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***Stoneridge Investment Partners v. Scientific-Atlanta* (8<sup>th</sup> Cir. 2006)  
What Makes It the Most Important Securities Case in A Decade?**

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*Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*<sup>1</sup> is scheduled for oral argument before the U.S. Supreme Court on October 9, 2007. It has been described as “arguably the most important securities law case to reach the Court in a decade”<sup>2</sup> and as securities lawyers’ “*Roe v. Wade.*”<sup>3</sup> What is the legal issue that has occasioned this much attention? Phrased as a technical legal argument, plaintiff asserts that it may establish that outside actors<sup>4</sup> committed a Rule 10b-5 violation on a theory of “scheme liability;” in contrast, defendants assert that *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>5</sup> which found no statutory basis for aiding and abetting liability, precludes plaintiff’s theory of liability.

What is on trial before the Supreme Court, however, may be the future of private securities fraud litigation. Beyond the legal issue, the parties’ positions reflect the differing views in the ongoing debate on the value of private securities fraud litigation. Thus, plaintiff argues that scheme liability enhances the compensatory and deterrent functions of private litigation, while defendant argues that scheme liability is simply aiding and abetting under a new label and presents the same risks of uncertain and expansive interpretation that led both the Court and, later, Congress to conclude that

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<sup>1</sup> 443 F.3d 987 (8<sup>th</sup> Cir. 2006).

<sup>2</sup> Description taken from CWRU program, Oct. 5, 2007.

<sup>3</sup> Professor Donald Langevoort, NPR, Oct. 1, 2007.

<sup>4</sup> Outside actors is used in this paper to describe actors other than the issuer and its officers, directors or controlling persons.

aiding and abetting would contribute to abusive private litigation. Thirty one *amicus* briefs have been filed in the case, about equally divided between the plaintiff's and the defendant's position.<sup>6</sup> There was disagreement within the executive branch as to which side the Solicitor General should support – the SEC (not unanimously) voted to file in support of the plaintiff and the Treasury Department urged support for the defendant, with President Bush himself reportedly breaking the tie and deciding that the government would support the defendant's position.<sup>7</sup> Most recently, the SEC announced that it would, in response to a letter from six law professors, hold a spring 2008 roundtable to air the various positions on private securities litigation.<sup>8</sup>

This paper will first analyze the legal issue in *Stoneridge*, describe the policy issues from the perspective of the *amicus* briefs and then provide some commentary on the case's significance to the law and policy of private securities fraud litigation. This paper is a work-in-progress, to be continued upon the Court's opinion.

## **I. Scheme Liability**

*The Central Bank Opinion.* A municipal Public Building Authority issued bonds to finance public improvements at a development. The bonds were secured by liens on the property, and the bond covenants required that the land be worth at least 160% of the bonds' outstanding principal and interest and that the developer provide an annual report to the indenture trustee to that effect. Prior to the second issuance of bonds, Central Bank of Denver, the indenture trustee, had concerns that the 160% test was not being met. Instead of obtaining an independent appraisal at that time, as it was permitted, but not

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<sup>5</sup> 511 U.S. 164 (1994).

<sup>6</sup> List *amicus* filers.

<sup>7</sup> Washington Post article

<sup>8</sup> BNA Daily

required, to do, the Bank agreed to postpone the appraisal until year-end. Shortly after the issuance of the bonds, the Authority became insolvent. The complaint alleged that the Bank's reckless conduct aided and abetted the securities fraud.

In holding that § 10(b) liability did not extend to aiding and abetting, the majority of the Justices found that the statutory language controlled. The statute prohibits conduct involving manipulation or deception and does not include giving aid to a person who commits a manipulative or deceptive act. The majority also found this result consistent with policy, noting that secondary liability exacts costs that may disserve the goals of fair dealing and efficiency in the securities market.<sup>9</sup>

Finally, the majority noted that its decision did not foreclose primary liability on outside actors, since:

[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person ... who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.<sup>10</sup>

After *Central Bank*, Congress amended the Securities Exchange Act to allow the SEC to bring aiding and abetting actions,<sup>11</sup> but declined to extend the right to private parties, citing the concerns about abusive securities fraud litigation.<sup>12</sup>

*The Eighth Circuit Opinion.* Stoneridge Investment Partners (Stoneridge) brought this securities fraud class action on behalf of purchasers of the stock of Charter Communications, Inc. (Charter), alleging that Charter engaged in a “pervasive and

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<sup>9</sup> 511 U.S. at 1454.

