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The Investor Compensation Fund

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The Investor Compensation Fund

Alicia Davis Evans*

The prevailing view among securities regulation scholars is that compensating victims of secondary market securities fraud is inefficient. As the theory goes, diversified investors are as likely to be on the gaining side of a transaction tainted by fraud as the losing side. Therefore, such investors should have no expected net losses from fraud because their expected losses will be matched by expected gains. This Article argues that this view is flawed; even diversified investors can suffer substantial losses from fraud, presenting a compelling case for compensation.

The interest in compensation, however, should be advanced by better means than are currently in place. The present system relies on securities class action lawsuits to compensate victims, but these suits not only undercompensate victims, but also underdeter fraud. To improve compensation and better deter fraud, this Article explores the creation of an investor compensation fund. Under this proposal, when a share of stock is sold in the secondary market, a fee, payable by the selling shareholder, will be placed into a fund for fraud victim restitution. The size of the fee will vary by the fraud risk rating assigned to the firm whose stock is sold and, naturally, will affect that stock's trading price. Therefore, firms will have incentives to institute corporate governance practices that minimize the likelihood of fraud.

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I. INTRODUCTION

In 1985, Frank Easterbrook and Daniel Fischel, in an influential article, asserted that active traders with diversified portfolios are as likely to be on the gaining side of a transaction tainted by securities fraud as on the losing side.¹ Therefore, diversified investors should have no expected net losses from fraud because their expected losses will match their expected gains.² The idea of compensation for securities fraud losses has been under attack in the legal academy virtually ever since this article was published. Though Easterbrook and Fischel ultimately argue against ending compensation for securities fraud losses,³ scholars, nevertheless, have used Easterbrook and Fischel's insight to decry the provision of securities fraud compensation as inefficient and to promote reforms that would eliminate it from the securities regulation regime.⁴ In 2005, the U.S. Chamber of Commerce Institute for Legal Reform commissioned an empirical study to test the theoretical assertion that securities fraud risk can be diversified away. The study purported to find that large diversified institutional investors generally break even on their investments in firms accused of fraud.⁵ The study captured mainstream media attention,⁶ reflecting the importance of the issue to the business community and the public more broadly.

This Article challenges the idea that fraud compensation for investors is not warranted. All investors, including diversified investors, can suffer substantial injury from securities fraud, and because there is measurable harm from fraud, there is a basis for granting compensation to its victims. This Article also contends that, as a practical matter, political exigencies make achieving the end of shareholder compensation in the post-Enron era unlikely. Therefore, what is most appropriate at this time, in my view, is an exploration of ways to provide compensation more effectively and efficiently.

1. Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 641 (1985).

2. *See id.*

3. *Id.* Easterbrook and Fischel state,

[T]he optimal damages in [secondary market fraud] cases are [not] zero just because most gains and losses net out. There will be the usual net harms of the costs of guarding against and litigating about the wrong, and there will be an allocative efficiency loss if transactions of a particular sort create uncompensated risk. The larger the transfer among investors, the more they will spend guarding against the problem.

Id. Easterbrook and Fischel, however, do argue that “the optimal [damage] award is surely a good deal smaller than the gross transfer of wealth.” *Id.* at 641-42.

4. *See, e.g.*, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487 (1996) (proposing a shift from traditional securities litigation to a system of civil penalties to deter fraud); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 983 (1999) (advocating an end to securities litigation and outlining an alternative enforcement regime run by stock exchanges with no damages to be paid to victims of fraud).

5. ANJAN V. THAKOR ET AL., THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION 12-14 (2005), available at <http://www.instituteforlegalreform.org/issues/docload.cfm?docId=855>.

6. *See* Jonathan D. Glater, *Critics of Shareholder Suits Aim at Big Holders*, N.Y. TIMES, Oct. 27, 2005, at C (describing the U.S. Chamber study); Kenneth M. Lehn, Commentary, *Private Insecurities*, WALL ST. J., Feb. 15, 2006, at A16 (providing commentary that refers to the U.S. Chamber study).

The current compensatory mechanism, the securities class action lawsuit, has important shortcomings. Defrauded shareholders currently rely primarily on class actions (so called “fraud on the market suits”) filed against corporations and corporations’ officers and directors for compensation for securities fraud losses. However, these suits provide limited compensation. The average securities fraud settlement award is trivial in relation to shareholder losses, with recovery of as little as 2%-3% of estimated damages.⁷ Shareholder losses stemming from fraud at a large firm with actively traded stock can total billions of dollars, easily dwarfing the amounts available for shareholder compensation from current sources, i.e., payouts under directors’ and officers’ (D&O) liability insurance policies, company funds, and, occasionally, the personal resources of officers and directors. Moreover, not only do fraud on the market suits provide minimal compensation, but they also do a poor job of deterring fraud. These suits often allow the perpetrators (e.g., corporate officers) to evade personal responsibility by settling such suits, with no admission of wrongdoing, using the corporation’s money or the proceeds of D&O insurance policy payouts.⁸ This seriously undermines the purported deterrence effect of such lawsuits on corporate managers.

To improve compensation and better deter fraud, this Article explores the creation of an investor compensation fund (ICF). Under this proposal, fraud on the market suits will be eliminated, and a special purpose insurance fund will be created to provide investor restitution for fraud-related losses. Every time a share of stock or similar security is sold in the secondary market, a fee (premium) will be collected from the selling shareholder and placed into the fund. A firm’s fraud risk rating, reflecting the likelihood of fraud occurring, will determine the size of the fee to be paid by each selling shareholder. The ICF premium feature acts as a fraud deterrent because the size of the ICF premium will be reflected in a company’s share price, providing incentives for managers to institute the control mechanisms necessary to minimize the likelihood of fraud. The ICF also offers the promise of a large source of funding for defrauded shareholder compensation.

In addition to setting forth a reform proposal, this Article makes another contribution to the literature. Exploring the creation of an investor compensation fund provides an opportunity to consider the advantages and disadvantages of *ex ante*⁹ (i.e., regulation through the use of fraud risk ratings) and *ex post* (i.e., litigation) approaches to limiting harm from securities fraud. There are costs and benefits to both approaches to managing the securities fraud problem. The ICF, with elements of both approaches, can

7. See LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS, 2006 REVIEW AND ANALYSIS 6 (2007) (finding settlements represent a median 2.4% of “estimated damages” in 2006 and 3.6% of “estimated damages” in 1996-2005), available at http://www.cornerstone.com/pdf/practice_securities/2006Settlements.pdf. Cornerstone Research cautions that its damages estimates should not be assumed to be the amount of actual damages borne by shareholders, as the figure is derived using a highly simplified methodology. *Id.* at 4. Thus, one should employ caution when comparing investor recoveries to this measure of damages. Nonetheless, it is clear that, on average, there is a sizable difference between typical settlement recoveries and investor losses. It should be noted, however, that there are exceptions to this general rule and that recovery as a percentage of total losses is generally higher in smaller settlements. *See id.* at 6.

8. For exceptions to this general rule, see, e.g., Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1057 (2006) (“In [the Enron and WorldCom settlements], outside directors agreed to make substantial payments out of their own pockets to settle securities class action lawsuits . . .”).

9. Of course, the securities laws now employ a robust regulatory mechanism. However, implementing the ICF would add to this regime significantly.

be used as a vehicle to highlight some of the more salient issues and tradeoffs in this area.

The Article proceeds as follows. Part II addresses what, given the current state of securities regulation scholarship, is likely to be one of the principal objections to the ICF Proposal by responding to the argument against compensation for securities fraud losses. The section does not include a full discussion of all of the considerations relevant to compensation for securities fraud losses, but rather outlines responses to those who argue that such compensation is unnecessary. Part III of the Article briefly examines the securities class action mechanism and describes its shortcomings. Part IV sets forth the ICF Proposal and addresses potential objections and key implementation challenges. Creation of the ICF, though in all likelihood an improvement over the current regime as a theoretical matter, would entail significant implementation and administrative challenges. This Article, by design, does not address fully all of these challenges, but rather suggests what the primary concerns about implementation of a proposal of this type might be. Finally, Part V of the Article considers several alternative reform proposals. After reviewing these proposals, it should become clear that the ICF is not as unorthodox as it may seem initially. All of the proposals are in some respects similar to the ICF and have attractive features. However, in comparing these schemes to the ICF, one will be able to recognize the unique advantages of the ICF and its ability to provide superior compensation to securities fraud victims and deter fraud.

II. RESPONSE TO THE ANTI-COMPENSATION ARGUMENT

Many leading scholars oppose the idea of compensation for securities fraud losses. The following statement, made by Janet Cooper Alexander in a well-known article, is representative of the prevailing view:

The chance of being on the losing or winning side of a transaction when the stock price is distorted by a securities violation can be assumed to be random. The more trades investors make, the more likely that, in the aggregate, their gains from trading while material facts are withheld will equal their losses.¹⁰

Under this theory, active traders with diversified portfolios will benefit as often from securities fraud as they will be harmed by it. Therefore, investors should have no expected overall losses from securities fraud, making efforts to provide compensation inefficient.

Under the capital asset pricing model (CAPM), investors receive compensation (investment returns) *only* for bearing systematic risks. A systematic risk is a risk that affects almost all stocks trading on the market to a greater or lesser degree (e.g., inflation, interest rates, general economic conditions). An unsystematic, or idiosyncratic, risk, on the other hand, is a risk that affects one or a small number of stocks trading on the market (e.g., a failed product launch, the loss of a key executive). Under this model, proper diversification virtually eliminates an investor's exposure to unsystematic risk and thus is

10. Alexander, *supra* note 4, at 1502. There are two investors (ignoring for present purposes the role of any "market maker" that matches buy and sell orders) involved in each trade of a stock artificially inflated by securities fraud. The shareholder (Shareholder A) who purchased stock before the commencement of any fraud and then sold that stock to another investor (Shareholder B) at an artificially inflated price *while* the fraud was occurring but *before* the fraud was uncovered benefited from the fraudulent scheme and enjoyed a "gain."

a prudent investment strategy.

The argument set forth by those who oppose compensation for securities fraud is not merely that fraud risk is idiosyncratic, like many other business risks, and hence can be largely eliminated by diversification. Their claim is different. They suggest that, with respect to securities fraud risk specifically, the risk of loss from fraud is, on average, equal to the prospect of gain *from fraud elsewhere* (not just a gain from any other type of business occurrence).¹¹ The focus by compensation opponents on the purported equality of gains and losses, rather than diversification generally, serves as a tacit acknowledgement that securities fraud risk is different in kind from other types of business risks and that its effects should be considered separately.¹² Indeed, securities fraud risk is different. Even risk-seeking investors who intentionally fail to diversify feel legitimately cheated by securities fraud. Investors understand that the market entails risk and that some investment decisions will lead to losses. However, buying a stock while fraud is ongoing disadvantages an investor in an unfair way. Fundamental company analysis is meaningless when the information upon which that analysis is based is fraudulent.

Those who oppose compensation for securities fraud losses effectively assert that, on average, investors are not harmed by fraud on the market. This is a type of corrective justice argument, though generally not expressed as such.¹³ Corrective justice requires compensation in the face of harm.¹⁴ Thus, even if it were true that, in the aggregate, gains and losses from fraud are equal,¹⁵ there are a number of instances in which this will

11. A CAPM adherent could make the claim that diversification alone would provide investors with substantial protection from fraud. Just as an investor could lose 75% of her investment in a company because of fraud, an investor could see the value of her investment in another company increase because of some unexpected good news (e.g., a company in which she is invested has discovered the cure for cancer). I leave to future work exploration of whether securities fraud is fully diversifiable generally. However, because in my view, as described in this section, fraud risk is different in nature from other business risks, the answer to this question does not affect the basic thesis of this Article.

12. *But see* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 13 (2007) (arguing that “[t]he risk of simple securities fraud is like any other ordinary business risk”).

13. These are notable exceptions, however. For examples of works in which corrective justice is discussed in connection with securities litigation, see Elizabeth Chamblee Burch, *Reassessing Damages In Securities Fraud Class Actions*, 66 MD. L. REV. 348, 371-72 (2007) (describing, but ultimately rejecting, the corrective justice argument for private securities class actions); William M. Sage, *Some Principles Require Principals: Why Banning “Conflicts Of Interest” Won’t Solve Incentive Problems in Biomedical Research*, 85 TEX. L. REV. 1413, 1462 (2007) (briefly discussing the failure of fraud on the market suits to advance corrective justice).

14. *See, e.g.*, Jules L. Coleman, *The Practice of Corrective Justice*, 37 ARIZ. L. REV. 15, 15 (1995) (“[T]hose who are responsible for wrongful losses of others have a duty to repair them . . .”). In the discussion that follows, the Investor Compensation Fund will be described as advancing the aims of corrective justice by requiring the wrongdoers (i.e., the corporate officers participating in the fraud) to contribute to the fund, while providing an insurance mechanism to cover the gap between the wrongdoers’ ability to pay and the total losses caused. *See* text accompanying *infra* note 316.

15. It should be noted that the gains-equals-losses in the aggregate argument does not hold with respect to non-insiders in the presence of insider trading. (“Insider trading” is trading by insiders (e.g., company officers) while in possession of material, non-public information.) If insiders commit securities fraud by deceiving the market about a firm’s prospects and do so to be on the winning side of trades tainted by fraud, then outside shareholders, by definition, will be on the losing side of these trades. Thus, when factoring in trades by insiders, on average, outsiders will be net losers. *See generally* Pritchard, *supra* note 4, at 946 n.78 (stating that “investors cannot diversify away wealth transfers to” traders with an asymmetric information advantage); *see also* Booth, *supra* note 12, at 14 (“Fraud with insider trading constitutes a net loss to investors in the

not be true for any individual investor.¹⁶ The examples that follow illustrate that securities fraud can cause substantial injury to investors of all types. Compensation, therefore, is justified to make these investors whole.

A. Asymmetries Stemming from the Market's Reaction to Fraud Announcements

The losses of the investors on the losing side of trades tainted by fraud are more likely to exceed the gains of the investors on the winning side of such trades, without regard to diversification or trading activity. While fraud is ongoing, but before it is revealed, investors who sell fraud-tainted stock have an “improper” gain equal to the sale price of the stock minus the price at which the stock would trade in the absence of fraud. At the time of the trade, the investor that buys the fraud-tainted stock has an equivalent unrealized loss in the form of overpayment. However, when the fraud is revealed, the price of the stock generally does not decline only to where it would have been in the absence of fraud. Instead, the stock declines further, as the market discounts the price of the stock for the uncertainty surrounding what additional bad news may be forthcoming from the company.¹⁷ There is a fundamental asymmetry here. Under this scenario, for gains and losses from fraud to be equivalent over time, an investor has to find herself on the winning side of fraud-tainted trades more, by dollar volume, than she finds herself on the losing side. Being on either side in roughly equal proportions is not sufficient to avoid net overall losses.

Even if the market's response upon the fraud disclosure is a temporary overreaction, compensation for loss is still justified. It may be true that if the market overreacts to the news of fraud by lowering the stock price too much, then investors who purchase at the excessively low price are achieving a gain. This result then leads to a situation where shareholder gains and losses again are equal in the aggregate. However, the type of investor that decides to sell upon a fraud announcement because of fears of additional bad news to come is of a different type than the speculative trader who buys the stock precisely at that moment because she believes she is receiving a bargain. The shareholder who sells after the fraud revelation suffers harm, and the gain of the speculative trader does not diminish that harm in any way.

B. The Potential for Loss is Substantial for all Investors

There is empirical evidence that demonstrates that, in any individual case, even large, diversified investors can suffer significant net harm from securities fraud. In 2005, the U.S. Chamber of Commerce Institute for Legal Reform, a vocal foe of the current

aggregate.”).

16. “Individual” in this context means “single,” as opposed to multiple. As used here, “individual” does not refer only to natural persons.

17. See Shantaram P. Hegde, Chris B. Malone & John D. Finnerty, *The Financial Impacts of Fraud and Securities Class Action Suits* 41 (Jan. 7, 2003) (unpublished manuscript) (“Overall, the [study’s] findings are consistent with the proposition that investors faced with fraud allegations and ongoing uncertainty about a firm’s reputation and prospects will exit *en-masse* such firms, almost without regard to price. Investors are clearly ‘frightened’ by concerns over agency costs, information asymmetry, bad reputation and uncertainty.”), available at <http://207.36.165.114/Denver/Papers/10b5.pdf>; see also Booth, *supra* note 12, at 5 (describing the negative effect the anticipation of the company paying damages in a securities class action suit can have on stock price upon a fraud revelation).

securities litigation regime,¹⁸ commissioned an empirical study (the “U.S. Chamber Study”) to test the theoretical assertion that aggregate trading gains and losses from fraud, over time, are equivalent. The authors of the study, which review trades over a ten-year period, find that large, diversified institutional investors¹⁹ have an average (median) fraud-related net trading loss of \$5 million (\$0.25 million).²⁰ The authors acknowledge the potentially devastating effects of securities fraud on undiversified investors,²¹ but conclude the theoretical assertions of the anti-compensation camp are correct—over time, net losses from securities fraud for *large, diversified* investors will be approximately zero. However, the U.S. Chamber Study, while purportedly providing evidence that compensation for securities fraud is unnecessary for large, diversified investors, finds results that are telling: even large, diversified investors can be large net losers from securities fraud.

The data reproduced in the U.S. Chamber Study show that several large institutional investors suffered significant trading losses during the ten-year study period. Though one investor (out of 2,596) enjoyed a net gain of over \$200 million, 18 investors suffered net losses exceeding \$200 million.²² Eight of these 18 investors had net losses exceeding \$500 million, and one investor suffered a net loss of over \$1 billion.²³ No investor enjoyed gains exceeding \$300 million.²⁴ These findings are significant because the U.S. Chamber Study, which purports to describe trading gains and losses from every securities

18. For an example of the securities litigation issues on which the Institute for Legal Reform focuses, see, Inst. for Legal Reform, Securities Litigation, <http://www.instituteforlegalreform.com/issues/issue.cfm?issue=SLI> (last visited Sept. 18, 2007).

19. Defined as those investors required by the SEC to file quarterly Form 13F statements detailing their investment holdings. See THAKOR ET AL., *supra* note 5, at 10-11. Investors that are required to file 13Fs are investment managers with \$100 million or more in assets under discretionary management. SEC, Division of Investment Management: Frequently Asked Questions About Form 13F, May 2005, available at <http://www.sec.gov/divisions/investment/13ffaq.htm>. Managers must report all long common stock positions of at least 10,000 shares or \$200,000 in fair market value. *Id.* One of the limitations of the U.S. Chamber study is that it must rely on Form 13Fs, which aggregate data for fund families (e.g., all of the Fidelity funds or all of the Janus funds). No data is available for individual funds within the organization. Investors do not invest in fund families, but rather in individual funds. Therefore, any insights derived from this study cannot fairly be described as giving us a sense for what any individual investor would have experienced as a result of securities fraud over the ten-year study period. However, the study is useful in that it attempts to simulate the experience of large, diversified investors.

20. This figure does not factor in any potential recoveries from litigation. THAKOR ET AL., *supra* note 5, at 12.

21. *Id.* at 19.

22. *Id.* at 12 fig.2, as confirmed by study authors.

23. *Id.*

24. *Id.* The sample in this study includes corporations that issued shares during the class action period, and the study’s results show that, overall, investor net losses are likely to be greater when the defendant corporation issues shares during the class action period. See THAKOR ET AL., *supra* note 5, at 15-17 (discussing this finding). As the authors explain, this is because, under this scenario, the corporation itself sells shares to the market, which creates a situation under which the number of shares purchased by investors will exceed the number of shares sold by investors while the fraud is ongoing. *Id.* at 15. This finding may explain, in part, the reason for the asymmetry between the number of extreme net gainers and extreme net losers in the study. One must note that because the study does not limit its sample exclusively to frauds that affect secondary market prices only, but also includes cases that affect primary market purchases, the results are somewhat less relevant to a consideration of the creation of the Investor Compensation Fund, which, as described *infra*, will provide recovery for instances of fraud that affect secondary market prices only. It is clear that investors suffer net losses when purchasing shares at artificially inflated prices directly from the corporation.

fraud case involving common stock,²⁵ shows that even professional investors with large, diversified portfolios can find themselves on the losing side of trades tainted by fraud more often than on the winning side and incur net losses of \$1 billion or more over a ten-year period. Thus, if the study's authors are correct, not only is it possible for gains and losses to fail to be exactly equivalent or even approximately equivalent over time, they can be significantly different. The existence of losses of this magnitude (\$5 million on average or as much as \$1 billion) suggests that securities fraud risk is significant—too significant for a prudent investment manager to ignore. Indeed, potential uncompensated losses of this magnitude can lead to allocative efficiency losses, as investors expend resources attempting to guard against the harm from securities fraud.²⁶ Specifically, these traders will spend time ferreting out information related to fraud risk, at the expense of gathering information that bears on company fundamentals (e.g., sales growth potential and market competition).²⁷ Even diversified investors want to avoid being on the losing side of a trade tainted by fraud²⁸ and will take the necessary steps to achieve this objective.

Of course, if the U.S. Chamber Study is correct, for large, diversified institutions, *expected* net losses from fraud should be approximately zero, even if reality can differ and differ substantially. If the managers of institutions believe the findings of the U.S. Chamber Study (i.e., believe that gains and losses, over time, will be equal) and act rationally, eliminating compensatory mechanisms for securities fraud loss would have no effect on their behavior. We would expect to see no resources expended by such investors to guard against the harm of uncompensated (ex post) losses because they have no reason to believe that their outcomes will differ from the average. However, managers of institutional investors do not always behave rationally.²⁹ This suggests that these managers indeed will engage in what some may term inefficient behavior by expending resources to minimize their downside exposure. No manager wants to suffer large investment losses of any sort, including from fraud, regardless of any gains from fraud she unknowingly may have enjoyed in the past or may enjoy in the future. In fact, because of loss aversion,³⁰ investors are likely to be far more worried about fraud losses than they are pleased by the prospect of fraud gains. Loss aversion applies in many contexts, but it is reasonable to conclude that its effect would be magnified in the securities fraud context because the investors that achieve “gains” do not know they are receiving a gain at the time they receive it and, indeed, may never realize it.

C. Buy-and-Hold Investors are Likely to Suffer Significant Harm from Securities Fraud

The fraud losses of buy-and-hold investors, even those who are well diversified, are

25. The cases studied exclude analyst and IPO cases. *Id.* app. I at 1.

26. See Easterbrook & Fischel, *supra* note 1, at 641.

27. See generally Pritchard, *supra* note 4, at 941-42 (discussing the effect of fraud on research and verification efforts by traders).

28. Easterbrook & Fischel, *supra* note 1, at 641.

29. See Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 17-20 (2003) (describing the ways in which institutional managers “suffer from behavioral biases”).

30. Under the theory of “loss aversion,” the loss of, for example, \$100 hurts an investor more than gaining \$100 will provide pleasure. Richard H. Thaler, *Mental Accounting Matters*, 12 J. BEHAV. DECISION MAKING 183, 185 (1999).

likely to exceed any gains from fraud.³¹ Those who assert that expected gains and losses from fraud over the long-term will be approximately equal assume active trading.³² This is because one must sell stocks with prices that are inflated by fraud as often (by approximate dollar volume) as one buys stocks with prices that are inflated by fraud. Alexander, a proponent of the anti-compensation argument, acknowledges that the purported offsetting of fraud-related gains and losses is a reflection of “statistical probabilities.”³³ As Alexander states, “The more trades that are made and the more diversified the investments, ... the more an individual’s experience is likely to approach the statistical mean.”³⁴ Thus, if an investor is risk averse (which is generally the case), she will want to reduce the variance (a measure of the extent to which potential outcomes may differ from expected returns) and have her actual outcome be as close to the expected outcome as possible.³⁵ This is achieved by active trading, rather than holding a constant portfolio, no matter how well diversified.³⁶ Thus, the only way for an investor to “protect” herself from being a “net loser” from securities fraud is not only by diversifying, but also by trading frequently.

Imagine the extreme case of the buy-and-hold investor that buys, but never sells (i.e., she holds the stocks in her portfolio until infinity). If this investor purchases a stock with a price that is inflated by fraud, the amount of this overpayment will never be recouped by a gain from selling a stock that also has an inflated price. This investor never sells. It is, of course, somewhat unrealistic to speak of an investor that never sells stock. Liquidity needs prompt virtually every investor to sell some stock eventually. However, the net buyer (rare seller) is not likely to have equivalent gains and losses from fraud. Thus, it is clear that this type of investor, who is following a rational investment strategy, is not going to be economically indifferent to the incidence of fraud.³⁷

31. This analysis relies on the assumption that there are more instances of “bad news” fraud (i.e., fraud that results in an artificially high stock price because bad news is concealed) than “good news” fraud (i.e., fraud that results in an artificially low stock price because good news is concealed). This is generally understood to be the case. *See, e.g.*, Booth, *supra* note 12, at 6 (“There are notable examples of both types of fraud, but bad news fraud is far more common . . .”).

32. *See, e.g.*, Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646 (1996) (“At least *active* traders with large, diversified portfolios have roughly the same chance of being winners as losers from securities fraud . . .”) (emphasis added).

33. Alexander, *supra* note 4, at 1502 n.58.

34. *Id.*

35. *See* RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 84-85 (2d ed. 1995) (discussing how variance decreases with increased numbers of transactions (coin flips in their simplified example)).

36. Recall the anti-compensation argument is not that fraud risk is diversifiable just like any other business risk, but that gains and losses from the same risk—namely fraud risk—will be equal.

37. For other arguments that buy-and-hold and long-term investors suffer net losses from securities fraud, see Booth, *supra* note 12, at 11 n.23 (describing the “intergenerational conflict” that, according to Julian Velasco, affects the “equivalent gains and losses” argument). Velasco suggests that younger buy-and-hold investors are net buyers and suffer disproportionately from fraud that inflates stock prices because they may not sell as often as they buy. *Id.* Though they will sell periodically for tax or rebalancing reasons, there is some question as to whether the number of purchases will outweigh the number of sales. *Id.* Velasco points out that these investors will become net sellers as they age, and then the bias will reverse. *Id.* However, this “may not be enough to overcome the time-value of earlier lost returns.” *Id.*; *see also* Jill Fisch, *Criminalization of Corporate Law: The Impact on Shareholders and Other Constituents*, 2 J. BUS. & TECH. L. 91, 94 (2007) (arguing, generally, that though short-term “in and out” traders benefit from fraud, investors in indexed mutual funds suffer because index funds do not “get out of [the stock of] a company [engaging in fraud].”) [hereinafter Fisch,

The evidence suggests that the typical buy-and-hold investor is a retail investor.³⁸ Therefore, retail investors are more likely to suffer harm from securities fraud than institutions because individuals generally trade less frequently than institutions. Though annual market turnover exceeds 100%,³⁹ suggesting highly active trading in the market overall, one survey of 2,187 retail investors conducted by the Investment Company Institute and the Securities Industry Association found that 60% of these investors did not trade at all in 2004; 57% of those that did trade made fewer than six trades that year.⁴⁰ Other studies have found similar levels of trading activity among retail investors.⁴¹ Though they trade infrequently, retail investors, according to a 2000 report on share ownership by the New York Stock Exchange (NYSE), directly own approximately 40% of the value of U.S. stocks⁴² and therefore comprise a significant portion of the investment community. Therefore, the assumption of active trading is not a valid one for a meaningful segment of the investor population.

One could argue that, even if active trading is required to eliminate the risk of securities fraud, we simply could encourage retail investors not only to diversify, but to diversify and trade frequently. However, doing so would have adverse consequences. Frequent trading is costly for retail investors, and not only because of transaction costs,⁴³

Criminalization of Corporate Law].

38. "Retail investors" are natural persons.

39. See, e.g., New York Stock Exch., NYSE Group Turnover Statistics, <http://www.nysedata.com/nysedata/Home/FactsFigures/tabid/115/Default.aspx> (follow "Market Activity" hyperlink; then follow "NYSE Group Turnover" hyperlink) (last visited Sept. 18, 2007).

40. INV. CO. INST. & SEC. INDUS. ASS'N, EQUITY OWNERSHIP IN AMERICA 25 fig.34 (2005), available at http://www.ici.org/shareholders/dec/1rpt_05_equity_owners.pdf. The survey defines an equity trade as either the sale or purchase of a corporate stock or shares in a mutual fund. *Id.* at 39. Thus, these figures overstate the level of direct trading by retail investors.

