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Private Equity & Private Suits: Using 10B-5 Antifraud Suits to Discipline a Transforming Industry

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NOTES

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Introduction

[A]s if clicking one's heels and wishing to find oneself in a land free of . . . Rule 10b-5 were enough to make it happen.[1]

When investors in the public capital markets lose money, they sue; when investors in private equity market lose money, they do not.[2] That private equity funds have largely managed to not only avoid public regulation, but to avoid private investor suits,[3] is uncanny. After all, Securities

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1. James C. Spindler, *The Going Private Phenomenon: How Private is Private Equity, & at What Cost?*, 76 U. Chi. L. Rev. 311, 312 (2009).

2. *Id.* at 315-16 (finding that "firms [in public capital markets] can count on being sued almost any time they lose substantial amounts of money; in some contexts, such as initial public offerings, the overall incidence of lawsuits rose as high as, for instance, 39 percent in high-tech industries in the peak bubble years of 1999 and 2000." Additionally, "[w]e might expect, in general, that a limited partner who lost money on speculative ventures would often sue its general partner. But quite to the contrary, this does not appear to happen very often at all.").

3. *Id.* at 311-312 ("The very essence of private equity is exemption from the public securities laws . . . . Staying below the regulatory radar is paramount. The breadth of the law's reach, and what one must do to escape it, largely defines what private equity is.").

and Exchange Commission ("SEC") Rule 10b-5[4]—the "chief" antifraud action available to private investors[5]—"applies just as much to purchases and sales of limited partnership interests [in private equity firms] as it does to purchases and sales of publicly traded securities."[6] However, with the financial crisis and the subsequent passing of the Dodd-Frank Act, the private equity market is running out of luck. The industry, newly exposed to investor suits, is no longer able to avoid litigation over investors' losses.

This note demonstrates why private equity will no longer be able to avoid private investor suits as it has (mostly) done in the past and explores the industry's response to a growing number of investor suits. Notably, the industry has already begun to shift its strategy from regulatory avoidance to regulatory capture, at least in part to avoid investor suits. Given these changes, this note proposes that the best way to maintain discipline in the transforming private equity market is to protect the ability of investors to bring private suits.

The note proceeds as follows. Part I outlines how private equity has avoided investor suits in the past, particularly by keeping limited partner investors to a minimum. Part II describes changes to the market and regulatory environment—specifically the financial crisis and the Dodd-Frank Act—that have made the industry increasingly vulnerable to investor suits, and gives a brief description of why 10b-5 investor suits are the proper tool to take advantage of the changes described. Part III examines a wider securities suit context, in which some judges have responded to increased liability for other securities issuers by erecting judicial barriers to 10b-5 suits. Part IV reviews George Stigler's theory that industries, when they become powerful enough, demand regulation, or attempt to capture it, and suggests that the behavior of the private equity industry already fits this description. Part V concludes that 10b-5 investor suits are the best tool for maintaining discipline in the private equity industry and proposes changes to judicial inferences and the JOBS Act (described in Parts III and IV, respectively) that will protect 10b-5's role in disciplining the market.

I. Private Equity: Solving Agency Problems Below the Regulatory Radar

The breadth of the [securities laws'] reach, and what one must do to escape it, largely defines what private equity is.[7]

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4. 17 C.F.R. § 240.10b-5 (2012).

5. Spindler, *supra* note 1, at 316.

6. *Id.* Indeed, 10b-5, in conjunction with the other securities laws, is particularly difficult to avoid because Section 29(a) of the Securities Exchange Act restricts what can be disclaimed in a contract, and because any disclosures a firm makes are subject to 10b-5's antifraud liability standard. *Id.* at 322-23.

7. *Id.* at 312.

Private equity, heretofore, has largely been a study in flying "below the regulatory radar."[8] Private equity funds do this by avoiding the securities laws[9] and the SEC rules and regulations that help implement them (including SEC Rule 10b-5, which gives investors a private right of action considered consistent with SEC enforcement).[10] This practice, however, has been changing since the financial crisis—and not just because Mitt Romney's 2012 presidential candidacy made it harder for private equity to "stay in the shadows."[11]

This part: (1) explains the philosophy motivating the private equity fund strategy of leveraged buyouts; (2) outlines the ways in which private equity funds can expose themselves to the dual-liability of public enforcement and private investor suits; and (3) describes how private equity has avoided public enforcement and private investor suits. Part II then discusses why the private equity industry is finding it increasingly difficult to avoid private securities suits.

A. *Private Equity as a Solution to Agency Problems*

If we are to assume that the desire for personal profit is the prime force motivating control, we must conclude that the interests of control are different from, and often radically opposed to, those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group.[12]

Private equity—a term that gets applied to a variety of investment vehicles and strategies—is fundamentally an approach to investing that at-

8. *Id.* at 311-312 ("The very essence of private equity is exemption from the public securities laws . . . . Staying below the regulatory radar is paramount. The breadth of the law's reach, and what one must do to escape it, largely defines what private equity is.").

9. *E.g.*, the Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (2006); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (2006); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006); Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1to -2 (2006).

10. *See* Eileen Appelbaum & Rosemary Batt, A Primer on Private Equity at Work 5 (2012), *available at* http://www.cepr.net/documents/publications/private-equity-2012-02.pdf.

11. Maureen Farrell, *SEC To Step Up Scrutiny of Private Equity Firms*, CNN Money (Jan. 27, 2012, 12:09 PM), http://money.cnn.com/2012/01/26/markets/private_equity_SEC/index.htm ("The private equity world is struggling to stay in the shadows. It's harder to do so with Republican presidential contender Mitt Romney getting criticized for his private equity roots."); *see also* Dan McCrum, *Private Equity Profits Called into Question*, Fin. Times (Jan. 23, 2012, 9:42 PM), http://www.ft.com/cms/s/0/d3b9614a-42f1-11e1-b756-00144feab49a.html ("The [private equity] industry faces mounting political scrutiny as the presidential candidacy of Mitt Romney, a former private equity executive, has drawn attention to its business model and favourable tax treatment."); D.M. Levine, *Private Equity Gears Up For PR and Lobbying Blitz*, Huffington Post (Feb. 18, 2012, 8:12 AM), http://www.huffingtonpost.com/2012/02/18/private-equity-public-relations-lobbying_n_1284604.html (According to one executive at a global private equity firm, 2012 was to be the year that shaped the entire industry).

12. Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 114 (Harcourt, Brace & World rev. ed. 1968) (1933).

tempts to address the agency problems inherent in the modern, publically-traded firm.[13] Private equity "close[s] the gap between ownership and control"[14] through the leveraged buyout: the fund identifies companies that they believe can be improved through direct management, buys a public company (or more accurately a number of companies), takes that company private, and then attempts to improve the value of the company in order to resell it (either publically or privately) later. Private equity funds thus "hold out the promise of eliminating the modern corporation's agency problems by concentrating ownership and control in a single institution [i.e. the private equity fund itself]."[15]

B. *Private Equity's Exposure—Four Vulnerable Points*

Private equity funds face two regulatory threats, both created by the securities laws: public enforcement of the securities laws and private suits brought by investors. The SEC, and to a lesser extent other agencies, such as the Commodity Futures Trading Commission ("CFTC"), enforces the securities laws in a number of ways including: by issuing subpoenas,[16] issuing cease and desist orders (§ 21C), suspending a violator's ability to trade (§ 12(k)), barring officers and directors from serving as officers and directors of public companies or working in the securities industry,[17] ordering a company to comply with disclosure rules (§ 15(c)(4)), or publically scolding a company (§ 21(a)). Private investors, also under the authority of the securities laws, bring "10b-5" suits (or "actions").[18] 10b-5 suits are investor suits brought pursuant to SEC Rule 10b-5, which was promulgated by the SEC under the authority provided by § 10(b) of the Exchange Act. Investor suits can be brought on behalf of investors (as a class action) or on behalf of the public corporation itself (as a "derivative suit").

Private equity funds typically only expose themselves to both SEC enforcement of the securities laws (i.e. public enforcement) and to private investors' suits by entering the public markets in some way. Both the SEC and private investors lack recourse through the securities laws (though

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13. *See id.*

14. Stephen F. Diamond, *Beyond the Berle and Means Paradigm: Private Equity and the New Capitalist Order* 12 (Santa Clara Univ. Legal Studies Research Papers Series, Working Paper No. 10-01, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1544599.

15. *Id.* at 26.

16. Alison Frankel, *After Libor, Arguments Against Financial Regulation Are a Joke*, Reuters (Dec. 19, 2012), http://blogs.reuters.com/alison-frankel/2012/12/19/after-libor-arguments-against-financial-regulation-are-a-joke/ ("[R]egulators armed with subpoenas are the only hope we've got.").

17. *See* Sec. & Exch. Comm'n v. First Pac. Bancorp, 142 F.3d 1186, 1193 (9th Cir. 1998).

18. *See* 17 C.F.R. § 240.10b-5 (2012).

common law fraud claims may still be available to investors) for most purely private transactions—at least for ones that do not involve fraud.[19]

Private equity funds expose themselves to public markets in four ways. First, they can "go public" themselves "by selling a small percentage of their management firms to outside investors."[20] Second, private equity funds sometimes sell corporations "to another corporation for either cash or shares in the new company."[21] Third, funds invest in public companies, without immediately or fully taking those companies private, in order to later sell them privately or through an initial public offering ("IPO"). Finally, private equity funds may incorporate into large multi-purpose asset management firms,[22] blurring their private and public roles.[23]

C. *How Private Equity Firms Have Avoided Securities Laws*

It is as President Calvin Coolidge once remarked, "I have found out in the course of a long public life that the things I did not say never hurt me"—and the same is true for issuers of securities . . . .[24]

Private equity funds have escaped the securities laws and 10b-5 suits by staying private allowing them to avoid disclosure (to investors and to the SEC), cede little to no control to investors, and limit opportunities for investors to exit their investment in the fund.[25]

10b-5 suits, promulgated by the SEC under the authority provided by § 10(b) of the Exchange Act, require a plaintiff to allege five elements (hereinafter the "*Daou* test"[26]): "(1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security ("traceability"), (4) transaction and loss causation, and (5) economic loss."[27] By limiting disclosure, private equity funds also limit op-

19. Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital-Raising* 15 (Geo. L. & Econ. Research Paper, Paper No. 12-031, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2132813 ("Truly private offerings become 'fraud-only' . . . ."); *see also* Gustafson v. Alloyd Co., 513 U.S. 561 (1995).

20. Diamond, *supra* note 14, at 4.

21. *Id.* at 19.

22. *See, e.g.*, Litwin v. Blackstone Grp., L.P., 634 F.3d 706 (2d Cir. 2011).

23. *See* Appelbaum & Batt, *supra* note 10, at 34 ("[A]s private equity, hedge funds, and sovereign wealth funds are increasingly incorporated into large multi-purpose asset management firms, the distinctions among them have begun to blur. PE invests in publicly-traded enterprises; hedge funds buy the distressed debt of PE-owned portfolio companies; while sovereign wealth funds take on the limited partner role and invest in PE funds").

24. Spindler, *supra* note 1, at 323-24.

25. *Id*. at 325 ("In sum, then, for a fund that wants to remain beyond the purview of the public antifraud regime, the three ingredients of little or no disclosure to investors, little or no investor control, and reduced avenues of investor exit are all key.").

26. Some approaches condense loss causation and economic loss. *See, e.g.*, Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 338 (2005).

27. *In re* Daou Sys. Inc., 411 F.3d 1006, 1014 (9th Cir. 2005).

portunities for investors to claim that a fund's agents made fraudulent statements or negligent misrepresentations (or omissions) that satisfy the first element of this test.[28] Limiting disclosure can also make scienter harder to plead because scienter is often plead by comparing inconsistent statements. Restraining investor control similarly denies investors the ability to obtain information that investors might use to plead those first two factors. Finally, limiting opportunities for investor exit prevents plaintiffs from pleading the third, fourth, and fifth elements of a 10b-5 suit: that there was a purchase or sale that resulted in an economic loss. If no sale was permitted, there cannot have been any transaction that resulted in loss.

Note that private equity funds face liability for two types of transactions. First, funds may face suits brought by their own investors. Second, when funds exit their investments (i.e. by selling the company they invested in and turned around) they often do so with a public offering. Funds may be sued by the investors (i.e. the shareholders) who buy shares in such an offering as well.

