
January 2002

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Recommended Citation

Marc I. Steinberg, *Curtailing Investor Protection under the Securities Laws: Good for the Economy*, 55 SMU L. REV. 347 (2002)
<https://scholar.smu.edu/smulr/vol55/iss1/18>

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CURTAILING INVESTOR PROTECTION UNDER THE SECURITIES LAWS: GOOD FOR THE ECONOMY?

Marc I. Steinberg*

I am delighted to participate in this Law Review Symposium in honor of Professor Joseph W. M^cKnight. The accomplishments of Professor M^cKnight's brilliant career are universally admired. As his colleague I am a beneficiary of Joe's good humor, insight, and common sense. This Symposium is a fitting tribute to a gentleman who contributes so very much to the vitality and decency of this superb law school.

Today the U.S. securities markets are one of this country's great treasures.¹ Other nations justifiably seek to implement the liquidity, transparency, integrity, and investor protection qualities that embody our securities markets.² Relatively efficient trading markets are based on a disclosure regime where transactions are expeditiously executed and competitively priced. Supported by competent self-regulation oversight as well as government regulation, the U.S. securities markets are preeminent.³ Nonetheless, difficulties have been experienced ranging from perpetration of fraudulent practices⁴ to episodic market failures⁵ to self-

* Rupert and Lillian Radford Professor of Law and Senior Associate Dean for Academics, Dedman School of Law, Southern Methodist University. Copyright 2002 by Marc I. Steinberg. All Rights Reserved. My thanks to the Law School's Faculty Excellence Endowment for my 2001 Summer Research Grant and to Mr. Brooks Leavitt for his research assistance.

1. See David L. Ratner, *The SEC at Sixty: A Reply to Professor Macey*, 16 *CARDOZO L. REV.* 1765, 1779 (1995).

2. See MARC I. STEINBERG, *INTERNATIONAL SECURITIES LAW—A CONTEMPORARY AND COMPARATIVE ANALYSIS* (1999).

3. See Ratner, *supra* note 1, at 1779 (asserting that "the U.S. securities markets are the best markets in the world"). See generally Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 *N.C. L. REV.* 475 (1984).

4. See, e.g., *United States v. O'Hagan*, 521 U.S. 642 (1997); *United States v. Russo*, 74 F.3d 1383 (2d Cir. 1996); *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099 (D.C. Cir. 1988). Cf. Howard Fineman & Michael Isikoff, *Lights Out: Enron's Failed Power Play*, *NEWSWEEK*, Jan. 21, 2002, at 14.

5. For example, on October 19, 1987, labeled as Black Monday, the Dow Jones Industrial Average plunged 508 points, causing \$500 billion of paper losses. The market trading issues, included those relating to price volatility, liquidity services, exchange specialist performance, order execution, and clearance and settlement, are addressed in *The October 1987 Market Break, A Report By the SEC's Division of Market Regulation* (1988). See also C. Edward Fletcher, *Of Crashes, Corrections, and the Culture of Financial Information—What They Tell Us About the Need for Federal Securities Regulation*, 54 *MO. L. REV.* 515 (1989); Roberta S. Karmel, *Securities Industry Self-Regulation—Tested by the Crash*, 45

regulatory organization ("SRO") neglect.⁶

In its efforts to enhance capital raising and entry into the U.S. securities markets, the Securities and Exchange Commission ("SEC") has made widespread accommodations for both domestic and foreign issuers. These actions, for example, include: the adoption of the "accredited purchaser"⁷ principle under Regulation D,⁸ thereby dismantling the mandatory disclosure framework in offerings made solely to accredited purchasers⁹ and relegating such investors to private redress under federal law exclusively to the Section 10(b)¹⁰ anti-fraud remedy;¹¹ shortening the

WASH. & LEE L. REV. 1297 (1989); Janet E. Kerr & John C. Maguire, *Program Trading - A Critical Analysis*, 45 WASH. & LEE L. REV. 991 (1988); Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993 (1988); Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis*, 57 FORDHAM L. REV. 191 (1988). With respect to the SEC's and the market's responses to September 11th, see, e.g., Securities Exchange Act Release No. 44791, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,530 (2001); *Gloomy Return: U.S. Stocks Plummet as Trading Resumes Without Major Hitches*, WALL ST. J., Sept. 18, 2001, at A1.

