NOTE

CONGRESS, THE SUPREME COURT, AND THE RISE OF SECURITIES-FRAUD CLASS ACTIONS

INTRODUCTION

The United States has a complex regime of securities-fraud enforcement in place to protect its securities markets. Functioning properly, securities markets help drive the American economy by providing investors with valuable information, facilitating business combinations, and raising capital. But these markets can malfunction in many ways — fraud can run rampant, or excessive litigation can lead executives to withhold useful information. The trick is having a regime that deters fraud while simultaneously encouraging information sharing. The problem is that our current regime is not up to the task, primarily because it allows for securities-fraud class actions.

These actions have become much more frequent over the last three decades, spurred on by the Supreme Court's decision in *Basic Inc. v. Levinson*.[1] Commonly filed against corporations that have suffered a significant stock price change, securities-fraud class actions usually allege that the corporation or its executives made a false statement that improperly increased or propped up the stock price prior to the change.[2] For example, in the classic securities-fraud case, a CEO might suggest in an interview that her company is on track to deliver its best quarterly returns ever, only to later admit that returns will actually be lower than expected, causing the stock price to drop. An individual investor who relied on the CEO's initial statement to purchase stock could sue the corporation before *Basic*; what *Basic* allowed is for suits — including class actions — to proceed even if the suing investors did not know about or directly rely upon the statement.[3]

The Court seems to have thought facilitating class actions in this way would advance the twin purposes of anti-securities-fraud laws: victim compensation and fraud deterrence.[4] However, class actions have been shown to be a poor means of accomplishing either purpose. They do not compensate effectively because the end result of most class actions is an arbitrary transfer of wealth between groups of innocent

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[1] 485 U.S. 224 (1988).

[2] Another type of securities class action, related to merger and acquisition activity, has also become common in recent years. *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2017 YEAR IN REVIEW 5 (2018), https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2017-YIR [https://perma.cc/HBP7-2DTG].

[3] *See Basic*, 485 U.S. at 247.

[4] *See* James Cameron Spindler, *We Have a Consensus on Fraud on the Market — And It's Wrong*, 7 HARV. BUS. L. REV. 67, 70 (2017).

shareholders — many of whom are diversified investors who, in aggregate, likely net out from securities fraud.[5] Nor do class actions deter securities fraud efficiently; instead, by incentivizing private plaintiffs to file sometimes-frivolous suits against corporations in order to reach quick settlements, they generate substantial overdeterrence costs.[6]

So it was with great fanfare among advocates of securities-litigation reform that the Court took up *Halliburton Co. v. Erica P. John Fund, Inc.* (*Halliburton II*),[7] a case that appeared to have promise as a way to limit securities-fraud class actions and minimize some of their downsides. And the Court's decision, affording defendants an opportunity to defeat class certification by showing that a misstatement did not affect a security's price,[8] on the surface seemed to do just that. However, *Halliburton II*'s apparent promise was doomed from the start because of the "price-maintenance theory" — a theory that had been around for years when *Halliburton II* was decided. By allowing plaintiffs to argue that defendants' misstatements fraudulently kept a security's price at artificially high levels, the price-maintenance theory makes it nearly impossible for defendants to show that a security's price was not affected by alleged fraud. As a result, defeating class certification is nearly impossible as well, and *Halliburton II* ultimately does almost nothing to restrain securities-fraud class actions.

Perhaps predicting that its decision would not successfully curb securities-fraud class actions, the *Halliburton II* Court suggested that if there was a more pervasive problem with this area of the law, it was Congress's to fix. In light of the failure of *Halliburton II* and other Supreme Court decisions to stem the tide of securities-fraud class actions, Congress should heed the Court's call, overturn *Basic*, and centralize authority for civil securities-fraud enforcement in the U.S. Securities and Exchange Commission (SEC). There *are* real costs of securities fraud — primarily, inefficient allocation of resources and increased cost of capital.[9] Giving the SEC control over civil enforcement would help combat these real costs while eliminating the overdeterrence costs associated with class actions and avoiding wasteful and circular transfers of wealth among shareholders. It would also allow the SEC to set broad enforcement priorities and pursue cases large and small without worrying that private enforcement will get in the way.

This Note proceeds in three parts. Part I describes the post-*Basic* rise of securities-fraud class actions, why the class action is ineffective

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[5] *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1556–61 (2006).

[6] Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 650–51 (1992).

[7] 134 S. Ct. 2398 (2014).

[8] *Id.* at 2414.

[9] *See* Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2179–80 (2010).

at deterring fraud and compensating victims, and the Court's response in *Halliburton II*. Part II then explains how *Halliburton II*'s attempt to limit securities-fraud class actions has been undermined in practice by the so-called "price-maintenance theory," thus making Congress the only actor that can tackle the issue of securities-fraud class actions. Finally, Part III offers a legislative solution, arguing that the problems introduced by securities-fraud class actions can be eliminated by congressional action centralizing civil enforcement power in the SEC.

I. THE RISE OF THE SECURITIES-FRAUD CLASS ACTION AND *HALLIBURTON II*'S RESPONSE

A. The Law of Securities Fraud

Section 10(b) of the Securities Exchange Act of 1934[10] and the SEC's Rule 10b-5[11] proscribe securities fraud, and though neither § 10(b) nor 10b-5 expressly creates a private cause of action, courts have long implied one.[12] That private action — frequently used to sue companies said to have spoken falsely — includes six elements: (1) a material misrepresentation or omission; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.[13]

Before *Basic*, securities-fraud plaintiffs suing as a class could usually establish the "reliance" element only by showing that each class member was aware of and traded a security based on a specific falsehood.[14] This requirement thwarted most attempts to bring 10b-5 class actions, because individual issues of reliance almost always eclipsed class-wide issues, preventing the action from moving forward under Federal Rule of Civil Procedure 23(b)(3).[15] The Court's 4–2 decision in *Basic*,[16] however, upended the existing individual-reliance regime and modified the private 10b-5 action to allow securities-fraud class actions to proceed.

Basic's innovation was to create a rebuttable *presumption* of reliance based on the "fraud-on-the-market" theory, which holds that the price of a security in an efficient market reflects all publicly available information,

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[10] 15 U.S.C. § 78j(b) (2012).

[11] Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2018).

[12] Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

[13] *Id.*

[14] Erica P. John Fund, Inc. v. Halliburton Co. (*Halliburton I*), 563 U.S. 804, 810 (2011). An earlier case, *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), had created a presumption of reliance in cases alleging primarily omissions, but this presumption was invoked infrequently and the case ultimately had a narrow legacy compared to *Basic*. *See* Jill E. Fisch, *The Trouble with* Basic*: Price Distortion After* Halliburton, 90 WASH. U. L. REV. 895, 904–08 (2013).

[15] *Halliburton I*, 563 U.S. at 810; *see also* FED. R. CIV. P. 23(b)(3).

