From Basic to Halliburton

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Judges made the securities class action mess, but who can clean it up?

BY M. TODD HENDERSON AND ADAM C. PRITCHARD

Securities fraud class actions are big business for lawyers. Since 1996, nearly 4,000 suits have been filed, with the majority resulting in companies paying substantial settlements. The top 10 settlements alone totaled about $35 billion; plaintiffs’ lawyers took home billions in fees. Companies paid their own lawyers similar sums for defending them. If spending these gigantic sums on lawyers deterred corporate fraud (that is, if they helped sort cases of actual fraud from mere business reverses), then that might be money well spent. But if lawyers are paid billions without reducing the probability or magnitude of corporate fraud, then from a social welfare perspective these payments to lawyers are a deadweight loss.

When thinking about the efficiency of the private litigation system, the relevant comparison is not to an enforcement vacuum, but rather to government enforcement of antifraud prohibitions. The Securities and Exchange Commission and the Department of Justice are authorized to bring suits to enforce the securities laws in general and antifraud rules specifically. Absent a system of private suits, presumably the government would pick up some of the slack. The choice between public and private is not obvious. Private litigation could be more effective and efficient than government enforcement against corporate fraud because of the financial incentives private lawyers may have to ferret out fraud and bring complex cases. If the rules of the game are not finely tuned, however, these large financial incentives can result in litigation having nuisance value unrelated to the merits of any fraud claim. Unfortunately, the securities class action system in use today gives scant confidence that private litigation is striking the right balance in encouraging socially desirable suits while discouraging nuisance claims.

In a representative democracy, you might think that the people’s representatives in Congress would make the choice between public and private enforcement of antifraud principles. But the current system of private suits as the primary mechanism for policing corporate fraud comes not from Congress but from the courts. Judges, egged on by the SEC, created the securities class action industrial complex on their own. There is nothing in the statute—in this case, §10(b) of the Securities Exchange Act of 1934—that authorizes a private cause of action for securities fraud. Instead, the courts invented it out of whole cloth, ignoring private causes of action explicitly created by Congress in other parts of the statute. Over the ensuing decades, the Supreme Court has at various times expanded and contracted the private cause of action, based on virtually no empirical data on how securities class actions work in the real world. In general, however, the §10(b) private right of action has grown from what William Rehnquist called a “legislative acorn” into a “judicial oak.”

Securities class actions really took off after Basic v. Levinson, a 1988 Supreme Court case that held plaintiffs need not show individual reliance on alleged corporate misrepresentations, but instead could rely on the market price having incorporated those misstatements: the “fraud-on-the-market” (FOTM) presumption. This meant that certifying a class action became much easier for plaintiff lawyers, while defendants would face enormous costs from litigating and settling the suits. The incentives to bring cases for nuisance value alone were enormous. After Basic there was a huge spike in securities litigation, but almost never did those suits get to the question of whether corporate fraud had actually occurred. Stock prices dropped (by reason of fraud or otherwise), suits were brought, and settlement monies were paid. Former shareholders got pennies from current shareholders, and lawyers (and their experts) took home the real money.

Congress responded to that flood of cases by tweaking the rules of securities class action a bit in 1995, and the Supreme Court has tried to trim the oak it created in a series of controversial decisions. Neither Congress nor the Court was willing to cut down the tree...
and start anew, in part because the Court never squarely faced the issue of whether to overrule Basic—at least, until recently.

A case in the last Supreme Court term—known in legal circles as Halliburton II—presented the question of whether Basic should be overruled, thus presenting the Court an opportunity to rethink securities fraud class actions altogether. Instead of pursuing fundamental reform, the Court tinkered around the periphery, adding a new battle of the experts to these cases. The Court’s Halliburton II decision arguably makes a bad situation worse. At the very least, it will make these suits more expensive for shareholders, without any obvious benefit in terms of deterring corporate fraud. In other words, the Court’s decision will yield more costs with no benefits, or what one might call a lose-lose.