6. See, e.g., *In re Nat'l Ass'n of Sec. Dealers, Inc.*, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,825 (Dec. 20, 1996); See also MARC I. STEINBERG & RALPH C. FERRARA, *SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT* § 13:01 (2d ed. 2001):

In 1996, the SEC brought an administrative enforcement action against the NASD, and censured the SRO for allegedly failing to enforce compliance with the Exchange Act as well as its own rules. Simultaneously, the Commission issued a Section 21(a) Report of Investigation. In settling the enforcement action, without admitting or denying the SEC's findings, the NASD undertook to spend a total of \$100 million during the next five years to enhance the SRO's enforcement, surveillance, and examination oversight functions. . . .

7. See Rule 501(a) of Regulation D, 17 C.F.R. § 230.501(a) (2001). See generally Marc I. Steinberg, *The "Accredited" Individual Purchaser Under SEC Regulation D: Time to Up the Ante*, 29 SEC. REG. L.J. 93 (2001).

8. Securities Act Release Nos. 6389, 24 SEC Docket (CCH) 1166 (Mar. 8, 1982); Securities Act Release No. 6759, 40 SEC Docket (CCH) 449 (Mar. 3, 1988); Securities Act Release No. 6825, 43 SEC Docket (CCH) 704 (Mar. 14, 1989). See generally J.W. HICKS, *LIMITED OFFERING EXEMPTIONS: REGULATION D* (2000).

9. See Manning G. Warren, III, *Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984):

[T]he [Regulation D] reforms adopted by the SEC . . . may overestimate the abilities of the presumably wealthy. It is important to note that the categories of "wealthy" investors frequently include the widows and orphans whose protection traditionally has been the sacred trust of the SEC. Experience indicates that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment. Consequently, they frequently fail to seek professional advice. . . .

10. 15 U.S.C § 78j(b) (1997).

11. Note that the Supreme Court's decision in *Gustafson v. Alloyd & Co.*, 513 U.S. 561 (1995), forecloses invocation of Section 12(a)(2) of the Securities Act to private offerings. See *infra* notes 39-40 and accompanying text.

holding period to resell restricted securities¹² to one year¹³ and permitting unrestricted resales by nonaffiliates¹⁴ of the subject issuer after a two-year holding period;¹⁵ authorizing extensive incorporation by reference¹⁶ in registered offerings by less than premier issuers¹⁷ pursuant to the shelf registration rule¹⁸ and SEC Form S-3;¹⁹ promulgating Regulation S²⁰ and Rule 144A,²¹ thereby facilitating “offshore” offerings of securities²² without implicating the Securities Act’s registration mandates and the subsequent resale of such securities in the United States in a market comprised solely of “Qualified Institutional Buyers”;²³ and the relaxation of disclosure requirements for foreign companies.²⁴

12. The term “restricted securities” is defined in SEC Rule 144(a)(3), 17 C.F.R. § 230.144(a)(3) (2001). Generally, the term encompasses “securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer in a transaction or chain of transactions not involving any public offering.” Adoption of Rule 144, Securities Act Release No. 5223 [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,487 at 81,049 (Jan. 11, 1972).

13. See 17 C.F.R. § 230.144(d) (2001); Securities Act Release No. 7390, 63 SEC Docket (CCH) 2077 (Feb. 20, 1997).

14. See 17 C.F.R. § 230.144(a)(1) (2001) (defining an “affiliate” of an issuer as “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer”).

15. See 17 C.F.R. § 230.144(k) (2001); Securities Exchange Act Release No. 7390, 63 SEC Docket (CCH) 2077 (Feb. 20, 1997). See generally, MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 136-44 (3d ed. 2001).

16. Securities Act Release No. 6231, 20 SEC Docket (CCH) 1059 (Sept. 2, 1980); Securities Act Release No. 6331, 23 SEC Docket (CCH) 288 (Aug. 18, 1981); Securities Act Release No. 6383, 24 SEC Docket (CCH) 1262 (Mar. 3, 1982); Securities Act Release No. 6964, 52 SEC Docket (CCH) 2015 (Oct. 22, 1992).

