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Eliminating Claims that Jeopardize the Stature of America's Capital Markets

Jeffrey W. Apel*

*"Unless we improve our corporate climate, we risk allowing New York to lose its pre-eminence in the global financial-services sector. This would be devastating both for our city and nation. . . . [One prominent factor driving this trend is that] [t]he U.K. and other nations have laws that far more effectively discourage frivolous suits."*¹

I. INTRODUCTION

New York is in serious jeopardy of losing its identity as the financial capital of the world, with London set to take its place. A number of factors presently contribute to New York's waning financial dominance. One of the most prominent factors driving this trend is the increasing cost of defending meritless securities suits inuring to companies listed on American stock exchanges.² Despite Congress' repeated attempts to deter such suits through renewed securities litigation statutes, the problem persists and threatens the stability of New York's financial markets. The Second Circuit compounded the already serious problem in 2005 by demonstrating that even those plaintiffs that present the most frivolous of securities claims can sometimes be given standing when a creative plaintiff's lawyer is able to exploit the ambiguous language of the relevant securities statutes.³

The Securities Litigation Uniform Standards Act ("SLUSA") provides that class action claims alleging fraud "in connection with the purchase or sale" of securities cannot be pursued in state court or under state law; such claims are preempted by federal law and removed to federal court.⁴ The vague "in connection with the purchase or sale" language provides the plaintiff's lawyer with the means for exploitation since the phrase "in connection with" is not expressly de-

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1. Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn From London*, WALL ST. J., Nov. 1, 2006, at A18.

2. *Id.* Other factors listed include the globalization of the capital markets, overregulation, and incompatible accounting standards.

3. See *Dabit v. Merrill Lynch*, 395 F.3d 25 (2d Cir. 2005).

4. 15 U.S.C. § 78bb(f)(1) (2007).

fined within the statute itself. Capitalizing on the federal preemption provision's definitional ambiguity, the Second Circuit, in *Dabit v. Merrill Lynch*, imported an additional twist into that statute's application that would allow certain plaintiff classes to avoid the statute's preemptive mandate. The Second Circuit held that a plaintiff class could escape federal preemption of their claims by tailoring the class to include only those plaintiffs that merely *held* their securities in response to the alleged fraud.⁵ Accordingly, only those plaintiffs that actually bought or sold securities in response to the alleged fraud would see their claims federally preempted.⁶ This differentiation will be explained in greater detail later in this article.

Creating such an exemption to SLUSA's preemptive scope has far-reaching implications. First, allowing such "holding claims" to escape federal preemption allows a class of plaintiffs to try to take advantage of less-stringent state securities laws, which is the reason that SLUSA was enacted in the first place. Second, the absence of any purchase or sale of the plaintiff's security renders any calculation of damages inherently suspect because these holding claims must be calculated by relying solely on the unreliable words of the plaintiff. Third, creating loopholes in SLUSA sends a signal to corporate executives that America's legal system is unpredictable and risky, further jeopardizing New York's position as the financial capital of the world.

The Seventh Circuit, observing Supreme Court precedent and recognizing the inherent danger of allowing such holding claims to escape federal preemption, rejected the view later accepted by the Second Circuit.⁷ The Supreme Court reviewed the circuit split in 2006 and properly rejected the Second Circuit's holding claim exemption to SLUSA's preemptive scope.⁸ In doing so, the Court dismissed the idea that such class-tailoring can be used to evade the more rigid federal securities law requirements imposed on plaintiffs under the Private Securities Litigation Reform Act⁹ ("PSLRA").¹⁰

Apart from the Court's statutory interpretation, its decision is supported by three important legal justifications. First, the Court's interpretation of the "in connection with" language of SLUSA gives effect to the policy considerations behind Congress' enactment of the statute.¹¹ Second, the damage arising out of a plaintiff's holding claim is

5. *Dabit*, 395 F.3d at 47.

6. *Id.*

7. *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005).

8. *Merrill Lynch v. Dabit*, 126 S. Ct. 1503, 1507 (2006).

9. Pub.L. No. 104-67, 109 Stat. 737 (1995).

10. *Merrill Lynch*, 126 S. Ct. at 1507.

11. See *infra* Part IV.B.

an economic fallacy: such claims do not result in any damages-in-fact.¹² Third, holding claims represent the most dangerous and least meritorious theories of securities claims, which Congress has repeatedly tried to subvert through federal legislation.¹³

Most importantly, the Supreme Court's holding helps stabilize America's capital markets by reducing meritless securities suits that would otherwise add to the complexity and inherent legal risk for companies listed on American stock exchanges.¹⁴ Such an effect is especially important today as America's stature as the financial capital of the world is in jeopardy, with recent evidence demonstrating that London is now overtaking New York as the world's preeminent city for the financial services industry.¹⁵ In sum, the Supreme Court's decision undermines this negative trend, thereby reinforcing New York's position as the financial capital of the world.

This Comment dissects the Supreme Court's decision to reject holding claims as a means of evading federal preemption into four parts. Part I analyzes the specific federal securities statutes that provide the background for the Court's decision. Part II introduces the Second and Seventh Circuit opinions, as well as the Supreme Court's resolution of the circuit split. Part III explores why the Court's reasoning is in line with precedent and essential to a proper textual reading of SLUSA. Last, Part IV argues that the Supreme Court's decision strengthens America's capital markets, thus helping New York retain its position as the financial capital of the world.

II. BACKGROUND

A. Introduction

Prior to the 1930s, securities litigation was regulated by the individual states, effectively creating a system that allowed securities promoters to engage in the outrageous conduct that contributed to the economic downturn of the late 1920s.¹⁶ It was not until the 1929 stock market crash and the advent of the New Deal that Congress intervened by enacting two landmark statutes: the Securities Act of 1933¹⁷

12. See *infra* Part IV.C.

13. See *infra* Part IV.D.

14. See *infra* Part V.

15. See Schumer & Bloomberg, *supra* note 1.

16. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION*, § 1.2[2] (4th ed. 2002).

17. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2007)). The 1933 Act is primarily concerned with full disclosure before the initial issuance of securities to the buyer.

("The 1933 Act") and the Securities Exchange Act of 1934¹⁸ ("The 1934 Act"). This Article focuses principally on the impact of The 1934 Act since the statutory basis for rejecting holding claims is found within the later Act.

B. *The 1934 Act*

The 1934 Act, while providing the statutory basis for plaintiffs to pursue a private cause of action premised on a holding claim theory, also serves as the statutory basis for justifying the rejection of these same claims. Congress passed the 1934 legislation "[t]o provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."¹⁹ The purpose of the legislation was two-fold. First, the 1934 Act was designed in part to supplement the disclosure requirements of the 1933 Act by compelling publicly held corporations to disclose information about their corporate affairs in a manner substantially comparable to that required of issuers under the 1933 Act.²⁰ The second purpose of the 1934 Act was to regulate broker-dealers and the markets for post-distribution purchases and sales of securities.²¹ Thus, the 1934 Act broadened its scope to regulate the entire marketplace rather than just purchasers and sellers of securities. Most importantly, it is Section 10(b), and the analogous Rule 10b-5, that provides the statutory basis for both the right to pursue, and the subsequent rejection of, a cause of action premised on a theory of "holding" damages.

C. *Section 10(b) and Rule 10b-5*

While the securities acts set forth numerous anti-fraud provisions, the most relevant provision to holding claims is Section 10(b) of the 1934 Act, later promulgated as Rule 10b-5 by the SEC in 1948.²² Rule 10b-5 makes it unlawful:

for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(a) To employ any device, scheme, or artifice to defraud,

18. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm (2007)).

19. *Id.*

20. 1-1 Federal Securities Exchange Act of 1934, MB § 1.01 (2007).

21. *Id.*

22. 17 C.F.R. § 240.10b-5 (2007).

- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.²³

Rule 10b-5 is a broad catch-all provision that serves as a key component in the federal regulation of corporations.²⁴ The rule now overshadows any other express or implied right of action, becoming the principal foundation for civil litigation under The 1934 Act.²⁵ While this rule concerns itself with securities fraud, it does not cover all types of fraud – only that which occurs “in connection with the purchase or sale” of securities.²⁶

In order to prevail on a Section 10(b) or Rule 10b-5 claim, the plaintiff must prove that (1) the defendant made a false representation or omission of a material fact, (2) the defendant acted with scienter, (3) the plaintiff justifiably relied on the defendant's misrepresentation, (4) the misrepresentation or omission occurred “in connection with” the purchase or sale of securities, and (5) that the defendant's actions proximately caused the plaintiff's damages.²⁷ The “in connection with” requirement serves as the essential nexus between the fraud and the securities transaction. As evidenced in the forthcoming discussion of *Dabit*, it is the single most scrutinized element in interpreting the statute (and rule). Moreover, if the claim is not brought in federal court, but rather in state court and under state law, these more stringent requirements of proof may not apply since a cause of action premised on state securities law may not carry with it the same burden of proof standard found under federal securities law. This is why federal preemption becomes so important to the ultimate success of the claim. Because the “in connection with” requirement is the only disputed issue in *Dabit*, this background section will not further develop the other four requirements of a Section 10(b) claim.