[16] Three of the Justices — Chief Justice Rehnquist, Justice Scalia, and Justice Kennedy — "took no part in the consideration or decision of [the] case." Basic, Inc. v. Levinson, 485 U.S. 224, 250 (1988).

including any falsehoods.[17] When an investor trades in that security, she implicitly relies on the information — true or false — incorporated in the price.[18] Successfully invoking the *Basic* presumption establishes the reliance element for an entire class; common issues thus predominate over individual ones and the class can become certified.[19]

A key requirement of the presumption is that an alleged falsehood must have actually had some impact on the price of the security traded by the plaintiffs; otherwise, the plaintiff cannot be said to have relied on the falsehood, even indirectly.[20] According to *Basic*, a defendant can rebut the presumption by showing that there was no such price impact, thereby "sever[ing] the link" between falsehood and price.[21] The *Basic* Court did not explain, however, whether defendants could adduce evidence showing a lack of price impact *before* class certification, or if they must wait to do so until after certification. This question was to remain unanswered until 2013, when the Court took it up in *Halliburton II*.

B. The Troubling Rise of the Securities-Fraud Class Action After Basic

After *Basic* was decided in 1988 and removed the restraints on securities-fraud class actions, there was a predictable surge in 10b-5 lawsuits. The number of suits invoking fraud-on-the-market tripled by 1991,[22] and ten years later, in 2001, securities class action filings (of any kind) reached an all-time yearly peak of 498.[23] Between 2002 and 2004, almost half of all pending class actions in federal courts were securities related.[24] Another surge is now underway. Since 2012, securities-fraud suits have steadily increased each year; most recently, there was a 7.5% year-over-year increase in 2016 and an additional 15.1% jump in 2017.[25]

This explosion in securities-fraud filings has been a cause of concern for some of the Justices, academics, and Congress. In *Basic* itself, the dissenting Justices predicted the looming explosion, arguing that the fraud-on-the-market theory could "have many adverse, unintended effects" for "years to come."[26] Six years later, in the midst of the acceleration in filings, Justice Kennedy — speaking for a majority of the Court — reiterated the

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[17] *See Halliburton I*, 563 U.S. at 811; *Basic*, 485 U.S. at 246–47.

[18] *Halliburton I*, 563 U.S. at 811.

[19] *See id.* at 810–11.

[20] *Basic*, 485 U.S. at 248.

[21] *Id.* However, this proved difficult in practice. Before *Halliburton II*, a mere six attempts at rebuttal had ever been successful, with only two in the class action context. *See* Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 69 BUS. LAW. 307, 360 (2014).

[22] Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 179.

[23] *Federal Securities Class Action Litigation 1996 – YTD*, STAN. L. SCH. SEC. CLASS ACTION CLEARINGHOUSE, http://securities.stanford.edu/charts.html [https://perma.cc/P6R9-UFQL].

[24] Coffee, *supra* note 5, at 1539 tbl.1.

[25] *See* CORNERSTONE RESEARCH, *supra* note 2, at 39 (core filings).

[26] *Basic*, 485 U.S. at 251 (White, J., concurring in part and dissenting in part).

"danger of vexatiousness" inherent in 10b-5 suits.[27] And, as will be seen in section C, at least three Justices have supported overruling *Basic* in light of "[t]ime and experience."[28]

Similarly, academics have launched a compelling campaign against the securities-fraud class action, citing its many conceptual issues. Their arguments will be explored in detail in Part III, but in short, many academics have concluded that the primary consequence of most 10b-5 suits is not to achieve the purposes of the securities-fraud prohibition — victim compensation and efficient fraud deterrence — but instead to effect a circular transfer of wealth between two groups of innocent shareholders.[29] Moreover, these academics have noted that diversified investors, who hold an overwhelming majority of U.S. stock, do not actually suffer losses from corporate securities fraud in aggregate because they will benefit from fraud in some investments and lose in others. Even pursuing "compensation" as a goal, then, may be fundamentally misguided. The academics also worry that an inundation of meritless "strike suits" is deterring companies and their executives from providing socially valuable but speculative information to the public, for fear that the information will later be attacked as fraudulent.[30]

These criticisms by securities-litigation reform advocates persuaded Congress to enact the Private Securities Litigation Reform Act of 1995[31] (PSLRA) in an attempt to cut back on meritless securities suits. The PSLRA raised pleading standards and included several other reforms; notably, the original draft of the Act would have eliminated the *Basic* presumption altogether.[32] However, while the PSLRA did reduce frivolous lawsuits to some extent,[33] the continuing surge in securities-fraud class actions suggests that excessive litigation remains a serious problem. Moreover, the PSLRA did nothing to address the conceptual problems raised by academics. At a minimum, then, there appears to be support in the courts, the academy, and the legislature for both (1) cutting down on meritless securities-fraud filings and (2) ensuring that such cases, once filed, do not survive the motion-to-dismiss or class-certification stages of litigation. An opportunity to achieve one or both of these goals through judicial intervention arose in *Halliburton II*.

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[27] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 189 (1994) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975)).

[28] *Halliburton II*, 134 S. Ct. 2398, 2427 (2014) (Thomas, J., concurring in the judgment); *see id.* at 2418.

[29] *See, e.g.*, Coffee, *supra* note 5, at 1556–61.

[30] *See* Mahoney, *supra* note 6, at 650–51.

[31] Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

[32] John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 335–36, 348, 357–58 (1996).

[33] *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1492–93 (2004).

C. Halliburton II*: The Supreme Court's Response to the Rise*

Halliburton II marked the second time that the long-running class action against Halliburton Co. for alleged securities fraud — then in its thirteenth year[34] — had been before the Supreme Court. In 2011, the parties had clashed over whether plaintiffs must prove loss causation before or after class certification.[35] This time, Halliburton presented the Court with two questions: first, whether the *Basic* presumption should be overruled, and second, whether defendants can rebut that presumption at the class-certification stage by showing a lack of price impact.[36]

As to the first question, the Court declined to overrule *Basic*. Writing for the majority, Chief Justice Roberts[37] noted that stare decisis counsels against overturning time-honored precedent like *Basic* without "special justification"; Halliburton's arguments did not satisfy this demanding criterion.[38] Halliburton fared better with respect to the second question: the Court held that the *Basic* presumption can be rebutted before class certification.[39] Noting that the presumption is merely an indirect means of showing price impact, intended to facilitate 10b-5 class certification, Chief Justice Roberts found that this sort of "indirect proxy should not preclude direct evidence" of a lack of price impact.[40] He thought a contrary ruling would be strange because the very same evidence that defendants would introduce to show that there was no price impact was *already admissible* before class certification in order to counter a part of the *Basic* presumption.[41] If the evidence failed to counter that part of the presumption but *did* prove that there had been no price impact, a district court would have to blind itself to this fact and certify the class under the fraud-on-the-market theory, even though the theory was plainly not applicable.[42] This "bizarre result[]" could not stand.[43]

In answering the two questions presented, Chief Justice Roberts was careful to avoid stepping into the spirited policy debate over 10b-5 class actions. Halliburton did attempt to raise policy concerns — for example, that securities-fraud class actions may "allow plaintiffs to extort large settlements . . . for meritless claims."[44] But the Chief Justice said that

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[34] *Case Summary: Halliburton Company Securities Litigation*, STAN. L. SCH. SEC. CLASS ACTION CLEARINGHOUSE, http://securities.stanford.edu/filings-case.html?id=102452 [https://perma.cc/7PD2-VDZM].