<sup>10</sup> *Id.* at 191.

<sup>11</sup> 15 U.S.C. § 78t(d).

continuous fraudulent scheme intended to artificially boost the Company's reported financial reports"<sup>13</sup> through a variety of ways over a period of nearly three years, including transactions with two equipment vendors, Scientific-Atlanta, Inc. and Motorola, Inc. (collectively, the "vendors"), who were named as defendants.<sup>14</sup> According to the complaint's factually detailed allegations, Charter agreed to pay the vendors \$20 over the contract price for each set-top box in exchange for the vendors returning the additional money in the form of advertising fees. Plaintiff alleged that the vendors knew, or at least recklessly disregarded, that these were sham transactions done for the sole purpose of inflating Charter's operating cash flow in order to meet analysts' expectations for one quarter during the class period. The district court dismissed the claims against the vendors on the basis of *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>15</sup> because, in its view, the allegations, if proven, would establish only that the vendors aided and abetted Charter's fraud.<sup>16</sup>

In affirming the district court, the Eighth Circuit confronted the troublesome issue left open by *Central Bank* -- the distinction between primary and secondary liability. The Eighth Circuit derived three governing principles from *Central Bank*. One of them is incontrovertible: the scope of liability under Rule 10b-5 cannot exceed the statute; hence, to be liable, one must "use or employ" a "manipulative or deceptive device or

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<sup>12</sup> Legislative history

<sup>13</sup> 443 F.3d at 989.

<sup>14</sup> Other defendants were Charter, ten Charter executives and Charter's auditor, Arthur Andersen, LLP.

<sup>15</sup> 511 U.S. 164 (1994).

<sup>16</sup> After the district court dismissed the complaint for failure to state a claim against the vendors, plaintiff sought reconsideration of the dismissal of the claims against the vendors and moved to amend the complaint to include additional allegations that detailed the vendors' knowledge of, and participation in, the fraudulent scheme that it had recently obtained through discovery. The district court refused to reconsider the dismissal and denied the motion to amend, since filing an amended complaint would be futile. 2004 WL 3826760 (E.D. Mo. Dec. 20, 2004).

contrivance.”<sup>17</sup> Another principle is well-established in Supreme Court case law: the term “manipulative” in federal securities law has a narrow, technical definition (“virtually a term of art,”<sup>18</sup> as the Supreme Court puts it) referring to certain illegal trading practices such as “wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.”<sup>19</sup> As a result of these two principles, most Rule 10b-5 claims are based on the statute’s “deceptive device or contrivance,” and, at least until *Central Bank*, most allegations involved material misstatements<sup>20</sup> or material omissions when there was a duty to disclose.<sup>21</sup> According to the Eighth Circuit, then, *Central Bank*’s third governing principle is that liability premised on a deceptive device or contrivance requires that the defendant make a material misstatement (or material omission when there is a duty to disclose).<sup>22</sup> As a result of this line of reasoning, the Eighth Circuit held that the vendors could not be primarily liable because they did not make any public misstatements about Charter’s financial condition and they did not owe Charter investors any duty to disclose.<sup>23</sup>

Besides this statutory analysis, the court also articulated policy grounds for its holding:

[t]o impose liability for securities fraud on one party to an arm’s length business transaction in goods or services other than securities because that party knew or should have known that the other party would use

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<sup>17</sup> 443 F.3d at 992. The Supreme Court has stated this many times; *see, e.g.*, *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77(1977).

<sup>18</sup> *Id.* at 476-77.

<sup>19</sup> *Id.* The Fifth Circuit agreed with the Eighth Circuit’s analysis and rejected the district court’s use of scheme liability to certify a class action brought on behalf of Enron investors against several investment banks. *See Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, F.3d (5<sup>th</sup> Cir. 2007).