17. See MARC I. STEINBERG, SECURITIES REGULATION 292 (3d ed. 1998):

[I]n 1992 the Commission lowered the requirements for use of Form S-3. First, an issuer generally must have an Exchange Act reporting history of twelve months rather than the former thirty-six months. Second, with respect to issuer primary offerings of common stock, once in the reporting system for twelve months, an issuer would qualify for Form S-3 by having a public float prior to such offering of at least \$75 million (representing the aggregate market value of the company’s voting stock held by non-affiliates). The former three million share annual trading volume test has been eliminated. This rule change enabled approximately 450 additional issuers to qualify for Form S-3. . . .

Id. (citing, Securities Act Release No. 6964, 52 SEC Docket (CCH) 2015 (Oct. 22, 1992)).

18. See 17 C.F.R. § 230.415 (2001); Securities Act Release No. 6499, 29 SEC Docket (CCH) 138 (Nov. 17, 1983). See generally Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984).

19. Securities Act Release No. 6383, 24 SEC Docket (CCH) 1262 (Mar. 3, 1982).

20. Securities Act Release No. 6863, 46 SEC Docket (CCH) 52 (Apr. 24, 1990). The SEC amended Regulations S in 1998. See Securities Act Release No. 7505, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,006 (SEC 1998).

21. Securities Act Release No. 6862, 26 SEC Docket (CCH) 26 (Apr. 23, 1990). See Marc I. Steinberg & Daryl L. Lansdale, *Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Marketplace*, 29 INT’L LAW. 43 (1995).

22. See 17 C.F.R. § 230.902(i) (2001). See generally Samuel Wolff, *Offshore Distributions under the Securities Act of 1933: An Analysis of Regulation S*, 23 LAW & POL’Y INT’L BUS. 101 (1991-1992).

23. The definition of “qualified institutional buyer” is set forth in Rule 144A(a). 17 C.F.R. § 230.144A(a) (2001).

24. See, e.g., Securities Act Release Nos. 6437, 26 SEC Docket (CCH) 964 (Nov. 19, 1982); Securities Act Release No. 7053, 56 SEC Docket (CCH) 1256 (Apr. 19, 1994). See

Along similar lines, the U.S. Congress has enacted legislation seeking to foster capital formation and relieve publicly-held enterprises from the travails of frivolous litigation (also known as "strike suits").²⁵ Indeed, from 1995 to 1998, Congress passed three major Acts²⁶ that: preempt state securities regulation in significant respects;²⁷ facilitate corporate disclosure of forward-looking information²⁸ by setting forth safe harbors from private liability;²⁹ render plaintiff's task of establishing liability more onerous;³⁰ and implement purported reforms that impede private litigants from pursuing class actions.³¹

The federal courts, most particularly the Supreme Court, have also been influential during the past twenty-five years in restricting investor access to redress with perhaps the concomitant effect of encouraging capital formation.³² Examples include confining Section 10(b) to deception or manipulation (thereby foreclosing that statute from reaching breaches of fiduciary duty);³³ restricting the Section 10(b) statute of limitations to

generally, STEINBERG, *supra* note 2, at 34-38; Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498 (1997); Bevis Longstreth, *A Look at the SEC's Adaptation to Global Market Pressures*, 33 COLUM. J. TRANSNAT'L L. 319 (1995).

25. A strike suit may be defined as "[a] lawsuit of questionable merit initiated largely, if not solely, for its nuisance value and which seeks to induce the named defendants to settle the action." STEINBERG, *supra* note 15, at 407.

26. The three Acts are: The Private Securities Litigation Reform Act ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 (1995); National Securities Markets Improvement Act ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996); and the Securities Litigation Uniform Standards Act ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227 (1998).

27. For example, NSMIA preempts state regulation of Rule 506 Regulation D offerings and SLUSA, with certain exceptions, preempts state law in securities class actions involving nationally traded securities. *See, e.g.*, Robert G. Bagnell & Kimble Cannon, *The National Securities Markets Improvement Act of 1996: Summary and Discussion*, 25 SEC. REG. L.J. 3 (1997); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998).