[35] After. *See Halliburton I*, 563 U.S. 804, 807 (2011).

[36] *Halliburton II*, 134 S. Ct. 2398, 2405 (2014).

[37] The Chief Justice was joined by Justices Kennedy, Ginsburg, Breyer, Sotomayor, and Kagan.

[38] *Halliburton II*, 134 S. Ct. at 2407 (quoting Dickerson v. United States, 530 U.S. 428, 443 (2000)).

[39] *Id.* at 2414.

[40] *Id.* at 2415.

[41] *Id.* at 2414–15.

[42] *Id.* at 2415.

[43] *Id.*

[44] *Id.* at 2413.

these types of concerns were "more appropriately addressed to Congress," pointing out that Congress had proven itself willing to respond to "perceived abuses" of 10b-5 class actions by enacting the PSLRA.[45]

Justice Thomas concurred in the judgment[46] and made clear his frustration with the persistence and evolution of the judge-made private securities-fraud action. He would have overruled the *Basic* presumption, which in his view has resulted in "an unrecognizably broad cause of action ready made for class certification"[47] that is inconsistent with both the economic literature[48] and the Court's subsequent class-certification caselaw.[49] Doubting that an opportunity for pre-certification rebuttal would accomplish much, Justice Thomas contended that as a practical matter rebuttal had thus far proven nearly impossible — and would continue to be so even if allowed before class certification.[50]

II. THE UNFULFILLED PROMISE OF *HALLIBURTON II*

On the surface, *Halliburton II* appeared to hold great promise as a means of ensuring that cases with little merit do not survive class certification. Commentators[51] and common sense alike suggested that by affording defendants an opportunity to defeat meritless claims before a class was certified (and before the pressures to settle became overwhelming), *Halliburton II* would allow those meritless claims to actually be defeated at a meaningful rate. But this Part argues that *Halliburton II*'s promise was an illusion and could have been identified as such on the day that the decision was issued, for one simple reason: the price-maintenance theory.

Already well established in 2013, the price-maintenance theory says that a misrepresentation can have a price impact even if it does not change the price when the misrepresentation is first made. The theory — invoked in 60–70% of 10b-5 class action complaints, as shown by research conducted for this Note — makes it nearly impossible for defendants to successfully rebut the *Basic* presumption, regardless of the merits (or lack thereof) of a plaintiff's case. Indeed, since *Halliburton II*, twenty-seven judicial decisions have analyzed and rejected a rebuttal attempt; in contrast, only one attempt has succeeded.[52] In twenty of the

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[45] *Id.*

[46] Justice Thomas was joined by Justices Scalia and Alito. Justice Ginsburg also wrote a short concurrence, joined by Justices Breyer and Sotomayor.

[47] *Halliburton II*, 134 S. Ct. at 2427 (Thomas, J., concurring in the judgment).

[48] *Id.* at 2420–23.

[49] *Id.* at 2423–24.

[50] *Id.* at 2424 (citing Grundfest, *supra* note 21, at 362).

[51] *See, e.g.*, Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market: Reflections on* Amgen *and the Second Coming of* Halliburton, 57 ARIZ. L. REV. 37, 47 (2015); John C. Coffee, Jr., *Death by One Thousand Cuts*, CLS BLUE SKY BLOG (June 30, 2014), http://clsbluesky.law.columbia.edu/2014/06/30/death-by-one-thousand-cuts/ [https://perma.cc/Z2NL-5EAQ].

[52] The data runs through July 31, 2018. *See* Appendix, https://harvardlawreview.org/wp-content/uploads/2018/12/1067-1088_Appendix.pdf [https://perma.cc/5YAM-UXRA].

rejections, over 74%, the judge used the price-maintenance theory; in all twenty, the theory was the decisive factor dooming rebuttal. The theory's success makes it clear that *Halliburton II* cannot, on its own, solve the problems created by *Basic* and securities-fraud class actions.

A. Overview of the Price-Maintenance Theory

Halliburton II altered 10b-5 litigation by allowing consideration of price impact at the class-certification stage. Though the Court's holding may seem to afford defendants an additional opportunity to defeat securities-fraud class actions, plaintiffs can easily surmount this new hurdle by asserting the price-maintenance theory. The complicated means by which defendants must show a lack of price impact under the price-maintenance theory, and the difficult burden of persuasion placed on them, combine to effectively inoculate plaintiffs against rebuttal.

Generally, to rebut the *Basic* presumption through lack of price impact, a defendant must introduce evidence that fully severs the link between an alleged misrepresentation and a security's market price. This evidence comes most often in the form of "event studies": economic analyses that disentangle the price effects of specific events from fluctuations in a security's price that are attributable to the market or relevant industry as a whole.[53] A defendant's goal for rebuttal purposes is to have an event study conclusively show that the "event" in question (a misrepresentation or corrective disclosure) had no impact on a security's price.

In theory, the price impact to be rebutted can show up in two ways. The first — so-called "front-end" price impact — is obvious: a misrepresentation can cause a shift in market expectations about a security and trigger an immediate swing in its price. For example, assume the market expects a company to earn profits of $100, the company actually does earn $100, but the CEO lies and reports profits of $125. As the market incorporates the good (but fraudulent) news, the price of that company's stock should increase. This artificial inflation should later dissipate when the truth eventually emerges in a corrective disclosure. To rebut the *Basic* presumption in a 10b-5 suit alleging front-end price impact, a defendant must demonstrate that the price did not change at the time of the alleged misrepresentation.[54]

The second type of price impact, dubbed "price maintenance," is slightly less obvious: a misrepresentation can artificially inflate or deflate a security's price by *confirming* the market's expectations.[55] For instance, assume the market expects a company to earn profits of $100, the company actually earns only $75, and the CEO lies and reports profits of $100. Since the market's expectations were met, the price of the

[53] *In re* Vivendi, S.A. Sec. Litig., 838 F.3d 223, 253–54 (2d Cir. 2016).
[54] *See id.* at 256.
[55] *See id.* at 256–57.

company's stock should remain stable at the pre-misrepresentation baseline. Nonetheless, the price-maintenance theory holds that there *is* price impact, because the misrepresentation prevented the market price from falling as it would have if the CEO had told the truth. Here, too, inflation will dissipate once a corrective disclosure leads the market to incorporate the truth into the market price.

Unlike in a front-end price-impact case, a defendant cannot successfully rebut the *Basic* presumption in a price-maintenance case merely by showing that the price did not move after a misrepresentation. Instead, defendants must show that none of the price movement on the date of an alleged corrective disclosure was related to the disclosure.[56] This is a tall order. There will almost always be some price movement on that date, because plaintiffs typically file 10b-5 suits in the wake of a significant price change alleging it was the result of a corrective disclosure.[57] Attempts to rebut the presumption then run into the limits of event studies: when there are multiple pieces of firm-specific news on a given date, as is often the case on days with significant price movement, event studies cannot easily isolate the effect of any individual piece of news.[58] As a result, defendants usually cannot convincingly show that *none* of the drop was related to the corrective disclosure, and the price-maintenance theory — if valid — has made it next to impossible for defendants to rebut the presumption, even in meritless cases.

