WHY CIVIL LIABILITY FOR DISCLOSURE VIOLATIONS WHEN ISSUERS DO NOT TRADE?

MERRITT B. FOX*

Should nontrading issuers that make misstatements face civil liability? Fairness does not require compensation for the resulting trading losses. Compensation will reduce the disutility in society arising from trading risks generated by such misstatements, but the gain is very modest relative to the cost.

The alternative rationale for civil liability, deterrence, depends on finding insufficient the ordinary social mechanisms to attain public regulation compliance: governmentally imposed administrative and criminal sanctions. The usual "private attorney general" argument that civil suits are a helpful supplement to the efforts of otherwise overstretched public enforcement officials is open to challenge. Full enforcement of a rule is not necessarily optimal and a limited budget allocation may represent a political decision concerning the enforcement level that is. The Paper considers a number of answers to this challenge. It also considers other arguments for civil liability: that private litigation is in fact the natural primary enforcement mechanism for disclosure rule violations, with public enforcement being the supplement, that civil liability constitutes an efficient outsourcing to private agents of work the government wants accomplished, and that civil liability promotes useful legal innovation. On balance, the deterrence rationale for civil liability is found to be substantial, but would be more persuasive if the U.S. system were properly reformed.

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* Michael E. Patterson Professor of Law, Columbia Law School; BA 1968, JD 1976, PhD (Economics) 1980, Yale University. The author wishes to thank Jill Fisch and Jeff Nielsen for their helpful comments on an earlier draft of this Paper and Rachel Epstein for her valuable research assistance.

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INTRODUCTION

Civil damages liability for securities law periodic disclosure violations has come under attack, particularly fraud-on-the-market class-action lawsuits for investor losses incurred in connection with trading in the secondary market when the issuer has not sold shares. The main line of attack has been the weakness of the compensatory rationale for such suits.[1] Without a compensatory justification, the attackers suggest, the availability of this cause of action is hard to defend given the very substantial use of social resources involved in the

1. *See, e.g.*, ANJAN V. THAKOR ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION 5 (2005) [hereinafter THAKOR, ECONOMIC REALITY], *available at* http://www.instituteforlegalreform.com/index.php?option=com_ilr_docs&issue_code=SLI&doc_type=STU&itemid=29 (critiquing fraud-on-the-market class-action lawsuits because of the weakness of the compensation rationale); ANJAN V. THAKOR, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 14 (2005) [hereinafter THAKOR, UNINTENDED CONSEQUENCES], *available at* http://www.instituteforlegalreform.com/index.php?option=com_ilr_docs&issue_code=SLI&doc_type=STU&itemid=29 (same); INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 5, 72, 81–82, 109–10 (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (pointing out reforms which effectively would significantly reduce such actions, and arguing that these reforms should be undertaken because the cost of such suits hurts the competitiveness of U.S. capital markets and that the compensatory justification for them is small); *see also* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1556–66, 1585–86 (2006) (critiquing such actions because of the inadequacy of the compensation rationale); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646–47 (1996) (same); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 625–26, 632 (1992) (same).

litigation that it generates. The critics are right concerning the weakness of the compensatory justification for civil liability. They ignore, however, a second potential justification: deterrence.[2]

This Paper considers the deterrence justification for civil liability. The basic question is whether civil liability should provide at least part of the system of incentives for compliance with securities-law periodic disclosure rules, or whether reliance solely on governmentally imposed administrative and criminal sanctions would be better. In most areas of public regulation, enforcement is solely governmental. There are exceptions, however, where government enforcement is supplemented by civil liability. Antitrust, consumer law, environmental law, and governmental procurement fraud prevention are prominent examples in the United States. From a social-policy perspective, is it desirable to include securities disclosure regulation among these exceptions?[3] The analysis here should usefully inform both the ongoing debate concerning securities class-action-lawsuit reform in the United States and discussions abroad concerning increasing the use of civil liability in other countries.[4]

2. There are exceptions. Professor Rose considers the advantages and disadvantages of relying, at least in part, on civil litigation to deter issuer misstatements in furtherance of a proposal that the Securities and Exchange Commission (SEC) supervise such suits. Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1306–07 (2008). Professor Arlen considers issuer liability primarily as a device to deter issuers from failing to report disclosure violations by their agents to governmental officials, and wishes authorities to be able to immunize cooperating issuers from such liability. Jennifer Arlen, Public Versus Private Enforcement of Securities Fraud 2–5 (unpublished manuscript, on file with author). This Paper avoids the issue of whether the SEC can reliably play the screening roles contemplated by Professors Rose and Arlen. It instead starts with the assumption that if a country chooses to have civil liability, the system will operate independently of public enforcement, and asks whether, at least under this assumption, having civil liability is in fact worthwhile.

3. There is no explicit private right of action provided in the Securities Exchange Act of 1934 ("Exchange Act") for violations of section 10(b), under which the Securities and Exchange Commission Rule ("Rule") 10b-5 was promulgated. Fraud-on-the-market lawsuits rely on the earlier established theory that violations of Rule 10b-5 give rise to an implied right of action. *See Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12–13 (1971). The discussion here addresses the policy question of whether it is desirable to have civil liability to help enforce public regulation in the form of mandatory disclosure. It is not concerned with the much debated issue of whether it is proper for the courts to imply such a right of action, which involves, in addition to this policy question, the issue of the respective roles of the Congress, the courts and, in this case, administrative agencies as well. These two issues—of public policy and of allocation of governmental authority—tend to be conflated in debates in the United States concerning fraud-on-the-market lawsuits.

4. There is a growing literature, applicable across countries, that private damages lawsuits play a helpful role in enforcing securities disclosure laws. Bernard S.

Parts I and II motivate the inquiry. Part I explores the compensatory justification for civil liability and concludes that it is weak, as the critics of civil liability claim. The same conclusion is reached with respect to the associated investor-protection rationale for governmentally sponsored periodic disclosure rules. Part II argues that there are, however, important corporate-governance and liquidity-enhancement reasons for having these rules. The social purposes served by such a regulatory regime having thus been identified, the remainder of the Paper addresses the desirability of having civil damages liability provide at least part of the incentives for compliance with such rules.

Parts III and IV critically review various justifications for having civil liability. Part III considers the "private attorney general" idea that civil liability is needed to supplement inadequate public-enforcement budgets. Part IV turns this idea around and explores the enforcement implications of the argument that mandatory disclosure is simply a corrective for disclosure-level shortfalls in what would otherwise be privately negotiated and enforced contractual arrangements concerning disclosure between shareholders and management. Under this view, private litigation can be justified as the natural primary enforcement mechanism, with public enforcement being the supplement. Part V explores the idea that civil liability constitutes an efficient outsourcing to private agents of work the government wants accomplished. Part VI considers the idea that civil liability is needed to promote socially useful legal innovation.

This Paper concludes that there are substantial reasons for using some kind of civil-liability scheme as at least part of the enforcement mechanism for mandatory disclosure regulations.

Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 796 (2001); Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 1–2 (2006) (conducting an empirical study finding a relationship between the availability of private enforcement of securities laws and capital-market development); Katharina Pistor et al., *Law & Finance in Transition Economies*, 8 ECON. OF TRANSITION 325, 326–28 (2000); Arlen, *supra* note 2, at 1–2; Erik Berglöf & Stijn Claessens, *Enforcement and Corporate Governance*, (World Bank Pol'y Research, Working Paper No. 3409, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625286. Actions by Canada and some countries in Europe suggest at least some movement toward making securities actions based on issuer disclosure violations more effectively available. *See* INT'L FIN. L. REV., GUIDE TO THE WORLD'S LEADING CAPITAL MARKETS LAWYERS 28–30 (5th ed. 2006), *available at* http://www.goodmans.ca/pdfs/Article%20%20Canada%20Introduces%20Securities%20Disclosure%20Liability.pdf; Stefano M. Grace, *Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the* Acquis Communautaire, 15 J. TRANSNAT'L. L. & POL. 281, 290–97 (2006); Peter Geier, *A Wary Europe Moves a Step Closer to Class Actions*, LAW.COM, Dec. 5, 2006, http://www.law.com/jsp/article.jsp?id=1165244464820#.

I. THE WEAKNESS OF THE COMPENSATORY JUSTIFICATION

Suppose an issuer not offering securities violates applicable periodic disclosure rules by making a material misstatement that inflates its share price. Consider the persons who purchase the issuer's shares in secondary trading during the period between the time of the violation and the time at which the market realizes the truth. These investors pay more than they otherwise would have but for the violation. The argument that there is a social gain in providing compensation for these losses, however, is weak.