Despite the fact that disclosure obligations, especially at the public offering stage, are "enormous," and statements are "subject to strict liability for material misstatements and omissions," private equity funds have avoided 10b-5 actions by avoiding disclosure to investors and the SEC.[29]

At the macro (and most straightforward) level, private equity funds avoid disclosures by staying private. The Exchange Act empowers the SEC to monitor "publicly-traded firms via requirements for registration, public reporting, and detailed record keeping."[30] Investors, and plaintiffs' firms, frequently base 10b-5 suits on claims that 10-K and 10-Q disclosures made to the SEC by a company and its management were false.[31] Private equity funds avoid the Exchange Act and disclosures to the SEC by taking public companies private and remaining private themselves (i.e. they register as limited partnerships).

28. Typically, plaintiffs allege that disclosures made by senior managers themselves constitute the fraudulent statements or negligent misrepresentation. Often, plaintiffs will then claim that subsequent disclosures by managers constitute admissions that previous statements were fraudulent. These later admissions can be particularly important when pleading scienter (whether corporate or individual scienter). *See, e.g., Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 275 (3d Cir. 2009) ("[Shareholders] point to an April statement by [Defendant], which they construe as an "admission" that "he was fully aware [of unusual discounting] during the Class Period," even as early as the first quarter."); *Makor Issues & Rights, Ltd. v. Tellabs Inc.* ("*Tellabs II*"), 513 F.3d 702, 710 (7th Cir. 2008) (Finding that "[t]here would be a strong inference of corporate scienter [where a] dramatic . . . announcement [revealed information that] would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.").

29. Spindler, *supra* note 1, at 320-21.

30. Appelbaum & Batt, *supra* note 10, at 5 (internal citations omitted).

31. *See, e.g.*, *In re* Cabletron Sys., Inc., 311 F.3d 11, 24 (1st Cir. 2002) ("The falsely inflated earnings figures that resulted from these improper practices were then used in [defendant]'s filings with the SEC during the class period and in company press releases announcing quarterly results").

At the micro level, private equity funds avoid disclosure by limiting the quantity of investors they sell limited partner interests to and restricting those sales to "accredited investors." The Securities Act, which prohibits fraud, also compels companies to supply investors with information on the company's business operations, financial statements, and risk factors.[32] Private equity funds, however, take advantage of a "safe harbor" exemption offered under Regulation D[33] and § 4(2) of the Securities Act,[34] which allows them to avoid those disclosure requirements when privately placing limited partner interests by offering sales to only "accredited investors."[35] Private equity funds that have fewer than 100 accredited investors or 499 "qualified purchasers" are exempt from the reporting and disclosure requirements of the Securities Act, the Exchange Act, and the Company Act.[36] Accredited investors are wealthy individuals (annual income over \$200,000–\$300,000 including spouse, or net worth of over \$1 million) and large institutional investors (such as pension funds).[37] Qualified purchasers have more than \$5 million in investments or represent qualified purchasers with at least \$25 million in investments.[38] Private equity funds can keep these numbers low not only by not filing a registration statement and limiting the numbers of holders of record, but also by having "beneficial investment interests held through a limited number of intermediaries," who serve as the holders of record.[39]

Private equity funds also avoid regulation by relying on two exemptions from the Investment Company Act. By limiting the number of investors and assuring that the offering of securities (here the limited partnerships) remains private, a fund can avoid being classified as an "investment company." Section 3(c)(1) of the Investment Company Act "excludes from the definition of "investment company" any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 beneficial owners, and which is not making and does not currently propose to make a public offering of its securities." Section 3(c)(7) of the Act excludes "any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," and which is not making and does not at that time propose to make a public offering of its securities."[40]

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32. Appelbaum & Batt, *supra* note 10, at 5.

33. 17 C.F.R. § 230.506.

34. 15 U.S.C. § 77d(2).

35. Spindler, *supra* note 1, at 320-21.

36. Appelbaum & Batt, *supra* note 10, at 5.

37. *Id.*; Spindler, *supra* note 1, at 321-22.

38. Appelbaum & Batt, *supra* note 10, at 5.

39. Spindler, *supra* note 1, at 321-22.

40. Alexandra Poe et al., *SEC Proposes New Rules under the JOBS Act*, Reed Smith (Oct. 3, 2012), http://www.reedsmith.com/SEC-Proposes-New-Rules-under-the-JOBS-Act-10-03-2012/.

Until recently, private equity funds also secured exemption from the disclosure rules of the Advisers Act by limiting the number of investors and restricting investors to only accredited ones.[41] The Advisers Act, among other regulations, required the registration of fund managers.[42] Private equity funds were exempt from the Advisers Act if they had fewer than 15 clients (each fund counts as one client).[43] Many private equity funds manage, nevertheless, to be "extraordinarily large and powerful" while limiting the number of shareholders to avoid registration and other regulation.[44] The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd–Frank Act") changed this rule, as discussed below.[45] Private equity funds still manage to avoid registration and other regulations

Finally, in addition to reducing mandatory disclosures, private equity funds take the obvious and prudent step of limiting voluntary disclosures, "making clear in any contract with fund investors that the fund is required to disclose little, if any, information."[46]

Private equity funds have also avoided 10b-5 actions by limiting investor control and by reducing the opportunities for investors to exit their investments. If investors do not have control over the operations of the fund they cannot compel disclosure. As discussed above, investors frequently base 10b-5 claims on information obtained from disclosure.[47] And, if investors cannot easily exit their investment, usually because private equity funds have long maturity dates and contractually prevent resale, then investor-plaintiffs cannot claim they suffered harm. If it was not possible to have suffered harm during the "effective period" of the fraud[48] (because purchase or sale was impossible), investors are unable to allege harm, an essential element of a 10b-5 suit.[49]

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41. Spindler, *supra* note 1, at 322.

42. Appelbaum & Batt, *supra* note 10, at 5.

43. *Id.*

44. Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 Geo. L.J. 337, 355 (2013).

45. Appelbaum & Batt, *supra* note 10, at 5.

46. Spindler, *supra* note 1, at 323-24. Note, however, that Section 29(a) voids contractual agreements to waive compliance with Exchange Act. *Id.* at 323; 15 U.S.C.A. § 78cc(a) (West Supp. 2012) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.").

47. Spindler, *supra* note 1, at 323-25.

48. James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong About 10b-5?*, 13 Am. L. & Econ. Rev. 359, 363 (2011). Note that the "effective period" of the fraud is also referred to as the "class period" in 10b-5 class actions. *Id.*

49. *See* Spindler, *supra* note 1, at 324-25 ("[R]estricting rights also restricts the ability of investors to sue for fraud; if there is nothing the investor can do to act upon disclosure, it cannot be the case that the disclosure (or lack thereof) harmed the investor.").

II. Private Equity Exposed: Post-Crisis Market, Regulatory Changes and 10b-5 Investor Suit Liability

From the investor's vantage point, the private equity market is illiquid and high-risk, its major enticement being the potential for astronomical (or at least above-market) returns.[50]

Private equity funds will have an increasingly difficult time avoiding the securities laws—including both public enforcement and private investor suits—because: (1) poor economic conditions have caused credit to dry up and time horizons to extend, which may encourage previously reticent investors to sue the general partners of private equity funds; (2) given economic difficulty, the biggest players in the private equity industry are increasingly participating in public markets, exposing them to exactly the type of oversight and litigation risk private equity was designed to avoid;[51] (3) funds will not be able to avoid Dodd-Frank Act disclosure requirements, which went into force in 2012, in the same way they avoided Exchange Act disclosures;[52] and (4) the SEC intends to increasingly target the industry for enforcement.[53]

This part begins with a quick tour of the 10b-5 private cause of action and then explains how each market and regulatory change identified here will increase private equity funds' exposure to 10b-5 investor suits. While other developments, in particular the Jumpstart Our Business Startups Act (the "JOBS" Act of 2012),[54] will shield some (small and medium sized) private equity funds from investor suits,[55] on balance the regulatory and market environment is changing in ways that will make the world less hospitable for private equity funds.

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50. Sam Singer, *The Foreign Corrupt Practices Act in the Private Equity Era: Extracting a Hidden Element*, 23 Emory Int'l L. Rev. 273, 283 (2009).

51. Pete Brush, *SEC's Kaplan Details Plan To Target Private Equity*, Law360 (Jan. 27, 2012, 12:00 AM), http://www.law360.com/articles/304069/sec-s-kaplan-details-plan-to-target-private-equity ("Kaplan's comments also come at a time when the biggest players in the industry, such as The Carlyle Group, are getting bigger and are testing their appeal on public markets with initial public offerings.").

52. Farrell, *supra* note 11 ("Congress' Wall Street reform legislation, the Dodd-Frank law, will force private equity firms to disclose more information about their investments and outside advisors later this year. Kaplan said such disclosure will help the SEC do its work more easily").

53. Brush, *supra* note 51 ("'There will be more private equity cases coming from the division of enforcement in coming years than there have been previously,' Kaplan [co-chief of the SEC's asset management unit] said").

54. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) ("An Act To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.").

55. *See* Adam C. Pritchard, *Revisiting 'Truth in Securities Revisited'; Abolishing IPOs and Harnessing Markets in the Public Good* (Univ. of Mich. Law & Econ. Research Paper Series, Working Paper No. 12-010, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2103246.

A. *10b-5—the chief antifraud private cause of action for private parties*

A 10b-5 suit[56] is a versatile legal tool for investors who think themselves the victims of fraud. The key reason 10b-5 can be such an effective tool in targeting private equity is its flexibility. Under the *Howey* test[57]—from the classic Supreme Court opinion expansively interpreting "investment contract" in § 2(1) of the Securities Act—"virtually any financing activity" is considered to involve a security, and is therefore subject to 10b-5 liability.[58] Thus, investments in private equity funds, "without regard to whether those securities are publicly traded or have been registered under the Securities Act or Exchange Act,"[59] are subject 10b-5 suits.[60]

Avoiding 10b-5 suits is difficult. Section 29(a) of the Exchange Act imposes "severe limits on the ability of parties to contract around securities fraud liability" by prohibiting disclaiming of fraud protections.[61]

Finally, 10b-5 is a tough rule because it has evolved in two specific ways that make it difficult for defendants: first, cases that survive motions to dismiss (and motion for summary judgment and class certification—if a class suit, i.e. not a derivative suit) usually settle;[62] and, second, "faced with a Rule 12(b)(6) motion to dismiss a § 10(b) action, courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true."[63]

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56. Spindler lays out this investor remedy's history:

> Rule 10b-5 and Section 10b of the Securities Exchange Act of 1934 make actionable material misstatements or omissions in the sale or purchase of securities, with a private right of action granted to investors by the Supreme Court in 1971 in *Superintendent of Ins. v. Bankers Life & Cas. Co.* Subsequent developments of legal doctrine allow multiple plaintiff claims to be aggregated into class actions, and, as implemented in the Supreme Court case of *Basic v. Levinson* in 1988, the efficient capital markets hypothesis creates a market test for the non-scienter elements of fraud (causation, reliance, materiality, and damages). This market test is whether a change in stock price occurred at the time that information reached the market that corrected the misstatement or omission. That is, making out a 10b-5 fraud-on-the-market class action is largely a matter of conducting an event study on stock price movement around the time that the market learned of the fraud.

Spindler, *supra* note 48 at 363.

57. Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 296 (1946).

58. Spindler, *supra* note 1, at 320, 334; *Howey*, 328 US at 297-99.

59. Spindler, *supra* note 1, at 322-23.

60. Private equity funds can only insulate themselves from the securities laws completely by making the limited partners—the investors—active managers. *Cf. Howey,* 328 U.S. at 298.

61. Spindler, *supra* note 1, at 322-23 (though "some leeway exists to negotiate the disclosures to which Rule 10b-5 will apply, any disclosures that are made will be subject to Rule 10b-5's antifraud liability standard").

62. *See* Stephen J. Choi & A.C. Pritchard, Securities Regulation: Cases and Analysis 214-15 (3d ed. 2012).

63. Tellabs, Inc. v. Makor Issues & Rights, Ltd. (*Tellabs I*), 551 U.S. 308, 332 (2007).

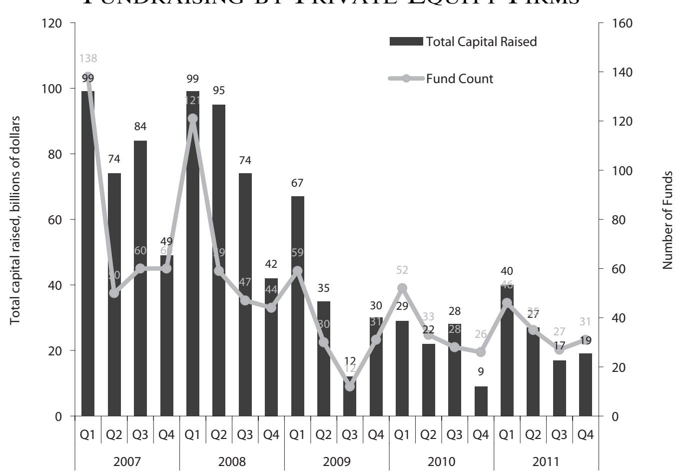
Thus, though there are a number of elements[64] a plaintiff must sufficiently allege to survive the threshold challenges to get to discovery (and therefore settlement), 10b-5 is a flexible and potent arrow in the plaintiffs' bar's quiver.