23. *Id.*

24. CHARLES O'KELLEY & ROBERT THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 872 (4th ed. 2003).

25. 1-5 Federal Securities Exchange Act of 1934, MB § 5.04 (2007).

26. O'KELLEY & THOMPSON, *supra* note 24, at 872.

27. Phillips v. LCI Int'l, Inc., 190 F.3d 609, 613 (4th Cir. 1999).

1. The “In Connection With” Requirement

Section 10(b) of the 1934 Act, and similarly Rule 10b-5, require that the alleged fraud occur “in connection with” the purchase or sale of securities.²⁸ While the wording is indeed broad in scope, the language itself actually limits which plaintiffs have standing to bring private suit under the Act. In *Birnbaum v. Newport Steel Corp.*, the Second Circuit held that Rule 10b-5 extended protection only to the defrauded purchaser or seller of securities, thus denying relief to claimants pursuing a claim for breach of fiduciary duty or corporate mismanagement.²⁹ Relying on the fact that Section 16(b) of The 1934 Act³⁰ gave an express remedy for issuers and shareholders against corporate insiders misusing their position while neither Section 10(b) nor Rule 10b-5 granted such an express remedy, the court refused to allow the shareholders’ claims to proceed under Section 10(b) or Rule 10b-5.³¹ Accordingly, the court limited the availability of a private remedy under Section 10(b) and Rule 10b-5 to plaintiffs having already purchased or sold the securities in question.³²

Twenty-three years later, in *Blue Chip Stamps v. Manor Drug Stores*, the Supreme Court affirmed the rule established in *Birnbaum* that the “in connection with” language of Section 10(b) and Rule 10b-5 limits the civil remedy solely to classes of purchasers and sellers.³³ To give every plaintiff the ability to proceed to trial (or settlement) without some form of substantive limitation increases the potential for abuse of the discovery system.³⁴ Moreover, the Court noted the importance of the limitation because, “[w]ithout the *Birnbaum* rule, an action under Rule 10b-5 will turn largely on which oral version of a series of occurrences the jury may decide to credit, and therefore no matter how improbable the allegations of the plaintiff, the case will be virtually impossible to dispose of prior to trial other than by settlement.”³⁵ Thus, while the rule undoubtedly excludes some legitimate plaintiffs who allege violations of Rule 10b-5, the rule operates to give standing to those plaintiffs whose version of the facts is more likely to

28. 15 U.S.C. § 78j(b) (2007); 17 C.F.R. § 240.10b-5 (2007).

29. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952); see also *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (holding that Congress did not seek to regulate transactions which constitute no more than corporate mismanagement under §10(b)).

30. Securities Exchange Act of 1934, ch. 404, § 16(b), 48 Stat. 881, 869 (1934) (current version at 15 U.S.C. § 78p(b)).

31. *Birnbaum*, 193 F.3d at 464.

32. *Id.*

33. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975).

34. *Id.* at 741.

35. *Id.* at 742.

be believed while separating out those plaintiffs who are less likely to succeed.³⁶ In sum, the “in connection with” language operates to exclude those plaintiffs from bringing claims under §10(b) or Rule 10b-5 who have neither purchased nor sold securities in reliance on the defendant’s alleged misrepresentation or omission of fact.

D. *A Private Right of Action Under Rule 10b-5*

Congress’ failure to expressly provide for a private right of action in The 1934 Act resulted in a circuit split over whether a plaintiff class may premise damages on a holding claim theory and survive federal preemption. While the 1934 statute was a direct outgrowth of its 1933 predecessor, Congress did not include a private right of action in the 1934 statute: the private right is wholly implied from the statute by the courts.³⁷ Indeed, there was never any indication that Congress even considered the possibility of private suits under the Act at the time of its passage.³⁸ Congress initially enacted rule 10(b)-5 believing that the SEC would enforce the statute through administrative and injunctive actions.³⁹ Further, there is no indication that the SEC, in adopting the rule, considered the question of private civil remedies under this provision.⁴⁰

Beginning with the seminal decision *Kardon v. National Gypsum Co.* in 1946, the federal courts began to imply a private right of action pursuant to rule 10b-5.⁴¹ While this private right of action was not expressly allowed under the statute, it was not expressly disallowed either.⁴² The court thought it more important to imply the private right of action, a result the court deemed to be in harmony with the Act’s general purpose: providing a remedy for persons injured by pro-

36. *Id.* at 743. In further explaining its rule, the court noted:

Obviously there is no general legal principle that courts in fashioning substantive law should do so in a manner which makes it easier, rather than more difficult, for a defendant to obtain a summary judgment. But in this type of litigation, where the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate component of settlement value, but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial, such a factor is not to be totally dismissed.

Id. at 742-43.

37. *Blue Chip Stamps*, 421 U.S. at 728-29.

38. *Id.* at 729.

39. *Central Bank of Denver, N.A., v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994).

40. *Blue Chip Stamps*, 421 U.S. at 730.

41. *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

42. *Kardon*, 69 F. Supp. at 514.

scribed deceptive and manipulative acts.⁴³ Thus, as Judge Easterbrook notes, this private right of action under 10b-5 is a judicial creation.⁴⁴ Accordingly, when the courts deal with these private rights of action, they are dealing with “a judicial oak which has grown from little more than a legislative acorn.”⁴⁵ Twenty-five years later the private right principle introduced in *Kardon* was affirmed by the Supreme Court.⁴⁶ While this private right of action was created by the courts, its legitimacy has since been endorsed by Congress. Congress recognized that a private right of action is an indispensable tool for investors that helps promote public and global confidence in capital markets by deterring wrongdoing and ensuring proper job performance.⁴⁷

E. *Private Securities Litigation Reform Act of 1995*

In 1995, Congress passed⁴⁸ the Private Securities Litigation Reform Act (“PSLRA”),⁴⁹ an extensive overhaul of the 1930s securities acts, to provide uniform standards for class actions and other suits alleging fraud in the securities market.⁵⁰ The enactment of the PSLRA was a direct response to plaintiffs who were abusing the private cause of action, and Rule 10(b)-5 in particular, by bringing meritless class action suits.⁵¹ These meritless class actions – so called “strike suits” – were brought with the simple goal of coercing large corporations into exorbitant settlements.

Irked investors typically brought these claims following a substantial drop in a company’s stock price.⁵² The classic strike suit usually involved the volatile stock of a high-growth tech-company that had a record of outstanding performance but eventually missed Wall Street expectations.⁵³ A securities class action lawyer then waited for the moment the stock price plummeted to immediately file a complaint.⁵⁴ The lawyer then named the company’s officers, directors, accountants,

43. *Id.*

44. *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 483 (7th Cir. 2005).

45. *Blue Chip Stamps*, 421 U.S. at 737.

46. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

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

48. Congress actually enacted the law over a presidential veto.

49. Private Securities Litigation Reform Act, Pub. L. 104-67, 109 Stat. 737 (1995).

50. *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

51. *Id.* at 107.

52. H.R. REP. NO. 104-50, pt. 1, at 18 (1995) (Conf. Rep.).

53. *Id.* at 15.

54. *Id.*

and consultants as defendants in the suit in the hopes of extracting hundreds of millions of dollars in damages.⁵⁵

While it is logical to believe that these suits were filed because of investor frustration, it was often the more troubling scenario of an entrepreneurial trial lawyer using a "professional plaintiff" as a means of "riding" into court.⁵⁶ These plaintiffs were dubbed "professional plaintiffs" for their propensity to be retained over and over by the same law firms, garnering extra compensation for their participation, while holding only a few shares of the defendant-company's stock.⁵⁷

It is precisely this type of gamesmanship and manipulation that the federal securities laws, specifically the PSLRA, aim to deter. The overriding purpose of such laws is to protect investors and to maintain confidence in the securities markets.⁵⁸ However, the preexisting statutes were not having the desired effect, as the House and Senate Committees heard an alarming production of evidence confirming the abusive practices of plaintiffs and lawyers: specifically, the practice of routinely filing lawsuits against issuers of securities and other parties whenever there was a significant change in the issuer's stock price, wholly without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might eventually lead to some plausible cause of action.⁵⁹ Naturally, these plaintiffs targeted defendants with deep pockets, including accountants, underwriters, and individuals who might be covered by insurance, without regard to any actual wrongdoing.⁶⁰ These suits were successful largely because the expense of defending against such claims forced defendants to settle, regardless of the merits of the action. As a result, innocent investors inevitably became the ultimate losers as the suits undercut investor confidence in securities markets.⁶¹

Congress remedied these problems by instituting a number of new procedural requirements for initiating a securities fraud claim in fed-

55. *Id.* at 15-16.

56. *Id.* at 16.

57. H.R. REP. NO. 104-50, pt. 1, at 16.

58. H.R. REP. NO. 104-369, at 31.

59. *Id.*

60. *Id.* Further abuses include the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle and the manipulation by class action lawyers of the clients whom they purportedly represent.

