT. RES. 485, 488 (2006) ("Firms in countries with more extensive disclosure requirements, stronger securities regulation, and more effective legal systems have a significantly

the exits en masse, the very viability of capitalism itself falls into question[59] as macroeconomic pain mounts.[60] In just the twenty-five years before the federal securities laws, the nation endured three such macroeconomic catastrophes.[61] Congress recognized, finally, that securities transactions are the lifeblood of modern capitalism and require regulation to stem fraud, speculation, panics and general economic catastrophe.[62]

A. The Original Conception of the Federal Securities Laws

Shortly after taking office, President Franklin Roosevelt proposed legislation that ultimately became the Securities Act.[63] Indeed, the Act was a cornerstone of the famous 100 days when President Roosevelt took vigorous action to address the economic cataclysm of the Great Depression.[64] The federal role in securities regulation thus has its roots in the financial and macroeconomic catastrophe of the Great Depression.[65] The President and Congress intended to insure disclosure to investors.[66] The Securities Act required the registration (and

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lower cost of capital.").

59. Nouriel Roubini, *Is Capitalism Doomed?*, PROJECT SYNDICATE (Aug. 15, 2011), http://www.project-syndicate.org/commentary/is-capitalism-doomed.

60. Thomas Mucha, *America the Gutted: What Happens When the Middle Class Disappears?*, CNBC (Sept. 12, 2012), http://www.cnbc.com/id/48998081.

61. As I wrote in 2003:

> In 1920 to 1922, the economy contracted 17.3%. In 1907, the economy contracted 7.4%. In 1929 to 1933, the economy contracted 33%. Since then there has not been a single contraction of the same magnitude as these three contractions. Thus, from 1907 to 1929, a period of twenty-two years, the economy suffered three significant contractions. In seventy years since the beginning of the New Deal, no contraction of similar magnitude has occurred. Since the end of the Depression in 1938, there has only been one year of negative economic growth. In 1949, the economy suffered a contraction of 0.8%.

Ramirez, *The Law and Macroeconomics of the New Deal*, *supra* note 20, at 564 n.377.

62. In the words of Congress:

> National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

15 U.S.C. § 78b(4) (2012).

63. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77zz).

64. SCHLESINGER, *supra* note 48, at 1–23.

65. During the Great Depression, unemployment peaked at over 25% and GDP contracted by over 30%. Steven A. Ramirez, *The Law and Macroeconomics of the New Deal*, *supra* note 20, at 524.

66. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the statute is to

accompanying full disclosure) of initial distributions of securities.[67] The Act focused primarily upon initial offerings of securities.[68] Nevertheless, the Securities Act also provided broad private remedies for those investing in securities based upon a material misrepresentation—at least as a matter of the plain meaning of the statute.[69] These broad remedies sought to inspire, through fear of liability, broader disclosure and more careful marketing in connection with the sale of securities.[70]

In order to fill out the gaps left, Congress enacted the Exchange Act, which required periodic disclosure for publicly held companies and created the SEC to monitor securities exchanges and enforce the new laws.[71] The Exchange Act also directed the newly minted agency to promulgate broad anti-fraud rules.[72] The SEC ultimately imposed Rule 10b-5,[73] the broadest anti-fraud provision under the federal securities

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protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").

67. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW §§ 1.02, 4.01 (6th ed. 2009).

68. *Id.*

69. Under section 12(a)(2) (formerly section 12(2)) of the Securities Act:

> Any person 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, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable . . . to the person purchasing such security . . . to recover the consideration paid for such security with interest thereon.

15 U.S.C. 771(a)(2) (2012).

70. William O. Douglas, *Protecting the Investor*, 23 YALE REV. 522, 523–26 (1934), *available at* http://www.sec.gov/news/speech/1934/030034douglas.pdf.

71. STEINBERG, *supra* note 67, §§ 1.02, 5.03.

72. 15 U.S.C. § 78j(b) provides:

> 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 use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

73. Rule 10b-5 provides:

> 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,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

laws applying to both purchases and sales of securities and broadly reaching all fraud in connection with securities transactions, and beyond—at least as a matter of the plain meaning of the legislative regulation.[74] Indeed, Professor Thel persuasively demonstrates that the original object of Rule 10b-5 focused on punishing those engaged in wrongdoing in connection with the purchase or sale of securities for wrongdoing of less than fraud.[75]

Roosevelt made clear that these acts were designed to heighten disclosure obligations in securities transactions in order to restore public confidence in the nation's financial markets.[76] Congress joined the President in emphasizing the importance of investor confidence within a modern economic system.[77] Broad federal remedies played a vital role in the federal regulatory overlay, and those remedies operated cumulatively with any state remedies so that federal law could only enhance investor rights.[78] The Securities Act as well as the Exchange

> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2013).

74. Thel, *supra* note 53, at 385–86 (arguing that the events surrounding passage of the Exchange Act and section 10(b) show that the provision was intended to empower the SEC to regulate any practice that might contribute to speculation in securities or tend to move security prices away from investment value—an interpretation that, while consistent with the language and structure of the Exchange Act, is fundamentally different from the judicial construction of section 10(b)).

75. *Id.* at 387–90.

76. "This proposal . . . puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." H. R. REP. NO. 73-85, at 2 (1933) (quoting letter from President Franklin D. Roosevelt regarding the Securities Act of 1933); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("A fundamental purpose [of the federal securities laws] was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.").

77. The House Report accompanying the Exchange Act states:

> Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.

H.R. REP. NO. 73-1383, at 5 (1934).

78. The "purpose of the [federal securities laws] is to expand, not restrict the public's remedies." Sennott v. Rodman & Renshaw, 414 U.S. 926, 929 (1973) (Douglas, J., dissenting from order denying certiorari). One of Congress's primary objectives in enacting the federal securities laws was to "rectify perceived deficiencies in the available common-law protections." Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983). The power of the states over

Act made this point perfectly clear.[79] Those remedies specifically sought to avert the problems with state law claims and accompanying hyper-technicalities.[80] The original conception of the federal securities laws intended to substitute a philosophy of full disclosure for traditional notions of caveat emptor.[81]

This original conception of the federal securities laws can only be termed hugely successful.[82] In fact, despite dire predictions from the experts running Wall Street, securities distributions revived in 1935, when initial offerings more than doubled the amount floated in 1933, to $800 million.[83] Full disclosure of material facts backed by both public and private enforcement ultimately secured investor confidence and therefore investment.[84] Since then, stock market valuations and stock ownership has soared.[85] Ultimately the federal securities laws, including broad private remedies, became a model internationally.[86]

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securities-related claims, and remedies available to investors under state law, had been preserved since the very incipiency of federal securities regulation. Only in 1998 did Congress see fit to preempt state law claims through the SLUSA.

79. *See* 15 U.S.C. § 78bb (2012) ("The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity."); *see also id.* § 77p (same).

80. *See* I LOUIS LOSS ET AL., *supra* note 42, at 262–63 (citing Douglas, *supra* note 70) (stating that the new expanded liabilities under the Securities Act will protect investors by inspiring care rather than recklessness).

81. "This proposal adds to the ancient rule caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller." H.R. REP. NO. 73-85, at 2 (quoting letter from President Franklin Roosevelt).

82. *See* S. REP. NO. 104–98, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 715 (presenting comments by Sens. Sarbanes, Bryan and Boxer that "[o]ur securities markets have been operating under the Federal securities laws since those laws were enacted 60 years ago . . . [and] our markets today are the largest and most vibrant in the world . . . not in spite of the Federal securities laws, but in part because of the Federal securities laws"); *U.S. Securities and Exchange Commission Chairman Arthur Levitt, Remarks at 22nd Annual Securities Regulation Institute*, *in* 1 PRACTICING LAW INST., SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAW 300, 304 (1996) ("Our markets are the best in the world, partly because our securities laws are the best in the world."); *see also* Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382, 389 (1964) ("We doubt that any person reasonably well acquainted with the evolution of stockmarket practices between the pre- and post-SEC periods could lament or underrate the success of the new legislation in eradicating many of [the] weaknesses in our capital markets.").

83. SCHLESINGER, *supra* note 48, at 462–64, 469–70.

84. *See* 3 MORISON, *supra* note 41, at 306–09 (stating that the federal securities laws worked a permanent reform of American capitalism); *see also* Joel Seligman, *Memories of Bill Carey*, 2013 COLUM. BUS. L. REV. 318, 328 (showing an explosion in private securities litigation starting in 1961).

85. LOUIS LOSS ET AL., FUNDAMENTALS OF SECURITIES REGULATION 8 (6th ed. 2011) (stating that stock ownership has expanded from 1.5% of the population in 1930 to nearly 50% of the population in 2008).

86. Dr. Gerhard Wegen, *Congratulations from Your Continental Cousins, 10b-5: Securities*

More importantly, this original conception of the federal securities laws ushered in an unprecedented era of financial stability.[87] For example, after the New Deal,[88] bank failures nearly disappeared from the U.S., until they spiked again in 2007–2011 to even higher levels (as a percentage of gross domestic product ("GDP")).[89] After the Great Depression the nation did not suffer another macroeconomically significant financial crisis until 2007.[90] Either anti-inflationary monetary policy or oil price shocks caused the more significant recessions of the post-World War II era prior to 2007.[91] In fact, Professor Kindleberger's landmark study of macroeconomically significant financial crises, *Manias, Panics and Crashes*, did not identify or discuss any post-World War II financial crisis in the U.S. that led to an economic recession.[92] Only after the betrayal of the original conception of the federal securities laws (as will be shown) did a massive financial crisis strike the U.S., leading to macroeconomic distress.[93] In fact, the Great Recession of 2008 ultimately proved to be

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Fraud Regulation From the European Perspective, 61 FORDHAM L. REV. S57, S74 (1993) (inviting Rule 10b-5 to "visit" both Western and Eastern Europe); *Going for the Golden Egg*, ECONOMIST, Sept. 28–Oct. 4, 1996, at 89–90 (stating that "America has been much better than Europe at hatching small firms" and detailing European efforts to imitate American securities markets).

87. *E.g.*, KINDLEBERGER, *supra* note 33, at 1 ("[R]ecessions from 1945 to 1973 were few, far between, and exceptionally mild.").

88. I have consistently posited that many New Deal innovations contributed to this financial stability. *See, e.g.*, Ramirez, *The Law and Macroeconomics of the New Deal*, *supra* note 20, at 569–72.

89. David Cay Johnston, *The Taxpayers' Burden*, REUTERS, Dec. 4, 2011, *available at* http://blogs.reuters.com/david-cay-johnston/2011/12/04/the-taxpayers-burden/ (showing that failed deposits as a percentage of GDP peaked in 1933 and 2008–2009 after a long period of small and few failures).

90. In 1984, a financial crisis hit the U.S. as the result of the failure of massive numbers of savings and loans. Nevertheless, this financial crisis (although clearly the most significant financial crisis since World War II other than the subprime crisis) was a "relatively mild" crisis compared to the Great Depression and the subprime debacle. CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT 216 (2009).

91. The most significant post-war recession prior to the Great Recession of 2007–2009 was the recession of 1981–1982, and it was caused by the aggressive use of monetary policy to fight inflation. TODD A. KNOPP, RECESSIONS AND DEPRESSIONS 168 (2d ed. 2010). Another significant recession in 1973–1975 was triggered by high oil prices. *Id.* at 167. Oil Price hikes also triggered less significant recessions in 1991 and 1980. *Id.* at 169. Tight monetary and credit conditions led to a number of milder recessions between 1946 and 1961, as well as in 1969. *Id.* at 164, 166.

92. KINDLEBERGER, *supra* note 33, at 21–22 (predicting that macroeconomically significant financial crises in the U.S. may not be a "relic of the past" but failing to identify any such event in the U.S. in the course of discussing his model's relevancy as of 2000). Professor Kindleberger's study is limited to macroeconomically significant financial crises. *Id.* at 1.

93. YOUSSEF CASSIS, CRISES AND OPPORTUNITIES 150 (2011) ("The financial debacle of 2007–8 was the most severe financial crisis in modern history."). This essentially echoes the

the deepest and longest economic contraction since the Great Depression.[94] Further, the recession spawned more job losses than any contraction since the Great Depression as well as a painfully slow recovery.[95]

The courts initially embraced the remedial nature of the federal securities laws and broadly interpreted their provisions to achieve those ends.[96] Further, the courts, as well as the SEC, recognized the crucial role of private securities enforcement proceedings as an essential supplement to the SEC's limited enforcement resources.[97] Indeed, in 1946, the federal courts began to imply private rights of action under the federal securities laws.[98] Since then, the Supreme Court has determined the existence of a private action under Rule 10b-5 to be "beyond

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conclusion of the last two Federal Reserve Chairmen, Ben Bernanke and Alan Greenspan. *See supra* note 2.

94. Increasingly, economists refer to the recession of 2007–2009 as the Great Recession. Thomas F. Siems, *Branding the Great Recession*, DALLASFED (May 31, 2012), http://www.dallasfed.org/assets/documents/banking/firm/fi/fi1201.pdf ("Depicting the 2008 economic downturn as the Great Recession seems justifiable. It was the longest and deepest economic contraction, as measured by the drop in real GDP, since the Great Depression.").

95. *Id.* ("[T]he time it took to return to prerecession peak output was far longer than any other post-Great Depression recovery. Job losses during the Great Recession were also the most dreadful since the Great Depression.").

96. *See, e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (noting that the intent of the Exchange Act was to "'achieve a high standard of business ethics in the securities industry'" and must "be construed . . . 'flexibly to effectuate its remedial purposes'" (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186, 195 (1963)); Silver v. N.Y. Stock Exchange, 373 U.S. 341, 366 (1963) ("It requires but little appreciation of . . . what happened in . . . the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail as to every aspect of the [securities markets].").

97. *See, e.g.*, Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) (stating that private actions are indispensable for the enforcement of securities laws); Berner v. Lazzaro, 730 F.2d 1319, 1322 (9th Cir. 1984) ("[T]he resources of the [SEC] are adequate to prosecute only the most flagrant abuses.").

98. *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (implying a private right of action under the federal securities laws). The SEC filed a brief in *Kardon* demonstrating its intent that Rule 10b-5 give rise to a private right of action. *See* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 990 n.130 (1994) ("The Commission filed an amicus brief in *Kardon* urging the court to imply a private right of action under Section 10(b) and Rule 10b-5 on precisely the grounds on which the court ultimately relied."). The SEC filed this brief only four years after it had promulgated Rule 10b-5. *Id.* Additionally, the SEC consistently advocated for private rights of action for violations of the federal securities throughout the 1940s. *Id.* at 990. The SEC has consistently asserted that the private remedy under Rule 10b-5 is a "necessary supplement" to the SEC's enforcement powers and a "most effective" enforcement tool. *See* Brief for the SEC as Amicus Curiae at 1, Lampf, Pleva, Lipkind, Prupis, & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (No. 90-333); Brief for the SEC as Amicus Curiae at 6, Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) (Nos. 81-680, 81-1076); Brief for the SEC as Amicus Curiae at 10 n.2, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193–94 (1976) (No. 74-1042).

peradventure,"[99] and has proceeded to define this implied private right of action in a series of opinions.[100] The Court, with the support of the SEC, allowed the private remedy under Rule 10b-5 to thrive, and no Justice has ever seriously questioned the propriety of recognizing such a remedy.[101]

Congress also supported the fundamental approach of the federal securities laws and recognized the key role they played in the prosperity of the nation since the Great Depression. Thus, Congress amended the federal securities laws numerous times since the 1930s, but before the 1990s these amendments invariably operated to enhance their reach and to extend the basic theme of investor protection.[102] Notably, none of these amendments operated to curtail private remedies even though those remedies operated robustly to secure deterrence in full view of Congress.[103] Moreover, in the legislative history accompanying these amendments, Congress heaped praise on the federal securities laws with no mention at all of any problems arising from private securities litigation.[104] Ultimately, demanding responsibility and basic

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99. *Herman & MacLean*, 459 U.S. at 380.

100. *E.g.*, *Ernst & Ernst*, 425 U.S. at 193–94 (holding that a Rule 10b-5 plaintiff must allege and prove scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (holding that a Rule 10b-5 plaintiff must be an actual seller or purchaser); Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 169 (1971) ("[W]e read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face.").

101. David S. Ruder, *The Development of Legal Doctrine Through Amicus Participation: The SEC Experience*, 1989 WIS. L. REV. 1167, 1168 (pointing out, as former Chairman of the SEC, that "private securities litigation plays an essential role in federal securities regulation" and that approximately 90% of securities cases were privately pursued in 1988).

102. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.) (expanding SEC oversight of self-regulatory organizations that supervise broker-dealers); Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (codified as amended at 15 U.S.C. §§ 78aaa–78111) (extending insurance to balances held by securities broker-dealers); Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified as amended in scattered sections of 15 U.S.C.) (extending the regulatory power of the federal securities laws and the SEC to over-the-counter markets).

103. The first recognition of an implied remedy under Rule 10b-5 occurred in 1946. *See Kardon*, 69 F. Supp. at 514. The Supreme Court first took up the issue of implied remedies in 1964. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (stating that private litigation is a most effective weapon in the enforcement of the securities laws and a necessary supplement to Commission resources). Congress, however, maintained its focus on protecting investor confidence rather than any concerns on supposed vexatiousness.

104. For example, in 1964 Congress (through the House Committee on Interstate and Foreign Commerce) stated:

> The Securities Act of 1933, relating to truthful disclosure of information about new security offerings; the Securities Exchange Act of 1934, relating to disclosure of information about listed securities and regulating practices in exchange and over-the-

accountability of corporate and financial elites[105] proved unsustainable.[106] Memories faded, unprecedented prosperity and inequality took root,[107] and elites quickly used their vast resources to replicate the preconditions of the Great Depression.[108]

B. The War on Private Securities Litigation

The success of the federal securities laws bred complacency.[109]

> counter operations; and succeeding legislation which is administered by the Securities and Exchange Commission; represent legislation of which this committee and the Congress are justly proud. These statutes have gone a long way in the mitigation and elimination of undesirable practices in the securities field, in the restoration of confidence in securities markets, and in the protection of the investing public.

H.R. REP. NO. 88-1418, at 4 (1964), *reprinted in* 1964 U.S.C.C.A.N. 3013, 3016. Congress has emphasized investor protection and investor confidence as an important, even compelling, policy objective because "[i]t is a basic teaching of this nation's financial history that continued economic health fundamentally depends upon the maintenance of investor confidence." H.R. REP. NO. 94-123, at 43–44 (1975); *see also* S. REP. NO. 91-1218, at 2 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5256; H.R. REP. NO. 88-1418, at 6–7 (demonstrating congressional determination to maintain investor confidence).

105. This was the overall intent of the federal securities laws. *See* 86 CONG. REC. 5231 (1940) (statement of the President upon the signing of the Investment Advisors Act of 1940) ("[A] conscientious and successful effort has been made to require the investment banker, the broker, and the dealer, the security salesman, the issuer, and the great financial institutions themselves to recognize the high responsibilities they owe to the public.").

106. Former SEC Chair and Justice William O. Douglas predicted in 1934 that the use of litigation to protect investors would ultimately be subject to sustained political attack and emasculation by the courts. Douglas, *supra* note 70, at 525.

107. *See* KNOPP, *supra* note 91, at 169 (noting that the longest economic expansion in U.S. history commenced in 1991 and ended in 2001). Economists predict that higher inequality leads to subverted law in favor of the very rich. *See* Edward Glaeser, Jose Scheinkman & Andrei Shleifer, *The Injustice of Inequality*, 50 J. MONETARY ECON. 199, 200 (2003) ("[I]f political and regulatory institutions can be moved by wealth or influence, they will favor the established, not the efficient.").

108. *See generally* Carbone, *supra* note 30, at 1035–49.

109. According to Andrew Lo:

> During extended periods of prosperity, market participants become complacent about the risk of loss—either through systematic under-estimation of those risks because of recent history, or a decline in their risk aversion due to increasing wealth, or both. In fact, there is mounting evidence from cognitive neuroscientists that financial gain affects the same "pleasure centers" of the brain that are activated by certain narcotics. This suggests that prolonged periods of economic growth and prosperity can induce a collective sense of euphoria and complacency among investors that is not unlike the drug-induced stupor of a cocaine addict. Moreover, the financial liberalization that typically accompanies this prosperity implies greater availability of risk capital, greater competition for new sources of excess expected returns, more highly correlated risk-taking behavior because of the "crowded trade" phenomenon, and a false sense of security derived from peers who engage in the same behavior and with apparent success.

