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10b-5

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Retail Investor Remedies under Rule 10b-5

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I. Introduction.

Any student in a basic securities regulation class knows that the institutionalization of U.S. markets significantly impacts the regulatory decisions made by Congress and the Securities and Exchange Commission. So much attention is paid to institutional investors that it is easy to overlook the fact that there are still many individual investors who choose to invest directly in the stock markets. And, like all investors, these retail investors can be the victims of false corporate disclosures. The goal of this paper is assess how the private remedies available under the antifraud provisions of the federal securities laws treat these defrauded retail investors.

The obvious answer is that retail investors are not treated very well. I say that this is an obvious answer because the federal securities laws have a distinctly anti-investor flavor to them these days. It has become increasingly difficult for defrauded investors to recover in securities fraud class actions. So, arguably, *all* defrauded investors – retail investors and institutional investors alike – are not treated very well by federal law. However, that answers only part of the question. To truly see how defrauded retail investors are treated under the antifraud provisions of the federal securities laws, it is

helpful to compare the treatment they receive to the treatment received by institutional investors.

This comparison reveals that retail investors who have been defrauded by false corporate disclosures are particularly disadvantaged by the federal securities laws. Such disfavored treatment of an important subset of investors is surprising, given that retail investors are commonly thought to be more in need of protection under the federal securities laws than institutional investors.

Part II of this paper provides the background necessary to understanding the disfavored treatment received by retail investors seeking a remedy for securities fraud. It begins with an overview of retail investors. After demonstrating the significance of the retail investor on U.S. markets, I describe the demographic profile and behavioral characteristics of the typical retail investor. Part II also provides a brief summary of the legal framework of investor remedies under the antifraud provisions the federal securities laws. It begins with a discussion of Rule 10b-5, the general antifraud provision of the federal securities, and then moves on to a discussion of the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998.

In Part III, I identify several areas in which the federal securities laws disfavor retail investors who have been defrauded by false corporate disclosures. First, I examine the treatment of retail investors who qualify as members of a securities fraud class action. I show that retail investors often lose the opportunity to manage a securities fraud class action to an institutional investor. Moreover, judicial application of the “reasonable investor” materiality standard can negatively impact retail investors seeking damages in a securities fraud class action. Second, I demonstrate that retail investors – who generally

engage in buy-and-hold investment strategies – often do not have any remedy for fraud under the federal securities laws. And, finally, I argue that the federal securities laws have created a two-tiered system of investor remedies for securities fraud. Institutional investors are permitted to pick and choose which law and forum offers them the most attractive chance for recovery, but retail investors typically do not have this opportunity. They are forced to sue under federal law in federal court. I then show that the disfavored treatment of retail investors does not appear to be intentional; instead, retail investors appear to be simply overlooked.

In Part IV, I discuss what, if anything, can be done to address the disfavored treatment of retail investors. I show that disfavored treatment could lead retail investors to question the fairness of the federal securities laws, contributing to a loss of investor confidence in U.S. markets. In addition, I analyze whether the specific areas of disfavored treatment of retail investors can be corrected. I conclude by exhorting policymakers to recognize that the securities fraud class action significantly disadvantages retail investors. Policymakers need to become much more aware of the plight of the defrauded retail investor when considering reforms to private securities fraud litigation and when determining enforcement initiatives.

II. Background.

A. The Retail Investor.

What is a “retail investor?” In one sense, the term “retail investor” can be used simply as a way to differentiate individual investors from institutional investors. Thus, any individual who owns stock by any means, direct or indirect, could be defined as a

retail investor.¹ However, I use the term “retail investor” in a more limited way to mean an individual who *directly* owns stock, as opposed to an individual who owns stock indirectly through a mutual fund or retirement plan. Most retail investors, of course, also own stock indirectly.

Recent information about retail investors is available through two important surveys: (1) the Survey of Consumer Finances (“SCF”), conducted by the Federal Reserve Board,² and (2) Equity Ownership in America, 2005, a survey prepared by the Investment Company Institute and the Securities Industry Association.³ The SCF surveys respondents on a wide variety of financial questions, including direct and indirect ownership of publicly-traded stocks. The ICI and the SIA conduct their own, more specific, survey, which focuses entirely on direct and indirect ownership of publicly-traded stocks. These surveys, together with other resources, provide intriguing insights into retail investors.

The U.S. securities markets have become increasingly institutionalized over the years, and the number of retail investors has in turn dramatically declined.⁴ But reports of the death of the retail investor are premature. A significant number of individuals continue to invest directly in the stock market. According to the most recent Survey of Consumer Finances, approximately 20% of American families directly own stock in

¹ The New York Stock Exchange identifies four ways that individuals can own stock: (1) direct ownership; (2) indirect ownership through mutual funds outside of retirement plans; (3) indirect ownership through retirement plans, such as 401(k) plans; and (4) indirect ownership through defined contribution pension plans. See NEW YORK STOCK EXCHANGE, SHAREOWNERSHIP2000 10 (2000).