61. *Id.* at 32.

eral court.⁶² The most significant requirements were the heightened pleading standard and a mandatory stay of discovery.⁶³

1. The PSLRA's Heightened Pleading Standard

Prior to the enactment of the PSLRA, plaintiffs pleading securities fraud under rule 10b-5 had to meet the pleading standard imposed by Rule 9(b) of the Federal Rules of Civil Procedure. Accordingly, "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."⁶⁴ However, the federal circuit courts were in disagreement about how to apply this rule. Under the Second Circuit's approach, plaintiffs were required to allege facts that gave rise to a strong inference of fraudulent intent.⁶⁵ Regarded as being the most stringent standard of any federal circuit, this standard served as the starting point for the standard later adopted in the PSLRA.⁶⁶ The Ninth Circuit, however, imposed an almost nonexistent standard, requiring only that plaintiffs allege that scienter existed.⁶⁷

Relying on the apparent inability of Federal Rule of Civil Procedure 9(b) to curb abusive lawsuits, Congress set about changing the federal pleading requirements.⁶⁸ Consequently, pursuant to the PSLRA, plaintiffs now have to meet two requirements in order to survive a motion for summary judgment.⁶⁹ First, plaintiffs who allege that the defendant misrepresented or omitted a material fact are required to specify each statement alleged to have been misleading and must set forth the reasons why that statement is misleading.⁷⁰ Further, if the allegation is based on information and belief, the plaintiff must state with particularity all facts on which that belief is formed.⁷¹ Second, the plaintiff must set forth sufficient facts giving rise to a

62. See James A. Kassis, *The Private Securities Litigation Reform Act of 1995*, 26 SETON HALL LEGIS. J. 119 (2001). The most notable provisions of the Reform Act that intended to deal with abusive and frivolous litigation are the safe harbor provision for forward-looking statements, the heightened pleading standard, sanctions for frivolous filings, proportionate liability, appointing a lead plaintiff, aiding and abetting liability, and a statute of limitation.

63. *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

64. FED. R. CIV. P. 9(b).

65. See *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994).

66. H.R. REP. NO. 104-369, at 41 ("The Conference Committee language is based in part on the pleading standard of the Second Circuit.").

67. See *In re Glenfed Ins. Sec. Litig.*, 42 F.3d 1541, 1547 (9th Cir. 1994).

68. H.R. REP. NO. 104-369, at 41.

69. 15 U.S.C. § 78u-4(b)(3)(A) (2007).

70. § 78u-4(b)(1).

71. *Id.*

strong inference that the defendant acted with the required state of mind.⁷² Thus, Congress was able to follow through by establishing more uniform and stringent pleading requirements to curtail the filing of meritless securities suits.⁷³

2. Safe Harbor for Forward-Looking Statements

Abusive litigation severely affects the willingness of corporate managers to disclose information to the marketplace by instilling a sense of fear that this information will later trigger the filing of class-action securities claims.⁷⁴ This lack of disclosure takes away some of the most important information that existing and potential shareholders use to evaluate the future outlook of the company.⁷⁵ Recognizing this chilling effect, Congress adopted a safe harbor provision to enhance market efficiency by encouraging companies to disclose forward-looking statements.⁷⁶ Accordingly, the provision grants protection to any forward looking statement that is “accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.”⁷⁷ For statements to lose their protection, the plaintiff must prove that the statement was issued with actual knowledge that it was false or misleading.⁷⁸

3. Mandatory Discovery Stay

Congress also incorporated a mandatory stay of discovery into private securities actions⁷⁹ in order to prevent unnecessary imposition of discovery costs on the defendant.⁸⁰ However, Congress also provided an exception, whereby the mandatory stay will be excused if particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.⁸¹

72. § 78u-4(b)(2).

73. H.R. REP. NO. 104-369, at 41.

74. *Id.* at 42-43.

75. *Id.* at 43.

76. *Id.*

77. 15 U.S.C. § 78u-5(c)(1)(A)(i) (2007).

78. § 78u-5(c)(1)(B)(i). “[I]f made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or (ii) if made by a business entity; was— (I) made by or with the approval of an executive officer of that entity; and (II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.” *Id.*

79. § 78u-4(b)(3)(B).

80. H.R. REP. NO. 104-369, at 32.

81. § 78u-4(b)(3)(B).

4. Other Important Provisions

The new rules also give another incentive to parties facing frivolous law suits. The legislation contains a provision requiring the court to include in the record specific findings of whether or not all parties and all attorneys have complied with Rule 11(b)⁸² of the Federal Rules of Civil Procedure.⁸³ Further, if any party fails to satisfy the requirements of Rule 11(b), there is a presumption that the prevailing party will be awarded its attorneys fees and costs for the entire action.⁸⁴ Because the courts had previously failed to impose the Rule 11 sanctions against parties bringing frivolous claims, this new procedure has the effect of “giving teeth” to the rule.⁸⁵

F. *Securities Litigation Uniform Standards Act*

Prior to the passage of the PSLRA, there were essentially no significant securities class action suits brought in state court.⁸⁶ However, because the PSLRA made it more difficult for plaintiffs’ attorneys to bring a securities fraud claim in federal court, the PSLRA naturally forced attorneys to file their claims in state court.⁸⁷ Relying heavily on a study published by Stanford law professor Michael Perino,⁸⁸ Congress took notice of the shift of plaintiffs beginning to file their securities suits in state court as opposed to federal court. To remedy this unwanted consequence, Congress enacted the Securities Litigation Uniform Standards Act three years later which provides that:

- (A) No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging – (1) An untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) That the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.
- (B) Any covered class action brought in any state court involving a covered security, as set forth in [subsection (A)], shall be removable

82. FED. R. CIV. P. 11(b).

83. 15 U.S.C. § 78u-4(c)(1) (2007).

84. 15 U.S.C. § 78u-4(c)(3)(A) (2007).

85. H.R. REP. NO. 104-369, at 39 (1995).

86. See Michael Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 307-08 (1998).

87. See *id.* In general, Perino discusses the empirical study he co-authored with Joseph Grundfest, demonstrating significant support for the inference that attorneys began to file their claims in state court in response to the Private Securities Litigation Reform Act of 1995. In particular, Perino reasons that attorneys are filing apparently weaker claims in state court to avoid the Reform Act’s heightened pleading standards, which in turn has the effect of undermining the policy initiatives of the Reform Act. *Id.* at 337.

88. See *id.*

to the Federal district court for the district in which the action is pending, and shall be subject to [subsection (A)].⁸⁹

Consequently, class action securities fraud claims that arise in connection with the purchase or sale of securities predicated upon state law can no longer be advanced in state court, and more importantly, claims arising out of federal law must be advanced in the federal court system.⁹⁰ This legislation therefore aimed to further the goals of the PSLRA in protecting the interests of shareholders and employees of public companies that are the target of meritless strike suits.⁹¹ Thus, SLUSA has the intended consequence of closing the PSLRA loophole, and accordingly, prevents plaintiffs from seeking to evade the protections that federal law provides against abusive litigation by filing suit in state, rather than federal, court.⁹² It is readily apparent why it is so important for defendants to be able to defend the litigation in federal court and, in turn, why the application of SLUSA's preemption provision is so important.

However, Congress did exempt certain state actions alleging fraud from the application of SLUSA. Specifically, SLUSA does not apply to actions maintained in state or federal court by a private party under the law of the state in which the issuer is incorporated or organized,⁹³ actions brought under the "Delaware carve-out,"⁹⁴ derivative actions,⁹⁵ actions brought by states and political subdivisions,⁹⁶ and finally, actions under contractual agreements between issuers and indenture trustees seeking to enforce provisions of the indenture.⁹⁷

III. THE PREEMPTION OF STATE-LAW CLASS ACTION HOLDING CLAIMS

A. Introduction

Congress' enactment of the PSLRA and SLUSA in the mid to late 1990s combined to target the perceived abuses of class action securities lawsuits, specifically those being brought in state court.⁹⁸ More specifically, in enacting SLUSA, Congress intended to make the fed-

89. 15 U.S.C. § 77p (2007).

90. *Id.*

91. H.R. REP. NO. 105-803, at 13 (1998) (Conf. Rep.).

92. *Id.*

93. See 15 U.S.C. §§ 77p(d)(1)(A), 78bb(f)(3)(A)(i) (2007).

94. See §§ 77p(d)(1)(B), 78bb(f)(3)(A)(ii).

95. See §§ 77p(f)(2)(B), 78bb(f)(5)(C).

96. See §§ 77p(d)(2), 78bb(f)(3)(B) (requiring that the plaintiffs be named and have authorization to participate in the action).

97. See §§ 77p(d)(3), 78bb(f)(3)(C).

98. See *infra*, Parts IID-E.

eral court the exclusive venue for class action securities suits “by mandating that such class actions be governed exclusively by federal law.”⁹⁹

Subsequently, plaintiffs became more creative: they attempted to circumvent SLUSA’s preemption provision by tailoring the plaintiff class to “holders,” rather than purchasers or sellers, of the securities. Here, the idea was that because a class of “holders” neither purchased nor sold the security, the “in connection with the purchase or sale” language could not be met, thus SLUSA would not apply. And accordingly, they could pursue their securities claims in state court and under state law. The following cases illustrate how the Second and Seventh Circuits approached the issue and how the Supreme Court subsequently decided that “holder” claims were preempted by SLUSA.