41. For example, one study analyzing retail trading behavior between 1991 and 1996 finds that the average turnover rate in portfolios at a retail brokerage house was 7.59% and that the typical retail investor made fewer than ten trades per year. Alok Kumar & William N. Goetzmann, *Equity Portfolio Diversification* 8 (Yale ICF, Working Paper No. 00-59, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=287998. Another study, which followed the trading behavior of individual investors over a six-year period, finds that the median number of stocks traded by retail investors in a month was 0.37. Gina Nicolosi et al., Do Individual Investors Learn from Their Trading Experience? 19 *tbl.1* (unpublished manuscript) (2004), available at <http://faculty.gsm.ucdavis.edu/~nzhu/papers/learning.pdf>; cf. Brad M. Barber & Terrance Odean, *Trading is Hazardous to Your Wealth*, 55 J. FIN. 773, 781 (2000) (analyzing a set of discount brokerage data and finding that "[t]he average household turns over more than 75 percent of its common stock portfolio each year"). Barber and Odean further note that the high turnover rate among the individuals in their study contributed to lower returns. *Id.* at 773. Even if the Barber and Odean study sample is more representative of the overall individual investor population with respect to trading frequency than those in the studies described above, and this is not clear, there are still valid reasons, as described in this section, not to provide incentives for excessive trading by eliminating compensation for fraud losses. Moreover, an investor that owns a small number of stocks (e.g., four stocks) can turn over 75% of her portfolio in a year by making only a few sell/buy trades (e.g., three) in that year. Thus, for purposes of this discussion, this still would represent a low level of trading activity.

42. NEW YORK STOCK EXCH., SHAREOWNERSHIP 2000: BASED ON THE 1998 SURVEY OF CONSUMER FINANCES 34 (2000), available at <http://www.nyse.com/pdfs/shareho.pdf>. This figure on "household sector" ownership (41.1%) includes ownership by individuals and nonprofit institutions. *Id.* at 33. Nonprofit holdings are estimated to be approximately 5% of the household sector total. *Id.* It also should be noted that the corporate stock represented in this data includes some closely held stock. *Id.* at 32-33.

43. See, e.g., Barber & Odean, *supra* note 41, at 775 ("Trading costs are high. The average round-trip

there is evidence that frequent trading leads to lower overall returns for such investors.⁴⁴ In addition, for at least the past 70 years, financial economists have warned against the risk of excessive trading and have worried that investors focused on achieving short-term gains through speculation would hinder the primary purpose of the market (i.e., allocating capital to American businesses).⁴⁵ So, were compensation for securities fraud discontinued, investors, in effect, would have incentives to trade more, perhaps more than is justified by company fundamentals, in order to sell some “lemons” to others and protect themselves from the risk of fraud.⁴⁶

D. The Undiversified Investor Has a Legitimate Claim to Protection From Fraud

There is no question that undiversified investors can suffer substantial harm from securities fraud. Despite the oft-repeated call to diversify, many retail investors in the United States do not hold well-diversified portfolios. According to the most recent Survey of Consumer Finances published by the Federal Reserve Board, almost 60% of individual investors (households) surveyed hold stock in three or fewer companies, and approximately 35% hold stock in only one company.⁴⁷ Another study of retail investor diversification finds similar results and shows not only that individuals invest in low numbers of stocks, but also that even those individuals investing in larger numbers of stocks invest in the wrong *mix* of stocks for sufficient diversification.⁴⁸ In this study, the researchers find no evidence that retail investors make up for their lack of diversification by mutual fund or “safe” investing elsewhere,⁴⁹ suggesting the figures reported, in all likelihood, accurately reflect the lack of diversification in the United States. Though reasons for the lack of diversification vary⁵⁰ and may be economically irrational, the

trade in excess of \$1,000 costs three percent in commissions and one percent in bid-ask spread.”)

44. See, e.g., *id.* at 774 (stating that their study evidence shows “households that trade frequently earn a net annualized geometric mean return of 11.4 percent, and those that trade infrequently earn 18.5 percent”).

45. See Dean Baker et al., *The Case for a Securities Transactions Tax: Taxing the Big Casino* 1-2 (Econ. Pol’y Inst., Technical Paper No. 229, 1995).

46. Doing so, of course, would accomplish nothing with respect to lessening overall investor losses from fraud, but each investor would have incentives to try to avoid being on the losing side of fraud-tainted trades.

47. Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL. 2006, at A15 (2006), available at <http://www.federalreserve.gov/pubs/oss/oss2/2004/bull0206.pdf>.

48. See, e.g., Mark S. Rzepczynski, *Portfolio Diversification: Investors Just Don’t Seem to Have Enough*, JWH J. (John W. Henry & Co., Boca Raton, Fla.), 2003, at 2, available at http://www.jwh.com/Documents/JWHJournal_2003.pdf (discussing results of study performed by Kumar and Goetzmann, described in note 41, *infra*). As Rzepczynski explains, the study finds that even for the portfolios that hold larger numbers of stocks, there is no “appreciable difference in the average correlation across the stocks.” *Id.* Thus, the holders of these portfolios do not appear to do a better job at diversifying (other than because of the higher numbers of stocks owned) than do the holders of portfolios with a small number of stocks. *Id.*

49. Kumar & Goetzmann, *supra* note 41, at 4 (noting that mutual fund allocation was approximately 15% of the investors’ overall portfolios, on average, and that such allocation did not vary significantly by investor based on diversification of the studied portfolio).

50. See *id.* at 31-32 (stating that the reasons for the lack of diversification include (1) search and monitoring costs, (2) the “false perception” by investors “that they can manage their portfolio risks better by a thorough understanding of a small number of firms rather than diversifying,” (3) an illusory sense of control stemming from direct involvement in the investment process in lieu of reliance on others (e.g., through mutual funds) to make investment decisions, and (4) gambling tendencies).

reality is that many retail investors, who as a group directly hold over 40% of the value of U.S. stocks, are not well diversified. Thus, even if being diversified would make one as apt to be on the winning side of a trade tainted by fraud as on the losing side, this would not be the case for many retail investors who simply are not diversified. Thus, failing to provide compensation for securities fraud losses would harm a large segment of the investment community and could discourage more widespread participation in securities markets.⁵¹

One of the fundamental tenets of our legal system is that when someone is harmed by the misconduct of another, she should receive compensation for her loss. The commission of securities fraud can lead to real human suffering, primarily in cases where retail investors are not properly diversified and lose virtually all of their savings because of an investment in a company engaging in fraud. Richard Booth, in accord with the conventional wisdom in this area, argues that the law should provide no compensation to investors for fraud-related losses.⁵² According to Booth, “it is irrational for an investor not to diversify,”⁵³ and diversified investors, in the absence of insider trading, will suffer no harm from securities fraud.⁵⁴ Therefore, because “[s]ecurities law should protect only reasonable investors,”⁵⁵ no compensation for securities fraud losses is necessary.

As previously discussed, not only the undiversified or irrational are harmed by securities fraud; even diversified investors can suffer measurable harm. However, even if it were the case that only investors who failed to diversify adequately could suffer fraud-related losses, it does not necessarily follow that compensation is not warranted. When corporate officers commit fraud by intentionally misleading shareholders who lose money on their investments, the investors have a legitimate claim to be made whole, without regard to whether they could have self-insured against the loss by diversifying.⁵⁶

51. There is evidence that individual investors already believe that they are protected against losses from securities fraud. See OPINION RESEARCH CORP., INVESTOR SURVIVAL SKILLS SURVEY: AN EXAMINATION OF INVESTOR KNOWLEDGE AND BEHAVIOR 8 (2005) (showing that 92% of individual investors surveyed do not know that their investments are not insured against losses from securities fraud by the government), available at http://www.sipc.org/pdf/121305_SIPC_IPT_survey.pdf. Approximately 80% of those surveyed believe their investments are insured by the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), and/or the Securities Investor Protection Corporation (SIPC), which only protects investors against loss of property (e.g., cash and securities) at failed brokerage firms. *Id.* One possible source of the confusion may stem from the reforms passed following the spate of accounting scandals in connection with the Sarbanes-Oxley Act, such as the creation of Fair Funds, discussed in Part V.A., *infra*. In any event, if there is another major accounting scandal that leaves investors largely uncompensated for their losses (as will be the case, with respect to the lack of compensation, in the absence of reform), investors will be disabused of their mistaken belief in the existence of meaningful insurance protection and may exit the markets. It is worthwhile to note that the survey participants are current investors. It is, therefore, conceivable that a belief in the existence of an insurance mechanism gives these investors greater confidence to invest. Providing a real insurance fund, such as the ICF, discussed in Part IV, *infra*, and publicizing its existence, may encourage more individuals to enter the market.

52. Booth, *supra* note 12, at 11. For a description of exceptions to this view, see *id.* at n.40.

53. *Id.* at 12. Booth offers limited exceptions to this general view. See *id.* at 14-15 & n.40.

54. *Id.* at 12, 14.

55. Booth, *supra* note 12, at 10.

56. One might argue that what would be most appropriate given the foregoing arguments is for compensation for fraud losses to be provided only to undiversified investors. However, such a regime could have negative unintended consequences. First, it could result in companies eschewing investments by individual investors on the margin. If managers intend to engage in fraud, in such a regime, they would prefer to have

E. Political Considerations

Even if one remains unconvinced of the necessity or appropriateness of compensation in this context, it seems clear that current political exigencies make achieving the end of shareholder compensation unlikely. The 1995 Republican-led Congress enacted, over President Clinton's veto, sweeping reforms to the securities class action system through the Private Securities Litigation Reform Act (PSLRA) in an effort to make securities fraud suits more difficult to bring and win.⁵⁷ However, despite the broad nature of the reforms, neither the PSLRA, nor any proposed legislation leading up to passage of the PSLRA, eliminated or even substantively reduced the compensation available for fraud losses.⁵⁸ This suggests that Congress may have been far from enamored with securities litigation, but still saw some value in providing damages for losses, or found it politically unviable to limit them. If Congress in 1995 was unwilling to abolish compensation, it is unlikely that any post-Enron era Congress would consider doing so. If Congress declared an end to compensation for victims of securities fraud, there undoubtedly would be expressions of outrage from investors. The economic arguments against investor compensation would not be able to withstand the ensuing political pressure amid the public demand for justice.⁵⁹ Thus, in my view, it is appropriate for securities regulation scholars to consider ways to provide compensation effectively and efficiently.

diversified investors (such as large institutions) in the pool of potential claimants. (To discourage individual stock ownership, firms could fail to do stock splits after significant stock price increases or fail to market their shares to individual investors. Of course, one may argue that a manager intent on engaging in fraud would prefer an investor base consisting more of retail investors than institutional investors because retail investors are less likely to serve as effective monitors. However, there is reason to question whether an investor base comprised exclusively (or almost so) of institutions would engage in substantially more monitoring than occurs now. See *infra* note 113 for further discussion of this point.) In addition, providing compensation for only undiversified investors could provide incentives for individual investors to avoid mutual fund investments in favor of direct investment. Though the benefits of diversification that may be achieved through a mutual fund are substantial, investors may forego that benefit if they feel they will have more protection from fraud by investing directly in stocks. Finally, administering such a scheme would be very challenging because claimants would have to prove not only that they were shareholders in the subject company, but also prove that they lack sufficient additional investments, so as to be considered a true "undiversified investor." Compensation for all fraud losses suffered by all investors, therefore, should be an integral part of our securities regulation regime.

57. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. (1995) (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

58. See Alexander, *supra* note 4, at 1488 (recognizing that, despite "the sweeping changes that won approval in one or both houses," no reform "addressed the measure of damages"). One limited exception to the foregoing is the so-called "bounceback" provision (codified at 15 U.S.C. § 78u-4(e)) which affects damages awards by separating fraud-related losses from losses caused by market conditions at the time of the corrective disclosure. John Finnerty & George Pushner, *An Improved Two-Trader Model for Measuring Damages in Securities Fraud Class Actions*, 8 STAN. J.L. BUS. & FIN. 213, 224 (2003). The PSLRA accomplishes this by requiring that plaintiff damages in "bad news" fraud cases be no more than the difference between the price paid for the stock and (1) the average trading price during the 90-day period following the corrective disclosure or (2) the average price during the period the stock is held by the investor following the corrective disclosure if shorter than 90 days. 15 U.S.C. § 78u-4(e)(1)-(2). Comparable provisions apply in "good news" fraud cases. Despite the enactment of the bounceback provision, the basic calculation of damages for securities fraud losses was unchanged by the PSLRA.

59. Of course, the creation of an investor compensation fund, as described *infra* Part IV.C.8., poses its own set of political challenges.

III. SECURITIES CLASS ACTIONS

In the prior section, I argue that compensation is a necessary feature of securities regulation. However, the primary means of providing compensation to defrauded shareholders, the securities class action lawsuit, is largely ineffective.⁶⁰ Under Rule 10b-5 of the Securities Exchange Act of 1934 (the “Exchange Act”),⁶¹ private litigants may sue a corporation and its officers and directors for securities fraud if the private litigants either purchased or sold securities during a period when fraud affected the price of the securities. These so-called “fraud on the market” suits, however, provide limited compensation for fraud-related losses. According to Cornerstone Research, the average securities fraud settlement award in each of 2006 and 2005 represented only 2.4% and 3.1%, respectively, before plaintiffs’ attorneys’ fees, of estimated shareholder damages.⁶² Despite the small recoveries, the securities class action provides more compensation for investors than any other means. The Securities and Exchange Commission (SEC) itself concluded, “private litigation [rather than SEC enforcement action] remains the best mechanism for investor recovery of losses.”⁶³ This is an unfortunate fact, indeed, given the small amounts available for investor restitution.

The low level of compensation to the shareholder class is driven in part by the nature of the insurance market. Damages in securities fraud cases equal the difference between the price paid⁶⁴ for the share of stock and what the price would have been in the absence of fraud, multiplied by the number of shares traded while the fraud is ongoing.⁶⁵ For a large firm with actively traded stock, these damages can total billions of dollars. For example, 18 (out of over 90) of the securities litigation cases settled in 2006 had estimated damages, as defined by Cornerstone Research, of over \$5 billion; half of these cases had estimated damages exceeding \$10 billion.⁶⁶ Though there are notable exceptions,⁶⁷ research shows the overwhelming majority (96%, by one estimate) of

60. Securities class actions have been highly criticized along a number of dimensions. In this section, I focus only briefly on their effectiveness with respect to compensation and deterrence and on the cost of administration.

61. 17 C.F.R. § 240.10b-5 (2007).

62. SIMMONS & RYAN, *supra* note 7, at 6. See text accompanying note 7, *supra*, for cautionary language regarding these damages estimates. Plaintiffs can pursue parties other than the corporation and its officers, such as auditors, in hopes of achieving higher recoveries. However, according to one plaintiffs’ attorney with over 25 years of securities litigation experience, with whom I spoke on condition of anonymity, establishing liability for non-insiders and winning such cases is typically more difficult. Telephone Interview with plaintiffs’ attorney (June 21, 2007) [hereinafter Telephone Interview #1]. See also John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1550 (2006) (stating, “Auditors... appear to be named as defendants in only a very low percentage of securities class actions”).

63. SEC, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES-OXLEY ACT OF 2002, at 20 (2003) [hereinafter SEC, SECTION 308(C) REPORT], available at <http://www.sec.gov/news/studies/sox308creport.pdf>.

64. This also can be the price sold if the allegation of fraud involves the withholding of “good news” that would have made the price higher than the one at which the investor sold. These claims, however, occur much less frequently than claims that the price was inflated by the nondisclosure of bad news. See discussion in note 31, *supra*.

65. This definition of damages, though accurate, oversimplifies the complicated damages calculation. See note 122, *infra*, for further discussion on the damages calculation.

66. SIMMONS & RYAN, *supra* note 7, at 4.

67. Coffee, *supra* note 62, at 1556.

securities class actions settle within D&O insurance policy limits.⁶⁸ Corporations cannot afford the premiums on, and insurers are not willing to offer, policies with liability limits that even would begin to approach the total measure of damages in large-scale fraud cases.⁶⁹ In fact, there is evidence that insurers generally do not offer policy limits in excess of \$300 million.⁷⁰ Therefore, the limits imposed by the D&O insurance marketplace generally preclude full compensation for investor losses.⁷¹

Not only are fraud on the market suits ineffective at providing meaningful compensation, they are also largely ineffective at deterring fraud. The securities class action supplements the efforts of the SEC and the U.S. Department of Justice (DOJ), the two government agencies tasked with securities regulation and anti-fraud enforcement, and serves as an additional fraud deterrent. On the surface, given the relative pervasiveness of securities class action suits, one would think they would be effective fraud deterrents.⁷² According to NERA Economic Consulting, within a five-year period, the average public company has a 6.4% chance of being named a defendant in a securities class action.⁷³ Thus, such suits, particularly given their sometimes high profile nature, occur with sufficient regularity to capture the attention of corporate managers.⁷⁴

However, the reality of securities class actions is different from their promise.⁷⁵ These suits suffer from several deficiencies brought on by the incentives of the plaintiffs'

68. *Id.* at 1550-51.

69. *Id.* at 1556.

70. See Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1806 (2007) (noting that, based on the results of interviews with D&O insurance executives, "the largest available [D&O] coverage limit is \$300 million"), cited in Coffee, *supra* note 62, at 1556 n.83. However, one D&O insurance executive (with over 25 years of experience in various aspects of the industry), with whom I spoke on condition of anonymity, stated that corporations generally could obtain more insurance than they do. The question is how much protection they are willing to purchase given the cost. The executive suggested that it might be possible to put together a package of D&O insurance for a large corporation of as much as \$1.1 billion if backed by contingent pools of capital from reinsurers. Telephone interview with D&O insurance executive (July 11, 2007) [hereinafter Telephone Interview #2]. Of course, the premiums on this level of insurance coverage would be extremely high and in all likelihood not cost-effective for the corporation. See Coffee, *supra* note 62, at 1556 (stating, "No corporation can afford to insure its board for \$1 billion..."). Moreover, this level of insurance, while a significant improvement over current levels, still would represent only a portion of investor losses in large-scale fraud cases.

71. Researchers have found the same limiting effect of insurance in medical malpractice lawsuits. See Kathryn Zeiler et al., *Physicians' Insurance Limits and Malpractice Payments: Evidence from Texas Closed Claims, 1990-2003*, J. LEGAL STUD. (forthcoming 2007) (manuscript at 39) ("Although most legislatures have shied away from capping economic damages, insurance policy limits appear to be an important source of soft caps on malpractice plaintiffs' total recoveries."), available at <http://ssrn.com/abstract=981192>. The fact that the same phenomenon occurs in two different, but prominent litigation areas—securities class actions and medical malpractice suits—suggests that it is unlikely that much more in payments can be extracted from corporate defendants through securities litigation.

72. See Coffee, *supra* note 62, at 1548 (stating, "[S]ecurities class actions do seem sufficiently pervasive to constitute a deterrent threat for most public corporations").

73. TODD FOSTER ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: FILINGS STAY LOW AND AVERAGE SETTLEMENTS STAY HIGH—BUT ARE THESE TRENDS REVERSING? 7 (2007), available at http://www.nera.com/image/PUB_RecentTrends_Sep2007-FINAL.pdf. Estimate based on filing rate from 2005-2007(projected). *Id.* at 7, 16, n.6. Because of the decline in the number of securities class action filings over the last two years, the probability of facing suit is lower than it has been in prior years. *Id.* at 7.

74. Coffee, *supra* note 62, at 1548.

75. See *id.*

attorneys and the corporate managers that control the course of the litigation. Plaintiffs' attorneys, who, as independent entrepreneurs, are primarily motivated by the size of the potential recovery and attorneys' fees, bring and largely manage fraud on the market suits. All things being equal, the potential recovery in a class action lawsuit involving a large firm with actively traded shares is likely to exceed the recovery in a case involving a small firm with thinly traded stock. Thus, securities class actions can underdeter small firms because such firms are less likely to face suit.⁷⁶

In addition, fraud on the market suits often allow wrongdoers to evade financial responsibility. The typical class action lawsuit is settled. During the settlement process, the claims against the officers and directors are settled along with those of the corporation. Settlement agreements often are structured such that there is no finding of intentional wrongdoing by the corporate officers, thus preserving the officers' eligibility for D&O insurance coverage.⁷⁷ Therefore, as stated by Adam Pritchard, "managers [may] avoid personal liability by paying the claims with the corporation's money."⁷⁸ Empirical evidence shows that corporate officers rarely contribute to settlements, and when they do contribute, there are special circumstances surrounding such agreements (e.g., the defendant corporation is judgment proof because it has declared bankruptcy, the D&O insurance is inadequate or has been rescinded due to fraud in the application, or individual defendants agree to contribute to the settlement to receive a reduced jail sentence or avoid indictment).⁷⁹ This state of affairs significantly undermines the deterrence benefits that could flow from securities class actions.⁸⁰

Finally, conducting securities litigation is costly. In securities fraud class actions, though judges and lead plaintiffs monitor attorney awards, studies have shown that plaintiffs' attorneys' fees can equal from 16% to 32% of class recovery.⁸¹ These figures,

76. See *id.* at 1543 (noting that, because attorneys' fees are related to the size of recovery, small market capitalization companies are not as likely to be sued); see also Telephone Interview #1, *supra* note 62 (stating that small market capitalization companies with thinly traded stocks are less likely to be sued because expected damages, due to the low trading volume, are not high and because class certification issues are more challenging in these cases because reliance on the alleged fraudulent statements by the individual members of the class must be shown); *c.f.* *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (setting forth rebuttable presumption of reliance on misstatements where stock is traded in an efficient market). The SEC, however, has a renewed focus on prosecuting fraud in smaller companies. See *Testimony Concerning A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission: Hearing Before the H. Comm. on Financial Services*, 110th Cong. (2007) (statement issued by the witnesses representing the SEC: Christopher Cox, Chairman, Paul S. Atkins, Comm'r., Roel C. Campos, Comm'r., Annette L. Nazareth, Comm'r., Kathleen L. Casey, Comm'r.) ("We have created [a] special working group . . . within our Enforcement Division to deal with . . . microcap fraud."), available at <http://www.sec.gov/news/testimony/2007/ts062607sec.htm>. Thus, the extra enforcement resources from the SEC could offset to a limited degree the lack of attention from plaintiffs' lawyers.

77. Pritchard, *supra* note 4, at 957.

78. *Id.* at 928.

79. Coffee, *supra* note 62, at 1550-51.

80. However, as Coffee notes, nonfinancial consequences flowing from securities class actions such as the "risk of ouster" for insiders also can have deterrent effects. *Id.* at 1554.

81. See THAKOR ET AL., *supra* note 5, app. III, at Exhibit A (finding total plaintiffs' attorney fees of \$3.1 billion in connection with total gross settlements of \$19.8 billion, which reflects attorney fees of approximately 16% of class recovery); Coffee, *supra* note 62, at 1546 & n.37 (citing a study by Denise N. Martin et al. and noting that the figure for attorneys' fees as a percentage of recovery for suits in the 1990s—32%—may have declined in recent years due, in part, to today's larger recoveries).

while high, do not take into account the additional costs exacted by the system, including defense attorneys' fees,⁸² litigation expenses, court costs, as well as lost productivity of the defending corporation while the litigation is ongoing.⁸³ In addition, these suits consume significant judicial resources.⁸⁴ According to data collected by the Federal Judicial Center, from July 1, 2001 – June 30, 2006, securities class actions represented approximately 30% of all class actions filed in federal court and were the largest single category of class actions.⁸⁵ Moreover, due to their complexity, securities class action suits demand a great deal of judicial time and attention.⁸⁶ As John Coffee says, “[S]ecurities class actions [because of their impact on the federal court system] are essentially subsidized by the U.S. taxpayer, and thus, they raise the question of whether society is receiving an adequate return on its investment.”⁸⁷ Therefore, though there are compelling reasons to provide compensation for securities fraud victims, the securities class action is an inefficient way to do so.

IV. THE INVESTOR COMPENSATION FUND PROPOSAL

A. Overview

This Article proposes eliminating fraud on the market suits⁸⁸ and explores the creation of an investor compensation fund to better achieve not only the compensatory, but also the deterrence goals of securities regulation. This Article is not intended to, and does not, address all of the many considerations that accompany a major overhaul of the U.S. securities regulation regime. It is not possible to address all potential concerns in a

82. One group of commentators suggests that defense attorney fees are roughly equivalent to those of plaintiffs' attorneys, who they assert generally receive 20%–30% of shareholder recovery. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2080 (1995). More recently, one insurance industry executive estimated that defense costs of 25%–35% of the settlement amount are common; however, defense costs can be significantly higher. Baker & Griffith, *supra* note 70, at 1815 n.95, cited in Coffee, *supra* note 62, at 1546 n.38.

83. See Pritchard, *supra* note 4, at 953–54 for further discussion of these costs.

84. Coffee, *supra* note 62, at 1540.

85. E-mail from Emery G. Lee III, Senior Research Associate, Federal Judicial Center, to author (September 10, 2007, 12:17:42 EDT) (on file with author). These figures include all securities class actions, not just class actions related to secondary market fraud, the subject of this Article. Figures represent actual class actions filed before consolidation. *Id.* After consolidation, securities class actions represent 9.4% of all class actions filed in federal court. *Id.* Though this is a significantly lower percentage of class actions than the percentage on a pre-consolidation basis, judicial time must be expended in the consolidation process. Thus, considering the number of single filings is worthwhile in the context of this debate. Data were collected as part of a study by the Federal Judicial Center of “The Impact of the Class Action Fairness Act of 2005 on the Federal Courts.” *Id.* For a brief description of how the data were collected and the types of actions included in the study, see THOMAS E. WILLGING & EMERY G. LEE III, THE IMPACT OF THE CLASS ACTION FAIRNESS ACT OF 2005 ON THE FEDERAL COURTS: THIRD INTERIM REPORT TO THE JUDICIAL CONFERENCE ADVISORY COMMITTEE ON CIVIL RULES 23 (2007), available at [http://www.fjc.gov/public/pdf.nsf/lookup/cafa0407.pdf/\\$file/cafa0407.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/cafa0407.pdf/$file/cafa0407.pdf). See note 111, *infra*, for a discussion of the decline (and recent rebound) of securities class action filing activity.

86. Coffee, *supra* note 62, at 1540.

87. *Id.*

88. Under this proposal, class actions for primary market fraud (i.e., fraud in connection with initial public offerings and seasoned equity offerings) will remain. Claims that a related set of misrepresentations affected both purchasers in an offering and secondary market purchasers will have to be bifurcated into two cases, with only the secondary market purchasers being eligible for recovery from the ICF.

single piece. The purpose of this Article, thus, is to suggest that, despite challenging administrative and implementation issues, creating a compensation fund is worthy of serious consideration. Though I will outline some of the primary issues in Part IV.C., *infra*, I leave to future work a consideration of solutions to some of these challenges.⁸⁹

B. The Proposal

Under the ICF Proposal, a newly created division of the SEC (the “ICF Division”) will administer an investor compensation system, whose funding will come from assessments on equity securities transactions. Every time a share of stock of, or similar security⁹⁰ related to, a U.S. listed corporation is sold in the secondary market (except sales made by exchange specialists and market makers),⁹¹ the selling shareholder⁹² will pay a fee, set as a percentage of the dollar value of the sale transaction (the “ICF premium”), that will be placed into a fund to be used for investor restitution in the event of losses from securities fraud. Selling shareholders will not pay these fees directly to the ICF Division; instead, the ICF Division will collect the fees in the aggregate from the securities exchanges and associations where the transactions occur in a manner similar to that currently employed for collecting Section 31 fees.⁹³ All funds collected will be

89. I acknowledge that the administrative problems inherent in creating an investor compensation fund may be too difficult to overcome. Therefore, no matter how prudent creating a compensation fund may be as a theoretical matter, it may not be very practicable. Further study will provide illumination of this important issue.

90. Specifically, the ICF premium also will be levied on equity derivatives. Derivatives are securities that “derive” their value from other underlying assets. Equity derivatives include securities such as call options (which give holders the right, but not the obligation, to buy a share of stock) and put options (which give holders the right, but not the obligation, to sell a share of stock).

91. Exchange specialists and market makers are market liquidity providers that match buy and sell orders and help stabilize markets as necessary. Sales of stock by exchange specialists and market makers in connection with making a market in the stocks for which they are contractually bound to provide liquidity will be exempt from the ICF premium.

92. The seller of the security will pay the ICF premium. Hence, the “statutory incidence” or legal responsibility for the payment lies with the seller. However, statutory incidence tells us nothing about who, as between the seller and the buyer, actually will bear the burden of the premium (the “initial economic incidence”) because the price to be paid by the buyer may in fact increase to compensate for the premium levied on the seller. Given stock market dynamics (e.g., the demand and supply curves of stock), it is likely that the buyer will have to pay for as much as half of this protection.