B. Plaintiffs' Invocation and Courts' Acceptance of the Price-Maintenance Theory

There is little question that the theory *is* valid. Though it has not yet been endorsed by the Supreme Court, nor has it become a cause célèbre among scholars,[59] the theory is frequently invoked in securities-fraud complaints and widely considered valid by the courts — and this was true long before *Halliburton II*. Research conducted for this Note

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[56] *See* Waggoner v. Barclays PLC, 875 F.3d 79, 104–05 (2d Cir. 2017).

[57] Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 514 (1991) ("Once potential securities violations have been identified by screening for large, sudden price declines, plaintiffs can file suit and use the tools of discovery to learn whether a violation actually occurred.").

[58] *See* Victor E. Schwartz & Christopher E. Appel, *Rebutting the Fraud on the Market Presumption in Securities Fraud Class Actions:* Halliburton II *Opens the Door*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 33, 54–56 (2015).

[59] The only law review article discussing the theory in depth was published in 2017. *See* Matthew L. Mustokoff & Margaret E. Mazzeo, *Loss Causation on Trial in Rule 10b-5 Litigation a Decade After* Dura, 70 RUTGERS U. L. REV. 175, 179–96 (2017). Another article from 2015 discussed the results of price-impact analyses post–*Halliburton II*, but did not focus on the role of the price-maintenance theory. *See* Allen Ferrell & Andrew Roper, *Price Impact, Materiality, and* Halliburton II, 93 WASH. U. L. REV. 553 (2015).

shows that out of a sample of thirty-five 10b-5 complaints[60] from between 2011 and November 2013,[61] twenty-three (or 66%) explicitly invoked the price-maintenance theory. These complaints used language along the lines of "[d]efendants . . . engaged . . . in an effort to *maintain* artificially high market prices."[62] It is important to note that this count of twenty-three includes only those complaints that expressly invoked the theory; even more complaints may indirectly invoke it by describing what seem to be confirmatory misstatements. The complaints thus show that the theory was well known, at least within the securities-litigation bar, when *Halliburton II* was decided.

Plaintiffs did not just invoke the theory pre–*Halliburton II* — courts accepted it, too. The first circuit to expressly approve the theory was the Seventh in 2010, in an influential opinion by then–Chief Judge Easterbrook, which emphasized that "an unduly optimistic statement stops a price from declining," and that any price impact from such a falsehood can be discerned only upon corrective disclosure.[63] With this intellectual grounding in place, the Eleventh Circuit adopted the theory in 2011,[64] followed by the Second Circuit in 2016.[65] Only the Fifth Circuit seems to have outright rejected the theory, holding that confirmatory statements are not actionable,[66] although subsequent decisions by district courts in the circuit applying the price-maintenance theory raise the question whether the Fifth Circuit opinion is still good law.[67]

As might have been expected, given the importance *Halliburton II* places on the price-impact analysis as a make-or-break moment for class actions, the price-maintenance theory has continued to be invoked at

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[60] This sample, and the one in the third paragraph of section B, was drawn using the Stanford Securities Database. This one comprises the first available Rule 10b-5 complaint from each month between January 2011 and November 2013, excluding complaints from the Second Circuit (which, by 2008, already allowed defendants to rebut the presumption at class certification, *see In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 486 (2d Cir. 2008)).

[61] The Court granted certiorari in *Halliburton II* in November 2013. Halliburton Co. v. Erica P. John Fund, Inc., 571 U.S. 1020 (2013) (mem.).

[62] *See, e.g.*, Class Action Complaint for Violation of the Federal Securities Laws at 31, Kuhns v. Equifax Inc., No. 17-cv-03463 (N.D. Ga. Sept. 8, 2017) (emphasis added).

[63] Schleicher v. Wendt, 618 F.3d 679, 683 (7th Cir. 2010); *see also* Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 415 (7th Cir. 2015) ("[M]ovement of a stock price immediately after a false statement often tells us very little about how much inflation the false statement caused.").

[64] *See* FindWhat Inv'r Grp. v. FindWhat.com, 658 F.3d 1282, 1314–15 (11th Cir. 2011).

[65] *See In re* Vivendi, S.A. Sec. Litig., 838 F.3d 223, 259 (2d Cir. 2016).

[66] Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 666 (5th Cir. 2004). In 2016, a panel of the Eighth Circuit also declined to apply the price-maintenance theory, though the court did not explicitly reject it. *See* IBEW Local 98 Pension Fund v. Best Buy Co., 818 F.3d 775, 782–83 (8th Cir. 2016). In dissent, Judge Murphy argued that the price-maintenance theory should have been applied, *see id.* at 784 (Murphy, J., dissenting), and charged the majority with "misappl[ying] the presumption of reliance standard," *id.* at 783.

[67] *See, e.g.*, Erica P. John Fund, Inc. v. Halliburton Co., 309 F.R.D. 251, 262 (N.D. Tex. 2015) ("[M]any alleged misrepresentations conceal a truth. Thus, the misrepresentation will not have changed the share price at the time it was made." (citation omitted)).

about the same rate in the wake of the Court's ruling. Out of a sample of forty-two complaints from between July 2014[68] and the end of 2017, twenty-five (or 60%) invoked price maintenance. And, as will be seen, courts sometimes rely upon the theory to reject defendants' rebuttal attempts even when not referenced in a plaintiff's complaint.

C. The Price-Maintenance Theory's Success in Defeating Defendants' Rebuttals

As demonstrated in section A, the price-maintenance theory has the potential to doom defendants' rebuttal attempts and thus their hopes at preventing class certification. And as explained in section B, the theory is widely invoked by plaintiffs and accepted as legitimate by courts. It was, therefore, eminently predictable that *Halliburton II*'s innovation of allowing pre-certification rebuttal of price impact would not, in practice, be an effective means of disposing of meritless securities-fraud suits. Plaintiffs can simply allege that a misrepresentation was confirmatory and lock in the *Basic* presumption. Indeed, analysis of the four years of post–*Halliburton II* price-impact analyses by lower courts makes concrete what was already clear in theory: *Halliburton II* does not present a real opportunity for defendants to counter meritless suits, in large part because of the price-maintenance theory.

In the years since *Halliburton II*, twenty-eight federal district court opinions have analyzed a defendant's attempt to rebut the *Basic* presumption.[69] Twenty-seven rejected the attempt, and one found the presumption rebutted. Three facts about the role and dominance of the price-maintenance theory in these cases are striking. First, twenty of the opinions (71%) referenced the price-maintenance theory. And in *all twenty* of them, the theory was the reason the rebuttal attempt failed.[70] In other words, if only front-end price impact were valid, those twenty cases would have almost certainly come out the other way. Notably, the only reason price maintenance did not come up in the remaining eight cases appears to be that the theory was not relevant: the plaintiffs were able to show front-end price impact.