B. *A Stagnant Economy Makes it Easier to Find Investor-Litigants to Bring Suit*

10b-5 suits cannot be brought by just anyone; they need to be brought on behalf of investors who bought or sold stock during the class period (and who therefore can plausibly claim to have suffered damages as a direct result of the defendants' fraud). Poor economic conditions cause three developments that will make it easier for plaintiffs' firms to find investors willing to sue—private equity funds are: (1) earning lower returns; (2) making longer-term investments; and (3) taking on new investors. Investors were not necessarily enamored with the private equity industry before the financial crisis;[65] these market developments should make it easier for plaintiffs' firms to find disgruntled investors who bought or sold stock during the class period and are willing to sue.

First, and most obviously, private equity investors who lose money (or receive lower returns than anticipated), will be more inclined to sue. The more investors willing to serve as plaintiffs, the easier it will be for plaintiffs' firms to bring suits. And private equity returns in the wake of the financial crisis are down significantly:

FUNDRAISING BY PRIVATE EQUITY FIRMS[66]



64. *In re* Daou Sys. Inc., 411 F.3d 1006, 1014 (9th Cir. 2005) (enumerating (1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss).

65. Singer, *supra* note 50 ("From the investor's vantage point, the private equity market is illiquid and high-risk, its major enticement being the potential for astronomical (or at least above-market) returns").

66. APPELBAUM & BATT, *supra* note 10, at 23.

Arguably, funds will no longer be able to stick to their historic commitment of taking cuts from profits only on returns amounting to at least eight percent.[67] Lower returns mean more dissatisfied investors and (possibly) greater potential for investor suits, especially for funds holding "high levels of committed funds (so-called 'dry powder'[68]), which . . . have not been . . . put to work earning returns for investors and which . . . are under enormous pressure to [be] invest[ed]."[69]

Second, poor economic conditions mean that funds have had trouble finding outlets for their investment, such as companies to buy for later resale.[70] Funds are also having trouble successfully exiting their investments in portfolio companies via IPOs.[71] When the "IPO market shuts down, it becomes much harder to return money to investors, which then means it becomes harder for investors to write [checks] for new funds."[72] As a result, funds have had to increase the timeline required for investing strategies and have had to delay purchases to the detriment of investing available funds sooner. As investors wait longer to see returns, or come across increasing amounts of investments sitting idly by, funds may see an uptick of investor suits. Such suits make an increasingly attractive option for investors looking to recoup some of their investment. Indeed, even if an investor is disinclined to sue—because she is generally optimistic for the long-term health of a fund, or because she is reticent to antagonize repeat business partners or future partners—that investor may, nonetheless, need to sue if her other investments turn sour.

Even if investors do not sue, the more prolonged an investment is the greater the likelihood that the investor will sell her limited partnership interest. The purchasing investor may not be so reticent to sue, and every

67. Henny Sender, *TPG Co-founder Warns on Returns*, FIN. TIMES (Sept. 30, 2012, 10:01 PM), http://www.ft.com/cms/s/0/77e03df8-07a9-11e2-8354-00144feabdc0.html.

68. APPELBAUM & BATT, *supra* note 10, at 33 (dry powder levels are estimated at $376 billion or higher as of mid-November 2011).

69. *Id.* at 2 ("The continued slow growth of the economy limits the number of potentially lucrative targets—increasing the competition for and the price of the more attractive companies. Overpaying for a portfolio company at purchase can sharply reduce returns at exit. Some private equity firms are sitting on high levels of committed funds (so-called 'dry powder'), which they have not been able to put to work earning returns for investors and which they are under pressure to invest. Many have been unable to exit their portfolio firms without incurring losses or lower than anticipated returns. Unable to sell mature investments to the market—either through an initial public offering (IPO) on a stock exchange or as a strategic purchase by another company, PE firms are increasingly selling portfolio companies to other private equity firms. As a result of these challenges, some PE firms are having difficulty attracting limited partners and raising new funds and have sought greater participation by hedge funds and sovereign wealth funds").

70. APPELBAUM & BATT, *supra* note 10, at 32 ("the recession has made it difficult to find opportunities for investment,. . .private equity funds continue to have large amounts of 'dry powder'," and there is "a dearth of promising target companies in a slowly growing economy.").

71. *Id.* at 33.

72. Sender, *supra* note 67.

time someone buys or sells a security that investor can now meet the transactional requirements of the *Daou* test[73] (specifically, factors three, four, and five described above and assuming proof of fraud). Furthermore, the longer investors must wait, the longer a class period potentially gets, increasing plaintiffs' firms' opportunities to conduct "event studies."[74]

Third, private equity funds, in response to these economic problems,[75] are taking on new clients—especially hedge funds and sovereign wealth funds.[76] These clients typically demand more control over their investments, are better informed, and are better able to bring suit (as well as possibly less reticent to do so).[77] According to Applebaum and Batt, these funds have made a "dramatic shift from [being] indirect and passive investors to direct and proactive ones," including in private equity funds.[78] These new investors have more clout in demanding disclosure, control,

73. *See In re* Daou Sys. Inc., 411 F.3d 1012, 1014 (9th Cir. 2005).

74. Spindler, *supra* note 48, at 363 ("Rule 10b-5 and Section 10b of the Securities Exchange Act of 1934 make actionable material misstatements or omissions in the sale or purchase of securities, with a private right of action granted to investors by the Supreme Court in 1971 in *Superintendent of Ins. v. Bankers Life & Cas. Co.* Subsequent developments of legal doctrine allow multiple plaintiff claims to be aggregated into class actions, and, as implemented in the Supreme Court case of *Basic v. Levinson* in 1988, the efficient capital markets hypothesis creates a market test for the non-scienter elements of fraud (causation, reliance, materiality, and damages). This market test is whether a change in stock price occurred at the time that information reached the market that corrected the misstatement or omission. That is, making out a 10b-5 fraud-on-the-market class action is largely a matter of conducting an event study on stock price movement around the time that the market learned of the fraud.").

75. Though fundraising by private equity funds did climb in 2012. Hillary Canada, *U.S. Fundraising Climbed in 2012, No Matter What Bad Things People Said About Bain Capital*, Wall St. J.: Private Equity Beat (Jan. 7, 2013, 4:32 PM), http://blogs.wsj.com/private equity/2013/01/07/u-s-fundraising-climbed-in-2012-no-matter-what-bad-things-people-said-about-bain-capital/?mod=WSJBlog.

76. Especially as they lose some traditional investment funds, such as pension funds—as, for example, happened when the "Ontario Municipal Employees Retirement System (OMERS) recently sold a large portfolio of 11 private equity fund investments to AXA Private Equity for $850-million. . . . OMERS Private Equity chief executive officer Paul Renaud said the sale is part of a broader strategy to invest directly in private assets rather than through investment funds." Leo Kolivakis, *Private Equity Giants Adapting to New Normal?*, Pension Pulse (July 13, 2012), http://pensionpulse.blogspot.com/2012/07/private-equity-giants-adapting-to-new.html.

77. *See* Appelbaum & Batt, *supra* note 10, at 31, 34.

78. *Id.* at 31 ("In recent years, sovereign wealth funds have shifted from low-risk strategies to higher-risk/higher-return investment choices and are now employing a higher-risk/higher return strategy (Weiss 2008). In addition, dissatisfied with fund performance during the financial crisis, sovereign wealth funds are undertaking a dramatic shift from indirect and passive investors to direct and proactive ones. Qatar Investment Authority (QIA), for example, was given a seat on the board or represented at the director level for its investment in Veolia Environment and in Harrods (Monitor 2011). Recently sovereign wealth funds have begun to take minority ownership stakes in the private equity firms themselves. The Abu Dhabi Investment Authority (ADIA), for example, bought a 9 percent stake in Apollo Management and a 7.5 percent stake in the Carlyle Group. More recently, the Kuwait Investment Authority and the Government of Singapore Investment Corporation have gained a 5 per-

and avenues for investment exit, and consequently make ideal clients for plaintiffs' firms (which should actively court them).[79]

Beyond increased liability, which accompanies any new client, especially this type of client, private equity funds face added liability risks due to the nature of their client-fund relationship. The novel type of investing relationship that funds have with clients imposes liability. These relationships expose funds to new types of risks and opportunities to commit fraud. For example, as private equity funds seek new clients and investment opportunities they increasingly expose themselves to the conspiracy (and bid-rigging) charges that have entangled private equity funds and traditional Wall Street firms alike.[80]

Second, as private equity funds, hedge funds, and sovereign wealth funds are "increasingly incorporated into large multi-purpose asset management firms" and "the distinctions among them . . . blur,"[81] opportunities by plaintiffs to forum shop will increase. This is because civil suits may be brought in any district "wherein any act or transaction constituting the violation occurred" or "wherein the defendant is found or is an inhabitant or transacts business."[82] Plaintiffs' firms already have wide latitude in deciding where to bring suit; arguably, this latitude will increase as funds take on newer clients. Section 27 of the Exchange Act facilitates bringing suit by providing for nationwide service of process for claims of violations of federal securities law.[83] Furthermore, the ability to name multiple defendants as securities laws violators, who are liable as co-conspirators, gives plaintiffs "considerable room for choice in selecting a forum" because the "venue in that district is extended to cover the other defendants, even in the absence of any contact or substantial contact by any of the

cent stake in TPG (Zuckerman 2011), and China Development Bank is seeking a minority stake in TPG (Sender 2011)").

79. Hedge funds may not be as disinclined to sue large market participants as other investors are thought to. *See* Spindler, *supra* note 1, at 330 ("Many of the investors are repeat players, such as funds-of-funds, insurance companies, pensions, and other institutional investors, and do not want to acquire reputations as troublemakers, which would deny them investment opportunities in the future"). The hedge fund Baupost, for example, thought to have backed out of mortgage backed securities related litigation, in fact continues to actively pursue its claims against Bank of America and Countrywide. Alison Frankel, *Baupost Hedge Fund Files Hot Put-back Complaint vs Bear Stearns*, REUTERS (Sept. 12, 2012), http://blogs.reuters.com/alison-frankel/2012/09/12/baupost-hedge-fund-files-hot-put-back-complaint-vs-bear-stearns/.

80. *See* Liz Hoffman, *PE Titans Try Again to Whittle LBO Bid-Rigging Claims*, LAW360 (July 24, 2012 3:52 PM), http://www.law360.com/articles/363124; *see also* RICHARD H. FALLON, JR., ET AL., HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM (6th ed. 2009).

81. APPELBAUM & BATT, *supra* note 10, at 33-34.

82. 15 U.S.C. § 78aa (1988); *see* Bourassa v. Desrochers, 938 F.2d 1056 (9th Cir. 1991).

83. *Bourassa*, 938 F.2d at 1057.

other defendants within that district."[84] Increased partnerships with other funds and investment banks will increase the ability of plaintiffs' firms to file multidefendant complaints and choose their venue.

The search for yield has already pushed funds to hazard riskier practices[85]—plaintiffs' firms should recognize the opportunity, and private equity the litigation risk, therein.

C. *Flirting with Public Status: Increased Public Market Entry Exposes Funds to the Securities Laws they Were Designed to Avoid*

Because the Exchange Act empowers the SEC to monitor publically traded firms,[86] and because plaintiffs base 10b-5 suits on disclosures made to the SEC pursuant to that monitoring,[87] the more private equity funds enter—and linger in or fail to exit—public markets, the more they expose themselves to investor suits.

Private equity funds expose themselves to public markets in four ways. First, they can "go public" themselves, "by selling a small percentage of their management firms to outside investors."[88] Second, sometimes private equity funds sell corporations "to another corporation for either cash or shares in the new company."[89] Third, funds invest in public companies, without immediately or fully taking those companies private (to later sell them privately or through an IPO).[90] Finally, private equity funds may

84. F. Hodge O'Neal and Ronald R. Janke, Utilizing Rule 10b-5 for Remedying Squeeze-Outs or Oppression of Minority Shareholders, 16 B.C. Indus. and Com. L. Rev. 327, 344-45 (1975), *available at* http://lawdigitalcommons.bc.edu/bclr/vol16/iss3/1.

85. *See, e.g.*, *Investors fight over "B+" bonds at 5.75%*, Sober Look (Sept. 14, 2012), http://soberlook.com/2012/09/investors-cant-get-enough-of-b-bonds-at.html.

