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ARTICLE

THE MULTIENFORCER APPROACH TO SECURITIES FRAUD DETERRENCE: A CRITICAL ANALYSIS

AMANDA M. ROSE[†]

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INTRODUCTION

The United States employs a mishmash of enforcers to deter fraud in its national securities markets. Most controversially, it relies upon class action lawyers to supplement the Security and Exchange Commission's (SEC) enforcement of Rule 10b-5, the primary antifraud provision in federal securities law.¹ Complaints about Rule 10b-5 "strike suits" led Congress to enact the Private Securities Litigation Reform Act of 1995 (PSLRA),² which imposed a variety of new burdens on private plaintiffs bringing federal securities claims. Three years later, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA),³ in response to charges that class action lawyers were avoiding the PSLRA's intended prohibitions by filing securities fraud claims under state law. SLUSA precludes most state-law-

¹ 17 C.F.R. § 240.10b-5 (2009) (prohibiting, inter alia, the making of "any untrue statement of a material fact . . . in connection with the purchase or sale of any security").

² Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

³ Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

fraud class actions involving securities traded on national exchanges and those issued by large mutual fund companies.⁴ It explicitly preserves, however, the authority of state officials to bring enforcement actions.⁵ Thus, in addition to facing federal fraud liability at the hands of both the SEC and class action plaintiffs,⁶ participants in the U.S. national securities markets also face potential fraud liability at the hands of fifty state governments.⁷

This multienforcer approach to securities fraud deterrence is more the product of historical happenstance than coherent design choices.⁸ It is therefore worthwhile to step back and ask, from first principles, whether this approach makes any sense. The question is a timely one. Stories of the spectacular frauds perpetrated by Bernie Madoff and Allen Sandford have led many ordinary Americans to conclude that our

⁴ 15 U.S.C. §§ 77p(b), 78bb(f) (1) (2006) (proscribing “covered class action[s] based upon the statutory or common law of any State” alleging fraud “in connection with the purchase or sale of a covered security”).

⁵ *Id.* §§ 77p(e), 78bb(f) (4) (permitting “State[s] [to] retain jurisdiction . . . to investigate and bring enforcement actions”).

⁶ The Department of Justice should be added to this list, as should the Financial Industry Regulatory Authority, a self-regulatory organization with authority to pursue fraud claims against brokers and brokerage firms.

⁷ Nothing akin to the “internal affairs” doctrine in corporate law applies to securities fraud. The internal affairs doctrine provides that a corporation shall be subject to the state laws *only* of its state of incorporation with respect to “matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.” *Edgar v. Mite Corp.*, 457 U.S. 624, 645 (1982) (5-4 decision). By contrast, in securities fraud litigation modern jurisdictional and choice-of-law principles generally allow any state to sue pursuant to its own laws so long as one of its citizens purchased the implicated securities. See Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 326 (1998) (“As a practical matter, because issuers cannot prevent the residents of particular states from buying their securities on impersonal national exchanges, corporations will have no choice but to subject themselves to the laws of all states.”).

⁸ For example, the federal securities laws predate the Supreme Court’s adoption of the “minimum contacts” test in *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), and therefore were enacted at a time when most state courts had difficulty obtaining personal jurisdiction over out-of-state defendants in securities fraud cases. See Margaret V. Sachs, *The International Reach of Rule 10b-5: The Myth of Congressional Silence*, 28 COLUM. J. TRANSNAT’L L. 677, 704 (1990) (noting that Congress enacted securities laws when personal jurisdiction was still “largely territorial”). Moreover, when the SEC promulgated Rule 10b-5 in 1942, it never intended for the rule to be privately enforced, and the judges who later found the rule to imply a private cause of action could not have foreseen the development of the modern Rule 10b-5 class action. For a detailed historical account of how the private cause of action under Rule 10b-5 evolved, see Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1307-15 (2008).

securities fraud deterrence regime is broken, and the financial community has been complaining loudly in recent years that a “lack of coordination and clarity on the ways and means of enforcement” is a drag on the competitiveness of our capital markets.⁹ Perhaps most urgently, the Obama administration is seeking to replicate the multi-enforcer approach in the realm of consumer financial protection, with potentially far-reaching consequences for the economy.¹⁰

This Article critically analyzes the United States’ multienforcer approach to securities fraud deterrence. The analysis reveals that the efficacy of the approach is dubious. Although in theory there are conditions under which a multienforcer approach would promote optimal deterrence, it is highly uncertain whether those conditions exist in the United States. Unfortunately, additional empirical research, though warranted, is unlikely to resolve the issue. But maintenance of the status quo is not the best response to this irreducible uncertainty. Rather, this Article suggests that a superior approach would be to consolidate the enforcement authority now shared between federal regulators, state regulators, and class action lawyers in a federal agency, such as the SEC, and to grant that agency exclusive authority to prosecute national securities frauds—while simultaneously enacting reforms to align that agency’s enforcement incentives more closely with the public interest. In addition to conferring the benefits of simplicity, a unitary-enforcer approach would allow the United States to capture important enforcer-based efficiency gains that are unattainable under the current regime.

The Article proceeds in four parts. To understand when a multi-enforcer approach may serve the cause of optimal deterrence, one must first understand the meaning of that goal. Part I thus provides a primer on optimal securities fraud deterrence, explaining how— notwithstanding its scienter requirement—securities fraud liability can produce nontrivial overdeterrence costs. The task of policymakers is to

⁹ MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL SERVICES LEADERSHIP 17 (2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

¹⁰ The Obama administration’s blueprint for financial regulatory reform calls for granting a new federal agency—the “Consumer Financial Protection Agency”—broad authority to interpret and enforce federal statutes related to “credit, savings, payment, and other consumer financial products and services,” while at the same time granting states the right to concurrently enforce these laws and preserving their authority to enforce stricter state laws. U.S. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM—A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 14 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

design a liability regime that minimizes the sum of these costs, other enforcement costs, and the social costs of securities fraud.

Part II explains why focusing on enforcer incentives—as opposed to narrowing the scope of the substantive fraud prohibition, lowering sanctions, or toughening procedural rules—is a superior way to deal with the risk of overdeterrence inherent in securities fraud litigation. Unlike those other methods, improving the incentives of the enforcer can reduce overdeterrence costs by increasing the accuracy of prosecutions without simultaneously weakening the regime’s ability to deter fraud. Aligning enforcer incentives with society’s interest in achieving optimal deterrence confers other important benefits as well: it increases the potential for regulatory flexibility and minimizes the unique risk of overdeterrence that the use of vicarious liability presents. Despite these benefits, enforcer-focused reforms have taken a backseat to substance-, sanction-, and procedure-focused reforms in the debate over how to improve the U.S. securities fraud deterrence regime. The neglect of enforcer-focused reforms would be understandable if it were clear that the securities fraud enforcers we currently employ are as good as it gets. But no one has rigorously examined the optimality of our current mix of enforcers.¹¹

Part III begins to fill this gap. It explains that we cannot evaluate the efficacy of a multienforcer approach without first making important assumptions about regulatory behavior. If, for example, we believe that government agents seek to maximize the social welfare of the jurisdictions they serve, it would be unwise to use multiple enforcers to deter fraud in our national securities markets. Using concurrent enforcers generally, and private enforcers in particular, would lead to fewer of the enforcer-based efficiency gains discussed in Part II than would the use of an exclusive, public, federal enforcer—without providing any obvious offsetting benefits. If, instead, we take a more skeptical view, we cannot say anything so definite. In a world with

¹¹ Emerging scholarship suggests that enforcement is a better predictor of a nation’s financial development than the formal “law on the books,” further bolstering the case for enforcer-focused reform. See, e.g., John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 245-55 (2007) (suggesting that enforcement may be a more important variable than substantive doctrinal differences in explaining the development of countries’ capital markets, and casting doubt on prior studies that focused on the latter—most notably, Rafael La Porta et al.’s seminal article, *Law and Finance*, 106 J. POL. ECON. 1113 (1998)); Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 275 (2007) (hypothesizing that it may not be “law, but enforcement that matters” to capital market development).

imperfect government agents, a multienforcer approach to securities fraud deterrence *may* be efficient, but only if three conditions are met. Specifically, it must be the case that: (1) if a federal enforcer were given exclusive enforcement authority, it would systematically err on the side of underdeterrence; (2) additional enforcers save more in underdeterrence costs than they create in enforcement costs; and (3) no alternative reforms designed to align the federal enforcer's incentives more closely with the public's interest in optimal deterrence are available that would lead to an even greater net savings in social costs. The discussion in Part III illustrates that it is far from clear that these conditions are currently met in the United States, casting doubt on the efficacy of both state and private enforcement. Significant further research is warranted.

Part IV addresses what should be done in light of this uncertainty. It suggests that, rather than privileging the status quo, policymakers should consider unifying securities fraud enforcement authority under a single federal regulator, while simultaneously addressing any increased risk of systematic underdeterrence this change would create by enacting reforms designed to improve the federal enforcer's incentives. State and private enforcers might continue to play a role in securities fraud deterrence following such a change, but a role that is subordinate to that of the federal enforcer. Moving to a unitary-enforcer approach may or may not lead us closer to optimal deterrence—we cannot know based on existing evidence. But such a move would allow us to potentially capture the enforcer-based efficiency gains described in Part II. It would also simplify the U.S. securities fraud deterrence regime, making it easier to evaluate and improve its effectiveness going forward.

I. OPTIMAL SECURITIES FRAUD DETERRENCE: A PRIMER

This Article assumes that the goal of securities fraud liability is deterrence. To be justified, a deterrence-focused securities fraud liability regime must save more in social costs from fraud than it creates in enforcement costs. To be *optimal*, the regime must minimize the sum of these costs.¹² Section I.A briefly surveys the social costs of securities

¹² To be truly optimal, the liability regime must also minimize social costs relative to other possible forms of legal intervention, such as government preclearance of corporate communications for accuracy. See STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 575-81 (2004) (discussing the determinants of the "optimal structure of legal intervention").

fraud and the circumstances that dictate their severity. Section I.B addresses the enforcement costs of a securities fraud deterrence regime, explaining how the regime's design will influence the magnitude of those costs.

A. *The Social Costs of Securities Fraud*

1. What Are They?

Securities fraud, like other failures in the market for information, produces deadweight social costs that may justify regulation. First, fraud increases the cost of capital in a variety of ways. For example, if potential investors in primary offerings fear that issuers will defraud them, they will predictably discount the price they are willing to pay for the securities. Secondary market fraud also increases the cost of capital, though less directly. As explained more fully below, investors trading on secondary securities markets can largely diversify away the risk of out-of-pocket losses attributable to corporate misstatements because the resultant price distortions will at times work to their advantage. But some secondary market traders will nevertheless expend resources to verify the truthfulness of corporate disclosures, in an attempt to win more than they lose from secondary market fraud. This response may cause other investors to refrain from trading—or to discount what they are willing to pay—out of fear that they will systematically lose to these more informed traders. The effect will be an increase in bid-ask spreads and a reduction in liquidity, which will increase the transaction costs associated with portfolio adjustments. Anticipating these costs, investors will pay less for new issues.

Securities fraud can also upset the efficient allocation of resources in the economy. If fraud is rampant, investors may be unable to distinguish between good and bad firms and may therefore pay too little for securities of the former and too much for securities of the latter. As a result, “[c]ompanies whose stock is overvalued may raise too much equity and overinvest. On the other hand, companies whose stock is undervalued may find it costly or impracticable to obtain sufficient capital from alternative sources, and thus underinvest.”¹³

Securities fraud can also have allocative consequences through its impact on corporate governance. Accurate disclosure helps shareholders and markets monitor management, which in turn “en-

¹³ Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977, 1010 (1992).

hance[s] efficiency by improving corporate decisions relating to which proposed new investment projects in the economy are selected for implementation and how already existing projects are operated.”¹⁴ Inaccurate disclosures, by contrast, can disguise poor management and prevent value-enhancing changes in control.

An effective securities fraud deterrence regime would reduce all of these social costs, which I will refer to as “underdeterrence costs.” By successfully deterring fraud, it would bring skittish investors back to the capital markets, reduce the “fraud discount” they may otherwise be inclined to charge, and generally improve corporate governance. Allocative distortions would thereby be minimized, and the cost of capital reduced.

* * *

Notably absent from the catalog of underdeterrence costs laid out above are the actual out-of-pocket losses investors may suffer from discrete instances of fraud. This is because such losses represent a mere redistribution of societal wealth, something with which a deterrence regime is not directly concerned.¹⁵ If readers find this orientation distasteful, a unique feature of secondary market securities fraud (the most controversial target of the U.S. securities fraud deterrence regime¹⁶) may provide a degree of comfort. Such fraud does not typically involve a wealth transfer between the fraudster and the victim; instead, a nontrading fraudster manipulates the price at which equally blameless investors trade. Thus, “each loser—the buyer or seller disadvantaged by the fraud—is balanced by another [innocent] winner: the person on the other side of the trade.”¹⁷ Well-diversified investors’ out-of-pocket gains and losses from secondary market securities fraud should therefore roughly net out over time.

¹⁴ Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 253 (2009).

¹⁵ A deterrence regime is concerned with distributional effects only insofar as “the possibility of an uncompensated wealth transfer may cause certain socially detrimental investments and result in other reductions in societal wealth.” Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 630 (1992).

¹⁶ Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 642 (1996) (observing that so-called “fraud-on-the-market” class actions, which target secondary market fraud, are “the subject of most of the attention with respect to allegedly abusive litigation”).

¹⁷ *Id.* at 646 (citing Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 634 (1985) (revised and reprinted in FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 334 (1991))).

Admittedly, this netting out will not always be perfect.¹⁸ Moreover, there are types of securities fraud that present investors with non-diversifiable risks of loss, such as fraud in primary offerings, fraud by money managers, and fraud accompanied by insider trading. In these cases, we cannot so easily dismiss distributional concerns. But here, too, such concerns may be less pressing than they initially appear. First, if compensation were unavailable for these frauds, “securities would be discounted to reflect deterrence’s failure in a certain percentage of cases,” such that their price would be “fair ex ante, even though some investors [would] be unlucky and suffer a loss ex post.”¹⁹ Second, lawmakers could use other mechanisms, such as the income tax and transfer system, to redistribute wealth to the victims of these sorts of frauds if they felt them deserving of compensation. This way, they could address distributional concerns without interfering with the design of the deterrence regime.²⁰ Finally, it may best serve deterrence to allow investors to sue for compensatory damages, restitution, or disgorgement in these cases; if so, members of society with divergent normative commitments might come to what Cass Sunstein has dubbed an “incompletely theorized agreement” to permit such suits.²¹

2. What Determines Their Severity?

How big would the social losses from securities fraud be in the absence of legal intervention? As discussed below, the answer will depend on both the predisposition of firm agents to commit fraud and the efficacy of the market-based mechanisms that would emerge to combat it.

¹⁸ See Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 227-34 (2007) (explaining that even diversified investors can suffer net losses from secondary market fraud); James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 340-42 (2009) (noting the limitations of diversification as a shield against securities fraud losses).

¹⁹ Fox, *supra* note 14, at 283.

²⁰ This is not a fanciful idea. See Lynnley Browning, *Madoff Victims Will Get a Tax Break*, N.Y. TIMES, Mar. 18, 2009, at B3 (reporting on the IRS plan to provide tax deductions to victims of Madoff’s financial fraud); see also SEC, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, at 1-5 (2003), available at <http://www.sec.gov/news/studies/sox308creport.pdf> (explaining that the “Fair Fund” provision of the Sarbanes-Oxley Act of 2002 permits the SEC to pay penalties recovered in administrative proceedings to defrauded investors).