<sup>20</sup> Rule 10b-5(b).

<sup>21</sup> Rule 10b-5(a) or (c).

<sup>22</sup> 443 F.3d at 992.

<sup>23</sup> *Id.*

the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be left to Congress.<sup>24</sup>

*The Ninth Circuit Opinion.* In contrast, the Ninth Circuit recognized scheme liability as a viable theory in *Simpson v. AOL Time Warner Inc.*,<sup>25</sup> although it held that the plaintiff's allegations failed to state the claim. Plaintiff attempted to impose liability on AOL Time Warner for its business relationships with Homestore that were allegedly part of a fraudulent scheme to overstate Homestore's revenues. According to the complaint, Homestore would find a financially strapped corporation and agree to purchase shares at an inflated price, or goods and services it did not need, in exchange for the corporation's agreement to buy advertising from AOL Time Warner. AOL Time Warner, in turn, would share the revenue with Homestore pursuant to their advertising agreement.

Unlike the Eighth Circuit, the Ninth Circuit did not interpret the statute or *Central Bank* as requiring that a primary violator make a material misstatement (material omission etc.) to investors. Instead, it read the phrase "deceptive device"<sup>26</sup> more broadly as encompassing deceptive acts in furtherance of the scheme. Largely adopting the SEC's test set forth in an *amicus* brief, the Ninth Circuit held that primary liability could be imposed in a private suit if the defendant

engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a *transaction* in which the defendant was involved had a deceptive purpose and effect;

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<sup>24</sup> *Id.* at 992-993.

<sup>25</sup> 452 F.3d 1040 (9<sup>th</sup> Cir. 2006).

<sup>26</sup> The Supreme Court defines "device" in § 10(b) as "an invention; project; scheme; often, a scheme to deceive;" *see* *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 n. 20 (1976).

the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect.<sup>27</sup>

Adoption of a more expansive test, however, did not help the plaintiff, since the plaintiff did not allege that the advertising agreements were illegitimate or sham transactions.<sup>28</sup> In this way, the Ninth Circuit was able to assert that its holding was consistent with the Charter and Enron cases, as those courts had viewed the transactions as customary business transactions. Most commentators, however, view the Eighth and Ninth opinions as creating a split in the circuits.<sup>29</sup>

In contrast to the Eighth Circuit, the Ninth Circuit's opinion is light on policy analysis, stating only that it saw no policy justification to limit liability only to those who make public statements.<sup>30</sup> It also repeated the Supreme Court's rubric (generally used in actions when the SEC or the government is the plaintiff) that § 10(b) "should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes."<sup>31</sup>

*Reliance and Loss Causation.* Interpreting a "deceptive device or contrivance" as encompassing more than material misstatements/omissions – an interpretation that is consistent with the Supreme Court's guiding principle, "plain meaning" --, however, does not necessarily establish a private claim based on scheme liability, as *Central Bank* makes clear that all elements of a Rule 10b-5 claim must be established to establish

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<sup>27</sup> 452 F.3d at 1048.

<sup>28</sup> The Ninth Circuit remanded so that the plaintiff could seek leave to amend the complaint.

<sup>29</sup> authority

<sup>30</sup> *Id.* at 1049. The Ninth Circuit actually goes further than the statement in the text and imposes primary liability on those who draft and edit public statements. This is a minority position, *see* *Wright v. Ernst & Young*, 152 F.3d 169 (2d Cir. 1998).

<sup>31</sup> *See, e.g., SEC v. Zanford*, 535 U.S. at 819.

primary liability.<sup>32</sup> If the Charter securities fraud class action named only Charter and other inside actors, it would be a typical “fraud on the market” material misrepresentations case, with the plaintiff having the presumption of reliance under *Basic Inv. v. Levinson*<sup>33</sup> and the burden of proving loss causation under *Dura Pharmaceuticals, Inc. v. Broudo*.<sup>34</sup> What is the appropriate analysis under a scheme liability theory? Specifically, are the elements of reliance and causation<sup>35</sup> required, and if so, how are they satisfied?