B. *The Second Circuit’s Decision: Dabit v. Merrill Lynch*

In January 2005, the Second Circuit issued a controversial decision in *Dabit v. Merrill Lynch*,¹⁰⁰ allowing class action suits to proceed under state law if the plaintiff class was narrowly tailored to include only those persons that held, but did not buy or sell, the securities in response to a false or misleading statement.¹⁰¹ In *Dabit*, plaintiff Shadi Dabit brought a putative class action against Merrill Lynch in Oklahoma District Court alleging that Merrill Lynch had issued biased research and investment recommendations designed to garner investment banking business.¹⁰² More importantly, Dabit sought relief under Oklahoma’s state securities laws.¹⁰³ The case was subsequently removed to the Southern District of New York, at which point the case was dismissed pursuant to Federal Rule of Civil Procedure 12(b)(6)¹⁰⁴ as preempted by SLUSA.¹⁰⁵ The case was then appealed to the Second Circuit.

Previously, in 2002, the New York Attorney General instituted a formal investigation into Merrill Lynch’s investment practices, suspecting that the firm’s loyalty to its investment banking clients re-

99. H.R. REP. NO. 105-803.

100. *Dabit v. Merrill Lynch*, 395 F.3d 25 (2d Cir. 2005). The opinion actually centers on two separate appeals which were consolidated to present a single issue of first impression before the court. The second appeal, involving IIG Investments, is beyond the scope of this Comment.

101. *Id.* at 44.

102. *Id.* at 28.

103. *Id.*

104. FED. R. CIV. P. 12(b)(6).

105. *Dabit*, 395 F.3d at 28.

sulted in the firm issuing biased research and investment advice.¹⁰⁶ This suit, among other private securities fraud actions, soon followed.¹⁰⁷ Dabit, a former Merrill Lynch broker himself, claimed that Merrill Lynch had overrated certain stocks in the process, resulting in artificially inflated trading prices.¹⁰⁸ In turn, Dabit claimed that he and other former Merrill Lynch brokers, who owned the affected stocks, refrained from selling the recommended securities due to the misleading research and advice.¹⁰⁹

Having heard Dabit's claim, the court was faced with deciding whether the plaintiff's state law based holding claims were preempted by SLUSA.¹¹⁰ Immediately, the court noted that four conditions must be satisfied to trigger SLUSA's removal and preemption provisions: (1) the underlying suit must be a "covered class action;"¹¹¹ (2) the action must be based on state or local law; (3) the action must concern a "covered security;"¹¹² and (4) the defendant must have misrepresented or omitted a material fact or employed a manipulative or deceptive device or contrivance "in connection with the purchase or sale of" that security.¹¹³ It is clear from Dabit's allegations that the stocks

106. *Merrill Lynch v. Dabit*, 126 S. Ct. 1503, 1507 (2006).

107. *Id.*

108. *Dabit*, 395 F.3d at 29. Similar to the initial complaint, the amended complaint also asserts claims of breach of fiduciary duty and breach of covenants of good faith and fair dealing.

109. *Id.* Dabit also claimed that he lost clients as a result of purchasing the recommended stocks on behalf of his clients.

110. *Id.* at 27.

111. SLUSA defines a "covered class action" as:

(i) any single lawsuit in which –

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which –

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

15 U.S.C. § 78bb(f)(5)(B) (2007).

112. SLUSA defines a "covered security" as "a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933, at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred."

15 U.S.C. § 78bb(1)(5)(E) (2007).

113. *Dabit*, 395 F.3d at 33.

in question are “covered securities” and the lawsuit is a “covered class action.”¹¹⁴ Accordingly, the central question on appeal became whether the alleged misrepresentations and omissions were alleged to be “in connection with the purchase or sale” of the covered securities.¹¹⁵

Here, the “in connection with” language parallels what is found in Section 10(b) and Rule 10b-5, which has been extensively analyzed in that context by the Supreme Court. Accordingly, the court noted that this language should have the same established meaning as it does in the context of Section 10(b) and Rule 10b-5.¹¹⁶ Moreover, the “in connection with” language “must be read flexibly, not technically” to effectuate its purpose.¹¹⁷ In setting up the crux of its holding, the court noted that whether an alleged fraud arises “in connection with the purchase or sale” of a security, such that it gives rise to a private right of action for damages, the plaintiff’s claims are initially subject to a very important procedural limitation.¹¹⁸ That is, the rule of standing (also known as the “purchaser-seller rule”) affirmed in *Blue Chip Stamps v. Manor Drug Stores* must be applied.¹¹⁹ Again, the rule developed in *Blue Chip Stamps* operates to limit standing in a private action under Rule 10b-5 to actual purchasers or sellers of the security.¹²⁰

The outcome of Dabit’s claims then turned on the extent to which the purchaser-seller rule limits the preemptive reach of SLUSA. Merrill Lynch argued that the purchaser-seller rule is inapplicable to the question of SLUSA’s preemption power;¹²¹ Dabit argued that the rule applies to limit the “in connection with” language of SLUSA, therefore rendering preemption inappropriate since the plaintiff class neither purchased nor sold the securities in question, but only held them.¹²² In the end, the court found Dabit’s argument more persuasive than Merrill Lynch’s policy-based argument.¹²³ The court reasoned that “[b]ecause *only* purchasers and sellers have a federal private damages remedy, it is far more natural to suppose that Con-

114. *Id.* at 34.

115. *Id.*

116. *Id.*

117. *Id.* at 37. Accordingly, the cases generally give the “in connection with” language an expansive construction. *Id.*

118. *Dabit*, 395 F.3d at 37.

119. *Id.*; see also *Blue Chip Stamps v. Manor Food Stores*, 421 U.S. 723, 754-55 (1975).

120. *Blue Chip Stamps*, 421 U.S. at 754-55.

121. The Securities and Exchange Commission also supported this position in the *amicus curiae* brief.

122. *Dabit*, 395 F.3d at 39.

123. *Id.*

gress meant to import the settled standing rule along with the 'in connection with' phrase as a substantive standard."¹²⁴

The court also felt that if they were to preempt these non-purchaser/non-seller claims, they would be holding that the federal statute was completely preemptive of all state securities laws.¹²⁵ Thus, while "the legislative history includes some language that generally indicates a broad preemptive intent," the statute did not specifically preempt these claims.¹²⁶ In sum, the court held that SLUSA operated only to ensure that private class actions brought by plaintiffs who satisfy the purchaser-seller rule are subject to federal preemption.¹²⁷ Accordingly, in the Second Circuit, plaintiffs bringing a class action securities lawsuit could escape federal preemption by tailoring their class to include only plaintiffs that held the securities in question, without having actually purchased or sold the securities "in connection with" the defendant's alleged omission or misrepresentation.¹²⁸

C. *The Seventh Circuit Decision: Kircher v. Putnam Funds Trust*

The Seventh Circuit, led by Judge Easterbrook in a decision prior to *Dabit*, took the opposite stance on this preemption issue in *Kircher v. Putnam Funds Trust*.¹²⁹ In *Kircher*, plaintiff investors brought a class action suit in Illinois state court, charging the mutual funds with setting prices in a way that left the funds open to exploitation by arbitrageurs.¹³⁰ The funds then removed the suit to federal court and sought dismissal under SLUSA; instead, the federal judges remanded the suit.¹³¹ The decision was subsequently appealed.

The Seventh Circuit then had the task of deciding the same issue that was presented to the Second Circuit in *Dabit*: whether a plaintiff class composed of entirely non-purchasers and non-sellers could bring a class action securities suit in state court under state law.¹³² Plaintiffs were all investors in mutual funds that were operated by defendant, Putnam Funds Trust. The plaintiffs accused the defendant mutual funds of acting recklessly in failing to prevent arbitrageurs from taking

124. *Id.* at 40.

125. *Id.* at 41.

126. *Id.*

127. *Id.* at 43.

128. It is also worth noting that *Dabit* failed to properly tailor his holding class strictly to non-purchasers and non-sellers. Rather, his class contained plaintiffs that had purchased securities. While his class failed to survive preemption, and was subsequently dismissed, it was done without prejudice so that he could plead a claim sounding only in state law. *Id.* at 47.

129. 403 F.3d 478 (7th Cir. 2005).

130. *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 480 (2005).

131. *Id.*

132. *Id.*

advantage of inter-market discrepancies in the price of stocks in their funds.¹³³

The court, much like the Second Circuit, began by analyzing the four conditions that must be satisfied to trigger SLUSA's preemption provision: (1) the underlying suit must be a "covered class action"¹³⁴; (2) the action must be based on state or local law; (3) the action must concern a "covered security"¹³⁵; and (4) the defendant must have misrepresented or omitted a material fact or employed a manipulative or deceptive device or contrivance "in connection with the purchase or sale of" that security.¹³⁶ Here, again, only the last prong – the "in connection with" requirement – was contested by the parties.¹³⁷ Accordingly, as in *Dabit*, the outcome turned on whether or not the holding claims alleged an untrue statement or omission of a material fact "in connection with" the purchase or sale of the security.