86. Appelbaum & Batt, *supra* note 10, at 5 (internal citations omitted); *see generally* Part I.

87. *See, e.g.*, *In re* Cabletron Sys., Inc., 311 F.3d 11, 24, 35-37 (1st Cir. 2002) ("The falsely inflated earnings figures that resulted from these improper practices were then used in [Defendant]'s filings with the SEC during the class period and in company press releases announcing quarterly results."); s*ee also* Part I.

88. Stephen F. Diamond, *Beyond the Berle and Means Paradigm: Private Equity and the New Capitalist Order*, in The Embedded Firm Corporate Governance, Labor, and Finance Capitalism 151, 152 (Cynthia A. Williams & Peer Zumbansen eds., 2011), *available at* http://digitalcommons.law.scu.edu/facpubs/56/.

89. *Id.* at 162.

90. *See* Helia Ebrahimi, *Private Equity's Purgatory May Feel Like Hell*, Sober Look (Feb. 12, 2010, 10:07PM), http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/privateequity/7224357/Private-equitys-purgatory-may-feel-like-hell.html ("Private equity owners failure to exit the companies could leave them nursing a major headache just as they hoped the sector was showing signs of recovery after one of the darkest passages in its history. Most will sit in a kind of IPO purgatory and hope that conditions improve enough to give them a second chance [to exit their investments through sales].").

incorporate into large multi-purpose asset management firms,[91] blurring their private and public roles.[92]

Selling a company in an IPO is increasingly attractive because: funds are strapped for capital (as discussed above); IPOs can be structured in ways that allow a fund to raise capital while ceding little control (e.g. Class B shares with limited or no voting rights sold while Class A shares are quoted but not traded);[93] and funds can use debt to pay dividends to private investors, then take a company public and not pay dividends.[94]

Entering and exiting investments are the toughest challenges facing private equity.[95] And, if Facebook is a harbinger,[96] increased exposure to public markets is a dicey proposition, especially with increased public enforcement scrutiny (see below) focused on private equity.

Like a hermit crab that must expose itself every time it moves from one shell to the next, private equity funds expose themselves to litigation risk every time they enter the public markets (to enter and exit investments), where they face increased scrutiny and disclosure requirements (not to mention financial risk). Private equity funds are not only more active in public markets, they are experimenting with novel organizations such as multi-purpose asset management firms; the increased disclosure

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91. *See, e.g.*, Litwin v. Blackstone Grp., L.P., 634 F.3d 706 (2d Cir. 2011), *cert. denied*, 132 S. Ct. 242, 181 L. Ed. 2d 138 (2011).

92. *See* Appelbaum & Batt, *supra* note 10, at 34 ("[A]s private equity, hedge funds, and sovereign wealth funds are increasingly incorporated into large multi-purpose asset management firms, the distinctions among them have begun to blur. PE invests in publicly-traded enterprises; hedge funds buy the distressed debt of PE-owned portfolio companies; while sovereign wealth funds take on the limited partner role and invest in PE funds.").

93. Daniel Stanton & Fiona Lau, *Manchester United drops Asia IPO for U.S.*, Reuters (June 13, 2012, 6:01 PM), http://www.reuters.com/article/2012/06/13/us-singapore-us-ipo-manchester-united-if-idUSBRE85C0MO20120613.

94. *See* Dan Primack, *AutoTrader: Dividends for us, not for you*, CNN Money (June 18, 2012, 3:28 PM), http://finance.fortune.cnn.com/2012/06/18/autotrader-dividends-for-us-not-for-you/; *see also* Appelbaum & Batt, *supra* note 10, at 21 (describing the HCA case: "The PE owners attempted to exit the deal in 2010 with an IPO, but, when the market did not allow them to, they paid themselves $4.25 billion in a series of dividend recapitalizations—in part by issuing junk bonds and loading the company with additional debt. Such dividend recapitalizations appear to contradict the argument that PE returns come from building value in portfolio companies and derive from the difference between the price PE paid to acquire the company and the price at which it sells when it exits the investment. In March, 2011, HCA was finally successful in going public, with a $3.8 billion IPO. While the owners more than recouped their initial investment, HCA is now saddled with $26 billion in debt—$12 billion more than the company's assets.") (citations omitted).

95. *See* Hillary Canada, *Survey Says: Entering And Exiting Are Toughest Challenges In PE*, Wall St. J.: Private Equity Beat (Oct. 25, 2012, 3:26 PM), http://blogs.wsj.com/privateequity/2012/10/25/survey-says-entering-and-exiting-are-toughest-challenges-in-pe/?mod=WSJBlog.

96. *See* Aaron Smith, *Investors sue Facebook, Morgan Stanley*, CNN Money (May 23, 2012, May 2:48 PM), http://money.cnn.com/2012/05/23/technology/facebook-lawsuit/index.htm.

required to be active in public markets, and exposure to more clients increases funds' exposure to investor suits as well.

D. *Dodd-Frank Act disclosure requirements*

New Dodd-Frank disclosure and registration requirements make it easier for investor suits to adequately plead the threshold requirements necessary to get to discovery, and easier to get to settlement as well.[97] Title IV of the Dodd-Frank Act includes the Private Fund Investment Advisers Registration Act of 2010 (the Registration Act), which directly regulates private equity.[98] The recordkeeping and reporting obligations imposed by Dodd-Frank will provide investors with more information on which to base suits. This section first examines how the Dodd-Frank regulates private equity funds by asset size and number of shareholders, then looks at how investors can use the disclosures required under those regulations to draft a 10b-5 complaint.

The size of a private equity fund will play the most important role in determining how much disclosure and other regulation a fund faces. Private equity funds with $2 billion or more in assets have the highest reporting requirements. About 155 private-equity fund advisers fall into this category.[99] Comparatively, a modest number of funds[100] having just $25 million in assets or less are not required to register at the federal level.[101] Under the Registration Act, funds with $25 million in assets or less must instead register only with state regulators.[102] The Registration Act

97. *See* Choi & Pritchard, *supra* note 62, at 214-15.

98. Appelbaum & Batt, *supra* note 10, at 7.

99. *Id.*

100. Though I have been unable to find statistics on the number of private equity funds with under $25 million in assets, the number is apparently quite small: "Unless the SEC, by rulemaking, significantly increases the $25 million threshold . . . [the] exemption for this purpose is fairly narrow, and will limit the ability of non-U.S. advisers to raise significant funds in the United States without first registering as investment advisers." Heather Cruz, *Private Fund Investment Advisers*, Skadden (*July 9, 2010),* available at http://www.skadden.com/insights/private-fund-investment-advisers.

101. Bingham McCutchen LLP, Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act 3 (Oct. 2010), *available at* http://www.bingham.com/Alerts/2010/10/~/media/Files/Docs/Summary_of_the_Dodd-Frank_Wall_Street_Reform_and_Consumer_Protection_Act_5859pdf.ashx. Whether funds with between $25 and $100 million in assets register with the SEC is less straightforward. As Bingham McCutchen explain: "The Act, however, provides that an adviser that (a) is required to be registered in the state in which it maintains its principal office and place of business, (b) if registered, would be subject to examination by such state and (c) has assets under management between $25 million and $100 million, may not register with the SEC, unless it otherwise would be required to register with 15 or more states or is an adviser to an investment company registered under the 1940 Act, or any entity electing to be treated as a business development company under the 1940 Act." *Id.* at 4.

102. U.S. Securities and Exchange Commission, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission 8-9 (2012), *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

amended § 203(b)(3)[103] of the Advisers Act so that private equity funds with more than $150 million in assets "are no longer exempt from. . .SEC registration, recordkeeping, and reporting obligations."[104] Private equity funds with more than $150 million in assets were required to register with the SEC by March 2012.[105] Funds that register with the SEC are required to:

- maintain such records and file such reports with the SEC regarding Private Funds advised by the investment adviser as the SEC deems "necessary or appropriate in the public interest and for the protection of investors";
- provide the Financial Stability Oversight Council (the "Council") with the data necessary to monitor systemic risk issues;
- maintain the following records with respect to the Private Funds they advise:
  - the amount of assets under management and use of leverage (including off-balance sheet leverage);
  - counterparty credit risk exposure;
  - trading and investment positions;
  - valuation policies and practices of the fund;
  - types of assets held;
  - side arrangements or side letters providing favorable terms for certain investors;
  - trading practices; and
  - all other information that the SEC determines, in consultation with the Council, to be "necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk"; and
- be subject to SEC examinations to be determined by the SEC.[106]

This list is a minimum; larger funds will have to disclose even more information. These measures have already required "more than 750 advisers to disclose information about their investors and employees, the assets they manage, as well as any perceived conflicts of interest and activities outside of advising funds."[107]

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103. *See* Bingham McCutchen LLP, *supra* note 101.

104. Appelbaum & Batt, *supra* note 10, at 7.

105. *Id.*

106. Bingham McCutchen LLP, *Dodd-Frank Wall Street Reform and Consumer Protection Act - A Summary*, Practicing Law Inst., at 2-3 (2010); *see also* Appelbaum & Batt, *supra* note 10, at 7 ("Reporting requirements include basic organizational and operational information on each fund managed; the size and ownership of each fund; nature of services; types of clients; employees; advisory and non-advisory activities; and potential conflicts of interest. . . .").

107. *SEC Registration*, Private Equity Growth Capital Council, http://www.pegcc.org/issues/the-dodd-frank-act-summary/private-equity-sec-registration/ (last visited Feb. 28, 2013).

Private equity funds face regulations according to the number of shareholders they have investing in the fund, as well. The JOBS Act, however, relaxes these regulations, raising the shareholder limit for triggering public company status under the Exchange Act to 2,000 investors overall (i.e. accredited and non-accredited), and excluding from that number shareholders who received the securities under an employee compensation plan exempted from registration.[108] This latter provision, in particular, "promises to [substantially] delay the point at which a growing company would be forced to make the periodic disclosures required of public companies."[109]

Because investor suits frequently begin as "event studies"—plaintiffs' lawyers look for large drops in stock price, then match the date of those drops to preceding statements they allege to be fraudulent[110]—increased disclosure provides litigants with more statements (such as those made in 10-Qs) to match to stock movement.[111]

Disclosure also provides more information that can be used to establish scienter. Plaintiffs can indicate scienter in many ways, including from facts demonstrating falsity (the same facts relied on in event studies). Because "falsity and scienter in private securities fraud cases are generally strongly inferred from the same set of facts . . . the two requirements may be combined into a unitary inquiry under the [Private Securities Litigation Reform Act of 1995 ("PSLRA"[112])]."[113] This allows scienter to be inferred, at least in part, from the falsity of statements—especially the required statements made in 10-Ks and 10-Qs. The most direct way to show both falsity and scienter is via contemporaneous reports or data available to the party that contradict those statements.[114] The more statements that

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108. Pritchard, *supra* note 55, at 15-16 (paraphrasing JOBS Act §§ 501-02).

109. *Id.*

110. *See, e.g.*, DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) ("The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud.").

111. *See* John E. Schreiber & Ian C. Eisner, *The Piggyback Strike Suit*, L.A. DAILY JOURNAL, (July 25, 2012), http://www.dailyjournal.com/public/pubmain.cfm?logout=& seloption=&eid=&vid=&CFID=1205149&CFTOKEN=60934684. *See also* Spindler, *supra* note 48, at 363 ("[The] market test is whether a change in stock price occurred at the time that information reached the market that corrected the misstatement or omission. (citation omitted). That is, making out a 10b-5 fraud-on-the-market class action is largely a matter of conducting an event study on stock price movement around the time that the market learned of the fraud.").

112. "The PSLRA was passed to redress certain perceived abuses in securities litigation including 'the abuse of the discovery process to coerce settlement,'" especially by raising the pleading requirements for securities plaintiffs. Seippel v. Sidley, Austin, Brown & Wood LLP, No. 03 Civ. 6942 (SAS), 2005 U.S. Dist. LEXIS 2388, at *7-8 (S.D.N.Y. Feb. 17, 2005) (quoting *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 530-31 (3d Cir. 1999)).

113. *See In re* Daou Sys. Inc., 411 F.3d 1006, 1015 (9th Cir. 2005).

114. Nursing Home Pension Fund, Local 144 v. Oracle Corp., 380 F.3d 1226, 1230 (9th Cir. 2004).

plaintiffs can match to market data (i.e. stock price movement), the easier it is for plaintiffs to meet the threshold showing they need to get to discovery—which more often than not ends in settlement.[115]

With the number of private equity funds and advisers registering already climbing, increased transparency is a fact of life for most funds (the JOBS Act notwithstanding). Disclosure, in turn, exposes private equity funds to public enforcement and the private suits that "piggyback" off of public enforcement—the subject of the next sub-section.