In this essay, we briefly present the core economic and legal issues presented in the most recent battle over the FOTM presumption. We show how the Court missed an opportunity to reduce wasteful litigation and redirect legal resources toward deterring actual corporate fraud. We also argue that despite the Court’s inviting Congress to address the problems of securities fraud class actions, Congress is unlikely to accept that invitation. We also outline what fundamental reform would look like if Washington could be spurred to action. In our view, meaningful reform of securities fraud class actions needs to begin with reining in the grossly inflated measure of damages used in such cases. The SEC, however, stands in the way of reforming the damages measure in securities fraud class actions. As a result, corporations may resort to self-help to eliminate securities class actions altogether.

INSTITUTIONAL BACKGROUND: SECONDARY MARKET SECURITIES FRAUD CLASS ACTIONS

Congress did not create a general private cause of action for fraud when it enacted the Securities Exchange Act in 1934, instead opting to create narrow causes of action for specific types of conduct, like market manipulation. Congress did, however, authorize the SEC to adopt antifraud rules that the agency could then enforce. The SEC exercised that rulemaking authority in 1940 when it adopted Rule 10b-5. The rule, like § 10(b) (the statutory provision that authorizes the rule), says nothing about a private cause of action. The courts, however, have not been deterred by that void and have implied a sweeping cause of action under Rule 10b-5.

Courts being courts, they have relied heavily on the familiar requirements of common law deceit (the typical cause of action for fraud) in fleshing out the details of that Rule 10b-5 cause of
action. At common law, plaintiffs were required to claim that they had relied on the allegedly fraudulent misstatement and that it induced them to make the purchase. So for a fraud claim involving a company’s common stock, an investor-plaintiff would have to show that he read the misstatements that allegedly distorted the price of a company’s stock before he purchased (or sold) the stock. The problem, however, is that for companies whose shares are publicly traded, many (perhaps most) of the investors buying and selling the company’s shares will not have read the misstatement or even been aware of it, so they will not be able to claim reliance in the traditional sense. Thus, the reliance requirement posed a substantial obstacle to bringing a case under Rule 10b-5. If all plaintiffs were required to allege that they had read and relied on the misstatement in making their decision to purchase, a class could not be certified because it would have too many factual questions that were not common to the class (a prerequisite to class certification). And individual investors would rarely have sufficient losses to justify the expense of bringing suit on their own.

To overcome this obstacle, the Supreme Court effectively gutted the reliance requirement for most claims of secondary market fraud with its decision in Basic. The Basic Court, with Justice Harry Blackmun writing for the majority, adopted the so-called “fraud on the market” presumption of reliance. The FOTM presumption allows plaintiffs to skip the step of alleging personal reliance on the misstatement, instead allowing them to allege that the market relied on the misrepresentation in valuing the security and that, in turn, the plaintiffs relied on the market price that was distorted by the deception. The economic premise underlying the FOTM presumption is the efficient capital market hypothesis, which holds that markets rapidly incorporate information—true or false—into the market price of a security. Thus, the price paid by the plaintiffs would have been inflated by the fraud, establishing a causal connection between the fraud, the purchase, and the loss. For Blackmun, the economic analysis was painfully obvious: “Who would knowingly roll the dice in a crooked crap game?”

Justice Byron White, dissenting in Basic, worried the economics were more complicated: “[T]he Court, I fear, embarks on a course that it does not genuinely understand, giving rise to consequences it cannot foresee.” Presciently, White noted that adopting the appropriate measure of damages was critical to the implementation of the Court’s new FOTM regime. White also noted that Blackmun and the Court majority had ducked that issue.

Without any guidance from the Supreme Court on the question of damages, lower courts assumed that the traditional out-of-pocket measure of damages, typically applied in face-to-face cases of fraud, also applied in FOTM cases. The out-of-pocket measure gives shareholder-plaintiffs the difference between the price they paid and the securities’ “true” value at that time. Combining that measure with the FOTM presumption exponentially expanded the potential damages exposure for companies whose stock traded on the New York Stock Exchange (NYSE) or Nasdaq. Every investor who purchased while a misrepresentation was affecting the company’s stock price—and did not sell it before the truth was revealed—has a cause of action under Rule 10b-5 against the company and its officers. Importantly, however, the company will be the primary target in these suits, despite the fact that the corporation will rarely have sold securities during the time of the alleged fraud. Because the company did not benefit from fraud, it has no institutional incentive to spend real resources in executing the fraud—and thus no reason to encourage the investor reliance that the FOTM presumption seeks to promote.