Andrew W. Lo, Written Testimony Prepared for the U.S. House of Representatives Committee on Oversight and Government Reform Hearing on Hedge Funds: Hedge Funds, Systemic Risk, and

Financial elites never held the federal securities laws in high esteem.[110] Before their enactment many financial elites claimed the "grass would grow on Wall Street."[111] Not long after the enactment of the federal securities laws, experts predicted that memories would fade and that those holding economic power would exploit those fading memories to undercut the federal securities laws.[112] After all, the homeless and those on food stamps do not get sued under the federal securities laws.[113] Given the huge lobbying resources that corporate and financial

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the Financial Crisis of 2007–2008 12–13 (Nov. 13, 2008) (citations omitted), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstractid=1301217.

110. Elite hostility to the constraints implicit in the federal securities laws, in general, and robust private remedies, in particular, makes sense. Even after decades of judicial and legislative paring, private actions still operated to impose damages of up to $19 billion per annum in recent years. *See* ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2011 REVIEW AND ANALYSIS 1 (2011) [hereinafter CORNERSTONE SETTLEMENTS 2011] (charting total settlement dollars in court-approved securities class action settlements from 2002–2011). One can only imagine the deterrent and compensatory power of private securities litigation in full bloom in accordance with the rollbacks offered in this Article. Of course, as previously shown, under private securities litigation there are many sanctions imposed upon corporate managers beyond paying damages to victims of securities fraud—ranging from steep stock price declines to a higher risk of bankruptcy. *See supra* note 22.

111. DAVID RATNER, SECURITIES REGULATION IN A NUTSHELL § 11 (2d ed. 1982).

112. One visionary was Ferdinand Pecora. Pecora served for seventeen months, from January 1933 to July 1934, as counsel to the Senate Committee on Banking and Currency, during the time of hearings on the Securities Act and the Exchange Act. *See* FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS 3 (1939) (Augustus M. Kelley ed., 1973). Pecora published a summary of those congressional hearings because "[a]fter five short years, we may now need to be reminded what Wall Street was like before Uncle Sam stationed a policeman at its corner." *Id.* at xi. Pecora was prescient in predicting a failure of public memory:

> Under the surface of the governmental regulation of the securities market, the same forces that produced the riotous speculative excesses of the "wild bull market" of 1929 still give evidences of their existence and influence. Though repressed for the present, it cannot be doubted that, given a suitable opportunity, they would spring back into pernicious activity. Frequently we are told that this regulation has been throttling the country's prosperity. Bitterly hostile was Wall Street to the enactment of the regulatory legislation. It now looks forward to the day when it shall, as it hopes, reassume the reins of its former power. . . . The public, however, is sometimes forgetful. As its memory of the unhappy market collapse of 1929 becomes blurred, it may lend at least one ear to the persuasive voices of The Street subtly pleading for a return to the "good old times." Forgotten, perhaps, by some are the shattering revelations of the Senate Committee's investigation.

Id. at ix–x.

113. As Professor Miller observes:

> I think it is fair to say that a number of the Justices (as well as other federal judges) have a predilection (perhaps subliminal) that favors business and governmental interests. Surely, a significant number of opinions in recent years do show that orientation. Nor do I think it unfair to say that some Justices on the current Court and some members of the federal judiciary are disenchanted with civil litigation and wish

elites control, an attack on the federal securities laws seemed inevitable.[114]

Soon, private securities litigation fell into scorn and disrepute.[115] Judicial impulses to protect the powerful necessarily permeated the federal courts over time at least insofar as private securities litigation is concerned.[116] By the 1990s, the Supreme Court in particular seemed determined to reign in private securities claims. In 1991, in *Lampf,*

> to limit it, which, of course, negatively impacts access and works against those in our lower and middle economic classes who want entre to the civil justice system. That is an unfortunate echo of today's societal inequities and reflects the stunning disparity in power, people's income, and status in our nation.

Miller, *supra* note 16, at 366–67. It is noteworthy that the government subsidizes the legal expenses of every securities fraudfeasor through the tax system. *See* JEROLD S. AUERBACH, JUSTICE WITHOUT LAW? 144 (1983) (terming deductibility of legal fees for businesses "a gigantic government subsidy").

114. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xviii (2011) [hereinafter FCIC REPORT] (finding that the financial sector spent $2.7 billion in lobbying expenses from 1999 to 2008 and $1 billion in campaign contributions through political action committees). The press tagged the PSLRA as a prime example of influence peddling. Dowd, *supra* note 10, at 132 (listing the PSLRA as the top example of the relationship between laws, money and lobbying, and noting that PSLRA was backed by a $29.6 million war chest); *see also* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal Journey for Plaintiffs in Fed. Sec. Law Actions*, 65 U. CIN. L. REV. 3, 24 (1996) (examining supposed policy arguments in favor of the PSLRA and concluding that none was sound and that "[i]nstead, money . . . and politics . . . fueled the rush to enact [the] draconian" PSLRA); D. Brian Hufford, *Deterring Fraud vs. Avoiding the Strike Suit*, 61 BROOK. L. REV. 593, 641 (1995) ("Ultimately, the evidence does not support the securities reform advocates . . . the [PSLRA] arises from . . . well-funded public relations and lobbying efforts . . . .").

115. The broadest and most litigated provision of the federal securities laws is Rule 10b-5 which prohibits fraud in connection with the purchase or sale of securities. In order for a plaintiff to state a claim for securities fraud under Rule 10b-5 they must prove: (1) a material misrepresentation or omission; (2) made with scienter (i.e., an intent to defraud); (3) inducing reliance; (4) causing; (5) damages. Allyson Poulos et al., *Securities Fraud*, 50 AM. CRIM. L. REV. 1479, 1482–83 (2013). As such, it is difficult if not impossible to fathom judicial and legislative licentiousness for securities fraudfeasors. Class biases and excessive judicial discretion have so far been offered for the odd and inexplicable attitudes that cropped up in the 1990s to support protective judicial doctrines for fraudfeasors and those knowingly aiding securities fraudfeasors. *See* Dain C. Donelson & Robert A. Prentice, *Scienter Pleading and Rule 10b-5: Empirical Analysis and Behavioral Implications*, 63 CASE W. RES. L. REV. 441, 495, 508–09 (2012); Miller, *supra* note 16, at 305, 366–67. With respect to protective legislation, raw economic power untethered to any real policy basis probably looms larger. *See, e.g.*, Branson, *supra* note 114, at 24. This Article seeks to add a manifest failure to understand financial history and macroeconomics to the list of factors offered to explain the facially inexplicable.

116. Justice Douglas predicted successful political attacks in the courts and through Congress on private securities remedies in 1934. Douglas, *supra* note 70, at 525. He was profoundly correct. *See, e.g.*, *In re* Glenfed, Inc. Sec. Litig., 42 F.3d 1541, 1557 (9th Cir. 1994) ("The driving force behind securities fraud suits filed to extract early settlements disproportionate to the merits is the expectation that once plaintiffs get past the pleading stage, they will automatically gain access to virtually unlimited discovery."); *In re* Time Warner Sec. Litig., 9 F.3d 259, 263 (2d Cir. 1993) (stating that securities plaintiffs use the litigation process to "extract[] undeserved settlements" because defendants are faced with large costs of defense).

Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, the Court dramatically shortened the statute of limitations applicable to private claims under Rule 10b-5.[117] Before the Court's decision in *Gilbertson*, the circuit courts had looked to state law to define the statute of limitations for claims under Rule 10b-5 for over forty years.[118] Invariably, these statutes of limitations were more generous to injured investors in terms of the statutory periods in which claims must be brought.[119] This is because the Supreme Court in *Gilbertson* basically engrafted a strict liability, rescission-based statute of limitations upon a fraud-based remedy.[120]

The Court struck again in 1994. In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Court eliminated aiding and abetting liability in private actions under Rule 10b-5.[121] Through aiding and abetting liability, federal courts had historically permitted plaintiffs to recover against those who aided or abetted the securities violations of others.[122] Common law fraud long recognized liability for those aiding

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117. 501 U.S. 350, 360–62 (1991) (holding that the limitations period for 10b-5 claims is one year from discovery, but in no event more than three years from the date of the transaction), *superseded by statute on other grounds*, Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236.

118. As Justice Stevens argued:

> The policy choices that the Court makes today may well be wise—even though they are at odds with the recommendation of the Executive Branch—but that is not a sufficient justification for making a change in what was well-settled law during the years between 1946 and 1988 governing the timeliness of action impliedly authorized by a federal statute. This Court has recognized that a rule of statutory construction that has been consistently applied for several decades acquires a clarity that "is simply beyond peradventure."

Id. at 368–69 (Stevens, J., dissenting) (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983)).

119. Rescission is viewed as a harsh remedy because it unwinds transactions and upsets business expectations. Consequently it makes sense that Congress would limit the rescission remedy provided in section 12 of the Securities Acts. Another section where Congress imposed a short one-year/three-year limitations regime is the strict liability imposed by section 18 of the Exchange Act for false filings. *See id.* at 376 (Kennedy, J., dissenting). Justice Kennedy also objected to an absolute statute of repose of three years because it "conflicts with traditional limitations periods for fraud-based actions . . . and imposes severe . . . limitations on a federal implied cause of action that has become an essential component of the protection the law gives to investors who have been injured by unlawful practices." *Id.* at 374.

120. *Id.* at 376. Congress partially repaired the damage of the courts with respect to the statute of limitations. *See* 28 U.S.C. §1658(b) (2012). Unfortunately, more needs to be done. Michael J. Kaufman & John M. Wunderlich, *Toward a Just Measure of Repose: The Statute of Limitations for Sec. Fraud*, 52 WM. & MARY L. REV. 1547, 1611 (2011) (showing that the pleading requirements of the PSLRA still create unjust statute of limitations issues for plaintiffs and permit unremedied securities fraud).

121. 511 U.S. 164, 191 (1994) (holding that aiding and abetting liability was not statutorily authorized after thirty years of lower courts imposing such liability).

122. *See, e.g.*, Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992);

and abetting fraud.[123] Recognition of aiding and abetting liability under the federal securities laws was often crucial in imposing accountability upon so-called "gatekeepers."[124] This enhances compensation by providing investors with meaningful remedies against so-called "deep pockets" such as lawyers or accountants; after all, the presence of such professionals could well have advanced frauds perpetrated by impecunious actors.[125] Moreover, these professional "gatekeepers" often could act to forestall massive securities fraud.[126] Yet, once again, the Court simply ignored decades of lower court rulings and congressional acquiescence in those rulings and overturned decades of pre-existing case law.[127]

In 1995, in *Gustafson v. Alloyd*, the Court restricted the availability of rescission claims against sellers of securities under the Securities Act by engrafting a requirement that a plaintiff in such an action be a purchaser in a public offering.[128] Importantly, section 12(2) does not require proof of scienter.[129] Lower courts long applied the plain meaning of the

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Schlifke v. Seafirst Corp., 866 F.2d 935, 937 (7th Cir. 1989); Kerbs v. Fall River Indus. Inc., 502 F.2d 731, 739–40 (10th Cir. 1974), *abrogated by Central Bank*, 511 U.S. 164; Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *abrogated by Central Bank*, 511 U.S. 164.

123. *See* RESTATEMENT (SECOND) OF TORTS § 876(b) (1977).

124. As used in this Article, the term "gatekeepers" includes: (1) auditors that act to verify a company's financial statements; (2) debt rating agencies that evaluate the creditworthiness of the company; (3) investment bankers that issue fairness opinions or facilitate the distribution of securities; and (4) attorneys that advise issuers or opine in connection with specific transactions. Coffee, *supra* note 38, at 1405.

125. Noted scholars attribute the Enron series of corporate failures precisely to "gatekeeper" failure. "Logically, as legal exposure to liability declines and as the benefits of acquiescence in the client's demands increase, gatekeeper failure should correspondingly increase—as it did in the 1990s." *Id.* at 1419.

126.

> Although other spectacular securities frauds have been discovered from time to time over recent decades, they have not generally disturbed the overall market. In contrast, Enron has clearly roiled the market and created a new investor demand for transparency. Behind this disruption lies the market's discovery that it cannot rely upon the professional gatekeepers—auditors, analysts, and others—whom the market has long trusted to filter, verify and assess complicated financial information. Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified.

Id. at 1403.

127. *Central Bank*, 511 U.S. at 192–98 (Stevens, J., dissenting).

128. 513 U.S. 561 (1995) (stating that when Congress enacted section 12(2) of the Securities Act, it could not have intended to create "vast additional liabilities").

129. Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 911 (1992) ("[S]cienter (whatever it means) is alien to the language of section 12(2). Instead, Congress shifted the burden of proof to the defendant to show that he 'did not know, and in the exercise of reasonable care could not have known,' of the untruth or omission.").

statute to allow section 12(2) actions in a non-public offering.[130] Moreover, as Justice Ginsburg argued in dissent, "[s]tate adaptations of [section 12(2)] have been applied consistently beyond public offerings [and] have been read to cover secondary transactions."[131] Justice Ginsburg also demonstrated that securities law scholars (including scholars involved in the drafting of the Securities Act or its early implementation) clearly stated that they intended the section 12(2) remedy to reach beyond public offerings.[132] Professor Bainbridge termed the *Gustafson* opinion "the most poorly-reasoned, blatantly results-driven securities opinion in recent memory."[133] This decision effectively granted additional protection to all sorts of securities peddlers, and directly defies the policy of the Securities Act.[134]

In 2005, the Court ruled in *Dura Pharmaceuticals, Inc. v. Broudo*,[135] that plaintiffs seeking to recover under the federal securities laws must allege and prove "economic loss."[136] That requires an allegation that the defendant's misconduct did not merely touch upon the losses suffered but proximately caused those losses.[137] This in turn requires

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130. *E.g.*, Haralson v. E.F. Hutton Grp., Inc., 919 F.2d 1014, 1032 (5th Cir. 1990); Adalman v. Baker, Watts & Co., 807 F.2d 359 (4th Cir. 1986); Nor-Tex Agencies v. Jones, 482 F.2d 1093, 1099 (5th Cir. 1973) (applying section 12 to non-public offering).

131. 513 U.S. at 613 (Ginsburg, J., dissenting).

132. *Id.* at 600–01.

133. Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231, 1231 (1995).

134. Loss, *supra* note 129, at 908–09, 917.

135. 544 U.S. 336 (2005).

136. *Id.* at 343 (citing 15 U.S.C. § 78u-4(b)(4)). More specifically,

> As we have pointed out, the plaintiffs' lengthy complaint contains only one statement that we can fairly read as describing the loss caused by the defendants' "spray device" misrepresentations. That statement says that the plaintiffs "paid artificially inflated prices for Dura['s] securities" and suffered "damage[s]." The statement implies that the plaintiffs' loss consisted of the "artificially inflated" purchase "prices." The complaint's failure to claim that Dura's share price fell significantly after the truth became known suggests that the plaintiffs considered the allegation of purchase price inflation alone sufficient.

Id. at 346–47 (internal citations omitted).

137. According to Justice Breyer:

> But it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind. At the same time, allowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about harm of the very sort the statutes seek to avoid. It would permit a plaintiff "with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence."

Id. at 347 (citation omitted).

linking the misrepresentations to the ultimate losses sustained.[138] The opinion is limited to claims brought by purchasers of securities who pursue private securities fraud claims based on the fraud-on-the-market theory,[139] and therefore applies to a relatively narrow band of securities fraud cases.[140] Further, compliance with the essential teaching of the case poses only mild pleading challenges.[141] Nevertheless, it is a perfect illustration of the hyper-technical road counsel must now tread in order to avoid dismissal of a Rule 10b-5 action.[142] Professor Michael Kaufman has noted that this requirement of "economic loss" is not in the legislation, nor in the legislative history underlying the Private Securities Litigation Reform Act ("PSLRA"), and "raises the specter of result-oriented reasoning."[143]

Worse, the Supreme Court expanded the protection for those aiding and abetting securities fraud in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.* in 2008.[144] After *Central Bank*, a majority of lower courts held that primary securities fraud liability should be narrowly imposed only upon those making direct or attributable fraudulent statements.[145] *Stoneridge* affirms this approach.[146] As Professor Prentice demonstrates convincingly, however, common law

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138. *Id.*

139. *See* Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988) (holding that plaintiffs may rely on the integrity of market prices). As Professor Kaufman explains, "fraud-on-the-market cases" are Rule 10b-5 actions in which the "element of 'reliance' can be 'nonconclusively' presumed from the fact that plaintiffs purchased their shares at a price that 'reflects a material misrepresentation.'" Michael J. Kaufman, *At a Loss: Congress, the Supreme Court and Causation Under the Federal Securities Laws*, 2 N.Y.U. J.L. & BUS. 1, 41 (2005).

140. Professor Kaufman states:

> Accordingly, the decision does not address SEC actions, which are not at all governed by the PSLRA. Nor does the opinion reach private actions for securities fraud where the plaintiffs are not attempting to take advantage of the nonconclusive presumption of reliance on the fraud-on-the-market theory. Examples include cases involving securities not traded on a public market, cases involving claims of actual reliance on a fraudulent misrepresentation, cases involving a presumption of reliance from a material omission, and even cases involving a presumption of reliance from the "fraud - created the-market" theory. Finally, and somewhat paradoxically, the Court's decision does not take into account any claims brought by defrauded sellers of securities who sell their securities at artificially deflated prices.

Id. at 42.

141. *Id.* at 42–46.

142. *See generally* Branson, *supra* note 114, at 6 (discussing how the Burger and Rehnquist Courts have radically changed a prior presumptive reliance on 10b-5 by determining many cases for defendants and defense interests).

143. Kaufman, *supra* note 139, at 48–49.

144. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

145. *See, e.g.*, Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1223–27 (10th Cir. 1996).

146. 552 U.S. at 158–59.

fraud always operated to impose liability on those participating in fraud as direct fraudfeasors with no need to actually speak.[147] Prentice notes that as a result of this reality the "Rule 10b-5 cause of action actually provides markedly less protection than investors enjoyed before 1934, rather than more."[148] This can only be termed a yet another perversion of the original conception of the federal securities laws. As Professor Prentice concludes: "The activist *Stoneridge* majority has . . . completed its self-appointed task of largely eviscerating the private right to sue that it began in *Central Bank* without any sufficient basis in law or policy for doing so."[149] Dissenting, Justice Stevens spoke no less directly: "I respectfully dissent from the Court's continuing campaign to render the private cause of action under §10(b) toothless."[150]

Some commentators have noted that the Court had been scaling back investor protections under the federal securities laws for decades even prior to this series of cases that aggressively limited the scope of private securities remedies under the federal securities laws. Professor Branson catalogued the carnage as of 1996: "In forty federal securities law decisions, the Court decided thirty-two cases for defendants and, in almost every one, significantly narrowed the reach of federal securities laws."[151] Today, the Court obviously seeks to abolish or at least severely limit private securities fraud litigation.[152]

147.

> When Congress legislated in 1934, the common law of fraud and virtually every existing body of fraud jurisprudence imposed liability upon those who knowingly participated in a fraud. It is nearly inconceivable that a Congress legislating in 1934 (or an SEC making rules in 1942) would have intended anything else for the broadly drawn Section 10(b)/Rule 10b-5.

Robert Prentice, Stoneridge*, Securities Fraud Litigation and the Supreme Court*, 45 AM. BUS. L.J. 611, 622–23 (2008) (and authorities cited therein).

148. *Id.* at 612.

149. *Id.* at 675.

150. 552 U.S. at 174 (Stevens, J., dissenting). In the latest assault of that campaign, the Court limited accountability under Rule 10b-5 (yet again) only to those exercising "ultimate authority" over a fraudulent statement. Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011).

151. Branson, *supra* note 114, at 6.

152. Incandela, *supra* note 30, at 938 (citing *Janus* and concluding that the Court holds an "apparent desire to abolish the private right of action under § 10(b)"). During approximately the same time the Court shifted its attitude regarding private enforcement of the federal securities laws, it also led the charge against the retrenchment of public enforcement of the securities laws. Thus, the SEC Historical Society notes on its website that the SEC emerged victorious from every challenge to its authority in the Supreme Court from 1941 to 1971. SEC HISTORICAL SOC'Y, *Fair To All People: The SEC and the Regulation of Insider Trading, Counterattack From the Supreme Court*, http://www.sechistorical.org/museum/galleries/it/counterAttack_a.php (last visited Mar. 10, 2014). Subsequently, the Court pared the SEC's authority and challenged its interpretation of the federal securities laws. *Id.* (citing A. C. Pritchard, *Justice Lewis F. Powell,*

In late 1995, Congress joined the campaign and enacted the PSLRA.[153] The PSLRA imposed a new, more stringent pleading standard regarding scienter on plaintiffs seeking relief under the federal securities laws even before discovery may commence; imposed a new sanctions provision applying a loser-pays rule to such plaintiffs; created a safe harbor for forward-looking frauds; restricted the ability of plaintiffs to seek class action relief under the federal securities laws; imposed a stricter statutory causation standard for private securities litigants; and restricted the availability of joint and several liability for such claimants.[154] Collectively, these provisions gave securities fraudfeasors wider shelter from private claims.