E. *SEC Enforcement Aids 10b-5 Plaintiffs and Hinders Defenses*

Increased attention from the SEC will make it easier for investors to bring 10b-5 suits against private equity funds because investors will have more opportunities to bring suits that "piggyback"[116] off SEC enforcement.[117] The same is true for any criminal referrals the SEC makes to the Department of Justice ("DOJ").[118] Where civil or criminal charges make it successfully through court, investors will likewise bring more effective suits against funds, because defendant funds will be collaterally estopped from denying admissions they already plead to or criminal violations for which they have already been convicted.

SEC enforcement of private equity funds is increasing for several reasons. First, Dodd-Frank requires private equity funds to register with the SEC. Second, there is increased regulatory will to target private equity. For example, as Pete Brush states, the SEC recently "fired a shot across the [private equity] industry's bow," promising more enforcement targeting the camera-shy industry.[119] Lastly, disclosure requirements will im-

115. *See* Choi & Pritchard, *supra* note 62, at 214-15; *see also* Victor D. Quintanilla, *(Mis)judging Intent: The Fundamental Attribution Error in Federal Securities Law*, 7 N.Y.U. J. L. & Bus. 195, 216-17 (2010) ("As an empirical matter, however, denial of summary judgment results not in trial, but settlement whether or not defendants are culpable. Trials are exceedingly infrequent. For example, the Stanford Law School Securities Class Action Clearinghouse reported that approximately 3,052 federal securities class actions were filed between January 1, 1996 and December 21, 2009. During that time only fifteen (15) federal securities class action cases were tried to verdict—one half of one percent of total cases filed.") (internal citations omitted).

116. *See* Schreiber & Eisner, *supra* note 111; Choi & Pritchard, *supra* note 62, at 769.

117. *See, e.g.*, *In re* Qwest Commc'ns Int'l Inc., 450 F.3d 1179, 1192 (10th Cir. 2006) (in which private plaintiffs were able to obtain through discovery documents produced to the SEC that constituted waiver of the attorney-client privilege and work-product doctrine).

118. "The Securities Act and The Exchange Act "explicitly empower[s] the SEC to investigate possible infractions of the securities laws with a view to both civil and criminal enforcement, and to transmit the fruits of its investigations to [the Department of] Justice in the event of potential criminal proceedings. . . . Under the same subsection of the '34 Act the SEC may 'transmit such evidence as may be available concerning such acts or practices * * * to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.' The '33 Act is to similar effect." Sec. & Exch. Comm'n v. Dresser Indus., Inc., 628 F.2d 1368, 1376-77 (D.C. Cir. 1980) (citations omitted).

119. Brush, *supra* note 51 ("'There will be more private equity cases coming from the division of enforcement in coming years than there have been previously,' Kaplan [co-chief of the SEC's asset management unit] said").

prove SEC targeting and will translate into more and more effective enforcement. This is part of a normal phenomenon where "companies and their lawyers spend considerable energy avoiding public status . . . . [Such] regulatory arbitrage . . . in turn induce[s] the SEC to spend like effort in curtailing those attempted evasions of public status."[120] Having now registered with the SEC, funds can expect increasing scrutiny.[121]

Where limited partners are kept in the dark, they may have no way of knowing that a private equity fund general partner has engaged in fraud. A public enforcement action alerts investors not only to the fraud, but also to the high chance of winning (since the SEC naturally tends to prefer to bring strong cases) if they were to bring a claim against the fund. Indeed, even where the SEC abandons an enforcement action, private litigants may nevertheless proceed with their claim.[122]

Plaintiffs base suits on enforcement actions, even when the SEC ultimately abandons them. Even where investors are aware of fraud, and intend to bring a 10b-5 without a parallel SEC action, they can benefit by obtaining the documents provided to the SEC as part of the Commission's investigation. Private suit plaintiffs can subpoena public documents (e.g. Wells Submissions, disclosure made by registered entities, such as 10-Ks and 10-Qs, and discovery documents from trial) for evidence that defendants have previously made available to government agents.[123] And, as Bain Capital recently learned, "[t]here is a well-established common-law presumption of public access to judicial documents."[124] Sometimes the SEC will even make documents available to private litigants without a subpoena.

Just as greater disclosure requirements lead to greater frequency for 10b-5 claims, because the disclosed material makes such claims easier to bring, so too can documents obtained through public investigations and discovery aid subsequent suits filed under 10b-5 claims.

Less common, but incredibly damaging to any defendant, is the threat that a SEC enforcement action can lead to a referral to the DOJ for criminal prosecution (usually a stay is put on the parallel civil case). Criminal prosecutions are not only dangerous in their own right, they may also increase civil liability, as defendants who plead guilty to, or are convicted of,

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120. Pritchard, *supra* note 55, at 6.

121. Laura Kreutzer, *Putting Dodd-Frank to the Test: Is Private Equity Ready?*, Wall St. J: Private Equity Beat (Aug. 28, 2012, 11:20 AM), http://blogs.wsj.com/privateequity/2012/08/28/putting-dodd-frank-to-the-test-is-private-equity-ready/?mod=WSJBlog.

122. *See, e.g.*, Sawant v. Ramsey, No. 307-cv-980, 2010 U.S. Dist. LEXIS 102899 (D. Conn. Sept. 28, 2010).

123. Choi & Pritchard, *supra* note 62, at 768-69. *But see id.* at 214-15 ("Private parties cannot directly free ride on the SEC's investigative efforts—§ 21(g) of the Exchange Act requires SEC permission for any private action to be consolidated with an SEC injunctive action and such permission will rarely be granted.").

124. Dahl v. Bain Capital Partners, Civ.A. 07-12388-EFH, 2012 WL 4045194 (D. Mass. Sept. 14, 2012) (citing Fed. Trade Comm'n v. Standard Fin. Mgmt. Corp., 830 F.2d 404, 408 (1st Cir. 1987)).

a criminal count are "collaterally estopped" from challenging a related civil suit (i.e. a fund or manager cannot disclaim liability in a civil suit when s/he/it has already pleaded guilty to a criminal action involving the same actus reus and mens rea).[125]

The particularly good news for plaintiffs' firms that might seek to take advantage of public enforcement targeting private equity funds is that the SEC plans to focus on insider trading and conflicts of interest.[126] Because Dodd-Frank will "significantly increase the number of private equity firms subject to SEC regulation as 'investment advisers,' private equity firms must [create] written policies and procedures reasonably designed to prevent violation of the federal securities laws."[127] The SEC has promised to use this requirement to examine private equity funds that may engage in insider trading and conflict of interest violations of the securities laws.[128] And while a bevy of enforcement actions targeting private equity funds have yet to materialize, the SEC did send letters in late 2011 "to a number of private equity firms in the U.S. notifying them that they were subject of an informal inquiry into how they value the private companies in which they invest."[129]

With the SEC recently setting its sights on insider trading violations, the most difficult element of a 10b-5 claim to prove just got much easier. The most difficult element in a 10b-5 suit to specifically[130] allege is usually scienter.[131] Plaintiffs will frequently have a statement made by a private equity fund, along with some evidence they claim shows that the statement is false. Indeed, they may even have evidence that the maker of the statement knew the statement to be false. Even with solid evidence as to falsity, however, plaintiffs will find it difficult to allege a motive. Although a

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125. *See, e.g.*, Sec. & Exch. Comm'n v. Gordon, 822 F. Supp. 2d 1144, 1157 (N.D. Okla. 2011) (Defendants criminally convicted for "pump and dump" securities fraud scheme collaterally estopped from challenging civil violations of § 10(b) of the Exchange Act and Rule 10b-5); *see also In re* Bilzerian), 153 F.3d 1278, 1283 (11th Cir. Fla. 1998) (citing Mun. of Anchorage v. Hitachi Cable, 547 F. Supp. 633, 644 (D. Alaska 1982) ("[defendant]'s pleas of guilty to the mail and wire fraud counts estop it from denying that it engaged in a pattern of racketeering activity")).

126. *SEC Enforcement to Focus on Private Equity Insider Trading and Conflicts of Interest*, Private Equity Law (June 28, 2012), http://privateequitylawreview.com/2012/06/28/sec-enforcement-to-focus-on-private-equity-insider-trading-and-conflicts-of-interest/.

127. Id.

128. Id.

129. Levine, *supra* note 11.

130. Because 10b-5 suits are based in fraud, the higher pleading standard of Rule 9 (i.e. "particularity") is required at the pleading stage, rather than Rule 8's lower standard (i.e. "a short and plain statement of the claim"). *See* Fed. R. Civ. P. 8(a) and 9(b).

131. *C.f.* Tellabs, Inc. v. Makor Issues & Rights, Ltd. (*Tellabs I*), 551 U.S. 308, 325 (2007) ("While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal. . . . [A]llegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint.").

motive is not required,[132] courts frequently dismiss cases for failure to state a claim or grant summary judgment in cases lacking one.[133] Insider selling—where senior managers make public statement to inflate the value of their companies stock while selling their own shares—is the easiest way to allege a motive (and win the sympathy of the court)—because there the profit motive is clear.[134] With the SEC increasingly investigating the *types* of violations that 10b-5 suits can most easily "piggyback" off of—indeed, that are likely to yield to private suits the evidence most difficult for them to allege and so survive a motion to dismiss—investors should have an increasingly easy time bringing parallel suits.

And, increased SEC attention is not the only enforcement threat facing the private equity industry. Private equity funds may also be beginning to make an appearance in FCPA actions,[135] and they may find themselves the subject of state prosecutions as well (with New York Attorney General Schneiderman leading the way[136]).

With the above regulatory attention, plaintiffs' firms may find that government agencies have already done much of the work investigating defendant funds for them. Though the SEC, when bringing an enforcement action, is not required to make some of the showings that a 10b-5 claimant must (e.g. the SEC is not bound by geography, as 10b-5 litigants are by *Morrison*,[137] and does not need to show reliance[138]), the SEC does need to establish some of the same factors (e.g. scienter[139]). And the easier (and cheaper, because investigating fraud and preparing a complaint costs money) 10b-5 suits are to bring, the more the suits private equity industry will face.

132. *Id.*

133. *See, e.g.*, In re *Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989) (holding that despite sales of $84 million in shares, the defendants still retained such a large percentage of their holdings—92 percent—that an inference of scienter was functionally negated); *See also* In re *Silicon Graphics*, 183 F.3d 970 (9th Cir. 1999) (no scienter where despite over $13.8 million in stock sales, the defendants still retained over 90 percent of their holdings).

134. *See, e.g.*, *In re* Daou Sys., Inc., 411 F.3d 1006, 1022 (9th Cir. 2005) (quoting Greebel v. FTP Software, Inc., 194 F.3d 185, 197 (1st Cir. 1999) ("Unusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter")); Rubinstein v. Collins, 20 F.3d 160, 169-70 (5th Cir. 1994).

135. *See* Singer, *supra* note 50, at 293.

136. Nicholas Confessore et al., *Financial Firms Face Subpoenas on Tax Strategy*, N.Y. Times, Sept. 2, 2012, at A1, *available at* http://www.nytimes.com/2012/09/02/business/inquiry-on-tax-strategy-adds-to-scrutiny-of-finance-firms.html?pagewanted=all&_r=0.

137. *See* Morrison v. Nat'l Australia Bank Ltd., 130 S. Ct. 2869 (2010).

138. *See* SEC v. True N. Fin. Corp., Civ. 10-3995 DWF/JJK, 2012 WL 5471063 (D. Minn. Nov. 9, 2012).

139. An action brought by the SEC pursuant to §17(a)(1) of the Securities Act (which makes it unlawful to employ any device, scheme or artifice to defraud), for example, requires the SEC to show scienter (though §17(a)(2) and §17(a)(3) do not). Aaron v. Sec. & Exch. Comm'n, 446 U.S. 680, 697 (1980).

F. *Brave New World: An Opportunity for Plaintiffs' Firms*

Private equity, which has long operated in the regulatory shadows,[140] is in need of private market discipline.[141] Plaintiffs' firms, which are facing decreasing returns in traditional areas of litigation,[142] should take advantage of increased regulatory and market vulnerability to act as private attorney generals and impose that private discipline. Because plaintiffs' firms cannot bring 10b-5 suits unless they have an investor-client directly harmed by an alleged fraud, plaintiffs' firms should begin by courting new clients. Private equity limited partners, including the new types of investors in the private equity investment market such as hedge funds and sovereign wealth funds, present a great opportunity to do just that.

Inevitably, whatever steps plaintiffs' firms take against private equity funds on behalf of investors, private equity will try to avoid the increased liability in two ways: by working harder to avoid such suits or by working to prevent them.