²¹ Cass R. Sunstein, Commentary, *Incompletely Theorized Agreements*, 108 HARV. L. REV. 1733, 1735 (1995). This Article’s brief discussion of the topic is unlikely to satisfy those concerned about the distributional consequences of securities fraud, but the goal of this Article is to apply, not defend, the deterrence framework. For a vigorous normative defense of the economic approach to social policymaking, see generally LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002).

a. *Likelihood of Fraud*

The likelihood that firm agents will commit fraud depends on numerous context-specific factors. These include the mores of a nation's business and financial community, which may fluctuate over time, as well as the size and structure of a nation's securities markets. For example, it has been observed that fraud is essentially nonexistent in markets in which the same buyers and sellers engage in repetitive transactions with one another over lengthy periods of time.²² It follows that there is a greater risk of fraud in larger, more impersonal markets.

The prevailing corporate ownership structure is also highly relevant. Securities fraud may best be understood as a species of agency costs.²³ In other words, corporate agents may commit fraud not to benefit existing shareholders, but rather to enrich themselves; an inflated stock price can, after all, disguise managers' poor performance and enhance the value of their stock-based compensation. If this view is correct, securities fraud should be less of a problem in countries with concentrated ownership structures. It should also be less of a problem the more successfully other corporate governance arrangements work to control agency costs.²⁴

Donald Langevoort has offered an explanation for why officers commit fraud that rivals the agency cost theory. To simplify somewhat, he argues that information-flow problems in large organizations combine with "corporate cultural biases" (particularly overoptimism and confirmation biases) to skew the information that reaches officers and to cause them to disseminate false information to the marketplace—first innocently and later intentionally—in what he describes as an "optimism-commitment whipsaw effect."²⁵ If his theory is cor-

²² GORDON TULLOCK, *THE LOGIC OF THE LAW* 228 (1971).

²³ See, e.g., Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 694 ("Fraud on the Market is a product of agency costs between owners and managers in circumstances where the managers fear themselves to be in their last period of employment.").

²⁴ See Coffee, Jr., *supra* note 11, at 296 (hypothesizing that securities enforcement in the United Kingdom may be less rigorous than in the United States in part because the corporate governance regimes prevailing in the United Kingdom permit shareholders to protect themselves more effectively); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 905 (2003) (arguing that U.S. federal securities fraud litigation works "to fill the hole in Delaware law brought about by the lack of liability for, and concomitant inability to sustain, suits for breaches of the fiduciary duty of care").

²⁵ Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 108, 167 (1997).

rect, the prevailing organizational culture and structure of firms may also inform the likely occurrence of fraud.

b. *Market-Based Solutions*

Another critically important factor bearing on the magnitude of the social costs of securities fraud is the efficiency of the market-based mechanisms that would emerge to prevent such fraud. In a world without a legal prohibition against securities fraud, high-value firms might try to reduce the risk premium investors would otherwise charge by taking steps to certify their disclosures. They could do this in a variety of ways, including by hiring reputational intermediaries (or “gatekeepers”) to vouch for their honesty.²⁶

More formalized mechanisms might also arise through private arrangement. For example, securities exchanges might impose and enforce antifraud rules on listed firms, thereby allowing those firms to signal their quality to investors. Though a securities fraud deterrence regime would diminish the need for these private efforts, themselves a source of social costs, its value will depend on how much *more* efficiently—if at all—the regime operates to reduce underdeterrence costs.

B. *The Social Costs of Enforcement*

1. What Are They?

That securities fraud produces social costs is not itself a sufficient rationale for government intervention. There is always a risk that the cure will be worse than the disease. Legal prohibitions against fraud create their own batch of social costs, which will be referred to collec-

²⁶ John Coffee has defined gatekeepers as possessing two key characteristics:

First, the gatekeeper is a person who has significant reputational capital, acquired over many years and many clients, which it pledges to assure the accuracy of statements or representations that it either makes or verifies. Second, the gatekeeper receives a far smaller benefit or payoff for its role, as an agent, in approving, certifying, or verifying information than does the principal from the transaction that the gatekeeper facilitates or enables.

John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308 (2004). These features make it unlikely (though certainly not foolproof, *see generally id.*) that a gatekeeper would knowingly participate in its client's fraud, thus providing investors with some assurance of the credibility of the client's disclosures. “Legal scholars long have recognized that investment banking, accounting, and law firms can act as private gatekeepers to financial markets.” Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 491 (2001).

tively as “enforcement costs.” *Direct* enforcement costs include the resources consumed in detecting, prosecuting, defending, and adjudicating securities fraud cases. Enforcement costs may also manifest *indirectly* in the form of overdeterrence. The overdeterrence risk presented by securities fraud liability is sometimes ignored in the literature because it is assumed that fraud’s traditional scienter requirement ensures that regulated parties can costlessly avoid liability.²⁷ But overdeterrence remains a concern to the extent that regulated parties fear inaccurate prosecution and legal error. Moreover, as explained later, overdeterrence is a risk even in the absence of such fear if firms are held vicariously liable for the fraud of their agents.

As detailed below, overdeterrence produces some of the very same social costs as securities fraud itself: it can increase the cost of capital (e.g., if fear of liability causes companies to overinvest in precautionary measures or causes financial intermediaries to charge more for their services) and upset the allocative efficiency of the economy (e.g., if fear of liability causes companies to reduce disclosure of truthful information or, conversely, to disclose too much trivial information, thereby impeding share-price accuracy). These costs might easily dwarf direct enforcement costs. The latter are incurred only if an actual investigation is launched and affect only the targeted members of the regulated population. By contrast, *all* regulated parties may potentially produce overdeterrence costs. Lawmakers should therefore pay close attention to these costs lest the securities fraud deterrence regime ends up doing more harm to the economy than good.

2. What Determines Their Severity?

The magnitude of the overdeterrence costs that a securities fraud liability regime produces will depend on lawmakers’ design choices regarding: (1) the scope of the substantive fraud prohibition; (2) the threatened sanctions; (3) the procedural rules governing investigation and adjudication of claims; and (4) the enforcer. The first three are discussed below. As will become apparent, choices along these dimensions involve an inescapable tradeoff between over- and underdeterrence costs. The role of the enforcer in mitigating overdeterrence costs warrants special consideration and is addressed in the next Part.

²⁷ See, e.g., Arlen & Carney, *supra* note 23, at 692 n.8 (suggesting that overdeterrence is not an issue in securities fraud cases due to fraud’s scienter requirement).

a. *Substance*

The more ambitious the fraud prohibition, the greater potential reduction in underdeterrence costs and the greater potential *increase* in overdeterrence costs. Imagine, for example, a regime with a narrow fraud prohibition, one that imposes liability only on officers who knowingly make false statements of historical fact. Let us also assume for the time being that these agents cannot shift their risk of liability to the firm.²⁸ The overdeterrence costs this regime would create should be minimal because it is relatively easy for law-abiding agents to verify—and later prove—the accuracy of past facts. Such a narrow prohibition would not, however, deter more subtle forms of fraud.

For example, it would not deter individuals from attempting to mislead the market by releasing falsely optimistic statements about the future prospects of a company. If the prohibition were extended to capture these sorts of statements, it might decrease underdeterrence costs, but it might also increase enforcement costs—most importantly, overdeterrence costs. This is because, without a crystal ball, one cannot ensure the “accuracy” of forward-looking statements, and it is always possible that prosecutors would view mistaken predictions, after the fact, as having been made with fraudulent intent.

The risk of inaccurate prosecution and subsequent legal error is particularly acute in cases involving forward-looking statements due to “hindsight bias,” or “the tendency of decision makers to attach an excessively high probability to an event simply because it ended up occurring.”²⁹ “In the context of securities regulation, hindsight [bias] can mistakenly lead people to conclude that a bad outcome was not only predictable, but was actually predicted by managers,” and it “thus creates a considerable obstacle to the fundamental task in securities regulation of sorting fraud from mistake.”³⁰ It stands to reason that the threat of undeserved liability might deter some honest disclosure of forward-looking information. Because the value of a firm is best judged by future prospects rather than past performance,³¹ less disclo-

²⁸ This assumption is relaxed in subsection I.B.2.b *infra*.

²⁹ Christine Jolls et al., *A Behavioral Approach to Law and Economics*, in *BEHAVIORAL LAW AND ECONOMICS* 13, 38 (Cass R. Sunstein ed., 2000).

³⁰ Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 774 (2004).

³¹ See Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1121 (1987) (“Persons invest with the future in mind and the market value of a security reflects the judgments of investors about the future economic performance of the issuer.”) (quoting *Disclosure of Projections of Future Economic Per-*

sure of this sort would be particularly problematic from the standpoint of allocative efficiency.

To deter more fraud, the prohibition might be extended beyond affirmative misstatements to encompass material *omissions*. Investors must be aware of both positive and negative information about a firm to value its shares accurately. A prohibition on material omissions may deter a firm's agents from selectively disclosing the former while omitting the latter, in an attempt to mislead the market. But again, the price of broader liability will be an increased risk of over-deterrence. Disclosure is expensive, and a firm's agents must make judgment calls about the volume of information to collect, verify, and release. If those judgments are second-guessed in court, it might cause firms' agents to overdisclose information.³² This would increase the expense of corporate compliance and, thus, the cost of raising capital. It might also upset the allocative efficiency of the economy: a flood of trivial information, like a drought of material information, can impede share price accuracy.³³ Hindsight bias again heightens the potential for inaccurate prosecution and legal error in this context—the fact that omitted information turned out to be important may cause the prosecutor and the factfinder to overestimate the likelihood that the agent believed it to be material at the time of the omission.³⁴

Fraud liability might also be extended beyond the culpable individuals responsible for the misstatements or omissions. For example, it could be vicariously imposed on the firms that employ them. The standard deterrence rationale for vicarious liability is that firms can combat misconduct by their agents through a mixture of "executive

formance, Securities Act Release No. 5362, [1972–1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶79,211, at 82,667 (Feb. 2, 1973)).

³² See Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279, 280 (1986) ("[U]ncertainty often allows an actor to reduce the probability of punishment . . . by 'playing it safe' and modifying his behavior by more than the law requires. . . . [This] can give even risk-neutral parties an incentive to 'overcomply.'"); Jason S. Johnston, *Bayesian Fact-Finding and Efficiency: Toward an Economic Theory of Liability Under Uncertainty*, 61 S. CAL. L. REV. 137, 159 (1987) ("[W]hen fact-finding is imperfect and the risk of being found liable falls as care increases, the defendant may be induced to take too much care.").

³³ See generally Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (evaluating mandatory disclosure in securities regulation).

³⁴ See Jolls et al., *supra* note 29, at 42 (noting that since the liability "determination must be made against the backdrop of knowledge that the issue or problem in fact materialized, and produced a large drop in the company's stock price," a "decision maker will likely find it difficult to see how a reasonable ex ante decision maker might have thought the prospective issue or problem other than material").

selection, contracting and monitoring strategies.”³⁵ Exposing firms to vicarious liability for their agents’ delicts, the theory goes, encourages firms to undertake these socially desirable deterrence efforts.

If sanctions were calibrated to cause firms to internalize precisely the social costs of their agents’ frauds, and if there were no fear of legal error in the underlying fraud determination, vicarious liability would simply encourage firms to take the socially optimal level of precaution. Overdeterrence would not be a risk because, if a particular precaution were more costly than the fraud it could be expected to prevent, firms would not take it but would instead pay the sanction in the event of fraud.³⁶

If, however, one allows for either imperfectly calibrated sanctions or legal error—and one must, to say anything useful about the real world—vicarious liability becomes a potentially costly expansion of the fraud prohibition. It might encourage firms to take excessive precautions, thus increasing the cost of capital to no good end and potentially upsetting the allocative efficiency of the economy. Moreover, as Jennifer Arlen has observed, absent highly sophisticated and patently unrealistic sanction calculations, vicarious liability might actually *discourage* firms from policing and exposing agent misconduct (as opposed to taking measures to prevent it) because by doing so they would expose themselves to liability.³⁷ Thus, vicarious liability might (counterproductively) increase underdeterrence costs as well.

Lawmakers might also consider extending the scope of liability so that it captures those who do not themselves communicate a falsehood to the market but rather knowingly aid and abet another’s fraud. As alluded to in subsection I.A.2.b, a variety of financial intermediaries, such as auditors and investment bankers, stand in a position to detect and prevent—or advance—securities fraud. When a desire to preserve reputational capital is insufficient to induce these gatekeepers to do the right thing, a threat of legal liability might make the difference. Aiding-and-abetting liability, however, may produce its own batch of overdeterrence costs.

³⁵ Langevoort, *supra* note 16, at 654.

³⁶ Nor would overdeterrence be a risk if the firm knew with certainty that it could costlessly and completely shift its liability back to the offending agent. But if the firm could fully and freely offload its risk in this manner, the specter of liability would not affect its behavior and thus would not decrease underdeterrence costs either.

³⁷ Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 836 (1994).

Hindsight bias might cause prosecutors and factfinders to overestimate the likelihood that gatekeepers knew of (or recklessly failed to discern) their clients' frauds. Realizing this possibility, gatekeepers might demand compensation for the risk of misguided prosecution and legal error by increasing the prices they charge to all firms, thus raising the cost of capital. Alternatively (or additionally), they might act with an excessive degree of caution that, in turn, would dilute the informational value of the services they provide, to the detriment of allocative efficiency. It has been observed, for instance, that fear of litigation in the United States has caused auditors to develop "a system of narrow, technical [accounting] rules that provide certainty and protection" from liability,³⁸ but that may not convey information to investors as well as a principles-based system of accounting would. Moreover, as Reinier Kraakman has observed, "[i]f outside gatekeepers cannot shift their liability risks, . . . they will have a powerful incentive to lobby for the overinvestment of firm resources in monitoring for offenses and against profitable but risky innocent conduct. In the extreme, they may even withdraw their services entirely from small or risky firms."³⁹

Aiding-and-abetting liability might also produce overdeterrence costs apart from any risk of legal error if such liability is vicariously imposed on gatekeeping firms and sanctions are miscalibrated. For example, vicarious aiding-and-abetting liability might cause gatekeeping firms to spend excessive amounts of money on monitoring their agents—costs which will ultimately be charged back to the firms' clients in the form of higher fees, thus raising the cost of capital.

b. *Sanctions*

Determining the scope of the substantive legal prohibition is but one step in constructing a securities fraud deterrence regime. The credible threat of sanctions is the means by which the prohibition influences behavior. Sanction setting itself requires a difficult balancing of under- and overdeterrence costs.

How do lawmakers begin to determine the appropriate sanction? Law and economics scholarship instructs that an "optimal" sanction will cause potential perpetrators to internalize fully the social costs of

³⁸ JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 370 (2006).

³⁹ Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 892 (1984).

their contemplated behavior.⁴⁰ This goal requires that the sanction reflect the probability of enforcement: if the externalized social costs from the contemplated fraud equal \$100 and the sanction is set at that price, but there is only a 50% chance of being caught and prosecuted, a rational, solvent, risk-neutral potential perpetrator will internalize only the expected value of the sanction, \$50, in deciding how to act. Thus, to cause full internalization of the social costs, the sanction must be set at least at \$200. In a world without transaction costs (and inhabited solely by *homo economicae*), this sanction would lead to Kaldor-Hicks-efficient outcomes: the fraud would take place only if the benefit to the perpetrator exceeds the fraud's social costs, such that the perpetrator could theoretically compensate society for its loss while still retaining some surplus benefit.⁴¹

There is, however, an obvious objection to this approach. Why credit the perpetrator's utility at all? There is nothing socially redeeming about fraud, so why encourage the potential perpetrator to weigh the social costs of fraud against his personal benefit? A better approach would be to set the sanction much higher than \$200 to ensure that *no* fraud takes place, whatever the perceived benefit to the perpetrator.⁴² This approach would also relieve the sanction setter of the many difficulties it would otherwise face in attempting to craft the "optimal" sanction. These difficulties include quantifying the social costs of fraud (which are amorphous), estimating the total level of fraud in society (necessary to calculate the probability of enforcement), and controlling the level of enforcement (so that the sanction remains appropriately calibrated over time). It also takes pressure off

⁴⁰ For the seminal article on optimal sanctions, see Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

⁴¹ See Michael K. Block, *Optimal Penalties, Criminal Law and the Control of Corporate Behavior*, 71 B.U. L. REV. 395, 398 (1991) ("[The optimal deterrence] framework ensures that fines promote efficient results in which the allocation of resources maximizes societal wealth."); A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880, 880 (1979) (analogizing optimal sanctions to a Pigouvian tax).