Yet, individually, the pleading standard imposed under the PSLRA operates as the most pernicious and illogical element of the PSLRA.[155] The PSLRA requires all securities plaintiffs to plead *scienter*—that is, intent to defraud—through "facts giving rise to a strong inference that the defendant acted with the required state of mind."[156] Moreover, these facts must be pled without the benefit of discovery.[157] The Federal Rules of Civil Procedure ("FRCP") exemplify a far more reasoned approach. FRCP 9(b) merely requires that while fraud must be alleged with particularity, scienter may be alleged generally; this means a plaintiff need not produce strong facts bearing on a defendant's state of mind before discovery, but instead must prove scienter to the trier of fact.[158] Recently, the Court addressed the meaning of a "strong

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Jr. and the Counterrevolution in the Federal Securities Laws, 52 DUKE L. J. 841, 843–44 (2003)).

153. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

154. Ramirez, *Arbitration and Reform*, *supra* note 11, at 1084 ("The recent 'reforms' of private securities litigation are a betrayal of several fundamental goals of the federal securities laws and expose our financial system to risks that are not fully appreciated.").

155. *See, e.g.*, Curt Cutting, *Turning Point for Rule 10b-5: Will Congressional Reforms Protect Small Corporations*, 56 OHIO ST. L.J. 555, 583 (1995) ("Evidence indicating a defendant's state of mind is virtually impossible to discover without conducting [discovery]. Requiring plaintiffs to produce such evidence before discovery is 'putting the cart before the horse.'"); Charles W. Murdock, *Corporate Corruption and the Complicity of Congress and the Supreme Court—The Tortuous Path from* Central Bank *to* Stoneridge Investment Partners, 6 BERKELEY BUS. L.J. 131, 188 (2009) ("Congress and the federal courts are operating in a fairyland world. Unless the accountants decide to recast the financial statements, or the board of directors or a bankruptcy court initiates an investigation which is made public, or whistleblowers are found, requiring specificity in pleading without discovery is an almost insurmountable hurdle."); *see also* Sale, *supra* note 38, at 578 ("[W]hen vigorously applied, the combination of a strict pleading standard with a stay of discovery creates a pleading barrier so high that few complaints will survive it."); Weiss & Roser, *supra* note 38, at 500 (showing through a case study that if courts fully enforce the PSLRA "much fraud will go unremedied").

156. 15 U.S.C §78 u-4(b)(1) (2012).

157. *See id.* §§ 77z-1(b)(2), 78u-4(b)(3)(B).

158. FED. R. CIV. P. 9(b).

inference" under the PSLRA.[159] According to the Court, that standard is satisfied only if "a reasonable person would deem the inference of [the required state of mind] cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[160] In other words, a plaintiff must rebut the possibility of an innocent misrepresentation at the pleading stage, without the benefit of discovery.

The PSLRA imposed a sanctions provision that applied only to plaintiffs and approached a loser-pays regime for securities plaintiffs.[161] The Act creates a rebuttable presumption that any finding of a FRCP 11[162] violation with respect to a complaint (but not responsive pleadings by defendants) entitles the defendant to "reasonable attorneys' fees and other expenses incurred as a direct result of the violation."[163] Further, Congress required courts to conduct a mandatory review as to whether counsel violated Rule 11 at the conclusion of the litigation, and deprived courts of the discretion to decline to impose sanctions even if a Rule 11 violation occurs.[164] Other than with respect to private securities litigation, Rule 11 applies the same standards and procedures with respect to all pleadings, and Rule 11 scrutiny is triggered only by motion.[165] This particularly harsh approach to sanctions for private securities claims naturally chills all claims regardless of ultimate merit.[166]

The PSLRA also abolishes joint and several liability in private securities litigation except for knowing violations.[167] As a result, securities fraudfeasors will generally only be liable for an apportioned

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159. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314, 324–26 (2007).

160. *Id.* at 324.

161. President Clinton cited the sanctions provision as a key basis for his veto of the PSLRA. PRESIDENT BILL CLINTON, PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995—VETO MESSAGE FROM THE PRESIDENT OF THE UNITED STATES, H.R. DOC. NO. 104-150 (1995). He noted that the measures lacked balance and treated plaintiffs more harshly than defendants. *Id.* The President also objected that the provision resembled a "loser-pays" approach that is contrary to American tradition. *Id.*

162. FED. R. CIV. P. 11.

163. 15 U.S.C. § 78u-4(c)(3)(a) (2012).

164. *Id.* § 78u-4(c)(1).

165. *Id.*

166. According to Professors Choi and Thompson:

> Most of the sanctions cases occur in disputes between individual investors and their broker or money manager in contexts far removed from the class action context that generated the motivation for the passage of the PSLRA. These non-class action cases generated a majority of the examples (seven cases) in which sanctions were imposed (a total of eleven cases in our sample).

Choi & Thompson, *supra* note 28, at 1502.

167. 15 U.S.C. § 78u-4(f)(2)(A).

share of the total damages in their fraud causes, as determined by the jury.[168] This "reform" essentially shifts the risk of an insolvent or judgment-proof defendant to the plaintiff from a co-defendant found guilty of securities fraud.[169] This provision came under immediate attack since it only applies to meritorious claims—meaning it specifically applies only to proven securities fraudfeasors to reduce their exposure.[170] Thus, this element of the PSLRA belies any claim that it took aim only at frivolous claims.[171] Clearly, the Act was simply pro-securities fraudfeasors.[172] If there were a truth-in-legislating requirement, the PSLRA would be called the Leave No Securities Fraudfeasor Behind Act.

In 1998, Congress followed up on the PSLRA with the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[173] The SLUSA

168. *Id.* § 78u-4(f)(2)(B).

169. This provision transparently operates to simply favor securities fraudfeasors over innocent securities investors. I catalogued the various and sundry mechanisms the judiciary and Congress have put in place that incentivize securities fraud at the expense of compensation for victims and deterrence in 1999. Thus, I highlighted the pleading rule that allowed potential securities fraudfeasors to escape responsibility if alleged to have acted fraudulently in exchange for professional fees or salaries. Ramirez, *Arbitration and Reform*, *supra* note 11, at 1070 n.60. I also argued that courts had crafted a rule that no fraud can occur if it is forward-looking fraud that "bespeaks caution." *Id.* at 1071 n.61. I also wrote against the abolition of joint and several liability. *Id.* at 1078. Each of these provisions simply amounts to a known subsidy for fraudulent actors in the securities markets.

170. *See* Donald C. Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 BUS. LAW. 1157, 1174 (1996) (concluding that because this reform applies to meritorious, non-class action claims, it is overbroad).

171. *See, e.g.*, REPRESENTATIVE NEWT GINGRICH ET AL., CONTRACT WITH AMERICA 150 (Ed Gillespie & Bob Schellhas eds., 1994) ("Since class-action lawyers can make decisions that are not in the best interest of the clients . . . shareholders are often exploited. Strike suits are money-makers for the lawyers but such frivolous claims destroy jobs and hurt the economy."). In fairness, the PSLRA included many class action reforms that I do not criticize here. Ramirez, *Arbitration and Reform*, *supra* note 11, at 1078–79. Similarly, the PSLRA included a safe harbor for forward-looking frauds. *Id.* at 1076. This provision defies the historical bases of the federal securities laws. *See* Joel Seligman, *The Private Securities Reform Act of 1995*, 38 ARIZ. L. REV. 717, 732 (1996) ("[The safe harbor provision] appears to go far, for the first time in the history of federal securities laws, to immunize certain deliberately false statements."). Yet, as will be shown it played only a marginal role (at best) in the massive securities frauds of 2001–2002 and the Great Financial Crisis of 2008. *See infra* Part II.

172. Early on, other commentators came to conclusion that the PSLRA was overbroad. *See* Cutting, *supra* note 151, at 582 ("Like the fee shifting provision . . . the requirement that scienter be pled with particularity disposes of meritorious claims as well as meritless ones."); *see also* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 377–78 (1996) ("To the extent the Act makes meritorious cases more difficult to pursue, it will not have served a worthwhile purpose. The strength of our markets depends on investor confidence that those markets operate honestly and fairly.").

173. Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15

eliminated state class actions in securities disputes involving public companies.[174] For the first time in history, the federal securities laws operated to *narrow* investor rights of action.[175] This directly undermines the longstanding ideal that the federal securities laws only operate to enhance remedies available to investors.[176] As I stated previously: "A more reactionary cycle could hardly have been imagined by the promulgators of the federal securities laws in the early 1930s."[177]

Professor Branson sums up the net effect of all of this: "[T]hey—conservative federal judges, lobbyists for corporate American and other defense interests and Congress—have joined together to destroy completely the federal courts as places of refuge and protection for defrauded investors."[178] Notably, he published his conclusion in 1996. Since then, Congress piled on with the SLUSA and the Supreme Court piled on with ever more draconian interpretations of Rule 10b-5.[179] Both Congress and the courts simply ignore the history of massive securities fraud and the basic economic logic that compels stemming fraud in the financial markets.

There can be little doubt that all of this extreme effort to deter private securities litigation affected the number of claims pursued and the settlements paid (if any)—and therefore critically changed the risk/reward relationship that drives individuals to commit securities fraud.[180] After the PSLRA, trials of securities fraud class actions

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U.S.C.).

174. *Id.* After the SLUSA, federal law now operates to destroy state law private rights of action. *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006) (holding that the SLUSA preempted class action relief for plaintiffs alleging fraudulent inducement to hold securities and thereby destroyed such claims).

175. Historically, the federal securities laws had operated only to expand investor rights because federal remedies were cumulative with any state law rights of recovery. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) (stating that Congress enacted the federal securities laws in order "to rectify perceived deficiencies in common law protections").

176. *See supra* notes 78–81, 147 and accompanying text (explaining how federal remedies collaborated with state remedies to enhance only the rights of investors).

177. Ramirez, *Arbitration and Reform*, *supra* note 11, at 1084.

178. Branson, *supra* note 114, at 40–41.

179. *See supra* notes 144, 159, 173 and accompanying text (citing the SLUSA and relevant Supreme Court cases).

180. Fraud is a function of incentives and disincentives under law. Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 594–95 (2000). Today the law fails to adequately deter fraud. *Id.* at 596. Professor Yablon recognized this fact early on, at the turn of the century, and proved prescient:

> One further reason for not seeking additional curbs on . . . securities claims at this time is that managerial incentives to engage in such fraudulent conduct may be increasing. The reason for this may be stated in three words: pay for performance. In recent years, most CEO compensation packages have become increasingly dependent on stock performance, often stock performance within a limited period of time, like an options

became a rarity and settlements amounted to only 2.1% of estimated damages.[181] Ironically, now that securities litigation suffered evisceration at the hands of the judiciary and Congress, commentators argue further restrictions are warranted because private litigation offers neither compensation nor deterrence.[182] Essentially, the argument is that now that Congress and the judiciary gave a green light to securities fraud, we should lift the speed limit.

This war on private securities litigation did not proceed openly on the basis that law should operate to destroy the economy, enrich a small band of powerful securities fraudfeasors, and permit mass fleecing of investors worldwide. Instead, it relied upon policy props that all held that private securities litigation caused great harm.[183] One prop was the mythological litigation explosion.[184] Another prop was the "urban legend" of the extortionate settlement.[185] A third prop argued that too

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> exercise period. This may not be a bad thing, but it has certainly increased the incentives of corporate managers to control or delay the flow of bad news to the securities markets. Given this trend, now seems a particularly bad time to weaken or remove one of the major disincentives to such conduct.

Id.; *see also* JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 61 (2006) (noting that, after the PSLRA was passed, "class-action plaintiffs virtually ceased suing secondary defendants"). Of course, resort to numbers of claims filed since the PSLRA to assess its impact is likely futile, as the key number that matters is unknowable—the number of claims chilled and not pursued due to the draconian "reforms" to the law for the benefit of fraudfeasors. More importantly, if the PSLRA facilitated more securities fraud then the raw number of claims pursued as a measure of the impact of the so-called reforms is confounded by the reality of more securities fraud.

181. RENZO COMOLLI ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2012 FULL-YEAR REVIEW 39 (2012), *available at* http://www.nera.com/67_7992.htm; CORNERSTONE SETTLEMENTS 2011, *supra* note 110, at 7, 8.

182. *See, e.g.*, Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1306 (2008) (arguing that to avoid over-deterrence the SEC should have pre-clearance authority over private complaints without any assessment of the possible macroeconomic harm wrought by massive securities fraud).

183. *See* Ramirez, *Arbitration and Reform*, *supra* note 11, at 1055 (summarizing commentators' attacks on private securities litigation).

184. *E.g.*, Stephen S. Meinhold & David W. Neubauer, *Exploring Attitudes About the Litigation Explosion*, 22 JUST. SYS. J. 105, 112 (2001) ("[T]he myth of the litigation explosion continues to be widely held and appears to be permanently entrenched"); Jack B. Weinstein, *After Fifty Years of the Federal Rules of Civil Procedure: Are the Barriers to Justice Being Raised?*, 137 U. PA. L. REV. 1901, 1909 (1989) (questioning the existence of a litigation explosion and noting that federal judges have about the same number of cases as in 1960); *see also supra* note 36.

185. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1536 n.5 (2006) (comparing extortionate settlements to a "unicorn"); Arthur R. Miller, *From* Conley *to* Twombly *to* Iqbal*: A Double Play on the Federal Rules of Civil Procedure*, 60 DUKE L.J. 1, 103 (2010) ("[C]laims of excessive costs, abuse, and frivolousness in litigation may have much less substance than many think, and

much frivolous litigation imposed a tax upon capital formation holding back economic growth.[186] None of these props holds any true policy validity.[187] Yet, these essential arguments provided crucial political cover for the true purpose of the war—to allow corporate and financial elites to garner enhanced profits from fraud-related activities without concern for possible accountability.[188] As the next Part demonstrates, that was the predictable effect of the indulgences granted securities fraudfeasors during the war on private securities litigation.[189]

II. THE ERA OF MASSIVE SECURITIES FRAUD

Persistent scandals following the war on private securities litigation, such as the failure of Enron and other high profile firms in 2001–2002, demonstrate that fraudfeasors can now too easily line their pockets at the expense of shareholders and general financial stability.[190] Enron

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extortionate settlements may be but another urban legend."). As Professor Miller later explained, it is virtually impossible to identify or measure the reality or frequency of any extortionate settlement. Miller, *Simplified Pleading*, *supra* note 16, at 362.

186. Hufford, *supra* note 114, at 641. Of course excessive, theoretical, random and arbitrary litigation may tax innovation and suppress growth. Yet, the counterpoint (based in actual reality) is that investors shun financial markets tainted with massive securities fraud, as occurred during the Great Depression. *See supra* note 56 and accompanying text. Today, experts attribute the disappearance of the retail investor to a host of factors including Wall Street scandals. Barry Ritholtz, *Where has the retail investor gone?*, WASH. POST, Aug. 12, 2012, http://www.washingtonpost.com/business/where-has-the-retail-investor-gone/2012/08/17/9a915 eee-e7cf-11e1-936a-b801f1abab19_story.html ("[P]eople believe the game is rigged against them. They aren't conspiracy nuts, they are merely observing what has been going on . . . . [I]t appears that bankers have corrupted the political process for their own gains. Investors are wondering why they should participate in such an absurd environment.").

187. *See* Ramirez, *Arbitration and Reform*, *supra* note 11, at 1086–89.

188. The FCIC found that a "systemic breakdown in accountability and ethics" formed a root cause of the crisis. FCIC REPORT, *supra* note 114, at xxii. The millions in compensation garnered from such misconduct boggles the mind. *Id.* at 61–63. The massive lobbying and campaign contributions behind the war on securities litigation came from the very interests that profited mightily from a free-wheeling financial sector—financial elites. *Id.* at xviii.

189. Scholars in various fields increasingly show what has long been obvious—that legal indulgences for securities fraudfeasors produces more fraud. Thus, one innovative study that exploited legal differences among circuits in the degree of laxity extended to securities fraud defendants showed that more laxity means more fraud. Justin Hopkins, Market-Based Regulation: Does Securities Litigation Prevent Financial Misrepresentations? 4–5 (Aug. 23, 2013) (unpublished and unnumbered working paper), *available at* http://ssrn.com/abstract=18 72068 (finding that a court decision that reduced the risk of fraud claims led to more financial restatements and earnings management, especially among firms facing a higher risk of litigation). In another innovative study of the impact of the PSLRA business scholars found more questionable accounting outcomes for large accounting firms most likely affected by the PSLRA relative to those less likely subject to the protections of the PSLRA. *See* Lee & Mande, *supra* note 11, at 93.

190. Douglas Guerrero, *The Root of Corporate Evil*, INTERNAL AUDITOR, Dec. 2004, at 37 (stating that, with regard to the corporate failures of 2001–2002, "highly placed executives used

became the prime example: in the end, Enron's Chief Executive Officer ("CEO"), Chairman of the Board and Chief Financial Officer were indicted and convicted of securities fraud (or at least found guilty by a jury).[191] Nevertheless, before their convictions, the three received nearly $500 million in aggregate compensation.[192]

Essentially, Enron's senior managers used accounting fraud to hide losses and debts in special purpose entities ("SPEs")[193] that should have been consolidated under Generally Accepted Accounting Principles ("GAAP") with Enron's financial statements (and disclosed in Enron's Form 10-K).[194] Enron valued other derivatives trades pursuant to "rosy assumptions" under fair value accounting permissible under GAAP.[195] The temporary result of this securities fraud was to enhance accounting performance.[196] The effective result was that Enron's senior managers greatly enriched themselves at great loss to shareholders.[197] The problem with all of this accounting chicanery is that it makes it impossible for shareholders to understand their own corporations and

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their power . . . to achieve financial targets fraudulently, boost the stock price, and further enrich themselves via compensation schemes that rewarded those achievements").

191. Scott Cohn, *Fastow: Enron Didn't Have to Go Bankrupt*, CNBC (June 26, 2013, 9:24 PM), http://www.cnbc.com/id/100847519 (noting that while Fastow and Skilling served years in prison, Ken Lay's conviction was set aside due to his reported death before sentencing).

192. JOSEPH E. STIGLITZ, THE ROARING NINETIES 242 (2003).

193. As Professor Cunningham explains: "The company engaged in volatile trading activity and housed it in special purpose entities (SPEs) to insulate the company's earnings and hence stock price from resulting short-term gyrations. Using SPEs is legitimate and lawful as matters of accounting and commercial and securities laws, so long as rules are observed." LAWRENCE A. CUNNINGHAM, INTRODUCTORY ACCOUNTING, FINANCE AND AUDITING FOR LAWYERS 440 (6th ed. 2013).

194. Under GAAP accounting:

> To obtain off-balance treatment, SPEs must satisfy general well-known rules of consolidation accounting and particular arcane rules applied to these entities. The general rule provides that to avoid full consolidation of an entity, a third-party must control a majority of that entity's equity . . . ; the arcane rule says that at least 3% of the SPE's total capital must be equity (capping the debt equity ratio at approximately 97:3 or about 32:1). In early transactions, Enron followed both rules, capitalizing SPEs with a debt: equity ratio no greater than 32:1 and placing a majority of the equity with a third party. In subsequent deals, however, one or both requirements went unmet. In most of these, either Enron, an affiliate or an Enron executive held the equity. This meant that all the deals constituted related-party transactions and all should have been disclosed and/or consolidated on Enron's books. None was. Debt housed in these controlled entities ran to billions of dollars, and the security was often Enron's own stock. When business conditions turned adverse, its stock price weakened and the debts came home to roost in cascades, leading to bankruptcy.

Id. at 441.

195. *Id.*

196. STIGLITZ, *supra* note 192, at 243.

197. *Id.*

make decisions accordingly.[198]

When Enron collapsed, the carnage was widespread. First, at the time, Enron held the dubious title of being the largest bankruptcy in history, meaning shareholders essentially were wiped out.[199] Second, numerous gatekeepers allegedly participated in the Enron fraud, including Arthur Anderson,[200] JPMorgan Chase, Citigroup and Enron's law firm, Vinson & Elkins,[201] all of which faced legal sanctions. Third, from a macroeconomic perspective, the failure of Enron could not have come at a worse time, as the first revelations of deception arose on October 16, 2001, as the nation was in the grips of recession that started in March of 2001,[202] and just over a month after the terrorist attacks of September 11.[203] Finally, Enron proved to be the beginning of a crisis rather than the end.[204]

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198. The entire purpose of the public accounting system is to provide an accurate depiction of a firm's financial condition and performance for end users of financial statements including investors in securities. CUNNINGHAM, *supra* note 193, at 11.

199. According to NBC News:

> Enron plummeted into bankruptcy proceedings in December 2001 amid revelations of hidden debt, inflated profits and accounting tricks. Jurors determined after a 16-week trial that both Lay and Skilling repeatedly lied to investors and employees about the company's health when they knew their optimism masked fraud. The collapse obliterated more than $60 billion in market value, almost $2.1 billion in pension plans and, initially, 5,600 jobs.