² The Federal Reserve Board conducts the SCF every three years. The most recent survey tracks 2004 consumer behavior; the 2007 survey is currently being conducted.

³ INVESTMENT COMPANY INSTITUTE & SECURITIES INDUSTRY ASSOCIATION, EQUITY OWNERSHIP IN AMERICA, 2005, Figure 48 at 44 (2005). The 2005 survey was the third such survey conducted by the Investment Company Institute and the Securities Industry Association. Previous surveys were conducted in 2002 and 1999.

⁴ In 1950, over 90% of U.S. stocks were directly owned by individual investors. By 2004, less than a third of U.S. stocks were directly owned by individual investors. See John C. Bogle, *Individual Stockholder*, R.I.P., WALL ST. J., Oct. 3, 2005, at A16.

publicly-traded companies.⁵ As the following table⁶ shows, this number does not appear to be declining:

<u>Year</u>	<u>Percentage of Households Directly Owning Publicly-Traded Stock</u>
1989	19.0% ⁷
1992	17.8% ⁸
1995	15.3% ⁹
1998	19.2% ¹⁰
2001	21.3% ¹¹
2004	20.7% ¹²

Moreover, it is estimated that retail investors are responsible for approximately a third of the trading volume on U.S. exchanges.¹³ Thus, despite the institutionalization of stock ownership in the United States, a substantial number of American investors appear to be committed to investing directly in the stock market.

⁵ Brian Bucks, Arthur B. Kennickell, & Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, Table 5.b, at A13 (2006) (available at <http://federalreserve.gov/pubs/oss/oss2/2004/bull0206.pdf>). A more recent survey prepared by the Investment Company Institute and the Securities Industry Association places the percentage of families directly owning the stock of publicly-traded companies at an even higher number: approximately 25%. INVESTMENT COMPANY INSTITUTE & SECURITIES INDUSTRY ASSOCIATION, *supra* note 3, at 44. In addition, this study estimates that 28.4 million households – and 42.5 million individuals -- directly owned stock in 2005. *See id.*

⁶ This table was created using information from the relevant SCF.

⁷ *See* Arthur Kennickell & Janice Shack-Marquez, *Recent Changes in U.S. Family Finances from the 1983 and 1989 Survey of Consumer Finances*, Table 4, at 5 (Jan. 1992) (available at <http://federalreserve.gov/pubs/oss/oss2/89/bull0192.pdf>).

⁸ *See* Arthur B. Kennickell & Martha Starr-McCluer, *Recent Changes in U.S. Family Finances: Evidence from the 1989 and 1992 Survey of Consumer Finances*, Table 5.B., at 869 (Oct. 1994) (available at <http://federalreserve.gov/pubs/oss/oss2/92/bull1094.pdf>).

⁹ *See* Arthur B. Kennickell, Martha Starr-McCluer & Annika E. Sunden, *Recent Changes in U.S. Family Finances: Evidence from the 1992 and 1995 Survey of Consumer Finances*, Table 5.B., at 9 (Jan. 1997) (available at <http://federalreserve.gov/pubs/oss/oss2/95/bull01972.pdf>).

¹⁰ *See* Arthur B. Kennickell, Martha Starr-McCluer & Brian J. Surette, *Recent Changes in U.S. Family Finances: Evidence from the 1995 and 1998 Survey of Consumer Finances*, Table 5.B., at 11 (Jan. 2000) (available at <http://federalreserve.gov/pubs/oss/oss2/98/bull0100.pdf>).

¹¹ *See* Ana Aizcorbe, Arthur B. Kennickell & Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, Table 5.B., at 13 (Jan. 2003) (available at <http://federalreserve.gov/pubs/oss/oss2/2001/bull0103.pdf>).

¹² *See* Bucks, *supra* note 5, Table 5.B., at A13.

¹³ *See* John M. Griffin, Jeffrey Harris & Selim Topaloglu, *The Dynamics of Institutional and Individual Trading*, 58 J. OF FIN. 2285 (2003).

What do we know about these retail investors? Retail investors can be found in all demographic categories. Although it is difficult to generalize, two demographic trends have emerged from the studies. Not surprisingly, perhaps, retail investors tend to be wealthy,¹⁴ and they tend to be older than the typical investor.¹⁵

Although wealth is sometimes used as a proxy for sophistication, it is clear that the typical retail investor is not especially knowledgeable about investing.¹⁶ In a recent “investor literacy” survey conducted by the National Association of Securities Dealers (“NASD”),¹⁷ only 35% of respondents were able to answer seven out of 10 basic questions on the securities markets and investing.¹⁸ Perhaps most shockingly, a large number of respondents believed that they were insured against losses from the stock market.¹⁹

A relative lack of sophistication does not seem to prevent retail investors from putting a fair amount of money into their direct stock holdings. While the median value of stock held by all families who directly own publicly-traded stock is \$15,000,²⁰ that number dramatically increases as the wealth and/or net income of the family increases.²¹

¹⁴ Bucks, *supra* note 5, at A14.