⁴² To use terminology coined by Robert Cooter, it would be better to "sanction" than to "price" securities fraud. See Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1523 (1984) (defining a sanction as "a detriment imposed for doing what is forbidden, and a price as money extracted for doing what is permitted"). John Coffee explains that a "sanction," in Cooter's lexicon, "inherently creates an abrupt, discontinuous jump in the costs the actor must incur when he violates the legal standard." John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"? Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 226 (1991). But "this abrupt jump disappears when a pricing system is used because prices are continuous and thus bring costs and benefits into balance." *Id.*

the less-than-realistic assumptions underlying the formula (e.g., that potential perpetrators are perfectly informed rational actors, with identical risk preferences, capable of engaging in basic algebra before deciding whether to act). If sanctions are set high enough, all but the most recalcitrant will desist from committing securities fraud.

It is here that overdeterrence costs again rear their ugly heads. Any sanction—even one that falls short of causing potential perpetrators to internalize fully the social costs of fraud—risks overdetering in a world with legal error.⁴³ But this risk is clearly amplified by higher expected sanctions. Moreover, a high-expected-sanction approach risks overdetering even in the absence of legal error if vicarious liability is a feature of the regime. Vicarious liability is not designed to deter firms unconditionally in the way that the underlying fraud prohibition is designed to deter potential fraudsters. Instead, it is designed to prompt firms to invest a socially optimal amount in fraud-prevention measures by forcing them to internalize fully the social costs of their agents' frauds. If firm-level sanctions are set at an amount *higher* than the externalized social costs of fraud (as adjusted to reflect the probability of nonenforcement), firms will have an incentive to overinvest in precautions. An obvious solution is to lower firm-level sanctions to the "optimal" level. But this approach may not be a practical option, as it reintroduces the need to determine the value of all the variables described above—variables that will be densely clouded in empirical uncertainty. Thus, lawmakers are likely to err on one side or the other. Whereas overdeterrence will result if they overestimate the optimal sanction, vicarious liability will fail to achieve its full deterrence objective if instead they underestimate the optimal sanction.

The bottom line is that lawmakers face a clear tradeoff in setting sanctions: set sanctions high in an effort to deter more fraud, but risk increasing overdeterrence costs, or set them low to minimize overdeterrence costs, but risk increasing the incidence of fraud. If we assume, as seems reasonable, that those inclined to commit fraud are more likely to be risk seeking, whereas those inclined to obey the law are more likely to be risk averse, the tradeoff in sanction setting becomes even starker. "[R]isk aversion strengthens the incentive to

⁴³ See John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 995 (1984) ("Even when the probability of punishment is less than one, if that probability declines as defendants take more care, then defendants may tend to overcomply. In such a case, increasing the expected fine or damage award [to reflect the possibility of nonenforcement] would only increase overdeterrence, exacerbating the problem rather than curing it.").

overcomply and risk preference strengthens the incentive to undercomply.⁴⁴ Thus, more severe sanctions are necessary to deter the risk seeking than are necessary to deter the risk averse. But lawmakers cannot practically apply different sanctions to these groups. If they opt for more severe sanctions to deal with the risk-seeking “bad apples,” the solution will have an outsized effect on the incentives of the risk-averse “good apples” to overcomply.

* * *

Thus far we have assumed that agents cannot offload the risk of being sanctioned onto their firms. What if they can? How would this affect the likely level of overdeterrence costs that the securities fraud deterrence regime produces? The first thing to note is that risk shifting cannot eliminate the threat of overdeterrence that exists due to the possibility of legal error; it can only reduce it.⁴⁵ Even if a firm relieved its officers of all liability risk by granting them indemnification rights or purchasing liability insurance on their behalf, the firm (via its board) or its insurer would still have incentives to cause officers to overcomply to decrease the risk of erroneous liability; and these incentives would grow stronger as the expected sanction increased in severity. Moreover, officers would retain some residual personal incentives to overcomply, given reputational concerns and firm-specific investments.⁴⁶

However, as indicated above, risk aversion increases the incentive to overcomply. If, as is generally presumed, shareholders are less risk averse than firm agents, overdeterrence should be less severe if firms assume their agents' liability risks.⁴⁷ But there is a catch: where the risk of legal error is significant, and thus risk shifting is actually warranted, firms (or their insurers) may have difficulty distinguishing between the justly accused and the falsely accused. After all, if such distinctions were easy to draw, we would not be worried about legal error in

⁴⁴ Craswell & Calfee, *supra* note 32, at 280 n.3.

⁴⁵ Risk shifting from agent to firm will not reduce the risk that vicarious liability will cause firms to overinvest in precautionary measures or take other socially costly actions to avoid liability.

⁴⁶ See Bruce Chapman, *Corporate Tort Liability and the Problem of Overcompliance*, 69 S. CAL. L. REV. 1679, 1688 (1996) (“[I]ndividual agents who are employees within [a] corporation have their future very specifically invested there, and are understandably quite averse to risking any of the assets of the corporation which employs them.”).

⁴⁷ See, e.g., Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1228 (1985) (“[S]ince corporations are either risk neutral or if risk averse less so than individuals, . . . there is much less danger of causing the shareholders to be too careful in hiring, supervising, and terminating directors (and through the board of directors, the managing employees).”).

the first place. Firms may, therefore, end up assuming the liabilities of *both*. If so, it would severely weaken the deterrent effect of sanctions, at least for this category of cases.⁴⁸ Thus, risk shifting in a sense replicates for firms the dilemma lawmakers face in setting sanctions.

c. Procedure

The procedural rules that govern the investigation and adjudication of securities fraud claims will also influence the level of underdeterrence and enforcement costs the regime produces. Perhaps most importantly, they will influence the occurrence of "false positives" and "false negatives." In the context of securities fraud, "an example of a . . . false positive would be a judicial finding that a defendant had fraudulently misrepresented something, when in fact no fraud occurred";⁴⁹ it is the kind of legal error we have been discussing throughout this Section. A false negative, by contrast, "occurs when a court trying to decide whether the defendant has committed fraud mistakenly finds there has been no fraud, even though fraud actually occurred."⁵⁰

To mitigate the risk of false positives, and hence overdeterrence,⁵¹ lawmakers might impose high burdens of proof or demanding pleading standards on enforcers. Toward the same end, they might require that bonds be posted for costs, adopt "loser pays" fee-shifting rules, or use sanctions to deter marginal suits. But the tradeoff for adopting such rules would be an increased risk of underdeterrence, as meritorious cases might be discouraged *ex ante* and weeded out by procedural obstacles *ex post*, along with more marginal suits. Lawmakers might instead attempt to mitigate false negatives by, for example, adopting low burdens of proof or forgiving pleading standards, in which case the tradeoff would be a greater risk of overdeterrence.⁵²

⁴⁸ See SHAVELL, *supra* note 12, at 526-28 (discussing when permitting sanction insurance is likely to promote social welfare); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1236-37 (1984) (highlighting the tradeoffs between the benefits of risk shifting and the costs of deterrent dilution when agent behavior is unobservable).

⁴⁹ Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 711 (1996).

⁵⁰ *Id.*

⁵¹ False positives can increase underdeterrence costs, as well, by reducing the cost of wrongdoing relative to compliance. See SHAVELL, *supra* note 12, at 452 ("[T]he incentive to obey the law is enhanced by reducing errors that penalize the innocent . . .").

⁵² Certain procedural innovations may improve accuracy without these sorts of tradeoffs—for example, greater rights to appellate review. See Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307, 356 (1994).

In choosing the procedural rules that will govern securities fraud cases, then, lawmakers face yet another difficult challenge. Though the goal is clear enough—to set rules that minimize net social costs—figuring out just what that requires presents murky empirical questions. And, as should by now be obvious, the design of the other components of the securities fraud deterrence regime will dynamically inform the answers. For example, if the regime's substantive prohibition is broad or its sanctions high, it may require tougher procedure than if the opposite were true.⁵³ The characteristics of the enforcer, given special attention next, will also influence the optimal design of a securities fraud deterrence regime.

II. THE VALUE OF A WELL-INCENTIVIZED ENFORCER

Bracketing for a moment the special case of vicarious liability, the overdeterrence risks discussed above are all traceable to a single source: *regulated parties' fear of falsely positive scienter determinations*. Absent such fear, the foregoing design choices would be relatively easy to make—lawmakers clearly should choose a broad substantive fraud prohibition, high sanctions, and enforcer-friendly procedural rules, and should prohibit firms from assuming their agents' securities fraud liability risks. These choices would reduce underdeterrence costs without producing any overdeterrence costs, given that firm agents could costlessly avoid liability simply by declining to engage in (or aid and abet) securities fraud. Lawmakers' only task in such a world would be ensuring that prosecutors are aggressive enough in their enforcement efforts, and that the marginal *direct* enforcement costs produced by the regime do not exceed the marginal savings in underdeterrence costs.

(explaining that “better information or better analysis” can reduce the potential for false positives and false negatives).

⁵³ See, e.g., Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rule-making*, 3 J. LEGAL STUD. 257, 276 (1974) (discussing the reduction of the prosecutor's burden of proof and the increased specificity of the substantive legal rule as alternative methods for increasing deterrence and comparing their relative effectiveness); Johnston, *supra* note 32, at 140 (suggesting that “one way to eliminate over-deterrence is to reduce the legal standard or require a more extreme departure for liability” and that another way is “to increase the plaintiff's burden of proof,” while pointing out that increasing penalties could offset the reduced incentives to comply); V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1514 (1996) (“[T]he possibility of a severe sanction under an uncertain legal standard may chill desirable behavior A higher standard of proof may be useful to mitigate this chilling effect.” (footnote omitted)); Posner, *supra* note 47, at 1206 (“[I]t may make sense to make proof easier but at the same time make the penalty less severe in order to reduce avoidance and error costs.”).

Unfortunately, the risk of falsely positive scienter determinations is significant in securities fraud cases, making overdeterrence an issue that lawmakers must confront in designing the liability regime. This is due in part to the reality that scienter cannot be strongly inferred from the fact that a defendant made a misstatement or, especially, a material omission or erroneous prediction: such events are commonplace in investor communications. As Paul Mahoney has observed, in other types of intentional tort cases "the fact of the harm is a much better indicator of guilty intent."⁵⁴ For example, "it is rare that a person punches another or takes another's property by stealth, without really meaning to do so."⁵⁵ And the risk of error is particularly high in securities fraud cases involving omissions, forward-looking statements, and aiding-and-abetting allegations, given the hindsight bias phenomenon discussed earlier. So the relevant design question becomes: how should lawmakers address the overdeterrence risk that flows from the possibility of legal error in securities fraud cases?

One way lawmakers could approach the issue is by adopting a narrower fraud prohibition, lower sanctions, or more defendant-friendly procedural rules than they would if legal error were not a risk. To determine whether specific variations of this type are desirable, lawmakers would have to predict whether such changes would lead to a net savings in social costs. Unfortunately, this type of analysis may be impossible to do with any degree of confidence. As illustrated in the previous discussion, choices regarding substance, sanctions, and procedure almost invariably involve a tradeoff between over- and underdeterrence costs, and it will be hard for lawmakers to know whether the choices save more in the former than they produce in the latter. The social costs of both fraud and overdeterrence are exceedingly difficult to observe and measure. Moreover, lawmakers cannot anticipate the precise impact of specific design choices on the behavior of collective entities populated by complex human beings. Thus, there will be a great deal of empirical uncertainty regarding whether such variations do more good (by saving enforcement costs) than harm (by increasing underdeterrence costs).

There is an alternative route: lawmakers could focus instead on the incentives of the enforcer. To be sure, an enforcer who is incentivized to pursue at full throttle every case it believes it might win before the factfinder will do nothing to reduce overdeterrence costs. With

⁵⁴ Mahoney, *supra* note 15, at 649.

⁵⁵ *Id.*

that sort of enforcer—whom we might label an “aggressive enforcer”—lawmakers’ only option is to make (or encourage the courts to make) the sorts of adjustments to substance, sanctions, and procedure discussed above. But the same is *not* true if instead the enforcer is incentivized to exercise self-restraint in its enforcement efforts. This type of enforcer would forgo bringing some cases that it might indeed win because it does not believe the defendants truly acted with scienter or because it recognizes that significant uncertainty exists on that score. If the enforcer is more accurate in its scienter assessments than the factfinder (and there are good reasons to believe that it could be⁵⁶), such a self-restrained enforcer could, through its enforcement decisions, reduce the occurrence of false positives and hence the fear of legal error that leads to overdeterrence. Importantly, it could do so without the same tradeoff (in the form of increased underdeterrence) that more sweeping adjustments to substance, sanctions, and procedure would inevitably produce.⁵⁷ Thus, if lawmakers are concerned about overdeterrence, they would be well advised to focus their attention first on improving, to the extent possible, the incentives of the enforcer to exercise this sort of laudable self-restraint. Only once they have exhausted their options in that regard should lawmakers consider what adjustments to substance, sanctions, and procedure are necessary in light of any overdeterrence risks that remain.

Of course, in selecting an enforcer, lawmakers should not single-mindedly focus on reducing the occurrence of false positives. They must also be concerned with the enforcer’s impact on underdeterrence costs. If the enforcer is perceived as incompetent at dis-

⁵⁶ For example, an enforcer is likely to develop expertise regarding corporate communications, as well as a sensitivity to the workings of hindsight bias, that will render it better at making scienter assessments than the factfinder, particularly if the factfinder is a lay jury or a generalist judge. See Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 558-60, 577-78 (2002) (discussing the potential for experts to make better decisions than lay people, including juries and judges, because they have experience with particular substantive questions and an ability to adapt to cognitive limitations that impair decisionmaking).

⁵⁷ Relying on discretionary nonenforcement has long been recognized as a potentially superior alternative to rewriting substantive laws to eliminate overinclusion. See, e.g., William M. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 38 (1975) (arguing that, in light of the inability of the legislature to tailor a criminal statute perfectly, discretionary nonenforcement is an attractive way to reduce the costs of an overinclusive statute without increasing the costs of an underinclusive one). My discussion above suggests that similar advantages may flow from using a self-restrained enforcer in situations where the law itself is not technically overinclusive (and a scienter-based fraud prohibition is not), but rather becomes overinclusive in practice due to legal error.

covering fraud or as reluctant to pursue meritorious cases, the deterrent effect of the regime will be diluted by virtue of a reduction in the probability of enforcement. What lawmakers should want is not an enforcer who is careful to avoid inaccurate prosecution at all costs, but rather one whose incentives are most closely aligned with (or can be forced into closest alignment with) society's interest in achieving optimal deterrence—that is, in minimizing the net social costs of fraud and enforcement. We might label the desired enforcer a “well-incentivized enforcer.”