Worse still, the out-of-pocket measure of damages relied on by the lower courts provides no offset for the windfall gain on the other side of the trade. For every shareholder who bought at a fraudulently inflated price, another shareholder sold: the buyer’s individual loss is offset by the seller’s gain. But the investors lucky enough to have been selling during the period of the fraud do not have to give their profits back. Consequently, the out-of-pocket measure exaggerates the social harm caused by FOTM because it fails to account for the fact that losses and gains will be a wash for shareholders in the aggregate, although some individual shareholders on the losing side will suffer substantial losses in particular cases. The net social losses are nearly zero in almost all of these cases. But given the trading volume in secondary markets, the potential recoverable damages in securities class actions can be a substantial percentage of the corporation’s total capitalization, easily reaching hundreds of millions of dollars and sometimes billions of dollars. Despite this incoherence, the out-of-pocket measure persists, and as a result class actions are a big stick to wield against fraud, real or imagined. Companies confronting FOTM lawsuits, if they cannot get the case dismissed at an early stage, have little choice but to settle. Going to trial to seek exonerating means risking a potentially bankrupting judgment.

THE DELUGE AND THE RESPONSE

The FOTM presumption of reliance was adopted by the Supreme Court to facilitate securities fraud class actions. Measured by this criterion, Basic was a tremendous success. The number of securities fraud class actions increased dramatically after Basic validated the FOTM presumption.

Although the FOTM presumption ensured that private plaintiffs would have incentives to sue, the out-of-pocket measure of damages meant that the incentives to sue were excessive. The FOTM presumption generated too many suits because the defendants’ incentive to settle these cases has little to do with the merits: even a small prospect of losing at trial puts a big thumb on the scale toward settlement, even if the company has done nothing wrong. The math is simple: a 1 percent chance of losing a $2 billion judgment makes it economically rational to cut a check for $20 million, even ignoring the massive costs of mounting a defense. Even supremely confident defendants will settle meritless cases. Such settlements are wasteful: investors do not benefit when companies pay settlements that have little to do with the
merits of the case because the settlements generate no deterrence. Securities class actions are a costly form of insurance against fraud and business reverses, and investors are the ones who ultimately foot the bill. Only the lawyers are enriched.

Even in cases of actual fraud, the FOTM regime is far from optimal. To see this, consider that any lies are told not by “the company”—an artificial legal construct—but by executives who speak on its behalf. These individuals may benefit from the lies along with any shareholders who sell their shares after the lies but before the fraud is revealed. But these people would not pay damages to compensate those who buy shares after the lies and hold the shares. The company pays the losing investors, which effectively means current shareholders pay, even though they do not profit from the lies. This transfer of wealth from innocent current shareholders to former shareholders (with a big chunk going to lawyers) serves no obvious retributive purpose. And with wrongdoing managers typically not paying any portion of the damages, the case for deterrence is weak as well.

The incentives unleashed by Basic spawned a flood of securities fraud suits, often targeting start-up firms with high volatility, regardless of connection to actual fraud. When the stock prices of those firms fell, plaintiffs’ lawyers filed suits and then combed disclosures for potential misstatements. Settlements followed quickly, however, obviating any need to find fraud. The consequence was a tax on risk, raising the cost of capital for start-up firms.

In response, Republicans made securities class action reform a centerpiece of their Contract with America in 1994. When the Republicans took control of Congress that year, they passed the Private Securities Litigation Reform Act of 1995 (PSLRA), with substantial Democratic support necessary to override President Bill Clinton’s veto. Supporters summarized the target of their reforms: “the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer’s stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action.”

The PSLRA made a number of reforms intended to reduce the extortionate threat of securities class actions. For example, it raised the standards for pleading fraud, delayed discovery until after a hearing on a motion to dismiss, and changed the selection of lead counsel from a race to the courthouse to a presumption in favor of the attorney chosen by the shareholder plaintiff with the largest economic stake in the outcome. Congress, however, did not address the underlying drivers of these suits: the FOTM presumption and the perverse measure of damages. The House of Representatives considered eliminating the FOTM presumption, but the SEC opposed the provision and it was abandoned in favor of a codification of FOTM that would have set forth more clearly when the presumption would apply. By the time the bill came out of conference, this codification of the FOTM presumption also had been abandoned. The result was a stalemate on the FOTM presumption.