Where the analysis of the Second and Seventh circuits deviated was how the purchaser-seller rule of *Blue Chip Stamps* applies to SLUSA. In explaining the purpose of the purchaser-seller rule, the Seventh Circuit first noted that the rule was developed

not because §10(b) and Rule 10b-5 are limited to situations in which the plaintiff itself traded securities, but because the private right of action to enforce these provisions is a judicial creation and the Court wanted to confine these actions to situations where litigation is apt to do more good than harm.¹³⁸

133. As explained by Judge Easterbrook:

Mutual funds must set prices at which they sell and redeem their own shares once a day . . . [e]ach defendant sets that price at 4 p.m. Eastern time, shortly after the New York Stock Exchange closes. . . . When the funds hold assets that trade in competitive markets, they must value the assets at the market price. . . . For domestic securities, this yields a current price; for securities of foreign issuers, however, it may produce a price that is as much as 15 hours old. . . . If foreign stocks move predominantly up during this interval (or if one foreign security moves substantially higher), the mutual fund as a whole would carry a 4 p.m. price below what would be justified by the latest available information, and an arbitrageur could purchase shares before 4 p.m. with a plan to sell the next day at a profit. Likewise arbitrageurs could gain if the foreign stock falls after close in its home market, and the arbitrageur knows that the U.S. mutual fund will be overpriced at 4 p.m. relative to the price it is likely to have the next trading day when new information from abroad finally is reflected in the fund's valuation.

Id. at 480-81 (citing Richard L. Levine, Yvonne Cristovici & Richard A. Jacobsen, *Mutual Fund Market Timing*, Federal Lawyer 28 (Jan. 2005)).

134. *See supra* note 111.

135. *See supra* note 112.

136. *Kircher*, 403 F.3d at 482.

137. *Id.* at 481-82.

138. *Id.* at 483. Hence, anyone can say that the failure to trade was a consequence of the defendant's actions, but judges and juries would have an exceedingly tough time knowing whether the plaintiff's claim was in fact honest. *Id.*

More importantly, Judge Easterbrook read the Supreme Court's decision in *Blue Chip Stamps* as evincing a judicial intent to limit private actions to claims borne out of actual trading on misrepresentations (or omissions), while leaving the other securities offenses to public prosecutors – including holding claims such as plaintiff's.¹³⁹ As Judge Easterbrook noted, the decisions that follow *Blue Chip Stamps* affirm the fact that the purchaser-seller rule “deals with private actions alone and does not restrict the coverage of the statute and regulation.”¹⁴⁰

In the end, the Seventh Circuit held that class action holding claims pursued in state court or under state law must be litigated as derivative claims or committed to public prosecutors.¹⁴¹ Additionally, the court stated that the plaintiffs' effort to tailor their class to only those who merely held the stock in response to the defendant's action was a mere pretext towards evading the PSLRA.¹⁴² The sole purpose of this tailoring was to litigate their claim in state court in the hope of receiving an idiosyncratic award - the very situation that SLUSA was enacted to prevent.¹⁴³

D. *The Supreme Court's Ruling: Dabit Revisited*

On September 27, 2005, the Supreme Court granted *certiorari* to review the Second Circuit's decision in *Dabit*. Approximately six months later, on March 21, 2006, the Supreme Court reversed the Second Circuit, siding heavily with the Seventh Circuit's interpretation of SLUSA's reach, as announced in *Kircher*.¹⁴⁴ In doing so, the Supreme Court held that the background, text, and purpose of SLUSA's preemption provision all support the idea that state-law class-action holding claims are in fact preempted by SLUSA.¹⁴⁵

In deciding the proper relationship between the purchaser-seller rule and the “in connection with” requirement as it relates to SLUSA's preemption of these holding claims, the Court looked principally at the policy considerations behind the rule and the statute. First, the Court reiterated that the purchaser-seller rule is a judicially crafted remedy.¹⁴⁶ In *Blue Chip Stamps*, the Court chose to limit the

139. *Id.*

140. *Id.* at 483-84 (citing *United States v. O'Hagan*, 521 U.S. 642 (1997); *Holmes v. SIPC*, 503 U.S. 258 (1992); *United States v. Naftalin*, 441 U.S. 768 (1979)).

141. *Id.* at 484.

142. *Id.*

143. *Id.*

144. *Merrill Lynch v. Dabit*, 126 S. Ct. 1503, 1507 (2006).

145. *Id.* at 1507-14.

146. *Id.* at 1510. See also *Kircher*, 403 F.3d at 483. There the court noted that “*Blue Chip Stamps* came out as it did not because §10(b) and Rule 10b-5 are limited to situations in which

private remedy under the auspices of “policy considerations;” similar policy considerations were also the impetus for the enactment of the PSLRA – abuse of the securities laws.¹⁴⁷ Thus, the purchaser-seller rule was not divined from the text of §10(b) or Rule 10b-5.¹⁴⁸ Rather, the Court in *Blue Chip Stamps* looked to define the *scope* of a private right of action under Rule 10b-5, not to define the language of the Rule.¹⁴⁹

As the purchaser-seller rule itself was a product of policy considerations, its application to SLUSA was a matter of policy consideration as well.¹⁵⁰ Here, the Court noted that policy considerations favor a broad construction of SLUSA, thereby encompassing holding claims such as those brought by *Dabit*.¹⁵¹ More specifically, a narrow reading of the statute would “undercut the effectiveness of the PSLRA and thus run contrary to SLUSA’s stated purpose.”¹⁵² Moreover, past Supreme Court decisions favored a broad interpretation of the statutory language.¹⁵³ Specifically, the Court looked at its own previous interpretations of the statute, which only required that the alleged fraud “coincide” with the securities transaction.¹⁵⁴

Further, contrary to the claims of the Second Circuit,¹⁵⁵ reading the preemptive arm of the statute to include class-action holding claims does not result in the preemption of all state-law class-action claims (i.e., complete preemption).¹⁵⁶ Instead of viewing the statutory language in the context of what claims are in fact preempted,¹⁵⁷ the Su-

the plaintiff itself traded securities, but because a private right of action to enforce these provisions is a *judicial creation* and the Court wanted to confine these actions to situations where litigation is apt to do more good than harm” (emphasis added). *But see Dabit*, 395 F.3d at 40, for a differing view of the importance of the purchaser-seller rule being a judicial creation: “Nor are we moved by the observation that the standing rule is merely a judge-made gloss on the statute and the Rule”

147. *Merrill Lynch*, 126 S. Ct. at 1510 (citing *Blue Chip Stamps*, 421 U.S. at 738).

148. *Merrill Lynch*, 126 S. Ct. at 1512.

149. *Id.*

150. *Id.* at 1514-15.

151. *Id.* at 1513. “The presumption that Congress envisioned a broad construction follows not only from ordinary principles of statutory construction but also from the particular concerns that culminated in SLUSA’s enactment.” *Id.*

152. *Id.*

153. *Id.*

154. (citing *United States v. O’Hagan*, 521 U.S. 642, 651 (1997)).

155. *Dabit v. Merrill Lynch*, 395 F.3d 25, 41 (2d Cir. 2005).

156. *Merrill Lynch*, 126 S. Ct. 1514. “. . . SLUSA does not actually pre-empt and state cause of action. It simply denies plaintiffs the right to use the class action device to vindicate certain claims. The Act does not deny any individual plaintiff, or indeed any group of fewer than 50 plaintiffs, the right to enforce any state-law cause of action that may exist.” *Id.*

157. *See Dabit*, 395 F.3d at 41. The Second Circuit looked more at whether the statute explicitly included the preemption of holding claims, noting that “[t]he legislative history includes

preme Court thought it more significant to analyze what claims the statute excluded from preemption. Here the Court noted that the statute excludes a number of state-based claims, thus demonstrating that Congress was not “acting cavalierly” in preempting an overly-broad range of state-law claims thereby approaching complete preemption.¹⁵⁸ Consequently, the Court stated that “[t]he existence of these carve-outs both evinces congressional sensitivity to state prerogatives in this field and makes it inappropriate for courts to create additional, implied exceptions.”¹⁵⁹ Accordingly, the Court held that class-action holding claims based upon state law fall within the ambit of SLUSA’s preemption provision.

IV. STRENGTHENING THE LEGAL ARGUMENT IN FAVOR OF THE SUPREME COURT’S DECISION

A. Introduction

In *Dabit*, the Supreme Court provided a detailed, comprehensive analysis of why state-law class action holding claims are preempted by SLUSA, and in turn, the policy concerns that support its decision. Accordingly, this section will not seek to revisit and further develop each legal justification that the Court has already made. However, apart from the beneficial impact the decision has on the financial community, which will be addressed in the next section, it is worth outlining further justifications as to why the Supreme Court made the correct decision, while highlighting in greater specificity one of the principal factors in the Court’s holding. The three arguments outlined here that reinforce the Court’s holding are (1) The “in connection” with language of Section 10(b) should be interpreted broadly to support the policy behind the statute; (2) The supposed financial damage arising out of a plaintiff’s holding claim is an economic fallacy; and (3) Holding claims represent the most dangerous of securities claims.

some language that generally indicates a broad preemptive intent, but contains no specific mention of holding claims or other non-purchaser/non-seller claims.” *Id.*

158. *Merrill Lynch*, 126 S. Ct. at 1514. “. . . the tailored exceptions to SLUSA’s preemptive command demonstrate that Congress did not by any means act ‘cavalierly’ here. The statute carefully exempts from its operation certain class actions based on the law of the State in which the issuer of the covered security is incorporation, actions brought by a state agency or state pension plan, actions under contracts between issuers and indenture trustees, and derivative actions brought by shareholders on behalf of a corporation.” *Id.*

159. *Id.*

B. *The “In Connection With” Language Should Be Interpreted Broadly*

The “in connection with” language of SLUSA must be interpreted broadly to give effect to the intentions expressed by Congress. More important than policy justifications alone is the principle of *stare decisis*: the Supreme Court has consistently held that the “in connection with” language is to be interpreted broadly.¹⁶⁰ Accordingly, based on the Supreme Court’s prior statutory construction, the Court was again correct in deciding that plaintiffs’ holding claims arose “in connection with” Merrill Lynch’s alleged misrepresentations.