Selecting a well-incentivized enforcer, as opposed to an aggressive enforcer, carries two other important benefits. First, it would allow for a greater degree of regulatory flexibility. As described above, empirical uncertainty may cause lawmakers to miscalculate the social costs of fraud and overdeterrence and to misjudge how their design choices will affect these costs. Moreover, the discussion in subsection I.A.2 reveals that the magnitude of the social costs of fraud may change over time, as corporate ownership and governance structures evolve. They may also fluctuate depending on macroeconomic conditions. For example, John Coffee has argued that in the euphoria of market “bubbles” gatekeepers and other market-based mechanisms to combat fraud are rendered less effective.⁵⁸ The upshot of these observations is that a securities fraud deterrence regime will need to be adjusted over time, as market conditions change and new information comes to light.

To be sure, lawmakers could make these adjustments by expanding or contracting the scope of the substantive fraud prohibition, raising or lowering authorized sanctions, or changing the relevant procedural rules. But the initial design of these components is likely to be sticky. It takes time and political capital to enact such reforms, and it seems doubtful that lawmakers would succeed in doing so with the regularity and rapidity that an optimal securities fraud deterrence regime likely demands. Relying on the courts to make these adjustments is similarly problematic, given the judiciary's institutional limitations and the slow and incremental nature of case-by-case decisionmaking.

A superior alternative might be for lawmakers to keep substance broad, authorized sanctions high, and procedural rules liberal, and instead to rely on the *enforcer* to make adjustments as circumstances require. For example, the enforcer could respond to new information regarding the social costs from fraud and overdeterrence in real time by ratcheting up or down its enforcement efforts or by changing the

⁵⁸ See Coffee, Jr., *supra* note 26, at 323-26.

amount or type of sanctions it pursues. Similarly, it could alter the types of frauds and defendants it prosecutes most aggressively. The enforcer could make these adjustments with a level of nuance that lawmakers simply could not replicate were they to attempt to write them into law.⁵⁹ But this type of reliance on prosecutorial discretion is palatable only if the enforcer can be trusted to promote optimal deterrence—that is, only if the regime uses a well-incentivized enforcer.

Employing a well-incentivized enforcer would produce yet another important benefit: it would go a long way to alleviate the over-deterrence risk presented by the special case of vicarious liability. As explained in subsection I.B.2.b, vicarious liability threatens to overdeter even in the absence of legal error if sanctions are set “too high.” By the same token, it threatens to underdeter if sanctions are set “too low.” But getting sanctions “just right” can be incredibly difficult. Lawmakers could threaten firms with high authorized sanctions with less concern about overdeterrence, however, if the enforcer could be expected to exercise its prosecutorial discretion wisely in deciding whether to pursue a firm. Corporate boards would feel less pressure to overinvest in precautions, for example, if they trusted that good-faith efforts to create and maintain cost-effective internal controls would dissuade the enforcer from imposing liability on the firm in the event that a renegade agent committed fraud.⁶⁰

* * *

⁵⁹ The enforcer is also better positioned to make these sorts of adjustments than courts. See Richard A. Nagareda, *Class Actions in the Administrative State: Kalven and Rosenfield Revisited*, 75 U. CHI. L. REV. 603, 606 (2008) (observing that the policy concerns underlying discretionary nonenforcement are properly considered “by an administrative agency when setting its enforcement priorities, but they are much more awkward for judicial consideration”).

⁶⁰ This argument assumes that the enforcer can identify adequate internal controls, notwithstanding lawmakers’ inability to discern the information necessary to craft the optimal sanction. Though these propositions stand in some tension with one another, they are not irreconcilable. The information needed to craft the optimal sanction differs somewhat from that needed to determine the cost-effectiveness of internal controls. To set optimal sanctions, one must know both the externalized social costs of fraud and how firms perceive the probability of enforcement. But to identify whether the internal controls a particular firm adopts are adequate, one must estimate only whether the marginal cost of investing more in precautions would have exceeded the marginal gain in the form of reduced social harm from fraud. The latter information may be easier to obtain—or, more realistically, *approximate*—than the former. Cf. Cooter, *supra* note 42, at 1552 (observing that if it is more expensive to obtain “accurate information about external costs” than it is to obtain “accurate information about efficient behavior,” then it is best to enact a standard backed by a “sanction,” rather than to adopt a strict liability rule backed by a “price”).

It might strike the reader as obvious that the incentives of the enforcer are critically important to the design and success of a securities fraud deterrence regime. Nonetheless, the literature critical of the United States' regime tends to take its current mix of enforcers as a given, focusing instead on how substance, sanctions, or procedure ought to be tweaked to move the regime toward optimality.⁶¹ Not surprisingly, the academic debate has a sort of inevitability to it, as scholars with different intuitions about the prevalence of securities fraud and overdeterrence take opposite sides on issues that defy empirical resolution. The debate over Rule 10b-5 class actions vividly illustrates this point. Both the courts and Congress responded to concerns about overdeterrence costs by progressively narrowing the substantive scope of private Rule 10b-5 liability and by toughening procedural rules.⁶²

⁶¹ See, e.g., Rose, *supra* note 8, at 1321-24 (discussing various academic proposals in this vein). There are, however, some exceptions to this trend. See generally A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999) (arguing for enforcement by the securities exchanges); Rose, *supra* note 8 (proposing enforcer-focused securities litigation reform).

⁶² For example, the Supreme Court eliminated aiding-and-abetting liability in *Central Bank of Denver v. First Interstate Bank of Denver*, noting that, in the face of uncertain liability, securities professionals might refuse to provide services to some companies altogether and might increase the prices they charged to others. 511 U.S. 164, 189 (1994). Accordingly, the Court concluded that aiding-and-abetting liability might "exact[] costs that . . . disserve the goals of fair dealing and efficiency in the securities markets." *Id.* at 188. The Court recently reinforced that decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, observing that a broad interpretation of primary liability in private Rule 10b-5 actions might shift securities offerings away from domestic capital markets. 552 U.S. 148, 164 (2008). Courts also developed the "bespeaks caution" doctrine to shield forward-looking statements accompanied by sufficient cautionary language from liability, and Congress later codified a variant of this doctrine in the PSLRA. See 15 U.S.C. §§ 77z-2(c)(1)(A)(i), 78u-5(c)(1)(A)(i) (2006) (providing a safe harbor for forward-looking statements "accompanied by meaningful cautionary statements"). The justification for this statutory safe harbor is explicitly based upon overdeterrence concerns. The PSLRA's Senate Report asserts that "[f]ear that inaccurate projections will trigger the filing of a securities fraud lawsuit has muzzled corporate management"; the safe harbor is thus "intended to enhance market efficiency by encouraging companies to disclose forward-looking information." S. REP. NO. 104-98, at 16 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 695.

Well before the PSLRA, courts began applying heightened pleading standards in Rule 10b-5 class actions. Federal Rule of Civil Procedure 9(b) generally requires heightened pleading in cases alleging fraud, but it provides that allegations of state of mind may be asserted generally. See FED. R. CIV. P. 9(b). Some courts, nonetheless, required more particularized scienter allegations in securities fraud cases given the uniquely high risk of overdeterrence. See Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 549-51 (1998) (discussing pre-PSLRA case law requiring heightened pleading of scienter). The PSLRA later codified that heightened standard, mandating that Rule 10b-5 plaintiffs allege with specificity facts giving rise to

These reforms have provoked a firestorm of controversy showing no signs of abatement. Some believe they were ill-advised and have likely led to a greater increase in underdeterrence costs than a savings in overdeterrence costs, while others think that the reforms have not gone far enough and that Rule 10b-5 class actions likely still do more harm to the economy than good.⁶³ As James Cox and Randall Thomas have observed, very little empirical research exists that might confirm or refute these divergent positions, given the inherent difficulty of measuring the deterrence value of private suits.⁶⁴

What explains the relative lack of attention academics have given to potential *enforcer*-focused reforms? It may be that reforms challenging the allocation of enforcement authority are simply viewed as political nonstarters. But this explanation fails to justify the neglect: political reality changes over time, sometimes in *response* to cogent academic inquiry. Another possibility is that many securities law scholars believe that the mix of federal, state, and private enforcers currently used in the United States is in fact as good as it gets. If this belief exists, however, it lacks foundation: the optimality of the United States' multienforcer approach to securities fraud deterrence has not been subjected to rigorous examination. The next Part begins to fill this void in the literature.⁶⁵

a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(1)–(2). The expressed purpose of this provision is to "curtail the filing of meritless lawsuits." H.R. REP. NO. 104-369, at 41 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 730, 740. The PSLRA also adjusts procedure in other important ways. For example, it stays discovery pending decision on a motion to dismiss, thus relieving the pressure to settle at least through that stage of adjudication. 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B).

⁶³ Compare, e.g., Brief for Former SEC Commissioners and Officials and Law and Finance Professors as Amici Curiae Supporting Respondents at 7, *Stoneridge Inv. Partners*, 552 U.S. 148 (No. 06-43) (warning that reversal could "give rise to substantial costs that might exceed its questionable deterrent benefits"), with Brief for Professors James D. Cox, Jill E. Fisch, Donald C. Langevoort, Richard M. Buxbaum, Melvin A. Eisenberg, and Hillary A. Sale as Amici Curiae Supporting Petitioners at 4, *Stoneridge Inv. Partners*, 552 U.S. 148 (No. 06-43) (cautioning that affirmance "could seriously impair the integrity of our securities markets").

⁶⁴ James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law* 20-21 (Vanderbilt Univ. Law Sch. Law & Econ. Research Paper No. 09-10 & Duke Univ. Law Sch. Pub. Law & Legal Theory Research Paper No. 246, 2009), available at <http://ssrn.com/abstract=1370508>.

⁶⁵ Empirical studies have suggested that private enforcement is more important than public enforcement in promoting financial development. See Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 27-28 (2006) (concluding that public enforcement matters little, if at all, to larger stock markets, whereas "extensive disclosure requirements and standards of [private] liability" matter significantly). More recent scholarship, though, casts doubt on this conclusion, further highlighting the need to

III. WHEN WILL MULTIPLE ENFORCERS PROMOTE OPTIMAL DETERRENCE?

When, if ever, does it make sense to concurrently employ federal agents, state agents, and private parties to deter fraud in the national securities markets? The answer to this question turns on, among other things, one's assumptions about regulatory behavior. Section III.A therefore analyzes the issue under the assumption that public officials seek to maximize the social welfare of the jurisdictions they serve. Section III.B then explores how the analysis changes if we take a more skeptical view.

A. *Public Servants as Social Welfare Maximizers*

If public officials seek to promote the social welfare of the jurisdictions they serve, the United States' current allocation of securities fraud enforcement authority is difficult to defend. As explained below, under this assumption it would be suboptimal to employ private enforcers. Rather, public enforcers would be preferable, and employing an exclusive public enforcer would be better than employing concurrent public enforcers. Moreover, the exclusive public enforcer would best operate at the federal rather than the state level—at least absent the stringent preconditions for effective regulatory competition between states. While other considerations, such as relative detection and resource advantages, might justify an enforcement role for state agents and private parties, their relationship with the federal public enforcer would differ significantly from the relationship that exists today between the SEC, state regulators, and the Rule 10b-5 class action bar.

1. Public vs. Private Enforcement

By definition, a private enforcer is incentivized to maximize her private welfare, which we can expect to diverge from social welfare in significant ways. The potential enforcer-based efficiencies discussed

rethink fundamentally the proper allocation of securities fraud enforcement authority in the United States. See Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* 34 (Harvard Univ. Law Sch. Pub. Law & Legal Theory Research Paper Series, Paper No. 0-28, & John M. Olin Ctr. for Law and Bus. Law & Econ. Research Paper Series, Paper No. 638, 2009), available at <http://ssrn.com/abstract=1000086> (refuting suggestions that public enforcement is unimportant to financial markets by demonstrating that it “correlated significantly with key financial outcomes”); see also Coffee, Jr., *supra* note 11, at 302 (acknowledging that recent evidence casts doubt upon the superiority of private enforcement).

in Part II will therefore be less likely to materialize if the securities fraud deterrence regime is privately enforced than if it is enforced by a faithful public agent.

First, it is reasonable to assume that regulated parties' fear of inaccurate prosecution and legal error would be greater under a private-enforcement regime than under a public-enforcement regime. Whereas our idealized public enforcer would, for example, be sensitive to hindsight bias and weigh the overdeterrence ramifications of prosecuting cases involving forward-looking statements and omissions against the potential savings in underdeterrence costs, private enforcers could not be expected to exercise such self-restraint. Instead, they could be expected to behave like the "aggressive enforcer" described earlier, bringing suit so long as their expected private benefits exceed their expected costs, even if liability is questionable. Moreover, private enforcers could be expected to pursue the highest sanctions available and to exploit procedure to the fullest extent, so long as it is to their personal advantage. Assuming the bounty for bringing suit is substantial enough to make private enforcement worthwhile, the predictable result would be an increase in overdeterrence costs relative to a world with only public enforcement.⁶⁶ This consequence, in turn, would likely cause lawmakers or courts to narrow substance, lower sanctions, or toughen procedure in ways that may—or may not—efficiently mitigate these costs. Again, the history of Rule 10b-5 class action reform starkly illustrates the point.⁶⁷

Second, it is reasonable to assume that a securities fraud deterrence regime would be less flexible if it used private enforcement than if it relied exclusively upon public enforcement. Private enforcers

⁶⁶ If the rewards for bringing suit were not substantial enough to make private enforcement profitable, underdeterrence costs would increase relative to a world with exclusive public enforcement. Cf. Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333, 334 (1982) (asserting that the "divergence between the social and the private benefits of suit may result either in a tendency toward too little litigation . . . or toward too much litigation").

⁶⁷ See *supra* note 62 and accompanying text. Notably, most of the limitations that have been imposed on private Rule 10b-5 litigants do not constrain the SEC. For example, the PSLRA's safe harbor for forward-looking statements does not apply to SEC enforcement actions, nor do its pleading requirements or discovery stay. See 15 U.S.C. §§ 77z-2(c)(1)(A)(i), 78u-5(c)(1)(A)(i) (safe harbor requirement); 15 U.S.C. § 78u-4(b)(1)–(2) (heightened pleading requirements); 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B) (discovery stay). Moreover, the SEC retains authority to pursue aiders and abettors. See 15 U.S.C. § 78t(e) (expressly granting the SEC this authority). Ostensibly, those who have crafted these reforms believe that the SEC presents fewer overdeterrence risks relative to private enforcers, such that authority that is intolerable in the hands of the latter is not when entrusted to the former.

could not be expected to use their discretion to balance concerns for underdeterrence and enforcement costs the way our idealized public enforcer could.⁶⁸ Thus, if new information or changed circumstances called for an adjustment in enforcement policy, lawmakers would be unable to trust private enforcers to make that adjustment. Instead, lawmakers would be constrained to leave it to the courts or to do it themselves by reforming substance, sanctions, or procedure directly—with all the additional transaction costs those reforms entail. By contrast, in a world of public enforcement lawmakers could rely on the enforcer to respond in a more adroit fashion.

That private enforcement precludes reliance on prosecutorial discretion makes it a particularly costly choice for a regime that imposes vicarious liability on firms. One need not accept the proposition that private enforcers are likely to pursue marginal claims to agree that vicarious liability is more likely to overdeter in a regime of private enforcement than in a regime of public enforcement. Vicarious liability, recall, threatens to overdeter, even in the absence of any fear of legal error, if sanctions are set “too high.” As noted in Part II, an enforcer can help reduce this risk of overdeterrence by signaling to firms that they will escape liability for their agents’ frauds if they can demonstrate that they took efficient precautions. A private enforcer, however, is unlikely to send such a signal. Instead, the private enforcer could be expected to name the deep-pocketed firm as a defendant in every case it deemed economical to pursue. Thus, getting sanctions “just right” is more important in a world with private enforcement than in one with only public enforcement.