28. Forward-looking statements generally refer "to 'soft' future-oriented information rather than historical 'hard' information, encompassing projections of future performance and appraisals of specified assets." STEINBERG, *supra* note 15, at 394.

29. *See* Exchange Securities Act § 27A, 15 U.S.C. § 77z-2 (1997); Section 21E of the Securities Exchange Act § 21E, 15 U.S.C. § 77u (1997). For case law construing the parameters of the PSLRA safe harbor, *see, e.g.*, *Harris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999).

30. Another example is the enhanced pleading fraud with particularity requirements codified in the PSLRA. *See* Securities Exchange Act § 21D(b), 15 U.S.C. § 77u (1997). For case law interpreting Section 21D(b), *see, e.g.*, *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999); *Williams v. WMX Techs.*, 112 F.3d 175 (5th Cir. 1997).

31. *See* Securities Exchange Act § 27(a), 15 U.S.C. § 77z-1 (1997); Securities Exchange Act § 21D(2), 15 U.S.C. § 77u (1997). These provisions seek to curb the "professional plaintiff" problem and other perceived abuses in private securities class actions. *See generally* Symposium on the Private Securities Litigation Reform Act of 1995, 51 BUS. LAW. 975 (1996); Symposium, 33 SAN DIEGO L. REV. 831 (1996); Symposium, 24 SEC. REG. L.J. 115 (1996).

32. *See* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (adopting purchaser-seller standing requirement under § 10(b) due in part to the "threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial . . ."). *See also*, *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001).

33. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

that of a one-year/three-year period;³⁴ requiring that scienter³⁵ be proven in Section 10(b) actions;³⁶ narrowing the scope of insider trading liability;³⁷ eliminating aider and abetter liability in private actions;³⁸ limiting the coverage of Securities Act Section 12(a)(2)³⁹ to public offerings;⁴⁰ and upholding the validity of pre-dispute brokerage arbitration agreements mandating that broker-dealer customers forego their right to seek judicial redress and be relegated to the arbitral forum.⁴¹

This tripartite action—the Congress, Supreme Court and the SEC—has greatly altered the landscape of investor protection in this country. Today, aggrieved investors frequently are compelled to resort to a difficult-to-prove antifraud provision⁴² accompanied by onerous pleading requirements⁴³ with state law remedies largely preempted.⁴⁴ Customers of brokerage firms similarly find themselves in an unenviable position. Rather than pursuing their claims in state court before a jury, such investors now are compelled ordinarily to try their cases before three arbitrators, one of whom is an industry representative.⁴⁵ No written opinion or reasoning underlying a decision is normally required⁴⁶ and prospects for overturning an arbitral decision are dim.⁴⁷ Not surprisingly, although

34. *Lampf, Pleva, Lipkind, Prupis & Pettigrow v. Gilbertson*, 501 U.S. 350 (1991) (requiring that suit be brought under § 10(b) within one year after the violation was (or perhaps should have been) discovered by the complainant and in no event greater than three years after the violation).

35. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, 197 (1976) (defining “scienter” as “a mental state embracing intent to deceive, manipulate, or defraud” that may be proven by “knowing or intentional misconduct”).

36. *Aaron v. SEC*, 446 U.S. 680 (1980); *Ernst & Ernst*, 425 U.S. 185.

37. See, e.g., *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980). See also, *United States v. O’Hagan*, 521 U.S. 642 (1997). See generally WILIAM K. S. WANG & MARC I. STEINBERG, *INSIDER TRADING* (1996 & 2002 supp.).

38. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). In enacting the PSLRA, Congress provided the SEC with authority to pursue aiders and abettors for alleged violations of the Securities Exchange Act. See Securities Exchange Act § 20(f), 15 U.S.C. § 78t(f) (1997).

39. 15 U.S.C. § 77(a)(2) (1997).

40. *Gustafson v. Alloyd & Co.*, 513 U.S. 561 (1995). See Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231 (1995); Ted J. Filfis, *Gustafson v. Alloyd & Company, Inc.: Judicial vs. Legislative Power*, 23 SEC. REG. L.J. 423 (1996); Janet E. Kerr, *Ralston Redux: Determining Which Section 3 Offerings Are Public under Section 12(2) After Gustafson*, 50 SMU L. REV. 175, 178-79 (1996).