Meanwhile, the Supreme Court heard several big cases with Basic’s FOTM presumption lurking in the background. Its restrictive decisions suggest that the Court viewed the system as fundamentally broken. In Central Bank of Denver v. First Interstate Bank of Denver (1994), the Court held that there was no aiding and abetting liability for private securities fraud suits. The Court extended this ruling to cover alleged schemes to defraud in Stoneridge Investment Partners v. Scientific Atlanta (2008), and in Janus Capital Group v. First Derivative Traders (2011), which limits liability to the legal entity that actually makes a misstatement. In another series of cases, the Court narrowly interpreted the concept of causation. In Dura Pharmaceuticals v. Broudo (2005), the Court held that it was not enough for plaintiffs to show they bought shares at prices inflated by lies; they also had to show that the revelation of the lies caused the stock price to drop. Finally, in Tellabs v. Makor Issues & Rights (2007), the Court interpreted the PSLRA’s pleading standard to require that plaintiffs show—in their complaint—that the inference of a fraudulent intent was as strong as any innocent explanation. These cases, which repeatedly erected barriers to plaintiffs bringing securities class actions, make sense only against the backdrop of a highly dysfunctional system for deterring corporate fraud.

Although one could reasonably view this series of cases as the Supreme Court trying to tame the beast it unleashed upon the corporate world, in more recent cases the Court balked at killing the beast all together. In Erica P. John Fund v. Halliburton (2011), commonly called Halliburton I, the Court refused to extend the Dura rule to the class certification stage; it held that plaintiffs do not have to show loss causation at the class certification stage to invoke the FOTM presumption. Similarly, in Amgen v. Connecticut Retirement Plans and Trust Funds (2013), the Court held that plaintiffs are not required to prove alleged misstatements were material (that is, something a reasonable investor would care about when making an investment decision) at the class action certification stage. Instead, the plaintiff would only be required to prove materiality at trial. The Court refused to fashion special rules for certifying securities class actions, notwithstanding its apparently skeptical view of the merits of many of those claims. Or perhaps the Court saw the PSLRA as reducing the incidence of frivolous suits to an acceptable level. (See “Securities Litigation after Amgen,” Spring 2014.)

Against this background, it was somewhat surprising that in Amgen four justices—Antonin Scalia, Clarence Thomas, Anthony Kennedy, and Samuel Alito—each separately urged the Court to reconsider Basic altogether. The Court took up this invitation when its remand in Halliburton I came back to the Court for consideration in Halliburton II.

HALLIBURTON II

The defendants in Halliburton II argued that Basic should be overruled and that plaintiffs should have to show they relied on alleged misstatements. Such a decision would have made securities fraud class actions effectively impossible, likely rendering private enforce-
ment under § 10(b) a dead letter. (Corporate fraud would not have been left entirely unchecked because there would still be the threats of government enforcement, state law claims, and a variety of other potential federal law claims for private plaintiffs to pursue.)

Halliburton’s argument for overruling Basic was premised on empirical research raising doubts about the efficient capital market hypothesis, which was the basis of Basic’s conclusion that plaintiffs can rely on the market to quickly incorporate all information (true or false) into stock prices. Chief Justice John Roberts expressed the concern at oral argument in Halliburton II when he noted that the justices were not well positioned to digest the financial economics: “How am I supposed to review the economic literature and decide which [side in this case] is correct...?” Roberts is certainly correct that issues of financial economics are beyond the ken of most judges. Unfortunately, the Basic FOTM presumption, which the Court preserved in Halliburton II, requires trial judges to make similarly fraught economic decisions in determining market efficiency.

We filed an amicus brief in which we argued that instead of scrapping Basic’s FOTM presumption altogether, the Court should require plaintiffs to show “price impact” in order to certify a class. Price impact means the alleged misrepresentations caused the stock price to rise or stay steady when it otherwise would have fallen. Our proposal would have reformed FOTM class actions, putting them on a more solid economic footing. This argument went to the second question presented in Halliburton II: “Whether, in a case where the plaintiff invokes a presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the misrepresentations did not distort the market price of its stock.” Crucially, our proposal hinged on plaintiffs bearing the burden of proof at the class certification stage to show price impact, eliminating largely irrelevant debates about the efficiency of markets. Requiring plaintiffs (or, rather, the plaintiffs’ lawyers) to show price impact would discourage them from bringing weak cases for their settlement value.