A. Fairness Arguments

One argument for providing compensation is fairness. Disclosure violations, however, work no systematic unfairness among outside investors as traders. Traders in the secondary market are no better off on an expected basis transacting in the shares of an issuer that complies with periodic disclosure regulations than in the shares of a noncomplying one. If a falsely positive disclosure violation increases an issuer's share price by $5, every buyer pays $5 more per share than if there had been no violation. But every seller receives $5 more per share. For every share traded, the buyer's loss because of the violation is exactly counterbalanced by the seller's gain. More generally, the overall effect of a disclosure violation on investors trading in the secondary market is a zero-sum game: the winners' winnings just equal the losers' losses. Each winner and loser is in her position purely by reason of chance. The expected impact on an investor from trading in shares of an issuer that, from time to time makes price-inflating misstatements, is therefore zero.[5]

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5. This statement needs refinement in the case of the buy-and-hold investor. Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 232 (2007). Professor Evans posits for purposes of illustration the extreme case of the buy-and-hold investor who holds her shares for the life of the company and never sells. This investor faces the downside risk of buying at a misstatement-inflated price at the time of purchase, but not the upside risk of selling at a misstatement-inflated price. *Id.* Evans's observation reflects the larger point that an investor's returns on a share that she purchases are determined by a combination of the dividends and other distributions that she receives while holding the share and her proceeds, if any, from its sale at the end of her holding period. However, this point does not properly lead to the conclusion that there is, on an expected basis, any unfairness. In a world where there were no such misstatements, an issuer's share prices in an efficient market would be an unbiased estimate of the issuer's future dividends and distributions discounted to present value. In the real world, however, at any given point in time, the managers of some issuers are making falsely optimistic statements. Investors are aware of this fact, but they do not know, at least for sure, which managers are truthful and which are making misstatements. Therefore, all stock prices are discounted to one extent or another to

It might be argued that it is still unfair ex post when the investor in fact turns out to be a loser, even if there is no unfairness ex ante. The losing investor is, after all, innocent, and the loss would not have occurred but for the wrongdoing of others. Issuer civil liability does not provide a satisfactory way of curing this ex post unfairness, however. If the losers have a cause of action against the issuer, it will ultimately be paid for by the shareholders at the time the suit is brought, thereby passing on the ex post losses from one innocent chance group to another.[6] As has been widely recognized for some time, this means that, if a regime is in place by which the losers are compensated by issuers that make misstatements, the damages are in some sense "circular."[7]

reflect the possibility of untruthfulness. Unless market prices systematically underestimate the probability of such misstatements, the prices that the investor pays on average correctly reflect the possibility that they have been inflated by such a misstatement. The expected cost from purchasing a share that turns out to be inflated is exactly counterbalanced by the expected gain from buying, at a discount, a share that turns out not to be inflated.

6. Professor Mitchell argues in this same Symposium issue that the shareholders of the issuer are in fact not innocent because the misstatement was made by managers whom the shareholders elected and failed to adequately monitor. Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 287–90. Innocence is in the eye of the beholder, however. Most commentators, including myself, would probably not think that each of the dispersed shareholders of the typical U.S. issuer has a moral obligation to become informed as to the qualities and behavior of the issuer's managers and that as a result the shareholder gets what she deserves when the issuer's shareholders, as a group, fail to do so. From my perspective, Mitchell's underlying argument really rests on deterrence, not fairness. Imposing liability on the issuer for a violation of the securities laws when a manager makes a misstatement deters such behavior in just the same way as imposing liability on the issuer when a manager decides to violate any other rule, for example by illegally emitting noxious pollutants into the air. Because, in each case, these losses are ultimately borne by the shareholders, the same market mechanisms that in general create incentives for managers to make decisions that enhance share value create incentives for managers to comply with the law. The question, therefore, is not whether it is fairer for the shareholders at the time of suit to bear the losses than for the purchasers who initially incurred the losses to do so. The question is whether imposing these losses on the shareholders is an appropriate, cost-effective way of improving compliance with securities-law rules against misstatements.

7. *See*, *e.g.*, Coffee, *supra* note 1, at 1556–66; Mahoney, *supra* note 1, at 632, 635. Both Professors Coffee and Mahoney express skepticism concerning the compensation rationale for civil liability imposed on issuers to provide damages to those who trade in the secondary market at disadvantageous prices due to issuer misstatements. The U.S. Chamber of Commerce has used this idea of damage circularity as a key element in its recent attack on class-action fraud-on-the-market litigation. *See, e.g.*, THAKOR, ECONOMIC REALITY, *supra* note 1, at 4–5; THAKOR, UNINTENDED CONSEQUENCES, *supra* note 1, at 8–9.

B. Risk-Reallocation Arguments

There is another argument for requiring an issuer to compensate traders who suffer losses from purchasing the issuer's shares at misstatement-inflated prices: reducing the amount of disutility in society arising from the risk of suffering such a loss. Close examination suggests that providing compensation will in fact have this effect to a limited extent. Compared, however, to the alternative way of dealing with this risk—investor diversification—compensation is less effective and far more expensive.

1. COMPENSATION UNLIKELY TO SHIFT LOSSES TO MORE DIVERSIFIED PERSONS

Because an action against the issuer will ultimately be paid for by the shareholders at the time the suit is brought, the losses from one chance group are just passed on to another, as discussed above. Putting aside insurance for a moment, the persons who will ultimately bear these losses—the shareholders at the time suit is brought—are unlikely to be any more diversified than the persons who initially incur them.[8] Compensation ultimately paid for by issuer shareholders is thus not going to reduce the amount of risk-related disutility in society by having more diversified persons ultimately bear the losses.

2. COMPENSATION LIKELY TO INCREASE LOSS SPREADING

Through loss spreading, compensation can, however, somewhat reduce the amount of disutility in society arising from the risks of loss created by issuer misstatements. During any period when the price was inflated, some, and perhaps many, of the issuer's outstanding shares will be traded at least once. In all likelihood, not all the outstanding shares will be traded, however, because some shares held by persons prior to the misstatement will still be held by the same person at the time of the suit. If the issuer compensates the purchasers' losses from the shares that are traded, these losses are spread among the holders of all the issuer's shares, which, because some of the issuer's shares were

8. Indeed, much of the trading volume in most shares is undertaken by relatively diversified investment funds that buy and sell shares of the same issuer relatively frequently. Thus, the average purchaser of shares at prices inflated by misstatements is probably more diversified than the average of shareholders as a whole, a group that is likely to include, as well, individual shareholders, who are both less diversified and trade less frequently.

not traded, is a larger group.[9] Putting aside insurance again, the extent to which each dollar of compensation spreads the loss is often very modest, however. In the typical case, the rate of share turnover in the issuer's shares is sufficiently high and the period of time that the misstatement inflates price is sufficiently long such that a substantial portion of all the shares outstanding are purchased by someone at least once at the inflated price.[10] So, the number of persons ultimately bearing the losses may not be much greater than those suffering the losses in the first instance.[11]

3. THE EFFECT OF DIRECTORS AND OFFICERS INSURANCE

Most securities class-action settlements, other than the very large ones, are funded in total or in substantial part by proceeds from the directors and officers (D&O) insurance policies purchased by the issuer.[12] For the portion of any settlement so funded, the loss-spreading

9. At the time suit is brought, some of the issuer's shareholders have held their shares since prior to the issuer's misstatement, and so suffered no trading loss as a result of the misstatement because they neither bought nor sold at a price influenced by the misstatement. Thus, not all of the issuer's shares were traded at a disadvantageous price due to the misstatement. As a result, providing damages will spread the losses from the persons who did engage in such disadvantageous trades across the holders of all the outstanding shares, which is larger in number than the number of shares traded at a disadvantageous price.

10. Turnover for an issuer's shares in a given period is the number of shares traded in the period divided by the total number of the issuer's shares outstanding. In 2005, the annual turnover of the average New York Stock Exchange issuer was 103 percent. Nyxdata.com, NYSE Overview Statistics, http://www.nyxdata.com/factbook (last visited Feb. 11, 2009). Assuming 250 trading days per year, this implies a turnover of 0.42 percent per day. This means that for the average issuer, 99.58 percent of the outstanding shares do not trade each day. The percentage of shares that do not trade in any given period is thus 0.9958 raised to the power of the number of trading days in the period. Thus, in six months, 59.69 percent would not have traded at least once, and 40.31 percent would have traded. In two years, 12.69 percent would not have traded at least once and 87.31 percent would have. In four years, the corresponding figures are 1.61 percent and 98.39 percent. Casual empiricism suggests that in the vast majority of fraud-on-the-market class-action lawsuits, the class period, which normally corresponds to the length of the claimed period of price inflation, runs from between six months to two years. Of the 688 securities class actions filed from 2002 to 2008 that have settled or been dismissed, the class period has averaged about 1.5 years. NERA Economic Consulting, http://www.nera.com (proprietary database on securities class actions).

11. Based on the figures *supra* note 10, in the average case, to the extent that losses are not covered by D&O insurance policies, there is barely any loss spreading at all; losses suffered in connection with trades involving approximately 79 percent of the shares would be spread over the holders of 100 percent of the shares.