Enron sentences will be tied to investor losses, NBC NEWS (May 26, 2006, 6:38 PM), http://www.nbcnews.com/id/12993408/#.UpR1ieKzL0c.

200. Andersen warrants special comment. The longstanding accounting firm held a well-earned reputation for integrity. CUNNINGHAM, *supra* note 193, at 440. Nevertheless, the lure of easy money from consulting for Enron appears to have distracted it from its auditing role. The truth on this point will never be known for certain because the firm shredded massive amounts of documents once the SEC began to investigate. *Id.* This led to the obstruction of justice conviction that ultimately sunk Andersen. *Id.*

201. STIGLITZ, *supra* note 192, at 242.

202. *Id.* at 58–62 (linking "irrational exuberance" in equity markets (including Enron bubble) to the recession of 2001).

203. Cohn, *supra* note 191.

> On October 16, 2001, Enron announced a $618 million quarterly loss, most of it resulting from a one-time charge for terminating "certain structured finance arrangements." Those arrangements, known as the Raptors, allowed Enron to move liabilities off of its books and into a series of Fastow-controlled partnerships known as LJM. The vehicles were backed by Enron stock, which was already losing value.

Id.

204. "The proportion of listed companies on NYSE, Amex and NASDAQ identified as restating their financial reports tripled from 0.89 percent in 1997 to 2.5 percent in 2001 . . . . From January 1997 through June 2002, about 10 percent of all listed companies announced at least one restatement." U.S. GEN. ACCOUNTING OFFICE, GAO-03-138, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 4 (2002), *available at* .http://www.gao.gov/new.items/d03138.pdf. Further, the average size of the firm restating their financial results quadrupled (measured by market

Following the Enron fraud case, a series of accounting frauds ultimately emerged.[205] The most massive fraud disclosure also constituted the most massive bankruptcy, outdoing even Enron.[206] Specifically, in summer of 2002, telecommunications giant WorldCom entered into, what was then, the largest bankruptcy in U.S. history.[207] WorldCom's accounting fraud was far more primitive and basic than Enron's.[208] They simply booked expenses as assets.[209] WorldCom booked $7 billion they paid for access to local phone lines and claimed the expense as an asset.[210] Previously, WorldCom booked these expenses properly. When the improper accounting treatment was challenged internally the whistleblower met with dismissal.[211] After WorldCom failed, investor fears surged and credit tightened.[212] The stock market plunged.

Understandably, investors lost confidence and fled the securities markets. In one forty-eight hour period the Dow Jones Industrial Average lost 700 points.[213] In October 2002, the stock market reached a five-year low.[214] Total market value declined by $8 trillion and the country fell into recession.[215] This was the toll exacted upon the U.S. economy by the "devastating debacle" of Enron and the parade of other accounting scandals.[216] Economists generally agree today that the Enron series of frauds contributed to the recession in 2001 and retarded

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capitalization). *Id.* Thus, accounting irregularities reached epidemic proportions by 2002.

205. Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 32 (2002) [hereinafter Ramirez, *Fear and Social Capitalism*] ("Merck, Bristol-Myers Squib, Qwest, Xerox and others added to the drumbeat of scandals.").

206. Luisa Beltran, *WorldCom files largest bankruptcy ever*, CNNMONEY (July 22, 2002, 10:35 AM), http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy ("WorldCom, the nation's No. 2 long-distance phone company, filed for Chapter 11 bankruptcy protection late Sunday, nearly one month after it revealed that it had improperly booked $3.8 billion in expenses.").

207. *Id.*

208. *See* CUNNINGHAM, *supra* note 193, at 443 ("Treating operating expenses as a capital expense is an age old move . . . .").

209. *Id.* at 442.

210. *Id.*

211. *Id.* at 442–43.

212. Gregory Zuckerman, *Despite Rebound, Fears of Corporate Credit Crunch Linger*, WALL ST. J., July 25, 2002, at C1 (stating that investor fears are manifest in the degree of spread between corporate debt and zero-risk U.S. Treasury obligations; investors in 2002 were demanding greater yields, thereby expanding spreads and threatening a "much-feared credit crunch").

213. Ramirez, *Fear and Social Capitalism*, *supra* note 205, at 31.

214. KOZMETSKY & YUE, *supra* note 15, at 2.

215. *Id.*

216. *Id.* at 1–2.

the slow recovery that followed.[217] Certainly, many factors contributed to the recession of 2001, including the 9/11 terrorist attacks.[218] Nevertheless, for the first time since the Great Depression massive securities fraud played a key role in an American recession.[219]

Congress responded to the Enron crisis with the Sarbanes-Oxley Act of 2002 ("SOX").[220] SOX focused primarily on limiting the ability of the CEO to subvert or manipulate the audit function.[221] SOX mandated independent audit committees.[222] It provided that auditors for public firms report to and be accountable to the independent audit committee.[223] SOX provided a specific, if modest, definition of "independent."[224] It created an entirely new regulator for auditors of public companies.[225] Finally, public firms[226] must have one audit committee member with specific accounting expertise (or an explanation regarding the lack of financial expertise).[227] All of this

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217. Economists now attribute much of the losses in employment during the 2001 recession to earnings management and accounting fraud at firms like Enron. *See* Kedia Simi & Thomas Philippon, *The Economics of Fraudulent Accounting*, 22 REV. FIN. STUD. 2169, 2169 (2009) ("We show that during periods of suspicious accounting, firms hire and invest excessively, while managers exercise options. When the misreporting is detected, firms shed labor and capital and productivity improves.").

218. Kevin L. Kliesen, *The 2001 Recession: How Was It Different and What Developments May Have Caused It?*, FED. RES. BANK ST. LOUIS REV., Sept./Oct. 2002, at 23, 31 ("[T]he 2001 recession was also notable for the sharp decline in exports and business investment in structures and inventories. Further, the declines in business capital spending were probably magnified by the sharp declines in equity prices during the recession, which helped to raise firms' financial cost of capital.").

219. *See* KOZMETSKY & YUE, *supra* note 15, at 1 (noting that other significant recessions after WWII were caused by oil price shocks in the mid-1970s and the early 1980s); *see also* Zuckerman, *supra* note 212 (detailing how securities fraud has influenced the recession).

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

221. *See generally* 15 U.S.C. § 78j-1 (2012) (detailing the audit requirements).

222. *Id.* § 78j-1(m)(3)(A).

223. *Id.* §§ 78j-1(k), (m)(2).

224. *Id.* § 78j-1(m)(3)(B).

225. *Id.* §§ 101–109; *id.* §§ 7221–7219 (creating the "Public Accounting Oversight Board" to regulate audit firms of public companies).

226. Publicly held companies are: (1) those companies or corporations traded on a national securities exchange such as the New York Stock Exchange; and (2) those with 500 or more shareholders and $10 million or more in assets. *Id.* § 781(g) (stating statutory definition of public company); 17 C.F.R. § 12g-1 (2013) (SEC exemption for certain companies). Public corporations are the central economic institution in the U.S., as they command a total market capitalization of $19 trillion. *See Fundamental Characteristics of the Wilshire 5000*, WILSHIRE, http://web.wilshire.com/Indexes/Broad/Wilshire5000/ (last visited Nov. 4, 2013). As such, they are the primary store of investment capital in the U.S.

227. 15 U.S.C. § 7265. The SEC promulgated regulations implementing this section. *See* 17 C.F.R. §§ 228, 229, 249.

effectively stripped the CEO of autonomy over the audit function.[228] Yet, despite the manifest flaws in the anti-fraud legal framework, Congress did little to restore private claims for securities law violations to the past.[229] In particular, SOX did nothing to address auditor liability, meaning that auditors would still lack incentives to interfere with management efforts to achieve high compensation through fraud.

The compensation package that often led to the highest payouts, that is, the option plan, created perverse incentives at the pinnacle of the public corporation in America.[230] These incentives encouraged officers to fraudulently manipulate and inflate their share prices.[231] Thus, many commentators suggest that the series of corporate scandals were at bottom driven by perverse compensation incentives.[232] According to respected business leadership voices, these incentives operated to create a historic crisis in investor confidence that had macroeconomic significance.[233] Simply put, the war on securities fraud litigation materially contributed to the macroeconomic instability arising from the failure of Enron, WorldCom, Tyco, Global Crossing and others during 2001–2002.[234]

In the fall of 2005, more evidence emerged that the law failed to deter securities fraud. Refco was the largest independent futures broker in the

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228. Although this removal of CEO autonomy was met with some success, CEOs simply used their power to manipulate risk within the public firm to achieve excess compensation, as will be discussed below. *See* Raghuram Rajan, *Bankers' Pay Is Deeply Flawed*, FIN. TIMES, Jan. 9, 2008, http://www.ft.com/cms/s/0/18895dea-be06-11dc-8bc9-0000779fd2ac.html#axzz2vVKgVB2K (noting the incentives for CEOs and financial managers to tolerate excessive risks that increase short term returns in order to receive immediate compensation).

229. Congress extended the statute of limitations for securities fraud. More specifically, section 804(a) of Sarbanes-Oxley amended 28 USC § 1658(b) to provide for a two year statute of limitations and a statute of repose of five years.

230. *See* Douglas Guerrero, *The Root of Corporate Evil: Executive Compensation Plans and Overwhelming Authority Must be Controlled Through Better Governance Mechanisms*, INTERNAL AUDITOR, Dec. 2004, at 37 (suggesting, "[i]t appears that . . . highly placed executives used their power . . . to achieve financial targets fraudulently, boost the stock price, and further enrich themselves via compensation schemes that rewarded those achievements").

231. *Id.*

232. *See Federal Reserve Board's Semiannual Monetary Policy Report to the Congress: Hearing Before the Comm. on Banking, Hous. & Urban Affairs* (2002) (testimony of Chairman Alan Greenspan), *available at* http://www.federalreserve.gov/boarddocs/hh/2002/July/testimony.htm (stating that lax boards had contributed to a CEO-centric corporate power structure that permitted senior executives to "harvest" gains through manipulation of share prices).

233. THE CONFERENCE BD., COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 4, 6 (2003) (finding that excessive compensation, resulting in part from lax monitoring by boards, led to an "unprecedented" loss of investor confidence).

234. Seligman, *supra* note 15, at 112–15 (identifying lax state fiduciary standards, along with the PSLRA, as key legal elements underlying the corporate scandals of 2001–2002).

U.S.[235] Its CEO concealed $430 million in debts that he owed Refco through entities he controlled, leading to his indictment for securities fraud.[236] The Refco public offering would have triggered the full applicability of the SOX, but only after the company consummated its public offering.[237] The SEC had regulatory authority over the Refco public offering and its securities brokerage units.[238] Grant Thornton audited the firm's books in accordance with the new Sarbanes-Oxley regime governing audits of public firms.[239] Numerous underwriters and other professionals (including the attorneys) would have been subject to the "due diligence" requirements of the federal securities laws.[240] Still, despite all of this oversight, millions in debts owed by the firm's CEO were not discovered until after the public offering.[241] One expert concluded that "[t]here is no way you can rely on an auditor or an investment bank for a seal of approval or a guarantee of no chicanery . . . . The lesson to be learned from Refco is that you must do sleuth work yourself."[242]

The options backdating scandals that came to light in 2006 proved far worse.[243] Thousands of public corporations backdated options grants to past dates when their stock was trading lower to maximize payoffs to their senior executives.[244] The sheer pervasiveness of the wrongdoing

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235. Peter Robison, *Bennett's Refco Scheme Exposed by Late-Night Hunch: "It Hit Me" (Correct)*, BLOOMBERG.COM (Oct. 31, 2005), http://www.bloomberg.com/apps/news?pid=newsarchive&refer&sid=aNbiVOYM8VMA; *see* Steven A. Ramirez, *The Chaos of Smith*, 45 WASHBURN L.J. 343, 359 (2005).

236. Ramirez, *supra* note 235, at 359.

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.*

241. *Id.*

242. *Id.* (citing Emily Thornton, *Refco: The Reckoning*, BUS. WK. ONLINE (Nov. 7, 2005), http://www.businessweek.com/magazine/content/05_45/b3958095.htm (quoting veteran money manager Michael F. Holland)); *see id.* (quoting Professor John Coffee) ("[O]ur current system of due diligence by underwriters seems to be dysfunctional.").

243. *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1601 (2007) (finding that backdated options at forty-eight sampled companies resulted in approximately $500,000 in extra compensation for executives while costing shareholders at each company $389 million in market capitalization). "Recent research has established that many executives exert both legal and illegal influence over their compensation." *Id.* at 1641.

244. Stephanie Saul, *Study Finds Backdating of Options Widespread*, N.Y. TIMES, July 17, 2006, at C1 (reporting on an academic study finding "[m]ore than 2,000 companies appear to have used backdated stock options to sweeten their top executives' pay packages"); *see also* Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271, 276 (2006) (describing an example of the popularity of backdating by noting that the SEC found that one Silicon Valley firm had forty-nine

sounded yet more alarms of a fundamentally flawed system of securities regulation.[245] Once again, CEOs lined their pockets through fraud and imposed huge deadweight losses upon shareholders.[246] By the end of the summer of 2006, two criminal cases had been filed against executives at Brocade Communications and Comverse Technology and over 100 companies disclosed that their options practices were under investigation.[247] Rigging options grants to maximize payoffs is like "stealing [money] from the company and . . . shareholders."[248] One company backdated options grants to enrich a dead executive.[249] Law did not operate to deter this episode of massive securities fraud.[250]

Perhaps the greatest securities fraud in history operated in the run-up to the Great Financial Crisis of 2008.[251] For example, Countrywide

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instances of backdating between January 1996 and April 2002); Randall A Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executive have been Backdated or Manipulated?*, 55 MGMT. SCI. 513, 524 (2009) ("We . . . estimate that 29.2% of firms at some point engaged in manipulation of grants to top executives between 1996 and 2005.").

245. *See* Charles Forelle & James Bandler, *Matter of Timing: Five More Companies Show Questionable Options Pattern*, WALL ST. J., May 22, 2006, at A1 (quoting former SEC Chair Arthur Levitt) (suggesting options backdating is essentially "stealing" through the use of fabricated documents, unless fully disclosed).

246. M.P. Narayanan et al., *supra* note 243, at 1641 ("[O]ur evidence suggests that managerial theft is not a zero-sum game, but involves huge dead-weight losses for the shareholders.").

247. Editorial, *Phantom of the Options*, N.Y. TIMES, Aug. 24, 2006, http://www.nytimes.com/2006/08/24/opinion/24thu2.html?_r=0.

248. Carolyn Said, *Possible Options Scams at Several Local Companies*, S.F. CHRON., May 24, 2006, http://www.sfgate.com/business/article/Possible-options-scams-at-several-local-companies-2496290.php (quoting compensation expert Fred Whittlesey).

249. Peter Grant et al., *Cablevision Gave Backdated Grant To Dead Official*, WALL ST. J., Sept. 22, 2006, http://online.wsj.com/news/articles/SB115884346082669986.

250. On the contrary, former SEC Chair Arthur Levitt has termed options backdating to be "the ultimate in greed." Forelle & Bandler, *supra* note 245.

251. I use the term "Great Financial Crisis of 2008" to denote the massive global financial market disruption that commenced with the failure of Lehman Brothers on September 15, 2008 and ending in the spring of 2009 when the U.S. stock market hit a low of below 7000 in the Dow Jones Industrial Average. *See* Alexandra Twin, *For Dow, Another 12-year Low*, CNNMONEY.COM (Mar. 9, 2008), http://money.cnn.com/2009/03/09/markets/markets_newyork/ (noting that Dow closed at 6547, only 57% of the 2007 high). As both the current Federal Reserve Chair and his immediate predecessor recognize this reflects the unprecedented virulence of the financial crisis that struck the nation in the fall of 2008. *See supra* note 2 (comparing the Great Depression with the Great Financial Crisis of 2008). Indeed, the financial shock to our economic system rivals and may exceed the shock that led to the Great Depression. Only massive fiscal and monetary stimulus spared the nation from an economic collapse like the Great Depression. ALAN S. BLINDER & MARK ZANDI, HOW THE GREAT RECESSION WAS BROUGHT TO AN END 1 (July 27, 2010*), available at* https://www.economy.com/mark-zandi/documents/end-of-great-recession.pdf (stating that "the U.S. government's response to the financial crisis and ensuing Great Recession included some of the most aggressive fiscal and monetary policies in history" and finding that "its effects on real GDP, jobs, and inflation are huge, and probably averted what could have been called Great Depression 2.0"). Thus, the "Great Financial Crisis of 2008" focuses appropriately upon the magnitude of the financial disruption notwithstanding the fact that

Financial originated, serviced and packaged more subprime loans than any other firm.[252] Countrywide engaged in reprehensible lending practices; in fact, ultimately Countrywide settled allegations of predatory lending asserted by eleven states for over $8 billion, the largest such settlement in history.[253] The states alleged that Countrywide lied about its "no closing cost loans," misled consumers with respect to hidden fees, structured loans with risky features, paid brokers more to sell more risky loans and frequently lent based upon inflated borrowers' income (without borrower involvement).[254] *The New York Times* interviewed former employees[255] that corroborated (and documented) many of these allegations.[256] The profits generated through lax lending standards and high fees were so high that Countrywide continued its reckless[257] lending even after delinquency rates soared.[258] "As such, the company is Exhibit A for the lax and, until recently, highly lucrative lending that has turned a once-hot business ice cold and has touched off a housing crisis of historic proportions."[259]

Angelo Mozilo, the firm's CEO, garnered outrageous compensation for leading Countrywide into the subprime pit.[260] In 2006, Mozilo's

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the government successfully rescued the nation from a repeat of the Great Depression.

252. David Olive, *Corporate Rewards for Failure*, THESTAR.COM (Feb. 1, 2008), http://www.thestar.com/columnists/article/299415 (reporting that Countrywide's CEO sold $400 million in stock between 2005 and 2008).

253. Gretchen Morgenson, *Countrywide to Set Aside $8.4 Billion in Loan Aid*, N.Y. TIMES, Oct. 6, 2008, at B1.

254. *Id.*

255. Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, at B1 ("Such loans were made, former employees say, because they were so lucrative—to Countrywide. The company harvested a steady stream of fees or payments on such loans and busily repackaged them as securities to sell to investors.").

256. *Id.* ("One document, for instance, shows that until last September the computer system in the company's subprime unit excluded borrowers' cash reserves, which had the effect of steering them away from lower-cost loans to those that were more expensive to homeowners and more profitable to Countrywide.").

257. *Id.* ("The company would lend even if the borrower had been 90 days late on a current mortgage payment twice in the last 12 months, if the borrower had filed for personal bankruptcy protection, or if the borrower had faced foreclosure or default notices on his or her property.").

258. *Id.* ("One reason these loans were so lucrative for Countrywide is that investors who bought securities backed by the mortgages were willing to pay more for loans with prepayment penalties and those whose interest rates were going to reset at higher levels.").

259. *Id.* ("[T]he profit margins Countrywide generated on subprime loans that it sold to investors were 1.84 percent, versus 1.07 percent on prime loans. A year earlier, when the subprime machine was really cranking, sales of these mortgages produced profits of 2 percent, versus 0.82 percent from prime mortgages.").

260. James L. Bicksler, *The Subprime Mortgage Debacle and Its Linkages to Corporate Governance*, 5 INT'L J. DISCLOSURE & GOVERNANCE 295, 296 (2008).

compensation amounted to $102 million, which included a bonus of $20.5 million for increased earnings at Countrywide from $4.11 per share in 2005 to $4.62 per share in 2006.[261] In 2007, Mozilo exercised stock options, hauling in $127 million, just prior to the announcement on July 24, 2007 that Countrywide would write down $388 million in loan losses.[262] Mozilo earned an additional $102 million in salary and $30 million in options compensation in 2007.[263] He retired in 2008 with a $58 million benefit.[264] According to his own emails, Mozilo knew that Countrywide's loan products were "poison," and he called the risky loans the most "toxic" he had seen in all his years in home lending.[265] For the entire year of 2007, Countrywide lost $704 million, as 33% of its subprime mortgages were delinquent.[266] Shareholders lost over 80% of the value of their shares, relative to their value before the credit crisis.[267] Countrywide was acquired by Bank of America—where its subprime portfolio inflicted $33 billion in additional loan losses according to one analyst.[268] Mozilo and other Countrywide executives settled securities fraud claims with the SEC for $73 million in 2010 for failure to disclose Countrywide's reckless lending.[269] Angelo Mozilo paid just $22.5 million, or a small fraction of his fraudulent (according to the SEC) profits.[270]

Citigroup's CEO Chuck Prince famously stated in 2007 that if liquidity dried up "things will be complicated" but that "as long as the

261. *Id.*

262. *Id.* at 297.