Private equity funds avoid investor suits in two principal ways: (1) by staying small[143] (indeed, private equity is designed to avoid regulation by having the fund, which represents a collective of investors, count as a sin-

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140. There is clear evidence that the strategies employed by some private equity funds have perverse market effects. *See, e.g.*, APPELBAUM & BATT, *supra* note 10, at 15-16 (highlighting the bankrupting of Mervyn's, which put 18,000 employees out of work).

141. Private equity funds have not made good targets of 10b-5 class action and derivative suits in the past. *See, e.g.*, Tom Hals, *Delaware Judge Seeks Details of Novel Litigation Finance Deal*, THOMSON REUTERS: SECURITIES LAW (July 26, 2012), http://newsandinsight.thomsonreuters.com/Securities/News/2012/07_-_July/Delaware_judge_seeks_details_of_novel_litigation_finance_deal/.

142. 2011 saw the lowest number of approved settlements (by number and by dollar amount) in more than 10 years. ELLEN M. RYAN & LAURA E. SIMMONS, SECURITIES CLASS ACTION SETTLEMENTS: 2011 REVIEW AND ANALYSIS 1 (2011), *available at* http://www.cornerstone.com/files/News/85d21ef6-25ff-45d0-8147-b6e69dfd7115/Presentation/NewsAttachment/6d6e4c44-93a5-4616-8ba1-0e7e6ce519f8/Cornerstone_Research_Settlements_2011_Analysis.pdf. Cornerstone's mid-year report for 2012 finds: "There were 88 filings in the first six months of 2012, down 6 percent from both the first half and second half of 2011. If current trends hold, there will be 176 filings in 2012 by year-end, less than the 1997 to 2011 average of 193 but in line with the 2009 to 2011 average of 177." CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2012 MID-YEAR ASSESSMENT 1 (2012), *available at* http://www.cornerstone.com/files/News/0ed759b3-91f6-425f-93a4-88a80129adb5/Presentation/NewsAttachment/bd1ee3f5-d23b-44c7-aea8-91afad2ca7ea/Cornerstone_Research_Securities_Class_Action_Filings_2012_MYR.pdf.

143. Pritchard, *supra* note 55, at 9 ("Smaller companies, for which the opportunities for fraud and manipulation are most prevalent, remained largely unregulated"). Note that currently, under the new Dodd-Frank rules, 155 private equity funds are subject to Dodd-Frank's higher disclosures for large funds. Carla Main, *Hedge Fund Secrets, Bank Capital Deadline, Gupta: Compliance*, BLOOMBERG (Oct. 27, 2011), http://www.businessweek.com/news/2011-10-27/hedge-fund-secrets-bank-capital-deadline-gupta-compliance.html. *But see* Kail Jethmalani, *Regulatory Oversight in Private Equity: A One Way Street to Economic Inefficiency*, MICH. J. OF PRIVATE EQUITY & VENTURE CAP. L.: MJPVL BLOG (Oct. 23, 2012, 8:51 AM), http://mjpvl.org/blog/regulatory_oversight_in_private_equity1 (describing how the SEC may be targeting smaller funds, to the exclusion of enforcement against larger funds).

gle shareholder[144]), and, relatedly, (2) by using the JOBS Act to skirt regulation. As Pritchard explains,

> JOBS Act reforms have the potential to create a lower tier of public companies, thus blurring the line between public and private. These changes have been roundly criticized by advocates for investor protection, however, as opening the door wide for fraud and manipulation. Those criticisms carry some weight, given the abuses that repeatedly occur in the penny-stock market.[145]

There are other ways to blur the line between public and private, for example by: selling two classes of security[146]—especially if at least one of those classes are sold abroad;[147] or "using swaps to hedge currency or interest rate risk" in order to fall within certain de minimis exemptions.[148]

Private equity's world is changing. The literature on private equity can no longer ignore the impact of securities laws,[149] and suits may, will, and should proliferate. For private equity funds, these developments should serve as a wake up alarm. And so preventing suits—or at least having them dismissed pre-discovery—is the subject of the next section.

III. (Over)zealous Gatekeeping: Can Private Equity Take Advantage of Judicial Barriers to Investor Suits?

The number of pre-discovery motions to dismiss in securities arbitration has increased dramatically over the last few years. From 1996 to 2001, motions filed by respondents in arbitration proceedings quadrupled. This increase was not justified by a "corresponding increase in arbitration claims." In 2006, only 18% of arbitration claims were decided after a hearing on the merits . . . As motion practices have increased, awards to individuals have decreased. The percentage of cases where customer claimants were awarded damages has decreased every year since 2001. Whereas, the majority of customer dispute claims use to end in the customer's favor, customers were only awarded damages in 42% of the cases closed in 2006.[150]

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144. Thompson & Langevoort, *supra* note 19, at 25-26 ("Since its inception, Rule 12g5-1 has said that securities held of record by a corporation, partnership, trust or other organization shall be counted as one record owner. Indeed many institutional investors are collectives of individual economic investors—e.g., mutual funds, private equity and venture capital funds, many of which invest in pre-IPO companies—and there has been little question that their ownership interest is that of a single shareholder.").

145. Pritchard, *supra* note 55, at 4.

146. Stanton & Lau, *supra* note 93.

147. Lyle Roberts, Made in America, 10b-5 Daily (Aug. 17, 2012, 11:13 PM), http://www.the10b-5daily.com/archives/001191.html.

148. Noam Noked, *Changes to CFTC Regulations Affecting Private Funds*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Sept. 21, 2012, 9:00 AM), http://blogs.law.harvard.edu/corpgov/2012/10/11/changes-to-cftc-regulations-affecting-private-funds/.

149. Spindler, *supra* note 1, at 312 ("the private-equity literature has paid . . . little attention to the securities laws.").

150. Bridget B. Zoltowski, *Restoring Investor Confidence: Providing Uniformity in Securities Arbitration by Offering Guidelines for Arbitrators in Deciding Motions to Dismiss Before A Hearing on the Merits*, 58 Syracuse L. Rev. 375, 386 (2008) (footnotes omitted).

Since 1995, using the PSLRA as cover, some courts, at various levels, have raised the pleading requirements when bringing a 10b-5 action.[151] That trend has accelerated in the last few years under the Roberts Court. Like suits filed against publicly traded companies, private equity funds will likely take advantage of these judicially imposed barriers in order to prevent investor suits from moving forward in litigation.

This section discusses the PSLRA of 1995, examines how federal judges have used the PSLRA as cover to make it increasingly difficult for investors to move beyond the pleadings stage in 10b-5 suits, and reviews recent Supreme Court jurisprudence affecting plaintiff investor suits. Given this context, and the argument that private equity funds face increased 10b-5 liability from private investors, private equity firms will likely employ two methods to rebut increasing liability suits. First, private equity firms will employ the same procedural precedents used by public companies to convince judges to dismiss cases brought by plaintiff investors, and, second, firms will increase lobbying efforts (as discussed in Part IV).

A. *The PSLRA*

The Private Securities Litigation Reform Act of 1995 ("PSLRA") was passed by Congress "to curb perceived abuses of the § 10(b) private action—'nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers.'"[152] As a check against such abusive litigation by private parties, the PSLRA imposes "[e]xacting legal requirements" that require "plaintiffs to state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, i.e., the defendant's intention 'to deceive, manipulate, or defraud.'"[153] Though designed to curb abuses, some federal judges have used the PSLRA as a cover to dismiss even meritorious claims.

151. Quintanilla, *supra* note 115, at 208 ("Congress also elevated the motion to dismiss stage to a crucial adjudication point in private federal securities litigation. Section 21D(b)(3)(A) of the PSLRA states that, 'the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.' Congress contemplated that federal courts would use the strong inference standard as a means to filter out unmeritorious federal securities lawsuits. The locus of decision-making shifted to federal judges. Judges now serve as gatekeepers who screen out complaints, thereby minimizing the strike value of unfounded allegations and preserving the court's time and limited resources. Several empirical studies suggest that the PSLRA's heightened pleading standards have increased the dismissal of unmeritorious suits.") (footnotes omitted).

152. Tellabs, Inc. v. Makor Issues & Rights, Ltd. (*Tellabs I*), 551 U.S. 308, 320 (2007) (citing Merril Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006) (quoting H. R. Conf. Rep. No. 104-369, p.31 (1995))); Seippel v. Sidley, Austin, Brown & Wood LLP, No. 03 Civ. 6942 (SAS), 2005 U.S. Dist. LEXIS 2388, at *7-8 (S.D.N.Y. Feb. 17, 2005).

153. *Tellabs I*, 551 U.S. at 308 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976)).

B. *Overzealous Gatekeeping: Federal Court Barriers*

The increased dismissal of merited claims results in under-enforcement of the securities laws, which undermines the integrity of American markets.[154]

Some federal courts have interpreted the PSLRA's heightened pleading standard in ways that create "access barriers to remedies for securities fraud victims at the pleading, class-certification, and summary-judgment stages."[155] As a result of these heightened standards, significantly fewer securities class actions and derivative suits survive until discovery (let alone trial—though most securities suits end in settlement if not dismissed).[156] This section briefly outlines how judges impose heightened pleading standards for scienter at the motion to dismiss stage, for reliance and loss causation at the class certification stage, and for expert witnesses based on faulty notions of credibility at the motion for summary judgment stage.

Judges have made it more difficult for plaintiff investors to survive motions to dismiss by requiring a higher scienter than required under legislation or Supreme Court precedent.[157] The PSLRA requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[158] The required state of mind is "intent to deceive, manipulate, or defraud."[159] The plaintiff "alleging fraud under § 10(b) must plead facts rendering an inference of scienter at least as likely as any plausible opposing inference" (emphasis in original).[160] Because the standard is "at least as likely" circumstantial evidence should be admitted and sufficient for a plaintiff to survive a motion to dismiss.[161] Judges are also supposed to accept all factual statements as true, consider the complaint in its entirety, and take into account plausible opposing inferences.[162]

Courts have nevertheless insisted on a higher standard of scienter from plaintiffs: "Even though the federal courts have . . . reiterated that mere

154. Michael J. Kaufman & John M. Wunderlich, *The Judicial Access Barriers to Remedies for Securities Fraud*, 75 LAW & CONTEMP. PROBS. 55, 90 (2012).

155. *See id.* at 70 ("[B]y rewriting rules of procedure rather than deferring to traditional rulemaking bodies like Congress and the Advisory Committee on Civil Rules of the Judicial Conference, the judiciary has usurped the rulemaking function of the legislature. By rewriting Rule 23 and Rule 56, the judiciary has shown a disregard for the congressional rulemaking process and bucked the historical trend away from unilateral judicial decision-making toward a process that includes multiple gatekeepers.") (footnote omitted).

156. Jim Oliphant, *Unhappy Investors Increasingly Rejected in Efforts to Sue Public Companies*, MIAMI DAILY BUS. REV., Aug. 3, 1999, at A1.

157. *See* Kaufman & Wunderlich, *supra* note 154, at 55-59 (giving a much fuller treatment of the issue).

158. 15 U.S.C.A. § 78u-4 (2009).

159. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

160. Tellabs, Inc. v. Makor Issues & Rights, Ltd. (*Tellabs I*), 551 U.S. 308, 311 (2007).

161. *See* Kaufman & Wunderlich, *supra* note 154 at 55-59.

162. *Tellabs I,* 551 U.S. at 309.

recklessness is enough to satisfy the pleading standard," some courts "have found that the inference of scienter is less likely than virtually any other non-culpable mental state" (e.g. negligence or belief that undisclosed information was not material)."[163]

Judges have also made it harder to obtain class certification:[164] "The courts have rewritten Federal Rule 23 to require plaintiffs to prove to a judge the merits of the elements of reliance and loss causation by a preponderance of the evidence to obtain class certification, a burden at least equal to their burden of proof at trial."[165] Loss causation, is a particularly problematic element to demonstrate at the class certification stage, because: (1) "it denies plaintiffs the presumption of reliance in fraud-on-the-market cases," as required by the Supreme Court in *Basic*;[166] (2) "loss causation . . . is a question common to all class members; there can be no individual issues of loss causation;" and (3) "plaintiffs need not prevail on the merits to receive class treatment."[167]

Finally, some judges have erected barriers to 10b-5 suits by substituting their own conceptions of what is plausible under the aegis of "credibility"[168]—in other words, judges "exclude expert testimony that, on the basis of their personal scientific expertise, they deem unreliable."[169] Summary judgment is thus converted into "a factual determination of not just the reliability, but also the credibility of the plaintiffs' expert on issues of damages and loss causation."[170] And, because summary judgment is decided pre-trial it is a judge who makes this factual determination, not a jury.