12. *See generally* Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385 (2006).

effect of compensation would, in fact, be very extensive. But the amount paid out in settlements funded in this fashion represents only a small portion of all the claimed trading losses that become the subject of litigation.[13] Moreover, the very large settlements, though few in number, represent a substantial portion of all the dollars paid out in settlements, and these very large settlements are primarily funded by the issuers themselves, not by insurance.[14]

4. COSTS OF PROVIDING LIMITED LOSS SPREADING AND THE ALTERNATIVE OF SHAREHOLDER DIVERSIFICATION

Compensation's capacity to reduce the disutility in society arising from trading risks generated by issuer misstatements must be weighed against the high transaction costs associated with providing this compensation, and must be compared to the alternative ways of reducing this disutility.

a. Costs of providing compensation through securities litigation

In recent years in the United States, the lawyers' fees on the two sides of securities litigation have alone, in the aggregate, averaged about $2.5 billion per year.[15] On top of this is the cost of experts, the time and attention of issuers' executives required by litigation, the

13. *See generally* THAKOR, ECONOMIC REALITY, *supra* note 1.

14. *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2008: A YEAR IN REVIEW (2009), *available at* http://securities.cornerstone.com/pdfs/YIR2008.pdf.

15. For the years 2000–05, total annual securities class-action settlements have averaged about $4.1 billion. LAURA E. SIMMONS & ELLEN M. RYAN, POST-REFORM ACT SECURITIES SETTLEMENTS: 2005 REVIEW AND ANALYSIS (2006), *available at* http://securities.cornerstone.com/pdfs/Settlements_2005.pdf. Studies suggest that contingent-fee awards to plaintiffs' lawyers in securities class-action lawsuits average around 30 percent. FREDERICK C. DUNBAR & VINITA M. JUNEJA, RECENT TRENDS II: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS?., at tbl.4 (1993) (reporting that attorneys' fees averaged 31.32 percent of settlements in a sample of 135 cases from July 1991 through June 1993); FREDERICK C. DUNBAR ET AL., RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS?, at ii (1995) (reporting that although average settlements fell from 1993 to 1994, plaintiffs' attorneys' fees stayed constant, averaging one-third of the settlement awards, and that plaintiffs' attorneys' fees averaged "$1.96 million in 1993 and $2.03 million in 1994"). If we assume that defendants' lawyers are paid fees comparable in amount, this would suggest that the total annual legal expenses associated with these actions averaged about $2.5 billion ((0.30 + 0.30) x $4.1 billion). The plaintiffs' expenses come out of the judgment or settlement and hence diminish what would otherwise be paid to members of the class. The issuer defendant's expenses are ultimately borne by its shareholders at the time suit is brought.

administrative costs associated with D&O insurance, and the use of scarce judicial resources.

These transaction costs, including the $2.5 billion in legal fees, are real costs to society. They need to be weighed against the real gains to society from a wealth transfer that simply spreads more broadly $2.9 billion in losses.[16] These figures suggest, just on their face, that securities litigation is so costly, relative to the amount of loss spreading achieved, that it is unlikely to be worthwhile even if there were no alternative way of reducing the social disutility arising from the risks of issuer misstatements.

b. Diversification as an alternative

There is, however, an alternative, much more economical and effective way of reducing these risks: investor diversification. Many investors already have some or most of their equity investments in broadly based investment vehicles, such as index or mutual funds or broad-based 401(k) retirement accounts, or are otherwise highly diversified. For an investor directly or indirectly holding a diversified set of stocks, no risk reduction is achieved by shifting the misstatement-induced trading losses from purchases of the stocks making up the set to the issuers that made the misstatements. This is because, as set out below, the practice of issuers making misstatements imposes no significant risks in the first place on the holder of this set of stocks.

A broadly diversified investment portfolio is divided among hundreds, perhaps even thousands, of different stocks. At the time that the purchase of each of these stocks is made, there is a certain, fairly small percentage chance that the price has been inflated by the issuer having made a misstatement. The market is aware of this possibility and discounts the price of the stock to reflect its estimate of the chance of a misstatement and the expected inflation in price if there is one. The investor is like a fire-insurance company that gathers a large number of homeowners, each of whose home has a small percentage risk of burning down that is independent of the risk of any other policy holder's home burning down. In return for a fee, the insurance company agrees to absorb the full cost of a fire in any of the homes. Because of the law of large numbers, each year the insurance company will experience a fairly steady level of aggregate payouts on its policies. These payouts are covered by the fee, if set at the right level,

16. Based on the figures *supra* note 15, for the years 2000–05, the total annual securities class-action settlements have averaged about $4.1 billion, from which plaintiffs' lawyers are paid about $1.2 billion in contingent fees. This leaves about $2.9 billion to be distributed as compensation to cover the trading losses of the plaintiffs.

that it collects for issuing the policies. For the investor, the discount it receives in terms of the price of each stock is like the fee the insurance company collects from the homeowners. In an efficient market, the market's estimate of the chance that an issuer will make a misstatement and of the resulting inflated effect on share price will be unbiased in the sense that it will not consistently be too large or too small. So, the discount will, on average, in fact be at the right level.

Assume for a moment that at each point in time, any errors in these estimates for any given issuer are independent of the errors in the estimates for all the other issuers in the market. In such a world, the errors, again because of the law of large numbers, will tend to cancel each other out. Therefore, each year, the aggregate losses that the investor suffers from purchasing stocks that were in fact inflated by an issuer misstatement will, like with the fire-insurance company, be fairly steady and covered by the discount she receives on the price of all the stocks she purchased that were not inflated in price by a misstatement.[17] Thus, even without compensation, the investor faces no significant losses on a net basis from the fact that some issuers made price-inflating misstatements. Using securities litigation to shift losses arising from the misstatements of individual issuers to the issuers involves real social costs, with no gain in the form of reduced risk.

This assumption that, at any one point in time, the errors in the estimates with regard to any one issuer are independent of the estimates with regard to the others is almost certainly not entirely accurate. The market, at any one point in time, may under- or overestimate the extent to which issuers across the market are engaging in misstatements. We appear to have observed, for example, a negative market-wide impact from the series of scandals in the early 2000s of which WorldCom and Enron were the most prominent. The revelation of misstatements by the issuers involved in the scandals seems to have led to a market reevaluation of its estimates concerning the risks that other issuers were making price-inflating misstatements as well. To the extent, however, that the assumption deviates from reality, the case for securities

17. Even if the number of stocks held is not so large that the outcomes (purchasing the stock of a truthful company at a discount versus purchasing the stock of an untruthful company that results in a loss) cannot be expected to perfectly cancel each other out, the remaining risk associated with issuer misstatements is just one of many different risks associated with investing in each stock in the investor's portfolio. Most of these other risks will be independent of the remaining risk associated with issuer misstatements and so, with diversification, will tend to cancel out this remaining risk.

To the extent that losses are compensated through civil liability, the discount for these losses will be reduced. Substituting for this reduction, however, will be a discount for the fact that each issuer faces a certain percentage chance of having to pay out such compensation.

litigation as a way to reduce social disutility from risk is no stronger. The correlated error in the discount is a systematic risk, the disutility from which cannot be eliminated by shifting it around.

c. Investors who are not broadly diversified

Not all investors are broadly diversified, of course. Shifting such investors' trading losses to issuer shareholders will reduce their risks. And, as noted above, to the extent that this shift spreads these losses among a larger group of persons, it will reduce on a net basis the total amount of disutility in society from risks generated by issuers making price-inflating misstatements. Raising fairness again, but in a more refined way than before, one might argue that compensation should be paid as a simple matter of corrective justice. These undiversified investors, the argument would run, should not be forced to absorb risks created by the misdeeds of others just because the investors suffering losses did not protect themselves through diversification.[18]

The problem with this more refined fairness argument is that the very substantial transaction costs associated with providing this compensation are not borne primarily by the managers of the issuers making the misstatements, who are the persons actually committing the misdeeds. The costs are borne by an issuer's shareholders over time. Broadly diversified investors will constitute a substantial portion of these shareholders. One can therefore reverse the argument and say that it is unfair to impose pro rata on this broadly diversified portion of an issuer's shareholders these very substantial costs when they gain no risk-reduction benefit because they are already protected. Ultimately, therefore, fairness concerns are not helpful in resolving the issue, and the question comes back to what is the lowest-cost and most effective way to eliminate risk. Each investor, through her ability to diversify broadly, is the least-cost avoider of disutility arising from the risks generated by price-inflating issuer misstatements.

C. The Investor-Protection Rationale for Securities Disclosure Rules

Closely related to these discussions of fairness and risk is the proposition that the investor-protection rationale for securities disclosure rules is also weak (in contrast to the corporate-governance and liquidity rationales). Many provisions in the securities laws, including parts of broker-dealer regulation, have important fairness purposes. Fairness is not, however, a persuasive rationale for the disclosure regulation of established issuers trading in efficient markets.

18. *See* Evans, *supra* note 5, at 235–36.

Disclosure by such issuers is not necessary to protect investors against either unfair prices or risk.[19] According to the efficient-market hypothesis, the price of such a share is unbiased—as likely to be below the share's actual value as above—whether there is a great deal of information publicly available about the issuer or very little. In other words, greater disclosure is not necessary to protect investors from buying its shares at prices that are, on average, unfair—that is, greater than their actual values. Issuer disclosure may reduce risk, on average bringing prices closer, on one side or the other, to actual value, but the only kind of risk that it reduces is *unsystematic* risk. Simply by being diversified, investors can protect themselves from this unsystematic risk much more effectively and at less social cost than by increases in issuer disclosure.