Moreover, all of the circuit courts that have analyzed the statutory language have similarly concluded that the meaning of “in connection with” under SLUSA is coterminous with the meaning of the nearly identical language in Section 10(b) and Rule 10b-5.¹⁶¹ It then follows that the “in connection with” language should be analyzed with respect to Section 10(b) and Rule 10b-5. However, it is this analysis that became the “sticking point” since not all circuits agreed as to what Rule 10b-5 itself means.¹⁶² Here, however, even the Second Circuit, where Dabit’s claim originated, had recognized that the language of Section 10(b) and Rule 10b-5 “must be read flexibly, not technically and restrictively” so that “novel” and “atypical” as well as “garden type variety” frauds do not escape its prohibitive scope.¹⁶³ Moreover, Section 10(b) should be “construed not technically and restrictively, but flexibly to effectuate its remedial purposes.”¹⁶⁴

The Supreme Court has previously held that when the misrepresentation “coincide[s]”¹⁶⁵ with or is “touching”¹⁶⁶ the sale of securities, the “in connection with” language of Rule 10b-5 is satisfied. Accordingly, the misrepresentation and the sale of securities “coincide” when they are “not independent events.”¹⁶⁷ Thus, Rule 10b-5 is violated “whenever [false] assertions are made in a manner reasonably calculated to influence the investing public” in their decisions regarding the

160. See generally *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975); *United States v. O’Hagan*, 521 U.S. 642 (1997); *SEC v. Zanford*, 535 U.S. 813 (2002).

161. *Kircher*, 403 F.3d at 482; *Dabit*, 395 F.3d at 28. See also *Rowinski v. Salomon Smith Barney, Inc.*, 398 F.3d 294, 299 (3d Cir. 2005); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 506-97 (8th Cir. 2002); *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1131 (9th Cir. 2002); *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342-43 (11th Cir. 2002).

162. *Kircher*, 403 F.3d at 482.

163. *Dabit*, 395 F.3d at 37 (quoting *Superintendent of Ins. v. Bankers Life and Casualty Co.*, 404 U.S. 6, 11 (1971)).

164. *Zanford*, 535 U.S. at 819.

165. *Id.* at 825.

166. *Superintendent of Ins.*, 404 U.S. at 12-13.

167. *Zandford*, 535 U.S. at 820.

purchase or sale of securities.¹⁶⁸ These axioms do not just stand alone in the dicta of the Court opinions. Rather, they are the rules the Court has developed in analyzing the allegedly fraudulent transactions. As these cases point out, the application of these rules is consistent with a broad interpretation of the “in connection with” language of §10(b).

The Supreme Court’s decision in *United States v. O’Hagan*¹⁶⁹ lends further support to the position that the “in connection with” language of SLUSA should be interpreted broadly. O’Hagan was a partner at a major law firm which was representing a party considering a possible tender offer for the Pillsbury Company’s common stock.¹⁷⁰ Although O’Hagan did no specific work on the representation, he began purchasing stock in Pillsbury.¹⁷¹ When the tender offer was announced, O’Hagan had made a profit of roughly \$4.3 million through his illegal investment.¹⁷² O’Hagan was then charged and convicted with defrauding his law firm and its client by misappropriating for his own trading purposes, material nonpublic information regarding the tender offer.¹⁷³ The Supreme Court granted certiorari after the Eighth Circuit reversed all of O’Hagan’s convictions.¹⁷⁴

In reversing the convictions and rejecting the misappropriation theory in the context of Rule 10b-5, the Eighth Circuit held that “only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability.”¹⁷⁵ By analogy, one can see that this is the same argument that the Second Circuit found compelling in *Dabit*. However, the Supreme Court in *O’Hagan* disagreed with the Eighth Circuit, ruling that “§10(b) refers to ‘the purchase of sale of *any* security,’ *not to identifiable purchasers or sellers of securities*” (emphasis added).¹⁷⁶ The language of the Supreme Court’s decision in *O’Hagan* laid the groundwork for the Court’s later decision in *Dabit*.¹⁷⁷

The Court further solidified its ruling in *O’Hagan* six year later in *SEC v. Zanford*.¹⁷⁸ In *Zanford*, respondent was a broker who was

168. Brief of Amici Curiae United States, *Merrill Lynch v. Dabit*, 2005 WL 3048028, at *11 (quoting *SEC v. Tex. Gulf Sulfur Co.*, 401 F.2d 833, 862 (2nd Cir. 1968)).

169. 521 U.S. 642 (1997).

170. *Id.* at 647.

171. *Id.*

172. *Id.* at 648.

173. *Id.* at 649.

174. *See* *United States v. O’Hagan*, 92 F.3d 612 (8th Cir. 1996).

175. *Id.* at 644.

176. *O’Hagan*, 512 U.S. at 660.

177. *Merrill Lynch*, 126 S. Ct. at 1513.

178. 535 U.S. 813 (2002).

selling his customer's securities and using the proceeds for his own benefit without the customer's knowledge or consent.¹⁷⁹ The Supreme Court was again forced to decide whether the fraudulent conduct was "in connection with the purchase or sale of any security."¹⁸⁰ Yet again, the Supreme Court, while implementing a broad interpretation of the Section 10(b) language, held that the alleged conduct was within the meaning of the rule.¹⁸¹ In its ruling, the Court placed emphasis on the fact that "the securities sales and respondent's fraudulent practices were *not independent events*" (emphasis added).¹⁸² It was not the case where the fraudulent act occurred after the actual securities transactions.¹⁸³ Rather, the Court noted, "respondent's fraud *coincided* with the sales themselves" (emphasis added).¹⁸⁴

Thus, the Supreme Court has long recognized that a Section 10(b) violation is not predicated upon the fraud or deception of an identifiable purchaser or seller.¹⁸⁵ Rather, the misleading statement or omission must be "in connection with" the purchase or sale of *any* security.¹⁸⁶ Further, it is important to look to the temporal aspect of the alleged fraud – whether the fraud "coincides" with the purchase or sale of any security.¹⁸⁷ Applying these rules to the case at hand, it is readily apparent that the Supreme Court correctly followed its own precedent in holding that class action holding claims fall within the ambit of SLUSA's preemption provision since the Court's prior construction of the "in connection with" language certainly encompasses Dabit's claim.

C. *The "Damage" Arising out of a Holding Claim is an Economic Fallacy*

In the absence of injury in-fact, a court should not grant a plaintiff standing to pursue his claim, especially when that claim carries with it such disproportionate discovery costs, thereby increasing the chances of a meritless settlement. Plaintiff-investors that base their claims on the premise that they suffered damages by holding their stock in reliance upon a misrepresentation are incapable of proving real economic

179. SEC v. Zanford, 535 U.S. 813, 815 (2002).

180. *Id.*

181. *Id.* at 819.

182. *Id.* at 820.

183. *Id.*

184. *Id.*

185. *Merrill Lynch*, 126 S. Ct. at 1513.

186. *Id.*

187. *Id.*

injury.¹⁸⁸ Rather than cause the loss, the “misrepresentation merely postpones the timing of the preexisting holders’ recognition of a loss from a business setback.”¹⁸⁹ It is the earlier business setback that is the actual cause of the loss.¹⁹⁰

A thorough explanation of why class action holding claims have no legitimate economic damages can be found in the Fifth Circuit case of *Crocker v. Federal Deposit Insurance Corp.*:¹⁹¹

The flaw in the [holders’] argument is that it assumes a market for the stock existed at an artificially high price. This inflated price, and hence the particular market for the stock, was maintained only because of the wrongdoing of the [defendants], who concealed material financial information from the shareholders and the public that would have demonstrated the failing condition of the [company]. It follows that, had this information been released, the stock price would have immediately and precipitously fallen especially if, as is implicit in the [holders’] theory, an entire class of shareholders had simultaneously dumped their stock on the market. Thus, there would have been no market for the stock at the artificially high price. Without such a market, the [holders’] envisioned “profit opportunity” evaporates into hardly more than an illusion.¹⁹²

A holding class does not claim that they desired to sell their shares at a particular point, but rather, they were deterred from selling at all because of the misrepresentation.¹⁹³ The class then argues that had they known of the misrepresentation, they would have sold their shares at the artificially inflated price.¹⁹⁴ Consequently, the Fifth Circuit found that such a claim was too speculative to state an injury and accordingly, “the alleged ‘lost profit opportunity’ was, in reality, no profit opportunity at all.”¹⁹⁵ This type of claim is far different from the case of a purchaser or seller who actually decides to buy or sell shares in reliance on information later shown to be false since the price at which they decided to purchase or sell the securities was still affected by the misrepresented information. Conversely, shares that were merely held over the same period cannot produce a claim of economic injury since the false information no longer affects the stock

188. Brief Amici Curiae of the Securities Industry Association and the Bond Market Association in Support of Petitioner, *Merrill Lynch v. Dabit*, 2005 WL 3076091, at *17. “. . . prior to SLUSA, every federal court to examine a holder class claim had concluded that, as a class, holders cannot be injured by a misrepresentation or omission.” *Id.*

189. *Id.* at *18.