We argued that disputes over market efficiency were dragging district courts into costly and uncertain territory. Worse, the market efficiency requirement biases suits toward firms trading in obviously efficient markets (like the NYSE) instead of arguably less efficient ones (like the over-the-counter “pink sheets”). This is perverse because the probability of fraud is much lower for publicly traded firms on the large exchanges relative to more thinly traded over-the-counter stocks. Companies whose securities trade in “inefficient” markets—e.g., smaller companies and debt issuers—are essentially immune to securities class actions, even though those issuers are more likely to commit fraud because they generally lack the elaborate internal controls and Big Four auditors employed by the largest companies.

The Court in Halliburton II rejected our argument, preserving the requirement that plaintiffs show market efficiency to invoke the FOTM presumption. It did, however, allow defendants to prove there was no price impact from the alleged misrepresentation. This makes little sense. The Halliburton II decision does nothing to discourage plaintiffs’ lawyers from going after the deepest pockets or targeting firms that trade in more efficient markets. But the decision does add a new battle of the experts that will further increase the already enormous cost of litigating these cases.

Under Halliburton II, defendants will call on economists to testify that the alleged misstatements did not affect the market price; plaintiffs will respond with their own economists who will testify that it did. Markets vary in the speed with which they incorporate information. Moreover, the significance of the information matters, so it can be a challenging task to establish whether a statement affected the market price. That challenge can be particularly daunting if a company releases multiple pieces of information at the same time. With the burden of proof on defendants, many trial judges—faced with conflicting economic evidence that they are scarcely equipped to evaluate—will opt to certify a class. Consequently, the watered-down role for price impact evidence adopted by the Court in Halliburton II is likely to have minimal real-world effect on the mix of cases pursued by plaintiffs. Despite the limited prospects for success and the added litigation expense, it will be the rare defense lawyer that does not take advantage of the opportunity afforded by the Halliburton II decision; after all, they bill by the hour. Insurers will raise premiums paid by companies for directors’ and officers’ insurance to compensate. Recall that those premiums are ultimately born by shareholders.

Why did the Court make a legal move that was such a clear policy mistake? The Court fell back on stare decisis—it was reluctant to overturn (or even reform) a decades-old precedent that had become such a central feature of modern securities fraud litigation. The Court’s rationale for its timid approach was that more robust reform would require it to choose sides in a dispute about financial economics for which it was poorly equipped to evaluate. In reality, by choosing to retain the FOTM presumption, it did choose a side. The side it chose pushes in the direction of excessive amounts of litigation, targeting the wrong actors and yielding dubious deterrence of fraud.

The Court made it clear that it expects Congress to make any substantive reform to securities class actions, despite the fact that the Court created the current securities class action regime out of whole cloth. (Of course, the Court could have overruled Basic and given Congress the same invitation to create an explicit private right of action in the statute. That is effectively what happened in the wake of Central Bank of Denver—Congress responded by adding a public right of action for aiding and abetting in § 20(e) of the Securities Exchange Act.) But Congress is unlikely to take the Court up on that invitation, as we explain below.

WHO CAN FIX THIS MESS?

With its decision in Halliburton II, the Supreme Court has made it painfully clear that it lacks the appetite for fundamental reform
in securities class actions. Although judicial modesty may be a virtue, it is an odd response when the Court made the mess in the first place. Moreover, the Court’s deference to Congress seems misplaced when the politicians have also shown no appetite for reform. The Court’s commitment to stare decisis also likely carries little weight with the shareholders who (involuntarily) foot the bill for the Court’s experiment in fraud deterrence policy. Indeed, the Court’s continued tinkering around the edges of securities class actions has made a bad situation worse, as witnessed in Halliburton II.