Second, not a single district court rejected the theory, even though only three circuits (the Second, Seventh, and Eleventh) have explicitly accepted it. This resounding consensus was not for lack of trying on the part of defendants. In nearly every price-maintenance case, defendants objected to the theory and argued that only front-end price impact should be permissible.[71] But so far, courts have uniformly found the

[68] *Halliburton II* was decided in June 2014. *Halliburton II*, 134 S. Ct. 2398 (2014).

[69] For the author's research methodology and a complete list of cases, see Appendix, *supra* note 52.

[70] In two of the twenty, the court found *partial* rebuttal, but proceeded to certify anyway.

[71] *See, e.g.*, Hatamian v. Advanced Micro Devices, Inc., No. 14-cv-00226, 2016 WL 1042502, at *7–8 (N.D. Cal. Mar. 16, 2016).

logic behind the theory — that propping up a security's price through confirmatory statements constitutes a price impact — unimpeachable.

Third, courts agree that defendants bear the burden of persuasion when attempting to rebut the presumption.[72] That is, defendants must show by a preponderance of the evidence that any price change "was not caused *at least in part* by the disclosure of the fraud."[73] This requirement is "particularly onerous" and "daunting"[74] in price-maintenance cases because simply identifying other pieces of price-affecting news on the corrective disclosure date is not sufficient; such a showing does not demonstrate that *no* component of the change was associated with the disclosure.[75] The application of such a tough standard squares with the prediction made by one scholar immediately after *Halliburton II* that "trial judges, faced with conflicting economic evidence that they are scarcely equipped to evaluate, will opt to certify a class."[76]

These three facts together show that *Halliburton II*, in practice, does not provide a meaningful opportunity to rebut the *Basic* presumption. The price-maintenance theory simply makes it too difficult to do so. As a result, *Halliburton II* has failed to deliver on its promise of alleviating some of the burdens of excessive 10b-5 litigation. Moreover, the experience demonstrates the near futility of the Court's incremental attempts to rein in securities-fraud class actions. *Halliburton II* was merely the latest in a long series of Court decisions tinkering with the class action without dealing with the root of the problem. Such an approach has proven insufficient. Fixing *Basic* will take an act of Congress.

III. A CONGRESSIONAL FIX FOR SECURITIES-FRAUD CLASS ACTIONS

The Court's incremental approach in *Halliburton II* was coupled with an invitation to Halliburton: if the company had policy complaints

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[72] *See, e.g.*, Waggoner v. Barclays PLC, 875 F.3d 79, 100–03 (2d Cir. 2017); *In re* Intuitive Surgical Sec. Litig., No. 13-cv-01920, 2016 WL 7425926, at *13 (N.D. Cal. Dec. 22, 2016).

[73] Strougo v. Barclays PLC, 312 F.R.D. 307, 327 (S.D.N.Y. 2016); *see also, e.g.*, Thorpe v. Walter Inv. Mgmt., Corp., No. 14-cv-20880, 2016 WL 4006661, at *14 (S.D. Fla. Mar. 16, 2016) ("Defendants . . . have not shown that the price impact was *in no way related to* the . . . disclosure." (emphasis added)). The Second Circuit recently reaffirmed the preponderance standard, though it noted that defendants need not necessarily present "conclusive" evidence of a lack of price impact. *See* Ark. Teachers Ret. Sys. v. Goldman Sachs Grp., Inc., 879 F.3d 474, 485 (2d Cir. 2018). The litigants, with extensive amici support, continue to litigate the burden issue. *In re* Goldman Sachs Grp., Inc. Sec. Litig., No. 10-cv-03461, 2018 WL 3854757 (S.D.N.Y. Aug. 14, 2018), *appeal filed*, No. 18-2557 (2d Cir. Aug. 30, 2018).

[74] Aranaz v. Catalyst Pharm. Partners Inc., 302 F.R.D. 657, 673 (S.D. Fla. 2014).

[75] *See* Ferrell & Roper, *supra* note 59, at 561–62; *see also Thorpe*, 2016 WL 4006661, at *14 (finding that a showing of non-disclosure-related news that could have caused a price decline does not show that the corrective disclosure played "no part in the decline," *id.* at *13).

[76] A.C. Pritchard, Halliburton II*: A Loser's History*, 10 DUKE J. CONST. L. & PUB. POL'Y 27, 46 (2015).

about 10b-5 class actions, it should direct the complaints to Congress,[77] which has already shown some willingness to address those policy concerns by enacting the PSLRA. Halliburton, and ultimately Congress, should heed the Court's call. As securities-fraud filings continue to mount, the emergence and success of the price-maintenance theory has left defendants unable to rebut the *Basic* presumption. If class actions were meaningfully serving the ostensible purposes of the 10b-5 private action — compensation to defrauded victims and efficient deterrence against future fraud — then the increase in filings would perhaps not be such a problem. However, academics have identified two major issues with 10b-5 class actions that prevent them from adequately compensating the victims of securities fraud.[78] These issues, combined with the high transaction costs of private 10b-5 actions and the incentives the current regime creates for frivolous litigation, suggest that class actions are far from the most efficient means of deterring securities fraud.

Three decades of experience is enough. Congress should pass legislation eliminating the *Basic* presumption and restricting private actions to those where the plaintiff can show individual reliance, effectively ending 10b-5 class actions. Congress should couple this elimination with an express centralization of authority for civil securities-fraud suits in the SEC. By doing so, Congress would ensure that the *advantage* of class actions, their beneficial deterrence, remains, while getting rid of their many downsides, including the incentive for frivolous actions. Centralizing authority in the SEC would have the added benefit of allowing the federal government to set enforcement priorities and pursue only meritorious cases, without worrying about private-plaintiff interference. Moreover, targeted changes to the SEC's funding structure — and a commitment by Congress to set up a neutral process to regularly review the SEC's budget — could ensure that Enforcement Division staff remain properly funded and incentivized to aggressively pursue fraud.

A. Policy Problems with Securities-Fraud Class Actions

Many policy problems with 10b-5 class actions suggest that they are not the most efficient or effective means of enforcing the prohibition on securities fraud. That prohibition is intended to serve dual purposes: victim compensation and fraud deterrence.[79] Yet two major issues with 10b-5 class actions, the "circularity" and "diversification" problems, in addition to the high transaction costs of 10b-5 litigation, prevent them

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[77] *Halliburton II*, 134 S. Ct. 2398, 2413 (2014); *see also id.* at 2411 ("Congress may overturn or modify any aspect of our interpretations of the reliance requirement, including the *Basic* presumption itself.").

[78] *See* Pritchard, *supra* note 76, at 37–38.

[79] Spindler, *supra* note 4, at 70.

from meaningfully compensating fraud victims. Furthermore, the current regime leads to substantial overdeterrence costs, in part because of the incentives it creates for plaintiffs to file meritless "strike suits."