190. *Id.*

191. 826 F.2d 347, 351-52 (1987).

192. *Supra* note 188, at *17.

193. *Crocker v. Fed. Deposit Ins. Corp.*, 826 F.2d 347, 351 (1987).

194. *Id.*

195. *Id.*

price.¹⁹⁶ Accordingly, holding claims are not a plausible cause of action since there is no actual injury to the plaintiff.

D. *Holding Claims Represent the Most Dangerous of Securities Claims*

Holding claims are the type of vexatious securities claims that Congress tried to subvert when it enacted SLUSA. Ironically, the policy considerations that led the Court to create the purchaser-seller rule of standing in *Blue Chip Stamps* also serve as the basis for preempting state-law class action holding claims: a plaintiff who sues for damages, yet having neither purchased nor sold securities, is basing the claims upon a “largely conjectural and speculative recovery in which the number of shares [and price] involved will depend on the plaintiff’s subjective hypothesis.”¹⁹⁷

Speaking on the claims litigated in *Blue Chip Stamps*, Judge Easterbrook noted, “anyone can say that a failure to trade bore some relation to what the issuer did (or didn’t) disclose, but [] judges and juries would have an exceedingly hard time knowing whether a given counterfactual claim (“I would have traded, if only”) was honest.”¹⁹⁸ The same problem is presented within the issue of holding claims: the outcome is largely determined on which oral version of a series of occurrences the jury decides to credit.¹⁹⁹ The problem is further amplified because proof depends almost entirely on oral testimony, with the elements to which the plaintiff will testify being completely unknowable to the defendants.²⁰⁰ In sum, the dangers that arise out of a plaintiff’s holding claims are vexatious in nature and are the type of claims that SLUSA intended to stop.

V. STABILIZING AMERICA’S CAPITAL MARKETS BY PREEMPTING HOLDING CLAIMS

A. *Introduction*

In the most general sense, the Supreme Court’s decision in *Dabit* serves to further the directives set forth by Congress in its enactment of the PSLRA and SLUSA. More specifically, the Court’s decision helps bolster the objectives expressed in the securities acts by helping

196. *Id.*

197. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734-35 (1975).

198. *Kircher*, 403 F.3d at 483 (summarizing part of the Court’s opinion in *Blue Chip Stamps*).

199. Brief of the Chamber of Commerce of the United States of America as Amicus Curiae in Support of Petitioner, *Merrill Lynch v. Dabit*, 2005 WL 3067181, at *23 (citing *Blue Chip Stamps*, 421 U.S. at 742).

200. *Id.*

the courts maintain a uniform standard for class action securities suits while eliminating meritless securities claims. A uniform standard that deters frivolous securities suits is essential in creating a more equitable and predictable legal environment for corporations listed on America's stock exchanges.

The Court's decision should also have a demonstrable impact on a serious problem that is in the beginning stages of being addressed by members of Congress: New York City's fading dominance as the financial capital of the world.²⁰¹

B. *New York City's Waning Financial Dominance*

London's mayor, David Brewer, recently opined to a gathering of the world's most powerful bankers and business executives this past summer that "[London is] the international finance and business capital of the world, the world's greatest global finance center, without question."²⁰² Whether or not this statement by London's mayor should be written off as stylish pandering to London's financial elite, a growing number of politicians and financial commentators are raising concerns about the possibility that New York is relinquishing its century-long stronghold as the world's financial capital.²⁰³ Although the issue did not become a serious point of discussion until this past summer, evidence of New York's waning dominance surfaced when it was announced that 24 of the top 25 initial public offerings (IPO's) in 2005 were issued on exchanges outside of the United States.²⁰⁴

1. The Global Finance Trend

The importance of this recent relocation trend of the world's financial capital became readily apparent with the release of a study done by McKinsey & Company, which was commissioned by New York City Mayor Michael Bloomberg and New York Senator Charles Schumer ("the McKinsey Study").²⁰⁵ The McKinsey Study notes that, as of

201. See Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn From London*, WALL ST. J., Nov. 1, 2006, at A18.

202. Heather Timmons, *New York Isn't the World's Undisputed Financial Capital*, N.Y. TIMES, Oct. 27, 2006.

203. *Id.*

204. Alan Murray, *BUSINESS: Fees May Be Costing Wall Street Its Edge in Global IPO Market*, WALL ST. J., Aug. 2, 2006, at A2.

205. McKinsey Study, *Sustaining New York's and the US' Global Financial Services Leadership*, Commissioned by New York City Mayor Michael R. Bloomberg and New York Senator Charles E. Schumer (Jan. 22, 2007), available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf [hereinafter McKinsey Study].

today, the United States financial markets, with New York as its center, are still the world's largest and undoubtedly one of the most important.²⁰⁶ And in terms of global financial stock,²⁰⁷ the United States remains the largest market.²⁰⁸ However, what is disconcerting is the rate at which financial stock is growing in various markets around the globe relative to that of the United States. While the financial stock market in the United States is approximately 25% larger than that of Europe, approximately 61% higher than that of Japan, and approximately 75% larger than non-Japan Asia-Pacific, the growth rate shows a rapidly shrinking gap.²⁰⁹ The United States is last in growth during the period of 2001 to 2005: Non-Japan Asia-Pacific experienced growth of 15.5%, Japan at 7.5%, Europe at 6.8% (including the UK at 8.4%), and the United States with 6.5% growth.²¹⁰

Small-cap companies are adding to this trend as well, with London's Alternative Investment Market (AIM) becoming the dominant listing venue.²¹¹ Since the beginning of 2001, AIM has listed more than twice as many companies (484) as the NASDAQ (224).²¹² This marks a significant shift in NASDAQ's historical dominance of listings as well as volume.²¹³

Moreover, the trend is not just limited to the stock markets alone. The investment banking, sales, and trading revenues in Europe now almost match that of the United States as well, with totals reaching \$109 Billion in the United States, \$98 Billion in Europe, and \$37 Billion in Asia.²¹⁴ However, broken down even further, the sales and trading revenues in Europe in 2005 have now eclipsed those of the United States.²¹⁵ A more pronounced trend is now occurring in the international IPO market as well. Through the first ten months of 2006, the United States exchanges attracted barely one-third of the share of IPO's measured by market value that they captured back in

206. *Id.* at 9.

207. *Id.* at n. 5 (defining "financial stock" as equities, private debt, government debt, and bank deposits).

208. *Id.* at 9.

209. *Id.* at 9, Exhibit 1. As of 2005 the United States' financial stock is roughly \$51 Billion, Europe at \$38 Billion, Japan at \$20 Billion, and Non-Japan Asia-Pacific at \$13 Billion. *Id.*

210. *Id.*

211. McKinsey Study, *supra* note 205, at 50.

212. *Id.*

213. In 2004, NASDAQ had raised more than four times the capital of which was raised on London's AIM. However, during the first 10 months of 2006, the volume of new issuances of the two exchanges was practically even: \$11.9 Billion on the NASDAQ and \$10.4 Billion on the AIM. *Id.*

214. *Id.* at 11, Exhibit 2.

215. *Id.* Revenues from sales and trading have not reached \$74 Billion in Europe, \$69 Billion in the United States, and \$30 Billion in Asia. *Id.*, Exhibit 2.

2001.²¹⁶ Over the same period, Europe saw its market share of IPO's increase by 30% and Asian markets by 50%.²¹⁷

The trend has also surfaced in the derivatives market. In a market that is likely still in its infancy, Europe has cornered a 56% share of the \$52 Billion revenue pool from derivatives and a 60% share in the market for interest rate, foreign exchange, equity, and fund-linked derivatives.²¹⁸ Conversely, the United States leads only in the commodity derivatives market.²¹⁹ Further, as European lenders begin to embrace US-style credit terms, the United States' dominance in the leveraged lending market is likely to see intense competition in the near future as well.²²⁰

2. The Impetus for the Drift Away from New York

There is an extensive list of factors believed to be driving the recent geographical shift of financial dominance away from the United States; yet no single factor is entirely responsible for the effect. Fortunately, two lengthy studies released in the last year provide great insight into this occurrence: the June 2006 study by Oxera Consulting Ltd., commissioned by the City of London and the London Stock Exchange ("the Oxera Study")²²¹ and the January 2007 McKinsey Study²²² previously mentioned.

The Oxera Study gives one explanation why the recent trend in IPO's favors Europe: the underwriting fees charged by investment banks in the United States are roughly twice as high as those charged in Europe.²²³ Underwriting fees in the United States market typically range from 6.5 to 7.0%, while fees in Europe are usually in the range of 3 to 4%.²²⁴ One reason for the higher fees may be the difference in underwriting techniques used. In the United States, a technique called bookbuilding tends to be used for almost all IPO's, and fees for

216. *Id.* at 12.