93. Section 31 of the Exchange Act authorizes the SEC to collect transaction fees to recover the costs incurred by the federal government in supervision and regulation of the securities markets. 15 U.S.C. § 78ee(a) (2000 & Supp. II 2002). Currently, the transactions subject to the fee include sales of publicly traded equity securities (15 U.S.C. § 78ee(b)-(c) (2000 & Supp. II 2002), and the fee is assessed at a rate of 0.0011% of the dollar value of transactions. Order Making Fiscal Year 2008 Annual Adjustments to the Fee Rates Applicable under Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14(g), 31(b), and 31(c) of the Exchange Act, Securities Act Release No. 8794, Exchange Act Release No. 55682, 72 Fed. Reg. 25,809 7 (April 30, 2007), available at <http://www.sec.gov/rules/other/2007/33-8794.pdf>. Rather than investors paying the SEC the amount owed directly, the national securities exchanges and associations where the transactions occur report covered transactions and remit the appropriate payment to the SEC. *Id.*; 15 U.S.C. § 78ee(e) (Supp. II 2002); 17 C.F.R. § 240.31(b)(1), (a)(17) (2007). Since collection of the ICF premium will occur in a manner similar to that which is used to collect Section 31 fees and largely assess the same transactions, the systems for transaction reporting and fee collection are currently in place. Thus, the exchanges and associations will not have to make large investments in infrastructure for ICF premium collection. However, the collecting agencies will have to develop software to enable them to collect different amounts upon the sale of different stocks (as opposed to a fixed rate for large categories of securities, as is the case with Section 31 fees).

pooled; there will be no individual company accounts. No selling shareholders will receive a refund of any amounts deposited into ICF, even if no shareholder of a particular company ever makes a claim for recovery.⁹⁴ Participation in the ICF scheme will be mandatory for public corporations and investors.

The size of the fee paid upon sale will vary by underlying corporation and depend on a corporation's fraud risk rating. An independent, private fraud risk rating agency⁹⁵ that has been designated by the ICF Division will be tasked with generating fraud risk ratings for each corporation traded in the United States. Each year,⁹⁶ the designated rating agency will examine the governance and disclosure-related business practices of companies under review, specifically considering factors such as a company's internal control processes, history of fraud investigations or government enforcement actions, and ICF damage payouts. The ICF Division also will require input from a firm's auditor and D&O insurer on some of the "soft factors" related to corporate governance.⁹⁷ The fraud risk rating given will reflect the rating agency's assessment of whether the appropriate safeguards are in place to minimize the chances of securities fraud occurring.⁹⁸

Currently, a similar government designated rating agency mechanism is employed with respect to credit rating agencies. Since 1975, the SEC has recognized a select number of credit rating agencies as "Nationally Recognized Statistical Rating Organizations" (NRSROs).⁹⁹ The ratings from these agencies not only provide guidance to debt securities investors, but also are used as benchmarks for investment quality and safety in a number of federal and state laws and regulations.¹⁰⁰ Though not without its

94. This practice would be consistent with that of the Federal Deposit Insurance Corporation (FDIC), which gives no rebates. As long as the government correctly sets the ICF premium at the level of expected losses, there will be no need for rebates. See generally Andrew Kuritzkes, Til Schuermann & Scott Weiner, *Deposit Insurance and Risk Management of the U.S. Banking System: How Much? How Safe? Who Pays?* 36 (Wharton Fin. Inst. Ctr., Working Paper No. 02-02-B, 2002) (discussing this point in connection with FDIC insurance), available at <http://fic.wharton.upenn.edu/fic/papers/02/0202.pdf>.

95. See Part IV.C.4., *infra*, for a discussion of the challenges in generating fraud risk ratings.

96. In addition to the required annual assessment, an interim review will be possible, upon petition by the corporation or upon recommendation from the ICF Division if a "governance event" (e.g., an accounting restatement due to fraud) occurs before the next regularly scheduled review date.

97. See Part IV.C.4., *infra*, for further discussion of the role of auditors and D&O insurers in this process.

98. Just as with private credit ratings, a company will have no right to appeal the rating it receives, but it will be given an opportunity to correct any factual errors influencing the rating before the rating becomes effective.

99. Historically, SEC recognition of NRSROs followed a relatively informal determination by the SEC, that "among other things, . . . the credit rating agency [seeking NRSRO status] [was] recognized nationally by the predominant users of credit ratings as issuing credible and reliable ratings." Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55,875, 72 Fed. Reg. 33,563, 33,564 (June 18, 2007) [hereinafter Oversight of Credit Rating Agencies], available at <http://www.sec.gov/rules/final/2007/34-55857.pdf>. Amid claims that the NRSRO designation process led to anti-competitive behavior and a lack of innovation in credit rating processes, Congress enacted the Credit Rating Agency Reform Act of 2006. Laura Blinkhorn, *CQ Bill Analysis: HR2990 - Credit Rating Agency Duopoly Relief Act of 2006*, CONG. Q., Oct. 13, 2006. Under the new statute, a rating agency seeking NRSRO status must undertake a formal application process and be granted registration by the SEC. Oversight of Credit Rating Agencies, *supra*, available at <http://www.sec.gov/rules/final/2007/34-55857.pdf>. As of this writing, the SEC has recognized seven credit rating agencies as NRSRO's. Press Release, SEC, Seven Credit Rating Agencies Register with SEC as Nationally Recognized Statistical Rating Organizations (Sept. 24, 2007), available at <http://www.sec.gov/news/press/2007/2007-199.htm>.

100. Definition of Nationally Recognized Statistical Rating Organization; Proposed Rule, Exchange Act Release, 72 Fed. Reg. 33,8570, 34,51572 (Apr. 25, 2005), available at <http://www.sec.gov/rules/proposed/33->

critics,¹⁰¹ this agency designation process serves as a long-standing example of private actors performing a function that furthers the government's regulatory goals.

ICF premiums will be set at level equal to (1) a fixed percentage of expected fraud-induced losses plus (2) an assessment for fund administrative expenses.¹⁰² No corporation's related ICF premium will be zero.¹⁰³

The assessment of differing ICF premiums on sales of stock is designed to deter fraud. Lower fraud risk ratings will result in lower premiums paid by selling shareholders, while shareholders of companies with a history of fraudulent activities or a lack of mechanisms to prevent such occurrences will pay higher premiums into the ICF. Imposing a fraud risk-related fee every time an investor sells a share of stock will be reflected in a company's stock price. Corporate managers are extraordinarily focused on share price,¹⁰⁴ and, under the ICF Proposal, managers will have ample incentive to maintain the best fraud risk rating possible. Investors will know the ICF premium before the purchase of securities, so they generally will be able to factor a company's ICF premium into their investment decisions.¹⁰⁵

The dollar value of premiums collected will vary with market activity, so predicting the amount collected and, hence, the amount market participants will pay is difficult, as many factors affect market activity. However, assuming recoveries equal to 75% of

[8570fr.pdf](#). For example, certain types of offerings for securities that are rated investment grade by at least one NRSRO may be registered on a short-form registration statement without the issuer having to meet the normally applicable minimum public float requirements. *Id.* In addition, under the rules of the Investment Company Act of 1940, money market funds generally are limited to investing in securities that have received one of the two highest ratings for short-term debt from an NRSRO. *Id.*

101. The NRSRO credit rating agency designation and the use of NRSRO ratings in regulation have been subject to extensive criticism in the past. *See, e.g.,* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 624 (1999) ("In place of ratings-dependent regulation, I recommend a replacement: simply substitute credit spreads, the market risk measure of bonds, for credit ratings."); Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 93 (2004) (stating, "The easiest proposal to defend on theoretical grounds is probably the elimination of the NRSRO designation and replacement with a more market-based solution[.]" while cautioning "there are considerable perils of eliminating NRSRO designation too quickly"). However, the reforms enacted in the Credit Rating Agency Reform Act of 2006 should alleviate at least some of the concerns of critics of NRSROs, and lessons from this process will be transferable to a consideration of similar issues that may arise in the context of the ICF.

102. The premium levels will not be capped. One could argue that, in the absence of caps, the premium for repeat offenders theoretically could become so large as to decimate the company's stock price. This would be akin to effecting bankruptcy through ICF premiums (because no investor would want to buy the stock). This is a serious concern, as this practice could harm innocent shareholders and employees (much as securities litigation can today). However, adequate funding is essential for the survival of the ICF. With caps on premium levels, the premiums in risky companies would not reflect fully the risk they pose and would require increased premiums from shareholders of other, safer firms. In addition, employing caps would not provide appropriate managerial incentives, as the full extent of the firm's fraud risk would not be reflected in its stock price.

103. *See* Part IV.C.6., *infra*, for a discussion of the equitable considerations related to this design feature.

104. *See* LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 41 (5th ed. Supp. 2007).

105. With an average annual market turnover rate of over 100%, most investors (by volume) will have sold their shares before the next annual ICF determination. Shareholders who own stocks for more than a year will not know in advance of the purchase exactly how much the premium will be upon sale. However, in the absence of a fraud revelation or radical changes in the corporate governance practices of a firm, the ICF premium should not vary dramatically from year to year.

provable losses,¹⁰⁶ and based on the level of market transactions in 2006,¹⁰⁷ a weighted average premium of approximately 0.035% will be required to provide recovery for victims of securities fraud.¹⁰⁸ Thus, for example, if a shareholder sells 100 shares of Company XYZ stock at \$20 per share, the total premium to be paid into the ICF from this trade is \$0.70 (100 shares * \$20/share * 0.00035). Using 2006 trading volume and estimated damages¹⁰⁹ in securities class actions filed (with an assumption that 50% of these suits (by dollar volume) are meritorious),¹¹⁰ total ICF collections would have been \$15.3 billion in 2006.¹¹¹

106. See *infra* note 112 and accompanying text for a discussion on determining the appropriate level of recovery.

107. This represents all capital market sales subject to Section 31 fees. See *infra* Appendix I for additional information on how the figure is used to calculate the estimated premium. See *supra* note 93 for a discussion of Section 31 fees.

108. This figure includes an assessment for administrative costs equal to 10% of claim payouts, but excludes fund investment income and effects of the lack of premiums from market makers and specialists. See *infra* Appendix I for a full description of assumptions underlying this calculation and for calculations under additional assumptions.

109. The source of the “estimated damages” figure is Cornerstone Research data. The figure represents the “disclosure dollar loss amount,” defined as the difference in market capitalization of a defendant firm as of the trading day immediately before the end of the class period (with the end of the class period being generally when the fraud is revealed) and the market capitalization of the same firm the trading day following the end of the class period. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2006: A YEAR IN REVIEW 1 (2007) [hereinafter SECURITIES CLASS ACTION CASE FILINGS], available at http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf. This number is not intended to be a measure of liability for securities fraud, as factors unrelated to fraud could have affected the prices on these two dates. See *id.* However, the figure does provide an approximate sense for the losses suffered by investors.

110. For purposes of calculating the ICF premium, the disclosure dollar loss amounts are adjusted to reflect an assumption that 50% of suits filed are meritorious. For data on the number of securities class actions that survive a motion to dismiss and hence generally move on to settlement negotiations, see Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 685, 691 (2002) (finding, in a study of 167 federal court securities fraud decisions that address the “strong inference standard,” that 34.1% of motions to dismiss are denied in their entirety, and 36.5% are granted either in part or in their entirety without prejudice, thus making it possible for the plaintiff “to replead in such a manner as to allow the litigation to continue.”); A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 142 (2005) (finding that 52% of motions to dismiss are granted in a study of 1996-2002 Second and Ninth Circuit decisions in securities fraud class actions); FOSTER, *supra* note 73, at 7 (finding the dismissal rate to be 39.1% in 2004-2006, but acknowledging that this rate could be overstated as a practical matter because it includes suits dismissed without prejudice and suits dismissed “with prejudice that will be successfully appealed.”). It should be noted, however, that the figure used reflects a simplifying assumption. The fact that a suit gets past the motion to dismiss phase does not mean that 100% of the estimated market capitalization decline of the corporation upon the fraud revelation equals compensable damages.

111. Traditional (i.e., excluding IPO allocation, analyst, and mutual fund-related claims) securities class action filing activity has been on the decline in recent years (falling, for example, 38% from 2005-2006). See SECURITIES CLASS ACTION CASE FILINGS, *supra* note 109, at 3. In addition, the level of losses associated with the filings (defined on the basis of market capitalization losses upon disclosure of the alleged fraud) also has declined substantially. *Id.* at 1. Thus, if this downward trend in fraudulent (or at least detected fraudulent) activity continues, using 2006 data may overstate the premium required to fund the ICF. On the other hand, if the incidence of fraud returns to historical levels, this premium estimate, depending on the level of market activity relative to the amount of fraud, may be understated. Recent data compiled by NERA Economic Consulting suggests that the downward trend in filings may be reversing. FOSTER, *supra* note 73, at 3

The ICF holds the promise of providing significant additional compensation for securities fraud losses, well in excess of the limited compensation (as little as 2%-3% of losses) available today. However, shareholders will continue to bear some risk of loss. As is the case with most insurance, the recovery from the ICF will be equal to less than 100% of provable losses. The specific level of investor recovery will be determined by techniques similar to those employed in other insurance contexts¹¹² that will attempt to strike the proper balance between the benefits of preventing an investor from losing almost everything on an investment, on the one hand, and maintaining incentives for the investor to monitor the companies in which she invests, on the other.¹¹³

(describing the substantial increase (47% more in the first six months of 2007 than the last six months of 2006) of traditional or “standard” case filings and suggesting the downward trend in filings may be reversing). In addition, as discussed in Part III, *supra*, lawsuits often are not brought against small corporations because it is often uneconomical for plaintiffs’ lawyers to do so. If the ICF proposal is adopted, though there will be screens designed to limit frivolous suits and suits that would lead to a de minimus recovery, see discussion, *infra*, it is quite possible that the level of claims under the ICF will exceed the estimated damages of lawsuits today. Moreover, the premium level assumed for exposition purposes (0.035%) includes an assumption of annual administrative costs of 10% of claim payouts. This could understate the expense of administering the fund. Finally, the premium does not account for the fact that market makers and specialists will be exempt from payment of the ICF premium. Offsetting this, of course, is that the deterrent effects of the ICF may cause the incidence of fraud to decline, that there is increased trading because of greater investor confidence, or that the fund will earn sufficiently high investment income to offset a significant portion of its administrative costs. Nonetheless, it is possible that the average ICF premium could exceed 0.035%, perhaps significantly so. For a calculation of premiums under various assumptions, see *infra* Appendix I.

112. For a discussion of the techniques used in the insurance industry, see, e.g., Michael L. Smith & George L. Head, *Guidelines for Insurers in Pricing Deductibles*, 45 J. RISK & INS. 217 (1978) (describing how, among other things, to price deductibles to minimize adverse selection and deter nuisance claims in property insurance); Frank M. Bakker et al., *Deductibles in Health Insurance: Can the Actuarially Fair Premium Reduction Exceed the Deductible*, 53 HEALTH POL’Y 125, 130-31 (2000) (describing efforts to relate the level of out-of-pocket payments of insureds to the precise amount by which the demand for health care declines). Setting the precise level of recovery to minimize moral hazard concerns will be a significant challenge facing the ICF.

113. Requiring shareholders to bear some risk of loss will minimize moral hazard concerns (i.e., concerns about the incentives of investors to monitor fraud-prone companies). The degree to which we must be concerned about this type of moral hazard depends on our confidence with respect to the ability of shareholders to monitor corporate conduct. Retail investors are unlikely to have the ability to serve as effective monitors of corporate conduct. See Fisch, *Criminalization of Corporate Law*, *supra* note 37, at 93. However, many believe institutional investors are well suited to provide some monitoring of the corporate governance-related activities of corporations, but that such investors do not perform this role effectively. See, e.g., John C. Bogle Remarks, *The Mutual Fund Industry 60 Years Later: For Better Or Worse?*, 61 FIN. ANAL. J., Jan./Feb. 2005, at 18-19 (“With their long record of passivity and lassitude about corporate governance issues, [mutual] fund managers must accept a large share of the responsibility for the ethical failures in corporate governance and accounting oversight”), available at http://www.vanguard.com/bogle_site/sp20050102.htm. But see Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1011 (1994) (raising questions about whether institutions have the proper incentives to monitor corporations and whether they can do so effectively), cited in Fisch, *Criminalization of Corporate Law*, *supra* note 37, at 93. It may seem unfair to make retail investors responsible for some portion of their losses when they are not as effective at corporate monitoring as institutions. However, providing additional compensation for individuals, but not institutions, through the ICF, in effect, would be providing incentives for individuals to invest independently, rather than through funds, which could lead to individuals being less diversified. Another moral hazard concern relates to the incentives of investors to invest in fraud-prone companies. The degree to which we must be concerned about this type of moral hazard depends on how confident we are that non-insider shareholders are able to assess, with some degree of accuracy, which firms have a greater propensity for fraud. See Tom Baker, *Insurance Against*

The ICF Division will determine the amount of shareholder recovery in individual cases. Operating similarly to other government agencies,¹¹⁴ the ICF Division will not act on its own initiative to investigate secondary market securities fraud, but instead will respond to charges filed by the SEC's enforcement division or by defrauded shareholders holding, either individually or in combination with other shareholders, a minimum ownership of 1% of the outstanding equity of the company in question for a minimum of one year.¹¹⁵ The minimum ownership requirement will ensure that those bringing charges have a significant stake in the corporation.¹¹⁶ Because it is unlikely that any one retail investor will hold a 1% stake in a public company, generally institutions will be the only stockholders with the independent power (i.e., not as a part of a group) to initiate proceedings. The managers of such institutions, as sophisticated businesspeople, are unlikely to file charges that lack merit.¹¹⁷ In addition, the ICF Division will have the power to assess appropriate penalties for investors that submit claims that are later shown to lack any foundation.¹¹⁸ The threat of a penalty, coupled with the high ownership threshold for filing charges, should deter frivolous claims. Finally, claim administration

Misinformation in the Securities Market, in 2 CANADA STEPS UP 363, 381 (2006), available at <http://www.tfmsl.ca/>. See Part IV.C.6., *infra*, for further discussion of this point.

114. For example, the ICF Division will operate in a manner similar to the National Labor Relations Board (NLRB). The NLRB is an independent federal agency that was created by Congress in 1935 to administer the National Labor Relations Act (NLRA), the statute that governs union/employer relations. NLRB Fact Sheet, http://www.nlr.gov/about_us/overview/fact_sheet.aspx (last visited Sept. 18, 2007). The NLRB does not act on its own motion, and its administrative law judge decisions (issued failing a prior settlement by the parties or dismissal by the NLRB Regional Director that was not successfully appealed) are subject to review by the NLRB Board and U.S. Courts of Appeals. *Id.*

115. Option holders will be unable to file claims because they lack an ownership interest in the corporation, but they will be eligible for damages awards.

116. This is similar to the ownership requirement for eligibility for submitting shareholder proposals for inclusion in a public corporation's proxy statement under 17 C.F.R. § 240.14a-8(b) (2007). Note, however, that under Rule 14a-8, a shareholder must hold at least \$2000 in dollar market value of voting securities in the corporation or 1% of the corporation's outstanding voting stock in order to be eligible to submit a shareholder proposal, which makes the Rule 14a-8 standard significantly easier to meet than the one described above.

117. One could argue that institutions often will face conflicts of interest that keep them from filing claims. The possibility of institutional investor conflicts of interest has been raised previously in other contexts. Many believe private sector investors currently have conflicts of interest (e.g., banks or insurance companies that want to do business with companies in which they hold investments) that may prevent them from voting their shares against management and in a way that maximizes shareholder value due to fear of management reprisal. See generally Roberta Romano, *Does Confidential Proxy Voting Matter?*, 32 J. LEGAL STUD. 465, 467, 506 (2003) (providing a brief background on the arguments of those who advocate confidential corporate proxy voting, but finding that the practice has no significant effect on election outcomes). However, the high potential recovery under the ICF (e.g., possible recovery of 75% of fraud losses) and the fact that the company will not be paying the claims directly (though its shareholders will pay higher ICF premiums in the future) may overcome the disincentive to file claims. In addition, any company subject to a fraud enforcement action at the SEC will automatically have its case referred to the ICF. Thus, if the SEC Enforcement Division decides to pursue a fraud case, the failure of a shareholder to emerge to file a claim will not prevent investors from receiving compensation from the ICF. Finally, if the SEC still feels that claims are not being filed in meritorious cases, the SEC could design a process (e.g., website filing) to make it easier for retail investors to make a joint claim. A related concern is that there will be a free-rider problem (i.e., no investor will want to incur the time and expense to make a claim because the investor's proportional recovery will be no higher than that of any other shareholder). To address this possibility, the ICF will make the filing process as simple as possible and will reimburse reasonable expenses incurred in filing a claim.

118. So as not to deter potentially meritorious claims, liability will attach only if no rational person could have thought fraud had occurred.

costs will be lowered by requiring a certain threshold overall shareholder loss before the ICF Division will initiate a proceeding.¹¹⁹

When a shareholder files charges with the ICF Division, the ICF Division will conduct an investigation to determine whether there is reasonable cause to believe a securities violation has occurred. Employing a civil-style inquisitorial model,¹²⁰ administrative law judges (ALJs)¹²¹ will make fraud and damage award determinations. The decisions of the ALJs will be subject to limited federal court review. The ICF Division will grant damage awards in cases involving securities fraud, without regard to whether the company in question is bankrupt. The ICF Division will compute damages in a manner similar to that currently employed in calculating damages in fraud on the market lawsuits.¹²² All damage payouts will be made from the fund, with any shortfalls payable through loans from the U.S. Treasury.¹²³ With limited exceptions,¹²⁴ all

119. Since this determination would have to be made before a formal investigation is launched, the metric would have to involve something akin to a “disclosure dollar loss” as defined by Cornerstone Research (the difference in market capitalization of a firm as of the trading day before the alleged fraud is revealed and the market capitalization of the same firm the trading day following the revelation). See Appendix I, note 4, *infra*, for further discussion of this metric.

120. See Amalia D. Kessler, *Our Inquisitorial Tradition: Equity Procedure, Due Process, and the Search for an Alternative to the Adversarial*, 90 CORNELL L. REV. 1181, 1188 (2005) for a description and history of inquisitorial proceedings (“[I]n the inquisitorial model, the court itself initiates the litigation and undertakes significant responsibility for gathering evidence, not just for ruling on the conclusions that should be drawn from it.”). Though the proceeding will be non-adversarial, the corporation accused of fraud, in all likelihood, will retain counsel to help it respond to inquiries from the ICF Division. However, the shareholder filing the claim will not need to hire counsel or “present a case” during the proceedings.

121. The use of an administrative law judge (ALJ) is intended to reduce concerns about politicization (e.g., instances of elected officials pressuring the ICF Division to make unwarranted fraud determinations to satisfy angry investors that have lost money), competence and agency capture. ALJs generally are less subject to political pressures than are elected officials or political appointees and, under the Administrative Procedure Act, in a formal adjudication, ex parte communications (e.g., a conversation between a Congresswoman and an ALJ with the intent of influencing such judge’s decision) are prohibited. 5 U.S.C. § 554(d)(1) (2000). Competence also should not be a concern. Almost all securities fraud cases settle. Pritchard & Sale, *supra* note 110, at 128 (“[With rare exception,] [c]ases that are not dismissed on a motion to dismiss or at summary judgment, and that survive class certification...settle.”) Thus, as a practical matter, the rulings of judges with respect to motions to dismiss and summary judgment determine if plaintiffs recover damages. There is no reason to believe that ALJs would lack the competence to make accurate and fair decisions. Finally, because, in the post-Enron era, the media spotlight is trained on the efforts of the SEC to police corporate fraud, it is highly unlikely that the SEC would be able to use the ICF as a vehicle for serving the narrow interests of those it regulates. A related concern may be that the ALJs will have an incentive to rarely make fraud determinations, so as to protect the ICF from liability. To minimize the likelihood of such an occurrence, under the ICF proposal, a formal “ethical” wall of separation will be maintained between the ALJs and the ICF administrators.

122. See Finnerty & Pushner, *supra* note 58, for a discussion of damages calculations under the current securities litigation regime. As currently performed, this is a complex process. Alexander, *supra* note 4, at 1488 (stating “the amount of damages is a complex and intractable issue at trial. Expert testimony is required to calculate damages, and that testimony is contradictory even when the experts purport to be using the same methodology”). In designing this feature of the ICF, a tradeoff between providing shareholder recovery equal to the theoretically “accurate” amount of damage suffered by an investor and administrative tractability will be required. I leave detailed consideration of this issue to future work.

123. See *infra* note 188 for discussion of a consideration of equitable considerations related to this feature of the proposal.

124. Directors and executive officers of the corporation, as well as company employees involved in the fraud will be ineligible for recovery from the ICF.

shareholders who suffer a loss and submit a claim to the ICF Division will be eligible for recovery from the fund.¹²⁵

Generating credible estimates for the costs of administering the ICF is difficult, but there is evidence to suggest the costs will be significantly lower than the costs incurred in conducting fraud on the market suits. The ICF, as proposed, has elements of both an insurance program and a litigation system. One of the advantages of insurance systems is their ability to provide compensation to victims at lower costs than litigation systems.¹²⁶ There are a number of studies that show that average administrative costs in private lawsuits, including those for settled and litigated claims, are almost equal to or greater than the compensation received by victims.¹²⁷ This means that for every dollar a victim receives as compensation, a dollar or more is spent providing that dollar to the victim.¹²⁸ As described previously in Part III, plaintiffs' attorneys' fees in securities class actions can total almost one-third of fraud victim recovery, and defense costs can be comparable. These fees do not account for the judicial resources employed disposing of such cases.

The cost of insurance tends to be significantly lower than the cost of litigation. At one extreme are government insurance programs, such as the federal Old Age and Survivors Insurance Program (OASI), federal disability insurance, the SIPC, and the FDIC, whose administrative costs are quite low in comparison to total program expenditures or fund size.¹²⁹ These programs may be administered relatively

125. A claims administrator appointed by the ICF Division will be responsible for disbursing payments to eligible investors in a similar manner to that which occurs today for securities fraud class action settlements and Fair Funds (Fair Funds, SEC-administered funds for investor restitution following instances of securities fraud, are described in more detail in Part V.A., *infra*). These processes (i.e., finding individual investors and verifying claims) are administratively complex and rife with problems. For a description, written in 2005, of the problems accompanying the Fair Funds distribution process, see Deborah Solomon, *Paper Trails: Plan to Give Defrauded Investors Money from Fines Faces Hurdles*, WALL ST. J., July 7, 2005, at A1. The SEC acknowledges and has begun to address the Fair Fund distribution problem. See SEC, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 23 (2007) [hereinafter SEC 2006 PAR], available at <http://www.sec.gov/about/secpar2006.shtml>. The SEC recently announced the creation of new office dedicated to Fair Funds distribution. See *infra* note 317. For a description of the claims administration process in securities class actions, see James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 419-20 (2005). Consistent with the reform proposal of Cox and Thomas (see *id.* at 444-45), the ICF will maintain a web-based centralized clearinghouse for claim notices and claim forms to facilitate the filing of claims. Despite this feature, the distribution process will be one of the most significant challenges faced by the ICF.

126. See, e.g., Jeffrey O'Connell & John Linehan, *Neo No-Fault Early Offers: A Workable Compromise Between First and Third-Party Insurance*, 41 GONZ. L. REV. 103, 133 (2005/06) (praising workers' compensation plans for "largely eliminat[ing] the administrative and transaction costs derived from expensive litigation over fault and payment for pain and suffering").

127. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 281 (2004).

128. *Id.*

129. For example, in 2005, the administrative costs of OASI equaled 0.7% of total OASI expenditures, and comparable costs for federal disability insurance represented 2.6% of total expenditures. SOC. SEC. ADMIN., ANNUAL STATISTICAL SUPPLEMENT TO THE SOCIAL SECURITY BULLETIN, 2006 at 4.2, 4.4 (2007) (calculated by dividing "Administrative Expenses" by "Total [Expenditures]"), available at <http://www.ssa.gov/policy/docs/statcomps/supplement/2006/supplement06.pdf>. Similarly, from 2001-2005, total administrative expenses (including overhead expenses and administrative expenses related to liquidation proceedings) averaged approximately 2.0% of fund size for the SIPC, a quasi-governmental agency that oversees the liquidation of failed brokerage firms and insures brokerage customer property. Calculated using data from SEC. INVESTOR PROT. CORP., 2005 ANNUAL REPORT 16, 21 (2006) [hereinafter SIPC 2005 ANNUAL

inexpensively because there is no need to determine “fault” as we think of it in a litigation context.¹³⁰

Another government insurance program, unemployment insurance, which shares some important similarities with the ICF, has higher administrative costs on a relative basis than the aforementioned programs, but still appears to operate in a cost-effective manner. Briefly reviewing the UC system’s operations may be instructive. The unemployment compensation (UC) system’s¹³¹ fiscal year 2007 estimated administrative costs are \$3.9 billion or 8.7% of the estimated \$44.9 billion in collections.¹³² Under the UC system, employers are taxed on their payrolls.¹³³ Experience rating in the UC system requires employers with a history of higher layoffs and firings to pay higher taxes into the system.¹³⁴ Experience rating, therefore, discourages layoffs and other forms of involuntary unemployment.¹³⁵ Though the specific laws differ across states, generally, if an employee voluntarily resigns (other than for good cause attributable to the employer)¹³⁶ or is fired for gross misconduct,¹³⁷ she is not eligible for unemployment benefits.¹³⁸ The determination of eligibility for UC benefits is handled initially by an investigator employed by a state agency.¹³⁹ Both the employer¹⁴⁰ and the employee

REPORT], available at <http://www.sipc.org/pdf/2005AnnualReport.pdf>; SEC. INVESTOR PROT. CORP., 2004 ANNUAL REPORT 14 (2005), available at http://www.sipc.org/pdf/2004_AnnualReport.pdf; SEC. INVESTOR PROT. CORP., ANNUAL REPORT 2003 (2004), available at http://www.sipc.org/pdf/2003_Annual_report.pdf; SEC. INVESTOR PROT. CORP., ANNUAL REPORT 2002, at 14 (2003), available at http://www.sipc.org/pdf/SIPC_Annual_Report_03.pdf; and SEC. INVESTOR PROT. CORP., ANNUAL REPORT 2001 (2002) [hereinafter SIPC 2001 ANNUAL REPORT], available at <http://www.sipc.org/pdf/SIPCAnnualReport02.pdf>. The FDIC’s corporate operating budget expenses were 1.9% of fund size in 2006. Calculated using data from FED. DEPOSIT INS. CORP., ANNUAL REPORT HIGHLIGHTS 2006 at 32, 35 (2006), available at <http://www.fdic.gov/about/strategic/report/2006highlight/2006Highlights.pdf>.