1. Ineffective at Compensating Victims. — The first issue that prevents 10b-5 class actions from meaningfully compensating victims is termed the "circularity problem." To understand this problem, recall that in a typical securities-fraud class action, the class is composed of shareholders who purchased stock during the "class period" — the period in which the stock's price was allegedly affected by a misrepresentation.[80] That class period ends on the date of the corrective disclosure, when the effect of the misrepresentation dissipates.[81] The cost of any resolution of a securities-fraud suit against a corporation, whether it is a settlement or a judgment and damages, will ultimately be borne by the present shareholders of the corporation.[82]

When the dust clears, the class action will have resulted in a circular wealth transfer between two groups of shareholders: past shareholders, who purchased stock within the class period, and present shareholders, who purchased stock outside the class period. Usually, neither group is guilty of securities fraud — both are innocent.[83] The lawsuit, then, has effected the arbitrary transfer of money from one innocent group of shareholders to another. The wealth transfer, moreover, is quite frequently still more circular, because many shareholders purchase stock in a given corporation both during *and* outside the class period. In other words, these shareholders are on both sides of the litigation, and all that they have done at the end of the day is "shift[] money from one pocket to another, minus the high transaction costs of securities litigation."[84] The circularity of these wealth transfers erodes much of the compensatory effect that 10b-5 litigation is supposed to achieve.

The second issue, related to the first, is the "diversification problem." This issue arises because most stock is held by diversified investors who own a wide variety of stocks across many industries.[85] In any given instance of securities fraud, the loss is suffered by those who had the bad luck to buy at the wrong time, and that loss is exactly offset by the gains of those with the good luck to sell at the right time.[86] Assuming that fraud occurs fairly equally across the sorts of companies owned by

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[80] Coffee, *supra* note 5, at 1557.

[81] *Id.*

[82] *Id.*

[83] Grundfest, *supra* note 21, at 313.

[84] Coffee, *supra* note 5, at 1558.

[85] Richard A. Booth, *The Future of Securities Litigation*, 4 J. BUS. & TECH. L. 129, 138 (2009); *see also id.* at 138 n.91 ("[M]ore than three-quarters of all stock in the United States is held by well diversified investors." (citing Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud*, 2 J. BUS. & TECH. L. 185, 189–90 (2007))).

[86] *Id.* at 136–37.

a diversified investor, individual investors will sometimes win and sometimes lose, but in *aggregate* securities fraud will probably be a wash.[87] To be sure, not all investors are diversified; however, even for nondiversified investors, the existence of the circularity problem still means that compensating them for their out-of-pocket losses necessarily takes money from the pockets of other innocent shareholders. Professor John Coffee has noted that both problems can occur simultaneously: diversified investors who purchase shares of many companies' stock at many different times will probably be on both sides of the litigation in several class actions at once.[88] These investors will thus largely be "making wealth transfers [with] themselves."[89]

Further reducing any useful compensatory effect of securities-fraud class actions are their extremely high transaction costs. Those costs include not only the "legal fees paid to both plaintiffs' and defendants' counsel," but also "increased insurance premiums . . . , and the possible costs of business disruption."[90] In the case of one $9.3 million settlement, the direct transaction costs associated with achieving that settlement were "probably about equal to the amount to be distributed to the class" — and that is without considering indirect costs like "complying with discovery requests, the expenditure of judicial resources," or the "7-year delay in receiving payment."[91]

2. Inefficient Means of Deterring Fraud. — Problems like high transaction costs or the failure to compensate victims may not be an issue if one believes that the real purpose of 10b-5 class actions is only to deter future fraud. Some scholars believe that the tiny amount of out-of-pocket losses suffered by most individual investors demonstrates that "there is generally no legitimate utilitarian reason to care whether class members with small claims get compensated at all."[92] Instead, these scholars claim, "[t]here is but one true objective": for the class action to "cause[] the defendant-wrongdoer to internalize the social costs of its actions."[93] However, there is little evidence that 10b-5 class actions are an effective means of achieving this objective, especially in light of the substantial overdeterrence costs they can cause.

Overdeterrence costs result when a target of enforcement fears that an enforcer will aggressively pursue marginal cases, so that false

[87] *Id.* at 138–39; *see also* Charles R. Korsmo, *Market Efficiency and Fraud on the Market: The Danger of* Halliburton, 18 LEWIS & CLARK L. REV. 827, 843 (2014).
[88] Coffee, *supra* note 5, at 1558.
[89] *Id.*
[90] *Id.*
[91] Alexander, *supra* note 57, at 575; *see id.* at 574–75.
[92] Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 105 (2006).
[93] *Id.*

positives are likely.[94] Such a result may be occurring in the anti-securities-fraud context, where class action plaintiffs can "pursue cases that the government would refuse to bring even [if] it had infinite resources."[95] Overdeterrence "produces some of the very same social costs as securities fraud itself."[96] For example, fear of liability could cause companies to "overinvest in precautionary measures."[97] Or it could damage the efficiency of the market in allocating resources by incentivizing companies to "reduce disclosure of truthful information or . . . disclose too much trivial information."[98]

In a world with perfect adjudication of scienter, it "should be costless for defendants to avoid intentional falsehoods (they need [only] decide not to lie)."[99] However, as we have seen, 10b-5 class actions usually settle once a class is certified, before reaching the merits — thus, "the issue of scienter is addressed through circumstantial evidence with the plaintiff entitled to the benefit of the doubt."[100] False positives are likely, and class actions "will not simply deter lies, but will also deter the provision of beneficial information to the market."[101] This is not to say that class actions provide no beneficial deterrence, but instead, that it would be vastly preferable to use a method that deters without *over*deterring.

Further, class actions do not effectively deter fraud by corporate executives. For one thing, while executives are sometimes named in 10b-5 class actions, plaintiffs' attorneys more frequently go after deep-pocketed corporations who can pay the highest damages.[102] Equally important, executives almost never end up paying anything personally because damages are covered by the corporation or by the executive's corporation-paid insurance.[103]

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[94] *See* Rose, *supra* note 9, at 2184; *see also* James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 121 (2012) (defining "overenforcement" as "the tendency of some enforcers to bring more cases than is socially optimal").

[95] Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 970 (1994).

[96] Rose, *supra* note 9, at 2184.

[97] *Id.*

[98] *Id.*

[99] Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 647 (1992).

[100] *Id.* at 649; *see also* Park, *supra* note 94, at 139 ("Courts have struggled with defining scienter with any specificity, and there can be reasonable disagreement as to whether a certain set of facts supports a finding of scienter." (footnote omitted)).

[101] Mahoney, *supra* note 99, at 649.

[102] *See* Jed S. Rakoff, *The Cure for Corporate Wrongdoing: Class Actions vs. Individual Prosecutions*, N.Y. REV. BOOKS (Nov. 19, 2015), https://www.nybooks.com/articles/2015/11/19/cure-corporate-wrongdoing-class-actions/ [https://perma.cc/5K4U-95LP].

[103] Coffee, *supra* note 5, at 1550–51; *see also id.* at 1551 ("The reality is that corporate insiders are sued in order for the plaintiffs to gain access to their insurance, but their personal liability appears not to be seriously pursued.").