217. McKinsey Study, *supra* note 205, at 12.

218. *Id.* at 13.

219. *Id.* at 12.

220. *Id.* at 13.

221. Oxera Consulting Ltd., *The Cost of Capital: An International Comparison* (June 2006), available at http://www.londonstockexchange.com/NR/rdonlyres/B032122B-B1DA-4E4A-B1C8-42D2FAE8EB01/0/Costofcapital_full.pdf. The study was commissioned to independently analyze the attractiveness of the London capital markets compared with other financial centers. "The aim of the study is to assess the extent to which London provides an attractive venue for raising capital via public equity and listed debt relative to other markets, and to evaluate the implications for the cost to companies of raising capital in different markets." *Id.* at 7.

222. McKinsey Study, *supra* note 205, at 7.

223. *Id.* at 4.

224. *Id.*

bookbuilding are typically higher than those for other techniques.²²⁵ In the European underwriting market, a variety of cheaper techniques are used, including fixed-price public offers, placings, and auctions.²²⁶ And since underwriting fees constitute the single largest element of an IPO, the underwriting price distortion among international competitors fuels the financial capital relocation trend.²²⁷

The Oxera Study, however, focused primarily on the internal cost structure of IPO's in relation to exchange listings across the globe. Accordingly, the report was not meant to provide a quantitative comparison of the legal framework that governs each country's exchanges.²²⁸ While the Oxera Study's points certainly need be raised here, the study did not delve into the most important problem as it relates to this Article – the disparity in costs arising out of meritless securities suits that too often accompany a listing on America's stock exchanges – an area that the lengthier McKinsey study addresses.

A centerpiece of the McKinsey Study was its investigation into the attitudes of financial services leaders in the United States and overseas.²²⁹ The investigation identified three factors that clearly dominate financial services leaders' views of New York as a place to do business: skilled workers,²³⁰ the legal environment, and regulatory balance.²³¹ More specifically, the study noted that a fair and predictable legal environment was the most important criterion in determining a financial center's competitiveness that can be affected by policymakers.²³² This criterion certainly favored doing business outside of the United States, with financial leaders opining that the

225. *Id.* at 19.

226. *Id.*

227. *Id.* at 25.

228. McKinsey Study, *supra* note 205, at 30. As the reports acknowledges:

There are important differences in the regulatory frameworks of the countries that affect both the primary and secondary equity markets. An in-depth discussion would require considerable legal analysis and constitute a research study in itself [Thus, the study] presents only a summary of those aspects that were raised most frequently in interviews with companies as being relevant in the decision of where to float and raise capital.

Id.

229. McKinsey Study, *supra* note 205, at 14.

230. This criterion weighed in favor of New York as a place to do business with the people surveyed perceiving the talent pool in New York to be superior to that of London. *Id.* at 66.

231. The business leaders that were polled perceived the United Kingdom's "single, principles-based financial sector regulator – the Financial Services Authority (FSA) – as superior to a less responsive, complex US system of multiple holding company and industry segment regulators at the federal and state levels." *Id.* at 17.

232. *Id.* at 16. The talent of skilled workers was the top factor in determining a financial center's competitiveness, however, this is not a factor that can be changed by the courts and the legislature.

United States market was at a disadvantage due to America's propensity toward litigation and concerns that America's legal environment is less fair and less predictable than London's legal environment.²³³

The McKinsey Study further noted that settlements in securities cases reached a record \$3.5 billion in 2005, up more than 15% from 2004 and nearly 70% from 2003.²³⁴ Such figures seem to perpetuate the popular belief that America has a much higher propensity towards litigation: 85% of CEO's surveyed by McKinsey felt that the legal cost of doing business in London was lower, while not a single CEO held the equivalent belief about New York.²³⁵ This perception is further reinforced by the number of American companies forced into bankruptcy in recent years.²³⁶ It is thus clear that despite Congress' enactment of the PSLRA and SLUSA, securities litigation reform is still a pressing issue.

C. *The Beneficial Consequences of the Supreme Court and Dabit*

The aim of the McKinsey Study, apart from analyzing the problems facing America in its quest to continue its financial dominance, was to provide policymakers with recommendations to make the United States financial markets more competitive.²³⁷ The research primarily relied upon in the study strongly indicated that unless significant changes are made to America's litigation system, financial services businesses will likely favor less litigious jurisdictions abroad over the benefits of cheaper capital in America.²³⁸ Among what the report termed the "critically important priorities"²³⁹ is the need to implement securities litigation reform, which is the central reform discussed in this article.²⁴⁰

According to the study, the foundation of any reform should be to "eliminate those suits filed to pressure companies into settlement

233. *Id.*

234. *Id.* at 74. The 2005 figure excludes WorldCom related settlements of approximately \$6.2 Billion.

235. McKinsey Study, *supra* note 205, at 75. The remaining 20% did not choose a side. Adding to this perception may be the fact that Section 302 of the Sarbanes-Oxley Act imposes personal liability on corporate executives for failing to comply with the Act.

236. *Id.* at 76.

237. *Id.* at i.

238. *Id.* at 101.

239. The three critically important near-term priorities were (1) Provide clearer guidance for implementing the Sarbanes-Oxley Act; (2) Implement securities litigation reform; and (3) Develop a shared vision for financial services and a set of supporting regulatory principles. *Id.* at 18.

240. *Id.*

rather than to redress legitimate wrongs.”²⁴¹ The Supreme Court’s decision in *Dabit* has this exact effect. As discussed previously in Section IV B and C, the holder claims brought in *Dabit* are some of the most dangerous securities claims. Moreover, holding claims are not a valid economic claim and are thus not deserving of a settlement from a corporation. Accordingly, the *Dabit* decision has the effect of strengthening the integrity and efficiency of the market.²⁴²

Even weak securities cases, with little merit such as *Dabit*’s, may have substantial settlement value since “[t]he very pendency of the lawsuit may frustrate or delay normal business activity.”²⁴³ Naturally, as meritless cases such as *Dabit*’s are allowed to survive to the settlement phase, settlement values increase, thus compounding the already present problem of record securities settlements in domestic courts.²⁴⁴ Consequently, the availability of such claims fuel the perception held by CEO’s that foreign exchanges have a lower legal cost of doing business.

In ruling that holding claims are preempted by federal law, the Court’s holding helps quell the worries of business executives. As reported by the McKinsey Study:

Relative to most other countries, the US legal system is multi-tiered and highly complex. Not only is it divided between state and federal courts, but it also uses a variety of enforcement mechanisms, including legal actions by regulators, state and federal attorneys general, plaintiff classes, and individuals. As a result, and despite a high level of proficiency in most courtrooms (especially at the federal level), the system’s inherent complexity has the unfortunate side effect of making it harder to manage legal risk in the US than in many other jurisdictions.²⁴⁵

The Court’s holding directly subverts the basis for these sentiments. Moreover, the holding helps lend credence to the securities statutes enacted by Congress. Congress enacted SLUSA to stem the shift of class action from federal to state courts, thus aiming to create a less complex legal environment and thus prevent class action suits from frustrating the intentions of the PSLRA.²⁴⁶ The Supreme Court’s decision helps counter the widespread belief that other nations, including Great Britain, far more effectively discourage frivolous

241. *Id.* at 101.

242. See *Merrill Lynch*, 126 S. Ct at 1509. “The magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated.”

243. *Id.* at 1510, citing *Blue Chip Stamps*, 412 U.S. at 740.

244. McKinsey Study, *supra* note 205, at 74.

245. *Id.* at 77.

246. *Merrill Lynch*, 126 S. Ct. at 1511.

litigation.²⁴⁷ In sum, while a quantifiable affect from the decision might not be available, it is important to recognize that the Supreme Court has taken a step towards ensuring that New York (and the United States) retains its position as the financial capital of the world.²⁴⁸

VI. CONCLUSION

Congress' enactment of the PSLRA and SLUSA caused plaintiffs to become more creative in attempting to circumvent the federal preemption and subsequent dismissal of their class action securities suits premised on Rule 10b-5. Initially, the Second Circuit allowed these plaintiffs to escape federal preemption if they tailored their plaintiff class to those who had merely held, rather than purchased or sold, their securities. Fortunately, the Supreme Court, recognizing the vexatious nature of these holding claims, has now rejected this notion as a viable securities claim.

As a result, the Court's decision is in harmony with its prior construction of the federal securities statutes. Further, the decision is in accord with Congress' stated policy justifications for enacting the PSLRA and SLUSA. The Court's holding also has a beneficial impact on America's securities exchanges. By reducing the number of meritless securities suits in our courts, the perception that our securities exchanges leave businesses vulnerable to increased litigation costs is weakened. Consequently, the Court's decision helps reverse the dangerous economic trend of the financial services industry migrating overseas, thereby preserving America's status as the financial capital of the world.

247. McKinsey Study, *supra* note 205, at ii.

248. However, this is not to imply, in any manner, that the Supreme Court should base its decisions on economic protectionist policies, for that, if at all, would certainly be the role of Congress.