130. The SIPC must evaluate investor claims and provide recoveries where warranted, but its task (i.e., determining if a claimant was a customer at a brokerage firm and had securities that were missing) is more ministerial than the task of the ICF will be (i.e., determining if securities fraud occurred).

131. The UC system was created by the Social Security Act of 1935. It is a federal program that is administered by the states under state law. OFFICE OF WORKFORCE SEC., U.S. DEP’T OF LABOR, UNEMPLOYMENT COMPENSATION 1 (2007), available at <http://www.workforcesecurity.doleta.gov/unemploy/pdf/partnership2007.pdf>.

132. Calculated using data from *id.* at 2. This figure includes some administrative costs not directly related to operating the state UC system. Estimated fiscal year 2007 administrative costs for the state UC system only are \$2.64 billion. *Id.*

133. Three states in the United States also collect taxes from employees. *Id.* at 1.

134. See Katherine Baicker et al., *A Distinctive System: Origins and Impact of U.S. Unemployment Compensation*, in *THE DEFINING MOMENT: THE GREAT DEPRESSION AND THE AMERICAN ECONOMY IN THE TWENTIETH CENTURY* 227, 245 (Michael Bordo et al. eds., 1998). No state has “complete” experience rating (i.e., a system with no minimum or maximum rate). *Id.*

135. See *id.* at 246 & n.46.

136. An example of good cause may include a worker who suffered harassment or was forced to work in unsafe conditions. Telephone Interview with Frank Gumina, Partner, Whyte Hirschboeck Dudek S.C., Milwaukee, WI (August 9, 2007) (Mr. Gumina has 16 years of experience in labor and employment law).

137. In most states, “gross misconduct” is defined as behavior that evinces an intent against the employer’s interest. Gross misconduct can range from one instance of theft to habitual tardiness or rule breaking. *Id.*

138. *Id.*

139. The account set forth here is that of the Wisconsin unemployment compensation system. Though state processes vary, this account is representative of the administration of UC benefit disputes in the United States. *Id.*

140. The employer, of course, has an interest in the outcome because benefit payouts affect the employer’s

have the right to appeal the investigator's decision and have a brief hearing,¹⁴¹ generally without counsel and no pre-hearing discovery, on the merits before an ALJ or similar official.¹⁴²

The decision of the ALJ may be appealed to a higher authority within the UC system.¹⁴³ Any party that is dissatisfied with this review process may appeal to the state circuit court, with further appeals from there permitted though generally rare. Thus, resolution of disputes is handled largely within the administrative process. The UC system is able to set tax rates through experience rating, collect funds, disburse benefits, coordinate program administration efforts with 53 different state and jurisdictional offices, and adjudicate contested factual issues regarding benefits eligibility (excluding court appeals) at a cost of less than 10% of collected funds annually.

Administering the ICF program, of course, will be more costly than administering the UC. The ICF's administrative procedures will contain a mix of insurance and litigation elements, like the UC program. However, the costs of the ICF still will be significantly higher in all likelihood. Though the UC must set experience ratings for taxation purposes, generating fraud risk ratings will be a much more complex process, given the numerous variables that comprise the rating and the annual reviews that must be conducted on each publicly traded company. In addition, determining whether a claimant has met the standard for UC benefits is not as complex as the determination that will have to be made by the ICF. Determining eligibility for payment under the ICF (i.e., that investment losses were due to fraud, as opposed to, for example, negligent misstatements) requires an investigation into state of mind and the intent to defraud (scienter) of corporate officers. This can be costly as corporate officials must be deposed and corporate records reviewed. Finally, in the UC system, the parties usually (though not always) appear before the ALJ without counsel. Under the ICF, corporations, like employers in the UC system, will have an interest in intervening to contest fraud allegations, but not only because of the effect on the fraud risk rating. Managers also will be concerned about the potential damage to the corporation's reputation from an adverse fraud determination.¹⁴⁴ In addition, the corporation almost certainly will insist on being accompanied by counsel, and, under the ICF Proposal, will be able to do so. On the other

experience rating and level of UC taxes. *Id.*

141. In Wisconsin, these hearings generally last no longer than two hours. Telephone interview with Frank Gumina, *supra* note 136. Across the UC system generally, the hearings typically last 20-45 minutes. Emp. & Training Admin., U.S. Dep't of Labor [hereinafter ETA].

142. The parties generally opt not to be represented by lawyers unless another related claim is pending (e.g., a discrimination suit). *Id.* Also, pre-hearing discovery generally is not permitted, though the parties have the right to file for discovery at the hearing. *Id.* During the hearing, both parties are permitted to call witnesses and present exhibits. *Id.*; see also Wisconsin Dep't of Workforce Dev., Requesting a Hearing—Frequently Asked Questions, <http://www.dwd.state.wi.us/uibola/FAQs-12-01/> (answering general questions about unemployment benefit hearings).

143. In Wisconsin, this body is the three-person Labor and Industrial Review Commission (LIRC). Telephone interview with Frank Gumina, *supra* note 136. Appeals are briefed only; there are no live witnesses. *Id.* No new evidence is permitted, but LIRC confers with the lower ALJ on various issues, including credibility of the witnesses, and does a de novo review. *Id.* In five states or U.S. jurisdictions (Hawaii, Minnesota, Nebraska, the District of Columbia, and the Virgin Islands), there is no second level of appeal within the UC system. ETA, *supra* note 141.

144. This may even be more likely under the ICF than under the current class action regime because the reputational penalty from a government action is likely to exceed that from a class action filed by a private plaintiffs' attorney. See Part IV.C.3, *infra*.

hand, of course, the ICF will not have to process the volume of cases that the UC system has to, which will offset the costs of the complexity to some degree.¹⁴⁵

In any event, it seems likely that the costs of administering the ICF will be significantly lower than the costs accompanying private securities fraud litigation. Because of the non-adversarial nature of the ALJ proceedings, costs for fraud determinations under the ICF Proposal should be lower than the costs of private litigation, even after factoring in the costs of appeals of ICF decisions. Fraud securities class actions are very costly. In addition to the costs payable directly to plaintiffs' and defense counsel, as mentioned previously, administering such suits consumes a great deal of judicial resources. There are a number of costs incurred in litigation that will not exist if the ICF is adopted. For example, under the PSLRA, in a securities class action, the court is required to select a lead plaintiff, which initially requires a determination of which potential plaintiff suffered the greatest loss from the alleged fraud.¹⁴⁶ Deciding this issue, which essentially involves deciding among competing teams of lawyers,¹⁴⁷ will not be required under the ICF. Also, pursuant to the PSLRA, plaintiffs do not have the right to discovery unless they get past the motion to dismiss, which requires pleading with particularity facts that give rise to a strong inference of fraud.¹⁴⁸ As John Coffee explains, "Often, this process ... involve[s] multiple motions in which the parties contest whether this heightened pleading standard has been satisfied (with the plaintiffs typically receiving at least one leave to replead their complaint if their initial pleadings fail this test)."¹⁴⁹ Discovery disputes are also costly, as the individuals to be deposed (e.g., corporate officers, directors, and accountants) all have their own counsel who can put forth arguments limiting the plaintiffs' attorneys' access.¹⁵⁰ The settlement process also imposes costs as lawyers for all the parties attempt to negotiate a settlement with which they are comfortable and the court will approve. Complicating this process are any objectors—class members who believe the proposed recovery under the settlement is insufficient or those who attempt to hold up the process in hopes of extracting some unique personal benefit. Moreover, in recent years an increased number of institutional investors have chosen to opt out of class actions altogether to pursue individualized actions because they believe they can achieve a higher recovery through this process.¹⁵¹

145. In each of the last three last years, the UC system, nationwide, issued an average of 1,411,028 decisions in appeals (1,230,039 lower authority decisions and 180,988 higher authority decisions, on average), a number that dwarfs any plausible estimation of the number of annual ICF claims. ETA, *supra* note 141. According to Cornerstone Research, from 1996-2005, an average of 193 securities class actions (including non-secondary market fraud cases that will not be administered by the ICF) were filed each year. SECURITIES CLASS ACTION CASE FILINGS, *supra* note 109, at 1. Even if the existence of the ICF (because of the ease of filing and equality afforded to frauds of varying sizes not existent under the current regime) led the number of securities fraud cases administered each year to increase more than five-fold from current levels, which seems unlikely, approximately 1000 cases is significantly fewer than the number of cases processed by the UC system each year.

146. Coffee, *supra* note 62, at 1540.

147. *Id.*

148. *Id.* at 1541.

149. Coffee, *supra* note 62, at 1541.

150. *Id.*

151. Anecdotal evidence suggests they may be correct. See Kevin M. LaCroix, *Opt-Outs: A Worrisome Trend in Securities Class Action Litigation*, in INSIGHTS (Oakbridge Ins. Servs., Bloomfield, Conn.), Apr. 2007 (discussing institutional investors who claim to have received many times more in their opt out cases than they

Compounding the issue is the pursuit of some of these individualized cases in state court. Congress passed the Securities Litigation Uniform Standards Act (SLUSA) in 1998 to prevent plaintiffs from circumventing the strict pleading requirements of the PSLRA by filing an action in state court. However, SLUSA only pre-empts *class actions*, not individual suits brought under Rule 10b-5. Thus, a plaintiff that opts out of the class action is free to pursue a state action, which has the effect of adding to the defendants' litigation costs. Indeed, these opt out suits can lead to disputes between federal and state courts,¹⁵² which can add even more costs to an already costly system. None of the processes described above¹⁵³ would exist under the ICF.¹⁵⁴ Thus, even if one is inclined to suggest that the ICF will be "expensive" to administer, it seems unlikely that the costs would approach those of securities class actions.

Complexity can exist even in securities fraud cases where it is not clear that the additional costs yield significant benefits to shareholders. Consider the Blue Rhino Corporation case,¹⁵⁵ in which the class action period lasted 22 days (inclusive),¹⁵⁶ and the settlement amounted to \$1.25 million (with 21.5% of that amount plus expense reimbursement of up to \$230,000 going to the plaintiffs' attorneys).¹⁵⁷ The civil docket contains 112 entries with dates from May 2003 to October 2005, and many of these entries include various briefs, reply briefs, stipulations, and orders related to procedural rather than substantive determinations.¹⁵⁸ According to the settlement notice, the estimated average distribution per share is \$0.78 before deducting fees and expenses.¹⁵⁹ I offer no opinion on the complexity of the issues requiring resolution or the adequacy of the settlement. However, despite the apparent expense and complexity of the process, shareholders were entitled to receive limited compensation. Moreover, as of this writing almost five years after the end of the class action period, this compensation still has not

would have received as a participant in the related securities class actions), *available at* <http://www.oakbridgeins.com/Issue%2010%20Opt-Outs%20A%20Worrisome%20Trend%20in%20Securities%20Class%20Action%20Litigation.pdf>.

152. See Coffee, *supra* note 62, at 1541 n.17 (citing *Ret. Sys. of Ala. v. J.P. Morgan Chase & Co.*, 386 F.3d 419, 431 (2d Cir. 2004), in which a federal court of appeals invalidated a federal district court's injunction ordering Alabama state court to postpone its trial until after the conclusion of the district court's related securities litigation trial).

153. This is not an exhaustive list. There are other procedural aspects of litigation (e.g., motions related to jurisdictional or venue issues) that will have no place under the ICF.

154. One, of course, could argue that reforming securities class actions, rather than instituting the ICF, could solve these problems. However, that is a "second best" solution. Reforming class actions likely would do little to increase investor compensation for reasons described in *supra* Part III.

155. *In re Blue Rhino Corp. Sec. Litig.*, No. 03-3495 (C.D. Cal. Oct. 7, 2005), *available at* http://securities.stanford.edu/1028/RINO03-01/2005105_r01o_033495.pdf.

156. The initial complaint alleged a 175-day class action period (August 15, 2002 – February 5, 2003, inclusive). Complaint at 1, *In re Blue Rhino Corp. Sec. Litig.*, No. 03-3495 (C.D. Cal. May 19, 2003), *available at* http://securities.stanford.edu/1028/RINO03-01/2003519_o01c_033495.pdf.

157. Inst. S'holder Servs., Securities Class Action Services Database [hereinafter SCAS Database].

158. See Civil Docket, *In re Blue Rhino Corp. Sec. Litig.*, No. 03-3495 (C.D. Cal., filed May 19, 2003), *available at* http://securities.stanford.edu/1028/RINO03-01/2005216_r01k_033495.pdf. Total entries figure includes three error notices, but excludes four items placed in the file that were not used. *Id.*

159. Notice of Settlement of Class Action at 1, *In re Blue Rhino Corp. Securities Litigation*, No. 03-3495 (C.D. Cal. June 22, 2005), *available at* http://securities.stanford.edu/1028/RINO03-01/2005622_r01n_033495.pdf. Attorneys' fees and expense reimbursement are estimated to average \$0.18 per share. *Id.* at 2.

been disbursed to shareholders.¹⁶⁰ This example is admittedly anecdotal,¹⁶¹ but it demonstrates that securities class actions have the potential to consume a great deal of judicial resources, even in cases where it is not clear that shareholders receive a significant benefit from the process.

Though the ICF offers significant cost savings potential over fraud class actions, it has some costs that class actions do not—administering the fund and setting fraud risk ratings. In addition, one cost will, in all likelihood, be very similar—the fraud determination. The ICF must conduct an investigation and the ALJs, just like federal judges at the motion to dismiss stage in securities class actions, will need to review the evidence and determine whether fraud occurred. Of course, under the ICF, there will not be multiple teams of lawyers filing multiple motions, but the basic process of adjudging the commission of fraud will be the same.¹⁶²

One efficiency from implementing the ICF can come from eliminating redundant investigation costs. Under the ICF Proposal, the ICF Division will work closely with the SEC's Division of Enforcement, which currently carries out fraud investigations, so incremental investigation costs will be minimized to some extent. In addition, the SEC currently does not cooperate or share discovery with plaintiffs' lawyers pursuing claims against the defendants that the SEC is investigating.¹⁶³ Thus, the duplication of effort and costs to police the same behavior would end under the ICF Proposal.¹⁶⁴

160. See SCAS Database, *supra* note 157 (indicating that the status of the case is “settled” rather than “settled disbursed”).

161. Though this example is unusual due to the small absolute dollar value of shareholder recovery and the short class action period, the recovery is not that different from that which investors receive in many securities fraud class actions. According to Cornerstone Research, the median settlement value, in 2006 dollars, of class actions settled over the approximately 10-year period since the passage of the PSLRA through 2005 (excluding the Enron, WorldCom and Cendant mega-settlements) is \$6.7 million. SIMMONS & RYAN, *supra* note 7, at 2.

162. One possible way to reduce administrative costs would be to eliminate the scienter requirement so that damages could be awarded for losses induced by gross negligence. Some suggest that, in practice, juries (though rarely party to securities fraud determinations) and judges may find fraud liability when there is merely gross negligence, rather than an intent to defraud or recklessness, as required under the law. See, e.g., Donald C. Langevoort, *Reflections on Scienter (and the Securities Fraud Case Against Martha Stewart that Never Happened)*, 10 LEWIS & CLARK L. REV. 1, 9 (2006) (stating, “[J]udges and juries may be applying the law as if [negligence or gross negligence] were the standard”). Gross negligence, in all likelihood would be easier to prove—a material misstatement exceeding a certain threshold likely would suffice—and hence more administratively efficient for the ICF. The obvious drawback is that this would increase the number of loss payouts significantly. In addition, while it is easy to justify compensation for fraud losses when shareholders have been victimized by intentional misconduct, it is more difficult to defend providing compensation when corporate managers merely have been careless (even grossly so). This is true even though one could argue that even innocent misstatements lead to the inefficient allocation of capital. In addition, lowering the standard in this context may lead to managers taking excess precautions because of fear of liability. There are obvious trade-offs that must be made in this regard, but, on balance, removing the scienter requirement, though expedient, would not be appropriate.

163. One rationale for the SEC not sharing information with private plaintiffs is that corporate defendants are more likely to comply with disclosure requests from the SEC if they know the information will not be shared with plaintiffs' lawyers. Telephone Interview #1, *supra* note 62. SEC investigative files are exempt from disclosure under the Freedom of Information Act (FOIA). *Id.*; see also 5 U.S.C. § 552(b)(7) (2000) (“records or information compiled for law enforcement purposes, but only to the extent that the production of such law enforcement records or information...could reasonably be expected to interfere with enforcement proceedings...” are exempt from FOIA).

164. It should be noted, however, that with the end of private class actions, the SEC's enforcement budget

On the other hand, the existence of the ICF could lead to additional costs because of the possibility that the number of instances of fraud alleged will increase under the ICF from current levels because of the easier filing process and potential for increased recovery. As discussed in Part III, securities fraud class actions often are not brought against small corporations because the expected damages are too low to be attractive to plaintiffs' attorneys. Also, the SEC, because of its limited enforcement budget, is unable to pursue many of such cases, despite its relatively recent initiative to combat microcap fraud.¹⁶⁵ One benefit of the ICF is that, unlike the current securities fraud class action regime, the government will police fraud at large and small corporations through fraud risk ratings and ICF proceedings, hence increasing overall deterrence. However, with this benefit comes the potential added expense of more claims requiring resolution.

Ultimately, the costs of administering the ICF are uncertain. Further study in this area is necessary. I submit, however, that in all likelihood, the costs of our current securities class action regime exceed those of the ICF as proposed.

C. Possible Objections and Implementation Challenges

The ICF Proposal is designed to provide the deterrence and compensation benefits outlined above at lower administrative costs than those existing under the current regime. However, there are a number of factors that must be considered in a proposal of this magnitude. In this section, I address some possible objections to the ICF Proposal, as well as some key implementation challenges.

1. Mandatory Nature of the Program

One potential criticism of the ICF proposal is that participation in the ICF scheme will be mandatory for all corporations in the United States. One could argue that the absence of fraud risk insurance of this type in the marketplace suggests that investors do not want the insurance and that it is not value-enhancing. A number of scholars advocate contractual freedom in corporate law (i.e., the ability of corporations and shareholders to opt out of the laws that will apply to the corporation).¹⁶⁶ The basic argument for the "freedom of contract" view is that investors know their own interests better than regulators and are capable of contracting for the protections they desire.¹⁶⁷ If firms do not provide the features that stockholders desire, their stock prices will reflect that failure.¹⁶⁸ Thus, one also could argue that even if the government were to offer such insurance, it would be most efficient to allow corporations to opt out of the ICF scheme if they did not believe their shareholders would value its protections.

The first argument is a familiar critique of reform proposals.¹⁶⁹ However, as Lucian

would have to be increased significantly.

165. See *supra* note 76 (discussing the SEC's "renewed focus on prosecuting fraud in smaller companies").

166. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 875 (2005) ("In my own view, there are good reasons for limiting contractual freedom in corporate law. Some scholars, however, advocate complete or very broad contractual freedom.").

167. See Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, Foreword, 89 COLUM. L. REV. 1395, 1404 (1989) (describing the arguments of proponents of contractual freedom).

168. *Id.*

169. See Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, Reply, 119 HARV. L. REV. 1784, 1805 (2006) (describing what he terms "the standard contractarian argument that the marketplace can be expected to

Bebchuk points out, “If [this] argument were valid, it would have far-reaching consequences. It would imply that much of the protection U.S. investors now enjoy—which results from arrangements introduced by federal rules and exchange requirements and not previously offered . . . is value-reducing and should be dismantled.”¹⁷⁰ In this context, in particular, the absence of fraud insurance does not imply that the ICF Proposal has no merit. First, organizations such as RiskMetrics Group¹⁷¹ and The Corporate Library¹⁷² produce corporate governance ratings and sell them to investors. This suggests that corporate governance matters to investors and that they view external judgments on the quality of governance as adding value to their investment decisions. Of course, as discussed in Part IV.C.4., *infra*, the evidence does not suggest that the currently available ratings would be able to predict with any degree of certainty the likelihood of fraud occurring. That is irrelevant for present purposes. The fact that private actors are trying to provide more information about corporate governance risk suggests that if the ICF program could develop a method for generating accurate fraud risk ratings, it would be value-enhancing.

Second, a fraud insurance mechanism exists today—D&O insurance, which provides third party insurance for corporations.¹⁷³ However, as discussed in Part III, *supra*, the level of compensation received by shareholders is inadequate and highly unlikely to increase under this system. Of course, one response might be that government intervention is not needed because investors are satisfied with the current level of recovery, small though it may be. If that were not the case, they would “force” corporations to provide them with greater protection from fraud losses. However, what this position ignores is the growing trend of institutional investors opting out of class actions and pursuing individual cases. This suggests that investors are dissatisfied with current levels of recovery, and some are pursuing means to achieve greater compensation that impose high costs on the legal system.¹⁷⁴ In addition, under the status quo, there is not much that investors can do to “force” corporations to give them additional protection. As discussed in Part III, *supra*, private insurers generally lack the capacity to insure investors up to the full (or even almost full) extent of their losses, and, given the potential for astronomical losses, in all likelihood, would be reluctant to enter the first party insurance market for investors without government guarantees of some sort.¹⁷⁵ Thus, just as is the case with various catastrophic risks, government intervention is likely needed for this protection to be provided.

produce on its own *all* optimal governance terms” and which “can be rolled out against any proposed legal rule (whether default or mandatory) that changes current arrangements”).

170. *Id.*

171. See note 221, *infra*, for a description of RiskMetrics Group’s corporate governance ratings.

172. The Corporate Library (TCL) employs an “A-F” scale to indicate the degree of governance risk at a rated corporation. TCL uses ratings from four primary component categories (“board composition and succession planning, CEO compensation practices, takeover defenses, and board-level accounting concerns”) to generate an overall governance rating. The Corporate Library, TCL Ratings, *available at* <http://www.thecorporatelibrary.com/UserFiles/Ratings0907.pdf> (last visited October 11, 2007).

173. Baker, *supra* note 113, at 379.

174. Even if one were to argue that opt out suits are motivated for non-pecuniary reasons (e.g., public pension fund manager hoping to demonstrate a pro-corporate governance stance in a more prominent fashion), the fact remains that these suits impose additional costs on the litigation system.

175. See notes 187 & 343, *infra*, for further discussion of this point.

The chief response to the second argument is that mandatory corporate participation is a necessary feature of the ICF. Though I have outlined several benefits of the ICF in this Article, it is possible that not all corporate managers would agree with my assessment, particularly if they worry about the effects of the ICF premium on their stock prices.¹⁷⁶ If participation were optional, many corporations could choose to opt out of the scheme. Low participation rates make for an unattractive insurance market because insurers seek large risk pools, allowing them to set premiums with greater confidence.¹⁷⁷ Thus, to have a large risk pool and an appealing insurance market, participation in the ICF must be mandated. Certainly, not every public company in the United States must participate for there to be a viable insurance market, but if participation is not mandatory, there is no way to know *ex ante* whether sufficient numbers of corporations will opt in voluntarily.¹⁷⁸

A related potential criticism of the ICF proposal is that participation in the ICF scheme will be mandatory for all investors, as well. One could argue that some investors will not want to pay the ICF premiums and would prefer to self-insure through diversification to the extent possible, or just bear the risk of loss. It, therefore, is unreasonable to force them to take a “benefit” that they would rather not have. This argument is not without some force, and it is likely that some investors would prefer to opt out of the ICF scheme. However, this criticism rests on the mistaken notion that implementing the ICF Proposal would lead to imposing a tax to which investors were not previously subject. For sure, the form of the tax under the ICF scheme is new, but a tax for securities fraud compensation exists currently. It exists in two forms—first, in the premiums paid by corporations to their D&O insurers for protection against secondary market fraud lawsuits (meritorious or not) and second, in the form of direct and indirect¹⁷⁹ costs incurred by companies in defending such suits (which affect earnings and ultimately stock prices). Therefore, a more appropriate question for an investor evaluating the ICF Proposal is not whether she wants to pay a tax; she already is doing so, albeit indirectly. The better question, in my view, is whether the tax paid under the ICF scheme is more efficient than the alternatives, and this Article provides some evidence that it is.¹⁸⁰

176. It is possible that a number of corporate managers would welcome the end of the threat of secondary market securities class actions and happily opt in to the ICF.

177. See Marcus Radetzki & Marian Radetzki, *Private Arrangements to Cover Large-Scale Liabilities Caused by Nuclear and Other Industrial Catastrophes*, 25 GENEVA PAPERS ON RISK & INS. 180, 182 (2000) (“[S]imilar but uncorrelated risks insured must be numerous. The greater the number of such risks, the nearer the total damage cost will approach the underlying probability.”).

178. Similarly, though there are ways to mitigate the risk of adverse selection (e.g., by charging appropriate risk-based premiums), making participation in the insurance scheme mandatory eliminates adverse selection concerns. See Baker, *supra* note 113, at 383 (“Mandatory participation requirements, if enforced, always take care of adverse selection.”).

179. “Direct” costs include the costs specifically related to litigation such as attorneys’ fees and court costs. “Indirect” costs include items such as management inattention to the firm’s core business during the litigation process. See Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1027-28 (1996) (discussing direct and indirect costs of litigation), cited in Pritchard, *supra* note 4, at 953, n.106 (describing the indirect costs).

180. It is, of course, possible for an investor to argue that she does not want to pay a tax for compensation of any sort, whether it be through the class action mechanism, the ICF, or any other compensation scheme. However, as discussed previously, eliminating compensation for securities fraud losses is not politically

Furthermore, making investor participation voluntary also would undermine the deterrence effects of the ICF. The investors who would be most likely to opt for the protections of the ICF are individual investors because, as mentioned previously, they are generally less diversified than institutional shareholders and are more risk-averse. Though holding approximately 40% of the value of stocks in the United States, individuals account for a very small percentage of total trading volume.¹⁸¹ Thus, any trading behavior that is altered due to the level of the ICF premium is unlikely to have much effect on a company's stock price, since investors trading a small percentage of a particular company's stock will be considering the company's related ICF premium when making trading decisions. Without significant stock price effects, the deterrence benefits of the ICF Proposal largely disappear.

In addition, as a practical matter, voluntary investor participation is not administratively feasible. Buyers and sellers are brought together anonymously to trade securities. In the public markets, there is no practical way to determine which buyer has been matched with which seller. Thus, premiums cannot be collected only from sellers that have opted into the ICF or who are selling to buyers that have done so. This analysis, of course, is premised on the idea that there has to be a matching of sellers and buyers. Intuitively, this makes sense because of the implicit nature of this compensation fund (i.e., a seller leaves behind a payment in case the stock price was inflated by fraud). This, however, does not have to be the case because all ICF funds are fungible. However, funding would be more predictable if there were no worry that a disproportionate number of frequent buyers (or rare sellers) would opt in and lead to a funding shortfall. An additional administrative problem relates to collecting the premiums. As proposed, the ICF will require the exchanges to remit periodic payments based on trading volume. It would be much more difficult administratively for the exchanges to collect ICF premiums only from investors that have opted in to the program.

2. The Role of the Federal Government

Another potential criticism of the ICF Proposal relates to the role of the government in the ICF scheme. Some view government involvement with skepticism. Thus, one concern is that implementing the ICF Proposal would result in the creation of a federal bureaucracy, unconstrained by competition and unaccountable to shareholders. Indeed, other government managed compensation funds, including the FDIC,¹⁸² SIPC,¹⁸³ and

feasible. Thus, investors will continue to pay the costs of fraud protection for the foreseeable future.

181. Though precise data on the level of retail trading in the U.S. capital markets overall is not available, reviewing retail trades on the NYSE may be instructive. For the fifteen trading days between October 15, 2007 and November 2, 2007, inclusive, trades by retail investors represented, on average, approximately 1.7% of total NYSE trading volume. (Calculated by author as the greater of retail buy volume or sell volume, divided by total NYSE volume. Underlying data (the availability of which changes daily) was obtained from New York Stock Exch., NYSE Retail Trading and NYSE Dollar Volume Summary, available at <http://www.nysedata.com/nysedata/default.aspx> (follow "Retail Trading - Click here for more" hyperlink; also follow "Dollar Volume Summary - Click here for more" hyperlink) (last visited Nov. 3, 2007).) It is generally believed that retail trading as a percentage of total volume is higher on the NASDAQ than on the NYSE.