There is some authority that where the claim is based on a fraudulent scheme there is no need to establish reliance.<sup>36</sup> The Ninth Circuit relied on the fraud on the market theory and held that reliance is established “if the introduction of misleading statements into the securities market was the intended end result” of the scheme.<sup>37</sup> The difficulty with this analysis is that focus on the misleading statements may lead to a perceived conflict with *Central Bank*’s concern about imposing primary liability based on a misstatement on someone who made no statement to the plaintiffs.<sup>38</sup>

The most relevant Supreme Court precedent is *Superintendent of Insurance v. Bankers Life & Casualty*.<sup>39</sup> Manhattan Casualty allegedly was the victim of a complicated fraud that allowed a buyer of all its stock to pay for it with Manhattan’s own assets. Part of the fraud involved Manhattan’s sale of its Treasury bonds that may have

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<sup>32</sup> 511 U.S. at 1455.

<sup>33</sup> 485 U.S. 224 (1988).

<sup>34</sup> 544 U.S. 336 (2005).

<sup>35</sup> In addition, there is arguably an issue as to whether the vendors’ conduct was “in connection with” the market purchases of Charter’s stock, although there is no basis for not applying the Supreme Court’s expansive interpretation of the “in connection with” requirement under *SEC v. Zandford*, 535 U.S. 813 (2002), to private actions. Finally, a question as to how materiality would apply in this context, since the vendors’ played a small part in the overall fraud.

<sup>36</sup> See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION CASES AND MATERIALS* 697 (5<sup>th</sup> ed.)

<sup>37</sup> 452 F.3d at 1040.

involved deceiving the board that the corporation would receive the proceeds.<sup>40</sup> The Supreme Court, in reversing the lower courts' dismissal of the complaint, found that Manhattan, as seller of the bonds, was protected by the statute's prohibition against 'any manipulative or deceptive device or contrivance' in contravention of the rules and regulations of the Securities and Exchange Commission.<sup>41</sup> The Court does not discuss whether Manhattan had relied on any acts or statements made by any of the defendants, thus supporting the view that liability premised on a scheme does not require a showing of reliance. Rather, the court's language supports an interpretation that only causation is required: "the crux of the matter is that Manhattan suffered an injury as a result of deceptive devices touching its sale of securities..."<sup>42</sup> However, the significance of *Bankers Life* as precedent is diminished for several reasons. It was authored at an earlier time in Rule 10b-5 jurisprudence, before the Supreme Court began to interpret the statute more restrictively.<sup>43</sup> It involved a single defrauded plaintiff and thus does not raise the difficulties presented by modern securities fraud class actions. Finally, the Supreme Court's holding is limited to stating that the plaintiff, as a seller of securities, could bring a Rule 10b-5 claim; the opinion states that it does not address other elements of the cause of action.

*Loss Causation.* Section 21D(b)(4) of the Securities Exchange Act<sup>44</sup> requires the plaintiff in any private action to prove that the "act ... of the defendant ... caused the loss

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<sup>38</sup> 511 U.S. at 1455.

<sup>39</sup> 404 U.S. 6 (1971).

<sup>40</sup> The Supreme Court says this in a footnote, but the district court opinion, which gives a much more extensive findings of fact, does not state this..

<sup>41</sup> *Id.* at 167,

<sup>42</sup> *Id.* at 12-13.

<sup>43</sup> Post *Santa Fe*, the Supreme Court might well find that the scheme in *Bankers Life* involves breach of fiduciary duty and not securities fraud.

<sup>44</sup> 15 U.S.C. § 78u(b)(4).

for which the plaintiff seeks to recover damages.” This requires that the plaintiff plead “some indication of the loss and the casual connection that the plaintiff has in mind.”<sup>45</sup> In the typical fraud on the market case alleging misstatements that inflated the stock price, plaintiff must demonstrate that the defendant’s misrepresentation caused an economic loss, not intervening market conditions. This is done through showing a drop in the stock price when the misstatement is exposed as false. What impact *Dura* has on scheme liability is unclear. In post-*Dura* cases alleging market manipulation, courts require a showing from plaintiffs that the prices at which they purchased or sold securities were artificially inflated or deflated by the manipulation.<sup>46</sup> Since, however, the basic allegation in *Stoneridge* is false financial information entering the marketplace, the loss causation requirement should be the same as in *Dura*. The allegations against the vendors involve inflated operating cash flow of \$17 million for one quarter during a period of nearly three years.