41. *Rodriguez De Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989); *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

42. The elements of a Section 10(b) action are addressed in ALAN R. BROMBERG & LEWIS D. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 2.3 (2000); MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* §§ 7.01-7.10 (2001).

43. See *supra* note 30 and cases cited therein.

44. See *supra* note 27 and accompanying text.

45. See SECURITIES INDUSTRY CONFERENCE OF ARBITRATION (“SICA”), *UNIFORM CODE OF ARBITRATION* § 8(a)(2) (1999); NATIONAL ASSOCIATION OF SECURITIES DEALERS INC. (“NASD”), *CODE OF ARBITRATION PROCEDURE* Rule 19(c)-(d) (1996). See generally MARILYN B. CANE & PATRICIA A. SHUB, *SECURITIES ARBITRATION: LAW AND PROCEDURE* 37 (1991).

46. See e.g., NASD Rule 41, *supra* note 45.

47. Grounds for overturning an arbitration award, for example, include arbitrator misconduct, bias, or manifest disregard of the law. See *Federal Arbitration Act* § 10, 9 U.S.C. § 10 (1994); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros*, 70 F.3d 418, 421 (6th Cir.

meeting with some success, allegedly-aggrieved brokerage customers frequently lose in securities arbitration.⁴⁸

From a policy perspective, the foregoing limitations on investors' rights are justified as necessary to facilitate capital formation, help remove undue burdens that impede business efficiency, and curtail frivolous strike suit litigation fueled by plaintiffs' attorneys seeking lucrative contingency fees.⁴⁹ Clearly, these objectives are laudable and their effectuation has been promoted by actions taken by Congress, the courts, and the SEC. But they are not without costs. Investor protection has been diminished.⁵⁰

Examples of alleged unfairness abound: the widow having a tenth-grade education who has four school-aged children and is barred from court for failing to meet the Section 10(b) one-year inquiry notice period for statute of limitations purposes;⁵¹ the unsophisticated investor, who relies on his broker's oral representations that contradict the issuer's truthful written offering documents, being precluded from bringing suit;⁵² and the investor unable to procure discovery in a case purportedly "smelling of fraud" because she is unable to meet the pleading fraud with particularity requirements.⁵³ Similar examples arise with frequency.⁵⁴ Whether they occur in sufficient volume to undercut investor confidence in the fairness of the U.S. securities markets (and the availability of adequate avenues of redress) remains to be seen.

This diminution in investors' rights has been accompanied by the presence of an impressive bull market.⁵⁵ Investors seeking redress during

1995). Hence, challenging an arbitration award is usually fruitless and can be dangerous. Lewis D. Lowenfels & Alan R. Bromberg, *Securities Industry Arbitrations: An Examination and Analysis*, 53 ALB. L. REV. 755, 864 (1989). See also, David A. Lipton, *The Standard on Which Arbitrators Base Their Decisions*, 16 SEC. REG. L.J. 3 (1988).

48. See William Glaberson, *When the Investor Has a Gripe*, N.Y. TIMES, Mar. 29, 1987, at C. 1, 8 (stating that "the brokerage houses basically like the current system because they own the stacked deck"). See also, NORMAN S. POSER, *BROKER DEALER LAW AND REGULATION* §7.01[A] (3d ed. 1999); Cheryl Nichols, *Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias*, 5 OHIO ST. J. ON DISP. RESOL. 63, 127-28 (1999); Marc I. Steinberg, *Securities Arbitration: Better for Investors Than the Courts?*, 62 BROOK. L. REV. 1503, 1504 (1996).

49. See *Blue Chip Stamps*, 421 U.S. at 739 (stating that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree or in kind from that which accompanies litigation in general"); Private Securities Litigation Reform Act, Joint Explanatory Statement of the Committee of Conference, H.R. REP. NO. 104-369 (1995) (legislation needed "to reform abuses involving the use of 'professional plaintiffs' and the race to the courthouse to file the complaint"); *supra* notes 8-48 and accompanying text.

50. See examples *infra* notes 51-54 and accompanying text.

51. *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346 (2d Cir. 1993).

52. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1033 (2d Cir. 1993).