182. See, e.g., Anthony M. Santomero, *Deposit Insurance: Do We Need It and Why?* i (The Wharton Fin. Inst. Ctr., Working Paper No. 97-35, 1997) (arguing that "[D]eposit insurance has its own set of problems. It encourages: (i) risktaking by insured institutions; (ii) neglect by depositors; (iii) intervention by regulatory agencies."), available at <http://fic.wharton.upenn.edu/fic/papers/97/9735.pdf>.

the Pension Benefit Guaranty Corporation (PBGC),¹⁸⁴ have been criticized extensively, which suggests there are valid reasons to be concerned about government involvement in this context. However, some design elements of the ICF should give potential critics some comfort. First, the SEC will oversee the ICF. Despite recent corporate governance lapses, among academics, practitioners, politicians, and the public, the SEC generally enjoys a positive reputation.¹⁸⁵ Though sometimes subject to criticism, many attribute any of the SEC's shortcomings to its lack of funding¹⁸⁶ rather than any incompetence of its officials. Thus, the SEC should be able to manage the ICF well, assuming adequate funding. Second, the ICF will conduct high salience work. In the post-Enron era, the media spotlight is focused on the efforts of the SEC to police corporate fraud. Thus, it is less likely that the ICF would be able to carry on its activities with no accountability to the investment community.

One still may remain skeptical of the efficacy of government intervention in private markets, despite the features of the ICF designed to minimize such concerns. However, because the government has pricing and coverage advantages over private insurers, the federal government is the most efficient provider of securities fraud insurance and its involvement in the ICF scheme is justified.

First, the government can mandate corporate and investor participation. As described previously, small markets are unattractive insurance markets, so insurance coverage must be mandated, something only the government can do. Of course, the government could mandate the purchase of private market insurance,¹⁸⁷ resulting in many of the same benefits as would accrue from government provision of mandatory insurance. However, doing so would result in a loss of the advantages described below.

Government provision of insurance results in pricing advantages over provision by private insurers. The ICF, by design, will be self-financing. However, if actual damage payouts exceed expected losses, under the proposal, the U.S. Treasury will provide an interest-bearing loan to the ICF to make up any shortfall on damages payouts that are

183. See, e.g., U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: STEPS NEEDED TO BETTER DISCLOSE SIPC POLICIES TO INVESTORS 14 (2001) (describing how critics have claimed that the SIPC's primary goal is not brokerage customer protection, but rather protection of its industry-supplied fund); Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1114, 1126 (1999) (arguing, among other things, that the Securities Investor Protection Act (SIPA), which created the SIPC, "subsidizes the broker-dealer industry by shifting the costs of failures" and does not attempt to attack the root cause of brokerage firm failure, but rather provides for merely reacting once such failures occur"); but see U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: UPDATE ON MATTERS RELATED TO THE SECURITIES INVESTOR PROTECTION CORPORATION (2003) (noting that the SIPC has implemented significant reforms to improve its operations).

184. See, e.g., RICHARD A. IPPOLITO, THE ECONOMICS OF PENSION INSURANCE 10 (1989) (criticizing the PBGC's pricing structure, benefit guarantees and failure to address moral hazard effectively).

185. David C. Nixon et al., *With Friends Like These: Rule-Making Comment Submissions to the Securities and Exchange Commission*, 12 J. PUB. ADMIN. RES. THEORY 59, 73 (2002). Admittedly, the SEC oversees the SIPC, which has been subject to criticism. See note 183, *supra*.

186. See generally James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L. J. 737, 757 (2003) (describing the SEC as the "heroic David").

187. The question remains whether private insurers would have an interest in participating in this market. According to one D&O insurance executive, some private insurers would be reluctant to provide first party insurance for securities fraud. However, some insurers might consider participating in the program if a government mandate for coverage assured them of a market. See Telephone Interview #2, *supra* note 70. See also *infra* note 343, for further discussion of the likely interest of private insurers in this market.

due.¹⁸⁸ The ICF, therefore, will be able to charge lower premiums than private insurers would be able to. The government's size and borrowing capacity allow it to "produce" insurance at a lower cost than private insurance markets.¹⁸⁹ Because the level of the economic capital charge borne by the government effectively amounts to zero, it only has to set premiums at the level of expected loss if the intent is to price the insurance at cost.¹⁹⁰ Premiums charged for private fraud risk insurance would have to include not only an actuarial charge for expected losses, but also a charge for the economic capital required to absorb loss volatility.¹⁹¹ This also could lead to inefficient pricing because

188. The U.S. Treasury would provide this loan only after the ICF exhausted other funding possibilities, such as borrowing under a line of bank credit. A similar pre-arranged loan guarantee is in place with the SIPC. If the SIPC fund's assets (including its ability to borrow on a revolving line of bank credit) are insufficient to meet its obligations, the SIPC may borrow up to \$1 billion from the SEC, which the SEC would borrow from the U.S. Treasury. See SIPC 2005 ANNUAL REPORT, *supra* note 129, at 4. Though a benefit of this proposal, the government guarantee raises equitable considerations because following any extension of government credit (if it becomes necessary), future ICF premiums will have to be increased above projected expected losses in order to have sufficient funds available to repay the loan, thus disadvantaging investors post-loan vis-a-vis investors pre-loan. However, having a government guarantee in place is an important feature of the proposal because the government's guarantee provides benefits for all investors (both present and future), as it allows all ICF premiums to be lower than what they would be without such a guarantee. In addition, the equitable considerations are mitigated significantly (though certainly not entirely) when one considers that the overwhelming majority of trading volume on U.S. markets is undertaken by large institutional investors who are repeat players in the market and are likely to be both pre- and post-loan investors. Despite the benefits of the government guarantee, other methods to protect against funding shortfalls, such as securitization, should be explored. See Harry Panjer, *Insurance Against Misinformation in the Securities Market: Actuarial Aspects*, in 2 CANADA STEPS UP 423, 452 (2006) (discussing securitization (specifically selling to public market investors high-yield bonds, the yield on which is reduced to reflect losses) in connection with securities misinformation insurance in Canada), available at <http://www.tfmsl.ca/>. (See Part V.C., *infra*, for a description of securities misinformation insurance.) But see notes 332 and 333 *infra* and accompanying text for a discussion of the potential limits on public market participation in a securities fraud insurance scheme.

189. For a similar discussion with respect to FDIC insurance, see Kuritzkes et al., *supra* note 94, at 34-35.

190. For a parallel argument in the context of FDIC insurance that notes that this point is arguable because "[t]he United States government ultimately has a finite borrowing capacity, at least at a given cost of funds," see *id.* at 34. One may argue that even though the government does not have to charge as high a premium in advance, its ability to do so is due to its power to tax. If the ICF premium pricing is accurate, this will not be an issue. However, if the pricing is wrong, and the government has to make up for any shortfalls in premium collections, it will have to tax (or alternatively, use previously collected tax revenue). There are distortionary costs to taxing (i.e., taxes can alter the behavior of citizens, so if taxes have to be raised to bail out the ICF, it could impose other costs on society beyond the amount of the taxes). One response is that the ICF has ample incentive to get the pricing right, though admittedly correct pricing will be a challenge. (Part IV.C.4. explores some of these concerns in more detail.) Another response is that the government runs a number of insurance programs (e.g., the FDIC, unemployment insurance, flood insurance), and though its track record is not perfect, the government has proven itself competent to manage an insurance mechanism. Finally, even when the government has gotten the pricing wrong in the past in an extreme failure, such as the savings and loan crisis when it had to execute a large bailout, the effects were not long-term. The FDIC, which took over the responsibility for S&L deposit insurance from the Federal Savings & Loan Insurance Corporation (FSLIC), is now self-supporting. Of course, one cannot argue that enduring another crisis of the order of magnitude of the S&L crisis would be welcome. However, I use this example to show that, even in this extreme case, there appears to be no long-term effect from distortionary taxation. That said, this concern should be explored more fully in any further consideration of implementing the ICF.

191. See *id.* at 34 for a similar discussion in connection with FDIC insurance. Insurers calculate expected losses, but actual losses may be more or less than expected (i.e., be "volatile"). Thus, private insurers must maintain sufficient capital not only to meet *expected* losses, but also to cover losses that are higher than

the presence of large corporations in the insurance pool would require a private insurer to hold more incremental economic capital, irrespective of the relevant proportion of expected loss, thus leading to the possibility of the insurance premiums far exceeding the expected losses.¹⁹² Though the organizations are criticized on many grounds,¹⁹³ commentators generally agree that the FDIC and SIPC are able to provide depositor and investor protection at lower costs than private markets.¹⁹⁴ Thus, it is likely that, overall, the ICF would have the ability to insure against securities fraud risk at a lower cost than private insurers.

Moreover, government or single-provider fraud insurance can achieve administrative cost savings. Competing private insurers must incur duplicative costs related to marketing and underwriting, which can increase the price of insurance.¹⁹⁵ In addition, having a single provider can be more efficient because, before an insurer pays any claims, it will have to conduct an investigation into whether securities fraud occurred. It would be highly inefficient for individual insurers to conduct multiple independent fraud investigations. Of course, cooperation agreements among insurers are possible, but insurers in all likelihood would not relish taking on what has traditionally been the role of a judge in determining whether the requisite state of mind (*scienter*) was present to warrant a finding of fraud. This is outside the scope of their competence.

In addition, having the government serve as the sole insurer in this context makes collecting premiums more feasible administratively. The per-trade fee assessment is a key component of the ICF Proposal; without it, issuer-funding would be required and compensation would be limited significantly.¹⁹⁶ Collecting premiums on trades and then remitting them to various private insurers based either on issuer or, worse, by trader, adds another layer of complexity to the administration of the fund¹⁹⁷ and substantial costs.

Despite the administrative cost benefits of government management, there are also disadvantages. Private sector competition and profit motives might lead to innovation and administrative cost cutting in the private fraud insurance market—things that are less likely to exist with the ICF because of its use of government-employed managers who may be less sensitive to spending public dollars.¹⁹⁸ While this is a valid criticism of the

expected.

192. See generally *id.* at 37 for a discussion of this concept in connection with FDIC insurance.

193. See *supra* notes 182 and 183.

194. See, e.g., Joo, *supra* note 183, at 1115 (“It is unclear whether the private insurance market could provide satisfactory investor insurance, particularly at a low cost comparable to that of SIPC assessments.”); Kuritzkes et al., *supra* note 94, at 35 (stating that the government’s size means it can provide insurance at a lower cost than private markets).

195. Each insurance company must engage in underwriting and risk assessment, resulting in a duplication of effort not present if the government alone performs the function. See generally Timothy Stoltzfus Jost, *Our Broken Health Care System and How to Fix It: An Essay on Health Law and Policy*, 41 WAKE FOREST L. REV. 537, 577 (2006) (stating, in the health insurance context, that administrative costs such as marketing and underwriting are higher for individual insurance policies than for group or government-provided insurance).

196. See *supra* Part III (discussing the limits of a corporation’s ability to provide compensation for fraud losses); see also *infra* Part IV.C.6. (discussing why the fee should be based on trades and not holdings).

197. See Baker, *supra* note 113, at 415-16 (stating that, in connection with evaluating one possible scheme for Canadian securities misinformation insurance (described in Part V.C. *infra*), “There are no per-trade fees in the private market approach because of the administrative complexity involved in collecting the fees on behalf of multiple private market insurers”).

198. See generally Jost, *supra* note 195, at 579 (discussing, generally, these considerations in the context of public health insurance); Michael B. Rappaport, *The Private Provision of Unemployment Insurance*, 1992 Wis.

ICF Proposal, on balance, because of the government's ability to "produce" insurance at a lower cost than the private sector, as discussed above, it is likely that any potential administrative inefficiencies will be outweighed by the government's other pricing advantages.

In addition, government insurance precludes market price competition, which is usually believed, by market enthusiasts, to provide substantial benefits. However, it is not clear that pricing competition would advance the deterrence goals of the ICF Proposal. Currently, competitive pressures appear to make it impossible for D&O insurer premium prices to reflect governance risk fully.¹⁹⁹ There is no reason to think that these pressures would not exist if the insurance were sold to investors rather than corporations.

One also may argue that governmental involvement will impede the development of accurate fraud risk ratings. First, though an independent, private company will perform the risk assessments that determine the ICF premium, this government-hired ratings agency may have poorly aligned incentives. The primary downside to getting the risk assessment wrong will be reputational loss and, eventually, loss of the government contract. Though these are significant risks, the rating agency will not have its capital at risk, as is the case with private market insurers²⁰⁰ or investors. Also, as a government-sanctioned contractor, the agency will not have to compete in the marketplace for clients.²⁰¹ Thus, it will have reduced incentives to perform competently. Second, the agency will have no incentive to work to refine its pricing model. Private insurers compete to underwrite accounts, so they can obtain a significant benefit from refining their pricing models to allow them to underwrite accounts profitably that other insurers turn away (or price inappropriately). This will not be the case with the ICF-appointed rating agency. These are all valid concerns. However, it is clear that the government oversees a number of insurance programs (e.g., the FDIC, PBGC, SIPC, unemployment insurance) and has demonstrated that, even in the absence of competition, risk assessment

L. REV. 61, 105-06 (discussing, generally, some of these considerations with respect to the provision of unemployment insurance).

199. See Posting of Kevin Lacroix, director of OakBridge Insurance Services, to D&O Diary, http://dandodiary.blogspot.com/2006_12_01_archive.html (Dec. 03, 2006, 21:47 CST). Lacroix wrote,

It might be possible for a D & O insurer to insist on corporate governance reforms if the insurer could offer demonstrable insurance cost savings for qualifying companies, but the reality is that the D & O insurance sector has been and remains so competitive that it is impossible to show cost savings. There is always a competitor willing to offer the same or similar coverage at the same (or better) discount, and so companies who might otherwise accept their insurer's loss prevention requirements have little monetary incentive to do so.

Id.; see also Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 531 (2007) ("[T]he market for D&O insurance operates as a constraint on the ability of underwriters to factor risk into price."); *id.* at 526 (suggesting, based on their findings from interviews with D&O professionals, that there may be "short-term pressure on underwriters to generate premium volume notwithstanding possible long-term losses").

200. Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1179 (2006) ("[I]nsurers stake their own capital on their governance assessments and suffer directly from any error in evaluating risk.").

201. The rating agency, however, will have to compete for the government contract and be subject to the rigors of a competitive bidding process. This, of course, differs substantially from competing for the business of corporations.

can be handled competently. To be certain, government insurers have made pricing errors, but the same can be said for private market insurers. On balance, given the other benefits accruing from government oversight, concerns about the government's ability to oversee the ratings process are insufficiently strong to mandate private insurance in this context.

Finally, regardless of one's views on the efficacy of governmental involvement in private markets, it is clear that, thus far, private market solutions have not emerged to address effectively the serious problem of securities fraud. For sure, implementing the ICF carries some risks. I submit, however, that the ICF is likely to be a better alternative to the status quo.

3. Deterrence Effects

Though I have argued that implementing the ICF and imposing fraud risk ratings on corporations will increase deterrence, there are questions about whether that necessarily will be the case. One could argue that the establishment of fraud risk ratings will do little to deter fraud. The variations in premiums among companies necessarily will be only fractions of one percent. Therefore, one could argue that such small variations will not have much effect on the trading behavior of investors and, by extension, the behavior of corporate managers. Perhaps on small trades made by individuals, the premium differentials will be too small to have much of an impact because, in dollar terms, the differences will be small. However, this is not the case for institutional investors that are active traders. According to recent studies, trading commissions for institutional investors average approximately 10 basis points (bp) or 0.10% (a bp is one one-hundredth of one percent).²⁰² Thus, for example, a one bp difference in ICF premium could mean a 10% difference in sell-side transaction costs for an institutional investor.²⁰³ Therefore, even slight differences in ICF premiums among corporations in which an institution is considering investing, when multiplied over the large volume of likely trades, can be significant because of the effect on overall transaction costs. Shares of stock are largely fungible,²⁰⁴ and differences in transaction costs can make a difference in investment

202. See Sugato Chakravarty et al., *Did Decimalization Hurt Institutional Investors?* 8 J. FIN. MARKETS 400, 411 tbl. 3 (2005) (finding dollar-weighted average trading commissions of approximately 9 bp (post-decimalization of stock prices) to 11 bp (pre-decimalization) for a sample of 34 large institutional investors trading NYSE-listed stocks in the years 2000 and 2001); Michael Goldstein et al., *Brokerage Commissions and Institutional Trading Patterns* 50 tbl. 1 (Oct. 16, 2006) (unpublished manuscript) (showing a range of trading commissions, based on trading activity, of approximately 9-12 bp for a sample of 306 institutional investors in 1997, calculated by author by dividing the average commission per share (shown in cents) by the average price per share), available at <http://ssrn.com/abstract=528288>. Note that the study's authors state that average commissions decreased substantially from 1997 to 2003 (the final period in study). *Id.* at 31.

203. It should be noted that commissions are not the only trading costs incurred by investors. See Chakravarty et al., *supra* note 202, at 409 (discussing non-commission trading costs such as price impact on trade and administrative costs of "working an order" and the "opportunity costs of missed trades"). However, commissions are direct trading costs and hence more similar to the ICF premium than other, indirect types of trading costs.

204. As Claudio Loderer et al. explain, "[a] common assumption in finance theory is that individual assets have perfect substitutes." Claudio Loderer et al., *The Price Elasticity of Demand for Common Stock*, 46 J. FIN. 621, 621 (1991). In other words, shares of stock are fungible; a buyer easily can find a number of stocks with similar characteristics in which to invest. However, more recent finance scholarship has called this assumption into question. See *id.* at 623-625 (describing theories and studies related to this question, including, among

choices.

Another potential concern is that implementing the ICF will have a negative effect on deterrence; an end of respondeat superior²⁰⁵ will accompany an end to fraud on the market lawsuits. This, however, should not be a serious concern because, under the ICF Proposal, instances of fraud committed by an employee will have a negative impact on a company's fraud risk rating, and by extension, its share price. Corporations, therefore, will have ample incentive to monitor their employees' actions. Another pro-respondeat superior argument, made in the torts arena by Guido Calabresi, is that respondeat superior leads to a better allocation of resources because it allows the price of goods sold in the market to reflect injury costs.²⁰⁶ Under this theory, implementing the ICF also will lead to a better allocation of resources. A firm's fraud risk rating will affect its share price and cost of capital directly. In the secondary market securities fraud area, share price is where this cost should be reflected.²⁰⁷

One also could argue that, in many contexts, lawsuits, despite their drawbacks, provide more deterrence than is available under insurance regimes.²⁰⁸ The ex post determination of liability can result in more accurate outcomes than an ex ante insurance premium, which is necessarily based on the insurer's estimate of the likely behavior of the insured. The deterrence effects of the ICF Proposal rely, in large part, on the ability of the rating agency to generate a rating that reflects the actual risk of securities fraud. As discussed in Part IV.C.4., *infra*, generating fraud risk ratings will be one of the biggest challenges for the ICF program. One of the strengths of lawsuits is the potential for more information to be available after the fact about whether there was fraud than is available ex ante about the likely propensity for fraud.²⁰⁹ Accurate outcomes, while beneficial in

others, that stocks are not perfect substitutes for one another if the stock of one firm provides hedging opportunities for an investor that cannot be duplicated with the stock of any other firm). Nonetheless, the fact remains that investors have a number of investment choices, and different transaction costs will affect investment decisions.

205. Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1381-82 (1997) (explaining that respondeat superior is a common law doctrine that holds employers responsible for the actions of their employees in order to provide corporations and other principals with incentives to take care in hiring and monitoring their employees).

206. Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 544 (1961), *cited in* Prentice, *supra* note 205, at 1391 n.309.

207. Of course, higher fraud risk ratings will translate into lower stock prices and a higher cost of capital. This can affect product prices to some degree because, for certain projects to be profitable, companies with higher costs of capital will have to charge higher prices.

208. *See, e.g.*, Jon D. Hanson & Kyle Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 163-64, 166-68 (1990) (concluding, in the torts context, that, although first-party insurance theoretically could provide optimal levels of deterrence, insurers fail to perfectly classify risks according to consumption choices, thus leading to litigation (specifically an enterprise liability regime) promoting deterrence goals better than insurance). The context in which this debate is often conducted is with respect to automobile accidents and the efficacy of tort litigation over no-fault insurance (under which insurers pay the claims of their insureds, rather than litigating fault). Many studies related to the question of whether no-fault plans provide as much deterrence as exists under a tort regime offer contradictory results. James C. Harris, *Why the September 11th Victim Compensation Fund Proves the Case for a New Zealand-Style Comprehensive Social Insurance Plan in the United States*, 100 NW. U. L. REV. 1367, 1385 (2006) (“[N]o consensus at all has emerged regarding the effect of no-fault plans on accident rates.”).

209. *See generally* Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. LEGAL STUD. 357,

their own right, also generally result in better deterrence.

This is a weighty concern, but one that is mitigated somewhat by the context of securities regulation. As described in Part III, *supra*, securities litigation does a poor job of deterrence given its failure to affect a significant portion of firms (i.e., small firms) and the fact the perpetrators of the fraud generally do not pay the judgment. Thus, while the idealized version of litigation may provide superior deterrence to an insurance regime, it is not clear that would be the case with respect to securities litigation.²¹⁰

Ultimately, the best deterrence against fraud is likely strong enforcement action by government regulators. According to one securities plaintiffs' lawyer with whom I spoke, "There is no question that the best [fraud] deterrent is a more heavily funded SEC."²¹¹ A D&O insurance executive I interviewed expressed a similar sentiment by indicating that, in his view, the presence or absence of D&O insurance has little effect on managerial behavior; corporate managers worry more about actions initiated by the SEC and the DOJ.²¹² The reputational sanctions from a government investigation and the threat of civil penalties and jail time likely will provide a much more powerful deterrent than the fraud risk rating and level of ICF premiums. Thus, in connection with the ICF proposal, it would be prudent to increase government fraud enforcement budgets significantly.²¹³

359 (1984) (discussing this concept in the context of tort liability).

210. In addition, one problem with an ex post litigation regime is the defendant corporation may be bankrupt and hence judgment proof at the time of litigation, which means the threat of a damages award is not much deterrent to the corporate managers contemplating fraud. *See generally*, Coffee, *supra* note 62, at 1551 n.64 ("Securities class actions tend less frequently to be filed in the wake of bankruptcy because the usually deep-pocketed corporate defendant can no longer be sued once it has entered bankruptcy."). Indeed, fraud is often caused by the "last period" problem (i.e., managers, fearing the consequences of poor corporate performance, engage in fraud to give them enough time to turn the company's results around). Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 693, 703 (1992) cited in Pritchard, *supra* note 4, at 931. This technique, of course, may be ineffective. One study of 111 fraud on the market cases decided between 1975 and 1990 showed that almost 25% of the firms accused of fraud later went bankrupt. Arlen & Carney, *supra*, at 726.

211. Telephone Interview #1, *supra* note 62.

212. Telephone Interview #2, *supra* note 70.

213. For more effective deterrence, additional government budget increases would have to accompany the implementation of the ICF. The end of secondary market class actions would mean the end of the investigatory work of plaintiffs' lawyers in this area. These lawyers often bring significant resources and expertise to bear when ferreting out corporate fraud. Telephone Interview #1, *supra* note 62. One plaintiffs' attorney I interviewed describes, for example, the hiring of private investigators to find former employees. The testimony of a former employee that can support fraud allegations is very useful in surviving the motion to dismiss. Though a "bad news" disclosure and a large stock price drop make the possibility of fraud obvious to most, the harder cases are those in which there are no obvious signs of fraud, and the plaintiffs' lawyer has to "put together a case" before filing a complaint. *Id.* This process takes a great deal of time and will be lost with the end of class actions. The ICF Division of the SEC will have to step in to this role. For sure, the SEC currently performs its own independent investigations. It occasionally uses funding to hire private investigators, but that is not typically done. The SEC is able to call on the government's unique resources, as well (e.g., access to databases with social security numbers and the ability to subpoena bank records). One plaintiffs' attorney I interviewed indicated that he believed that when the fraud case is sufficiently high profile, the SEC is able to marshal the necessary resources to do a good job investigating the case. *Id.* However, what seems clear is that the SEC Enforcement Division, as currently constituted, does not have the available staffing to replicate the investigative efforts of plaintiffs' lawyers for the hundreds of potential instances of fraud that occur each year. Thus, with the implementation of the ICF would have to come significantly increased staffing levels at the SEC. One possible source of funds could come from an assessment of higher Section 31 fees. (See *supra* note 93 and accompanying text for a description of these fees.) Of course, this would have the effect of increasing

4. *Fraud Risk Ratings*

Perhaps the strongest possible criticism of the ICF proposal is its reliance on fraud risk ratings. The efficacy of the ICF proposal depends, in large part, on the ability to generate fraud risk ratings that are accurate and substantially tied to the risk of fraud occurring. Corporate governance rating systems, which share some similarities with fraud risk ratings as proposed in this Article, currently exist. However, no study, to my knowledge, ties the ratings generated by those mechanisms to the risk of fraud. Indeed, my own preliminary empirical analysis, described below, suggests there is no correlation between ratings from one leading corporate governance rating system and the incidence of fraud.

Moreover, recent work by Tom Baker and Sean Griffith suggests that many of the structural factors typically used in corporate governance ratings (e.g., number of independent directors) are poorly correlated with D&O insurers' assessments of securities litigation risk.²¹⁴ This suggests that the metrics currently employed in existing corporate governance rating systems will be of limited value for the ICF. One could argue that there are significant market incentives for a private entity to develop an effective corporate governance rating system and the failure of one to emerge suggests that this is a difficult undertaking. One could argue further that there is no reason to think that governmental oversight of the process will simplify the task. This is a strong objection and one for which there is no easy response.

Admittedly, it is unclear which corporate governance mechanisms most affect the likelihood of fraud occurring at any individual company. There is, however, some limited empirical evidence that may prove useful in this context. For example, one study shows that firms subject to SEC enforcement actions were, relative to a control group, more likely to have a higher proportion of insiders on the company's board, greater ownership of company stock by these insider directors, no large outside stockholder, founder-CEOs and combined CEO and board chair positions.²¹⁵ A number of other studies find similar relationships between corporate governance practices, on the one hand, and fraud and/or accounting restatements on the other.²¹⁶ Therefore, there is limited evidence that

transaction costs for investors.

214. See Baker & Griffith, *supra* note 199, at 517-25 (describing the importance of firm culture and manager character). Note that D&O insurers are trying to assess litigation risk, not just fraud risk, since D&O insurers have to protect corporate managers and corporations from non-meritorious suits.

215. Patricia M. Dechow et al., *Causes and Consequences of Earnings Manipulations: An Analysis of Firms Subject to Enforcement Action by the SEC*, 13 CONTEMP. ACCT. RES. 1, 21 (1996).

216. See, e.g., Hatice Uzun et al., *Board Composition and Corporate Fraud*, FIN'L ANALYSTS J., May/June 2004, at 41 (finding "as the number of independent outside directors increased on a board and in the board's audit and compensation committees, the likelihood of corporate [fraud] decreased"); Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J. L. ECON. 371, 371 (finding "the probability of restatement is lower in companies whose boards or audit committees have an independent director with financial expertise...," but noting that they find no relationship between board independence and restatements); Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667, 667 (2007) (finding "[financial] misstatements are...more likely for firms...that have a CEO who serves as board chair"); Lawrence A. Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature* 13 (Oct. 24, 2007) (unpublished manuscript) (There "is a well-developed body of evidence demonstrating a strong positive correlation between director independence and financial reporting quality..."), available at

corporate governance mechanisms bear some relationship with the incidence of fraud.²¹⁷

In addition, insurance companies have developed mechanisms to help them decide whether to extend D&O insurance coverage and, if so, at what premium.²¹⁸ Indeed, one factor in determining D&O insurance premiums is a company's corporate governance rating.²¹⁹ If the insurers find the metrics useful when making their own pricing and coverage decisions, it seems reasonable to conclude that the ICF Division would be able to generate, in collaboration with an outside entity, a meaningful rating system. However, the challenge will be determining exactly which factors are most likely to affect the incidence of fraud.

A review of one corporate governance rating system currently in use may be instructive. The "pre-meltdown" RiskMetrics Group (then ISS)²²⁰ CGQ (corporate governance quotient) index score²²¹ of a selected group of scandal-plagued companies appears below:²²²

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1024261. It should be noted that a restatement does not necessarily suggest that the restating firm engaged in securities fraud. See *infra* notes 234-237 and accompanying text for additional factors researchers find to be associated with the incidence of fraud or restatements.

217. One challenge in this area stems from the fact that many of the corporate governance practices of public corporations are required or strongly encouraged either under the law or exchange listing requirements. This will make it more difficult to make meaningful distinctions among companies for the governance variable portion of the fraud risk ratings, as all public companies will have some minimum level of "good governance mechanisms."