Ironically, it is also more difficult. If the sanction paid by the defendant is the recovery received by the private plaintiff, lawmakers will face a quandary that William Landes and Richard Posner long ago dubbed “the overenforcement theorem.”⁶⁹ The quandary emerges because profit-driven private enforcement makes it impossible for lawmakers to set the probability of detection and the magnitude of sanctions independently. To return to an earlier example, assume lawmakers raise the sanction for fraud from \$100 (the actual social costs) to \$200 in an attempt to compensate for a 50% probability of nonenforcement. Private parties would predictably respond to the higher potential recovery by investing more resources in enforcement,

⁶⁸ See Landes & Posner, *supra* note 57, at 38 (observing that discretionary non-enforcement “would not be a feature of private enforcement: all laws would be enforced that yielded a positive expected net return”).

⁶⁹ *Id.* at 15.

which would increase the probability of enforcement and in turn increase the expected sanction beyond its efficient level. If lawmakers responded by decreasing the sanction, enforcement would drop, and the problem would manifest in reverse. The upshot is that lawmakers would be hard-pressed to reach an enforcement equilibrium in a world with private enforcement.⁷⁰ With exclusive public enforcement, by contrast, a “high fine need not be taken as a signal to invest greater resources in crime prevention, since the public enforcer is not constrained to act as a private profit maximizer.”⁷¹ Thus, expected sanctions could be more stably set.

The overenforcement theorem can be solved if the sanction paid by the defendant is “decoupled” from the bounty received by the private enforcer; in class action litigation, for example, the plaintiffs’ attorney (who is the real impetus behind the suit) recovers only a portion of the sanction paid by the defendant. But this solution introduces its own problem: it “would drive a wedge between what offenders paid and what enforcers received,” and thereby create opportunities for collusive settlements.⁷² And it would still leave lawmakers with the unenviable task of attempting to craft the “optimal” sanction, which is, even apart from the complications introduced by the overenforcement theorem, exceedingly difficult to do for reasons previously discussed.

For purposes of this Article, the important point to take away is that private enforcement introduces a host of costs that could be avoided if lawmakers relied instead on a well-incentivized public enforcer. Only if we question the motivations of the public enforcer (or the government actors who control it) does private enforcement emerge as a potentially rational approach to securities fraud deterrence.

⁷⁰ Contract breaches and common law torts (including common law fraud actions that involve privity of dealing between the victim and the fraudster) may have a detection rate close to 100%. If so, private enforcement would not cause the instability problem described here and would therefore be less of a concern. *See id.* (explaining why the overenforcement theorem does not become a problem when the detection rate is 100%). Private enforcement would remain problematic, however, if inaccurate prosecution and legal error were significant concerns, or if the violation called for conditional deterrence and sanctions were particularly difficult to calculate.

⁷¹ *Id.*

⁷² *Id.* at 24. These opportunities arise because both parties would be better off negotiating a settlement for an amount that is less than the sanction facing the defendant but more than the bounty promised the enforcer. While settlements could be made subject to court approval, this is unlikely to be a foolproof remedy. *See* Brian T. Fitzpatrick, *The End of Objector Blackmail?*, 62 VAND. L. REV. 1623, 1652 n.106 (2009) (quoting commentators who explain why courts tend to favor even poor settlements).

2. Concurrent vs. Exclusive Enforcement

Part II explained why a well-incentivized enforcer may be better positioned to minimize the net social costs of a securities fraud deterrence regime (through careful use of prosecutorial discretion) than lawmakers or courts (through more formal, and predictably intermittent, adjustments of substance, sanctions, and procedure). That discussion assumed, however, that only *one* enforcer would be calling the shots. If instead concurrent enforcers were employed—that is, if multiple enforcers shared jurisdiction over the same regulated parties, with none exercising control over the discretionary enforcement decisions of the others (as do the SEC and state securities regulators)—prosecutorial discretion would lose much of its luster. Even if each enforcer were well incentivized to promote optimal deterrence, concurrent enforcers might rationally pursue enforcement strategies that, in combination, would lead to perverse results.

A simple example illustrates this point. Assume lawmakers have granted two enforcers, *X* and *Y*, concurrent enforcement authority over Firm *A* and its agents and affiliates. Both *X* and *Y* have recently come to believe that the securities fraud deterrence regime is producing excessive underdeterrence costs (i.e., that the regime could be adjusted in some way that would save more in underdeterrence costs than it would create in new enforcement costs). A variety of potential fixes are available; for example, aiders and abettors might be pursued more aggressively, higher sanctions might be imposed, more cases might be brought (increasing the probability of enforcement and, thus, expected sanctions), and so forth. Any of the foregoing adjustments to the regime could be anticipated to lower underdeterrence costs, albeit at the price of some (hopefully smaller) increase in overdeterrence costs. However, if *X* and *Y* make adjustments simultaneously, the combined effect might very well overshoot the mark.

Assume, for instance, that *X* doubles the sanctions it seeks to impose on violators, whereas *Y* doubles the number of enforcement actions it brings. Firm *A* and its agents and affiliates—who, recall, are susceptible to prosecution by both *X* and *Y*—would then face expected sanctions higher than intended by either *X* or *Y*. Whereas *X*'s or *Y*'s adjustment may have been efficient standing alone, in combination their adjustments may be less efficient, or may in fact do more harm than good (by increasing enforcement costs more than they decrease underdeterrence costs). Similar complications might arise if *X* and *Y* simultaneously reduce enforcement efforts in an attempt to mitigate excessive overdeterrence.

There is an obvious rejoinder to this concern: *X* and *Y* could—and, given our assumption of public-spiritedness, presumably *would*—voluntarily coordinate their enforcement efforts. They might consult with one another before making adjustments in enforcement policy, for example, or resolve to focus their energies on different types of firms, allocating responsibility in a way that caters to each enforcer's comparative advantage. But coordination requires effort and thus is not costless. The greater the number of enforcers, the costlier it will be. More worrisome, voluntary coordination can break down if disagreements arise over the best enforcement approach. This is a realistic possibility, even among well-incentivized enforcers, given the significant empirical uncertainty that will exist regarding the relative level of under- and overdeterrence costs.

If such a breakdown occurs, the enforcer concerned about underdeterrence will *always* stand in a position to thwart the efforts of the enforcer who is concerned about overdeterrence, leading to a potentially ill-advised ratcheting up of enforcement intensity. This is because market participants will predictably respond to the signals of the strictest enforcer with authority over them and conform their behavior accordingly. Thus, assume that *X*, in an effort to mitigate overdeterrence, chooses to forgo pursuing significant sanctions against firms that can demonstrate that they made good-faith efforts to create and maintain cost-effective internal controls, or decides to use extreme caution in pursuing claims premised on forward-looking statements, believing that such claims chill desirable disclosure. If *Y* disagrees that overdeterrence is a problem, and thus seeks heavy sanctions against firms notwithstanding a showing of good faith, or aggressively prosecutes cases involving forward-looking statements, it will defeat *X*'s efforts to cabin overdeterrence costs.

Without some affirmative reason to think that tougher enforcement is always better, it is unclear why lawmakers should opt for a system that is structurally biased in this way. The better approach would be to select the enforcer most likely to get enforcement policy right with respect to a particular group of regulated parties, and to grant that enforcer exclusive authority over them.

3. Federal vs. State Enforcement

All else being equal, then, in a world with faithful government agents the potential for achieving optimal deterrence is enhanced if regulated parties are subject to an exclusive securities fraud enforcer, and a public one at that. But should this enforcer be accountable to

the federal government or to a particular state government? Scholarship on the “economics of federalism” provides a principle to guide the assignment of jurisdiction. It instructs that

[i]f the costs and benefits of an action, whether public or private, stray across jurisdictional lines, then the highest level of government that can fully internalize the costs and benefits of the action ought to take responsibility. Only then will a governmental authority have the appropriate incentives to regulate the externality-generating activity.⁷³

This formulation supports assigning the federal government responsibility for deterring fraud in the national securities markets, while assigning state governments responsibility for deterring fraud targeted at their respective local capital markets.

No individual state would fully capture the benefits of designing an “optimal” liability regime for deterring fraud in the national securities markets, as those benefits would spill over to the national economy. As a result, states would predictably underinvest in the effort. They might, for example, devote their limited resources to issues of more local concern, neglecting national securities frauds. Conversely, they might use their authority aggressively to impose monetary sanctions on offenders to generate revenue for their state, without fully internalizing the potential overdeterrence costs of their actions. As Samuel Issacharoff and Catherine Sharkey explained, “Elected state officials could well respond to the political preferences of the voters of any particular state yielding ‘intra-jurisdictional efficiency’ at the expense of the ‘inter-jurisdictional efficiency’ concerns of the polity writ large. The end result could be underregulation or overregulation.”⁷⁴

If the preconditions for effective “regulatory competition” existed, the natural misalignment of states’ incentives could theoretically be overcome, and assigning jurisdiction to the states, rather than the federal government, would be preferable.⁷⁵ These preconditions include (1) that each firm is allowed to choose which state’s securities fraud liability regime will have exclusive jurisdiction over it; (2) that a sufficiently large number of states compete to attract and retain such

⁷³ Thomas S. Ulen, *Economic and Public-Choice Forces in Federalism*, 6 GEO. MASON L. REV. 921, 928 (1998).

⁷⁴ Samuel Issacharoff & Catherine M. Sharkey, *Backdoor Federalization*, 53 UCLA L. REV. 1353, 1387 (2006) (footnotes omitted) (citing Robert P. Inman & Daniel L. Rubinfeld, *Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism*, 75 TEX. L. REV. 1203, 1234 (1997)).

⁷⁵ This idea is traceable to Charles M. Tiebout’s seminal article, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

firms, lured by the prospect of fees or other benefits to the state that flow from being chosen; (3) that firms are able to switch between competing jurisdictions cheaply; (4) that investors desire a securities fraud liability regime that best approximates optimal deterrence; (5) that investors are able to discern differences in regulatory approaches, and thus to identify the jurisdiction that best approximates optimal deterrence and reward firms that choose it; and, finally, (6) that firms' agents are responsive to investors.

A functioning system of this sort would offer an important advantage over assigning the federal government exclusive jurisdiction to police fraud in the national securities markets: it would generate critical information about the efficacy of regulatory choices. As the discussion thus far has illustrated, the task of crafting an optimal securities fraud liability regime is beset with uncertainty. To return to our recent examples, would Enforcer *X*'s or Enforcer *Y*'s enforcement policies better approximate optimal deterrence? It is impossible to say as a matter of theory. Under the conditions of regulatory competition spelled out above, however, these various approaches could each be implemented, and their effects observed, and ultimately judged, by investors. The migration of firms to a particular jurisdiction would indicate that the jurisdiction had selected the most efficient regulatory approach.⁷⁶ If the preconditions spelled out above are not met, however, it would be difficult to judge the meaning of the information regulatory competition produced, and Occam's Razor would counsel in favor of exclusive federal jurisdiction.⁷⁷

⁷⁶ See ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 45 (2002) ("Competing regulators would make fewer policy mistakes than a single regulator as competition harnesses the incentives of the market to regulatory institutions.").

⁷⁷ The debate over regulatory competition as it relates to corporate law continues. See generally ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) (arguing that state competition for revenues from corporate charters has produced a system that, for the most part, benefits investors); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992) (suggesting limitations of state charter competition and advocating increased federal involvement in corporate law); Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067 (2008) (positing that federal preemption of securities law enhances competition); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (proposing increased federal interest in corporate law in light of Delaware's lead in the "race to the bottom"); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that state corporate regulation is superior to federal).

4. Other Considerations

Before asking how relaxing our assumption of social welfare-maximizing public servants changes the analysis, it is worth pausing to explore briefly a few other considerations that are commonly advanced in support of concurrent state and private enforcement. Closer analysis reveals that these considerations either (1) are unpersuasive in a world with faithful government agents or (2) potentially support a role for states or private parties in securities fraud deterrence very different from the one they currently play in the United States.

a. *Detection Advantages*

It is sometimes suggested that states or private parties may be better positioned to detect fraud than the federal government.⁷⁸ State regulators, for example, may be more accessible than their federal counterparts to investors complaining of fraudulent practices, and employees likely stand in the best position to uncover fraud at their employing firms. But even assuming that states and private parties do enjoy certain detection advantages, it does not follow that they ought to be granted concurrent enforcement authority. The federal government could instead offer them inducements to provide information to the federal enforcer, or permit them to sue subject to the federal enforcer's oversight. This approach would allow the federal government to exploit the detection capabilities of state regulators and private parties, while avoiding the potential complications that can arise when multiple independent enforcers are employed. Such an approach would differ markedly from the approach currently taken in the United States, which gives the SEC no control over state or private enforcement efforts, and in fact permits states to craft substantive rules, sanctions, and procedural rules in ways that diverge from federal law.

b. *Enforcement Efficiencies*

It is also sometimes suggested that enforcement efforts may be undertaken more efficiently in a regime that relies on private rights of action than in one that relies on a government enforcement bureau-

⁷⁸ See, e.g., *NASAA to Obama: Limiting Preemption Protects Investors*, NASAA INSIGHT (N. Am. Sec. Adm'rs Ass'n, Wash., D.C.), Spring/Summer 2009, at 1, available at http://www.nasaa.org/content/Files/NASAA_Insight_SpringSummer09.pdf (touting state regulators' role in fraud detection given, in the words of then-NASAA President and Colorado Securities Commissioner Fred Joseph, their "unique proximity to investors and to the industry participants within their state borders").

cracy.⁷⁹ But, assuming as we are that the public enforcer acts to promote optimal deterrence, there is no reason to think that private enforcers will make more cost-effective choices as viewed from a societal perspective; indeed, the opposite should be expected.⁸⁰ Moreover, public enforcement may provide economies of scale in the detection and prosecution of offenses that cannot easily be replicated in a regime of private enforcement.⁸¹

c. *Resource Constraints*

It is also often argued that budgetary constraints at the federal level warrant supplementary enforcement by the states or private parties.⁸² This argument, like the last, proceeds from a jaundiced view of public servants and thus is more appropriately treated in the next Section: in a world filled with public-spirited politicians, the budget afforded the federal securities fraud enforcer would, ipso facto, be set at an amount believed to be socially optimal. If politicians lacked adequate funds, they would raise taxes. But let us nevertheless assume that resource constraints might be a problem, even in a world with faithful government agents. It does not follow that granting multiple enforcers full, concurrent enforcement authority is the answer. The federal enforcer

⁷⁹ See, e.g., John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 224-25 (1983) (asserting that while it might be "more efficient for public agencies to concentrate on detection," litigation should be left to private enforcers).

⁸⁰ As Louis Kaplow observed,

[A] general belief in the efficient functioning of the markets does not provide any basis for inferring good results in adjudication (unless the form of adjudication was itself chosen in the market, as when it is specified by contract). The reason is that virtually every act of a litigant, by design, hurts the opponent; externalities are thus a central characteristic of behavior in litigation. This fundamental difference between litigation and other goods and services is often overlooked.

Kaplow, *supra* note 52, at 338 n.87.

⁸¹ See SHAVELL, *supra* note 12, at 581 (suggesting that if private enforcement were used in situations where effort must be expended to identify and apprehend violators, it would best be "undertaken by a large organization that has the basic characteristics of public enforcement organizations").