II. THE POTENTIAL FOR A DETERRENCE JUSTIFICATION

Given the weakness of the compensatory justification for civil liability when nontrading issuers violate periodic disclosure regulations, is deterrence a potential alternative justification for a system of civil liability? The first step in answering this question is to identify what, given the problems with the investor-protection rationale for mandatory disclosure, the societal function served by a governmentally sponsored periodic disclosure regime is. As developed below, issuer disclosure can enhance efficiency by improving corporate governance and increasing liquidity. Without a governmentally sponsored periodic disclosure regime, however, issuer disclosure is likely to be at a socially suboptimal level. The societal function for a governmentally sponsored disclosure regime having been identified, the stage is set to address the question to which the rest of the Paper is devoted: whether, given this social function, the deterrence effects of civil liability make a damages cause of action socially worthwhile. In essence, this is the question of whether civil-damages-liability based incentives for compliance with the governmentally sponsored periodic disclosure regime are likely to be worth their costs.

A. Issuer Disclosure's Role in Improving Corporate Governance and Liquidity

Disclosure enhances efficiency by improving the selection of proposed new investment projects in the economy and the operation of

19. I have considered the points discussed here in significantly more detail elsewhere. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2532–44 (1997).

existing projects. A corporation is well governed if it makes these decisions in share-value-maximizing ways. Disclosure prompts managers of established corporations to make share-value-maximizing decisions through its beneficial effects on the workings of both the legal mechanisms for assuring quality of corporate governance and the existing market mechanisms that help align managerial interests with those of shareholders. Disclosure also enhances efficiency by increasing the liquidity of an issuer's stock through the reduction in the bid/ask spread demanded by the makers of the markets for these shares.

1. LEGAL MECHANISMS

Disclosure strengthens the effective exercise of the shareholder franchise because a better-informed shareholder is more likely to vote for the directors who in fact are most likely to maximize share value, as well as for the share-value-maximizing choice with regard to all other matters subject to shareholder vote. Disclosure also enhances effective derivative-suit enforcement of management's fiduciary duties because managers are unlikely to voluntarily provide information concerning their breaches of these duties. And, by making the existence of such conflicts more easily detected, it makes more meaningful corporate-law provisions requiring special procedures in connection with the authorization of transactions in which management has an interest.

2. MARKET MECHANISMS

Disclosure has beneficial effects on the operation of three of the economy's key market-based mechanisms for controlling managerial behavior: the market for corporate control, share-price-based managerial compensation, and the terms at which new funding is available to the corporation.

a. Market for corporate control

Disclosure strengthens the effectiveness of the market for corporate control by increasing the threat of hostile takeover when managers act in a non-share-value-maximizing way. A potential acquirer must make an inherently risky assessment of what a target would be worth in its hands. Greater disclosure reduces the riskiness of this assessment. Because the potential acquirer's management is risk averse, this reduction in the riskiness of its assessment means that a smaller apparent deviation between incumbent management decision making and what would maximize share value is then needed to impel the potential acquirer into action. This reduction in the size of the

apparent deviation needed to impel action, by increasing the threat of takeover, better motivates incumbent managers to maximize share value. For those who fail nevertheless to do so, it increases the likelihood of the manager's replacement.

b. Share-price-based compensation

Disclosure strengthens the usefulness of share-price-based compensation as a way of motivating management by inducing management to accept a larger portion of its total compensation in share-price-based form. The problem for managers with share-price-based compensation, compared to straight salary with the same expected value, is the undiversifiable unsystematic risk that it imposes on the manager. More disclosure makes share prices more accurate, which reduces this unsystematic risk. More accurate share prices also make such compensation a more focused reward mechanism.

c. Terms of funding new projects

Disclosure, by improving share-price accuracy, also improves the allocation of scarce capital among the proposed real investment projects in the economy. This is clearest when a firm is considering funding a project through the issuance of new equity. Disclosure affects the terms at which such funds can be obtained. An inaccurately high price may encourage managers to invest in negative net-present-value projects, that is, to invest in projects with prospects inferior to the prospects of some proposed projects in the economy that do not get funding. An inaccurately low price may discourage investments in positive net-present-value projects, that is, to pass up projects with prospects better than some project proposals in the economy that do get funding. There is evidence that share price affects the terms demanded by other available external sources of funds as well.[20] Share price also appears to affect management's willingness to use internal funds to implement a new project.[21]

3. LIQUIDITY

More disclosure reduces illiquidity in the secondary market for an issuer's shares. Insiders and their tippees can make supranormal profits by engaging in trades based on nonpublic information. Since market

20. *See* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 123 (1979).

21. *See* MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY 282–87 (1987).

makers and specialists have difficulty knowing whether they are dealing with such inside-information-informed traders or with uninformed outsiders, they cover the expected costs of being on the other side of trades with informed traders through the bid/ask spread they offer all traders, that is, the difference between the price at which they accept buyer orders and the price at which they accept seller orders.[22] The bigger the spread, the less liquid the issuer's shares, and the less valuable they are to hold. Ongoing periodic disclosure, by reducing the amount of nonpublic information and hence the opportunities for insiders and tippees to engage in trades based on such information, reduces bid/ask spreads, increases liquidity, and, as a consequence, reduces the cost of capital.[23]

B. The Social Function of a Governmentally Sponsored Disclosure Regime

The fact that issuer disclosure enhances efficiency by improving corporate governance and increasing liquidity does not, by itself, show the need for a governmentally sponsored disclosure regime. Even without governmental regulation, market forces encourage issuers to provide a certain level of disclosure. Disclosure has costs as well as benefits, and so for each issuer there is some socially optimal level of disclosure. A governmentally sponsored periodic disclosure regime only serves a useful social purpose if, on average, it prompts a country's issuers to disclose closer to this level than they would if society relied on market forces alone.[24]

22. *See generally* LARRY HARRIS, TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 287–91, 299–302 (2003); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985).

23. For models working these points out more rigorously, see generally Robert E. Verrecchia, *Essays on Disclosure*, 32 J. ACCT. & ECON. 97 (2001) (noting that disclosure reduces information asymmetries and lowers a firm's cost of capital); Maureen O'Hara & David Easley, Information and the Cost of Capital (Nov. 2001) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=300715&high=%20maureen%20ohara (same).

24. This is a question that has given rise to much scholarly debate. Scholarly opposition to the U.S. mandatory disclosure regime began with empirical work by certain economists purporting to show that it had no benefit. *See, e.g.*, George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 149, 153 (1973); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 122–24 (1964). Signaling—the idea that issuers with good news will want to disclose it and that the market will infer from the silence of the rest that they do not have good news—added a theoretical component to the case against mandatory disclosure. *See* Steven A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory*

A governmentally sponsored disclosure regime could take one of two forms. One, existing largely only in the eyes of its academic proponents, is an "issuer choice" regime.[25] Under this approach, an issuer is not bound by a jurisdiction's disclosure rules unless it so chooses. Choosing a jurisdiction by which to be bound is a method of bonding to assure investors that the issuer will provide, long term, the level of disclosure required by the jurisdiction's rules. The other form is the traditional governmentally sponsored periodic disclosure regime, found around the world, where the rules are mandatorily applicable to a defined set of issuers, such as all issuers whose securities trade in the jurisdiction's markets or all publicly traded issuers that are nationals of the jurisdiction. The important point for the discussion here, however, is that each form, to be effective, requires incentives for compliance. So the question of the desirability of civil liability is relevant to both, though it potentially serves additional functions in the case of mandatory disclosure.

There are two discrete sets of reasons why it may be desirable to have a set of governmentally generated periodic disclosure rules. One set arises out of the role of disclosure, discussed above, in reducing the agency costs of management and market illiquidity, reasons applicable to both issuer choice regimes and mandatory ones. The other set relates to the market failure that arises because the social costs of an issuer's disclosure are lower than its private costs, and the social benefits of its disclosure are greater than its private benefits, reasons only applicable to mandatory regimes.

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and Signaling Theory, *in* ISSUES IN FINANCIAL REGULATION 177, 182 (Franklin R. Edwards ed., 1979). Despite their challenges, however, most law-and-economics-oriented scholars concluded, based on market-failure theories, that on balance the U.S. system should be retained. *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 725–28 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 684–85 (1984). In the late 1990s, the issue was raised again in a somewhat different form by scholars arguing that issuers should be able to avoid the U.S. regime if they chose instead the regime of any of the fifty states or any foreign country. Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 921–24 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361–62 (1998). For arguments that this issuer choice approach is undesirable, see Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999).

25. *See, e.g.*, Choi & Guzman, *supra* note 24, at 907; Romano, *supra* note 24.