53. *Wexner v. First Manhattan Co.*, 902 F.2d 169, 173 (2d Cir. 1990) (single investor claiming losses due to alleged fraud amounting to several million dollars).

54. See e.g., *Lampf, Pleva*, 501 U.S. at 369-70 (O'Connor, J., dissenting) (opining that in applying the one year/three year § 10(b) statute of limitations, the Court "inflicts an injustice on the respondents [and] [q]uite simply . . . shuts the courthouse door on respondents because they were unable to predict the future").

55. Many analysts date the bull market's birth to August 12, 1982. At that time, the Dow Jones Industrial Average was below the 1000 level. See Greg Ip, *Identity Crisis: Why*

such profitable times would seemingly be a relatively small percentage. Nonetheless, even in the midst of these booming markets, penny stock⁵⁶ fraud emerged as the leading type of investor fraud in this country.⁵⁷ With the markets (particularly the NASDAQ) having plummeted during the relatively recent past,⁵⁸ a greater number of investors likely are seeking monetary recompense.⁵⁹ Although investing in securities is not an insurance policy,⁶⁰ investors, believing that they have been deceived, will seek to hold allegedly-culpable parties responsible. The extent to which they receive their so-called “day in court” and the perceived fairness of that process may portend whether the U.S. securities markets will continue to attract individual investor participation with the same fervor.

Individual investor participation in equity securities is one of the significant strengths of the U.S. markets. Although institutional holdings comprise a majority of investor participation,⁶¹ individual holdings play significant roles in providing needed capital and liquidity to business enterprises and markets.⁶² Widespread recognition of the curtailment of investor redress for alleged securities fraud may induce individual investor relocation of assets to other sources, such as mutual funds, certificates of deposit, fixed annuities, real estate, and sports memorabilia. Such an eventuality would likely impair the efficiency of the U.S. markets and

the Bull is Acting More Like a Bear, WALL ST. J., Oct. 10, 2000, at C1. See also, Peter A. McKay et al., *Late Surge Pulls Industrials Out of Bear's Jaws*, WALL ST. J., Mar. 23, 2001, at C1.

56. “Penny stocks are low priced, highly speculative securities generally sold in the over-the-counter-market (OTC) and generally not listed on an exchange.” STEINBERG & FERRARA, *supra* note 6, at § 2:17.20.

57. See Penny Stock Reform Act of 1990, Pub. L. No. 101-429, Title V, § 501, 104 Stat. 951 (1990); SEC Rule 15c2-6, 17 C.F.R. § 240.15c2-6 (2001).

58. For example, in 2000, “the Nasdaq Composite Index plunged 39.3% to 2470.52, its worst year since it was created in 1971. Similarly, the Dow Jones Industrial Average fell 6.2% to 10786.85 for the year, breaking a nine-year winning streak and representing its worst calendar year since 1981. Likewise, the Standard & Poor’s 500-stock index lost 10.1% to 1320.28,” which was its worst year since 1977. See Greg Ip, *Though Nasdaq Was Massacred, Dow, S&P 500 Declines Missed Measuring Stick for Bear Market*, WALL ST. J., Jan. 2, 2001, at R1. For 2001, the Dow Jones Industrial Average closed the year at 10021.50 points. See *Market Diary*, WALL ST. J., Jan. 2, 2002, at C1.

59. Indeed, NASD Dispute Resolution Inc., a subsidiary of the National Association of Securities Dealers, reported that arbitration filings have increased 15% during the first quarter of 2001. Additionally, according to the SEC, complaints about brokers’ sales practices are growing. See Ruth Simon, *Sales-Practice Complaints to SEC Increase: Some Brokers Advised Buying Unsuitable Stocks*, WALL ST. J., Apr. 26, 2001, at C1.

60. See *Rifkin v. Crow*, 574 F.2d 256, 262 (5th Cir. 1978) (stating that absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission). See also Section 21D(b)(4) of the Securities Exchange Act, 15 U.S.C. § 77u (1997) (loss causation required to be shown).

61. See Market 2000 Report: An Examination of Current Equity Developments, Division of Market Regulation, Securities and Exchange Commission (1994) (stating that “[t]he ‘institutionalization’ of the market has accelerated since the 1970s [and that] by 1992, [institutions] owned slightly over 50%”).