218. In a study analyzing a cross section of Canadian public companies, a company's D&O insurance premium level was shown to bear a significant association with the quality of that company's corporate governance-related variables. John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J.L. ECON. & ORG. 449, 475 (2000), cited in Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 54 (2002). D&O premiums, however, would not be a perfect proxy for ICF premiums because, as discussed previously, D&O premiums have to include not only the risk of fraud being committed, but also litigation risk more generally. See Core, *supra* note 218, at 454 ("Business risk (such as firm size, profitability, and relative exposure to the U.S. legal system) also increases litigation risk. Thus a firm's D & O premium is hypothesized to be a function of both the quality of its corporate governance and its business risk."). The ICF premium will reflect, apart from a charge for administrative costs, only the risk of actual fraud because corporations will not be subject to secondary market strike suits (i.e., suits without merit filed in an effort to extract a settlement).

219. Many D&O insurance companies purchase the corporate governance ratings generated by RiskMetrics Group (then ISS) to assist them in setting insurance premiums. E-mail from John A. Deosaran, Vice President, Corporate Ratings, then Inst. S'holder Servs., to author (Sept. 11, 2006, 07:16:18 EDT) (on file with author). In addition, some insurers adjust the amount of the insurance premiums charged by up to 15% based on a company's Corporate Library governance score. See Baker & Griffith, *supra* note 199, at 522 n.159.

220. RiskMetrics Group acquired Institutional Shareholder Services (ISS) in January 2007. ISS is now a subsidiary of RiskMetrics.

221. RiskMetrics is a leading provider of proxy research and corporate governance services and maintains a database that contains CGQs for over 8000 companies in 31 countries. RISKMETRICS GROUP, CORPORATE GOVERNANCE QUOTIENT [hereinafter RISKMETRICS GROUP], available at <http://www.riskmetrics.com/pdf/products/RA10-CGQ.pdf> (last visited Nov. 13, 2007). RiskMetrics uses up to 65 data points in eight broad categories (board of directors, audit, charter and bylaw provisions, anti-takeover provisions, executive and director compensation, progressive practices, ownership and director education) to determine a company's CGQ. *Id.* RiskMetrics' CGQs appear to be the most widely respected set of corporate governance ratings available.

222. *Id.*

Name	CGQ Index Score
Adelphia Communications	15.9%
Enron	42.1%
Global Crossing	5.9%
Tyco	5.5%
WorldCom	11.3%

The CGQ index score compares the corporate governance rating of the company in question to the ratings of other companies in the relevant market index (e.g., S&P 500 firms). Tyco, for example, had a CGQ index score of 5.5%. This means that, at the time of the rating (i.e., before the fraud revelation), 94.5% of companies in the S&P 500 had a higher corporate governance rating than Tyco, suggesting that Tyco's corporate governance practices were lacking vis á vis other public companies.

In general, the corporate governance processes of the companies listed above, as assessed by RiskMetrics, were poor relative to those of companies in the market at large.²²³ However, these data provide only anecdotal evidence with regard to whether corporate governance ratings can assess the likelihood of fraud.

To gauge whether the RiskMetrics CGQs are correlated more broadly with the incidence of fraud, I analyze a proprietary data set²²⁴ consisting of the CGQs of all 100 companies that were the subject of settled securities class action lawsuits involving secondary market fraud, as of August 2006, with class periods between January 2002 (when CGQs were instituted) and August 2006. I observe that the CGQs at both the beginning and end of the class periods for the alleged fraudsters, as a group, failed to vary significantly from the CGQs of the overall universe of rated corporations. The average (median) CGQ index score at the beginning of the class period is 48.8% (48.8%), and the average (median) CGQ index score at the end of the class period is 51.2% (56.5%). This analysis reveals that, as the fraud continued, as a group, the firms' scores got somewhat better relative to the rest of the universe of rated companies.

These results cast substantial doubt on the predictive value of this metric for the typical fraud case. This is not a condemnation of RiskMetrics' CGQ; the metric was not designed specifically to predict fraud, but rather to assess broadly the quality of corporate governance practices, which have value apart from their effect on fraud risk.²²⁵ However, this evidence does highlight the fact that the ICF probably will not be able to employ a rating system currently in use without significant modification.

223. Enron's relatively higher (though still below the median) score notwithstanding, had investors incorporated this information into their investment decisions, perhaps the revelations of fraud would not have taken the market by surprise. What is unclear is why investors largely ignored these ratings. One possibility suggested by commentators for the lack of impact may be because the rating agencies lack access to nonpublic information, thus failing to add to the body of knowledge investors could have if they bothered to investigate. Apparently, however, investors neither heeded the corporate governance rating nor conducted their own independent investigations.

224. Institutional Shareholder Services Securities Class Action Database and Corporate Governance Quotient Database (data on file with author).

225. See generally INST. S'HOLDER SERVS., BETTER CORPORATE GOVERNANCE RESULTS IN HIGHER PROFIT AND LOWER RISK 1 (2005) (describing the results of a study that finds a correlation between good RiskMetrics (then ISS) corporate governance ratings and superior financial performance, specifically "lower risk, better profitability and higher valuation"), available at <http://www.issproxy.com/pdf/CGQSummary.pdf>.

It is possible that the factors most likely to affect the risk of fraud (e.g., firm culture and character and integrity of the managers)²²⁶ are things that are not readily observable or quantifiable by an external rating agency that has limited time to devote to developing each individual firm rating.²²⁷ Therefore, to enhance the quality of the fraud risk ratings used by the ICF Division, under this proposal, D&O insurers and auditors will be required to provide the ICF's designated rating agency with firm-specific information on some of the "softer issues" that cannot be captured in traditional corporate governance metrics.

During an audit, auditors have the ability to assess the potential for accounting fraud, and the insights gleaned from these processes can be useful in developing the appropriate fraud risk rating for a particular company.²²⁸ While it is not reasonable to believe that auditors will always be able to predict fraud or even provide accurate indications of all the "soft factors" that affect fraud risk, they are much closer to the company than any ICF representative ever would be and thus could provide valuable inputs into the rating process.

As mentioned previously, D&O insurers, to some extent, consider fraud risk when underwriting D&O insurance policies. Though these insurers do not have formalized underwriting standards to assess the risk of fraud, insurers, particularly now in the post-Enron era, explicitly factor corporate governance variables into D&O premium pricing.²²⁹ While insurers generally do not want to reveal their private pricing algorithms publicly,²³⁰ the ICF, as a division within a government agency, will be able to compel disclosure of these factors. Though the pricing models of D&O insurers will not be dispositive with respect to fraud risk (because underwriting competition and firm-specific factors, such as susceptibility to non-meritorious suits, can affect pricing),²³¹ the information gleaned from D&O insurers can be separated into components, with the factors most applicable for the ICF Division's purposes used to generate fraud risk ratings.²³² Moreover, because the ICF fraud risk ratings, unlike D&O insurance

226. See Baker & Griffith, *supra* note 199, at 517 ("Culture and character, we were regularly told [by D&O market participants interviewed], are at least as important as and perhaps more important than other, more readily observable governance factors in assessing D&O risk.")

227. The ICF's rating agency will have to be particularly careful about attempts by corporations to "game" the system by studying the inputs to the rating and making themselves appear less risky than they actually are.

228. Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit (SAS 99) provides standards to assist external auditors in assessing the risk of management fraud. SAS No. 99 contains examples of fraud risk factors classified into three categories: incentive/pressure (to commit fraud), opportunity (to commit fraud), and attitude/rationalization (to justify the fraud). Statement on Auditing Standards No. 99 (2002).

229. See Baker & Griffith, *supra* note 199, at 516-27 (describing how D&O underwriters evaluate corporate governance).

230. See *id.* at 528. However, insurers do disclose a version of their basic pricing algorithm to state insurance regulators. *Id.* at 528, n.183. Even if the ICF proposal is implemented, D&O insurers will have relevant information for this purpose because they still will provide insurance for primary market fraud suits, derivative litigation and similar suits.

231. See *supra* note 199 (discussing how underwriting competition can affect pricing).

232. For a similar discussion in connection with the benefits of publicizing D&O insurance premiums, see generally Baker & Griffith, *supra* note 199, at 536 n.212, who state

In order for the premium to have [a] signaling [of governance quality] effect, market analysts would have to control for the financial and industry factors that predict the likelihood of investment loss generally. These adjustments would control for each of the factors in the base price algorithm,

premiums in the United States, will be public, the ratings will be subject to testing and analysis by academic researchers and the investment community.²³³ This should lead to an improvement in the quality of fraud risk ratings over time. In sum, generating accurate fraud risk ratings will be a challenge, but the evidence suggests that it may not be an insurmountable one.

The prior discussion focuses on assessing the governance mechanisms that could lessen the opportunity for fraud to occur. However, researchers have found other metrics, outside of traditional corporate governance characteristics, that appear to affect the incidence of fraud. Thus, it is fruitful to explore these characteristics (which in many cases may be thought of as providing a “motive” to commit fraud) in connection with a discussion of the fraud risk rating process. As one might expect, studies show a correlation between the existence of equity-based incentives for managers (e.g., stock options) and the incidence of financial misreporting.²³⁴ However, perhaps somewhat surprisingly,²³⁵ according to one study, relative to other public corporations, firms that restate their financial reports as a result of what the authors conclude is likely to be intentional misconduct have higher market multiples, are more likely to raise equity capital while the alleged earnings manipulation is ongoing, and have longer periods of positive earnings growth and positive earnings surprises immediately preceding the alleged manipulation.²³⁶ The authors suggest that, at the time of the alleged misconduct,

leaving only the governance variables.

Id.

233. Sean Griffith has urged the public disclosure of D&O insurance premiums and contract terms for a similar reason. *See* Griffith, *supra* note 200, at 1203-07 (arguing for the required disclosure of D&O insurance premium amounts and key contract terms and stating, “[T]he only way to provide researchers and market participants with the information embedded in the D&O insurance premium may be to mandate disclosure of such data in U.S. securities law”).

234. *See, e.g.,* Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 35 (2006) (finding “the sensitivity of the CEO’s option portfolio to stock price is significantly positively related to the propensity to misreport” financial statements); Efendi et al., *supra* note 216, at 667 (finding “the likelihood of a misstated financial statement increases greatly when the CEO has very sizable holdings of in-the-money stock options”). *But see* Merle Erickson et al., *Is There a Link Between Executive Equity Incentives and Accounting Fraud?*, 44 J. ACCT. RES. 113, 113 (2006) (finding “no consistent evidence that executive equity incentives are associated with fraud”). Stock options are designed to align the incentives of managers with stockholders. Efendi et al., *supra* note 216, at 668. As the company’s share price increases, the value of the stock options increase. Therefore, managers have an incentive to engage in activities that benefit shareholders. Unfortunately, however, stock options also have the potential to provide incentives for managers to engage in fraud to increase the stock price. *See id.*

235. One does not generally think of successful firms as being more likely to engage in fraud, but as Tracy Wang, a researcher that finds a positive correlation between profitability and the propensity for fraud, explains, such firms are more likely to be successful at misleading the market. Tracy Yue Wang, *Investment, Shareholder Monitoring and the Economics of Corporate Securities Fraud* 19 (Weatherhead School of Mgmt., Working Paper No. 2, 2004) (“High [profitability] seems to increase the likelihood of fraud. This result may seem counterintuitive at first glance. However, it can be intuitive because it is difficult for a (known) troubled firm to sell a good earnings report. A firm will have incentive to fool the market and may easily succeed when the market believes the firm is profitable based on previous years’ performance, while negative shocks or deterioration in profitability has already started.”), available at <http://weatherhead.case.edu/bafi/Documents/TracyWangpaper2.pdf>.

236. Scott Richardson et al., *Predicting Earnings Management: The Case of Earnings Restatements 2* (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=338681.

managers of such firms were under tremendous pressure from the capital markets to continue to maintain prior good performance.²³⁷

Though more empirical evidence is required to assess which measures do, in fact, affect a manager's propensity to commit fraud, these studies suggest that it may be possible, after separating out the effects of litigation risk, to provide reasonably accurate fraud risk ratings. The question, of course, is whether, in the context of a government-sponsored insurance fund, these "motive-based" measures should be used.²³⁸ In the private insurance market, activities that are not inherently "wrong" (e.g., driving a particular type of car) can lead to higher insurance premiums, and society appears to accept that. However, it is questionable whether it would be politically feasible (and it is clear that it would not be economically wise) to charge higher premiums for, as an example, sales of stocks of high growth and highly profitable companies. This practice would be akin to levying a "success tax." Thus, using such factors in fraud risk ratings could distort economic incentives.²³⁹

5. Creation of a Fund Instead of Publication of Ratings Only

One may question the necessity of creating an investor compensation fund when the government simply could mandate the creation and dissemination of fraud risk ratings for public companies. According to traditional economic theory, an accurate stock price is one that is equal to the present value of expected future cash flows. In an efficient market, according to traditional theory, the current price will reflect fully all relevant information on these expected future cash flows.²⁴⁰ The risk of expected future cash flows not materializing, including because the market has been misled due to fraud, is the sort of information that would be reflected in the price. Therefore, in an efficient market, if the market were supplied with a reliable fraud risk rating,²⁴¹ the stock price would reflect the

237. *Id.*

238. It should be noted that there is some basis in current law for taking motive-based considerations into account in securities fraud cases. *See* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2511 (2007) ("[M]otive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference..."). However, rather than the general motives described in the text above, the courts generally require the motive ascribed to be specific to the manager (e.g., evidence of significant trading by the manager in the company's stock during the alleged fraud period). *See, e.g.,* *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 237 (3d Cir. 2004) ("[M]otives that are generally possessed by most corporate directors and officers do not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from this fraud.") (internal quotation marks omitted).

239. D&O insurers currently charge different premiums based on industry group and signs of financial stability. *See* *Baker & Griffith, supra* note 199, at 528-29 (describing how "many" or "most" insurers include industry group and accounting ratios in their pricing algorithms). However, D&O insurance, as discussed previously in note 214 *supra*, is designed to protect against litigation risk, even for unmeritorious suits. Historically, firms in certain industries (e.g., technology companies) have been frequent targets of litigation, largely due, in the opinion of many, to the volatility of their stock prices. *See* *Coffee, supra* note 62, at 1548-49 ("Whether an individual corporation will be sued in a securities class action is likely to depend principally on three factors: (1) its stock price volatility; (2) its industry classification, with consumer goods, technology, communications, and finance companies being the recent preferred targets; and (3) its market capitalization."). Thus, it is appropriate for a D&O insurer that wants to set prices appropriately to take industry into account. Under the ICF proposal, however, pricing should reflect the risk of fraud, not the risk of litigation.

240. *See* Eugene F. Fama, *Efficient Capital Markets: A Review Of Theory And Empirical Work*, 25 J. FIN. 383, 383 (1970).

241. One may question why we need the government to generate fraud risk ratings at all because of a belief

risk, and there would be no need for a compensation fund to levy a premium because the price paid by investors would take the risk of fraud into account (i.e., be lower).

As stated above, for the accurate price adjustments described above to occur, stocks must operate in an efficient market. Market efficiency is one of the most highly contested issues in finance,²⁴² and there is a great deal of evidence that is inconsistent with the notion that current prices accurately reflect current information.²⁴³ For example, studies have shown that markets are slow to incorporate bad news, including, for example, analyst sell recommendations, going concern opinions²⁴⁴ and credit downgrades.²⁴⁵ Thus, even if the information contained in fraud risk ratings were released, there is no guarantee that it would be incorporated quickly and fully into stock prices as would be the case with ICF premiums, which operate as direct offsets against share prices.

Some market efficiency adherents acknowledge that there may be times when prices deviate from value (one of the most notable examples of which occurred during the Internet bubble of the late 1990s).²⁴⁶ However, they suggest that, over the long-term, markets are efficient, primarily because it is not possible to exploit any inefficiencies in a way that will provide excess returns.²⁴⁷ Even if this is true, under the ICF system, if the

that the market can do a better job of predicting fraud occurrences than any government-hired rating agency could. There is reason to believe, however, that a rating agency, sanctioned by the government, offers distinct advantages. The rating process can generate more information than the market can obtain from corporations. The government has the ability to compel participation in the ratings process and to force companies to provide relevant information about fraud risk that the corporations may not want to share with the public markets. This non-public information can be helpful in the ratings context. This is somewhat similar to the credit ratings process. Though bond market participants, especially professional bond fund managers, are capable of performing their own analyses about default risk, evidence shows that they rely significantly on credit ratings generated by third parties such as S&P and Moody's, the leading credit rating agencies. It is believed that these ratings are beneficial, not only because they confirm the fund managers' analysis, but also because credit rating agencies are able to extract more information from companies because they agree to keep information given to them in connection with the ratings process confidential. *See generally* H. Kent Baker & Sattar A. Mansi, *Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors*, 29 J. BUS. FIN. & ACCT. 1367 (2002) (discussing, comprehensively, the use of credit ratings by institutional investors).

242. *See generally* Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, J. ECON. PERSPECTIVES, Winter 2003, at 59 (2003) (examining a number of criticisms leveled against the efficient market hypothesis).

243. For a description of a number of anomalies considered incompatible with the Efficient Market Hypothesis, see *id.* *See also* Richard J. Taffler et al., *In Denial? Stock Market Underreaction to Going-Concern Audit Report Disclosures*, 38 J. ACCT. & ECON. 263, 264 (2004) ("An increasing body of research suggests that the stock market takes time to assimilate bad news, in contrast to a more timely incorporation of good (positive) news.").

244. A going concern opinion is an opinion issued by a firm's auditor expressing "substantial doubt" about the firm's ability to continue to operate as a viable entity. *See Elizabeth K. Venuti, The Going-Concern Assumption Revisited: Assessing a Company's Future Viability*, CPA JOURNAL ONLINE, May 2004, <http://www.nysscpa.org/cpajournal/2004/504/essentials/p40.htm>.

245. Taffler et al., *supra* note 243, at 264-65.

246. *See generally* Malkiel, *supra* note 242, at 61 ("... I do not argue ... that ... market pricing is always perfect. After the fact, we know that markets have made egregious mistakes, as I think occurred during the recent Internet 'bubble.'"). It should be noted that there is not universal agreement among scholars that there was a technology bubble. *See* Luboš Pástor & Pietro Veronesi, *Was There a Nasdaq Bubble in the Late 1990s?*, 81 J. FIN. ECON. 61, 62, 64 (2006) (questioning whether there was a bubble (i.e., tech stocks were overvalued) in the late 1990s because of the high level of uncertainty regarding company growth rates, an important determinant of fundamental value).

247. *See* Malkiel, *supra* note 242, at 61.

premium assessments are accurate (which, admittedly, will be a challenge), the risk of fraud (and any changes thereto) will be reflected immediately in stock price, without the possibility of it taking weeks or months (or longer) for stock prices to adjust appropriately. Therefore, implementing the ICF can lead to a more accurate reflection of the risk of fraud in markets.

6. Equitable Considerations

Another possible critique of the ICF centers on the fairness of the way ICF premiums will be assessed. As described in Part IV.B., *supra*, all sellers of stock will be required to pay premiums into the ICF fund. The premium will be assessed, therefore, even on sales of the stock of corporations with excellent fraud risk ratings. One could argue that this system would lead to some unfair subsidization of shareholders of companies that are likely to engage in fraud by shareholders of companies where fraud is not likely to occur. Though the potential for some subsidization is present, this subsidization is necessary for accurate premium pricing. Just as a driver with an unblemished record (e.g., no traffic accidents) and the characteristics of a prototypical “safe driver” does not have zero-cost auto insurance premiums, companies with “clean” records still will have a cost levied against their shares because they will have expected fraud losses that are greater than zero.

One may argue further that it is unfair to tax the shareholders of all corporations for the frauds that will occur only in a subset of corporations. However, this critique ignores the nature of insurance. No public shareholder can know with any certainty that she is investing only in companies that will never engage in fraud, just as no homeowner can know that her house will never catch fire. Homeowners generally do not feel cheated or treated unfairly when their insurance premiums are used to pay claims to other homeowners who have suffered losses from fire; the homeowners are paying for the peace of mind in knowing that they will be protected should calamity strike.²⁴⁸ The ICF is similarly fair. The ICF will assess different premiums based on risk, but provide the same benefit to all shareholders—compensation when calamity (i.e., fraud) strikes.

One might even argue that the ICF, by design, is unfair to most shareholders because it subsidizes the investment in risky companies; an investor can now much more comfortably invest in fraud-prone companies because of the insurance protection offered by the ICF. This should not be of great concern, however, because if an investor seeks to purchase shares in companies that have high fraud risks in hopes of making profits from arbitrage, she is unlikely to succeed. She will internalize the cost of fraud if she sells the shares before any fraud is uncovered because she will be required to pay the ICF premium (which will be significantly higher than the average premium). Of course, if the investor buys while the stock is inflated by fraud and holds until the fraud revelation, it is true that she will be entitled to compensation under the ICF. However, the investor will have to bear some portion of her losses (assumed here for exposition purposes to be 25%).²⁴⁹ Thus, it is not clear that, if the ICF premiums are accurate, the efforts of an

248. Of course, if homeowners knew that their insurance companies were using their insurance premiums to subsidize other homeowners engaging in particularly risky behaviors, this might capture their attention.

249. In addition, as discussed in note 92, *supra*, through the statutory incidence of the ICF premium lies with the seller, the buyer in all likelihood will bear some portion of the economic burden for the ICF premium payment.

investor who intentionally seeks out fraud-prone companies will be subsidized by the ICF. Of course, if the premiums are inaccurate and systematically undercharge shareholders of likely fraudsters, traders, who are able to assess the pricing inaccuracy (which is questionable), may be more confident investing in risky companies. This further underscores the need for accurate fraud risk ratings.

Finally, one might argue that the appropriate tax base for the ICF premium is stock holdings, rather than stock transactions, because the risks and rewards of stock price movements are functions of holding stocks. One could argue further that it is unfair to tax an investor who frequently buys and sells stocks in very safe companies more heavily than an investor who buys and holds stocks in fraud-prone companies. However, trade-based payment is a necessary feature of this insurance program.²⁵⁰ The more an investor trades, the more likely she will be to sell the stock of a company engaging in fraud to a shareholder who will need compensation from the ICF.

7. *Effect on Financial Markets*

One of the most serious potential objections to the ICF proposal is the effect implementing the ICF proposal, which levies fees on capital markets activity, will have on the United States' well-functioning securities markets. Specifically, one could argue that levying the ICF premium, which is similar to a securities transactions tax (STT),²⁵¹ would lead to increased market volatility,²⁵² lower trading volume, and lower (or less accurate) overall securities prices.²⁵³ While there is no existing compensation system similar to the ICF from which to draw valid conclusions, one may glean some insights from a review of the literature on STTs. There currently is no consensus among

250. See also note 256, *infra*, for a discussion of the administrative benefits of trade-based payments.

251. STTs are taxes assessed on securities market transactions. In addition to providing government revenue, these taxes are designed to discourage short-term speculation in markets. In general, the theory underlying securities transaction tax proposals is that a small (on a percentage basis) fixed transaction cost in the form of a tax represents a negligible burden for long-term asset holders. However, the STT is more burdensome for short-term investors who trade frequently and hence must pay the tax frequently. These investors incur significant STT-related trading costs. See generally Robert Pollin, *Applying a Securities Transactions Tax to the US: Design Issues, Market Impact and Revenue Estimates*, in FINANCIALIZATION AND THE WORLD ECONOMY 409, 409-10 (Gerald Epstein ed., 2005).

252. Baker et al. describe why volatility is undesirable as follows:

Volatility in financial markets is generally considered undesirable, since it creates an additional element of risk for investors. If, for example, an asset was expected to give an average real rate of return of 5% per year, but its price could fluctuate randomly by large amounts (e.g., 20%) for significant periods, then there is a large risk that the owner of such an asset would have to sell it for a loss, since she may be forced to sell it when it is below its trend value. For this reason, assets that fluctuate a great deal in price must offer a higher rate of return than assets whose prices are relatively stable If the financial markets as a whole become less stable, then in general the cost to firms of raising capital will increase.

Baker et al., *supra* note 45, at 4.

253. See Karl Habermeier & Andrei Kirilenko, *Securities Transaction Taxes and Financial Markets*, in TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES 325, 328-29 (Patrick Honohan ed., 2003) (stating that “[e]mpirical studies seek answers to three main questions” and briefly describing the results of studies on the effect of transaction taxes on price volatility, trading volume, and securities prices).

researchers on the effects of STTs on financial markets.²⁵⁴ Several empirical studies of STTs in foreign markets have been undertaken, but, thus far, they have not resolved the long-standing debate.²⁵⁵ This section considers volatility, volume, and price effects below in turn.²⁵⁶

a. Volatility

Several researchers have studied the relationship between STTs and volatility. A primary appeal of STTs for their proponents is the potential to reduce market volatility, generally because of a decrease in destabilizing or noise trading. However, critics of STTs assert that STTs *increase* market volatility because increased transaction costs make it more expensive for dealers and market makers to perform their market stabilizing functions.²⁵⁷ Dealers, like all profit-seeking professionals, require compensation for their services and for the risks they undertake.²⁵⁸ As trading becomes more expensive, as is the case when trades are subject to an STT, dealers are unable to manage their risks as effectively and, correspondingly, are “less willing to put their own capital at risk.”²⁵⁹ Hence, as the theory goes, after implementation of an STT, there are fewer dealers willing to stabilize securities prices, leading to higher overall volatility. However, despite the plausibility of this theory, several researchers find that imposition of an STT has no significant effect on volatility.²⁶⁰ For purposes of evaluating the ICF Proposal, it will be difficult to determine *ex ante* what effect the ICF premium will have on market volatility. However, since sales undertaken by professional market makers will be exempt from the

254. *Id.* at 328.

255. One reason offered for this is the difficulty in separating the effects of STTs on price and volume from other policy or structural changes that may be occurring simultaneously. *Id.*

256. In addition to the three principal objections typically expressed in connection with STTs, there is another potential concern in this context: the lock-in effect. Edward McCaffery describes the lock-in effect as “a wedge between an owner’s willingness to sell a given asset and a buyer’s willingness to pay for it, all on account of the built-in tax liability.” Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 895 (2005). With any realization-based tax, which the ICF premium is, in effect, because it is due upon sale of a security, there is a concern about allocative efficiency. *See id.* Consider the following example, borrowed in large part from McCaffery: If Shareholder *A* has a subjective valuation of \$10 per share for stock in Company XYZ, and Shareholder *B* is willing to pay her \$10.25 per share for such stock, the transaction should occur. However, if there is a tax upon sale of, say \$0.50, Shareholder *A*, rationally taking her after-tax proceeds of \$9.75 into account, may not engage in the transaction and hold on to her stock longer than would be efficient. Thus, if a tax rate is too high, there will be many efficient deals that do not occur, resulting in assets not being allocated to their highest and best uses. *Id.* One way to address this concern (previously discussed by other commentators for eliminating the lock-in effect in other contexts) is to impose the ICF premium once a year on shareholder *holdings*, rather than on sale transactions. This solution is not optimal because it would increase overall system administrative costs, as the ICF would have to process annual statements and collect payments from every security holder in the country, rather than just collecting fees from a limited number of securities exchanges and associations as currently proposed. Though this process could be streamlined somewhat by tying it into the federal income tax process, the administrative costs in all likelihood still would outweigh taking advantage of the current Section 31 fee collection mechanism. In any event, the lock-in effect is likely to be a modest concern with respect to the ICF proposal because the ICF premium, as estimated, is a small percentage of stock price.

257. See Habermeier & Kirilenko, *supra* note 253, at 325-26.

258. *Id.* at 333.

259. *Id.*

260. *See id.* at 328-29.

ICF scheme,²⁶¹ the chief volatility-related concern with STTs (i.e., that higher transaction costs will deter dealers from performing their market stabilizing functions) will not be present.

b. Volume

Critics of STTs also generally assert the claim that imposition of the taxes reduces trading volume as investors migrate to other markets or instruments where they can avoid the tax. This migration affects liquidity and informational efficiency.²⁶² Trading volume can be affected primarily in one of three ways.²⁶³ Investors may (1) reduce the frequency with which they trade (which is the result desired by proponents of STTs), (2) change the location of their trading,²⁶⁴ or (3) migrate their investment dollars to other securities²⁶⁵ that are not subject to the tax.²⁶⁶

Critics of the ICF proposal may raise similar concerns. The average ICF premium will be small on a percentage basis, but the aggregate amount collected under the ICF will be large. Those most affected by the ICF Proposal will be institutional investors. Transaction costs matter to frequent traders, and creating the ICF will add to those costs significantly. In 2005, total commissions on institutional trades totaled \$13.2 billion.²⁶⁷ Using recent sales data as a guide, aggregate annual ICF premiums for mutual funds would total approximately \$754 million, while aggregate premiums for pension funds would total approximately \$238 million.²⁶⁸ Imposing the ICF premium, representing an

261. For a discussion of the exclusion of market makers from the ICF scheme, see *supra* note 91.

262. Under the standard rational expectations model, the migration of volume to other markets or other instruments does not result in any efficiency loss, as volume, per se, is just an outcome of the trading process and does not contain any information about underlying fundamental values. Researchers recently have questioned this view and assert that trading volume injects information about the precision of individual signals about value. Thus, under this view, a loss of volume can affect a market's ability to aggregate information. See Habermeier & Kirilenko, *supra* note 253, at 337-38 (discussing these points).