263. *Id.* at 296–97.

264. *Id.* at 297.

265. FCIC REPORT, *supra* note 114, at 20.

266. Roddy Boyd, *Countrywide: From Bad to Worse*, CNNMONEY.COM (Jan. 8, 2008), http://money.cnn.com/2008/01/29/news/companies/boyd_countrywide.fortune/.

267. *Bank of America and Countrywide: Fingers Crossed*, ECONOMIST, June 28, 2008, at 82.

268. *Bank of America Faces Lingering Financial Woes from Countrywide: Report*, MARKETWATCH (Feb. 8, 2009), http://www.marketwatch.com/story/bank-america-faces-lingering-financial-woes.

269. Press Release, U.S. Sec. & Exch. Comm'n, Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive (Oct. 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-197.htm (noting that the SEC settled based upon allegations that Mozilo (and others) "failed to disclose to investors the significant credit risk that Countrywide was taking on as a result of its efforts to build and maintain market share" and that "Mozilo engaged in insider trading in the securities of Countrywide by establishing four 10b5-1 sales plans in October, November, and December 2006 while he was aware of material, non-public information concerning Countrywide's increasing credit risk").

270. Walter Hamilton & E. Scott Reckard, *Angelo Mozilo, Other Former Countrywide Execs Settle Fraud Charges*, L.A. TIMES, Oct. 16, 2010, http://articles.latimes.com/2010/oct/16/business/la-fi-mozilo-sec-20101016.

music is playing you've got to get up and dance."[271] Citigroup worked to keep the music playing by including "liquidity puts" in its securitized pools of subprime mortgages it sold to investors.[272] The liquidity put required Citigroup to repurchase interests in subprime mortgages in the event of turbulence in the subprime market.[273] In the fall of 2007, Citigroup learned that its subprime exposure amounted to about half of its total capital, but concealed these facts from the investing public.[274] Only in November of 2007 did Citigroup publicly disclose for the first time that it had $55 billion in subprime mortgage exposure and anticipated losses of about $8 billion to $11 billion.[275] Prince resigned shortly thereafter.[276] In December of 2007, Citigroup announced it would assume $58 billion of debts that had been carried by structured investment vehicles ("SIVs") it had sponsored; the SIVs had invested in long-term assets (including mortgage related assets) with short term funding.[277] The risks of these losses went undisclosed to shareholders.[278]

Ultimately, the U.S. government was forced to bail out Citigroup, injecting $45 billion in capital and guaranteeing $306 billion in asset values.[279] During 2007, Citigroup's shareholders lost 45% of their value.[280] Its stock traded at $55 per share in 2006, and in early 2009, it traded at less than $4 per share.[281] Later, its shares traded at below $1 per share.[282] CEO Chuck Prince fared much better: his compensation amounted to $66.8 million over his last three years and he was paid a

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271. David Wighton, *Prince of Wisdom*, FIN. TIMES, Nov. 4, 2007, http://www.ft.com/cms/s/0/fce88e10-8b12-11dc-95f7-0000779fd2ac.html.

272. Carol J. Loomis, *Robert Rubin on the Job He Never Wanted*, FORTUNE, Nov. 26, 2007, at 69.

273. *Id.*

274. FCIC REPORT, *supra* note 114, at 264–65.

275. *Id.* at 265.

276. *Id.*; *see also* Tim Bowler, *The Rise and Fall of Citigroup*, BBC (Jan. 16, 2009), http://news.bbc.co.uk/2/hi/business/7746077.stm ("If the bank had been allowed to collapse, it could have caused financial havoc around the globe, seizing up fragile lending markets and causing untold losses among institutions holding debt and financial products backed by the company.").

277. Shannon D. Harrington & Elizabeth Hester, *Citigroup Rescues SIVs With $58 Billion Debt Bailout (Update5)*, BLOOMBERG.COM (Dec. 14, 2007), http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aS0Dm.iV5BCI.

278. In fact, not even the Chair of the Citigroup Executive Committee comprehended the risks from these instruments. Loomis, *supra* note 272, at 69.

279. Evan Thomas & Michael Hirsh, *Rubin's Detail Deficit*, NEWSWEEK, Dec. 8, 2008, at 45.

280. Bicksler, *supra* note 263, at 297.

281. Bowler, *supra* note 276.

282. Jonathan Stempel, *Citigroup stock falls below $1 for first time*, REUTERS, Mar. 5, 2009, *available at* http://www.reuters.com/article/bondsNews/idUSN0532847720090305.

"bonus" of $10.4 million for his last ten months of work which were marked by staggering losses.[283] He exited Citigroup with $40 million in severance pay.[284] Yet, a securities class action based upon a failure to disclose exposure to subprime mortgages settled for only $590 million.[285] The SEC settled a securities fraud claim for $75 million.[286]

Merrill Lynch CEO Stanley O'Neal garnered $91 million in compensation for 2006, a year in which Merrill reported record earnings.[287] In October 2007, Merrill recognized $14.1 billion in subprime losses and O'Neal retired.[288] His severance package totaled $160 million.[289] According to the allegations of securities fraud claims asserted by Merrill's shareholders, 2006 also marked the beginning of a multi-year effort by management to mislead investors about the nature and magnitude of Merrill's subprime mortgage exposure.[290] Merrill Lynch also worked hard to keep the music playing, and when customers stopped buying securities based upon subprime mortgages, Merrill purchased billions of its own products that its customers did not want—particularly collateralized debt obligation funds ("CDOs") based upon subprime mortgages.[291] The probable reason: "Merrill became addicted to the fees that flowed from financing CDOs, which reached $700 million in 2006."[292] Merrill lost $27.61 billion in 2008.[293] On January 16, 2009, Merrill Lynch announced it had reached an agreement with

283. Bradley Keoun, *Citi Cost-Cutters Skip Offices, Staff for Ex-CEOs Prince, Reed*, BLOOMBERG.COM (Feb. 17, 2009), http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=a.MJ0tBKx67w.

284. Bicksler, *supra* note 263, at 297.

285. Nate Raymond and Bernard Vaughan, *Judge approves Citigroup $590 million settlement*, REUTERS, Aug. 1, 2013, *available at* http://www.reuters.com/article/2013/08/01/us-citigroup-settlement-idUSBRE9700T420130801 ("The settlement resolves claims by shareholders who purchased Citigroup shares from February 2007 to April 2008 that the New York-based bank misrepresented its exposure to securities known as collateralized debt obligations that were tied to mortgage investments.").

286. FCIC REPORT, *supra* note 114, at 265.

287. Bicksler, *supra* note 263, at 297.

288. *Id.*

289. *Id.*

290. *Merrill Lynch Reveals $475M Deal to Settle Subprime Fraud Suit*, SEC. LITIG. & REG. REP., Jan. 27, 2009 ("The defendants, allegedly motivated by millions of dollars in cash bonuses and stock award grants tied to the company's performance, only gradually revealed the true extent of Merrill's mortgage-related losses in a series of statements beginning in October 2006.").

291. *See* Shawn Tully, *Wall Street's Money Machine Breaks Down*, FORTUNE, Nov. 26, 2007, at 64, 76 (alleging that Merrill was buying nearly all the top-rated debt from dozens of CDOs).

292. *Id.*

293. Jonathan Stempel, *Merrill Q4 loss $15.84 Bln, has material weakness*, REUTERS, Feb. 25, 2009, *available at* http://uk.reuters.com/article/hotStocksNewsUS/idUKTRE51N6YA20090225.

the plaintiffs' counsel to settle such claims for $550 million.[294]

American International Group, or AIG, once the world's largest insurance company, apparently lost more than any other firm.[295] On March 2, 2009, AIG announced the largest quarterly loss in all of corporate history of $61.7 billion, arising from a type of derivative termed a credit default swap ("CDS").[296] The CDS business centered in a subsidiary, AIG Financial Products, which was backed by the full credit and guarantee of the parent company.[297] The CDS business essentially guaranteed payment of billions in subprime mortgages.[298] Federal Reserve ("Fed") Chair Ben Bernanke maintains that AIG "exploited a huge gap in the regulatory system" and operated as an unregulated hedge fund that "made huge numbers of irresponsible bets."[299] Treasury Secretary Geithner concurred, calling AIG a hedge fund that grew "without any adult supervision."[300] The Treasury Secretary and the Fed Chair speak with particular authority since they engineered the bailout of AIG, which left the United States as the owner of nearly 80% of the firm.[301]

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294. Merrill Lynch & Co., Inc., Current Report (Form 8-K) 2 (Jan. 16, 2009), *available at* http://www.sec.gov/Archives/edgar/data/65100/000095012309000815/y74071e8vk.htm.

295. Hugh Son & Margaret Popper, *AIG's CEO Says Insurer Can Still Repay Taxpayers (Update1)*, BLOOMBERG.COM (Mar. 2, 2009), http://www.bloomberg.com/apps/news?pid=20601103&sid=ahykOmEesvWk&refer=us. AIG underwrote $450 billion of credit default swaps that obligated it to pay on pools of securities in the event that the primary obligees failed to pay. Lilla Zuill & Kristina Cooke, *AIG failure would be disastrous for global markets*, REUTERS, Mar. 2, 2009, *available at* http://uk.reuters.com/article/stocksAndSharesNews/idUKLNE52101620090302?pageNumber=1&virtualBrandChannel=0. As of March 2, 2009, the government had pumped $200 billion into AIG, but it still had $300 billion in credit default swap exposure. *Id.*

296. *See* Son & Popper, *supra* note 295 (requiring a delay to "its plan to sell subsidiaries and ask for more U.S. help after potential buyers balked because plunging values for financial assets left some of them short on capital").

297. Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 27, 2008, http://www.nytimes.com/2008/09/28/business/28melt.html?pagewanted=all.

298. *See* Michael Lewitt, *Wall Street's Next Big Problem*, N.Y. TIMES, Sept. 16, 2008, at A29 (one money manager defined credit default swaps as a credit insurance contract in which one party pays another party to protect it from the risk of default on a particular debt instrument: "The insurer (which could be a bank, an investment bank or a hedge fund) is required to post collateral to support its payment obligation, but in the insane credit environment that preceded the credit crisis, this collateral deposit was generally too small").

299. *Economic and Budget Challenges for the Short and Long Term: Hearing Before the S. Budget Comm.*, 111th Cong. 3 (2009) (statement of Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System).

300. *President's Fiscal Year 2010 Budget Overview: Hearing Before the H. Comm. on Ways & Means*, 111th Cong. 3 (2009) (statement of Timothy Geithner, Secretary, U.S. Treasury).

301. Joint Press Release, Bd. of Governors of the Fed. Reserve Sys. & U.S. Dep't of the Treasury, U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan (Mar. 2, 2009), *available at* http://www.federalreserve.gov/newsevents/press/other/20090302a.htm.

Essentially, the firm acted as credit insurer; yet, the CDSs were not insurance and AIG assumed these risks through an unregulated subsidiary, meaning it did not have to reserve fully against future losses nor carry any capital to fund potential losses.[302] The fees generated from the CDSs were consequently free income with little associated expense.[303] AIG literally gambled its viability away in the name of short term profits.[304] When the market for subprime securities crashed, AIG absorbed huge losses in the form of obligations to subprime investors.[305] The short term profits were used to fund a $600 million bonus pool for the officers in charge of the unit that underwrote the CDSs.[306] The CEO who managed AIG into this subprime mess was paid $47 million in severance pay when he was discharged.[307] The U.S. government effectively seized control in late 2008, at a cost of billions to U.S. taxpayers.[308]

AIG never disclosed the risks of its CDS business to its shareholders. Instead, AIG managers told shareholders on a conference call that AIG was highly unlikely to lose even $1 from the CDS business as late as

302. *See id.* (noting that AIG and "its regulated and unregulated subsidiaries are subject to very different resolution frameworks across their broad and diverse operations without an overarching resolution mechanism").

303. Stephen Taub, *New York: Credit-Default Swaps=Insurance*, CFO.COM (Sept. 22, 2008), http://www.cfo.com/article.cfm/12285201. Ironically, shortly after AIG's federal bailout, New York determined that credit default swaps would be regulated as if they were contracts of insurance, meaning that firms would have to hold capital reserves to secure the obligations. *Id.*

304. *See* Gretchen Morgenson, *A.I.G., Where Taxpayers' Dollars Go to Die*, N.Y. TIMES, Mar. 8, 2009, at BU1 (stating that AIG obligated itself to assume up to $440 billion in credit default swaps, which was more than twice its total market value of $200 billion. According to the article, "[t]hat means the geniuses at A.I.G. who wrote the insurance were willing to bet more than double their company's value that defaults would not become problematic. That's some throw of the dice. Too bad it came up snake eyes for taxpayers").

305. By the end of 2007, AIG had lost $61.7 billion due to its subprime related securities. David Glovin & Joel Rosenblatt, *Maurice Greenberg Sues AIG Over 'Inflated' Shares (Update1)*, BLOOMBERG.COM (Mar. 2, 2009), http://www.bloomberg.com/apps/news?pid=20601087&sid=aHDoc7YcjQZI&refer=home.

306. Lilla Zuill, *NY AG says targeting exec pay at AIG, elsewhere*, REUTERS, OCT. 22, 2008, *available at* http://www.reuters.com/article/newsOne/idUSTRE49L6I420081022?pageNumber=1&virtualBrandChannel=0.

307. *Id.* It is not clear how much of compensation will ultimately be paid to the AIG executives because their pay is being challenged by the Attorney General of New York. *Id.* "'It is not just compensation, but incentives—perverse incentives for executives to produce (short-term) profit rather than long-term growth,' said Cuomo." *Id.* (quoting Andrew Cuomo, New York Attorney General).

308. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 45 (Apr. 24, 2013), *available at* http://www.sigtarp.gov/Quarterly%20Reports/April_24_2013_Report_to_Congress.pdf (showing realized losses on disposition of AIG stock of $13.5 billion).

August 9, 2007.[309] At the time of this statement, Goldman Sachs had already demanded $1.2 billion in payment to cover AIG's exposure on the CDS held just by Goldman.[310] The next day AIG actually paid $450 million to Goldman in response to the Goldman collateral calls.[311] Neither of these facts was disclosed on the conference call.[312] Even as late as December of 2007, AIG told investors that the probability of loss on the CDS portfolio "is close to zero."[313] At the same time of that statement AIG was hemorrhaging cash on that very portfolio.[314] During 2008, AIG lost $99 billion largely as a result of the CDS portfolio.[315] The shares of AIG traded as high as $70 per share in 2007, and as of March of 2009, the shares traded for $0.42—a loss in value of over 99%.[316]

Lehman Brothers also appears to have failed in the aftermath of massive securities fraud.[317] The Bankruptcy Trustee for Lehman appointed former United States Attorney for the Northern District of Illinois Anton Valukas to investigate possible wrongdoing in connection

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309. According to the FCIC:

> On August 9, for the first time, AIG executives publicly disclosed the $79 billion in credit default swaps on the super-senior tranches of CDOs during the company's second-quarter earnings call. They acknowledged that the great majority of the underlying bonds thus insured . . . were backed by subprime mortgages. Of this amount, $19 billion was written on CDOs predominantly backed by risky BBB-rated collateral. On the call, Cassano maintained that the exposures were no problem: "It is hard for us, without being flippant, to even see a scenario within any kind of realm or reason that would see us losing $1 in any of those transactions." He concluded: "We see no issues at all emerging. We see no dollar of loss associated with any of [the CDO] business. Any reasonable scenario that anyone can draw, and when I say reasonable, I mean a severe recession scenario that you can draw out for the life of the securities."

FCIC REPORT, *supra* note 114, at 268.

310. *Id.*

311. *Id.*

312. *Id.*

313. *Id.* at 272.

314. *Id.*

315. Jonathan Stempel & Lilla Zuill, *AIG has $61.7 billion loss, new U.S. aid may not be last*, REUTERS, Mar. 2, 2009, *available at* http://www.reuters.com/article/ousiv/idUSN013445752009 0302.

316. *Id.*; Matt Krantz, *AIG: Removal from the Dow index is the least of your worries*, USA TODAY, Oct. 6, 2008, http://www.usatoday.com/money/perfi/columnist/krantz/2008-10-06-aig-stock-dow_N.htm.

317. Bloomberg reported in May of 2012 that the SEC would not pursue fraud claims in connection with the failure of Lehman Brothers based upon a leaked internal memorandum. Joshua Gallu, *SEC Staff Ends Probe of Lehman Without Finding Fraud*, BLOOMBERG (May 24, 2012), http://www.bloomberg.com/news/2012-05-24/sec-staff-said-to-end-lehman-probe-without -recommending-action.html.

with the firm's collapse on September 15, 2008.[318] According to Valukas: "I found that Lehman's decision not to disclose to the public a fair and accurate picture of its financial condition gave rise to colorable claims against senior officers who oversaw and certified misleading financial statements."[319] Valukas found that management knowingly used repurchase agreements with no economic substance to hide the degree of the firm's leverage from the investing public.[320] In fact, a whistleblower inside Lehman confirms Valukas' conclusions regarding accounting chicanery.[321] Lehman's bankruptcy constituted the initial shock that triggered the Great Financial Crisis of 2008.[322]

More recently, even more securities fraud from the subprime debacle emerged, in connection with the issuance of mortgage-backed securities by the nation's most significant banks.[323] In November 2013,

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318. *The Role of the Accounting Profession in Preventing Another Financial Crisis: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 55 (2011) (statement of Anton R. Valukas, Chairman, Jenner & Block, LLP).

319. *Id.*

320. *Id.* at 56. More specifically:

> Lehman repeatedly and heavily relied on Repo 105 transactions to temporarily remove—and I emphasize *temporarily*—some $50 billion off of Lehman's balance sheet right at quarter end. Lehman undertook $38.6 billion, $49.1 billion, and $50.38 billion of Repo 105 transactions at quarter-end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively. Lehman executives described this accounting device as a "gimmick," "window dressing," and a "drug we r on." Martin Kelly, Lehman's former Global Financial Controller, stated unequivocally that there was "no substance to the transactions."

Id.

321. Michael Corkery, *The Lehman Whistleblower's Letter*, WALL ST. J., Mar. 19, 2010, http://blogs.wsj.com/deals/2010/03/19/breaking-news-here-is-the-letter-at-the-center-of-the-lehman-report/.

322. John H. Cochrane & Luigi Zingales, *Lehman and the Financial Crisis*, WALL ST. J., Sept. 15, 2009, http://online.wsj.com/news/articles/SB10001424052970203440104574403144004792338.

323. According to the Department of Justice:

> The Justice Department, along with federal and state partners, today announced a $13 billion settlement with JPMorgan—the largest settlement with a single entity in American history—to resolve federal and state civil claims arising out of the packaging, marketing, sale and issuance of residential mortgage-backed securities (RMBS) by JPMorgan, Bear Stearns and Washington Mutual prior to Jan. 1, 2009. As part of the settlement, JPMorgan acknowledged it made serious misrepresentations to the public—including the investing public—about numerous RMBS transactions.

Press Release, Dep't of Justice, Justice Department, Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (Nov. 19, 2013), *available at* http://www.justice.gov/opa/pr/2013/November/13-ag-1237.html. The Department seems poised to pursue more such blockbuster recoveries related to fraud in connection with the purchase and sale of mortgage-backed securities:

> The settlement includes a statement of facts, in which JPMorgan acknowledges that it

JPMorgan Chase (the nation's largest bank) settled claims of fraud brought by government-affiliated investors to the tune of $13 billion—the largest settlement in history.[324] Shortly before this massive settlement, JPMorgan Chase settled similar claims brought by private investors for $4.3 billion.[325] JPMorgan Chase projects total exposure from its mortgage-backed securities misrepresentations to total $23 billion.[326] In 2011, Bank of America agreed to pay $11 billion to Fannie Mae.[327] In all, the megabanks have paid $66 billion to investors in toxic mortgages and experts project $100 billion in total payments

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> regularly represented to RMBS investors that the mortgage loans in various securities complied with underwriting guidelines. Contrary to those representations, as the statement of facts explains, on a number of different occasions, JPMorgan employees knew that the loans in question did not comply with those guidelines and were not otherwise appropriate for securitization, but they allowed the loans to be securitized—and those securities to be sold—without disclosing this information to investors. This conduct, along with similar conduct by other banks that bundled toxic loans into securities and misled investors who purchased those securities, contributed to the financial crisis.

Id. In one sample, 27% of the loans in a pool did not meet underwriting representations. More specifically: "According to a [report] prepared . . . by one . . . due diligence vendor . . . of the 23,668 loans the vendor reviewed for JPMorgan, 6,238 of them, or 27 percent, were initially graded Event 3 loans." DEP'T OF JUSTICE, STATEMENT OF FACTS 5 (2013), *available at* http://www.justice.gov/iso/opa/resources/94320131119151031990622.pdf. An Event 3 loan is a loan that does meet underwriting standards, has no compensating factors for any deficiencies or is missing critical documentation. *Id.* at 3. JPMorgan still included more than half the loans in mortgage backed securities pools. *Id.* at 4–5.