## II. Policy Perspectives from the *Amicus* Briefs.

Of the fifteen *amici* that support the plaintiff’s position, six were filed on behalf of states or public retirement funds that frequently serve as lead plaintiffs in securities litigation.<sup>47</sup> Other *amici* included North American Securities Administrators Association, several investors and consumers advocacy groups,<sup>48</sup> law professors, former SEC Commissioners,<sup>49</sup> Members of Congress,<sup>50</sup> and a trial lawyers’ association.<sup>51</sup> The policy

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<sup>45</sup> *Dura*, 125 S. Ct. at 1634.

<sup>46</sup> *See, e.g.*, *DH2, Inc. v. Athanassiades*, 404 F. Supp. 2d 1083 (N.D. Ill. 2005).

<sup>47</sup> The states specifically state they are interested as institutional investors as well as guardians for small investors.

<sup>48</sup> *E.g.*, AARP, Consumer Federation of America and U.S. PIRG filed a joint brief.

<sup>49</sup> Former Chairs Arthur Levitt and William Donaldson and Commissioner Goldschmid.

perspectives of the *amici* are similar. They generally assert that scheme liability is essential to promote the overarching goals of investor confidence and integrity of the securities markets. Complex financial frauds necessarily involve multiple actors, and the goals of compensation and deterrence would not be fully met if investors could not sue outside actors who actively participated in schemes designed to defraud them. This is consistent with the long recognized benefit of private securities litigation as a supplement to SEC and criminal enforcement. Moreover, with respect to compensation, third parties are frequently the only defendants with sufficient assets to satisfy a judgment, especially in cases where the issuer has declared bankruptcy. Given the requirement of scienter and PSLRA's heightened pleading requirements, the fears that actors who engage in legitimate business transactions with securities violators will be threatened with abusive litigation are unfounded. Finally, Congress addressed the abuses of private securities fraud litigation in PSLRA; further judicial restrictions on the statute's plain meaning are unwarranted.

Fifteen *amici* (excluding the Solicitor General, which will be discussed separately below) were filed in support of defendant's position, representing a broad segment of business associations,<sup>52</sup> business lawyers, accountants,<sup>53</sup> securities firms,<sup>54</sup> a group of former SEC commissioners and professors,<sup>55</sup> and the exchanges.<sup>56</sup> As in the case with plaintiff's *amici*, their arguments are similar. They assert that scheme liability is *Central*

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<sup>50</sup> The Honorable John Conyers, Jr., Chair, House Committee on the Judiciary, and Barney Frank, Chair, House Committee on Financial Services.

<sup>51</sup> American Association of Justice.

<sup>52</sup> E.g., The Business Roundtable; U.S. Chamber of Commerce.

<sup>53</sup> The American Institute of Certified Public Accountants.

<sup>54</sup> E.g., SIFMA and the Futures Industry Association filed a joint brief.

<sup>55</sup> Including Former SEC Commissioners Hills, Pitt, Williams, Charles Cox, Fleischman, Friedman, Grundfest, Hunt, Karmel, Lochner, Peters, Roberts, Unger, Wallman.

<sup>56</sup> The New York Stock Exchange and Nasdaq.

*Bank*-prohibited aiding and abetting with a new label, an uncertain and open-ended theory of liability that would promote abusive securities litigation. It is clear that collectively the effort is a full-scale attack on private securities litigation. Some of the references are angry, with references to “clever and unscrupulous” plaintiffs and even a reference to the indictment of the Milberg Weiss firm; others more dispassionately address the irrationality of damages to discredit the compensatory goal of private securities litigation.