3. Catalyst for Frivolous Lawsuits. — Finally, the structure of 10b-5 class actions encourages plaintiffs to file lawsuits in even the most tenuous of cases — as the huge number of 10b-5 suits filed each year demonstrates. Many *clearly* frivolous suits are disposed of at the motion-to-dismiss stage.[104] However, as described in section II.C, the price-maintenance theory allows classes with very little merit to be certified if they survive dismissal. And plaintiffs know that once they get past the certification hurdle, defendants have an enormous incentive to settle and avoid the uncertain crucible of a securities-fraud trial.[105] Yet settlements of meritless cases are wasteful and do not benefit investors in the corporation, except as a "costly form of insurance."[106]

B. Centralization of Civil Securities-Fraud Enforcement in the SEC

The many policy problems with 10b-5 class actions, therefore, demonstrate the desirability of using an alternative method to combat securities fraud that can achieve the same deterrence benefits with fewer downsides. Here, it is important to note that despite the problems of combating securities fraud via class action, there *are* real, damaging costs of securities fraud — primarily in inefficient allocation of resources and increased cost of capital.[107] If investors believe that fraud is rampant in the capital markets, they are likely to discount the price they are willing to pay for securities below what the security is really worth.[108] Such a market distortion would mean that companies cannot raise as much capital, which could lead to missed investment opportunities and, in turn, reduced value to shareholders. And while investors can largely diversify away the risk of fraud, some investors will "nevertheless expend resources to verify the truthfulness of corporate disclosures"[109] that they would not have spent in a world without securities fraud. Not only are those resources not being put to productive use, but other potential investors may refrain from trading out of concern that the more informed traders will consistently beat them.[110] Thus, some deterrence regime is desirable.

Congress should take up the baton from the Court and pass legislation eliminating the *Basic* presumption and largely centralizing authority for civil securities-fraud enforcement in the SEC. This legislation

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[104] *See* CORNERSTONE RESEARCH, *supra* note 2, at 15.

[105] *See* Alexander, *supra* note 57, at 514, 524. In short, "[t]he math is simple: a [corporation's] one percent chance of losing a $2 billion judgment makes it economically rational to cut a check for $20 million, even ignoring the massive costs of mounting a defense." Pritchard, *supra* note 76, at 38.

[106] Pritchard, *supra* note 76, at 39.

[107] *See* Rose, *supra* note 9, at 2179; Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1894–96 (2013).

[108] Rose, *supra* note 9, at 2179.

[109] *Id.*

[110] *Id.*

would help combat the real costs of securities fraud. And it would alleviate almost all of the problems in the current regime. The SEC would be able to set broad enforcement priorities and pursue only meritorious cases. Moreover, federal government enforcement actions would not arbitrarily benefit one set of shareholders over another like class actions do. Ultimately, a centralized regime — coupled with the enhancements and funding changes proposed in section C — is preferable to other reform approaches and could achieve the same deterrence benefits as a multienforcer regime.

1. Achieve More Optimal Level of Deterrence. — The major advantage of centralizing authority is that the SEC, acting alone, can achieve a more optimal level of deterrence than the current multienforcer system does. The SEC does not have the same incentives as plaintiffs' attorneys do to bring frivolous cases,[111] so it can instead focus on pursuing only meritorious cases, avoiding the substantial overdeterrence costs associated with 10b-5 class actions. And because the SEC has subpoena power, it can ascertain the merits of an enforcement action *before* filing suit.[112] This is in contrast to private plaintiffs who are, as Professor James Park puts it, "disadvantaged relative to government enforcers such as the SEC . . . because they do not have the power to subpoena documents before bringing a case. As a result, there is a greater risk of error in the suits that they bring."[113]

Thus, under an SEC-focused regime, actions would be brought only where the underlying merits of the case were strong, ensuring fewer false positives and allowing corporations to release material, relevant information to the market with less fear of later being sued (thereby preventing the main source of overdeterrence costs). A possible goal for the SEC could be to bring an enforcement action wherever a meritorious class action would be brought under the current regime — perhaps in collaboration with private plaintiffs, as discussed in section C. So long as the SEC continues to remain rigorously independent from political pressure, centralization would have the additional salutary effect of ensuring that corporations and individuals face severe reputational harms when an enforcement action is brought against them, as the public will know the action is likely meritorious.

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[111] *See* Grundfest, *supra* note 95, at 970 ("[P]rivate class action litigation involves a number of 'lower-quality' lawsuits that plaintiffs do not individually expect to win, but which plaintiffs can legitimately pursue without fear of judicial sanction and which serve as a basis for negotiating settlements with defendants unwilling to bear the risks and costs of a trial on the merits."); *see also id.* ("[I]t was my experience as a Commissioner that the agency consistently sought to avoid instituting an enforcement action if it did not in good faith believe that the action would likely prevail on the merits.").

[112] *See* Park, *supra* note 94, at 161.

[113] *Id.*

2. Focus on Investor and Market Confidence Rather than Compensation. — Another advantage of centralization is that the SEC could publicly deemphasize the nearly impossible effort to fairly compensate victims of securities fraud,[114] and instead focus on punishing the wrongdoers and communicating that punishment to the affected investors. Shifting the public perception of securities enforcement in this way is likely impossible while the class action bar continues to push for frequent litigation, promising investors compensation for their losses (which, as explained in section A, is fundamentally misguided).

It is true that the costs of enforcement in an SEC-focused regime will still ultimately fall on an unlucky group of shareholders.[115] But centralization has the benefit of not committing the *additional* injustice of transferring wealth from one innocent shareholder to another — a significant benefit over a system with class actions, because the loser in such a wealth transfer is likely to feel that loss every bit as keenly as the shareholder who originally lost money from fraud.

A criticism of this proposal may be that slighted investors, if not receiving compensation, will demand some symbolic proof that they have not suffered in vain — that the corporation or responsible people have been punished. The enhanced reputational harms explained above should help provide some of this symbolic justice. But the SEC should ensure that investors feel that justice has been done in each case by broadly publicizing the actions it takes and the fines it imposes on wrongdoers, as well as communicating updates to affected shareholders.

3. Set Broad Enforcement Priorities and Targets. — Centralization would also allow the SEC to create enforcement priorities and execute them properly. For example, the SEC could decide to focus on bringing a large quantity of low-stakes, low-cost cases.[116] Or it could focus on bringing comparatively few high-stakes, high-cost cases.[117] While the SEC does already have the ability to set enforcement priorities, since *Basic* it has been forced to contend with interference from the class action bar that can easily disrupt any strategy set forth by the SEC. For example, if the SEC decides to focus on bringing high-stakes cases against large corporations — front page of the *Wall Street Journal* material — and deemphasize suits against mid-sized companies to incentivize those companies to release more information, the entire strategy could be undermined by a class action bar that relentlessly files suit against mid-sized companies.