263. See Daniel Waldenström, *Why Are Securities Transactions Taxed? Evidence from Sweden, 1909-91*, 9 FIN. HIST. REV. 169, 171 (2002) (discussing three potential outcomes in connection with securities transactions taxes).

264. The evidence on volume migration is somewhat mixed. For example, volume on the Swedish stock market declined significantly following an increase in Sweden's STT, but one study of 14 STT changes in Asian markets finds no statistically significant differences in turnover before and after the tax changes. Habermeier & Kirilenko, *supra* note 253, at 329. However, the conventional wisdom is that investors will choose to invest where they can avoid the tax, assuming a similar quality of execution and access to desired investment opportunities.

265. The concern is, because of the tax, investors could be encouraged to trade more often overall by using securities that are not subject to the tax, while achieving the same underlying economic objectives. See *id.* at 328. Researchers generally acknowledge that it is difficult to design an STT that is "neutral" in that one portfolio of assets is not favored over another with the same payoff. For the ICF premium to be pay-off neutral, it would have to apply not only to all securities, but also be set such that a change in the value of the replicating portfolio (e.g., bonds, call options) would equal the change of price of the underlying asset (e.g., the stock) exactly. For this to happen, the ICF premium rates would have to be adjusted frequently. See *id.* at 336, for a discussion of this point in connection with STTs. This is an expensive and infeasible proposition administratively. Hence, it would not be possible to stem volume migration completely if the ICF were implemented.

266. Waldenström, *supra* note 263, at 171.

267. Goldstein et al., *supra* note 202, at 2.

268. See Appendix II, *infra*, for the calculations.

approximately 7.5% increase in overall direct trading costs, will have a significant effect on the market's largest investors.²⁶⁹ Thus, one could argue that implementation of the ICF will encourage investors to modify their trading behavior or leave the U.S. markets, which ultimately would result in a decline in U.S. trading volume.

Concerns about the effects of the ICF premium on trading frequency are valid. Though the evidence on the market impact of STTs is mixed, one example from the U.S. markets may be instructive. In 1975, pursuant to the mandates of the Securities Acts Amendments of 1975, the SEC prohibited fixed (minimum) brokerage rates on the New York Stock Exchange and ended what had been a 180-year old pricing practice.²⁷⁰ Immediately following this prohibition and the advent of negotiated commissions, average commission rates fell by 25%²⁷¹ and trading volume increased substantially²⁷² (an estimated 30%-100%, depending on the time period and estimation technique employed).²⁷³ Though there is reason to question whether a reduction in brokerage commissions is analogous to imposing the ICF premium,²⁷⁴ these data do suggest that increased transaction costs have the potential to affect U.S. market liquidity significantly.²⁷⁵

269. This is likely to have a relatively greater effect on index funds (i.e., funds that generally make portfolio adjustments only to bring their portfolios in line with the broad market index (e.g., S&P 500) they are tracking), whose overall costs tend to be (and must be for competitive reasons) lower than those of actively managed funds (i.e., funds that attempt to achieve superior returns through actively selecting investment opportunities). *See, e.g.*, Michael Maiello & Meghan Johnston, *ETF-O-Mania*, FORBES, Sept. 18, 2006, at 142, 142 (citing Financial Research Corp. statistics indicating that the average expense ratio (the percentage of a fund's assets used to cover managing the fund, including management fees and operating expenses) for index funds is 0.54%, while the average expense ratio for actively managed mutual funds is 1.12%). Individual investors often are encouraged to invest in index funds as a low-cost way to achieve diversification. Imposition of the ICF premium on sales of an index fund, if some of the costs are passed on to the fund's investors, which is likely, will increase the cost of this investment strategy. However, index fund managers generally, barring frequent index composition changes, trade less frequently than actively managed fund managers (hence, being subject to the ICF premium less frequently), minimizing this effect somewhat.

270. Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J. L. & ECON. 273, 273 (1984).

271. *Id.* at 280. The amount of the decline varied by the identity of the trader, trading frequency, order size, and stock price. Charles M. Jones & Paul J. Seguin, *Transaction Costs and Price Volatility: Evidence from Commission Deregulation*, 87 AMER. ECON. REV. 728, 730 (1997).

272. Jarrell, *supra* note 270, at 274.

273. Jones & Seguin, *supra* note 271, at 730 (citing findings by Jarrell, *supra* note 270).

274. The appeal of analogizing the deregulation of brokerage commissions to the ICF premium is that deregulation brought a one-time, substantial transaction cost reduction. *See id.* at 731 for a comparison of the deregulation of brokerage commissions and STTs. However, the analogy may not hold perfectly. The amount by which the commissions were reduced were not uniform (i.e., "institutional and active traders enjoy[ed] greater reductions"). *Id.* The ICF premium will not differ by type of investor, though the effects will be felt most by institutions and other active traders.

275. On the other hand, in 1996 Congress enacted the National Securities Markets Improvement Act (NSMIA), which expanded the reach of Section 31 collections to include trades of NASDAQ securities. Anecdotal evidence suggests that there was no deleterious effect on NASDAQ market volume following this change. *See The Effects of the Excessive Fees Collected Under Federal Securities Laws and Their Impact on the Financial Markets and on the Economy as a Whole: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. 3 (1999) (opening statement of Arthur Levitt, Chairman, SEC) [hereinafter *Effects of Excessive Fees*] (stating, in 1999, that "the fee rates in the NSMIA were based on projections of nearly 4 years ago...Our markets have experienced almost explosive growth, and the result has been collections that are way above what was estimated."). Of course, this observation tells us nothing about how much more the stock market could have grown in the absence of the Section 31 fee.

There are, however, features of the ICF premium that should lead one to conclude that its market effects will not be identical to those of a traditional STT (or brokerage commissions) and could be positive. The ICF premium, unlike commissions or a general securities transaction tax, is an escrow in anticipation of a benefit (and an exchange of uncertainty regarding securities fraud risk for certain costs and benefits) rather than a direct cost without an immediately corresponding benefit.²⁷⁶ The ICF premium is highly targeted²⁷⁷ and designed to provide direct compensation to those who suffer losses from securities fraud, and is, therefore, more akin to an insurance premium.²⁷⁸ Thus, trading frequency may not decline because the additional transactions cost will be offset by greater investor confidence in a significantly safer market. However, further study of this issue is required; the liquidity concern cannot be minimized.

Migration to other markets, however, is of far less concern. Even if investors do not view the ICF premium as a payment in exchange for a benefit, it is unlikely that they will leave U.S. markets in large numbers. Even with the ICF premium, trading transaction costs will be significantly lower in the U.S. than in foreign markets, as the United States enjoys a significant cost advantage over most foreign markets.²⁷⁹ In addition, many foreign exchanges impose securities transactions taxes²⁸⁰ that would exceed the costs (estimated, for exposition purposes, at 0.035%)²⁸¹ imposed by ICF premiums. Thus, U.S. trader migration to foreign markets following the imposition of the ICF premium is an unlikely occurrence.

Because of concerns about migration of investment to substitute securities, under the

276. Of course, shareholders receive indirect benefits from tax receipts (e.g., tax receipts can lower the national deficit and result in lower interest rates).

277. Funds collected through the ICF will be reserved for fraud compensation, not general government revenue. However, though it is true that ICF funds are targeted for fraud compensation, the ICF premium may still feel like a tax to investors since amounts collected will be pooled and no individual investor accounts will be established. However, this is no different from the design of traditional insurance products.

278. Though difficult to predict, it seems reasonable to conclude that investors, because of mental accounting effects, will be more willing to pay a premium for a targeted benefit to a specific class of beneficiaries (i.e., shareholders who have been defrauded) because they can imagine themselves as possible recipients of a cash payment from the fund for their losses. Indeed, many long-term investors have participated in class action settlements in the past.

279. Baker et al., *supra* note 45, at 23. However, foreign exchanges are becoming more competitive. See Effects of Excessive Fees, *supra* note 275 (statement of Robert H. Forney, President and Chief Executive Officer, Chicago Stock Exchange) (arguing that foreign exchanges could pose a threat to U.S. exchanges in the near future); see also notes 286 and 289 and accompanying text.

280. For example, the UK (0.5%), Switzerland (0.15%), France (0.15%), China (0.5%, 0.8% for Shanghai exchange transactions), Ireland (1.0%), South Korea (0.3%), India (0.5%), Greece (0.6%), and Austria (0.15%) all impose STTs on stock transactions that exceed the estimated ICF premium of 0.035%. See Pollin, *supra* note 251, at 412-14. Of course, there are markets, including those in Japan, Italy, Denmark, the Netherlands, and Sweden, where no transactions taxes are imposed. *Id.* However, it is unlikely that a significant portion of U.S. securities volume will migrate to these markets in response to the imposition of the ICF premium. U.S. investors tend to overweight U.S. investments in their portfolios relative to the levels indicated as optimal by finance models due not only to "home bias" (an irrational preference for domestic assets), but also due to barriers to international investment, both direct (e.g., capital controls limiting foreign investment, transaction costs) and indirect (e.g., information costs due to asymmetric information). Alan G. Ahearne et al., *Information Costs and Home Bias: An Analysis of US Holdings of Foreign Equities*, 62 J. INT'L ECON. 313, 313-15 (2004). The effects of home bias and investment barriers still would be present following the imposition of the ICF premium, lessening the likelihood of large-scale volume migration.

281. See *supra* note 111 for cautionary language in connection with this estimated premium.

ICF Proposal, sales of equity derivatives (the primary substitute for stock investment) are subject to the ICF premium. Though there may be valid theoretical reasons for excluding equity derivative sales from the ICF scheme,²⁸² because of the easy substitution of equity derivatives for stock, a failure to include equity derivatives in the ICF scheme could lead to a significant amount of volume migration.²⁸³

A related concern about imposition of the ICF is that even though the U.S. capital markets are the strongest in the world, U.S. companies nevertheless may choose to de-list from U.S. exchanges and list abroad in order to avoid participation in the ICF. Additionally, foreign issuers may forego listing in the United States, which would lead to a decrease in transaction volume in our market. However, these issues are unlikely to be of significant concern.

It is unlikely that a significant number of U.S. corporations will exit U.S. markets if the ICF is adopted. Companies tend to exhibit a bias toward listing in their home countries.²⁸⁴ This is not to say that we should have no concerns about the U.S. capital markets becoming uncompetitive, but, as a practical matter, U.S. corporations are unlikely to exit U.S. markets in large numbers (particularly in the short-term) regardless of their views on the efficacy of the ICF.

It also is unlikely that the ICF and its related premium would discourage foreign listings. According to one study, listing on a U.S. exchange reduces a foreign corporation's cost of capital by 70 to 110 basis points (0.70% to 1.1%).²⁸⁵ Thus, if the study's authors are correct, there are significant benefits that accompany a U.S. listing, and in all likelihood they would exceed the perceived costs of the ICF scheme.

Commentators have taken note of the increased competition the U.S. capital markets

282. For example, circuits currently are split as to whether an option holder may sue the company whose stock underlies the put or call for securities fraud under Rule 10b-5. Courts that reject option holders as proper plaintiffs in securities fraud do so generally because (1) companies cannot control the issuance of derivatives, (2) holding a derivative is more risky than share ownership, and (3) derivatives, unlike stock, "do not represent capital investment" in a company. Robert C. Apfel et al., *Short Sales, Damages, and Class Certification in 10b-5 Actions* 28 (Simon Sch. of Bus., Working Paper No. FR 01-19, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=285768.

283. Under this proposal as currently constituted, debt securities, credit derivatives, and hybrid securities (with a mixture of debt and equity characteristics) are not subject to the ICF premium. Though a wholesale migration from equity securities to debt securities to avoid the ICF premium is unlikely, it would be prudent to explore expanding the ICF program to include debt securities in order to avoid the migration problem. I leave to future work a discussion of how covering debt securities might affect the administration of the ICF.

284. See generally Luigi Zingales, *Is the U.S. Capital Market Losing Its Competitive Edge?*, J. ECON. PERSP. (forthcoming) (manuscript at 21) ("IPOs tend to list in the country where their business is located, even if this is not the most competitive market."), available at <http://research.chicagogsb.edu/igm/research/papers/1LZingalescompetitiveness.pdf>.

285. *Id.* (manuscript at 11) (describing a study found conducted by Luiz Hail and Christian Leuz). According to Zingales, changes in the cost of capital were computed by comparing corporate valuation and earnings forecasts in the period surrounding the listing decision. *Id.* This benefit may have decreased somewhat in recent years, as some studies have shown negative market effects from the passage of Sarbanes-Oxley. See Zingales, *supra* note 284 (manuscript at 11-14). Cost of capital reductions from listing on a foreign market have the potential to come from several sources, including from the enhanced liquidity on, and visibility afforded by listing on, the foreign market and because the foreign listing allows a corporation to "bond" or commit to provide better disclosure or institute better governance practices. *Id.* (manuscript at 7-8). Of course, foreign listings also have costs including listing fees, disclosure costs, and exposure to additional liabilities. *Id.* (manuscript at 8).

are getting from the London Stock Exchange (LSE),²⁸⁶ which has a securities transaction tax of 0.5%.²⁸⁷ Despite this STT,²⁸⁸ London has captured global initial public offering (IPO) market share from the U.S. exchanges, and even a few U.S. companies have chosen to list their IPOs on the LSE.²⁸⁹ This suggests that the existence of an STT has not substantially affected London's ability to attract foreign issuers. The ICF premium likely would not diminish the U.S. exchanges' ability to do so either. Indeed, it is possible that the implementation of the ICF actually would *encourage* foreign companies to list in the United States. Some suggest that one possible reason for the decline in the United States' market share is the fear of legal liability that accompanies a U.S. listing, particularly the threat of securities class actions.²⁹⁰ Though actual legal liability has changed little in recent years, the perception of increased risk still exists, due in part to the increasingly high value of securities class action settlements and the rare, but high profile, cases in which directors are required to fund part of the settlements with personal funds (i.e., beyond that which is payable by D&O insurance or the corporation).²⁹¹ It

286. *See, e.g., id.* (manuscript at 6) (stating “[t]he main beneficiary of this loss [of U.S. global IPO market share] is London. Revers[ing] more than a decade of declining market share, in the last three years London went from a market share of 5% to a market share of almost 25%”).

287. *See* Pollin, *supra* note 251, at 414.

288. Of course, there are those who believe the abolition of the 0.5% STT would enhance the UK market and economy. *See, e.g.,* Don Cruickshank, Chairman, London Stock Exch., Address at the Second City of London Biennial Meeting: The Increasing Impact of Stamp Duty on the UK Economy (Dec. 13, 2001) (stating, with respect to the UK's STT, “no modern economy, or aspiring modern economy, imposes such a burden on its wealth producing companies”), available at <http://www.londonstockexchange.com/en-gb/about/Newsroom/Media+Resources/Speeches/speech14.htm>.

289. Zingales, *supra* note 284 (manuscript at 2). According to Zingales,

[W]hile in the late 1990s the U.S. capital market was attracting 48% of all the global IPOs, its share . . . dropped to 6% in 2005 and is estimated to be only 8% in 2006. Even more surprisingly, in recent years we have observed [that] some U.S. companies choose to list in London rather than in the United States.

Id. (manuscript at 2). He goes on to state,

While this trend is too recent to be attributable to any single factor, it does not seem to be caused by a shift in the sectoral distribution of global IPOs, nor by a change in their geographical distribution. That almost all these companies sought to be marketed in the United States suggest[s] that the U.S. capital market retains some attractiveness. But the additional benefits derived from listing do not seem to be worth the direct and indirect costs associated with this decision.

Id. (manuscript at 2-3).

290. *See, e.g., id.* (manuscript at 18-19); *see generally* COMM. ON CAPITAL MARKETS REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 4-5 (2006) [hereinafter INTERIM REPORT] (stating that “differences in the legal rules governing the U.S. public markets and the foreign and private alternatives” are part of the reason for the loss of U.S. public capital market competitiveness), available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

291. Zingales, *supra* note 284 (manuscript at 18-19). Another potential reason for the decline set forth by some observers relates to the extensive regulatory requirements imposed on U.S.-listed companies by Sarbanes-Oxley. Corey Boles, *London Remains an IPO Draw, U.S. Changes Notwithstanding*, WALL ST. J., Aug. 8, 2006, at C4 (“Officials at NYSE Group Inc.’s New York Stock Exchange say [Sarbanes-Oxley] has been a major reason why the U.S. exchange has lost ground in luring foreign listings.”). *But cf.* Zingales, *supra* note 284 (manuscript at 17-18) (suggesting that the cost of compliance with Sarbanes-Oxley is unlikely to be the sole cause of the decline in U.S. global IPO market share because such costs do not appear to exceed the benefits of listing in the United States).

seems apparent that the litigation burden can affect listing choices. Thus, it is not certain that the ICF premium, which imposes a modest fee on shareholders in exchange for the end of secondary market securities class actions, would be unwelcome by corporations. Indeed, the ICF could make U.S. markets more attractive to both foreign and domestic issuers.²⁹²

c. Accuracy and Overall Level of Prices

Finally, another potential concern is the effect the ICF premium will have on stock prices. For many years, researchers have tried to assess the impact securities transactions taxes have on market prices. Opponents of such taxes cite two primary concerns. First, critics assert that STTs decrease overall price accuracy because the increased transaction costs from the STT can make repeated rebalancing in search of the correct price prohibitively expensive.²⁹³ One, therefore, could argue that implementing the ICF would reduce share price accuracy.

In my view, while this is an important consideration, the assertion that the ICF premium would lead to less accurate prices relies on two assumptions: (1) the ICF premium will cause trading frequency to decrease and (2) the constant turnover in stocks is moving the market toward a more accurate price. As discussed previously, it is not clear that imposition of the ICF premium will reduce trading frequency to any significant extent. Furthermore, while it is true that trades reveal information about fundamental firm values and can help to set accurate prices, some trades reflect speculation that is injecting no information into market prices.²⁹⁴ Researchers, when studying the effects of STTs, find it difficult to separate trading that is “stabilizing” and hence leading prices closer to fundamental values from trading that is destabilizing noise.²⁹⁵ Thus, in the context of the ICF, just as with STTs, if trading frequency is decreased because of imposition of the ICF premium, which may not be the case, it is not clear that the trading that declines will be the type of trading that helps generate more accurate share prices.²⁹⁶

Second, critics assert that STTs result in a decline in the overall level of market prices because investors will price in future transaction tax payments when they are making investment decisions. Accounting for the tax will result in a lower price paid for the security in question. Several empirical studies have been undertaken to determine the

292. See INTERIM REPORT, *supra* note 290, at 71. The report states,

Securities class actions do not exist in the United Kingdom, or in the markets of our major competitors. Indeed, [D&O] insurance costs are six times higher in the United States than in Europe. Foreign companies commonly cite the U.S. enforcement system as the most important reason why they do not want to list in the U.S. market.

Id. Of course, one could argue that we should have no interest in encouraging firms that fear legal liability to list in the United States. Indeed, keeping such companies out may help to minimize the amount of fraud in U.S. markets. See Zingales, *supra* note 284 (manuscript at 20) (exploring, but then rejecting, the possibility that the loss of global IPO market share is the effect of “benign” regulation). Though this argument is plausible, it is possible for honest managers to fear being subject to securities class action lawsuits that lack merit.

293. See Habermeier & Kirilenko, *supra* note 253, at 335.

294. See generally J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990) (describing the role of noise traders in financial markets).

295. Habermeier & Kirilenko, *supra* note 253, at 328.

296. See generally *id.* (“[I]t is hard to say which part of the volume [fundamental or noise] is more affected by [an STT].”)

effect such taxes have on stock prices. Many researchers found decreases (e.g., in the range of 1% to 3%) in stock market prices in selected markets following the imposition of STTs.²⁹⁷ However, the results, taken together, are inconclusive, and some question the methodology by which they were obtained.²⁹⁸

In any event, this should be less of a concern under the ICF Proposal because, if the ICF premium is set appropriately (i.e., the premium accurately reflects fraud risk), there should be no overall lowering of market prices. Currently, investors discount stocks for the risk of fraud²⁹⁹ (even if such discounts are imperfect),³⁰⁰ so imposition of ICF premiums that accurately reflect fraud risk should not result in any further discounting overall and may decrease such discounting substantially if investors currently are prone to overestimate the likelihood of fraud occurring.³⁰¹ However, if the ICF premiums are inaccurate and set at levels higher than the expected losses from fraud and there is a lowering of overall stock prices because of the imposition of an ICF premium,³⁰² then this effect may be offset by higher overall prices due to increased investor confidence, less management time spent on litigation, and lower D&O insurance premiums (because they will no longer cover secondary market fraud lawsuits, either meritorious or frivolous). Most importantly, however, is that companies with better fraud risk ratings will experience less of a negative share price impact from the imposition of the ICF premium—the desired effect to achieve the ICF’s deterrence objectives.

8. Political Considerations

Implementing the ICF would be a challenge politically. In theory, the ICF should appeal to those occupying various points on the political spectrum. It eliminates secondary market securities class actions (something that generally would appeal to the corporate community and conservatives) and also provides meaningful compensation to defrauded small investors (something that likely would appeal to those with more liberal political leanings).³⁰³ However, the ICF premium will be viewed by many as a pure tax (despite the fact that the premium confers an insurance benefit). New taxes generally are

297. *Id.* at 329.

298. *See, e.g., id.* at 329-30 (discussing the lack of appropriate data and methodological concerns).

299. *See generally* Paul A. Griffin et al., *Stock Price Response to News of Securities Fraud Litigation: An Analysis of Sequential and Conditional Information*, 40 ABACUS 21, 22 (2004) (“[I]nformed investors assess [securities fraud] litigation risk generally as part of their overall evaluation of a stock.”).

300. *See supra* Part IV.C.5. for a discussion of market efficiency and the market’s ability to price fraud risk.

301. This certainly is possible in the post-Enron era. *See generally* Arthur E. Wilmarth, Jr., *Controlling Systemic Risk in an Era of Financial Consolidation*, in 3 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 557, 578 (International Monetary Fund ed., 2005) (“[F]inancial markets often seem to be *ineffective* in predicting the onset of economic crises and *indiscriminate* in punishing risky firms *after* crises occur.”).

302. It is worth noting that any price impact would not be limited to secondary market prices. Prices at issuance are also subject to the effects of the ICF premium, as buyers, anticipating the payment of the ICF premium upon exit, may discount the price they are willing to pay the corporation for its shares.

303. This is not to say that compensating investors is not a priority for some conservatives. *See, e.g.,* Solomon, *supra* note 125 (quoting Michael Oxley, former Republican U.S. House Representative from Ohio who co-authored the Sarbanes-Oxley legislation that created the Fair Funds (see Part V.A., *infra*, for a description of Fair Funds) as saying the following: “When corporate executives make out like bandits, the money ought to go back to the investors . . .”).

unattractive to conservatives and the business community.³⁰⁴ In addition, implementing the ICF will eliminate the need for trial attorneys in secondary market class actions, something likely to be opposed by the plaintiffs' bar. I leave a more fulsome discussion of such political considerations to future work. However, it is clear that such factors must be taken into account when determining the political viability of the ICF.

D. Summary and Concluding Thoughts on the ICF and Securities Litigation

The evidence provided in this Article suggests that implementing the ICF, with its mix of ex ante and ex post elements, would yield significant benefits over securities class actions.³⁰⁵ First, the perpetrators of harm (i.e., the corporate managers who commit securities fraud) are unable to bear the full costs of the harm they create. Neither their personal resources, nor D&O insurance proceeds, are sufficiently large to compensate investors for the losses they suffer. Second, given the financial incentives of the chief enforcers of the securities laws (i.e., plaintiffs' lawyers), an entire class of likely perpetrators (i.e., small firms with thinly traded stock) are insufficiently deterred because they face no credible threat of suit,³⁰⁶ and managers of larger firms often are able to escape personal liability even when sued. Third, the administrative costs of securities class actions are extremely high. Current experience notwithstanding, generally, one thinks of litigation as having the potential to impose lower costs than regulatory regimes because litigation costs are incurred only when harm occurs, while regulation involves an ongoing cost that affects all market participants. However, the ICF Proposal suggests a regulatory mechanism that has potential costs that are substantially lower than those existing under the current regime.

The lower costs associated with the ICF, however, provide only illusory benefits if the scheme provides less deterrence than that of securities litigation. One might argue that the securities litigation regime is more complex and costly than an insurance regime, but the litigation requires the parties to engage in the time-consuming and complex exercise of determining fault. With the additional cost, one might argue, should come additional (or more accurate) deterrence. As the discussion on fraud risk ratings in Part IV.C.4.

304. A particularly appropriate example of this sentiment involves the reaction from the investment community when invited to participate in hearings on the amount of Section 31 fees (Section 31 fees are described in *supra* note 93). See, e.g., Effects of Excessive Fees, *supra* note 275 (containing testimony of several leading members of the investment community pointing to their perception of the Section 31 fee as "excessive" because total collections exceeded the cost of funding the SEC and thus was akin to a "tax"). Congress subsequently reduced Section 31 fee amounts by enacting the Investor and Capital Markets Fee Relief Act in 2002. One source of dissatisfaction with Section 31 fees, namely their effect on market making activity, will not exist under the ICF, because sales of market makers and specialists are exempt from the ICF premium, as described in *supra* note 91.

305. The framework employed in this section is borrowed, in large part, from Steven Shavell. See Shavell, *supra* note 209, at 359-64 (discussing when regulation is superior to legal liability for controlling risks in the torts context and arguing that (1) regulation is superior to liability when (a) the potential perpetrator is unable to pay for the full extent of the harm caused and when (b) there is a chance that she will not face suit for the harm caused and (2) liability is superior to regulation when (a) the would-be regulated party has more "knowledge about risky activities" than the regulatory authority and when (b) factoring in administrative costs because, in the litigation context, most of such costs are borne only after harm occurs).

306. As discussed in note 76, *supra*, the SEC has a renewed focus on microcap fraud, but the agency, at current staffing levels, will not be able to provide the level of deterrence necessary to minimize substantially the risk of fraud occurring.

makes clear, it is easier to determine if fraud has occurred *ex post* than it is to predict the propensity for fraud *ex ante*. Thus, if the benefits of accurate deterrence exceed the administrative costs of litigation, the additional expense is justified. The ICF, however, holds the promise of superior deterrence because its fraud risk-rating mechanism, unlike securities litigation, subjects all corporations to sanction. In addition, the ICF's *ex post* fraud determinations can fulfill the fact-finding role currently played by the litigation process. That said, further study on the likely deterrent effects of implementing the ICF is required.

Ultimately, as discussed previously, the best deterrent in this area is likely to be government enforcement and punishment directed at managers, rather than corporations. Therefore, combining increased funding for the SEC and DOJ with implementation of the ICF offers the promise of fewer losses from securities fraud and meaningful compensation for the inevitable losses that will occur.

V. A CONSIDERATION OF ALTERNATIVE REFORM PROPOSALS

The securities regulation regime is a frequent target of reform proposals. In this Part, I consider several recent proposals that are somewhat similar to the ICF and designed to enhance investor compensation.

A. *Fair Fund Expansion*

Under Section 308(a) of the Sarbanes-Oxley Act, also known as the "Fair (Federal Account for Investor Restitution) Fund Provision," Congress authorized the SEC to take civil money penalties and add them to disgorgement funds³⁰⁷ to create a separate fund for each instance of securities fraud.³⁰⁸ These so-called Fair Funds are designed to provide compensation to investors injured by securities law violations. While this is a laudable effort, the SEC itself has acknowledged that collecting sufficient amounts to compensate shareholders in securities fraud cases is "especially problematic, if not impossible" because the investor losses caused by the fraud tend to dwarf any profit accruing to the wrongdoer.³⁰⁹ This is because when fraud is ongoing, the gains from selling stock at an inflated price accrue not only to the wrongdoer who sells her shares on the open market, but also to the innocent investor who, by chance, happens to sell also while the fraud is ongoing. Thus, there is a substantial gap between total losses (which include the losses of all the investors on the other side of the trades with the "lucky" investors) and gains to the wrongdoer.

From 2002 through fiscal year 2006, the SEC collected \$8 billion for distribution through the Fair Fund process.³¹⁰ However, the amounts included in the Fair Funds for large scale frauds still have been small when compared with the magnitude of total shareholder losses.³¹¹ To try to increase compensation available to shareholders, the SEC

307. Wrongdoers can be ordered to disgorge profits from their illegal activities (e.g., profits on stock sales by an officer that perpetrated the fraud).