324. Michael Hiltzik, *How JPMorgan (sort of) copped to mortgage fraud—and won*, L.A. TIMES, Nov. 19, 2013, http://www.latimes.com/business/hiltzik/la-fi-mh-jpmorgan-fraud-20131120,0,4332353.story#axzz2lDksX6I7. JP Morgan did not admit to any violation of law, including fraud in connection with the purchase or sale of mortgage-backed securities. Instead, in the statement of facts accompanying the settlement:

> The statement's main theme concerns JPMorgan's sale of mortgage-backed securities to investors, including pension funds acting on behalf of their working-class members. The securities comprised pooled mortgages, and their values were based on the quality of those loans. The factors included the accuracy of the property appraisals, the borrowers' income statements and the level of documentation thereof. What the statement makes plain is that JPMorgan systematically lied about those factors, that its own staff knew about the misrepresentations and brought them to the attention of executives, and the bank sold the securities to unsuspecting buyers anyway.

Id. This means that private investors in the very mortgage-backed securities will still need to prove all elements of a Rule 10b-5 action. *See id.* (JPMorgan's chairman and chief executive stated, "[w]e did not admit to a violation of the law").

325. Karen Freifeld, *JPMorgan Chase to pay $4.5 Billion in mortgage security deal*, REUTERS, Nov. 15, 2013, *available at* http://www.reuters.com/article/2013/11/16/us-jpm-mortgage-deal-idUSBRE9AE15T20131116.

326. Stephen Gandel, *JPMorgan: We're prepared for $23 Billion in legal bills*, CNNMONEY (Oct. 13, 2013), http://finance.fortune.cnn.com/2013/10/11/jpmorgan-23-billion-legal-fees/.

327. Jessica Silver-Greenberg & Peter Eavis, *In Deal, Bank of America Extends Retreat From Mortgages*, N.Y. TIMES, Jan. 7, 2013, http://dealbook.nytimes.com/2013/01/07/bank-of-america-extends-retreat-from-mortgages/?_r=0.

from their issuance of mortgage-backed securities.[328] This is all consistent with the findings of the Financial Crisis Inquiry Commission ("FCIC") that the mortgage market in the U.S. was pervaded by fraud in connection with the purchase and sale of mortgage-backed securities immediately prior to the meltdown of 2008.[329] Indeed, the FCIC reported that up to $1 trillion of mortgage loans were tainted by fraud leading to losses of $112 billion.[330] By any measure, the Great Financial Crisis of 2008 originated in a massive securities fraud involving mortgage-backed securities.[331]

The FCIC also found one particularly pernicious form of securities fraud that emerged in connection with mortgage-backed securities.[332] Specifically, the so-called Magnetar Trade involved a sponsor of a collateralized debt obligation fund holding the riskiest equity tranche of the investment while simultaneously shorting the more senior tranches—unbeknownst to investors in the senior tranches.[333] The

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328. Saabira Chaudhuri, *U.S. Banks' Legal Tab Is Poised to Rise*, WALL ST. J., Oct. 28, 2013, http://online.wsj.com/news/articles/SB10001424052702304470504579163810113326856.

329. FCIC REPORT, *supra* note 114, at 160 (reporting that one analysis found that 13% of loans generated from 2005–2007 contained sufficient misrepresentations for compensation if securitized).

330. *Id.*

331. The SEC also sued mortgage securitizers for fraud in connection with the sale of mortgage-backed securities, and collected very large fines even if not as large as the settlements discussed above. *See, e.g.*, Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Bank of America With Fraud in RMBS Offering (Aug. 6, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539751924#.UpzkLeL1OAo (SEC alleges that Bank of America failed to disclose to mortgage-backed securities investors that more than 70% "of the mortgages [were] originated through the bank's 'wholesale' channel of mortgage brokers unaffiliated with Bank of America entities. Bank of America knew that such wholesale channel loans—described by Bank of America's then-CEO as "toxic waste"—presented vastly greater risks of severe delinquencies "); Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges J.P. Morgan and Credit Suisse With Misleading Investors in RMBS Offerings (Nov. 16, 2012), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486012#.UpzchuL1OAo (J.P. Morgan fine of $296.9 million and Credit Suisse fine of $120 million); Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Royal Bank of Scotland Subsidiary with Misleading Investors in Subprime RMBS Offering (Nov. 7, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540300002#.UpzZ2uL1OAo ($150 million fine paid).

332. FCIC REPORT, *supra* note 114, at 191–93. *See generally* Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (Apr. 9, 2010, 12:00 PM), http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going (discussing how the "Magnetar" hedge fund sponsored a complex securities deal misleading investors and earning "outsized returns" during the year the financial crisis began).

333. As Eisinger & Bernstein explain:

> According to bankers and others involved, the Magnetar Trade worked this way: The hedge fund bought the riskiest portion of a kind of securities known as collateralized debt obligations—CDOs. If housing prices kept rising, this would provide a solid

sponsor would then influence the selection of the collateral underlying the CDO to assure the rapid default of the senior tranches.[334] The sponsor would thereby profit from its short positions in the senior tranche well beyond the losses from holding the riskiest tranche.[335] The victims of this fraud included both the investors in the senior tranches as well as the mortgage borrowers entering into loan arrangements that were specifically designed for rapid default.[336] The FCIC found that by 2006 the Magnetar Trade infected much of the mortgage market.[337] Ultimately the SEC settled massive securities fraud claims against Goldman Sachs, Citigroup and JPMorgan Chase in connection with this scam.[338] At the time, the Goldman settlement was the largest SEC fine in history.[339]

The total cost of the Great Financial Crisis of 2008 cannot yet be

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> return for many years. But that's not what hedge funds are after. They want outsized gains, the sooner the better, and Magnetar set itself up for a huge win: It placed bets that portions of its own deals would fail.

Id.

334. Eisinger & Bernstein state:

> Along the way, it did something to enhance the chances of that happening, according to several people with direct knowledge of the deals. They say Magnetar pressed to include riskier assets in their CDOs that would make the investments more vulnerable to failure. The hedge fund acknowledges it bet against its own deals but says the majority of its short positions, as they are known on Wall Street, involved similar CDOs that it did not own.

Id.

335. The FCIC found that in Merrill Lynch's $1.5 billion Norma CDO, issued in 2007 Magnetar Capital, bought the riskiest equity tranche while shorting other tranches in Norma while involved in the selection of the assets for the CDO. FCIC REPORT, *supra* note 114, at 192. The SEC brought its first enforcement action for securities fraud against a CDO manager involving Magnetar Capital on October 18, 2013. *See generally* Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Fraud Charges Against Collateral Manager Of CDO (Oct. 18, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539908794#.UoiFnuL3Nbx (discussing the charges brought by the SEC against Harding Advisory LLC and Wing F. Chau for misleading investors in a collateralized debt obligation and breaching fiduciary duties).

336. *Id.* (explaining how Magnetar loans were set up to intentionally default, making clear the intent of Chau and Harding to place failing bets on its own deals).

337. FCIC REPORT, *supra* note 114, at 192 ("An FCIC survey of more than 170 hedge funds encompassing over $1.1 trillion in assets as of early 2010 found this to be a common strategy among medium-size hedge funds: of all the CDOs issued in the second half of 2006, more than half of the equity tranches were purchased by hedge funds that also shorted other tranches.").

338. Steven A. Ramirez, *The Real Subprime and Predatory Fraud (Fannie and Freddie Acquitted Again and Again II)*, CORP. JUST. BLOG (Nov. 6, 2011, 6:41 PM), http://corporatejusticeblog.blogspot.com/2011/11/real-subprime-and-predatory-fraud.html. Citigroup and JP Morgan Chase settled charges for $285 million and $153.6 million, respectively. *Id.*

339. Press Release, U.S. Sec. & Exch. Comm'n, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-123.htm.

calculated. Nevertheless, the cost of the crisis to the U.S. economy easily exceeds $15 trillion. Foregone GDP alone amounts to between $6 and $14 trillion.[340] This number doubles once losses in total wealth (including losses in human capital) are tallied in terms of permanent losses to future output.[341] The unprecedented efforts of the U.S. government to rescue the economy also must be added to the total cost of the crisis.[342] "An estimated $12.6 trillion in extraordinary government assistance was allocated to struggling businesses and households."[343] Much of this support meant increased spending and the lost revenue from the recession added $8 trillion in excess public debt through November of 2013.[344] In the future, both the Federal Reserve and the federal government will face constraints as a result of these extraordinary efforts.[345] Today, employment and wages remain stagnant.[346] Thus, a full reckoning remains years down the road.

In sum, the subprime debacle spared few from the ravages of securities fraud because it led to the Great Financial Crisis of 2008.[347]

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340. TYLER ATKINSON ET AL., HOW BAD WAS IT? THE COSTS AND CONSEQUENCES OF THE 2007–09 FINANCIAL CRISIS 6 (July 2013), *available at* http://dallasfed.org/assets/documents/research/staff/staff1301.pdf.

341. *Id.* at 2 ("The path of consumption since 2007 suggests household expectations of total wealth have been revised down significantly. It implies that the cost of the crisis would be more than double the 40 to 90 percent estimate based on output loss alone.").

342. Atkinson et al., state:

> Unprecedented fiscal and monetary action may have prevented a full-blown depression, but such intervention was not without significant costs. Society must deal with the consequences of a swollen federal debt, an expanded Federal Reserve balance sheet, and increased regulations and government intervention for years to come. Although we take a more comprehensive approach to extraordinary government spending as a "cost" of the crisis, this consideration of the broader impact of such public sector capital allocation is not directly comparable with our other cost calculations.

Id. at 2–3.

343. *Id.* at 15.

344. Fed. Reserve Bank of St. Louis, *Federal Debt: Total Public Debt (GFDEBTN)*, ECON. RES., http://research.stlouisfed.org/fred2/series/GFDEBTN/ (last visited Mar. 10, 2014).

345. ATKINSON ET AL., *supra* note 340, at 17 ("The fact that the nation is vulnerable to this reduced ability to respond to future downturns is an implicit, but significant, cost of the financial crisis.").

346. The civilian employment ratio, perhaps the broadest measure of employment remains stuck at 58.3%, barely above the lows in employment seen at the depths of the crisis. Fed. Reserve Bank of St. Louis, *Economic Research, Civilian Employment to Population Ratio (EMRATIO)*, ECON. RES., http://research.stlouisfed.org/fred2/series/EMRATIO (last visited Mar. 10, 2014).

347. As of this writing, another massive securities fraud has emerged. Specifically, due to a number of guilty pleas and payment of massive fines, there is no doubt that securities fraud occurred in connection with a massive scheme to manipulate a key benchmark interest rate known as LIBOR. *See, e.g.*, Press Release, Dep't of Justice, UBS Securities Japan Co. Ltd Sentenced for Long-running Manipulation of Libor (Sept. 18, 2013), *available at*

Shareholders of public firms certainly suffered massive losses as a result of material misrepresentations like those that senior officers at AIG peddled to its shareholders. Other shareholders purchased shares from insiders like Angelo Mozilo without the benefit of the inside facts that their sellers possessed. Investors in mortgage backed securities had no clue about the nefarious schemes that the sellers and sponsors of such securities had executed. As shocking as the Enron series of securities frauds, those frauds pale in comparison to the frauds perpetrated in connection with securities as part of the Great Financial Crisis of 2008. Indeed, at bottom, massive securities fraud defines the Great Financial Crisis of 2008 and led to an historic financial collapse.

III. THE VIRTUES OF PRIVATE LITIGATION

The last part of this Article shows that the transformation of private securities litigation away from its historical moorings is a dismal failure. The very concept of vexatious litigation against the most powerful and well-heeled firms and executives, with clear ability to hire the most skilled, experienced and well-connected law firms, today seems improbable at best.[348] Large firms always have more resources, and always can bear the massive cost for real discovery better than plaintiffs' firms.[349] Federal judges typically hail from larger law firms that represent the largest corporations and the wealthiest executives and seem far more focused on the interests of big business than protecting

http://www.justice.gov/opa/pr/2013/September/13-crm-1039.html. I do not include an extended discussion of the LIBOR scandal in this Article because as of publication it did not lead to, arise from, or foreshadow, a macroeconomically significant financial crisis. Moreover, while the LIBOR scandal qualifies as massive securities fraud, claims and enforcement actions appear to be in their infancy and therefore, facts and judicial rulings regarding the precise contours of what occurred, who was responsible and what damages were sustained, are not in the same state of maturity as the massive securities fraud underlying the Great Financial Crisis of 2008. *See* Karen Gullo, *Schwab Sues BofA and Other Banks Over Libor Manipulation*, BLOOMBERG (Apr. 30, 2013, 11:01 PM), http://www.bloomberg.com/news/2013-05-01/schwab-sues-bofa-and-other-banks-over-libor-manipulation.html. Nevertheless, it surely exemplifies the inadequacy of current legal and regulatory frameworks in deterring securities fraud. Even at this early stage, however, it is perhaps the greatest securities fraud in history because of the sheer quantity of securities tied to LIBOR. *See* 15 U.S.C. § 8302 (2012) (defining securities-based swaps to be securities).

348. Indeed, even after the PSLRA imposed more scrutiny upon securities litigation only four cases of frivolous class action filings emerged in the ten years following the PSLRA. Choi & Thompson, *supra* note 28, at 1502.

349. Amazingly, during the debates surrounding the PSLRA, Senator Orrin Hatch stated: "These lawyers are filing these lawsuits so that they can terrorize American companies into paying exorbitant settlements because they know these companies cannot afford the high legal fees that would be required to defend themselves even against meritless lawsuits." 141 CONG. REC. S19053–54 (daily ed. Dec. 21, 1995) (statement of Sen. Orrin Hatch).

plaintiffs.[350] Longstanding court observers wonder aloud about judicial bias.[351] Finally, no lawyer has either ethical or monetary incentive to settle for too much too soon before they know sufficient facts to form a sound professional opinion.[352] There was no litigation explosion[353] and the threat of frivolous litigation was always grossly overstated.[354] Therefore, the entire war on private securities litigation rests on a weak foundation—as has been established repeatedly elsewhere.[355]

The virtues of private litigation, on the other hand, seem worthy of review given the huge costs spawned by the war on private securities

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350. *See generally* Sheldon Goldman & Elliot E. Slotnick, *Clinton's Second Term Judiciary: Picking Judges Under Fire*, *in* JUDICIAL POLITICS 68, 74–79 (E. Slotnick ed., 1999) (showing that federal judicial appointments from larger firms far outpace appointments from smaller firms); Miller, *supra* note 16, at 364 ("The Supreme Court's opinions in *Twombly*, *Iqbal*, *Wal-Mart*, and *Concepcion*, the plurality opinion in *McIntyre*, and other judicial pronouncements reveal that a number of federal judges (and Justices) seem singularly concerned about the litigation burdens on corporations and government officials."). Professor Murdock argues that the judiciary is "complicit" in the massive securities frauds of recent vintage. Murdock, *supra* note 155, at 209 ("The theme of this article is that courts and legislatures, particularly Congress and the federal courts, led by the Supreme Court, have been complicit by creating an environment in which management is not called to account.").

351. Miller states:

> People frequently ask me: "Is this a business-oriented Supreme Court?" Or occasionally, someone will assert, with a certain bite in his or her voice: "The Chamber of Commerce seems to have a seat on the Supreme Court; any truth to that?" I don't believe that, but others have voiced sentiments in that general vein. Despite that expression of faith, I think it is fair to say that a number of the Justices (as well as other federal judges) have a predilection (perhaps subliminal) that favors business and governmental interests.

Miller, *supra* note 16, at 366. Lee Epstein, William M. Landes & Richard A. Posner, *How Business Fares in the Supreme Court*, 97 MINN. L. REV. 1431, 1471 (2013) (empirical study finding that the Roberts Court is "friendlier" to business than either the Rehnquist Court or Burger Court).

352. *See* MODEL RULES OF PROF'L CONDUCT R. 1.1, 1.3 (1983) (defining "competence" and "diligence").

353. As Professor Miller recounts:

> Americans have been defamed as fortune hunters trying to win the litigation lottery. Bogus caseload statistics are propagated, while empirical data is ignored, and fears are spread by claims that there is a litigation explosion in this country and that Americans are paying a litigation tax that renders our businesses uncompetitive. Political candidates and office holders score cheap points with attacks on our justice system, cloaking themselves in the deceptive mantle of "tort reform." Finally, urban legends about certain cases—and sometimes even imagined cases—abound, typically in highly distorted form. The so-called McDonald's coffee cup case, for example, has been grotesquely misdescribed and, with the aid of simplistic media accounts, has become a cosmic anecdote recounted countless times in the most disparaging terms.

Miller, *supra* note 16, at 302–03.

354. Even beyond class actions (the clear concern of the PSLRA) only eleven securities cases resulted in sanctions in the ten years following the PSLRA. Choi & Thompson, *supra* note 28, at 1502.

355. *See supra* notes 10, 155, 161, 166, 169, 170, 172, 180, 184, 185, 186.

litigation and the massive securities frauds that followed in its wake.[356] Private securities litigation offers institutional advantages not available from public enforcement, such as criminal proceedings brought by the United States Department of Justice ("DOJ") or civil enforcement proceedings brought by the SEC. The debate regarding private securities litigation too often overlooks these attributes.

First, private enforcement operates in a depoliticized context.[357] Senators and even presidents have no ability to influence private securities litigation through appropriations, informal influence over government agents, or promises of career advancement.[358] A typical plaintiffs' attorney (as well as her clients) acts to maximize payoffs and would suffer a competitive disadvantage if influenced in a partisan manner.[359] Indeed, despite numerous attacks on the plaintiffs' bar during the congressional debates surrounding the PSLRA, no criticism ever accused a plaintiffs' attorney of allowing politics to influence the management of any private securities action.[360] On the other hand,

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356. Ramirez, *supra* note 241, at 360.

357. *See* Issacharoff, *supra* note 25, at 379 (statement of SEC Commissioner Harvey Goldschmid) ("Private enforcement is . . . a safety valve against the potential capture of the agency by industry."). Enzo Incandela makes the same point but appropriately cast in terms of the rule of law:

> In today's market environment, protecting a broad application of the private right of action against securities fraud is imperative. The SEC has faced funding restrictions, and the reduction in available resources has limited its oversight capabilities. Also, anti-regulatory headwinds in the political arena create obstacles for the SEC to carry out its objectives. For regulators and investors alike, the apolitical private right of action under § 10(b) and Rule 10b-5 serves as an essential supplement to the ongoing focus of maintaining an orderly financial marketplace governed by the rule of law.

Incandela, *supra* note 30, at 938–39 (internal citations omitted). Those holding the power to bend the law irrationally for profit cannot meaningfully be said to be subject to the law. RAMIREZ, *supra* note 7, at 184–216.

358. According to former SEC Chair Schapiro:

> The amount of resources available to the SEC has not kept pace with the rapid expansion in the securities market over the past few years . . . either in terms of the number of firms or the explosion in the types of new and increasingly complex products . . . some of which were expressly designed to avoid SEC regulation and oversight.

Zachary A. Goldfarb, *SEC Officials Say the Agency Lacks Cash for Full Oversight*, WASH. POST, Jan. 28, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/01/27/AR2009012703395.html.

359. *See* Burch, *supra* note 23, at 72 ("Private investors suffering the financial consequences of fraud often have superior knowledge about the injury, and their profit-seeking motive makes them more efficient than their bureaucratic counterpart.").

360. For example, former Senator Alfonse D'Amato of New York, stated that plaintiffs' securities lawyers were "sharks, sharks for hire" and "bandits." 141 CONG. REC. S17935–36 (daily ed. Dec. 5, 1995) (statement of Sen. D'Amato). This demonization demonstrates that the PSLRA was founded on less than a rational basis.

recently both the SEC[361] and DOJ appear to act pursuant to powerful political considerations.[362] Indeed, criminal prosecutions for securities fraud plunged in the years prior to the crisis and still have not returned to their 2002 high.[363] Thus, robust private actions operate as a check

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361. *See* Edward Wyatt, *Responding to Critics, S.E.C. Defends 'No Wrongdoing' Settlements*, N.Y. TIMES, Feb. 22, 2012, http://dealbook.nytimes.com/2012/02/22/s-e-c-chairwoman-defends-settlement-practices/?_php=true&_type=blogs&_r=0 (reporting on a *New York Times* study finding that the SEC allows "nearly all of the biggest Wall Street firms [to settle] fraud cases by promising never to violate a law that they had already promised not to break, usually multiple times" and that the SEC "repeatedly granted exemptions to the biggest Wall Street firms from punishments intended by Congress and regulators to act as a deterrent to multiple fraud violations"); *see also* Walt Bogdanich & Gretchen Morgenson, *S.E.C. Is Reported to Be Examining a Big Hedge Fund*, N.Y. TIMES, June 23, 2006, at A1 (reporting that SEC investigator, Gary J. Aguirre, claimed he was terminated due to the political power of the hedge fund he investigated); Gretchen Morgenson, *S.E.C. Settles With a Former Lawyer*, N.Y. TIMES, June 29, 2010, at B3 (reporting that the SEC settled a wrongful termination suit with Aguirre for $755,000).