4. Preferable to Other Frequently Proposed Reform Approaches. — One can envision other potential approaches to reforming securities-

[114] *See* Coffee, *supra* note 5, at 1565.
[115] *See id.* at 1565–66.
[116] *See* Park, *supra* note 94, at 142.
[117] *See id.*

fraud enforcement; in fact, some have been proposed by other authors. For example, Congress could eliminate the private right of action altogether.[118] Or it could restrict the *Basic* presumption to suits against individuals, which do not have the same circularity problem as suits against corporations.[119] However, these other approaches have fundamental flaws that make them inferior to the approach proposed by this Note (retain the private right of action for cases of individual reliance while eliminating the *Basic* presumption). It would be problematic to eliminate the private right of action entirely, because there are certain circumstances where a private suit makes good policy sense — for instance, if a nondiversified investor relies on an executive's specific false statement and loses a lot of money, the most direct route for punishment and compensation may be a private suit against the executive, where none of the damages will come from other innocent shareholders (except insofar as the corporation paid for the executive's insurance). On the other hand, retaining the *Basic* presumption for class actions against individuals leaves in place incentives for frivolous litigation. This approach could result in overdeterrence costs, just like the current regime, if suits against executives came to replace suits against corporations.

C. Ensuring the SEC Aggressively Pursues Fraud

Key to the centralization plan is an SEC that is dedicated, well resourced, and properly incentivized to combat fraud. Indeed, proposals to centralize authority for securities-fraud enforcement in the SEC are frequently met with the criticism that the SEC will not pursue fraud aggressively enough, and will thus underdeter fraud relative to the current multienforcer regime.[120] One reason posited is that the SEC is "susceptible to capture by industry groups."[121] Another is that the SEC just does not have enough resources to vigorously enforce the law on its own.[122] This section proposes three additional steps Congress should take, in conjunction with the centralization proposed in section B, that together would address these concerns and ensure that an SEC-focused enforcement regime achieves a close-to-optimal level of deterrence.

The first and most obvious step is to increase the funding of the SEC. To be sure, the SEC lacks the resources to investigate *every* suspect disclosure, and even a significant increase in funding would not enable it to do so.[123] However, if Congress is going to cut off the supplemental enforcement performed by private plaintiffs, the SEC's budget will need

[118] *Cf.* Grundfest, *supra* note 95, at 976–78 (suggesting the SEC itself could eliminate the private right of action).

[119] *Cf.* Pritchard, *supra* note 76, at 51 (suggesting shareholders could add a provision to a corporation's articles of incorporation waiving their rights to sue using the *Basic* presumption).

[120] *See* Park, *supra* note 94, at 127.

[121] *Id.*

[122] *See id.*

[123] Grundfest, *supra* note 95, at 969.

to be increased to compensate and ensure that it can pursue its new, larger mandate effectively.

A potential problem with this step is that, if the SEC is going to be primarily responsible for civil securities-fraud enforcement, the congressional budgeting process — and issues of competence and political influence — becomes very important. One would hope that Congress would be up to the task of properly budgeting for an agency that is responsible for ensuring the integrity of our securities markets. And it is probably beyond the scope of this Note to solve modern congressional dysfunction. However, one way to safeguard the independence of the SEC from partisan winds during the budgeting process would be to assign the task of devising and reviewing the SEC's budget to a nonpartisan committee.

The second step, and one that ensures proper incentive alignment within the SEC, is for Congress to make at least part of the SEC, such as the Enforcement Division, self-funding. Congress could, for instance, allow the SEC to take a cut of whatever enforcement penalties it imposes on culpable corporations and individuals in order to support future enforcement actions. Such a proposal has been presented to Congress before, in 2010, and it had the support of SEC Chairwoman Mary Schapiro as well as a group led by former SEC Chairmen Arthur Levitt Jr. and William H. Donaldson.[124] As an example, in 2017, Enforcement obtained fines of $3.7 billion.[125] Diverting just 15% of those fines back into Enforcement's budget (instead of into the government's general coffers) could entirely cover its expected 2018 budget of $507 million.[126]

Self-funding would also combat "industry capture." A common refrain against the SEC is that it goes easy on powerful corporations because "SEC enforcement staff . . . hope to make connections leading to future private sector employment and may not want to alienate powerful industry members."[127] If SEC staff are "captured," they will likely bring smaller cases against smaller companies with less political clout.[128] But if Congress made Enforcement self-funding, Enforcement staff would have no choice but to bring some actions against large corporations to ensure the agency's survival.[129] Moreover, the industry capture argument is likely overblown. As Judge Rakoff has pointed out, federal prosecutors — and by analogy, Enforcement attorneys — are incentivized to pursue high-level fraud cases because of the "career-making benefits

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[124] Rose, *supra* note 9, at 2225.
[125] DIV. OF ENF'T, U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT 3 (2018), https://www.sec.gov/files/enforcement-annual-report-2017.pdf [https://perma.cc/U7B2-KDJR].
[126] U.S. SEC. & EXCH. COMM'N, CONGRESSIONAL BUDGET JUSTIFICATION: FISCAL YEAR 2018, at 15 (2018), https://www.sec.gov/files/secfy18congbudgjust.pdf [https://perma.cc/X2JK-E8RP].
[127] Park, *supra* note 94, at 149.
[128] *See id.*
[129] *See id.* at 149–50.

such prosecutions confer on the successful prosecutor."[130] Of course, defining the precise contours of the self-funding mechanism would be a task for Congress. As a policy matter, meeting the SEC's funding requirements would have to be balanced with the potential that an expansive self-funding system might result in a *too*-aggressive SEC.

Finally, Congress should direct the SEC to start an experimental program to either refer certain cases to private plaintiffs for enforcement or require private plaintiffs to submit cases to the SEC for approval.[131] This would allow the SEC to aggressively pursue fraud on its own *and* take advantage of the resources of private plaintiffs, while still pursuing a unified enforcement agenda. Under the approval approach, for instance, the SEC could create a set of public guidelines setting forth what its priorities are and what cases might benefit from private plaintiffs taking the lead. And the entire process, if public, could even combat underenforcement by allowing citizens to monitor and comment upon the SEC's decisionmaking.[132] If successful, this experimental program could grow and become a powerful supplement to the SEC's own enforcement actions, as well as help to mitigate budgetary pressures.

CONCLUSION

The stark increase in 10b-5 class actions since *Basic*, facilitated and fueled by the Court's incremental approach to securities-fraud cases in the intervening decades, has led to overdeterrence costs and, due to the circularity and diversification problems, it is far from clear that these class actions meaningfully compensate victims of securities fraud. Because the Court has indicated it will not substantially reform 10b-5 actions on its own, Congress can and should address this problem itself by centralizing authority for civil securities-fraud enforcement in the SEC. Not only would this avoid the problems stemming from 10b-5 class actions, but it would also allow the SEC to set broad enforcement priorities and pursue worthy, meritorious cases, without worrying that private enforcement will get in the way.

Three decades is long enough to evaluate whether an enforcement regime works well. Ours does not. The costs of securities fraud to the economy and investors are real and significant, but our inefficient multienforcer system is not doing all it can to mitigate those costs. Congress should act now to fix this long-running and persistent problem.

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[130] Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS (Jan. 9, 2014), https://www.nybooks.com/articles/2014/01/09/financial-crisis-why-no-executive-prosecutions/ [https://perma.cc/X2J8-5BWP].

[131] *See* Rose, *supra* note 9, at 2225.

[132] *See id.* at 2225–26.