1. AGENCY COSTS OF MANAGEMENT AND MARKET ILLIQUIDITY

The fact that an issuer's managers are in an agency relationship with its shareholders gives rise to a divergence between the manager's optimal level of disclosure at any given point in time and what is optimal for the issuer's shareholders. As developed above, disclosure, in addition to enhancing liquidity, increases the effectiveness of a number of devices that work to limit the ability of managers to deviate, for their own advantage, from acting in the shareholders' best interests: the shareholder vote, shareholder enforcement of management's fiduciary duties, the hostile takeover, and share-price-based compensation. This increased effectiveness is a cost to managers, who would prefer to pursue their personal goals under as few constraints as possible. Managers, of course, may also benefit derivatively from an increase in share price that reflects increased disclosure's improvements in managerial discipline and liquidity. The size of this benefit, however, would in many cases not be sufficient to cancel out the personal cost to the managers of having to work under greater discipline.

a. Bonding by means of a disclosure regime to assure shareholders

The level of disclosure that is optimal for the shareholders of a publicly traded issuer is the one that, to the extent cost effective, minimizes the deviation between management's decisions and what would maximize share value. In theory at least, there is a way, without a traditional mandatory disclosure regime, to assure that the firm will provide disclosure on an ongoing basis at this optimal level. A firm's original entrepreneurs can voluntarily commit the issuer at the time of its initial public offering (IPO) to provide periodic disclosure at this level in the future. They create this commitment by subjecting the firm to some kind of ongoing system of binding disclosure rules. The closer the expected level of future disclosure is to what would be optimal for the firm's shareholders, the less the market would expect management decision making to deviate from what is in shareholders' best interests in the future, and the higher the market price for the issuer's IPO. Because a higher price means that the firm will need to sell fewer shares in the IPO to obtain a given amount of financing,[26] and because

26. *See* Easterbrook & Fischel, *supra* note 24, at 684. The idea that entrepreneurs have an incentive to obligate the firm to comply with a disclosure regime that maximizes share value is an application of the larger principle, set out in Jensen and Meckling's seminal article, that firms that go public will contract with shareholders to provide the agency-cost-minimizing set of constraints on management. *See generally*

the entrepreneurs typically retain the issuer's remaining shares, the entrepreneurs capture this price improvement through a dollar-for-dollar increase in the size of their entrepreneurial surplus. They would therefore have an incentive to commit the issuer to disclose at the level that is in the issuer shareholders' best interests.

Subjecting the issuer to a governmentally sponsored disclosure regime is one way of assuring the purchasers of the shares that the issuer will provide this higher level of disclosure on an ongoing basis. This is the idea behind the issuer choice approach to disclosure regulation. A traditional mandatory regime, if it requires the right level of disclosure, will have the same result. Alternatively, the firm could try to bind itself through some kind of private rule-generating regime, for example by listing on a stock exchange with certain disclosure requirements. The governmentally based regime may, however, have the advantages of offering, as at least a partial enforcement mechanism, governmental investigation and prosecution of possible violations. The full power of the state can aid this mechanism through issuing subpoenas to acquire evidence and imprisonment for established violations.

b. Possible need for a mandatory regime

This internalization of the benefits from the disciplinary effects of disclosure will not be complete unless the market is confident at the time of the IPO that the issuer is fully committed to credibly disclose at the promised level for the life of the firm. It is probably impractical to institute a voluntary-commitment mechanism on the part of the issuer that provides such an ironclad guarantee. No voluntarily chosen institution providing enforcement and rule-making services can, whether private or public, be relied upon over the remaining life of the firm to continue to maintain the same rules. Even if one could, there would be a value in providing some kind of room for the firm to opt out later, in the event that the standards imposed by the institution no longer fit the firm well. Yet, the same opt-out provision would provide the opportunity for managerial opportunism. Thus, a mandatory regime of governmentally generated rules may be required to provide a regime that is essentially inescapable as long as the issuer stays public, but that has the flexibility to change the rules based on changing circumstances and new learning.

Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

2. PRIVATE VERSUS SOCIAL COSTS AND BENEFITS OF AN ISSUER'S DISCLOSURE

An additional and stronger case for a traditional mandatory disclosure regime arises from the fact that the social costs of an issuer's disclosure are lower than its private costs, and the social benefits of its disclosure are greater than its private benefits, with resulting market failure.

a. Divergence of private from social costs

For each individual issuer, a disclosure involves two different kinds of costs, "operational" costs and "interfirm" costs. Operational costs are the out-of-pocket expenses and the diversions of management and staff time that issuers incur to provide the information. Interfirm costs arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers, and major customers. Operational costs are costs both to the individual firm and to society as a whole. Interfirm costs are costs only to the individual firm. They are not social costs because the disadvantages to the issuer from the disclosure are counterbalanced by the advantages it confers on the other firms. Thus, at all levels of disclosure, an issuer's private marginal cost of disclosure will exceed its social marginal cost by an amount equal to these interfirm costs.

b. Divergence of private from social benefits

Information disclosed by one issuer does not just improve its corporate governance and reduce the illiquidity of its own shares. The information can be useful in analyzing other issuers as well, and thus have beneficial effects on their governance and liquidity. It could, for example, reveal something about possible industry-wide trends.[27] In particular, if one has detailed information about one issuer's performance, it is easier to detect shirking by the managers of its competitors who face a similar external business environment. These benefits will not be captured in the price of the issuer making the disclosure, and therefore the private benefit of disclosure to the issuer and its shareholders will be less than the social benefit.

c. Market-failure justification for mandatory disclosure

Because an issuer's disclosure involves both social costs and social benefits, each issuer has some socially optimal level of disclosure.

27. *See* Easterbrook & Fischel, *supra* note 24, at 685.

Because the private costs of an issuer's disclosure exceed the social costs and the private benefits fall short of the social benefits, even managers who completely identify with existing shareholders—ones who seek to maximize share value, so that costs of disclosure to the shareholders are equivalent to costs to the managers—would therefore choose to bind the firm to a disclosure level below the social optimum.[28] Mandatory disclosure can be viewed, in important part, as an effort to correct this shortfall. In this connection, it should be noted that if all issuers are required to increase their disclosures up to the socially optimal level, the effects of the interfirm costs that give rise to the divergence between private and social cost would likely be a wash for each firm. Each firm would lose as a result of its own increased disclosure, but gain from the disclosures of its competitors, major suppliers, and major purchasers. At the same time, the higher level of disclosure would further reduce agency costs of management and further improve liquidity.

C. Conclusion

Issuer disclosure is not necessary to protect investors from trading in the market at unfair prices. It does, however, enhance efficiency by improving corporate governance and increasing liquidity. Without a governmentally sponsored regime, issuer disclosure is likely to be at a suboptimal level. The functions of a governmentally sponsored disclosure regime having been identified, we can now ask the question addressed in the rest of the Paper: whether civil-damages-liability-based incentives for compliance with this regime are likely to be worth their costs. In other words, is there a deterrence-based justification for civil liability?

III. CIVIL LIABILITY AS A SUPPLEMENT TO GOVERNMENT ENFORCEMENT

The most common noncompensatory justification for providing civil liability damages based on the violation of a public regulation is

28. I have considered in more detail elsewhere the divergence of the private and social costs and benefits of issuer disclosure and the consequent tendency of issuers to disclose below their socially optimal level. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2537–39 (1997); *see also* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1490–91 (1992); Coffee, *supra* note 24, at 721–23; Easterbrook & Fischel, *supra* note 24, at 684–85; Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 846–74 (1995).

that plaintiffs who bring such civil actions act as "private attorney generals," who help society by supplementing the efforts of otherwise overstretched public officials. Indeed, this rationale for civil liability in the securities law disclosure area has been repeated by the Supreme Court of the United States multiple times,[29] and endorsed by Congress in the legislative history of the Private Securities Litigation Reform Act of 1995 (PSLRA), its largest effort to date at securities litigaton reform.[30]

A. Reasons for Initial Skepticism

Absent further elaboration, the argument that civil liability is needed because the public enforcement agency has inadequate resources to effectively enforce a given public regulation is unpersuasive. Less than total enforcement of a rule is not self-evidently inappropriate when that shortfall occurs as a result of a political process that gives the enforcement agency a budgetary allocation smaller than what would be needed for full enforcement.

Many public regulations are drafted in an overly broad fashion in the sense that it would not be socially worthwhile for them to be complied with in every circumstance. Even where compliance is socially worthwhile, once a violation has occurred, the social gain in terms of deterrence from bringing an action against the violator may not be worth the social resources consumed by the action. Budgetary allocations to an enforcement agency are arguably a way that the legislature can police agency determinations regarding when it is worthwhile to bring actions.[31] Permitting civil damage actions can undercut this policing and result in social resources—the lawyers' time

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29. In connection with finding an implied right of action for violations of the proxy rules under section 14(a) of the Exchange Act, the Court stated:

> Private enforcement of the proxy rules provides a necessary supplement to [SEC] action. As in antitrust treble damage litigation, the possibility of civil damages . . . serves as a most effective weapon in the enforcement of the proxy requirements. The [SEC] . . . examines over 2,000 proxy statements annually . . . . Time does not permit an independent examination of the facts set out in the proxy material.

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

The Court has reiterated this position with respect to Rule 10b-5 actions recently, saying that it has "long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the [SEC]." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007).

30. H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.).

31. *See, e.g.*, Kate Stith, *Congress' Power of the Purse*, 97 YALE L.J. 1343, 1352 (1988).

and the other transaction costs associated with litigation—being devoted to actions in amounts greater than is socially worthwhile.

There are several possible responses, however, to this critique of the private-attorney-general rationale for civil liability, based, in part, on the particular nature of securities disclosure rules and the ways that a civil-liability system might be designed with respect to their violation.