362. Criminal prosecutions against Wall Street executives have been non-existent. In early 2013, Frontline investigated "why Wall Street's leaders have escaped prosecution for any fraud related to the sale of bad mortgages." *Frontline: The Untouchables* (PBS television broadcast Jan. 22, 2013), *available at* http://www.pbs.org/wgbh/pages/frontline/untouchables/. Among its findings was an apparent lack of criminal Grand Jury investigations involving Wall Street executives. *Id.* The Inspector General of the Department of Justice also found that the Department mislead the public with regard to its prosecutorial efforts against financial and mortgage fraud. U.S. DEP'T OF JUSTICE, AUDIT OF THE DEPARTMENT OF JUSTICE'S EFFORTS TO ADDRESS MORTGAGE FRAUD, OFFICE OF THE INSPECTOR GENERAL AUDIT DIVISION, AUDIT REPORT 14-12, at 29 (Mar. 2014), *available at* http://justice. gov/oig/reports/2014/a1412.pdf. Thus, the criminal response to the frauds underlying the Great Financial Crisis of 2008–2009 has been weaker than reported. It was not always so. As stated in *United States v. Mulheren*, 938 F.2d 364 (2d Cir. 1991):

> In the late 1980's a wide prosecutorial net was cast upon Wall Street. Along with the usual flotsam and jetsam, the government's catch included some of Wall Street's biggest, brightest, and now infamous—Ivan Boesky, Dennis Levine, Michael Milken, Robert Freeman, Martin Siegel, Boyd L. Jeffries, and Paul A. Bilzerian—each of whom either pleaded guilty to or was convicted of crimes involving illicit trading scandals.

Id. at 365; *see also* JAMES B. STEWART, DEN OF THIEVES 16 (1991) (noting that Dennis Levine confessed to $12.6 million in insider-trading profits, Ivan Boesky agreed to pay $100 million in sanctions and Michael Milken agreed to pay $600 million); Dennis B. Levine, *The Inside Story of An Inside Trader*, FORTUNE, May 21, 1990, at 1, 80 (admitting that Dennis Levine "built $39,750 into $11.5 million" through seven weeks of insider trading); *The Insider-Trading Case's Cast of Characters*, WASH. POST, Sept. 8, 1988, at E4 (detailing law enforcement activity against the web of insider trading). Today not a single major figure from the fraud-ridden subprime debacle has faced criminal enforcement. Joe Nocera, *Biggest Fish Face Little Risk of Being Caught*, N.Y. TIMES, Feb. 25, 2011, http://www.nytimes.com/2011/02/26/business/economy/26nocera.html?pagewanted=all&_r=0 ("Most of the . . . Wall Street bigwigs whose firms took unconscionable risks—risks that nearly brought the global financial system to its knees—aren't even on Justice's radar screen. Nor has there been a single indictment against any top executive at a subprime lender.").

363. Michael Smallberg, *TRACking the Decline in Criminal Prosecutions for Financial Fraud*, TRAC (Nov. 30, 2011), http://trac.syr.edu/tracatwork/detail/A575.html. Fraud prosecutions involving financial institutions also plunged in the years before the crisis and

upon the dangers of agency capture.

Second, private claims of securities fraud require no government bureaucracy or other government funding support, other than the routine operation of a court system. This greatly expands enforcement resources with no substantial taxpayer expenditure.[364] Further, as in other areas, the private sector delivers services more efficiently than public agencies.[365] These private attorneys general will face market incentives to build networks of potential informants, tipsters and whistleblowers and these activities continue regardless of government resources or budget cuts.[366] Consequently, important law enforcement objectives can be achieved through private litigation at zero or very low cost to the government.[367] Simply stated: private securities litigation is a "most effective weapon in the enforcement" of the federal securities laws and "a necessary supplement to Commission action."[368] This means a diminished need for bureaucratic regulation.

Third, only private litigation both strips the fraudfeasor of the benefits of their wrongdoing and compensates the victim.[369] This in

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continued *downward* even after the catastrophe. *Criminal Prosecutions for Financial Institution Fraud Continue to Fall*, TRACREPORTS (Nov. 15, 2011), http://trac.syr.edu/tracreports/crim/267/.

364. Issacharoff, *supra* note 25, at 381. The former SEC chief of enforcement has stated: "Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetrate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection." *Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs*, 103d Cong. 113 (1993) (statement of William R. McLucas, Director, Division of Enforcement, SEC) [hereinafter Private Litigation Hearings].

365. Burch, *supra* note 23, at 73; *see also* William B. Rubenstein, *On What a "Private Attorney General" Is—and Why It Matters*, 57 VAND. L. REV. 2129, 2149–50 (2004) ("Private attorneys may be better at [enforcement] for a variety of reasons—because public attorneys may be fewer in number, underfunded, less skilled, or prone to political pressures.").

366. Burch, *supra* note 23, at 75 ("Private aggregation combined with contingency fees deputizes plaintiffs' attorneys to initiate cases that the SEC and exchanges either overlook or lack the budget to bring.").

367. Arthur Levitt, Chairman, Sec. & Exch. Comm'n, Remarks at the 22d Annual Securities Regulation Institute: Between Caveat Emptor and Caveat Venditor: The Middle Ground of Litigation Reform (Jan. 25, 1995), *available at* http://www.sec.gov/news/speech/speecharchive/1995/spch023.txt ("[T]he longtime SEC belief [is] that private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program.").

368. J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

369. Indeed, a representative of the North American Securities Administrators Association, representing all fifty state securities regulators, stated: "[P]rivate actions . . . are essential to deter prospective criminals, compensate the victims of fraud, and maintain public confidence in the marketplace." *The Market Reform Act of 1989: Joint Hearings before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs*, 101st Cong. 124 (1989) (statement of Mark J. Griffin, Director, Division of Securities, Utah Department of Commerce).

turn creates more incentives for enforcement and more disincentives for securities fraud.[370] The focus of the SEC does not include compensation for victims.[371] While the SEC frequently seeks disgorgement, too often the SEC settles too low in order to move on to other cases and score more enforcement "hits."[372] The DOJ does not typically focus on compensating victims.[373] Broadening the private enforcement of the securities laws therefore directly influences the risk/reward relationship that motivates many criminals. Compensation of victims enhances investor confidence.[374] That reduces the political demand for more heavy-handed regulation.

Fourth, private remedies allow a reduced reliance upon ex ante government regulation. Such regulation typically results in high entry barriers for insurgent business and higher transaction costs for those businesses that refrain from fraudulent misconduct.[375] Government regulation also operates in a pro-cyclical way: during boom times regulators become complacent and face pressure not to impede prosperity but in times of difficulty regulators awaken and crack down on deleterious practices in a way that can stifle non-fraudulent business.[376] Private attorneys naturally focus first on the most wrongful actors, escape open political pressure for permissiveness and are not likely to refrain from the pursuit of viable claims based upon passing economic conditions.

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370. For example, the two most remarkable frauds of the Enron crisis generated $13 billion in settlement payments. *See, e.g.*, *In re* Enron Corp. Sec. Derivative & "ERISA" Litig., No. MDL-1446, 2008 WL 4178151 (S.D. Tex. Sept. 8, 2008) (approving $7 billion settlement); *In re* WorldCom Sec. Litig., No. 02 Civ. 3288, 2005 WL 2319118 (S.D.N.Y. Sept. 21, 2005) (approving $6 billion settlement).

371. "[T]he Commission in no sense is to be considered a collection agency. . . . [T]he responsibility for examining the information and determining the investment merit of securities and the risks involved in their purchase rests with the investor." RICHARD W. JENNINGS & HAROLD MARSH, JR., SECURITIES REGULATION CASES AND MATERIALS 31–32 (5th ed. 1982).

372. *See* Bob Van Voris, *Citigroup May Need to Pay More to Keep SEC Accord, Attorneys Say*, BLOOMBERG (Nov. 23, 2011, 11:01 PM), http://www.bloomberg.com/news/2011-11-23/citigroup-may-need-to-pay-more-to-keep-sec-deal-lawyers-say.html.

373. In fact, between 2000 and 2002, private securities litigation returned twice as much to victims of securities fraud than public enforcement actions. Issacharoff, *supra* note 25, at 380–81.

374. S. REP. NO. 104-98, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 715 (statement of Sens. Sarbanes, Bryan, and Boxer) (stating that investor "confidence is maintained because investors know they have effective remedies against persons who defraud them").

375. Issacharoff, *supra* note 25, at 382 ("Even at the purely descriptive level, private enforcement is so central to our system of ex post accountability that the idea that a sufficient level of state or federal regulation could effectively displace private litigation is almost inconceivable.").

376. Anton R. Valukus, *White Collar Crime and Economic Recession*, 2010 U. CHI. LEGAL F. 1, 2.

Fifth, the broad definition of a security for purposes of the federal securities laws assures that virtually all financial transactions with the ability to disturb financial stability and macroeconomic conditions fall within the scope of the private remedy under Rule 10b-5.[377] At its broadest, a security is defined as an investment of money, in a common enterprise, with the expectation of profit, primarily from the efforts of others.[378] This definition is the essence of passive investment.[379] As such, no broader mechanism exists for securing honest markets in the world of finance and investment than private securities litigation. Rule 10b-5 thereby acts as the broadest protector of financial stability.

In essence, private litigation is a market-based mechanism for securing information disclosure in a very broad range of financial transactions in accordance with fundamental norms of capitalism and market ideology. Plaintiffs' counsel would be foolish to take a weak case against the most well-represented defendants in our society today, if not ever.[380] Frivolous claims will result in sanctions which will provide a further disincentive for pursuing weak claims.[381] Plaintiffs' counsel will also investigate based upon the perceived net present value of a potential claim which must be discounted for uncertainty.[382] To the

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377. The definition of a security includes over twenty instruments—such as bonds or stock—as well as a catch-all for "any instrument commonly known as a security." *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2012). One such instrument is an "investment contract." *Id.*; *see also* SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

378. *W.J. Howey Co.*, 328 U.S. at 299.

> Subsequent decisions have modified the third prong of *Howey* from "solely" to "substantially." For an investment to be deemed a security, *Howey* requires that the expectation of profits from the investment come "solely" from the efforts of others; courts have interpreted "solely" to mean "predominantly," recognizing that if "solely" were construed literally, the slightest effort on the part of the investor would frustrate the remedial purposes of the federal securities laws.

Lydie Nadia Cabrera Pierre-Louis, *Controlling a Financial Jurassic Park*, 8 U.C. DAVIS BUS. L.J. 35, 63 (2007).

379. "Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment." Reves v. Ernst & Young, 494 U.S. 56, 61 (1990); *see also* SEC v. Edwards, 540 U.S. 389, 393 (2004).

380. The most logical explanation for the conduct of plaintiffs' counsel is that they respond to probability, transactions costs, recoverable damages and an insurmountable degree of uncertainty. *See* Robert J. Rhee, *A Price Theory of Legal Bargaining: An Inquiry into the Selection of Settlement and Litigation Under Uncertainty*, 56 EMORY L.J. 619, 691 (2006) (stating that litigation decisions are the result of efforts to price an "ambiguous legal claim. By focusing on probability and transaction cost, the standard economic model fails to incorporate all risks into its valuation model, and thus the true economic cost of resolution is not reflected in the valuation. It overstates the measurability of probability").

381. *See supra* notes 161–66 and accompanying text.

382. *See generally* Choi, *supra* note 17 (empirically studying the impact of the PSLRA, including how plaintiffs' attorneys manage securities class actions).

extent that plaintiffs' counsel seeks recovery for other than the strongest claims or expends resources to investigate the weakest claims they would soon meet the most high-priced lawyers in a court of law and be subject to a dispositive motion.[383] It defies logic to assume that the wealthiest in America today would succumb to litigation threats based upon weak claims.[384] In fact, if the wealthy consistently paid out the cost of defense each time they were sued, the plaintiffs' attorneys would get very wealthy simply by suing the richest again and again.[385] In sum, market pressures here actually do currently provide sufficient

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383.

> [C]lass action defendants can and routinely do use dispositive motions to quickly dispose of frivolous claims. Researchers at the Federal Judicial Center conducting an empirical study of class actions in four federal district courts found that, for at least one-third of the 407 class actions they surveyed, "judicial rulings on motions terminated the litigation without a settlement, coerced or otherwise." In sum, dispositive motions provide a significant legal safeguard against frivolous class actions.

Allan Kanner & Tibor Nagy, *Exploding the Blackmail Myth: A New Perspective on Class Action Settlements*, 57 BAYLOR L. REV. 681, 695 (2005) (citing THOMAS E. WILLGING ET AL., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 42 (1996)).

384. As Professor Coffee states:

> The true "strike suit" nuisance action, filed only because it was too expensive to defend, is, in this author's judgment, a beast like the unicorn, more discussed than directly observed. Although small settlements may have been impelled in part by the high cost of defense, the corresponding observation is that the small damages in these cases also did not justify much effort on the plaintiff's side. Neither side wanted to invest much effort in them—but this does not make them inherently frivolous.

Coffee, *supra* note 185, at 1536 n.5. Professor Miller states that "extortionate settlements may be but another urban legend." Miller, *supra* note 185, at 103.

385. "If the defendant[s] . . . in a derivative suit or securities class action view themselves as 'repeat players,' they may believe that yielding to extortion in this fashion will only expose them to future litigation. Hence, they may behave strategically and insist on going to trial." John C. Coffee Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 702 (1986). Professor Silver proposes that:

> By describing class actions as legalized blackmail, judges have used inflammatory rhetoric that impugns the character of plaintiffs and trial lawyers who bring class actions, and of trial judges who certify them. They have done this needlessly and, I believe, wrongly. The problem in class actions is not blackmail and does not resemble blackmail in any interesting respect. The problem, assuming it exists, is excessive pressure resulting in decisions to settle made under duress. When one describes the problem dispassionately, one can see its factual and normative components clearly. One can also see that the argument supporting the claim of duress has not been made persuasively. Some versions of the argument conflict with others. Some versions rest on factual claims that are wrong, doubtful, unproven, or outdated . . . . Judges should . . . leave the task of demonizing plaintiffs, trial lawyers, and trial judges to others.

Charles Silver, *"We're Scared to Death": Class Certification and Blackmail*, 78 N.Y.U. L. REV. 1357, 1429–30 (2003).

incentives for plaintiffs' counsel to pursue only meritorious claims.

Of course, these virtues of private securities litigation remain unattainable so long as the substantive law underlying securities fraud defies the original conception of the federal securities laws.[386] In particular, for securities litigation to achieve its deterrent and compensatory purposes, aiding and abetting must be restored, pleading standards must revert to their historic norm, and individuals must face the prospect of liability for damages payments.[387] Remedies under the Securities Act must be restored.[388] Congress must repeal the SLUSA.[389] The judicial war on private securities litigation must end, and judicial innovations and legislation should expansively restore securities litigation to where it stood in the 1980s so that private securities litigation can operate to maintain investor confidence and by extension financial stability.[390]

The goal should be to fundamentally change the risk/reward relationship facing corporate and financial elites. While one may argue that the approach of the 1970s is more optimal than the approach prevailing in the 1980s, there is little reason for a return to that era. The major change to private securities litigation in the 1970s was the Court's

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386. While class action reform lies beyond the scope of this Article, the class action is a critical part of the deterrence that this Article argues has been sorely missing from financial markets. As Professor Coffee has highlighted, some securities class actions may produce wealth transfers among shareholders that serve neither to compensate nor to deter. Coffee, *supra* note 185, at 1535–36. Professor Coffee concludes, however, that the correct response to the shortcomings of the securities class action is to address those problems, not the underlying substantive law of securities fraud. *Id.* at 1534–39. He argues persuasively that the best way to assure deterrence is to force liability upon those most culpable—the senior officers of the public firm. For example, judges could simply approve higher fee recoveries for plaintiffs' counsel that secures significant recoveries from culpable parties or applying proportionate liability when assessing the fairness of settlements. *Id.* at 1572–82.

387. *See supra* note 386.

388. *See supra* notes 128–34.

389. *See supra* notes 173–77.

390. Professor Coffee has articulated the economic stakes well:

> The deeper problem in securities fraud is the impact of fraud on investor confidence and thus the cost of equity capital. Here, it is impossible to quantify the impact of any individual scandal, but clearly the cumulative impact of Enron, WorldCom, and a host of other scandals in the 2000 to 2002 era made stockholders wary, chilled the initial public offering market, and caused investors to demand a higher return based on the perceived higher risks—in short, the cost of capital rose. When the cost of capital rises, the economy as a whole suffers, as Gross National Product declines or stagnates, and unemployment may increase. As a result, not only investors, but also citizens throughout society experience a loss.

Coffee, *supra* note 185, at 1565. Professor Coffee wrote in 2006, before the concept of an outright financial panic appeared likely. Unfortunately, the Great Financial Crisis of 2008 demonstrates that investor confidence can be so damaged that an outright financial panic may occur with all the adverse macroeconomic consequences.

ruling in *Ernst and Ernst v. Hochfelder*.[391] The Court held in 1976 that while Rule 10b-5 is a catch-all, what it catches must be fraud—meaning that the defendant must act with an intent to defraud or scienter.[392] It is difficult if not impossible to attribute the scandals of the twenty-first century to an opinion from 1976.[393] Consequently, it is difficult to argue that after *Ernst & Ernst* the law failed to appropriately deter securities fraud.

Investor protection will lead to superior outcomes, because if investors are confident that their reasonable expectations will be secured by law, they will invest at a lower cost to entrepreneurs.[394] Thus, investor protection is associated with higher economic growth.[395] One study found that companies with superior corporate governance measures enjoyed superior stock market valuations.[396] This is consistent with other studies linking various indices of shareholder rights to financial performance.[397] Weak investor protection leads to a

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391. 425 U.S. 185 (1976); *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479–80 (1977) (holding that mere breaches of fiduciary duties are not actionable under Rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731–55 (1975) (holding that only securities purchasers or sellers have standing under Rule 10b-5).

392. *Ernst & Ernst*, 425 U.S. at 193.

393. Nevertheless, as the dissent noted, the outcome seems at odds with: (1) the plain meaning of the Exchange Act; (2) the plain meaning of Rule 10b-5; (3) the intent of drafters of the Act; and, (4) the intent of the SEC, the agency that drafted Rule10b-5. *Id.* at 215–217 (Blackmun, J., dissenting).

394.

> When their rights are better protected by the law, outside investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognize that, with better legal protection, more of the firm's profits will come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm. By limiting the expropriation, the law raises the price that securities fetch in the marketplace. In turn, this enables more entrepreneurs to finance their investments externally, leading to the expansion of financial markets.

Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1147–51 (2002). These authors further suggest that strong protections for investors of financial products can lead to higher rates of return. *Id.*; *see also supra* note 58. Financial market development is key to economic growth. *See supra* notes 56, 57.

395. Rui Castro, Gian Luca Clementi & Glenn MacDonald, *Investor Protection, Optimal Incentives, and Economic Growth*, 119 Q. J. ECON. 1131, 1133 (2004) ("[W]e employ standard techniques from the empirical growth literature to investigate the nature of the relation between investor protection and growth. Consistent with earlier studies we find a positive association.").

396. *E.g.*, Paul Gompers, Joy Ishii & Andre Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 108–109 (2003).

397. For example, the index used in the Gompers study has been refined into an apparently more powerful entrenchment index. *See* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783, 823–24 (2009) (finding that staggered boards, supermajority voting requirements, poison pills, golden parachute provisions, and limits on shareholder voting power accounted for most of the drag on financial performance attributable to weak corporate governance).

shift in the corporate balance of power in favor of management which will increase self-dealing and lead to higher compensation for executives.[398] If executive compensation is the "canary in the coal mine" signaling pervasively weak corporate governance, then there is cause for serious concern in the U.S., where CEO compensation relative to earnings has doubled over the past ten years.[399] In the long run, securing the reasonable expectations of investors through legal protection serves the economy, in general, and entrepreneurs in particular, while also operating to limit agency costs.