Two 10b-5 cases decided by Judge Easterbrook provide excellent examples of how a judge can prevent a claim from getting to discovery and jury trial by employing his personal understanding of economic incentives. In *Barker v. Henderson, Franklin, Starnes & Holt*, purchasers of bonds and notes sued a law firm and an accounting firm for violations of the Securities Exchange Act of 1934. Judge Easterbrook upheld the district court's grant of summary judgment on the grounds that "[Defendants] billed so little . . . that it is inconceivable that they joined a venture to feather their nests by defrauding investors.[171] In *DiLeo v. Ernst & Young* Judge Easterbrook employed similar reasoning: "An accountant's greatest asset is its reputation for honesty . . . Fees for two years' audits could not approach

163. Kaufman & Wunderlich, *supra* note 154, at 55-59.

164. *See id.* at 59-67.

165. *Id.* at 59.

166. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) ("[T]he reliance of individual plaintiffs on the integrity of the market price may be presumed.").

167. Kaufman & Wunderlich, *supra* note 154, at 64-65.

168. *See id.* at 67-70.

169. Paul D. Carrington, *Politics and Civil Procedure Rulemaking: Reflections on Experience*, 60 DUKE L.J. 597, 662-63 (2010).

170. *See* Kaufman & Wunderlich, *supra* note 154, at 67.

171. Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 497 (7th Cir. 1986).

the losses [the auditor] would suffer from a perception that it would muffle a client's fraud" so "[i]t would have been irrational for any of them to have joined [the fraud]."[172] In both cases, Judge Easterbrook ignored the evidence presented, as well as obviously plausible explanations (e.g. the firms assisted in the fraud at hand in order to retain business in the future). Judge Easterbrook also makes unsupported claims (e.g. how does he know that "[f]ees for two years' audits could not approach the losses [the auditor] would suffer from a perception that it would muffle a client's fraud"?). Judge Easterbrook does not consider and dismiss alternate explanations; he finds them *inconceivable*![173]

C. *Increased Securities Attention from the Roberts Court*

While federal judges at the district and appellate level have stretched the Supreme Court's holdings in *Tellabs* and other cases, the Supreme Court has, since then, devoted more attention to securities cases. Mid-2010 to mid-2012, have been particularly active years for the court, generating "more United States Supreme Court [securities laws] precedent than the previous eighteen [years]."[174] That precedent includes three key cases that make 10b-5 suits more difficult to bring:

- *Morrison*: Held that § 10(b) of the Exchange Act does not apply extraterritorially, limiting the ability of 10b-5 plaintiffs to bring suits against a range of securities offerors, including private equity funds.[175] Because even American private equity funds so frequently operate internationally (45% of investments are made outside of North America[176]), and are able to use the corporate form to segregate which business entity can be responsible for what statement (see *Janus* below), private equity funds can avoid 10b-5 liability by operating internationally.
- *Janus Capital*: Held that the 'maker' of a statement is "the person or entity with ultimate authority over the statement," limiting the ability of 10b-5 plaintiffs to bring suits not only against lawyers, accountants, and other professionals who help prepare fraudulent statements, but also against the parents or subsidiaries of a corporation which do not sign

172. DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990).

173. Judge Easterbrook may be "a leading proponent of law and economics analysis" but previous law and economics thinking on his part has left him in a position to dismiss other theories based on personal beliefs he has already made as to what is plausible and what is "inconceivable." Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 Nw. U. L. Rev. 133, 136 (2000).

174. Paul A. Ferrillo, *The Supreme Court's Recent Focus on 10b-5 Cases,* Harv. L. Sch. F. on Corp. Governance and Fin. Reg. (Sept. 21, 2012, 8:42 AM), http://blogs.law.harvard.edu/corpgov/2012/09/21/the-supreme-courts-recent-focus-on-10b-5-cases/.

175. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2883 (2010).

176. Private Equity Growth Capital Council, Geographic Dispersion of Private Equity Investment in 2011, at 2 (2012), *available at* http://www.pegcc.org/wordpress/wp-content/uploads/2011-Geographic-Dispersion-of-PE-Investment.pdf.

statements or have "ultimate authority" for their dissemination.[177] This holding allows parents and/or subsidiaries of a company to hide behind the corporate form—a key benefit for private equity firms, who invest in and control lots of companies, but keep them legally separate from the private equity fund that operates them.

- *Dukes*: Held that class certification requires not the lower bar of raising common questions, but the higher standard that the class-wide proceeding have "the capacity . . . to generate common answers apt to drive the resolution of the litigation."[178] In addition, *Dukes* (in dicta) raised the bar for class certification expert witnesses by implying[179] that they need be subjected to Daubert scrutiny (requiring "scientific community" peer review for expert testimony to be credible[180]).[181]

While not all Roberts Court jurisprudence in the securities arena has served to make 10b-5 claims more difficult to bring,[182] the increased attention means that funds operate in an environment in flux, increasing the risk of liability. What this means for private equity is that while there may be more suits, plaintiffs face difficulty in getting them to discovery, and settlement.

IV. Private Equity Comes of Age: Regulatory Avoidance to Regulatory Capture

In the wake of the financial crisis and widespread support for financial reform, the [private equity] industry attempted to avoid new regulation through voluntary self-regulation and extensive lobbying of Congress.[183]

As the regulatory and economic environment in which private equity operates changes, private equity seems to be substituting political engagement for regulatory avoidance (its previous approach) as its dominant business strategy. This shift is important because political engagement spells efforts by private equity to avoid 10b-5 suits and the public enforcement off which they frequently piggyback.

This section gives a brief background on George Stigler's theory that, when an industry reaches a certain level of maturity, it converts from

177. Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011).

178. Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541, 2551 (2011) (citing Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U.L.Rev. 97, 132 (2009)).

179. The Supreme Court has granted certiorari to resolve this issue. *See* Comcast Corp. v. Behrend, 133 S. Ct. 24 (2012).

180. Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579, 584-85 (1993).

181. *Wal-Mart*, 131 S. Ct. at 253-54.

182. *See, e.g.*, Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1321 (2011) (holding that for a misstatement to be material the impact need not be statistically significant); Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2186 (2011) (holding that plaintiffs do not need to plead loss causation to certify class).

183. Appelbaum & Batt, *supra* note 10, at 7.

avoiding regulation to demanding it. The section concludes by examining the JOBS Act (as applied to private equity) as an example of such a shift in strategy, and one that threatens the role that private investor suits can play in regulating the private equity industry.

A. *The Demand for Regulation and Desupervision*

Regulation may be actively sought by an industry, or it may be thrust upon it.[184]

A half century ago, George Stigler argued that, as firms and industries grow in influence, "regulation is acquired by the industry and designed and operated primarily for its benefit."[185] Firms do not only demand affirmative regulations (e.g. direct subsidies, barriers to entry by rivals, regulations affecting substitutes and complements, or price-fixing regulations[186])—they also lobby for "desupervision," (regulatory "rules remain in place, but are not enforced")[187] and exemption. As discussed above, exemption from regulation frequently allows funds to avoid private investor suits as well.

B. *Evidence for the shift—Lobbying & the JOBS Act*

We [private equity] don't want to be thrown out with the Wall Street bathwater.[188]

Private equity, created as a novel solution to the public corporation agency problem and designed to avoid the securities laws by flying "below the regulatory radar,"[189] no longer constitutes a niche industry.[190] Private equity funds "have grown substantially in size as well as political and financial significance in the last decade."[191] The private equity firm

184. George J. Stigler, *The Theory of Economic Regulation*, *in* The Citizen and the State: Essays on Regulation 114, 114 (1975).

185. *Id.*

186. *Id.* at 116-19.

187. William K. Black, *The Best Way to Rob a Bank is still to Own One,* New Econ. Persp. (Oct. 8, 2012), http://neweconomicperspectives.org/2012/10/the-best-way-to-rob-a-bank-is-still-to-own-one-a-postscript.html.

188. Levine, *supra* note 11 (quoting Stewart Kohl, co-CEO of Cleveland-based Riverside Co.).

189. Spindler, *supra* note 1, at 311, 312, 322-23.

190. Singer, *supra* note 50, at 275-76 ("Private equity is a valuable source of financing for small and mid-sized companies, many of which have risk profiles that make it difficult to raise capital through conventional channels. Private equity was popularized as a gap-filling vehicle, a source of capital for those companies large enough to seek external finance but not yet mature enough to obtain it from major lenders or public equity investors. Somewhere along the way, the private equity model matured from a chic cottage industry to a $100 billion-plus investment sector.") (footnotes omitted).

191. Diamond, *supra* note 14, at 3.

Kohlberg Kravis Roberts ("KKR"), for example, with 560,000 employees, is now the second largest employer in the United States.[192]

Commensurate with their growth in size and influence, private equity funds have already moved to a strategy of engagement more in line with the heftier profile—and the JOBS Act (both the lobbying for and subsequent use of) is the first clear example of the industry stepping out of the shadows to design their own regulatory environment. This is a development that threatens the role that 10b-5 investor suits play in regulating the industry.

This section describes how the private equity industry lobbied for the JOBS Act, analyses two features of the JOBS Act—the ability to advertise and qualify as emerging growth companies—that private equity funds can take advantage of, and explains why those features threaten investors' ability to bring 10b-5 suits.

The private equity industry lobbied for the JOBS Act: "[P]rivate equity firms . . . wanted the legislation and they got it."[193] The private equity industry had already created its own led industry lobbying group, The Private Equity Growth Capital Council, in 2007 as a complement to less coordinated lobbying efforts,[194] by the time the financial crisis struck.[195] When private equity funds got swept up in new Dodd-Frank regulations the industry responded with "extensive lobbying of Congress."[196] This lobbying (accompanied by a public relations campaign) only increased after Mitt Romney's presidential campaign focused a negative light on the industry, "based in part on fears that all this anger could result in costly new legislative or regulatory controls."[197]

The private equity industry (among others), for all its lobbying, got two key things in the JOBS Act: (1) elimination of the ban on public solicitation (advertising) of private offerings; and (2) the ability to qualify as emerging growth companies and engage in "reverse mergers." Investors—and investor suits—are potentially threatened by both.

First, Congress added § 201(b) of the JOBS Act, which states that: "[o]ffers and sales exempt under [the new implementing rules] shall not be deemed public offerings under the Federal securities laws as a result of

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192. *Id.*

193. Pam Martens, *The JOBS Act Should Be Re-Named the Jumpstart Investor Fraud Act*, Wall St. On Parade (Dec. 10, 2012), http://wallstreetonparade.com/2012/12/the-jobs-act-should-be-re-named-the-jumpstart-investor-fraud-act/.

194. Levine, *supra* note 11 ("But the lobby group isn't alone. Across the industry, private equity firms have begun to speak up, viewing Wall Street as something of a cautionary tale.").

195. Private Equity Growth Capital Council, *About the Private Equity Growth Council*, http://www.pegcc.org/about/ (last visited January 15, 2013); *see also* Levine, *supra* note 11.

196. Appelbaum & Batt, *supra* note 10, at 7.

197. Levine, *supra* note 11.

general advertising or general solicitation."[198] Private equity firms can now "take out full-page ads in newspapers, purchase radio spots or even buy commercial time on television."[199] Regulation D ("Reg D") of the Securities Act had formerly forced issuers to register with the SEC if they engaged in public solicitation; now the SEC will be unable to "make sure that the [funds are] following the law and operating above board."[200] As a result, private equity funds "have more control over when and how they can take their small portfolio companies public," and "can now lure investors who the government may label as "accredited," but who really have little financial education. Before it was hard to attract the elderly widow or the busy doctor, but advertising changes all that."[201]

Second, the JOBS Act creates new loopholes for funds able to label themselves as "emerging growth companies." Section 101(a)(19) amends the Securities Act to define an emerging growth company as "an issuer that had total annual gross revenues of less than $1,000,000,000."[202] Private equity funds (among others) have in turn discovered that they can create "[s]pecial-purpose acquisition companies" and "blank check" companies—"basically empty shells with almost no employees"—that will fall under the $1 billion maximum and can be used as a "backdoor route" to U.S. stock listings or in mergers (frequently referred to as a "reverse merger").[203] These include offshore shell companies incorporated in opaque jurisdictions such as the British Virgin Islands.[204]
By qualifying as emerging growth companies funds (or their shells) they avoid various "financial-reporting and corporate-governance requirements."[205] Qualifying funds, for example, "don't have to comply with the Sarbanes-Oxley Act's requirements that auditors review their internal controls. It also allows them to make fewer financial disclosures, use a new, confidential SEC review process for IPOs and lets their bankers communicate more freely with potential investors. The confidential reviews are designed to let companies sort out any differences with the SEC behind closed doors."[206] SEC staff have already identified private equity

198. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(b), 126 Stat. 306 (2012).