The fact of the matter is that the Court simply lacks the requisite institutional expertise for reform, even if it had the appetite. The members of the Court are all former government officials, academics, and appellate advocates. They are all highly talented lawyers but, simply put, they are not equipped to confront the institutional interests because the agency favors broad interpretations of its governing statutes. The SEC’s commitment to the plaintiffs’ bar goes beyond that interest, however, as it sides with the plaintiffs’ bar even on issues that relate purely to the terms of the implied Rule 10b-5 cause of action, like the price impact issue in Halliburton II. This commitment can only be ascribed to ideology, as the agency staff views its investor protection role broadly and sees plaintiffs’ lawyers as allies in that fight. The SEC has the authority to make the necessary changes to Rule 10b-5, but given the agency’s track record as a securities class action booster, it is unrealistic to expect reform to come from that quarter.

Perhaps shareholders could take matters into their own hands. They have the right incentives for evaluating reforms because they are forced to internalize both the benefits and costs of securities class actions. They benefit from securities class actions if those suits generate deterrence. Deterrence promotes accurate share prices and thereby reduces the cost of participation in the securities markets. Those benefits flow to corporations as well because they translate into a lower cost of capital. Shareholders (at least some of them) are also the beneficiaries of the compensation paid out in securities class actions, modest though it may be. On the other side of the equation, shareholders (all of them this time) ultimately bear the costs of securities fraud class actions, which include the payment of attorneys’ fees on both sides of the litigation, the cost of experts, and the distraction costs to executives arising from defending lawsuits. Directors and officers’ insurance will cover some of those costs, but the premiums to secure that insurance are ultimately paid by the shareholders. Less tangible, but perhaps more substantial, are costs firms incur to avoid being sued: yet more money spent on lawyers’ fees for flyspecking disclosure documents, higher auditors’ fees, new projects that are rejected because of the risk of suit, and less forthcoming disclosure. Those costs are not covered by insurance. How does the balance tip between the benefits of deterrence and its costs? Perhaps shareholders should be allowed to weigh for themselves.

One possibility would be to allow the shareholders to change the damages measure in Rule 10b-5 securities fraud class actions involving the company, its officers, and directors, to focus on deterrence rather than compensation. Specifically, shareholders could adopt an unjust enrichment model by making a partial waiver of the FOTM presumption of reliance in the corporation’s articles of incorporation. The waiver would stipulate to a disgorgement measure of damages, requiring violators to give up the benefits of the fraud, if the FOTM presumption were invoked in a securities class action. This partial waiver would not limit shareholder-plaintiffs who could plead actual reliance on a misstatement; they could still seek the standard out-of-pocket measure of damages in those cases. Thus, in a FOTM suit, the company itself would only be liable when

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highly technical field of securities law. It has been almost 30 years since the last justice with substantial experience as a corporate lawyer—Lewis F. Powell Jr.—retired from the Court. The Court has made it clear that it prefers to leave the field to Congress. That deference may come, in part, from the realization that the justices are not up to the task of reforming securities class actions.

Is it realistic to expect reform to come from Congress? Not anytime soon. As noted above, Congress punted on the question of the FOTM presumption when it adopted the PSLRA in 1995. Why? Political reality: two powerful constituencies were diametrically opposed. For the plaintiffs’ bar, the FOTM presumption was the foundation of their (lucrative) livelihood; repealing it would be an existential threat. On the other side of the battle was corporate America, particularly the high tech sector, warning that lawsuits were chilling growth and destroying jobs. Neither side had the political clout to declare outright victory. Congress tightened the screws on securities class actions, but never seriously threatened to end FOTM suits. With big donors on both sides, the FOTM presumption was simply too politically hot to handle.

Perhaps the SEC, an independent agency, could rise above the political fray? Its opposition to reform during the legislative process leading up to the PSLRA is hardly promising, and the SEC’s subsequent positions are no more encouraging. The SEC consistently sides with the plaintiffs’ bar in its amicus role. The SEC’s support for the plaintiffs’ bar in part reflects its own
making an offering or repurchasing shares. It would only be liable for out-of-pocket compensation to plaintiffs who actually relied on the misstatement to their detriment. Executives who violated Rule 10b-5 would be liable to repay their compensation tied to the stock price (bonuses, stock, and options) during the time that price was fraudulently manipulated; here the FOTM presumption could be invoked.