Investor protection entails mandatory disclosure of material information to the investing public—such as that required under the federal securities laws in the U.S.[400] To the extent investors have access to reliable investment information, they should theoretically be more willing to invest, meaning entrepreneurs and businesses will enjoy a lower cost of capital.[401] While one may expect private contracts to be the most effective way to assure an efficient means of securing appropriate information flows, in fact, such contracting appears prohibitively costly.[402] Beyond that, management is likely to be more focused on shareholder wealth maximization if they are required to disclose financial information periodically.[403] Empirical evidence now supports these theoretical conclusions. Specifically, Professors Greenstone, Oyer and Vissing-Jorgensen ("GOV-J") found that when the applicability of the federal mandatory disclosure regime was extended to firms traded in over-the-counter markets in 1964, those firms enjoyed excess returns and gains in operating performance when they commenced compliance as well as in the period following the

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398. Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Governance and Control*, *in* 1A HANDBOOK OF THE ECONOMICS OF FINANCE 1, 73–79 (George M. Constantinides, Milton Harris & René M. Stulz eds., 2003) (stating that corporate governance must stem self-dealing by managers and that soaring executive compensation in the U.S. is difficult to justify).

399. *See* Lucian Bebchuk & Yaniv Grinstein, *The Growth of U.S. Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 284–89 (2005) (finding that the proportion of S&P 500 profits going to top executive compensation approximately doubled as a percentage of profits from 1993 to 2003).

400. *See* Michael Greenstone, Paul Oyer & Annette Vissing-Jorgensen, *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments*, 121 Q. J. ECON. 399, 447 (2006) ("[T]hese results should cause policymakers to question the basis of recent calls to repeal U.S. federal mandatory disclosure requirements").

401. *Id.* at 399–400.

402. *Id.* at 405.

403. *Id.* at 406–407 (citing Andrei Schleifer & Daniel Wolfenzon, *Investor Protection and Equity Markets*, 66 J. FIN. ECON. 3, 5 (2002)) (articulating a theoretical financial model that accounts for the following empirical facts associated with better shareholder protection: that it yields larger firms that are more valuable and plentiful; that it lowers the diversion of profits and raises dividends; and, that it yields a lower concentration of ownership and more developed financial markets).

relevant legislative proposals.[404] "Overall, the results suggest that the benefits of the 1964 Amendments substantially outweigh the costs of complying with this law as measured by stock returns."[405] In addition, the GOV-J study concludes that the 1964 Amendments had a positive impact on operating performance "consistent with the hypothesis that mandatory disclosure laws can cause managers to focus more narrowly on the maximization of shareholder value."[406]

Given that investor protection is essential to securing the appropriate economic and financial operation of the public corporation, it would be natural to consider private enforcement and private rights of action as necessary components of an appropriate investor protection regime.[407] In fact, empirical evidence now demonstrates that "standards of liability facilitating investor recovery of losses are associated with larger stock markets."[408] This conclusion is supported by a transnational comparison of forty-nine nations in terms of financial development and strength of investor remedies, compiled with the input of attorneys from

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404. *Id.* at 446–447. Previous studies had reached divergent conclusions regarding the efficacy of the federal mandatory disclosure regime. *Compare* George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) ("[S]tudies suggest that the [SEC] registration requirements had no important effect on the quality of new securities sold to the public."), *with* Irwin Friend & Edward S. Herman, *The SEC Through a Glass Darkly*, 37 J. BUS. 382, 389 (1964) ("We doubt that any person reasonably well acquainted with the evolution of stock-market practices between the pre- and post-SEC periods could lament or underrate the success of the new legislation in eradicating many of [the] weaknesses in our capital markets."). These studies suffered from an inability to isolate the impact of the federal securities laws from exogenous events that impacted stock prices generally. GOV-J are able to avoid these problems by using the extension of the federal securities laws pursuant to the 1964 Securities Act Amendments to compare the performance of affected firms against firms listed on the major stock exchanges already covered by federal mandatory disclosure requirements. Greenstone et al., *supra* note 400, at 401.

405. *Id.* at 403.

406. *Id.* at 447.

407. Ramirez, *Arbitration and Reform*, *supra* note 11, at 1082–83. Finance professors state the justification for broader investor remedies as based upon efficiency considerations (which suggest the issuer is the lowest cost provider of information) and the need to create adequate incentives for the disclosure of information. *E.g.*, Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1, 5 (2006).

408. *Id.* at 28. More specifically:

> The results on liability standards are also consistently strong. The estimated coefficients predict that a two-standard deviation increase in this variable (roughly the distance from Denmark to the U.S.) is associated with an increase of 0.23 percentage points in the external-market-to-GDP ratio, a 28% rise in listed firms per capita, a 1.88 increase in the IPO-to-GDP ratio, a 6.6 percentage point drop in the block premium, a 0.75 point improvement in the access-to-equity index, a decrease of 6.6 percentage point drop in ownership concentration (but with a t-stat of only 1.58), and a 45.8 points increase in the volume-to-GDP ratio.

Id. at 19.

around the world.[409] The authors compared liability standards by focusing on the degree of culpability of the defendant—ranging from fraud to strict liability as a means of assessing strength of investor rights.[410] Importantly, this study regarding the appropriate role of private securities enforcement tracks the outcome of a parallel study of private remedies for self-dealing under corporate law: "the results [of this study] suggest that giving aggrieved shareholders the standing to sue, access to information to identify self-dealing, and a low burden of proof would deter self-dealing and promote stock market development."[411] Thus, it appears that facilitating private rights of action in favor of investors is a key element of sound investor protection.[412] Of course, these findings should not lead policymakers to withhold adequate resources for public enforcement mechanisms; instead, public and private enforcement may be the optimal tandem for enforcement of the securities laws.[413]

Too often the virtues of private securities litigation get lost in the cross-fire over the pros and cons of class actions.[414] This now seems inappropriate and even anachronistic.[415] First, very few commentators,

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409. *Id.* at 5.

410. *Id.* at 7.

411. Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 463 (2006), *available at* http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/working_papers/SelfDeal_April13.pdf.

412. The Djankov study, *id.*, was undertaken by a team that included many of the authors of the study assessing private securities enforcement, *see* La Porta et al., *supra* note 407, as well as many of the other studies associating investor protections with superior financial and economic outcomes, *see supra* note 404. As such they addressed the multicollinearity challenges posed by using different indices to determine stock market development. They concluded that "both disclosure and the power to enforce contracts through private litigation" appeared "important." Djankov et al., *supra* note 411, at 434.

413. *See* Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207, 237 (2009) (finding that "[p]ublic enforcement . . . correlated significantly with key financial outcomes, such as stock market capitalization, trading volumes, the number of domestic firms, and the number of IPOs" and that "public enforcement typically does no worse than disclosure-based private enforcement (and much better than liability-based private enforcement) in explaining these financial outcomes around the world").

414. For example, no one disputes that when wrongdoers pay damages pursuant to a class action, deterrence is enhanced. *See* Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. LEGAL STUD. 47, 49 (1975) ("The availability of the class action, by permitting the cumulation of individual damages into a sizable sum, may strengthen the deterrent effect of the substantive rule.").

415. *See, e.g.*, Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 HARV. J.L. & PUB. POL'Y 1187, 1226 (2013) (arguing in favor of an arbitration regime for securities claims due to the uncertain benefits of securities class actions). I argued in favor of arbitration for securities claims in 1999 in order to provide a rapid adjudication of meritorious claims and rapid termination of frivolous claims.

if any, seek to reverse the class action reforms of the PSLRA.[416] Second, the costs of promiscuous securities laws now dwarf the negligible inconvenience imposed upon securities fraudfeasors.[417] Third, regardless of the shortcomings of private securities litigation in the context of a class action, much of the focus in this Article on the war on securities litigation has nothing to do with class actions at all.[418] Fourth, restricting substantive rights due to flaws inherent in class actions completely discounts the costs arising from compromised deterrence.[419] Thus, the class action debate must not obscure the need to deter securities fraud. Regardless of the inconvenience or nuisance that powerful firms and their managers must endure as a result of their securities fraud, the substantive law of securities fraud must operate to secure investor confidence and financial stability.[420] Otherwise, the costs of tolerating excessive securities fraud are apt to be cast in trillions.[421]

Ramirez, *Arbitration and Reform*, *supra* note 11, at 1140–41. Professors Scott and Silverman argue that the costs of class actions exceed the benefits without a consideration of macroeconomic considerations or financial stability. Scott & Silverman, *supra*, at 1192–1202. In principle, arbitration could well operate to secure deterrence and enhance compensation, particularly if the SEC promulgated rules expanding discovery rights, simplifying pleading requirements, restoring secondary liability, imposing an expanded statute of limitations and permitting recovery for less than fraud. In other words, there is no reason why the rollback argued for herein could not be implemented through an SEC authorized arbitration procedure. *See* Ramirez, *Arbitration and Reform*, *supra* note 11, at 1134–40 (suggesting several methods of implementation of an ADR regime).

416. *Id.* at 1093.

417. Of course it is not possible to define with any precision the actual historic costs of massive securities fraud. This Article has highlighted the securities fraud and skullduggery in connection with the last two catastrophic financial collapses—The Great Depression and The Great Financial Crisis of 2008. *See supra* Parts I, II. If securities fraud holds even a 10% causation in such events then the costs of allowing law to be prostituted to elite interests in this area is many trillions of dollars. *See supra* notes 340–45.

418. "[E]ven if there is a problem with abusive class actions, the PSLRA is hopelessly overbroad and does not really address how to stem such abuses." Ramirez, *Arbitration and Reform*, *supra* note 11, at 1093.

419. Notably, Professors Scott and Silverman include as a cost the $68.1 billion paid to settle allegations of securities fraud from 2000 to 2012, as well as the costs of defense. Scott & Silverman, *supra* note 415, at 1202. This a relatively trifling amount relative to the macroeconomic harm imposed upon the entire economy when securities fraud becomes pervasive in financial markets. But, fundamentally, the amount paid by a fraudfeasor to compensate a victim is not a cost—it is beneficial deterrence. Fraudfeasors enjoy no economically rational basis for retaining their ill-gotten gains.

420. There is a wealth of data suggesting that our financial system is burdened with too much fraud since the PSLRA, even beyond the massive securities frauds discussed above. Thus, for example, between 1997 and 2002, accounting restatements soared from 92 to 250. U.S. GEN. ACCOUNTING OFFICE, GAO-03-138, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES AND REMAINING CHALLENGES 15 (2002).

421. Admittedly, it is impossible to disentangle the impact of declining financial institution

As Professor Kindleberger demonstrated, fraud and financial crises closely follow each other. Crashes and panics often are triggered by revelations of malfeasance.[422] Swindles arise from greed that is fed by the mania of a boom.[423] Investors seeking high returns abound in a boom and become easy prey for fraudfeasors.[424] At the end of the boom, insiders try to grab as much as they can before the coming collapse arrives.[425] Once the fraudulent foundation of the mania becomes manifest, capital runs for cover and safety with such rapidity and in such volume that the general economy suffers a credit shock and contracts as liquidity disappears from the system and cash hoarding sets in.[426] The frauds amplify the booms and exacerbate the busts.[427]

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fraud prosecutions and criminal prosecutions of securities fraud from a more promiscuous approach to private securities litigation. *See supra* note 363 and accompanying text (showing decline in criminal actions for financial institution fraud and securities fraud in the years prior to the Great Financial Crisis of 2008).

422. KINDLEBERGER, *supra* note 33, at 5, 77. The financial markets reacted violently in mid-September of 2008 to the news of Lehman's demise and the AIG bailout. In a classic response to the disclosure of previously concealed risks, investors rapidly crowded into the safest and least risky instruments available—short term Treasury obligations. The demand for such instruments reached such high and unprecedented levels that yields dropped essentially to zero. Deborah Levine, *Treasury's up after Housing Data Hint at Further Stresses*, MARKETWATCH (Sept. 17, 2008), http://www.marketwatch.com/story/treasurys-up-after-housing-data-hint-at-further-stresses; *see also* Paul Krugman, *Liquidity Trap*, N.Y. TIMES, Sept. 17, 2008, http://krugman.blogs.nytimes.com/2008/09/17/liquidity-trap/?_r=1. In just four business days, the yield on one-month Treasury obligations fell from 1.37% to .07%. *Daily Treasury Yield Curve Rates*, U.S. DEP'T OF TREASURY, http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2008 (last visited Mar. 10, 2014).

423. KINDLEBERGER, *supra* note 33, at 5. Recall that in late 2007, AIG told investors that the economic risk of their derivatives portfolio was "close to zero." FCIC REPORT, *supra* note 114, at 272. These statements were belied when it became apparent to the market that AIG needed a bailout to meet its commitment under its derivatives agreements. On September 15, 2008, AIG's stock plunged 61% on revelations regarding its true derivatives exposure. Paul Vigna, *This Day in Crisis History: Sept. 15-16, 2008*, WALL ST. J., Sept. 15, 2013, http://blogs.wsj.com/moneybeat/2013/09/16/this-day-in-crisis-history-sept-15-16-2008/. The entire stock market adjusted that day to new, undisclosed risks, as the Dow Jones Industrial Average fell 504 points. *Id.*

424. KINDLEBERGER, *supra* note 33, at 73, 76. Among the carnage of the Great Financial Crisis of 2008, lies the town of Narvik, Norway. The town invested money it borrowed upon the security of its power plant to "invest" in complex mortgage-backed securities peddled by Citigroup. The town lost big and ultimately sued Citigroup. Mark Landler, *U.S. Credit Crisis Adds to Gloom in Norway*, N.Y. TIMES, Dec. 2, 2007, http://www.nytimes.com/2007/12/02/world/europe/02norway.html?_r=1&hp&oref=slogin.

425. KINDLEBERGER, *supra* note 33, at 5. Thus, Angelo Mozilo of Countrywide sold massive shares of Countrywide through mid-2007, right before the firm sustained massive losses from subprime lending.

426. *Id.* at 90.

427. Kedia & Phillipon, *supra* note 217, at 2196–97 (explaining that firms engaged in fraudulent accounting invest and hire excessively to portray success, and shed workers and capital once fraud is detected).

Experience proves Kindleberger's central insights on the relationship between massive fraud and capital fight.

It is impossible to rank frauds in any objective way and the unavailability of data may in any event render such rankings impossible. Nevertheless, the Great Financial Crisis of 2008 involved massive securities fraud in connection with the marketing and sale of mortgage-backed securities as well as shares in public firms. We will never know how much capital would have been diverted from the housing boom during the critical years of 2004–2007 if the truth had been conveyed to the investing public about the subprime exposure of firms like AIG, Lehman Brothers, Countrywide and Citigroup. Nor will we ever know how many mortgages would not have been capitalized if the true risks of mortgage pools had been disclosed by the investors in such pools by firms such as Chase or Goldman Sachs. Finally, we cannot know if these capital flows, based upon materially misleading statements to the investing public, would have been reduced in the absence of the war on private securities litigation. Still, the economic fallout and sheer quantity of securities tainted by fraud at the heart of the crisis suggests that the Great Financial Crisis of 2008 may qualify as the greatest financial fraud ever experienced in the U.S.—rivaling even the massive securities frauds underlying the Great Depression.[428]

The experience of 2008 teaches much, particularly in conjunction with the fundamental lessons taught by the experience of the Great Depression.[429] Both episodes occurred during a period of time when investors held only narrow or restricted rights and remedies against securities peddlers and their associated professionals.[430] Both episodes reveal that corporate and financial elites concluded that they could walk off with huge wealth from massive and heinous frauds with limited accountability.[431] In short, the experience of 2008 as well as the Great

428. Observers of the years before the Great Depression called that period "the greatest era of crooked high finance the world has ever known." KINDLEBERGER, *supra* note 33, at 84.

429. The similarities between the wrongdoing underlying the Great Financial Crisis of 2008 and the Great Depression are striking. Both involved all of the most respected financial institutions and leaders in the nation. Further, both involved almost incomprehensible levels of culpability. *Compare supra* notes 51–55, *with supra* notes 260–78, 309–13.

430. In the Great Depression future Defense Secretary James Forrestal infamously engaged in a high-profit trading scheme involving legal machinations that limited his tax liability. When discovered, he paid additional taxes out of a sense of "moral obligation." 3 MORISON, *supra* note 41, at 283–84. He never repaid the investors who lost money as a result of his trading. *Id.* Like modern day Angelo Mozilo, he kept the great weight of the ill-gotten gains. *See* Hamilton & Reckard, *supra* note 269.

431. The FCIC found that Wall Street bankers used a specific term to describe their insulation from accountability. The term is: "IBGYBG." It means "I'll be gone, you'll be gone." FCIC REPORT, *supra* note 114, at 8.

Depression teaches that unconstrained elites will perpetrate frauds for profit in the securities markets to the great expense of investors and the macroeconomy.[432] In both experiences the law failed to productively curb and channel the economic power exercised by corporate and financial elites.

The life of the law is experience not logic.[433] As John Dickinson stated to the Constitutional Convention of 1787: "Experience must be our only guide. Reason may mislead us."[434] With respect to securities litigation this means that historic experience and empirical reality must trump theorizing or worse, anecdotes.[435] The experience of 2008 speaks loudly regarding the utter failure of the war on securities litigation.[436] This Article demonstrates based upon that experience that more robust enforcement of proscriptions against securities fraud must operate to help prevent and mitigate macroeconomic pain arising from severe financial crises. Deterrence should trump petty concerns about phantom extortionate settlements, nearly invisible frivolous claims and inconvenience to entrenched corporate and financial elites.

CONCLUSION

This Article argues for true securities litigation reform based upon the history of the U.S. financial markets and economic studies of what works in securities regulation—that is, based upon experience. It seeks to set the record straight from that perspective regarding the costs of the war on securities litigation. It includes an historical look at the configuration of the law when appropriate deterrence suppressed securities fraud for a period of six decades. It views the very concept of reform as likely to function appropriately in a macroeconomic sense

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432. *See supra* Part II.

433. OLIVER WENDELL HOLMES, THE COMMON LAW 1 (Dover Publications, Inc. 1991) (1881).

434. 2 MAX FARRAND, THE RECORDS OF THE FEDERAL CONVENTION OF 1787, at 278 (rev. ed. 1966). Dickinson's observation regarding the hazards of theorizing preceded Holmes' observation by over 100 years. In any event, the concept that law must permit empirical reality and experience to trump logic, reason and theory alone enjoys deep roots in American law and broad support among those involved in drafting the Constitution. Albert W. Alschuler, *From Blackstone to Holmes: The Revolt Against Natural Law*, 36 PEPP. L. REV. 491, 495–96 (2009) (citing THE FEDERALIST NO. 14, at 72 (James Madison) (Michael Lloyd Chadwick ed., 1987)).

435. *See supra* notes 36, 353 (describing unsubstantiated perceptions of American litigants).

436. I use the term "failure" in the context of the macroeconomic costs of massive securities as exemplified in both 2008 and the Great Depression. If the goal was to untether elites from accountability for securities fraud then the war on securities litigation succeeded in returning to a pre-Depression regime of limited accountability. The best demonstration of this is the eerie similarity of the frauds underlying both macroeconomic catastrophes. *See generally* Carbone, *supra* note 30 (revisiting the role of the Pecora hearings).

only when those holding concentrated economic power must face a legal system, not beholden to those interests, that cabins power productively. The story of the history of securities law in the U.S. evinces a powerful lesson—when judicial and legislative outcomes follow too tightly the parochial interests of powerful business leaders, it costs all of society dearly.

This narrative holds that in an era of high inequality, the subversion of the anti-fraud provisions of the federal securities laws seems inevitable. If the most powerful within our society wished to free themselves from legal restraints, a logical place to start would be the federal securities laws and their robust private remedies that existed prior to the 1990s. The definition of a security is sufficiently broad that virtually all financial and business endeavors that can support maximum wealth transfers must travel through the securities markets. This is why the broad remedies enacted during the New Deal successfully eliminated macroeconomically significant bouts of securities fraud.

From Ken Lay at Enron to options backdating to the Magnetar Trade and the insider trading scandals of Countrywide, securities fraud constitutes an easy road to windfall compensation and profits. The war on private securities litigation imposed costs on the American economy beginning in 2001 and culminating in the subprime debacle. Even more recently, securities fraud thrives in America, not just as an occasional nuisance as it was for over six decades but as a constant threat to the American economy as a whole. This is the predictable multi-trillion dollar cost of ignoring the virtues of private securities litigation. Law must revert to the approach that secured deterrence for decades: private securities litigation should operate robustly to punish securities fraudfeasors and compensate victims.

In the final analysis coddling securities fraudfeasors is a bad idea. Capitalism requires free-flowing, if not perfect, information. Capital can only be allocated well in accordance with sound information. Beyond efficiency concerns lies macroeconomic realities: fraudulent information fuels booms and busts, and busts too often lead to massive macroeconomic costs in the form of recessions or worse. These multi-trillion dollar catastrophes impose costs that dwarf the petty even venal concerns of the so-called reformers who seek to reverse laws associated with prosperity to entrench small bands of growth-retarding elites. Robust private enforcement of the federal securities laws should operate as a fundamental element of sound legal infrastructure.