62. *Id.* (stating that “individual investor participation in the markets is still widespread”).

adversely impact the vitality of the U.S. economy.⁶³

This eventuality highlights the risk and irony of the tripartite action taken by Congress, the courts, and the SEC. In seeking to enhance capital formation and alleviating the burdens placed on business by the threat of vexatious litigation, the scales may be tipped disproportionately against investor protection. If this is indeed the situation, access to capital will be impaired, particularly by smaller companies seeking to go public.⁶⁴ Indeed, whether the recent decrease in initial public offerings⁶⁵ can be traced in part to investor perception of the dearth of adequate redress raises a provocative question, the answer of which is unknown. Certainly, the bear markets that recently existed were mainly due to other reasons.⁶⁶ Nonetheless, while investors in equity securities generally part with their funds with profit as their dominant objective, many such investors will do so only if they feel secure that appropriate redress will be procured if they are deceived. Vindication of legitimate investor grievances is a core determinant for these investors.⁶⁷

Nonetheless, perhaps the proper balance indeed has been struck. The previous statutory, judicial, and regulatory pronouncements that now have been curtailed may have unduly impeded capital formation and favored strike suit plaintiffs and their lawyers. The passage of time with the presence of the accompanying market and economic conditions likely will reveal whether an appropriate accommodation has been reached.

The stakes in this process are high. Investor confidence and market integrity are key components underlying the primacy of the U.S. securities markets. Widespread investor perception that these qualities have been significantly diminished would be detrimental. Capital raising would be impeded, the secondary trading markets in many securities would experience reduced liquidity, and investor funds would flow to other types of investments. Such an eventuality would likely have signifi-

63. See Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis*, 57 *FORDHAM L. REV.* 191, 192-93 (1988). Cf. *Gloomy Return: U.S. Stocks Plummet as Trading Returns Without Major Hitches*, *WALL ST. J.*, Sept. 18, 2001, at A1; *Markets Reopening Seen as Victory, Despite Dow's Tumble Through Week*, 33 *Sec. Reg. & L. Rep. (BNA)* 1359 (2001).

64. See generally Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 *WASH. & LEE L. REV.* 527 (1990).

65. As of mid-March 2001, just 23 deals valued at \$4.03 billion had come to market during the first quarter of 2001. By contrast, the first quarter of 2000 saw 119 initial public offerings raising \$15.69 billion. See Raymond Hennessey, *IPO Outlook: For IPO Market, It Is a Quarter to Forget*, *WALL ST. J.*, Mar. 26, 2001, at C17; Kara Scannell, *IPO Rocket Lands as Investors Prefer Profits to Pipe Dreams*, *WALL ST. J.*, Jan. 2, 2001, at R6.

66. The recent bear market may be attributed in part to slowing revenue growth and declining earnings of Internet and technology companies. Additionally, recessionary concerns, a weakening global economy, and increasing oil prices also have played a role. See Gregory Zuckerman, *A Year After the Peak: How Nasdaq's Mighty Have Fallen*, *WALL ST. J.*, Mar. 5, 2001, at C1. See also, E.S. Browning & Gregory Zuckerman, *Market's Mood: Fast Stock Snapback? History Suggests You Shouldn't Be So Sure*, *WALL ST. J.*, Mar. 26, 2001, at A1.

67. See *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970); *J.I. Case v. Borak*, 377 U.S. 426 (1964).

cant adverse consequences for the U.S. economy.⁶⁸

On the other hand, if the proper balance has been struck, then the U.S. securities markets (absent dismal economic conditions) should continue to flourish, with widespread individual investor participation. Hopefully, Congress and the SEC, as the “statutory guardians” of the investing public,⁶⁹ will monitor this situation and seek to correct any undue imbalance that should arise.

68. Cf. *Enron's Sins*, WALL ST. J., Jan 18, 2002, at A10; Michael Schroeder, *Enron Debacle Saved Calls for Controls*, WALL ST. J., Dec. 14, 2001, at A4.

69. See *SEC v. Coven*, 581 F.2d 1020, 1027-28 (2d Cir. 1978).