199. Cyrus Sanati, *Get a piece of my hedge fund!*, CNNMoney: Term Sheet, (April 4, 2012, 10:22 AM), http://finance.fortune.cnn.com/2012/04/04/hedge-fund-advertising/.

200. Id.

201. Id.

202. Jumpstart Our Business Startups Act, § 101(a).

203. Emily Chasan, *Meet the JOBS Act's Jobs-Free Companies,* Wall St. J. (June 4, 2012, 7:22 PM), http://online.wsj.com/article/SB10001424052702303506404577443980893828956.html.

204. *Id.*

205. *Id.*

206. *Id.*

funds as businesses that might qualify as emerging growth companies under such a scheme.[207]

Together lifting the ban on advertising and making it relatively easy to qualify through a shell as an emerging growth company, make it more difficult for investors to bring suit in a 10b-5 (or § 11 or § 12 Securities Act claims, which are beyond the scope of this note) and defend their property against fraud. By avoiding SEC registration when advertising publically, private equity funds can now target a much broader range of investors without submitting to the SEC the important disclosure documents that contain statements that a plaintiff might use to claim there was a misrepresentation or omission (i.e. even if the advertisement itself was fraudulent the plaintiff will not have a disclosed statement to compare the advertisement to for inconsistency). Similarly, if funds can avoid making financial disclosures, including to their auditors, that narrows the scope of information that investors can use to plead fraud. In addition, by encouraging the SEC to "sort out" issues—including fraud—behind closed doors, investors are denied another source of information that could be useful in protecting their investment, and suing if their is fraud.

The result of the JOBS Act is that, while "[p]rivate equity doesn't have to be so private anymore,"[208] the industry may still be able to avoid disclosure and private suits.

V. Private Equity Discipline: Protecting the Private Suit's Role in Assuring Market Integrity

Even if "[p]rivate equity doesn't have to be so private anymore" there is still a danger that private investor suits—which operate most effectively when firms act publically—will not be available to reign in the worst abuses of the industry. Judicially created barriers and JOBS Act loopholes threaten to prevent meritorious private suits, and future lobbying may threaten private suits even more. 10b-5 actions, though not historically an important means of checking abuses in the private equity industry, have the capacity to do so. Policymakers should protect the ability of investors to bring private suits against private equity funds.

This section argues that 10b-5 suits have greater flexibility than SEC enforcement actions, and therefore are better suited to evolve with, and check, an industry. Moreover, the private equity industry is currently prone to fraud and other abuses. Therefore, this section also proposes that Congress and the SEC safeguard the role that private investors, using 10b-5 actions as a tool, can play by repealing sections of the JOBS Act, issuing instructions to the federal bench, and preventing future lobbying from threatening this unique tool.

207. *Id.* (SEC staff have already said that "business-development companies—essentially publicly traded private-equity firms that invest in start-ups and small businesses—could qualify for 'emerging growth company' status.").

208. Sanati, *supra* note 199.

A. *10b-5 suits are better suited to evolve with a transforming industry than SEC enforcement*

Private suits are the best bet to evolve with and respond to changes in the private equity—despite the fact that 10b-5 causes of action (an SEC rule, after all) are available to the SEC just as they are to private investors. Indeed, the SEC needs to prove fewer elements of an action, and is not limited by some of the caselaw (e.g. *Morrison*'s geographical limits) by which private suits are limited.

Private investor suits are superior tools for several reasons. First the SEC is prone to regulatory capture (i.e. the "revolving door" concern), and to political defunding (a serious concern given private equity's new lobbying strategy as described in Part V).[209] Private investor suits are removed from these capture concerns. Second, SEC employees have no profit motive, unlike plaintiff investors, and are resource constrained, so they may under enforce the securities laws.[210] Third, the SEC is frequently complacent (the commission, for example, faced a congressional probe for its failure to detect Bernie Madoff's Ponzi scheme, which was "not an isolated example").[211] Fourth, state enforcement—which otherwise might be better tailored to local conditions or less susceptible to capture—is largely preempted by the National Securities Market Improvement Act of 1996, which means that 10b-5 suits are the only alternative to federal enforcement available.[212] Lastly, self-regulation of the financial industry (for which the Financial Industry Regulatory Authority (FINRA) is primarily responsible) has largely been a failure, leaving 10b-5 plaintiff suits the preferred mechanism to guard industry accountability.[213]

In addition, private equity funds may prefer "the less draconian Rule 10b-5"[214] to public enforcement, because: (1) more causes of action are open to the SEC (e.g. § 17 actions), (2) stiffer penalties are available to SEC (e.g. trading suspensions, cease and desist orders (which can be more devastating because of their immediate effect), and criminal referrals to the DOJ);[215] (3) judicial oversight of SEC enforcement is weaker;[216] (4) investors, who are often repeat players, are less likely to bring frivolous suits (though the opposite is true for plaintiffs' firms); and (5) because

209. *C.f.* Stacy Kaper, *SEC Budget Battle Leaves Enforcement in Jeopardy*, NAT. J. DAILY, Sept. 16, 2011, at 1 ("The question of how to make the Securities and Exchange Commission work better drew very different answers from Republicans and Democrats on Thursday, leaving the agency's might in doubt and proving that consensus is still lacking on how to regulate financial markets").

210. CHOI & PRITCHARD, *supra* note 62, at 744-45.

211. *Id.* at 745.

212. *Id.* at 743.

213. Not only did self-regulation fail to prevent—or even predict—the global financial of 2007-08, but SEC can be overly reliant on self-reporting of violations. *Id.* at 748.

214. *See* Pritchard, *supra* note 55, at 33.

215. CHOI & PRITCHARD, *supra* note 62, at 760, 770.

216. *See id.* at 770-71.

10b-5 actions typically end in settlement, which are more private for funds.[217] Summarily, 10b-5 offers a resolution that is typically cheaper and does not require disclosure to the SEC (i.e. a settlement can be kept more private).[218] 10b-5 suits, therefore, are not only attractive options for both investors and private equity funds; these suits are also one of just a few options, if not the only option, for disciplining the private equity market.

B. *Private equity is prone to fraud and abuse*

Some would argue that private equity does not need to be disciplined—by investors or anyone.[219] Experience would beg to differ. Without reliving the recrimination dredged up by the attacks on Mitt Romney and Bain Capital, there are a number of concerns with the industry that are real and require attention, including "financialization"[220] and bid-rigging.

Financialization—or financial engineering[221]—is a charge frequently levied at the private equity industry. Financialization refers to the strategy of buying a company, taking it private, taking out new debt on behalf of the company to pay investors, and then selling the company, whether the company has been improved or not. Though the case that private equity is dominated by this strategy is likely overdone,[222] the practice occurs. A recent example comes from Bain's purchase and anticipated sale of Bright Horizons Family Solutions. Bain bought Bright Horizons for $1.3 billion in 2008, but spent only $640 million—the rest came from debt "that accrued onto the Bright Horizons balance sheet."[223] At that time Bright Horizons had a market capitalization of about $1.26 billion.[224] Bain then

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217. *See id.* at 214-15.

218. Item 401(f)(5) of Regulation S-K, for example, requires a "person [that] was found by a court of competent jurisdiction in a civil action or by the Commission to have violated any Federal or State securities law . . . ." to disclose in periodic disclosures to the SEC (i.e. 10-Ks and 10-Qs) the fact of that violation. 17 C.F.R. § 229.401. *See also* Sec. & Exch. Comm'n v. Fehn, 97 F.3d 1276, 1290 n.12 (9th Cir. 1996).

219. Spindler, *supra* note 48, at 359-60 ("the Economist (2006) branded 10b-5 suits "economic lunacy"—and an ever-growing academic literature has questioned the merits of the fraud-on-the-market rule with a number of significant theoretical objections").

220. Diamond, *supra* note 14 at 171.

221. *See* Kolivakis, *supra* note 76.

222. *C.f.* APPELBAUM & BATT, *supra* note 10, at 35 ("As exemplified in the case of HCA, the PE owners have already repaid themselves and profited from their investment while placing huge debt obligations on the HCA hospitals; but there has been no study of the impact of these actions on patient care or services.").

223. Dan Primack, *Bain will benefit from Bright Horizons IPO*, CNN MONEY (Jan. 14, 2013, 1:47 PM), http://finance.fortune.cnn.com/2013/01/14/bain-bright-horizons/ ?utm_source =feedburner&utm_medium=feed&utm_campaign=Feed%3A+ fortunefinance+%28Fortune +Finance%3A+Hedge+Funds%2C+Markets%2C+Mergers+%26+Acquisitions%2C+Private+Equity%2C+Venture+Capital%2C+Wall+ Street%2C+Washington%29.

224. *Id.*

"loaded the company up" with $922 million in debt, while paying itself $18 million in fees (should the firm "list" as publically traded).[225] Bain plans to exit the investment in early 2013 by taking Bright Horizons public again.[226]

Loading a company with debt is not the only way that a private equity fund takes advantage of its takeover targets. In 2004 a consortium of funds took-over Mervyn's department stores. The consortium then transferred Mervyn's real estate assets to a company they controlled, "used Mervyn's real estate as collateral to borrow $800 million," and "then leased the real estate back to Mervyn's stores at high rents in order to service the debt and to extract value over time."[227] Mervyn's went bankrupt, but profits realized to the fund "through the real estate deals far exceeded losses on the retail side."[228]

The private equity industry makes its living participating in buyouts and public offerings, where the potential for collusion is stark. In 2007 and 2008, for example, a number of companies sued Blackstone, Carlyle, KKR, Apollo Global Management, and Bain Capital, along with JPMorgan and Goldman Sachs, claiming that they all "conspired to rig bids and suppress prices for leveraged buyouts, depriving shareholders of billions of dollars."[229] Blackstone Group President Tony James allegedly told KKR co-founder George Roberts, "Together we can be unstoppable but in opposition we can cost each other a lot of money."[230]

C. *Safeguarding 10b-5's role*

Protecting investors' access to 10b-5 relief is difficult. Federal judges are appointed for life and have salary protection, and countering lobbying efforts is no mean feat. But there are a number of straightforward and practical reforms available. This note briefly highlights three suggestions.

First, the sections of the JOBS Act permitting advertising and allowing shell companies to qualify as emerging growth companies discussed in this note should be repealed. Preventing public solicitation will help ensure that private equity funds continue to raise funds from sophisticated investors who can properly assess risk. Preventing funds from taking advantage of the emerging growth companies loophole will require them to make the disclosures that investors rely on to protect their investments. Second, the IPO process should be reformed. Professor Pritchard's scheme to abolish IPOs (and replace them with two-tiered public-private system utilizing sta-

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225. *Id.*

226. *Id.*

227. Appelbaum & Batt, *supra* note 10, at 15-16.

228. *Id.* at 16.

229. Don Jeffrey et al., *Bain Joins Goldman to Urge Dismissal of Bid-Rigging Suit*, Bloomberg (Dec. 18, 2012, 5:00 PM), http://www.bloomberg.com/news/2012-12-18/bain-joins-goldman-to-urge-dismissal-of-bid-rigging-suit.html.

230. *Id.*

tus-based, rather than transaction-based,[231] liability), though beyond the scope of the note, is an excellent place to start (and would retain 10b-5 liability as the crucial check on issuers of securities).[232] Third, and more generally, public equity funds and the limited partners who invest in them should understand that settlements with investors are preferable to SEC enforcement or political backlash.

Conclusion

The private equity industry is in flux, and could still go in a number of directions—consolidation and demanding regulation or fragmentation and avoiding securities laws—possibly some combination of both (and possibly with hedge funds and sovereign wealth funds soon to follow). Investors, and plaintiffs' firms, are numerous and equipped to evolve with, and check (as "private attorney generals") the industry. Private equity funds need to recognize what increased liability will mean, and parties both public and private need to safeguard the important role that private investor suits have to play in regulating the industry; policy makers, focused perhaps too much on other private equity issues (e.g. whether to tax carried interest differently), need to recognize the important role that private investors can play in checking and even reforming the industry.

231. *See* Stephen J. Choi, *Company Registration: Toward A Status-Based Antifraud Regime*, 64 U. Chi. L. Rev. 567, 572 (1997).

232. *See* Pritchard, *supra* note 55, at 36; *see also* Langevoort & Thompson, *supra* note 44, at 383 ("Our proposal would have a permanent separation of the two classes of issuers, public and reporting, with firms crossing from one category to another based on a fairly simple metric of market capitalization. We suspect that the differences between what is required of merely reporting companies would be significantly (and justifiably) less than what is required of public companies.").