The *amici* also make reference to and repeat the arguments set forth in three recent reports asserting the declining competitiveness of the U.S. capital markets.<sup>57</sup> Thus, they argue that recognizing scheme liability would increase the costs of doing business with U.S. public companies, may even lead to outside actors avoiding doing business with U.S. public companies, and reduce the efficiency and competitive position of the U.S. capital markets. In sum, recognizing scheme liability would result in increased costs and little if any benefit – the SEC has the necessary tools to enforce the securities laws against aiders and abettors.

The *amicus* brief filed by the Solicitor General warrants special mention, both for the suspense as to which side the government would support and for its legal analysis. Like the other *amici* on defendant’s side, the government believes that the plaintiff should not be able to maintain its action against the vendors on a scheme liability theory. However, it arrives at this legal conclusion through a different route. It finds the Eighth Circuit’s interpretation of § 10(b) too narrow as encompassing only misstatements, omission when a duty to disclose, and manipulative trading practices. In its view, respondents’ alleged conduct constituted deceptive conduct within the statute’s plain

meaning.<sup>58</sup> The Eighth Circuit, however, was correct in dismissing the complaint against the vendors, because the causal connection between respondents' conduct and plaintiff's stock purchases was too attenuated to satisfy the reliance and loss causation requirements. The government believed that recognizing scheme liability would risk subjecting to liability outside actors too far removed from the market.

### **III. Commentary**

If *Stoneridge* is the most important most securities case, it is in part because the Supreme Court has accepted certiorari in just a few securities cases since *Central Bank*. Only three of them involve issues related to private securities fraud litigation, all decided in the last years – *Dura Pharmaceuticals v. Broudo*,<sup>59</sup> *Merrill Lynch v. Dabit*,<sup>60</sup> and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*<sup>61</sup>

More fundamentally, however, the post-PSLRA securities fraud class action is under scrutiny. In PSLRA Congress recognized the value of private securities fraud litigation, while at the same time it acknowledged its abuses. Accordingly, it legislated restrictions that were designed to weed out abusive securities fraud litigation and allow meritorious litigation to proceed. Nevertheless, despite a period of massive corporate financial fraud, the business community's opposition to private securities fraud class actions continues unabated. It has been advancing three principal arguments: the competitive disadvantages of the U.S. capital markets because of excessive securities litigation; the harm that private securities class actions inflicts on innocent shareholders

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<sup>57</sup> See *infra* note 62.

<sup>58</sup> The SEC does not have authority to bring aiding and abetting liability under the Securities Act, so the distinction between primary and second liability remains significant to them in this context.

<sup>59</sup> 544 U.S. 336 (2005) (loss causation).

<sup>60</sup> 126 S. Ct. 1503 (2006) (the scope of SLUSA preemption).

<sup>61</sup> 127 S. Ct. 2499 (2007) (pleading scienter).

of the issuer, who bear the cost of compensating other innocent investors; and the lack of necessity for private securities fraud litigation in the face of new SEC power to compensate investors. Each of these is discussed briefly below.

*The Competitive Disadvantage Resulting from Excessive Securities Litigation.* In late 2006-early 2007 three widely publicized reports<sup>62</sup> were released that sounded the alarm over the declining economic dominance of the U.S. capital markets. Each identified excessive securities fraud class action litigation as a disincentive to using the U.S. public capital markets, particularly for foreign corporations. The Bloomberg-Schumer Report named implementing securities litigation reform as a “critically important near-term priority.”<sup>63</sup> Similarly, the Capital Markets Regulation Report noted that “securities class actions do not exist in other major markets”<sup>64</sup> and “the public value of the securities class action litigation is questionable.”<sup>65</sup> Finally, the Chamber of Commerce Report supported efforts to reform the litigation system to reduce frivolous lawsuits<sup>66</sup> and urged the SEC to conduct a study on whether PSLRA was meeting its objectives.<sup>67</sup>

*The Harm Securities Class Action Litigation Inflicts on Small Investors.* The essential circularity of damages in securities class actions is not a newly discovered

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<sup>62</sup> The Interim Report of the Committee on Capital Markets Regulation (Nov. 30, 2006) (an independent, bipartisan committee composed of 22 corporate and financial leaders from the investor community, business, finance, law, accounting, and academia) (“Capital Markets Regulation Report”); Sustaining New York’s and the U.S. Global Financial Services Leadership (Jan. 23, 2007) (NYC’s Mayor Michael R. Bloomberg and New York Senator Charles E. Schumer asked McKinsey & Co. to work with the New York City Economic Development Corporation to interview financial services industry CEOs and other business leaders) (the “Bloomberg-Schumer Report”); and the Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century Report and Recommendations (Mar. 2007) (an independent bipartisan commission established by the U.S. Chamber of Commerce) (“Chamber of Commerce Report”).