⁸² See, e.g., Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 126-27 (2005) ("Because the SEC lacks adequate resources to effectively police the national securities market, supplemental enforcement is essential to achieve an appropriate level of deterrence."); Langevoort, *supra* note 16, at 652 (accepting "the conventional view that private litigation is a necessary supplement to SEC enforcement" because of federal resource constraints, while suggesting that Rule 10b-5 class actions could be eliminated entirely "in a world with an optimally staffed SEC").

could be relieved of its budgetary pressure if states or private parties were granted the right to sue *subject to* the federal enforcer's continued oversight and control. The federal enforcer could use its oversight authority to prevent duplication of effort and to ensure that neither states nor private parties pursued cases not in the public interest. This way, supplemental enforcement resources could be marshalled without sacrificing the advantages of exclusive federal enforcement.⁸³

d. *"Laboratories of Democracy"*

No metaphor is as often, and as inappropriately, used to support concurrent state enforcement as Justice Brandeis's famous reference to the states as democratic "laboratories" of policy experimentation.⁸⁴ First, there is nothing democratic about allowing one state to set national policy. Giving states concurrent authority to enforce a deterrence regime targeted at national securities frauds effectively does this because, as explained above, regulated parties will conform their behavior to meet the demands of the strictest regulator with authority over them. Thus, the vast majority of states across the nation could want to reduce excessive overdeterrence costs, but if a lone state decides underdeterrence is the bigger concern, it could single-handedly undermine the majority view by intensifying its enforcement policies.⁸⁵ Second, in a regime of concurrent enforcement (in sharp contrast to a regime of true regulatory competition) the import of the states' "experiments" with securities fraud deterrence will be impossible to discern, given that the combined choices of multiple enforcers will be responsible for a single outcome. This result, too, has antidemocratic implications because it obscures accountability.

B. *Public Servants as . . . Something Else*

Let us now drop our Pollyanna assumption and take a more realistic view. Public servants surely act to maximize their individual welfare, rather than the social welfare of the jurisdictions they serve—at

⁸³ For such a system to be effective, states and private parties would have to be given appropriate incentives to pursue cases notwithstanding the potential intervention of the federal enforcer. See Rose, *supra* note 8, at 1357 & n.253 (describing mechanisms to maintain such incentives in an oversight regime).

⁸⁴ *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may . . . serve as a laboratory . . .").

⁸⁵ State regulation of purely *intrastate* frauds, by contrast, clearly does promote democratic principles due to the absence of any spillover effects.

least some of the time. They are also human beings and are bound to make mistakes. What impact does this have on our preference for an exclusive federal enforcer?⁸⁶ More specifically, does it justify a multi-enforcer approach to securities fraud deterrence like the one taken in the United States? Some supporters of the current regime contend that the answer is yes. They warn of SEC capture and complacency, make assertions regarding the relative competencies of government and profit-motivated lawyers, and argue that Congress cannot be trusted to use its influence over the SEC in socially desirable ways.⁸⁷ But these assertions tend to be poorly specified,⁸⁸ and alone they fail to do the work needed to justify the concurrent use of federal, state, and private enforcers.

Three things must be true—in addition to the assumption of imperfect government actors—for a multi-enforcer approach to promote optimal securities fraud deterrence. As elaborated below, it must first

⁸⁶ How this reality affects a preference for regulatory competition among states is beyond the scope of this Article.

⁸⁷ See, e.g., Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 99 (2008) (observing that “securities class actions . . . guard against selective enforcement and inaction by the SEC” and “overcome[] lackluster governmental incentives”); Jones, *supra* note 82, at 122 (arguing in favor of dual state/federal securities enforcement because “the existence of multiple layers of government makes regulatory capture a more arduous task for interest groups”); see also Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 958 (2005) (suggesting that the SEC’s passivity in the wake of recent corporate scandals “was likely caused by the agency’s capture by the very special interests it was ostensibly regulating,” along with “the acquiescence of Congress and the relevant oversight committees that monitor the SEC and control its budget”).

⁸⁸ Criticisms of the SEC also tend to be only anecdotally supported. There are, however, some notable recent exceptions. See Maria M. Correia, *Political Connections, SEC Enforcement and Accounting Quality* 4 (Rock Ctr. for Corporate Governance, Working Paper No. 61, 2009), available at <http://ssrn.com/abstract=1458478> (presenting evidence “that firms with low accounting quality have greater political expenditures on average” and that they increase these expenditures “during the period of misreporting and are more likely to target them to the Congressional Committees with stronger ties to the SEC during this period”); Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers* 64-65 (Aug. 11, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1333717> (presenting evidence that the SEC treats big broker-dealer firms and their employees more favorably than they treat smaller broker-dealer firms and their employees, thus providing tentative support for the proposition that SEC officials treat defendants that could be their prospective employers preferentially); Frank Yu & Xiaoyun Yu, *Corporate Lobbying and Fraud Detection* 29 (Feb. 9, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=954368> (presenting evidence showing that lobbying firms have a lower fraud detection rate and evade detection longer than nonlobbying firms, and that fraudulent firms spend more on lobbying than nonfraudulent firms).

be the case that the federal enforcer, if given exclusive enforcement authority, would systematically deviate from optimality by excessively underdetering national securities frauds. If, instead, the federal enforcer systematically erred on the side of excessive enforcement, additional enforcers would be no antidote. Second, it must also be the case that exposing market participants to concurrent state or private enforcement would save more in underdeterrence costs than it would create in additional enforcement costs. Were it otherwise, using multiple enforcers would leave society worse off. Finally, it must be true that a greater net savings in social costs could not be realized by adopting alternative reforms designed to align more closely the federal enforcer's incentives with the national interest. Such alternative reforms should not be overlooked, as they hold the promise of reintroducing the enforcer-based efficiencies discussed in Part II—efficiencies that are lost or weakened when multiple enforcers are employed.

1. Systematic Underdeterrence?

One should not leap from the assumption of imperfect government actors to the conclusion that an exclusive federal enforcer would systematically underdeter. Predicting actual regulatory outputs requires a host of additional theoretical and empirical assumptions—assumptions that we should make explicit and carefully examine. The most fundamental of these is the presumed motivation of government actors. What drives government behavior, if not pure public-spiritedness? The answer one offers to this question, and the further assumptions one makes about the particular political economy under examination, will inform one's judgment about whether an exclusive federal enforcer would systematically underdeter. It will also inform one's judgment about whether concurrent state enforcement would do more harm than good, and the types of alternative reforms best suited to deal with systematic underdeterrence (should it prove to be a risk). Thus, much is lost by glossing over these specifics.

Two common motivational assumptions are briefly discussed below. The first is premised on public-choice postulates and the second on the teachings of psychology and organizational theory. As the discussion illustrates, neither leads inevitably to the conclusion that an exclusive federal enforcer would systematically underdeter.

a. *A Public-Choice Account*

Public-choice theory posits that people in government, like everyone else, act rationally to maximize their own utility.⁸⁹ If we ascribe this motivation to government actors, what would it suggest about the behavior of an exclusive federal securities fraud enforcer?

One cannot begin to answer that question without making yet another assumption, this time concerning the relationship between legislators and the enforcement agency. One school of thought is that administrative agencies like the SEC are under the effective control of Congress, and, more specifically, the congressional subcommittees responsible for the agency's oversight.⁹⁰ According to this so-called "congressional dominance" model, we should look to the utility function of the members of the relevant subcommittees when predicting the agency's behavior.⁹¹ A competing assumption is that congressional control over the bureaucracy is incomplete, and that agencies therefore retain substantial discretion in carrying out their duties.⁹² Under this so-called "bureaucratic slack" model, one should focus on the utility functions of those *within* the agency, as well.⁹³ Both assumptions are discussed below. Neither points clearly in the direction of systematic underdeterrence.

i. *Congressional Dominance*

What would members of the relevant congressional subcommittees prefer when it comes to securities fraud enforcement? A simplify-

⁸⁹ See DENNIS C. MUELLER, PUBLIC CHOICE III 1-2 (2003) ("The basic behavioral postulate of public choice . . . is that man is an egotistic, rational, utility maximizer.").

⁹⁰ See Barry R. Weingast, *The Congressional-Bureaucratic System: A Principal Agent Perspective (With Applications to the SEC)*, 44 PUB. CHOICE 147, 149 (1984) (arguing that "[i]t is not a bureaucratic imperative that drives agency decisionmaking but rather a congressional-electoral one" and detailing the mechanisms through which Congress exerts control).

⁹¹ See *id.* at 150 ("For any particular agency . . . it is not the Congress as a whole that is relevant for policymaking but rather the committee(s) with jurisdiction over the agency.").

⁹² "Bureaucracies have autonomy, it is often said, simply because the disciplinary weapons that external political forces might wield are imperfect . . ." Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1602 (2006). Moreover, intra-agency agency costs may lead to "outcomes that diverge from what even the agency itself, if we imagine it anthropomorphically, would consider to be in its best interest." *Id.* at 1603.

⁹³ See Barry R. Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765, 767 (1983) (describing the view that "bureaucratic insulation affords bureaucrats a degree of discretion which, in turn, is used to pursue their own private goals").

ing assumption employed in the public-choice literature is that legislators are “political support maximizers”—meaning that they use their influence over the bureaucracy in whatever way maximizes their likelihood of reelection.⁹⁴ This assumption, in turn, begs another question: how do politicians maximize the likelihood of their reelection? The answer, of course, is that it depends on the context.

One possibility is that politicians maximize their reelection chances by advancing the policy preferences of their constituents. If this is correct, the next question becomes what those voters will prefer with respect to securities fraud enforcement. It seems unlikely that the right answer is “systematic underdeterrence.” It is more probable that voters would favor excessive enforcement. Securities fraud is, after all, an issue that garners the ire of citizens,⁹⁵ who likely fail to appreciate the less visible costs of overdeterrence.⁹⁶ Voter-responsive politicians might therefore push the agency to overenforce, at least in the wake of well-publicized corporate scandals.⁹⁷

But in the absence of headlines focusing their attention on the issue, voters may not pay much attention to politicians’ positions on securities fraud enforcement.⁹⁸ Legislators’ political support-maximizing strategy during these quiet times might therefore be to defer to special interest groups, who promise in return to support the legislators’ reelection bids. If this were the case, what would it portend for securities fraud enforcement? Again, more information is

⁹⁴ Cf. Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 42 (1998) (noting that although “it seems safe to assume that legislators seek to retain their positions in office,” there are problems with assigning too much weight to legislators’ electoral goals).

⁹⁵ See A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1078 (2005) (noting the “public outrage” over corporate accounting frauds following the collapse of Enron and Worldcom).

⁹⁶ See Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 16, 45 (2003) (observing that “investors are likely to exaggerate the likelihood of fraud given its salience,” while often ignoring the “widely dispersed, and thus less observable, potential benefits from reducing regulatory costs”).

⁹⁷ See Pritchard, *supra* note 95, at 1078, 1082 (describing the “political overreaction to the fallout of corruption revealed by a bear market,” and observing that scandal-driven reforms spurred by a desire on the part of politicians to “do something[]” . . . may prove to be costly, ineffective or counterproductive”).

⁹⁸ See John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT’L L. 531, 561 (2001) (“[D]uring periods of ‘normal’ politics when securities-related issues are not on the ‘public agenda,’ . . . most voters do not concern themselves with the ordinary activities of the SEC.”) (footnote omitted) (citing Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. (SPECIAL ISSUE) 167 (1990)).

needed. What special interest groups would dominate, and what would they want? After all, if legislators were “captured” by a group interested in optimal deterrence, the result would count *against* a multienforcer approach.

It is not unrealistic to believe that such a well-meaning lobby might capture politicians.⁹⁹ One would not expect institutional investors, for example, to lobby for systematic underdeterrence, and there is some evidence that these investors hold sway in Congress and, indirectly, over the SEC.¹⁰⁰ Financial services firms, too, might be opposed to systematic underdeterrence, given that securities fraud hurts their bottom line by decreasing liquidity and chilling transactions.¹⁰¹ Securities fraud also clearly harms corporate issuers by raising the cost of capital.¹⁰²

This is not to say that no forces might emerge that prefer underdeterrence. Disloyal corporate managers or individual members of financial services firms, for example, might wish to commit fraud with impunity, or they may be honest but risk averse and fear the potential imposition of wrongful liability. In either case, they may have an incentive to lobby for excessively light enforcement. Moreover, even if financial services firms and corporate issuers support optimal securities fraud deterrence in theory, they might nonetheless lobby for a weakened enforcement agency if that agency possesses *other* regulatory authority over them that they wish to undermine.¹⁰³

The strength of any incentive on the part of individuals or firms to lobby for underdeterrence (or for a weakened enforcement agency more generally) must be evaluated, however, in light of the possibility

⁹⁹ See *id.* at 564 (“It may well be that the externalities of securities regulation are sufficiently small that what is good for capital-raising firms is good for America.”); Langevoort, *supra* note 92, at 1599 (“[W]e could expect a reasonably vigorous antifraud program from the SEC even with general industry capture . . .”).

¹⁰⁰ See generally Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273 (1984) (applying a political support-maximization theory to explain the SEC’s abolition of fixed-rate commissions on the NYSE in the face of the rise of institutional investors as a powerful interest group).

¹⁰¹ See Pritchard, *supra* note 61, at 966-76 (explaining that floor traders, market makers, and brokers should be proponents of vigorous antifraud enforcement given fraud’s effect on liquidity and transaction volume).

¹⁰² See *supra* subsection I.A.1 (explaining how securities fraud works to increase firms’ cost of capital).

¹⁰³ See Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story* 16 (Georgetown Law Faculty Working Papers, Research Paper No. 1475433, 2009), available at <http://ssrn.com/abstract=1475433> (“It is not because Wall Street wants to protect someone like Bernie Madoff, but because the abundance of tools and resources that might make [catching people like him] more likely . . . can too easily be put to use to threaten more sensitive interests.”).

mentioned at the outset: when scandal breaks, politicians may shift loyalties to placate voter outrage, resulting in increased regulation and higher enforcement intensity.¹⁰⁴ Anticipating this possibility, these actors may conclude that it is in their long-term best interest to support a robust deterrence regime that decreases the likelihood of scandals—and the harsh regulatory consequences that tend to follow in their wake.

My purpose here is not to make an actual prediction about which group, if any, would succeed at “capturing” the relevant congressional subcommittees, nor is it to guess what that would mean for securities fraud deterrence. Instead, the discussion is meant simply to illustrate that under some of the most standard assumptions in the public-choice literature, it is not *obvious* that we should expect excessive underdeterrence from exclusive federal enforcement.

ii. Bureaucratic Slack

According to the “bureaucratic slack” model, to predict agency behavior we should focus not only on the utility functions of the members of the relevant congressional subcommittees, but also on those of enforcement-agency personnel. What would motivate the personnel of an exclusive federal securities fraud enforcer, and what does this suggest about the likelihood of systematic underdeterrence? The answer, again, depends on the context.

For example, if agency personnel care primarily about increasing their leisure time, systematic underdeterrence is likely. If, however, they wish above all else to expand the jurisdiction and resources of the agency they serve, it is less clear that systematic underdeterrence would be the dominant strategy. If, instead, agency personnel care mostly about maximizing their future employment prospects, the implications are similarly uncertain. If future employers prefer weak securities fraud enforcement, agency personnel might underdeter in an attempt to curry favor. But that may not be the right assumption. For reasons discussed above, financial services firms and corporate issuers may prefer an optimal securities fraud deterrence regime. And, in any event, these may not be the future employers that enforcement agency personnel have in mind. Instead, agency personnel may anticipate employment at one of a handful of white-shoe law firms—firms that make money defending against securities fraud enforcement actions, not sitting on their hands. Thus, it has been observed that SEC

¹⁰⁴ See *supra* note 97 and accompanying text.

enforcement personnel may not maximize their career value by catering to Wall Street but rather “from having a reputation for being quite aggressive.”¹⁰⁵ By being aggressive, enforcement agency personnel not only serve the interests of the securities defense bar in general,¹⁰⁶ but they also underscore how lucrative their relationships with agency insiders could be to future clients. Moreover, aggressive enforcement provides agency personnel with more opportunities to gain valuable litigation experience.