B. Properly Designed Civil Liability Will Not Result in Overenforcement

A properly designed system of civil liability need not inevitably lead to overenforcement. The issue arises in the mandatory disclosure area because the civil-liability system as currently designed, with the dominant role played by fraud-on-the-market class-action lawsuits, can result in large damage awards that, for the same reasons that the compensation justification is weak, do not bear a one-to-one relation to the harm to society caused by the underlying violation.[32] Thus, the cause of action is likely to induce some lawsuits where the social resources consumed exceed the social benefits. As will be discussed below, the optimal solution to this problem would involve a redesign of the current civil-liability system in a way that eliminates, where the issuer does not trade, issuer liability and the payment of damages to investors who suffer secondary market trading losses. An alternative, second-best solution would be to retain these features of the system but to alter the fee structure for plaintiffs' lawyers who bring such suits.

1. COMPLETE REDESIGN OF THE CIVIL-LIABILITY SYSTEM

The overall system of civil liability for disclosure violations where the issuer does not trade can be redesigned so that it will deter disclosure violations at least as well as the current system, but the damages will bear a much closer relation to the social harm caused by the violation. With such a transformation, the risk that civil liability would lead to over enforcement is substantially eliminated.[33] I have

32. *See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 928 (1999).

33. The assumption here is that the deterrent value of a damages judgment is proportional to the social harm that the injury causes. The standard plaintiffs' lawyer percentage of recovery would need to be set to achieve the most cost-effective total level of litigation. *See* Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333, 333 (1982) (discussing both the relationship between who bears legal fees and the level of litigation and the relevance of deterrence value in determining the optimal level of litigation). Professor Shavell's

attempted to design such a system in a related article.[34] Under my proposed scheme, because of the weakness of the compensatory justification, fraud-on-the-market lawsuits would be eliminated and so an issuer would not be liable to investors for losses caused by its disclosure violations as long as it is not itself selling securities. Deterrence would be achieved by imposing civil liability on actors other than the issuer. An issuer's annual filings would be signed by an external certifier: an investment bank or other well-capitalized entity with financial expertise. If the filing contained a material misstatement and the certifier failed to do its due diligence, the certifier would face measured liability to the issuer itself. Officers and directors would be subject to a similar liability scheme and would not be permitted indemnification or insurance. Damages owed by each of these parties would be comparable to the amount for which the party would be liable today in a claim for contribution by another party that had paid the full amount of a judgment in a section 11 action under the Securities Act of 1933 in connection with a registered public offering in an amount equal, roughly, to the issuer's gross investment for the year. Suit could be brought under this system by any shareholder on behalf of the corporation in much the same fashion that a shareholder can now bring a lawsuit to recover for the corporation an insider's short-swing profits under section 16(b) of the Exchange Act, with attorneys' fees available for successful plaintiffs.[35]

2. CALIBRATING THE PLAINTIFF'S ATTORNEY FEE STRUCTURE UNDER THE EXISTING FRAUD-ON-THE-MARKET SYSTEM

Even if there is no such reform and the existing fraud-on-the-market liability system is maintained, the class-action plaintiffs' attorney contingency fee, which is typically a percentage of the damages paid to investors in settlement or at judgment, can be calibrated so that the level of enforcement is correct at least on average. The aggregate damages owed investors in a successful fraud-on-the-market action equals the number of the issuer's outstanding shares that

work in turn builds on some classic articles using economics to analyze public versus private enforcement of law and the optimal design of civil liability to promote efficient enforcement. *See* Gary S. Becker & George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1, 16–17 (1974); William M. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 1 (1975); A. Mitchell Polinsky, *Private Versus Public Enforcement of Fines*, 9 J. LEGAL STUD. 105, 106 (1980).

34. Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. (forthcoming 2009).

35. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir. 1943).

were purchased at least once during the period at the misstatement-inflated price, multiplied, for each such share, by the dollar amount by which the price was inflated at the time of its first purchase.[36] While there is not a one-to-one relation between the amount of these damages and the social harm caused by the material misstatements that trigger the suits, they share common determinants that lead to a positive correlation between the two. This in turn leads to a correlation between percentage-of-damages-based contingent-fee awards and social harm.

a. A misstatement's impact on market capitalization and its duration as determinants of fraud-on-the-market damages

(I) IMPACT ON MARKET CAPITALIZATION

The inflating effect of a misstatement on an issuer's market capitalization at any point in time equals the total number of the issuer's shares outstanding multiplied by the dollar amount by which the price is inflated. Stating the same relation slightly differently, per dollar of price inflation per share, the bigger the absolute dollar effect of the misstatement on the issuer's market capitalization, the greater the number of shares outstanding that are implied. For a period of price inflation of a given length, the larger the number of shares outstanding, the larger the absolute number of the issuer's shares will be traded at least once. Thus, for a given length of time before the market realizes the truth, for firms with an average turnover in share holdings, the total damages owing to investors in a successful fraud-on-the-market lawsuit—the number of shares traded at least once during the period multiplied by the amount of inflation at the time of first purchase—will

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36. Damages in fraud-on-the-market lawsuits are calculated in accordance with the out-of-pocket measure. Under this measure, the amount of damages owed to a purchaser of a share at a price inflated by a falsely positive misstatement is the amount by which the share price was inflated at the time of purchase (less, if it was sold prior to full revelation of the truth, the amount it was inflated at the time of sale). *Randall v. Loftsgaarden*, 478 U.S. 647, 661–62 (1986); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341–46 (9th Cir. 1976) (Sneed, J., concurring); *Estate Counseling Serv., Inc. v. Merrill Lynch*, 303 F.2d 527, 532–33 (10th Cir. 1962); LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4413–14 (3rd ed. 1998). Thus, for a share purchased just once during the period of inflation and held until revelation of the truth, the damages would equal the amount of the inflation at the time of purchase. For a share that was purchased multiple times during the period, the damages of the multiple purchasers would, in aggregate, equal the amount of inflation at the time of purchase, with each purchaser receiving damages equal to the amount, if any, that the price deflated during her period of holding the share.

be proportional to the effect of the misstatement on the market capitalization of the firm.[37]

(II) DURATION

Everything being equal, the longer the period before the market realizes the truth, the greater the number of the firm's outstanding shares are traded at least once at an inflated price, and hence the greater the damages.

b. A misstatement's impact on market capitalization and its duration as determinants of its social harm

The foregoing discussion demonstrates that, for issuers with an average rate of turnover of share holdings, a greater amount of damages means that the misstatement has had a larger absolute dollar effect on the market capitalization of the firm and/or a longer period of time transpired before the market realized the truth. Each of these contributors to the size of a firm's damages is positively related to the amount of social harm caused by the misstatement, both in terms of poorer corporate governance and decreased liquidity.

37. This point can be illustrated by an example. Imagine two firms, *A* and *B*. On June 1, the management of each makes a misstatement that inflates its firm's shares by $5 and continues to inflate the price by that amount through August 31. On September 1, the market discovers the truth with respect to each firm and in each case the price drops by $5, thereby eliminating all of the inflation caused by the misstatement. A successful fraud-on-the-market class-action lawsuit is filed on behalf of all persons who purchased *A*'s shares between June 1 and August 31 and who still held these shares on September 1. A similar successful action is filed against *B*. Assume that total damages in the suit against *A* are $50 million, and total damages in the suit against *B* are $150 million. These total damages figures imply that three times as many of firm *B*'s outstanding shares were purchased at least once during the three-month period of inflation than firm *A*'s outstanding shares. If each firm has an average rate of turnover in the holdings of its shares, this result in turn implies that firm *B* has three times as many shares outstanding, and hence the inflating effect of *B*'s management's misstatement on *B*'s market capitalization is three times as great as well. This result—that for firms with the same rate of turnover and the same duration before the market discovers the truth, total damages are proportional to the size of the effect of the misstatement on the firm's market capitalization—is independent of the amount of inflation per share. Thus, if the example were changed so that firm *B*'s shares were instead inflated by $10 per share (with *A*'s shares still being inflated by $5 per share) but with the damages still being $50 million for firm *A* and $150 million for firm *B*, the implication would be that, while firm *B* now would have only 1.5 times as many shares outstanding as *A*, the inflating effect of *B*'s management's misstatement on its capitalization would still be three times the effect of *A*'s misstatement on *A*'s capitalization.

(I) RELATIONSHIP BETWEEN IMPACT ON MARKET CAPITALIZATION AND SOCIAL HARM FROM POORER CORPORATE GOVERNANCE

The size of a misstatement's inflationary impact on an issuer's capitalization depends on the extent to which the misstatement deviates from the truth and the size of the issuer's enterprise. Both factors are also related to the social damage caused by the misstatement.

When a misrepresentation concerning an issuer of a given size constitutes a larger deviation from the truth, it will have a larger absolute dollar effect on the issuer's market capitalization. A misstatement that deviates more from the truth also has a more severe impact on the issuer's corporate governance because it more greatly diminishes the effectiveness of the legal and market mechanisms that help align managerial interests with those of shareholders. Thus, it causes more social harm.