<sup>63</sup> Bloomberg-Schumer Report at 100.

<sup>64</sup> Capital Markets Regulation Report at 5.

<sup>65</sup> *Id.* at 78.

<sup>66</sup> Chamber of Commerce Report at 12.

<sup>67</sup> *Id.* at 31.

problem; from the earliest Rule 10b-5 class actions, judges and commentators have expressed concern that the corporation's current innocent shareholders pay for the recoveries to other innocent investors.<sup>68</sup> Professor Coffee's 2006 law review article<sup>69</sup> expanded on the ramifications of this problem in arguing that that justification for private securities fraud litigation must be deterrence and not compensation. Both the Capital Markets Regulation Report and the Chamber of Commerce Report cite Professor Coffee's article to show that it is the longterm shareholders who bear the costs of private litigation, despite the fact that *Stoneridge* itself would impose liability on outside actors.

*Private Securities Litigation Unnecessary in Light of Increased SEC Powers.* As part of the Sarbanes-Oxley Act of 2002, Congress enacted § 308, the Fair Funds provision, which gives the SEC the power, in certain circumstances, to distribute corporate penalties imposed in SEC enforcement actions to shareholders as a Fair Fund. The SEC has embraced its power enthusiastically and has publicized with pride the large sums of money it has collected for investors pursuant to this provision. As a result, many in the business community have asserted that the private securities fraud class action has become unnecessary in light of the SEC's power.<sup>70</sup>

Apart from the policy arguments, the perception that plaintiffs' attorneys are less interested in investor justice and more interested in holding up the corporation for their personal gain is, unfortunately, enhanced by the 2006 indictment of the Milberg Weiss law firm and allegations that its partners made illegal kickbacks to named plaintiffs.

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<sup>68</sup> E.g., Friendly in TGS concurrence

<sup>69</sup> John C. Coffee, Jr., *Reforming the Securities Fraud Class Action: An Essay on Deterrence and its Implications*, 106 COLUM. L. REV. 1534 (2006).

<sup>70</sup> See Barbara Black, *Should the SEC be a Collection Agency for Defrauded Investors?* (forthcoming).

In the face of this energetic campaign by opponents of securities fraud class, the proponents have responded with the classic justifications for private enforcement: investor confidence in the capital markets. Compensation and deterrence are essential components of investor confidence. Accordingly, investors – particularly, small undiversified investors<sup>71</sup> -- will lose confidence in the markets if they cannot recover something for their losses from corporate fraud. In addition, investor confidence requires that corporate wrongdoers be punished, both to deter the specific wrongdoers and, more importantly, to deter future wrongdoing. Despite assertions that the “SEC has all the necessary tools,” empirical studies<sup>72</sup> and common sense tell us that the SEC cannot investigate and bring enforcement actions against all corporate wrongdoers. The private attorney general concept expresses the perception that securities class actions are a necessary supplement to the SEC’s enforcement powers in order to serve as a deterrent. Finally, in the post-PSLRA era, why has there been so little recognition that the private remedy has been substantially cut back, with presumably the elimination of many frivolous suits?

It remains to be seen how much force these classic arguments in favor of private securities class actions retain for the Supreme Court.

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<sup>71</sup> While no investor should have an undiversified portfolio, the small investor who is encouraged to buy stock in his employer may lack sufficient sophistication to understand this point and may not understand the availability of better investment vehicles, given the complexity of mutual fund disclosures and recent scandals involving mutual funds.

<sup>72</sup> James Cox and Randall Thomas, *SEC Enforcement Heuristics*, 2003 DUKE L.J. 738