A caveat is again in order: my goal here is not to offer a prediction about the likely motivations of agency personnel, but simply to illustrate the uncertainty of the proposition that excessive underdeterrence would necessarily flow from exclusive federal securities fraud enforcement—even if one concedes that a so-called “revolving door” exists between government and the private sector.

b. *A Behavioral Account*

Rather than highlighting the pursuit of self-interest as the main reason government actors may deviate from the public interest, a behavioral perspective would give primacy to certain cognitive biases likely to infect even a well-meaning agency’s operations.¹⁰⁷ In the context of securities fraud, a number of well-chronicled cognitive biases could be expected to skew an enforcement agency’s cost-benefit calculations, leading to suboptimal deterrence.¹⁰⁸

For example, the “so-called ‘availability heuristic,’ whereby salient risks are more available to one’s mind and thus receive more attention, as well as the ‘representativeness heuristic’ and ‘probability neglect,’ according to which people tend to overstate the probability of some bad recent event occurring again in the future,”¹⁰⁹ could lead agency personnel to place undue weight on the risk of fraud (which they see realized on a daily basis) relative to the less-visible risk of overdeterrence. This tendency may be exacerbated by “loss aversion,”

¹⁰⁵ Langevoort, *supra* note 92, at 1621.

¹⁰⁶ *Id.*

¹⁰⁷ See Rachlinski & Farina, *supra* note 56, at 562-82 (comparing public-choice and psychological explanations for government error).

¹⁰⁸ For a catalog of the behavioral biases that may plague an organization like the SEC, see Choi & Pritchard, *supra* note 96, at 21-36. Behavioral biases may also affect securities fraud enforcement by influencing lawmakers’ decisions regarding the scope of the enforcer’s authority and the size of the enforcer’s budget.

¹⁰⁹ Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1008.

or “the idea that people disfavor a loss more than they value a similar gain,” which may likewise cause agency personnel to “focus[] on preventing losses caused by fraud at the expense of yet-to-be realized benefits” in the form of reduced overdeterrence costs.¹¹⁰

The so-called “self-serving inference,” whereby the mind in ambiguous situations “tends to form stronger-than-justifiable inferences in the direction of a person’s self-interest,”¹¹¹ may also exacerbate the tendency to overweigh underdeterrence costs relative to overdeterrence costs. This result may occur if “good economic outcomes (e.g., lowering the cost of capital or creating more competitive markets) are hard for [agency personnel] to take credit for, while bad ones (e.g., scandals and troubles) generate intense criticism.”¹¹² Finally, features of the agency’s culture—its “source of shared sense-making”¹¹³—may also place a thumb on the scale. It has been observed that the SEC, for example, has a strong “investor protection” ethos and that those in its enforcement division are the most zealous in carrying it out.¹¹⁴

Notably, the foregoing all portends excessive *enforcement*, not the type of systematic underdeterrence that could potentially justify a multienforcer approach. But one could tell other plausible behavioral stories. For example, loss aversion might lead to underdeterrence if agency personnel, fearful of taking on a powerful defendant and losing, come to favor the pursuit of smaller fraudsters.¹¹⁵ The “self-serving inference” might bolster this tendency, too, if, for example, the agency is resource constrained,¹¹⁶ or if forgoing pursuit of large defendants

¹¹⁰ *Id.* at 1021 n.176.

¹¹¹ Donald C. Langevoort, *When Lawyers and Law Firms Invest in Their Corporate Clients’ Stock*, 80 WASH. U. L.Q. 569, 574 (2002).

¹¹² Langevoort, *supra* note 92, at 1611.

¹¹³ *Id.* at 1606.

¹¹⁴ See Pritchard, *supra* note 95, at 1083-84 (noting former SEC Chairman Arthur Levitt’s statement, “Investor protection is our legal mandate. Investor protection is our moral responsibility. Investor protection is my top personal priority.”) (quoting Arthur Levitt, Former Chairman, SEC, A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading, Remarks at the “S.E.C. Speaks” Conference (Feb. 27, 1998) (transcript available at <http://www.sec.gov/news/speech/speecharchive/1998/spch202.txt>)).

¹¹⁵ See James D. Cox & Randall S. Thomas with the assistance of Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 778 (2003) (“[T]he SEC’s focus on firms in financial distress, coupled with its preoccupation with small capitalization firms, is . . . consistent with the hypothesis that the SEC, at least during the [time period studied], preferred weak opponents.”).

¹¹⁶ See Langevoort, *supra* note 103, at 8-9 (positing this theory).

advances the career interests of agency personnel.¹¹⁷ Moreover, if agency personnel hail from the private sector (as is often the case at the SEC), they may “have become ‘socialized’ [to share the private sector’s] concerns and aspirations, carrying this perspective into their regulatory tasks.”¹¹⁸ If that perspective places undue weight on overdeterrence costs, it could likewise lead to excessive underdeterrence.¹¹⁹

Again, the point of this brief and necessarily superficial discussion is not to make predictions about regulatory outputs, but rather to highlight the precariousness of drawing casual conclusions about the likely behavior of an exclusive federal enforcer. That such an enforcer would systematically underdeter is a proposition that must be defended, not merely asserted.

2. Net Savings in Social Costs?

But let us assume for purposes of discussion that an exclusive federal enforcer would systematically underdeter. Undoubtedly, many believe this would be the case with a monopolistic SEC, either because a captured Congress would deny it sufficient funds to do its job properly, or because SEC personnel would—for whatever reason—lack the will to prosecute fraud aggressively.¹²⁰ Even so, for a multienforcer approach to be desirable it must *also* be true that exposing market participants to concurrent state or private enforcement would save more in underdeterrence costs than it would *create* in additional enforcement costs. Determining whether this condition is satisfied requires an analysis of the likely net value of private and state enforcement. To be sure, this sort of analysis is hard to conduct with confidence. But if one cares about the efficiency of the U.S. securities fraud deterrence regime, it is a challenge that one cannot ignore.

What follows are some very preliminary thoughts on the costs and benefits associated with the use of private and state enforcers in the

¹¹⁷ See Langevoort, *supra* note 92, at 1610 (hypothesizing that agency “culture takes on a self-serving character, causing perceptions and inferences that comfortably coincide with career interests”).

¹¹⁸ Gadinis, *supra* note 88, at 50.

¹¹⁹ An enforcement agency, however, is likely to be dominated by litigators, who may naturally be inclined “toward an expansive view of the law that is disconnected from cost-benefit analysis and leads to a more moralistic, ‘right versus wrong’ judgmental style.” Langevoort, *supra* note 92, at 1621. Moreover, securities lawyers as a class may tend to “see more value to regulation than there really is, because they have expertise that generates rents and are motivated to see legitimacy in that to which they have committed their . . . careers.” *Id.* at 1610 (footnote omitted).

¹²⁰ See, e.g., *supra* notes 82, 87.

United States. The discussion illustrates that it is very much an open question whether these enforcers do more good than harm—a question that calls for considerable future research.

a. *Private Enforcement*

The drawbacks of private securities fraud enforcement were described generally in subsection III.A.1. These drawbacks include the fact that profit-driven private enforcers are more likely to bring borderline cases than public enforcers, thus increasing the risk of legal error and, in turn, overdeterrence. This concern is far less significant in the United States today than it once was. A series of congressional and judicial reforms of Rule 10b-5 class actions—including stricter pleading requirements, a statutory safe-harbor for forward-looking statements, a discovery stay pending decision on a motion to dismiss, and the elimination of aiding-and-abetting liability—now strongly discourage private plaintiffs from bringing marginal suits.¹²¹

These reforms might lead one to suspect that a happy medium has been reached, with private plaintiffs authorized to bring cases unlikely to provoke significant overdeterrence costs and the SEC (and, in case it fails to do the job, state regulators) positioned to fill the residual enforcement gaps. But such a conclusion ignores the fact that vicarious liability remains a feature of the private enforcement regime. It is, in fact, the *central feature* of that regime, as individual defendants rarely contribute to private settlements.¹²² Because vicariously liable firms face private damage awards that likely far exceed the optimal sanction,¹²³ Rule 10b-5 class actions still threaten to overdeter notwithstanding the decreased likelihood of inaccurate prosecution and legal error.

¹²¹ See *supra* note 62.

¹²² See Michael Klausner, Are Securities Class Actions “Supplemental” to SEC Enforcement? An Empirical Analysis 30-31 (Feb. 23, 2010) (unpublished manuscript), available at <http://www.law.upenn.edu/academics/institutes/ile/penn-nyu2010.html> (finding that 122 of 139 class actions filed parallel to an SEC proceeding between 2000 and 2003 involved no payment by an officer or director).

¹²³ Damages in “fraud-on-the-market” Rule 10b-5 class actions are based on the out-of-pocket losses of all shareholders who purchased shares on the secondary market at a fraudulently inflated price. Robert F. Serio et al., *Basic Claims Under the Federal Securities Laws*, in SECURITIES LITIGATION § 2:2.2[A][4] (Jonathan C. Dickey ed., 2006). These losses, which shareholders can largely offset through diversification, bear no relationship to—and likely far exceed—the true social costs of fraud. See Langevoort, *supra* note 16, at 646 (observing that the measure of damages in secondary market fraud cases “is systematically excessive and dysfunctional”).

Yet the question remains: are the savings in underdeterrence costs attributable to private enforcement worth it? Here, reasonable minds may differ. Small-scale fraudsters are relatively immune from private enforcement, because the damages (and hence attorneys' fees) at stake are minimal. Dishonest officers at large firms also have little to fear, beyond reputational damage, from Rule 10b-5 class actions because, as just noted, they are rarely called upon to contribute financially to the resolution of the litigation. The deterrent pressure of Rule 10b-5 class actions is therefore likely felt most acutely at the firm level, incentivizing boards of large companies, either directly or through their insurers, to adopt internal controls to prevent fraud before it occurs. The marginal benefit of this deterrent is unclear, however, given that firms already have significant incentives to avoid managerial fraud.¹²⁴

If private enforcers discovered significant amounts of fraud that would otherwise go undetected, it would count in their favor, but there are good reasons to doubt that private enforcement plays an important role in detection.¹²⁵ In fact, private enforcement may impede effective detection. Public enforcers may have a more difficult time encouraging firms to self-report fraud if by doing so firms expose themselves to crushing private liability. Private enforcement might also weaken the effectiveness of public enforcement in other ways. For example, the threat of a follow-on class action may discourage individuals from cooperating with public enforcers. It might also affect the manner in which public enforcers resolve investigations. For instance, the SEC's routine practice of allowing firms to settle fraud charges without admitting wrongdoing, something that arguably dilutes the reputational impact of the public sanction, is clearly aimed at protecting firms from parallel private liability.¹²⁶

¹²⁴ As noted in subsection I.A.2.a, securities fraud may best be thought of as a species of managerial agency costs, which faithful directors should naturally seek to minimize. In addition, a firm's stock price is apt to take a significant hit upon revelation of fraud. See Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 582 (2008) (finding that a firm's reputation losses as a result of financial fraud "exceed[] the legal penalty by over 7.5 times, and . . . exceed[] the amount by which firm value was artificially inflated by more than 2.5 times").

¹²⁵ See Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?* 7-8, 12 (Univ. Chi. Booth Sch. of Bus., Working Paper No. 08-22, 2008), available at <http://ssrn.com/abstract=891482> (concluding that private securities litigation uncovered only 3% of the frauds exposed between 1996 and 2004 in companies with more than \$750 million in assets).

¹²⁶ See Samuel W. Buell, *Potentially Perverse Effects of Corporate Civil Liability* (discussing this phenomenon), in *PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW*

The foregoing musings hardly demonstrate that private enforcement creates no net social benefits. The reputational damage that private enforcement imposes, for example, may effectively deter officers and produce significant savings in underdeterrence costs. The threat of class action litigation may also galvanize the attention of directors on the risk of managerial fraud, prompting boards to implement better internal controls than they otherwise would. Moreover, private enforcement may have a positive effect on the SEC's own deterrence efforts, to the extent that SEC enforcement personnel fear the class action bar exposing their inadequate job performance. But the discussion does suggest that the question is close enough to warrant greater investigation by academics and policymakers, particularly when one takes into account the significant *direct* enforcement costs—in terms of lawyers' fees, judicial resources, and the like—associated with Rule 10b-5 class actions.

b. *State Enforcement*

As explained in subsection III.A.3, state enforcers motivated to maximize the social welfare of their respective jurisdictions might neglect national securities frauds (directing scarce state resources to issues of more local concern) or, at the other extreme, impose draconian sanctions on firms (as a way to raise revenue for their states). But we cannot assume that state enforcers would act as social welfare maximizers while also assuming that an exclusive federal enforcer, and its political overseers, would not. Thinking through the costs and benefits of state enforcement demands that we assign the same skewed motivations to state officials that we assign to their federal counterparts. If, for example, we predict that an exclusive federal enforcer would systematically underdeter because members of the congressional oversight committee are “political support maximizers” who would become “captured” by forces that prefer underdeterrence, consistency demands that we also assume that the elected overseers of state enforcers (or the state enforcers themselves, if they are elected officials) behave as political support maximizers. What this portends for the value of concurrent state enforcement is uncertain.

Under this assumption, state enforcement might serve as a valuable corrective. Forces that prefer optimal deterrence would need only capture one of the fifty states to overcome the clout of any special in-

terest groups that prefer underdeterrence. This is because of the dynamic described in subsection III.A.2: when there are concurrent enforcers, regulated parties will adjust their behavior to meet the demands of the strictest regulator with authority over them. The mere possibility that this result could occur might have a disciplining effect at the federal level, thus working to reduce underdeterrence costs even when state enforcement efforts are dormant.

But, by the same token, those who prefer *excessive* enforcement need capture only one state to introduce the possibility that state enforcement will do more harm than good. Who would ever lobby for excessive state enforcement? The plaintiffs' bar would, if—as in the United States—private enforcement is also a feature of the regime. Empirical studies show that Rule 10b-5 class actions are likely to settle more quickly, and for more money, if the government has brought a parallel action against the defendant.¹²⁷ Certain states also contract out (sometimes on a contingency fee basis) their securities fraud enforcement cases to the private bar,¹²⁸ creating a constituency of lawyers that may push for overly aggressive state enforcement. Voter preferences might also lead state officials to favor excessive enforcement, if being responsive to voters happens to be officials' political support-maximizing strategy. As explained above, because fraud is more salient than overdeterrence, voters are likely to overweigh underdeterrence costs relative to enforcement costs. A "political entrepreneur"—such as a state enforcement official seeking to propel himself to a higher office—may "take advantage of the[se] biases of the electorate, playing up recent instances of fraud to gain electoral support."¹²⁹

If instead of proceeding from public-choice assumptions about regulatory behavior, we predict that an exclusive federal enforcer would systematically underdeter due to the behavioral biases of agency personnel, we would need to consider how those biases might manifest themselves at the state level. Introducing concurrent state enforcement would not add much value, after all, if the same cognitive limitations that affect federal enforcement officials cause

¹²⁷ See, e.g., Cox & Thomas, *supra* note 115, at 777.

¹²⁸ Cf. BERNARD NASH ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, BEYOND DUE PROCESS—A LITIGATION PRIMER: CHALLENGING ATTORNEY GENERAL AND OTHER GOVERNMENT CONTINGENCY FEE ARRANGEMENTS 1 (Jan. 2009), available at <http://www.instituteforlegalreform.com/images/stories/documents/pdf/research/contingencyfeemanual.pdf> ("An increasing number of plaintiffs' attorneys are soliciting state Attorneys General . . . and other government officials to permit them to bring cases on behalf of state and local governments on a contingency fee basis.").