308. Sarbanes-Oxley Act, 15 U.S.C. § 7246(a) (Supp. II 2002).

309. SEC, SECTION 308(C) REPORT, *supra* note 63, at 20-21.

310. SEC 2006 PAR, *supra* note 125, at 23.

311. *See, e.g.,* Solomon, *supra* note 125 ("Investors are never going to be made whole by the SEC's settlement with WorldCom, which is just a small fraction of the billions of dollars investors lost in the fraud.").

suggested an amendment to the Fair Fund Provision.³¹² As enacted, the Fair Fund Provision only allows civil penalty amounts to be set aside in a fund for injured investors if such penalty amounts are *added* to disgorgement funds.³¹³ However, there are cases where penalty amounts are ordered from a defendant without a corresponding disgorgement order. Therefore, under current law, such civil penalty amounts are not available for distribution to injured investors.³¹⁴ The proposed amendment would make it possible for the SEC to distribute these civil penalty funds to defrauded shareholders even when there are no disgorgement proceeds.³¹⁵

Though allowing civil penalties to be added to Fair Funds even when there is no disgorgement order would be a positive development, unfortunately, the amounts available for shareholder compensation still would be extremely small in comparison to investor losses. The sources of civil money penalties (e.g., corporations, officers) lack the capacity to provide restitution for the full level of investor harm, and with several parties potentially staking a claim on their funds (e.g., plaintiffs' lawyers in securities class actions, the SEC, and possibly the bankruptcy court), the amounts available for Fair Fund use will continue to be inadequate.

Creation of the ICF, which collects a premium pegged to expected fraud losses *ex ante* rather than collecting illicit profits from wrongdoers *ex post*, as is the case with the Fair Funds, would provide a great deal more compensation to defrauded investors. All defrauded investors will be entitled to participate in damage recoveries through the ICF because the fund will be adequate to provide such compensation. Despite the current limitations of Fair Funds, under the ICF Proposal, the SEC will combine the funds collected by the ICF and Fair Funds efforts to provide even greater investor compensation for securities fraud losses. Combining the Fair Funds and ICF premiums provides the benefit of having the actual wrongdoers (i.e., the corporate managers that perpetrated the fraud) provide compensation to the victims of that fraud. This combination furthers the aims of corrective justice.³¹⁶

Recently, the SEC announced the creation of a new specialized office to coordinate the distribution of Fair Funds to defrauded investors.³¹⁷ The experience garnered from

312. U.S. GOV'T ACCOUNTABILITY OFFICE, SEC AND CFTC PENALTIES 31 (2005) [hereinafter 2005 GAO REPORT], available at http://energycommerce.house.gov/Press_109/109-GAO-05-670.pdf.

313. Sarbanes-Oxley Act, 15 U.S.C. § 7246(a) (Supp. II 2002).

314. *Id.*

315. *Id.* The Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179, 108th Cong. (2003), contained the SEC legislative recommendation. 2005 GAO REPORT, *supra* note 312, at 32. No vote on the bill ever took place. *Id.* However, there is no reason to believe the measure could not be reconsidered in the future.

316. See Ernest J. Weinrib, *Corrective Justice in a Nutshell*, 52 U. TORONTO L.J. 349, 350 (2002) ("A remedy directed at only one party does not conform to corrective justice. For the court merely to take away the defendant's wrongful gain does not suffice because the plaintiff is still left suffering a wrongful loss."). Unlike under the current regime, investors, because of the ICF, will have the opportunity for meaningful compensation that is well above the amounts that the wrongdoers have the capacity to pay. As described above, the ICF would provide protection in this context because the defendants generally will lack the resources to pay the claims of the victims fully.

317. See *Testimony Concerning Fiscal 2008 Appropriations Request: Hearing Before the S. Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations*, 110th Cong. (2007) (statement of Christopher Cox, Chairman, SEC) ("...I have ordered the creation of a new office that will focus the efforts of all of the SEC's offices around the country, and work full-time to return these [Fair Funds] to wronged investors."), available at <http://www.sec.gov/news/testimony/2007/ts051607cc.htm>.

managing this new office could allow for an easier transition to administering the ICF were the ICF Proposal adopted.

B. U.S. Insurance-Based Proposals

Two leading scholars recently set forth innovative insurance policy proposals to provide compensation for shareholders' fraud-related losses. David Skeel proposed creating a federal insurance fund to provide compensation for shareholder losses stemming from corporate fraud.³¹⁸ Skeel envisions an optional investor insurance scheme funded by corporate contributions and administered by a new federal agency, the Federal Investor Insurance Corporation.³¹⁹ In addition, Joshua Ronen set forth a proposal under which public companies would purchase financial statement insurance (FSI) that would compensate shareholders that suffered losses stemming from financial statement misrepresentations.³²⁰ Under this proposal, insurance carriers would hire auditors to audit the books of their policyholders, and companies would disclose to the public the amount of insurance coverage obtained and the premiums paid therefor.³²¹

Though commendable in many respects and worthy of serious consideration, the Ronen and Skeel proposals suffer from the same key deficiency—shareholder compensation for accounting fraud in all likelihood would not be much (if at all) higher under these proposals than is currently the case. Under the Skeel proposal, funding would be generated by fees levied on corporations and hence would be limited by the capacity of corporations to contribute. Given trading dynamics, investor losses from securities fraud occurring over an extended period easily can be of such a magnitude that a corporation would be unable to afford insurance premiums that would capture fully the risk of investor losses from fraud.³²² Thus, compensation for fraud under the Skeel proposal is unlikely to be higher than that which is currently available through D&O insurance payouts.³²³

Similarly, though providing an important improvement in auditor incentives (since the auditors' clients would be insurance companies, not the companies being audited), the Ronen proposal in all likelihood would not result in increased compensation. Under the proposal, companies would pay the premiums on the financial statement insurance.³²⁴ Ronen explores two possibilities with respect to the level of insurance coverage: 1) the level of coverage under FSI is the same as it is under the current regime or 2) the level of

318. DAVID SKEEL, *ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM* 214 (2005).

319. *Id.*

320. Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance and GAAP Re-Visited*, 8 *STAN. J.L. BUS. & FIN.* 39 (2002). Lawrence Cunningham also has set forth a proposal for financial statement insurance. See Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 *UCLA L. REV.* 413 (2004).

321. *Id.*

322. See *supra* Part III (describing the limits on D&O insurance which lead, in large part, to limits on investor compensation).

323. See generally Sean J. Griffith, *Daedalean Tinkering*, 104 *MICH. L. REV.* 1247, 1257 (2006) (reviewing DAVID SKEEL, *ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM* (2005) and stating that Skeel's investor protection proposal does not seem to add much to the current compensation regime (i.e., securities class actions funded largely by D&O insurance)).

324. Ronen, *supra* note 320, at 59.

coverage increases.³²⁵ If the former were to be the case, of course, for reasons discussed above in connection with the Skeel proposal, the payouts under the Ronen scheme are likely to be small fractions of total investor losses. If coverage were to increase significantly over current levels, Ronen suggests insurers would have the capacity to pay for this increased coverage by hedging, in the capital markets, the losses the carriers are insuring.³²⁶ Specifically, he states that insurers could buy special put options from institutional investors such as pension funds and mutual funds.³²⁷ Such puts, which would have durations corresponding to the insurance coverage period, would be exercisable upon a decline in the stock price of the insured company caused by financial statement misrepresentations or omissions.³²⁸

There is, however, reason to doubt that the insurers would be able to hedge against these losses effectively.³²⁹ Institutional investors of the sort identified by Ronen (i.e., pension funds and mutual funds) in all likelihood would have little interest in taking on the risk inherent in acting as a counterparty to this sort of hedge,³³⁰ and there is reason to question whether a sufficiently large group of new institutions (e.g., hedge funds) would emerge to perform this function because of the potential for catastrophic losses from a large-scale fraud. Selling a put to the carrier insuring a company whose fraud generated multi-billion dollar shareholder losses could signal financial ruin for an institution. Thus, it is unlikely, as Ronen implicitly acknowledges,³³¹ that any one institution would be willing to take on such a risk. For sure, several institutions could agree to assume the risk jointly. However, this could lead to difficult coordination issues, and, unless the group were of substantial size, still may not satisfactorily spread the risk. This type of risk would be best spread across numerous participants in the broader financial markets and

325. *Id.* at 54.

326. *Id.*

327. *Id.*

328. *Id.*

329. *See also* Cunningham, *supra* note 320, at 472-73 (questioning this aspect of the Ronen proposal and describing some potential risks associated with using the capital markets for reinsurance).

330. In general, the core competence of these institutions is investing in companies, not engaging in speculative activities. There is also evidence that these investors do not have an interest in pursuing such activities. According to one study of derivatives use by equity mutual funds, 79.2% of funds do not use derivatives at all. Jennifer Lynch Koski & Jeffrey Pontiff, *How are Derivatives Used? Evidence from the Mutual Fund Industry*, 54 J. FIN. 791, 795 tbl. 1 (1999). Only 8.5% of the funds that use derivatives engage in activities in which derivatives are used strictly for speculative purposes. *Id.* at 795. There is no reason to think that this market opportunity (i.e., speculating on the likelihood of securities fraud) would change that appetite dramatically. After Koski and Pontiff conducted this study, Congress enacted the Taxpayer Relief Act of 1997, which repealed a rule that prohibited, in order for favorable tax status to be maintained, more than 30% of a mutual fund's gross income being derived from gains on short-term investments, including derivatives. Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 Tax Law. 133, 136 (2003). Theoretically, this tax law change could encourage more use of derivatives by these institutional investors. However, there is some evidence to suggest that tax changes are not enough to change the risk appetite of traditional mutual funds. *See generally* Laura Santini, *Hedge Fund Strategies Just Too Risky: SEC Thinks Mutual Funds Might Mimic Them, but So Far They Haven't*, INV. DEALERS DIGEST, Oct. 20, 2003, at 9, 9 (stating, in an article written approximately six years after enactment of the Taxpayer Relief Act of 1997, "mutual fund analysts contend that many mutual funds . . . have the ability to engage in hedge-like strategies [which employ derivatives]—and don't. The reason, they argue, is that regulation or no regulation, it's just too risky").

331. Ronen, *supra* note 320, at 55 ("The put sellers can minimize their exposure on these written puts by constructing portfolios that are well diversified with respect to the risk of misrepresentations and omissions.")

may be what Ronen envisions. However, thus far, with limited exceptions,³³² the financial markets have played only a limited role in traditional insurance,³³³ and there is some question as to whether a financial product linked to FSI would be viable when no similar product has emerged with respect to most other types of insurance. The market appetite for these securities fraud puts simply may not exist in sufficient amounts to provide a robust public reinsurance market.

In sum, it is not clear that there would be substantial additional compensation beyond current levels under the Ronen proposal. The ICF Proposal, in contrast, because of the collection of premiums with each stock sale, promises a ready source of funding for investor compensation. That said, because the Ronen proposal has the potential to minimize the likelihood of misrepresentations in financial statements, there is no reason why elements of the Ronen proposal could not be implemented in conjunction with the ICF.

*C. Canadian Securities Misinformation Insurance*³³⁴

Tom Baker, a leading U.S. insurance law scholar, developed an innovative proposal for what he terms “securities misinformation insurance,” a program designed to compensate Canadian market investors for losses stemming from securities law violations.³³⁵ Baker, in a report to The Task Force to Modernize Securities Legislation in Canada, describes various ways in which the insurance program could be structured. These methods include (1) a government-sponsored, primary insurance program, funded by both per-trade fees³³⁶ payable by investors and annual risk-based assessments payable by issuers, with the fund having subrogation³³⁷ rights against responsible parties,³³⁸ (2)

332. One such exception is the limited use of catastrophe bonds. David M. Cutler & Richard Zeckhauser, *Extending the Theory to Meet the Practice of Insurance*, BROOKINGS-WHARTON PAPERS ON FIN. SERVICES, 2004, at 4, available at http://muse.jhu.edu/journals/brookings-wharton_papers_on_financial_services/v2004/2004.1cutler.pdf. Catastrophe bonds are high-yield debt instruments, the interest and/or principal on which generally is fully or partially forgiven upon catastrophic losses (e.g., losses due to a hurricane) to the issuer (the insurance company) or upon “catastrophic losses measured on some composite index of insurer losses.” Neil A. Doherty, *Financial Innovation in the Management of Catastrophe Risk*, J. APPLIED CORP. FIN., Fall 1997, at 84, 89-90.

333. Cutler & Zeckhauser, *supra* note 332, at 4 (stating that financial markets have played a limited role in insurance and arguing that the reason lies with “contracting difficulties,” including the challenge of “marry[ing] insurance expertise with ready pools of capital”). For additional discussion on this point, including an expression of the belief that some of these challenges will be overcome in the future, see also *id.* at 39.

334. The securities misinformation insurance program described in this section is not a concrete reform proposal, but rather an exploration of a potential reform, and was not intended to be applied to the U.S. market. However, because of the similarities between this program and the ICF, the program merits discussion.

335. Baker, *supra* note 113, at 370.

336. The fee will be proportional to the size of the trade, but not risk-rated. *Id.* at 405. However, in a separate report on the actuarial aspects of securities misinformation insurance, Harry Panjer notes that a flat percentage-based fee may be most appropriate initially, but could be replaced with a risk-rated fee at some point in the future. Panjer, *supra* note 188, at 430.

337. See Baker, *supra* note 113, at 401 (“Subrogation is the legal term given to the right of an insurer to step into the shoes of a beneficiary in order to recoup from the other liable parties what the insurer has paid to, or on behalf of, the beneficiary.”).

338. *Id.* at 404-07. In addition to annual assessments paid by the corporations, issuers may be called on to pay additional assessments if losses reduce reserves “below a target level.” *Id.* at 405. These additional assessments also would be payable under option two. *Id.* at 408.

company-provided excess insurance³³⁹ funded by annual issuer-paid risk-based premiums, with the fraud protection fund having subrogation rights³⁴⁰ against responsible parties,³⁴¹ and (3) mandatory³⁴² private market³⁴³ excess insurance³⁴⁴ funded by market-priced issuer premiums, with subrogation rights³⁴⁵ against the responsible parties for the securities protection insurer.³⁴⁶ Baker's report does not make a specific recommendation to the task force with respect to adopting any particular option. However, Baker does conclude that, although a securities misinformation insurance program could provide systemic benefits for the Canadian capital markets, including increased investor confidence and better securities law compliance,³⁴⁷ increased compensation (or "loss spreading") is not a valid basis for this type of insurance.³⁴⁸ Baker argues that the risk of securities fraud can be mitigated substantially (though not eliminated) much more inexpensively by diversification.³⁴⁹ Even undiversified investors, according to Baker, would not want, *ex ante*, the protection of securities misinformation insurance (what he calls "an expensive risk distribution strategy") to protect them from fraud risk.³⁵⁰

This Article has attempted to make the case for investor compensation, including the compelling case for corrective justice, and to explain the many benefits of a compensation fund. However, Baker's proposal differs significantly from the ICF Proposal, and it is understandable that he characterized the three options he set forth as "*expensive risk distribution strategies*."³⁵¹ One of the most attractive characteristics of the ICF Proposal lies in the elimination of secondary market securities class actions. This design feature affords significant administrative cost savings over the current regulatory regime. In contrast, the three options for Baker's proposal listed above all include subrogation rights and, in options two and three, the continued existence of civil litigation as fraud victims' first recourse for compensation. Thus, the costs of administering the insurance schemes would be additional costs above those of conducting litigation. In all likelihood, the costs of a single insurer suing the corporation and its officers pursuant to

339. This "excess" insurance provides compensation for investors that brought successful litigation, but were unable to collect 100% of awarded damages. *Id.* at 408.

340. Baker notes that because this is excess insurance, subrogation generally will be used only to collect damages that had already been assessed in the initial litigation. Baker, *supra* note 113, at 410.

341. *Id.* at 407-10.

342. Issuers would be required to either purchase the insurance or disclose, in all investor communications, that they did not purchase the insurance. *Id.* at 410.

343. Baker's conversations and personal experiences with private insurers indicate such insurers would have no interest in this type of insurance unless it were backed by some form of government or company-sponsored reinsurance (e.g., shortfalls could be made up with issuer assessments). *Id.* at 411 n.76.

344. This insurance functions as an excess to issuers' (and other potential defendants') existing liability policies, dropping down only if the basic insurance is uncollectible or if insurance funds have been exhausted. *Id.* at 411.

345. As with scenario two, subrogation generally will be used to collect damages already assessed in litigation. In addition, subrogation against the corporation that purchased the insurance for "fraud in the application" would be permitted. Baker, *supra* note 113, at 413.

346. *Id.* at 410-13.

347. *Id.* at 419.

348. *Id.*

349. *Id.* at 386.

350. Baker, *supra* note 113, at 387-88.

351. *Id.* at 387 (emphasis added).

the insurer's subrogation rights as contemplated by option one would be less than the costs of securities class actions as we know them in the United States because of the reduced complexity of such suits. However, most of the costliest aspects of litigation (e.g., discovery disputes) still remain. In addition, allowing civil litigation to continue under these proposals results in the likelihood of the company paying damages, something that, as noted by other commentators, has the effect of punishing the innocent shareholders remaining in the corporation.³⁵² For sure, the threat of litigation can serve as a fraud deterrent. However, the ICF provides deterrence through the use of fraud risk ratings without the costs of the civil litigation system.

VI. CONCLUSION

The conventional academic wisdom on securities fraud losses holds that shareholder compensation is unnecessary. However, the conventional wisdom ignores the substantial harm that defrauded shareholders, both diversified and undiversified, can suffer from securities fraud. The Investor Compensation Fund offers a way to compensate shareholders for fraud-related losses, while also increasing fraud deterrence. Of course, implementing the ICF would be a challenging and ambitious undertaking at best, and perhaps politically infeasible. Still, the ICF Proposal offers a promising avenue for a fundamental rethinking of the way we compensate securities fraud victims.

352. See Coffee, *supra* note 62, at 1561 n.96 for variations on this argument made by leading securities regulation scholars.

APPENDIX I

Estimated ICF Premium Calculations¹

Case ²	Equity Sales ³ (A)	Est. Damages ⁴ (B)	Meritorious Suits/Losses ⁵ (C)	ICF Recovery (D)	Admin. Costs (E)	Est. Premium (((B*C*D)+E)/A)
A. 2006 (Base Case)	\$43.9 trillion	\$37.0 billion	50%	75%	—	0.032%
B. 2005	\$34.6 trillion	\$86.5 billion	50%	75%	—	0.094%
C. Base Case - 10% Volume Decline	\$39.5 trillion	\$37.0 billion	50%	75%	—	0.035%
D. Base Case - 25% Volume Decline	\$33.0 trillion	\$37.0 billion	50%	75%	—	0.042%
E. Base Case - 50% Damage Claims Increase	\$43.9 trillion	\$55.4 billion	50%	75%	—	0.047%
F. Base Case - 100% Damage Claims Increase	\$43.9 trillion	\$73.9 billion	50%	75%	—	0.063%
G. Base Case - 300% Damage Claims Increase	\$43.9 trillion	\$147.8 billion	50%	75%	—	0.126%
H. Base Case + 10% Admin. Costs	\$43.9 trillion	\$37.0 billion	50%	75%	\$1.4 billion	0.035%
I. Base Case + 25% Admin. Costs	\$43.9 trillion	\$37.0 billion	50%	75%	\$3.5 billion	0.039%
J. Base Case - 100% Damage Claims Increase + 25% Admin. Costs	\$43.9 trillion	\$73.9 billion	50%	75%	\$6.9 billion	0.079%

Appendix I (continued)

Case ²	Equity Sales ³ (A)	Est. Damages ⁴ (B)	Meritorious Suits/Losses ⁵ (C)	ICF Recovery (D)	Admin. Costs (E)	Est. Premium (((B*C*D)+E)/A)
K. Base Case + 50% Admin. Costs	\$43.9 trillion	\$37.0 billion	50%	75%	\$6.9 billion	0.047%
L. Base Case - 100% Damage Claims Increase + 50% Admin. Costs	\$43.9 trillion	\$73.9 billion	50%	75%	\$13.9 billion	0.095%

¹ Above figures are rounded and designed to be estimates of possible premium levels. Calculations do not factor in investment income (which, to the extent such investments include equity securities, must be those of a market index such as the S&P 500 to minimize any appearance of impropriety), which would have the effect of reducing the required premium to fund the ICF. In addition, calculations do not reflect the impact of exempting sales related to professional market making activities from the ICF scheme or any additional collections required to maintain an adequate reserve of funds. Though precise figures on the level of market making on all U.S. exchanges is not available, researchers estimate that specialist or market maker trading represents approximately 10% of the volume on the New York Stock Exchange (Anne M. Anderson & Edward A. Dyl, *Trading Volume: NASDAQ and the NYSE*, FIN'L ANALYSTS J., May/June 2007, at 79) and as much as 50% (or possibly more) of trading on the NASDAQ, historically a dealer market in which a market maker acts as a transaction intermediary (*Id.*). The premium figures above, because they include volume attributable to market making activity, understate the premiums required to fund payouts equal to the amount assumed above. However, were the ICF adopted, as a practical matter, excluding market makers and specialists from the ICF scheme would decrease not only the premiums collected, but also the number of potential claimants and the amount of investor recoveries.

²The 12 case scenarios are:

(A) Base Case - 2006: Data based on 2006 market sales and estimated damages (see, *infra*, note 4 below) in lawsuits filed in 2006. Assumes that all claims are related to inflated prices in 2006, the year the lawsuits are filed.

(B) 2005: Data based on 2005 market sales and estimated damages in lawsuits filed in 2005. Assumes that all claims are related to inflated prices in 2005, the year the lawsuits are filed.

(C) 10% Volume Decline: Base Case, assuming a reduction of 10% of market sales volume due to imposition of ICF premium.

(D) 25% Volume Decline: Base Case, assuming a reduction of 25% of market sales volume due to imposition of ICF premium. Note the following: if the volume does decrease following the implementation of

the ICF Proposal, we also should expect to see a relatively proportional decrease in the number of claims for compensation from the ICF, which means the percentage premium estimates may remain constant over some range of volume assumptions.

(E) 50% Increase in Estimated Damages: 2006 estimated damages are assumed to be 50% higher, holding 2006 sales volume constant. 2006 estimated damages are low relative to prior periods. In 2006, estimated damages were approximately \$37 billion. On average, from 1996 – 2005, the estimated damages were \$123.7 billion. Of course, this 10-year period includes several large-scale fraud cases, so it is not clear that the average figure from that period is representative of what one might expect in the future.

(F) 100% Increase in Estimated Damages: 2006 estimated damages are assumed to be 100% higher, holding 2006 sales volume constant.

(G) 300% Increase in Estimated Damages: 2006 estimated damages are assumed to be 300% higher, holding 2006 sales volume constant.

(H) Base Case + 10% Admin. Costs: Base Case, assuming additional assessments for administrative costs totaling 10% of estimated fund payouts. This case provides the estimated ICF premium used throughout the text.

(I) Base Case + 25% Admin. Costs: Base Case, assuming additional assessments for administrative costs totaling 25% of estimated fund payouts.

(J) 100% Damage Claims Increase + 25% Admin. Costs: Assumes 2006 estimated damages are 100% higher, holding 2006 sales volume constant, and additional assessments for administrative costs totaling 25% of estimated fund payouts.

(K) Base Case + 50% Admin. Costs: Base Case, assuming additional assessments for administrative costs totaling 50% of estimated fund payouts.

(L) 100% Damage Claims Increase + 50% Admin. Costs: Assumes 2006 estimated damages are 100% higher, holding 2006 sales volume constant, and additional assessments for administrative costs totaling 50% of estimated fund payouts.

³ This figure includes equity and derivatives sales on U.S. securities exchanges currently subject to the SEC's Section 31 fee. Data Source: Order Making Fiscal Year 2008 Annual Adjustments to the Fee Rates Applicable under Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14(g), 31(b), and 31(c) of the Exchange Act, Securities Act Release No. 8794, Exchange Act Release No. 55682, 72 Fed. Reg. 25,809 (April 30, 2007), available at <http://www.sec.gov/rules/other/2007/33-8794.pdf>.

⁴ Data Source: CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2006: A YEAR IN REVIEW (2007), available at http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf. Figure represents “disclosure dollar loss amount,” defined as the difference in market capitalization of a defendant firm as of the trading day before the end of the class period and the market capitalization of the same firm the trading day following the end of the class period. This number is not intended to be a measure of liability for securities fraud, as factors unrelated to fraud could have affected the prices on these two dates. *Id.* at 5. However, the figure does provide an approximate sense for the losses suffered by investors from securities fraud. This figure is adjusted to exclude class action lawsuits that are unrelated to secondary market fraud. The figure is adjusted by using the data on the percentage of filings with 10b-5 claims. This percentage is based on number of filings, rather than dollar value of claims. Thus, it is merely an approximation for the disclosure dollar loss amount attributable to secondary market fraud cases. Figure excludes suits related to option backdating cases.

⁵ For purposes of calculating the ICF premium, the disclosure dollar loss amounts are adjusted to reflect an assumption that 50% of suits filed are meritorious. For data on the number of securities class actions that survive a motion to dismiss and hence generally move on to settlement negotiations, see Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 685, 691 (2002) (finding, in a study of 167 federal court securities fraud

decisions that address the “strong inference standard,” that 34.1% of motions to dismiss are denied in their entirety, and 36.5% are granted either in part or in their entirety without prejudice, thus making it possible for the plaintiff “to replead in such a manner as to allow the litigation to continue.”); A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 142 (2005) (finding that 52% of motions to dismiss are granted in a study of 1996-2002 Second and Ninth Circuit decisions in securities fraud class actions); TODD FOSTER, ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: FILINGS STAY LOW AND AVERAGE SETTLEMENTS STAY HIGH—BUT ARE THESE TRENDS REVERSING? 7 (2007), available at http://www.nera.com/image/PUB_RecentTrends_Sep2007-FINAL.pdf (finding the dismissal rate to be 39.1% in 2004-2006, but acknowledging that this rate could be overstated as a practical matter because it includes suits dismissed without prejudice and suits dismissed “with prejudice that will be successfully appealed”). It should be noted, however, that the figure used reflects a simplifying assumption. The fact that a suit gets past the motion to dismiss phase does not mean that 100% of the estimated market capitalization decline of the corporation upon the fraud revelation equals compensable damages.

APPENDIX II

Estimated Annual ICF Premiums for Mutual Funds and Pension Plans

U.S. Institutions	Total Industry Assets (A)	% Invested in U.S. Equities (B)	Assets in U.S. Equities (A * B) = (C)	Asset-Weighted Turnover (D)	Est. Annual Sales of U.S. Equities (C * D) = (E)	Est. ICF Premium ⁴ (F)	Est. Total Premium Cost (E*F)
Mutual Funds	\$10.4 trillion ¹	44% ²	\$4.6 trillion	47% ³	\$2.2 trillion	0.035%	\$754 million
Public Pension Funds	\$4.0 trillion ⁵	44% ⁶	\$1.8 trillion	19% ⁷	\$334.5 billion	0.035%	\$117 million
Private Pension Funds	\$2.2 trillion ⁵	43% ⁸	\$956.1 billion	36% ⁷	\$344.2 billion	0.035%	\$121 million

1. INV. CO. INST., 2007 INVESTMENT COMPANY FACT BOOK 16 (2007), available at http://www.icifactbook.org/pdf/2007_factbook.pdf.

2. *Id.*

3. *Id.* at 23.

4. See *supra* Appendix I.

5. Appendix: Additional Data on the U.S. Retirement Market, 2006, RESEARCH FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), July 2007, at 3, http://www.ici.org/stats/mf/fm-v16n3_appendix.pdf. Figures calculated by author. Numbers adjusted to account for the overlap of mutual fund holdings by defined benefit pension plans (estimated as 1.5% of total retirement assets). *Id.* at 4.

6. JULIA K. BONAFEDE ET AL., 2006 WILSHIRE REPORT ON STATE RETIREMENT SYSTEMS: FUNDING LEVELS AND ASSET ALLOCATION 11 (2006), available at http://www.wilshire.com/Company/2006_State_Funding_Report.pdf. Note: Allocation rate for federal pension plans assumed to equal that of state pension plans.

7. The Conference Board, INSTITUTIONAL INVESTMENT REPORT: TURNOVER, INVESTMENT STRATEGIES AND OWNERSHIP PATTERNS 11 (1998), cited in William Dale Crist & Kayla J. Gillan, Patient Pension Capital, CalPERS Commentary, <http://www.calpers-governance.org/viewpoint/speeches/crist.asp> (last visited Sept. 28, 2007).

8. Ronald J. Ryan & Frank J. Fabozzi, *Rethinking Pension Liabilities and Asset Allocation*, J. PORTFOLIO MGMT., Summer 2002, at 1, 3 exhibit 2, available at http://www.ryanalm.com/portals/5/press/20020701_Rethinking_Pension_Liabilities_and_Asset_Allocation.pdf (showing equity allocation of 43% in 2001).