When an issuer is larger, a misstatement constituting a given deviation from the truth would also have a greater absolute dollar effect on the issuer's capitalization. This is because a given deviation from the truth concerning the issuer's overall business situation relates to a larger underlying future cash flow, and so the misstatement will lead the market to overestimate the size of this future cash flow by a greater absolute amount. Similarly, the social harm caused by the misstatement would be greater because the larger size of the enterprise would mean that the misstatement's negative effect on the quality of the issuer's corporate governance would result in the mismanagement of a greater amount of assets.

Thus, these same two factors that enlarge the impact of a misstatement on an issuer's capitalization—the extent to which the misstatement deviates from the truth and the size of the issuer's enterprise—each also increase the social harm caused by the misstatement in terms of the social consequences of the resulting poorer corporate governance.

(II) RELATIONSHIP BETWEEN DURATION AND SOCIAL HARM FROM POORER CORPORATE GOVERNANCE

Similarly, for a given absolute dollar impact of a misstatement on an issuer's market capitalization, the longer the period before the market realizes the truth, the longer the misstatement is doing its damage to the issuer's corporate governance and the greater the accumulated social costs.

(III) RELATIONSHIP BETWEEN IMPACT ON MARKET CAPITALIZATION AND SOCIAL HARM FROM REDUCED LIQUIDITY

A similar story can be told with respect to liquidity. For an issuer of a given size, a misstatement's absolute dollar effect on an issuer's market capitalization is positively related to the extent to which the misstatement deviates from the truth. A larger deviation from the truth creates the possibility of greater information asymmetry between traders in the issuer's shares since the insider traders know the true situation. The market's experience of the misstatement, compared to an experience with a misstatement that deviates less from the truth, is likely to cause market makers to raise their bid/ask spreads more to protect themselves from future such incidents. Thus, it will have a more negative effect on liquidity and cause greater social harm.

Alternatively, the absolute dollar effect of the misstatement can be larger as the result of a misstatement being a given deviation from the truth, but concerning an issuer of a larger size. The increase in bid/ask spread will therefore relate to shares with a larger aggregate economic value and the decrease in liquidity will again be socially more harmful.

(IV) RELATIONSHIP BETWEEN DURATION AND SOCIAL HARM FROM REDUCED LIQUIDITY

The longer the period before the truth comes out after a misstatement is made, the more trades are potentially subject to the resulting information asymmetry between insiders and outsiders. For any given dollar effect of a misstatement on an issuer's market capitalization, the market's experience of the misstatement, compared to an experience with a similar misstatement but where the truth comes out sooner, is likely to cause market makers to raise their bid/ask spreads more to protect themselves from future such incidents. This greater reduction in liquidity again results in greater social cost.

Thus, as with a misstatement's negative corporate-governance effects, two principal determinants of the size of damages in a successful fraud-on-the-market lawsuit—the misstatement's impact on market capitalization and duration—positively correlate with factors determining the social costs resulting from the misstatement's negative liquidity effects.

c. Calibrating the contingency-fee percentage

Civil fraud-on-the-market damage actions for mandatory disclosure violations are generally brought by plaintiffs' class-action lawyers seeking a percentage-of-damages-recovered contingency fee. This fee-

award structure means that, given the correlation demonstrated above between damages and the amount of social harm, the amount of resources attracted to pursuing such actions will also be correlated with the amount of social damage. In other words, cases where the misstatement causes more social harm tend to be the ones that will generate larger damage awards, which in turn will offer bigger payoffs to plaintiffs' lawyers. Thus, under the current system, the amount of resources devoted to private enforcement will on average be proportional to the amount of social harm.

However, on average, the proportionality of enforcement resources to social harm does not guarantee that the ratio is optimal. The ratio is determined by the size of the prevailing contingency-fee percentage. If, with the current prevailing percentage, more resources on average are attracted to pursuing these actions than is socially desirable for a given amount of social harm, the ratio is too high and the fee percentage should be adjusted downward. If the opposite is the case, the ratio is too low and the fee percentage should be adjusted upward. After any such needed adjustment, the amount of resources devoted to private enforcement will, on average, not only be proportional to the social harm caused by the misstatement, it would be at a socially optimal ratio.

One further refinement of the contingency-fee formula would be desirable. The discussion so far has been in terms of designing a formula that attracts the socially optimal amount of private enforcement resources *on average*. Any particular case can still attract too many or too few resources because, even with the redesign suggested by the discussion so far, there is not a one-to-one relation between the measure of damages in each individual fraud-on-the-market lawsuit and social harm, only a one-to-one relation on average. The primary reason that individual suits deviate from the average is that the rate of turnover of an issuer's shares during the period before the market realizes the truth differs from one issuer to another: the higher the rate of turnover during this period, the greater the damages. Yet, turnover has no obvious relation to the social harm arising from a misstatement's damage to corporate governance, and not an entirely clear relation to the social harm arising from a misstatement's damage to liquidity.[38]

38. It is difficult to conjure up a relationship between the rate of turnover and the damage a misstatement makes to an issuer's corporate governance, at least in the case of larger issuers that are reasonably thickly traded. An exception applies, perhaps, in the case of an issuer whose turnover is sufficiently low that relevant actors put less faith in the informativeness of its share price as a predictor of its future distributions to shareholders discounted to present value. With such an issuer, price-related market mechanisms for controlling the agency costs of management are less effective in any event, and so the inaccuracies introduced by the misstatement would be less important.

Thus, a contingency-fee formula that is furthermore redesigned so as to reduce the fee percentage in cases with unusually high rates of turnover and to increase it in cases with unusually low ones would likely more closely match the amount of resources devoted to enforcement with social harm.

C. Private Litigation as a "User Fee"

A second response to the critique of the insufficient public-agency-budget rationale for allowing civil damage actions in the case of mandatory disclosure violations is to regard the costs imposed on investors arising from private securities litigation as roughly equivalent to a governmentally imposed "user fee." These costs would include the attorneys' fees for plaintiffs and for the issuer, experts' fees, executive time and attention, and the securities-damages-related portion of the administrative costs of D&O insurance, all of which will ultimately be borne by corporate investors as a class. These costs would not include any compensation received by investors for secondary market trading losses from purchasing inflated shares, because such compensation is simply a chance wealth distribution among investors.

Under this view, underfinancing public enforcement of mandatory disclosure rules is not a public decision to have a low total level of enforcement. Rather, it is a decision to rely on plaintiffs' lawyers to supplement public enforcers through an arrangement by which the segment of the population that benefits most from disclosure-compliance-induced improved corporate governance and liquidity—

Liquidity is more complex and so it is harder to dismiss the possibility of a relationship between turnover and social damage. A higher rate of turnover during the period that the misstatement affects price would suggest a higher rate of turnover more generally, and so the experience of the misstatement would have an effect thereafter on the bid/ask spread with regard to a larger volume of transactions. This might suggest more social damage. The effect of a bid/ask spread with regard to transactions that actually occur is purely a wealth transfer, however, and so a higher volume of transactions could merely mean more wealth would be transferred. The primary social harm from lower liquidity comes from the situations when a buyer or seller would wish to transact but for the unfavorable impact of the bid/ask price on the price he would have paid or received. Consider two issuers, *X* and *Y*, with the same increase in their respective bid/ask spreads due to a misstatement, but *X* has a higher rate of turnover than *Y*. If the higher turnover rate of *X* is the result of buyers and sellers rationally having reasons more often to want to buy and sell *X*'s shares, the increase in the bid/ask spread is going to block more such sales and purchases, and in the process do more social harm. If the higher turnover in *X* is due to some kind of irrational frenzy, it would not. For a discussion of reasons why different issuers might have different rates of turnover, see Andrew W. Lo & Jiang Wang, Stock Market Trading Volume (Sept. 5, 2001) (unpublished manuscript), *available at* http://home.uchicago.edu/~lhansen/vol4-4.pdf.

investors in publicly traded equities—will ultimately pay much of the costs of this enforcement. Focusing the costs of a public regulation on the segment that most benefits is perfectly sound public finance.

D. Legislative "Hands Tying" and Political Pressures on Administrative Agencies

The decision by a legislature to pass regulatory legislation that includes, explicitly or implicitly, a provision for civil liability can be viewed as a kind of "hands tying" exercise. The supposition behind this rationale is that the political actors who initially implement the rule fear that special interests who oppose the regulations will be able to more easily prevail later on and keep the budget low, thereby undermining the intended impact of the rule. As a result, they create a device, civil liability, that provides alternative social resources for enforcement should their fears prove correct.[39]

A related concern is a fear that administrative officials might fail to prosecute apparently worthwhile individual cases because of pressure from wealthy or powerful individuals who would be negatively affected. Civil liability, by providing an alternative avenue of enforcement, provides resources in cases where the legislature would want enforcement but where the responsible governmental agency does not act.[40] By providing this alternative, private enforcement can enhance the "rule of law," something that might be particularly important in countries where government administrators are prone to corruption or to the politicized application of justice, but where the judiciary is regarded as less subject to such pressures.