Obviously the damages paid under a disgorgement measure are unlikely to afford full compensation, but settlements currently only compensate for a trivial percentage of investor losses. More fundamentally, compensation is not the answer to securities fraud in the secondary market; diversification protects investors more completely (and cheaply) than lawsuits ever could. The goal of securities fraud class actions should be that of unjust enrichment: deterrence. The purpose of the FOTM version of the Rule 10b-5 cause of action should be to deprive wrongdoers of the benefits they obtained by violating Rule 10b-5.

Can shareholders amend corporate charters to fix this badly broken system? The staff of the SEC takes the position that such waivers are illegal. Section 29 of the Exchange Act voids “[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder.” Read broadly, § 29 would bar any provision affecting a right created by the Exchange Act. And written broadly, an anti-reliance provision could arguably waive compliance with § 10(b) (although SEC and criminal enforcement would still be available). The Supreme Court has not addressed waiver of reliance clauses; it has only interpreted § 29 in connection with mandatory arbitration clauses. After initially concluding that arbitration provisions conflicted with the anti-waiver provisions in the securities law, the Court reversed course, concluding that forum selection clauses and arbitration provisions were enforceable because they did not affect any “substantive obligation” imposed by the Exchange Act.

The SEC, however, takes the position that the FOTM presumption is a substantive obligation of the Exchange Act, despite the fact that it was created by the Supreme Court, not Congress. Moreover, the Supreme Court has described the FOTM presumption as “a substantive doctrine of federal securities-fraud law” in Amgen and Haliburton II, although the Court has not explained why. So a waiver of the FOTM presumption may be a non-starter under current law.

Another response to the problem of securities fraud class actions would be for shareholders to amend the corporate charter to require such disputes to be settled in arbitration, without the ability to consolidate individual cases into a class action. A consistent series of decisions from the Supreme Court interpreting the Federal Arbitration Act strongly supports the enforceability of such a provision. The SEC’s staff disagrees of course, taking the position that arbitration clauses violate § 29, notwithstanding the contrary Supreme Court precedent.

Assuming the resistance of the SEC could be overcome, would investors favor such clauses? An arbitration clause is something of a nuclear option, eliminating both the deterrent value of securities class actions and the waste they engender. Investors presumably all favor deterrence, but their interests may diverge on the availability of compensation, which might be hard to come by under a regime requiring arbitration. The relatively low rate of participation by retail shareholders in securities class action settlements suggests that they do not value compensation all that highly. Shareholders who are “holders,” trading infrequently, are likely to favor an arbitration regime because they are typically on the paying end of litigation and settlement in class actions. Investors who index, whether individual or institutional, are likely to see things the same way as holders. Indexers have protected themselves against the firm-specific risk of fraud through diversification; they are unlikely to favor paying large premiums to lawyers for additional insurance that they do not need. The votes of institutional investors who actively pick stocks are harder to handicap. On the one hand, they are more likely to have been trading during a fraud period, so they are more likely to be members of an FOTM class. On the other hand, the proposed regime would still allow such investors to pursue arbitration, which might be feasible if they made a large (losing) bet on a stock.

Of course, we will get prompt feedback if investors make the wrong call in voting to adopt an arbitration clause. If eliminating FOTM class actions undermines deterrence, we would expect to see a stock price drop for a firm that requires arbitration of securities disputes. That will be powerful evidence for opponents of arbitration. If, on the other hand, the stock price response is positive, shareholders of other firms are likely to follow the pioneering firm’s lead in requiring arbitration. We should at least encourage shareholders to experiment so that we can get an answer to the question of whether shareholders—those who the current system is supposed to benefit—value it as much as the lawyers and SEC do.

CONCLUSION
The Supreme Court has struggled for 25 years with the wrong turn it took in Basic. The FOTM regime established in Basic shifts money from one shareholder pocket to another at enormous expense. In Haliburton II, the Court extinguished any hope that it would fix its prior error. The Court’s institutional commitment to stare decisis—perhaps coupled with an awareness of its own limitations—kept it from making any meaningful change. Congress and the SEC have both had the opportunity to fix the problem created by Basic, but neither of those institutions has risen to the occasion.

Shareholders bear the costs of the FOTM regime, and shareholders have the power to end those costs by adopting arbitration provisions. That “nuclear option” comes at a cost, however, as it eliminates entirely the deterrent value of securities class actions. Will shareholders clean up the mess that the Supreme Court has created with securities class actions by requiring arbitration of securities fraud claims? Stay tuned.