¹²⁹ Pritchard, *supra* note 95, at 1080.

state enforcers to underdeter systematically. That said, it has been observed that “competition may have ameliorative effects on behavioral biases among regulators.”¹³⁰ Competition between federal and state enforcers to be viewed as the “best” regulator may therefore help mitigate behavioral biases that lead to underdeterrence.

This discussion barely scratches the surface of the considerations that would inform a rigorous examination of the costs and benefits of state enforcement. Such an examination would profit tremendously from empirical research into the nature and incidence of state securities fraud enforcement efforts—something that has gone largely unexplored in the academic literature. While the efforts of former New York State Attorney General Elliot Spitzer and his successor, Andrew Cuomo, have been well publicized, we know comparably little about what, if anything, the other forty-nine states have been doing to contribute to—or detract from—the goal of optimally deterring fraud in our national securities markets. These facts might provide insights on how better to leverage state enforcement in service of that goal.

3. Superior Alternatives?

Even if it could be shown that an exclusive federal enforcer would systematically underdeter and that introducing concurrent state or private enforcers would lead to a net savings in social costs, the case for a multienforcer approach to securities fraud deterrence would still be incomplete. As a functional matter, reforms designed to align the incentives of the federal enforcer more closely with the national interest serve as potential substitutes for the adoption of a multienforcer approach to securities fraud deterrence. As the following discussion makes clear, policymakers have numerous options in this regard. If such reforms would produce greater net savings in social costs than the use of multiple enforcers, they should clearly be preferred.

In thinking through possible alternative reforms—just as in thinking through the likely costs and benefits of state enforcement—it is important to analyze exactly *why* we have presumed an exclusive federal enforcer would systematically underdeter.

¹³⁰ Stephen J. Choi, *Channeling Competition in the Global Securities Market*, 16 TRANS-NAT'L LAW. 111, 118 (2002).

a. *Public Choice: Congressional Dominance*

If, for example, we believe that systematic underdeterrence would occur because congressional oversight committees “captured” by industry would periodically starve an exclusive federal enforcer of funds, instead of responding by adding new enforcers into the mix, we could make the enforcement agency self-funding. In the wake of the recent financial crisis, Senate Banking Committee Chairman Christopher Dodd circulated draft legislation proposing this idea for the SEC, and the idea has the support of SEC Chairman Mary Schapiro¹³¹ and the Investors Working Group, a nonpartisan group chaired by former SEC Chairmen Arthur Levitt Jr. and William H. Donaldson.¹³²

Another way to deal with funding concerns would be to permit the federal enforcer to tap state and private resources without surrendering control over enforcement policy. For example, we might allow private enforcement, but grant the federal enforcer authority to screen class action complaints prior to filing.¹³³ Similarly, we might permit state enforcement, but authorize the federal enforcer to invalidate state orders that it believes conflict with the public interest.¹³⁴ Because any decision to veto a class action complaint or override state enforcement efforts would be public, members of Congress would likely think twice before seeking to influence those decisions in a way that favors industry at the expense of optimal deterrence. These proposals would likewise “deter[] public enforcers from making self-serving . . . under-enforcement decisions by rendering their prosecu-

¹³¹ Mary L. Schapiro, Chairman, SEC, News Conference Call: Statement Concerning Agency Self-Funding (Apr. 15, 2010) (transcript available at <http://www.sec.gov/news/speech/2010/spch041510mls.htm>) (“[S]elf funding ensures independence, facilitates long-term planning, and closes the resource gap between the agency and the entities we regulate. In the process, it allows the SEC to better protect millions of investors whose savings are at stake.”).

¹³² INVESTORS’ WORKING GROUP, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS’ PERSPECTIVE 9 (July 2009), available at [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20(July%202009).pdf) (“To the extent possible, agencies should have funding flexibility to respond to [market changes and financial innovation] on their own.”).

¹³³ See Rose, *supra* note 8, at 1354-58 (proposing that the SEC be granted such authority). For a creative alternative suggested in the antitrust context, see David Rosenberg & James P. Sullivan, *Coordinating Private Class Action and Public Agency Enforcement of Antitrust Law*, 2 J. COMPETITION L. & ECON. 159, 178 (2006), in which the authors argue for an “auction-buyback” mechanism that allows the public enforcer “to auction off a private license to prosecute the class action while retaining the option of buying it back at the price of the winning bid.”

¹³⁴ See John C. Coffee, Jr., & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 779-81 (2009) (making this suggestion).

torial choices . . . politically transparent and therefore more readily subject to monitoring and discipline.”¹³⁵

A more difficult, but potentially more effective, way to limit the sway of interest groups over enforcement policy would be through reform of campaign finance laws,¹³⁶ or through a transfer of control over the agency from the legislative to the executive branch.¹³⁷ If we believe that the dominant interest groups really would prefer optimal securities fraud deterrence, but nevertheless would lobby for an underfunded federal enforcement agency because of *other* regulatory authority which that agency possesses,¹³⁸ an obvious solution would be to make the enforcement division its own separate agency.

b. *Public Choice: Bureaucratic Slack*

If instead we anticipate systematic underdeterrence by an exclusive federal enforcer because of the “revolving door” between the enforcement agency and Wall Street, a different set of potential reforms would logically present itself. For example, we might attempt to increase the transparency of the agency’s enforcement decisions, so that instances of favoritism would be more readily discovered and punished.¹³⁹ Or salaries at the enforcement agency might be made more competitive with those of the private sector, so that agency personnel would have greater incentives to make a career at the agency. If our concern were not the “revolving door,” but rather the laziness of government lawyers, salaries at the enforcement agency might be made more merit based, so as to create incentives for tougher enforcement.

c. *Behavioral Biases*

Finally, if we believe that behavioral biases would skew an exclusive federal enforcer toward systematic underdeterrence, we could imple-

¹³⁵ Rosenberg & Sullivan, *supra* note 133, at 166.

¹³⁶ See, e.g., Yu & Yu, *supra* note 88, at 3-4 (suggesting that there be more transparency in corporate political spending).

¹³⁷ See Pritchard, *supra* note 95, at 1099-1101 (arguing for such a shift); Peter J. Henning, *Should the SEC Spin Off the Enforcement Division?* 11 (Wayne State Univ. Law Sch. Legal Studies Research Paper Series, Research Paper No. 09-20, 2009), available at <http://ssrn.com/abstract=1470857> (suggesting that transferring the SEC’s fraud enforcement authority to the Department of Justice would “lessen[] the ability of Wall Street to lobby for a weaker enforcement regime”).

¹³⁸ See *supra* note 103 and accompanying text.

¹³⁹ See Gadinis, *supra* note 88, at 65-66 (suggesting various methods that “would provide benchmarks that could facilitate public monitoring of SEC enforcement”).

ment a variety of solutions. For example, "it may make sense for agencies such as the SEC to conduct periodic audits of assumptions (in the form of roundtable discussions, whether open or closed to the public) as an antidote to excessive habitual behavior."¹⁴⁰ The SEC might, for example, consider the critique that its enforcement division is particularly lax in boom times (when market-based mechanisms to combat fraud are at their weakest) and particularly aggressive in bust times (when market-based mechanisms to combat fraud are at their strongest) and adopt countercyclical enforcement policies to offset the biases that may be driving this phenomenon. If agency personnel are biased because they are overwhelmingly "socialized" in the private sector, the agency might try hiring from a more diverse pool of candidates.¹⁴¹

* * *

The foregoing is far from a complete list of possible alternative ways to mitigate the risk of systematic underdeterrence that an exclusive federal securities fraud enforcer may present. But even this quick survey of possibilities reveals that many options, short of adopting a multienforcer approach to securities fraud deterrence, are available to policymakers. These types of alternative reforms deserve more sustained attention than they have received to date.

IV. A NEW PATH FORWARD: ENFORCER-FOCUSED REFORM

The discussion thus far has raised many more questions than it has answered. Based on existing evidence, we cannot say that the preconditions for efficient use of a multienforcer approach to securities fraud deterrence exist in the United States. Nor can we say that they do not. What should policymakers do in the face of this uncertainty?

One response would be to gather more facts. For example, recent studies have attempted to elucidate how the SEC operates as a political institution,¹⁴² and further research along these lines might help us predict whether a monopolistic SEC would systematically underdeter and,

¹⁴⁰ Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527, 539 (1990); see also Rachlinski & Farina, *supra* note 56, at 592 (noting that "[i]nstitutional designers can . . . attempt to build in requirements of data collection and analysis, as well as incentives for periodic policy reassessment" as a technique for mitigating biases).

¹⁴¹ See Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 822 (2009) (arguing that the SEC should "incorporate a sufficient range of viewpoints to allow the agency to operate independently of Wall Street financial firms, corporate issuers, and other influential market participants").

¹⁴² See *supra* note 88.

if so, why. We must be cautious about the inferences we draw from this type of research, however: the SEC enforcement division does not necessarily behave today the way it would in a counterfactual world in which it were the exclusive enforcer.¹⁴³ Additional research might also help us better estimate the value of private and state enforcement, but this type of research will likewise have its limits. Isolating the impact of private and state enforcement on under- and overdeterrence costs is no easy task. Nevertheless, there remains fruitful work to be done. For example, we would benefit from additional information regarding state enforcement efforts, as well as a better understanding of how managers respond to the threat of liability at the hands of different types of enforcers. Still, one cannot help but feel that, though we can and should strengthen our intuitions regarding the efficiency of the current regime, we will never be able to resolve the issue definitively.

In the face of this sort of irreducible uncertainty, the status quo tends to persevere. This result will not trouble those who suspect that private and state enforcers produce a significant net savings in social costs and that nothing would mitigate SEC underdeterrence as efficiently as their unrestrained enforcement efforts. But I doubt that many knowledgeable observers share this suspicion. I, for one, do not. My guess is that the more prevalent sentiment is distrust of the SEC's ability to handle fraud deterrence on its own—at least as currently constituted—coupled with uncertainty regarding the benefits of private and state enforcement.

In light of these observations, there is no reason to accept the current allocation of enforcement authority in the United States as sacrosanct. Rather, we should give thoughtful consideration to consolidating enforcement authority in a single federal regulator, such as the SEC, while at the same time adopting reforms to align the federal enforcer's incentives more closely with the public interest (so as to offset any increased risk of underdeterrence this change might introduce). To be sure, we cannot know with certainty whether such reforms would result in a net savings in social costs. But they at least offer the potential for capturing the enforcer-based efficiencies discussed in Part II, which is an important advantage. Such reforms would also greatly simplify our securities fraud deterrence regime, making it easier to evaluate—and ultimately improve—its functioning going for-

¹⁴³ The SEC might perform better in such a world because it would be more accountable for securities fraud enforcement policy than it is today. On the other hand, it might be less disciplined if state and private enforcers were no longer around to expose its failings.

ward. The sheer complexity of the regime as currently constituted is a major obstacle to studying its effectiveness.

What types of reforms should accompany a move toward a unitary-enforcer approach? To answer that question would take us beyond the scope of this Article. However, several possibilities were raised in subsection III.B.3. For example, if a lack of funding is the primary reason we fear SEC underdeterrence, one option would be to make the agency self-funding. Another would be to retain private or state enforcement while giving the SEC ultimate authority over which cases proceed. Different reasons for doubting the SEC would give rise to different reform proposals. My aim here is not to declare which reasons are most compelling, but rather to suggest that these are issues that scholars and policymakers should be considering. It is time to move beyond the debate over where to draw the line on substance, sanctions, and procedure, and to deliberate seriously about enforcer-focused reforms.

CONCLUSION

In a world without legal error or vicarious liability, designing an effective securities fraud deterrence regime would be relatively easy. Because overdeterrence would not be a risk, lawmakers would be well advised to keep substance broad, sanctions high, and procedure liberal, and to employ an army of aggressive enforcers. Lawmakers' only hard job would be ensuring that marginal direct enforcement costs did not come to exceed the marginal savings in underdeterrence costs. But in a world like our own, with both legal error and vicarious liability, lawmakers must design a securities fraud deterrence regime in a way that accounts for the risk of overdeterrence.

They can do so in two unequally attractive ways. First, they can reduce the likelihood of overdeterrence by narrowing substance, lowering sanctions, or toughening procedure. These sorts of adjustments, however, are costly because they involve inevitable tradeoffs in the form of increased underdeterrence costs. They are also likely to provoke controversy because empirical uncertainty will cause some to believe that the adjustments do more harm than good. Alternatively, lawmakers can focus on the incentives of the enforcer. An enforcer whose incentives align well with society's interest in achieving optimal deterrence could mitigate overdeterrence costs in three important ways. First, by bringing more accurate prosecutions, such an enforcer could reduce the overall amount of legal error in the system without the same stark tradeoffs inherent in the previous approach. Second, use of such an enforcer could increase the flexibility with which the

securities fraud deterrence regime adjusts to new information and changed circumstances. Finally, such an enforcer could, through its use of prosecutorial discretion, mitigate the special overdeterrence risk that the use of vicarious liability presents.

Despite the value that a well-incentivized enforcer can add to a securities fraud deterrence regime, the scholarly literature critical of the U.S. system rarely considers enforcer-focused reforms. Instead, the literature is usually directed at how we might tweak substance, sanctions, and procedure to promote optimal deterrence more successfully. This trend would be understandable if it were clear that the mix of enforcers the United States uses is as good as it gets. But the optimality of our multienforcer approach to securities fraud deterrence has gone largely unexplored.

This Article takes a step toward filling that gap in the literature. Again, participants in the U.S. national securities markets face potential fraud liability not only at the hands of the SEC, but also at the hands of private parties enforcing Rule 10b-5, and state regulators enforcing state antifraud provisions. This arrangement undermines the enforcer-based efficiencies mentioned above in significant ways and complicates the ability of *any* of these enforcers to coherently pursue policies that approximate optimal deterrence. But it is not enough for those who favor preemption of state enforcement authority or the elimination of Rule 10b-5 class actions simply to point to these concerns. Nor is it enough for those who would defend state and private enforcement to rely on vague public-choice postulates and isolated cases of fraud that the SEC failed to deter (even big ones, like the Madoff scheme) to prove their case. To be persuasive, more sophisticated arguments are required.

The analysis in this Article suggests that the U.S. arrangement may serve the cause of optimal deterrence if, but only if, one takes a skeptical view of lawmakers or bureaucrats. Specifically, one must assume that the SEC would systematically underdeter, either on its own initiative or under congressional influence, if given exclusive reign. Further, one must assume that private and state enforcers, respectively, save *more* in underdeterrence costs than they create in additional enforcement costs. Finally, no other reforms must be available that would deal more efficiently with the risk of systematic SEC underdeterrence, should it exist, than the current regime does. These assumptions are not self-evidently correct—far from it—and future research, attention, and debate should focus on their validity.

But where does this leave us today? To be sure, the tendency in the face of this sort of uncertainty is to privilege the status quo. But the status quo approach to securities fraud deterrence in the United States is mostly the product of historical accident and has few disinterested defenders. I would therefore urge Congress at least to consider unifying enforcement authority under the aegis of a single federal regulator, while simultaneously implementing reforms designed to mitigate any risk of underdeterrence this change would introduce or exacerbate. A variety of such reforms are possible, including options that would preserve some (albeit subordinated) role for private and state enforcers. Which reforms are most desirable will depend upon what we perceive as driving the risk of underdeterrence. I cannot claim to know whether such a move would lead to a net savings in social costs, but it would, at least, introduce the possibility of capturing the enforcer-based efficiency gains described above. It would also reduce the amount of indeterminacy that exists today. It is hard enough to judge the performance of a securities fraud deterrence regime enforced by a single prosecutor; when multiple prosecutors—pursuing potentially conflicting enforcement priorities—are added to the mix, the task becomes immensely more complex.

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