IV. CIVIL LIABILITY AS THE PRIMARY MEANS OF ENFORCEMENT

There are several additional justifications for civil liability for mandatory disclosure violations that are independent of the private-attorney-general rationale. The first of these alternative justifications begins with questioning whether it is right to regard civil liability as the substitute for public enforcement, rather than the other way around. Public regulation of issuer disclosure is not necessarily transformative in its consequences. As discussed above, private parties, through

39. A future legislature could of course reverse this decision by passing legislation eliminating the private cause of action. Opponents of the regulations, however, would require more strength to effect such a change in law than simply to keep the enforcement budget low.

40. Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 32–33 (2002); Jill E. Fisch, *Class Action Reform,* Qui Tam*, and the Role of the Plaintiff*, LAW & CONTEMP. PROBS. 167, 169 (1997).

ordinary contracting, would have otherwise come to substitute arrangements. While, because of market failure, such private arrangements would have led to a suboptimally low level of issuer disclosure, they would have still resulted in a significant portion of the disclosure that mandatory disclosure provides.

If there were no mandatory disclosure, the private arrangements that would have arisen instead would have been entirely enforced by civil damage actions. Private enforcement of private arrangements is the norm in our legal system; when people have their privately defined rights invaded, they are the best judges of whether it is worth pursuing a remedy.

Public enforcement is only needed when there is some kind of enforcement-market failure. Because of externalities, a system relying exclusively on privately enforced private contractual arrangements would not provide sufficient incentives for issuer managers to disclose at the socially optimal level. Still, a considerable portion of the needed incentives can come from private suits. The rest can come from public enforcement. Under this view, the public-enforcement budget is making up for a shortfall of private enforcement, not private enforcement making up for a shortfall in the public-enforcement budget.[41]

V. CIVIL LIABILITY AS GOVERNMENT OUTSOURCING

Allowing civil liability means that some portion of the total societal resources devoted to the enforcement of disclosure rules goes to private plaintiffs' law firms instead of to a public enforcement agency. Relying at least in part on private firms has certain advantages. Organizational economics suggests that organizations devoted to any particular task have an optimal size that involves a tradeoff between economies of scale and scope on the one hand, and the managerial-incentive problems that tend to grow with firm size on the other.[42] Where all enforcement is concentrated in a single governmental agency, the resulting

41. There is in fact evidence that, for issuers below a certain size, almost all enforcement action is brought by the SEC. *See* Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 588–99 (1997). These are cases where the expected damage award is too small to make the private costs of bringing suit worthwhile. *Id.* at 588. However, the deterrence value of the public actions, which private parties cannot capture, may well justify the resources devoted by the SEC. *See also* Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 109 (2005) (commenting that the delegation of enforcement to private parties allows an agency's "scarce resources to [be put toward] detecting and prosecuting . . . violations where private plaintiffs lack sufficient incentives").

42. *See, e.g.*, OLIVER HART, FIRMS, CONTACTS, AND FINANCIAL STRUCTURE 51 (1995).

organization may be much larger than this optimal size and thus will suffer diseconomies of scale.[43] If so, it would be more efficient to divide the work among a number of entities, each of which would be closer to this optimal size. Arguably, this is exactly what happens when a substantial portion of enforcement activities are undertaken by private plaintiffs' firms. Private firms also compete and therefore are not subject to the risk of becoming a "lazy monopolist" in the way a single government enforcement agency is.[44]

A private firm may also, as a general matter, more efficiently provide incentives for its agents than a government bureaucracy.[45] This advantage may be counterbalanced, however, by the idealism that motivates some government enforcers. The orientation of such governmental officials may also make them more attuned to steering resources to the cases that are most likely to serve public purposes, whereas private firms are more rigidly guided by whatever the fee formula, combined with expected damages, suggests would maximize net revenues.

According to the outsourcing rationale, allowing civil liability is not an end run around a legislative decision to devote a smaller amount of resources to enforcement. Rather, the aggregate amount of society's resources going into enforcement is satisfactory to the legislature, but, through the provision of court-approved plaintiffs' class-action attorneys' fees, a portion of these resources are given to parties that will arguably use them more efficiently than would public-enforcement officials.[46]

VI. PROMOTING LEGAL INNOVATION

Compared to relying entirely on public enforcement, civil liability will result in multiple entities, each with its own organizational culture and incentive structure, bringing enforcement suits. Multiple entities

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43. Richard B. Stewart & Cass R. Sunstein, *Public Programs and Private Rights*, 95 HARV. L. REV. 1193, 1298 (1982).

44. Barton H. Thompson, Jr., *The Continuing Innovation of Citizen Enforcement*, 2000 U. ILL. L. REV. 185, 199 (opining that citizen suits under the environmental laws combat the tendency of a public enforcement agency to display the pathologies of monopoly).

45. John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 224 (1983).

46. Even if outsourcing is desirable, it is not obvious that the current method by which private firms obtain their portion of these enforcement resources is the most efficient. To the extent that outsourcing is the rationale for civil liability, it is fair to ask why the government should not hire the firms or perhaps even auction the right to pursue claims.

provide multiple sources of initiative to come up with original legal arguments.[47] Some of these arguments will resonate with judges and become precedent. Thus, civil liability promotes innovation in the law and adaptation of the law to changing circumstances.[48]

A comparison between the United States and Japan may provide an example. The two countries share an almost identical securities-law statutory framework, yet, in significant part because of judicial lawmaking, securities law has developed far more in the United States in terms of providing authority as to whether particular behaviors violate the law.[49] Many of the precedents that constitute this authority have arisen out of private litigation.[50] In Japan, where there has been little private litigation, there are far fewer such precedents.

CONCLUSION

Critics have attacked the fraud-on-the-market class-action lawsuit brought by secondary-market investors for losses based on an issuer's violation of periodic mandatory disclosure requirements when the issuer has not traded. These critics have argued that the compensatory justification for such actions is illusory. This criticism appears valid, especially given the substantial social costs that such litigation involves. It ignores, however, the other potential function of civil liability: deterrence.

A deterrence justification for civil liability depends on finding the alternative social mechanisms to attain public-regulation compliance—governmentally imposed administrative and criminal sanctions—insufficient. In the case of securities disclosure regulation, the usual justification of civil liability is that allowing private plaintiffs to bring civil suits creates a body of private attorney generals who help society by supplementing the efforts of otherwise overstretched public enforcement officials. This argument is too simple absent further elaboration, because it is not self-evident that there is something

47. Stephenson, *supra* note 41, at 112–13; Thompson, *supra* note 44, at 199.

48. The downside to this innovation is the inconsistencies and incoherence that can develop from a hydra-headed authority, such as the courts, making rules as opposed to a single specialized agency. *See* Richard J. Pierce, Jr., *Agency Authority to Define the Scope of Private Rights of Action*, 48 ADMIN. L. REV. 1, 14–15 (1996).

49. *See* Alan L. Beller et al., *Looks Can Be Deceiving—A Comparison of Initial Public Offering Procedures Under Japanese and U.S. Securities Laws*, 55 LAW & CONTEMP. PROBS. 77 (1992); George F. Parker, *The Regulation of Insider Trading in Japan: Introducing a Private Right of Action*, 73 WASH. U. L.Q. 1399 (1995).

50. A similar contrast between the United States and Japan, attributable to the difference in the prevalence of private actions, has been noted with respect to the antitrust laws. Harry First, *Antitrust Enforcement in Japan*, 64 ANTITRUST L.J. 137, 179–80 (1995).

inappropriate in less than total enforcement of a rule when this shortfall occurs as a result of a political process that gives the enforcement agency a budgetary allocation smaller than what would be needed for full enforcement.

Responses to this challenge to the private-attorney-general rationale include the idea that a properly designed civil-liability scheme need not result in a greater than optimal level of enforcement. Also, a legislature might want to include private enforcement as an indirect way of charging a user fee on those who benefit the most from the regulation. In addition, civil liability may be a safeguard provided by a legislature against inappropriately low future budgetary allocations for enforcement that it knows are likely because of expected special-interest pressure or against a politicized or corrupted administrative enforcement body.

There are also other reasons for having civil enforcement besides supplementing public enforcement. Under one view, private litigation can be justified as the natural primary enforcement mechanism, with public enforcement being the supplement. Another view is that civil liability constitutes an outsourcing to private agents of work the government wants accomplished. Finally, civil liability may be needed to promote socially useful legal innovation.

The case for retaining civil liability would be strongest if the underlying cause of action were reformed in a way that, as I have proposed elsewhere, explicitly recognizes the primacy of its deterrence function. Fraud-on-the-market actions against the issuer would be eliminated. Liability would instead be focused on corporate officers and directors and on some kind of outside external certifier of an issuer's periodic disclosure reports. Damages would be paid to the issuer, not to investors who suffer trading losses.

Absent such a broad reform, however, it would be better not to eliminate issuer fraud-on-the-market liability. Despite the weakness of its compensatory justification, the cause of action serves important deterrence functions that are unlikely to be equally well performed by public enforcement alone. If it can be shown that the fraud-on-the-market cause of action is resulting in overenforcement of mandatory disclosure rules, the better response is a recalibration of the class-action plaintiffs' lawyer contingent-fee structure, not elimination of the cause of action altogether with nothing in its place.