¹⁵ INVESTMENT COMPANY INSTITUTE & SECURITIES INDUSTRY ASSOCIATION, *supra* note 3, at 12.

¹⁶ However, retail investors do tend to use brokers.

¹⁷ NASD Investor Literacy Research, Executive Summary (2003) (available at www.nasd.com/web/groups/inv_info/documents/investor_information/nasdw_011459.pdf). These results paralleled the conclusions set forth in a 1999 report prepared by the SEC’s Office of Investor Education and Assistance. See OFFICE OF EDUCATION AND ASSISTANCE, U.S. SECURITIES AND EXCHANGE COMM’N, THE FACTS ON SAVING AND INVESTING—EXCERPTS FROM RECENT POLLS AND STUDIES HIGHLIGHTING THE NEED FOR FINANCIAL EDUCATION (1999).

¹⁸ See NASD Investor Literacy Research, *supra* note 17, at 6.

¹⁹ Only 38% of the respondents knew that they were not insured against losses in the stock market. 46% of the respondents believed that their losses were insured by a government agency, such as the SEC, or a quasi-governmental organization, such as the Federal Deposit Insurance Corporation (“FDIC”), the Securities Investor Protection Corporation (“SIPC”), or the NASD. 22% of the respondents were not sure if their losses were insured. See *id.*

²⁰ Bucks, *supra* note 5, Table 5.B., at A14.

²¹ Thus, for example, the median value of direct stock holdings by families in the top decile of income level is \$57,000, and the median value of direct stock holdings by families in the top decile of net worth is \$110,000. See *id.*

Thus, the mean value of stock held by families who directly own publicly-traded stock is in excess of \$160,000.²²

While the value of these direct stock holdings may be significant, the portfolios of retail investors indicate that they own stock in only a small number of public companies. The Federal Reserve Board's SCF reports that approximately 35% of retail investors owned stock in only one company, and approximately 60% of retail investors owned stock in three or fewer companies.²³ Less than 10% of retail investors owned stock in 15 or more companies.²⁴ Perhaps not surprisingly, retail investors also tend to own stock issued by their employers.²⁵

Although there seems to be a perception that many retail investors follow an aggressive "in-and-out" trading strategy, that perception is inaccurate. An overwhelming number of retail investors follow a "buy and hold" investment strategy. For example, according to the most recent ICI/SIA Equity Ownership in America survey, 86% of the respondents who directly owned publicly-traded stock agreed with the statement "I tend to follow a buy-and-hold investment strategy."²⁶ The same survey showed that 55% of retail investors did not conduct any stock transactions at all in 2004, and that number has held relatively steady through the years.²⁷ Moreover, the typical retail investor holds

²² *See id.*

²³ *See id.* at A15.

²⁴ *See id.*

²⁵ 37.1% of retail investors owned their own employer's stock. *Id.*

²⁶ INVESTMENT COMPANY INSTITUTE & SECURITIES INDUSTRY ASSOCIATION, *supra* note 3, Figure 51, at 50 (2005).

²⁷ INVESTMENT COMPANY INSTITUTE & SECURITIES INDUSTRY ASSOCIATION, APPENDICES: ADDITIONAL FIGURES FOR EQUITY OWNERSHIP IN AMERICA, 2005, Figure F.1, at 16 (2005).

publicly-traded stock for over 15 years.²⁸ Thus, the available information demonstrates that most retail investors tend to purchase securities, and then keep them.

What about the other retail investors, those who do choose to trade? Most engage in relatively few trades. About half of these retail investors conducted five or fewer trades in 2004.²⁹ However, there appears to be a large – and growing – number of retail investors who engage in heavy trading; the ICI/SIA survey reports that 24% of retail investors who conducted a retail transaction engaged in more than 12 trades during 2004.³⁰ Perhaps this growth in the subset of frequent traders has fueled the misconception that retail investors are typically heavy traders.

Behavioral finance scholars have shown that retail investors who *do* trade behave irrationally. Under this behavioral law and economics approach, individual investors, rather than behaving as rational actors, are heavily influenced by a variety of biases that can lead to bad investment decisions. There is a significant amount of scholarship in the behavioral finance area, but a long restatement of the work on investor biases would not be especially helpful for purposes of this paper. Instead, the following short statement by two influential law professors effectively summarizes the literature:

The list of [investor] biases has grown impressively with time, and includes overconfidence, the tendency of investors to overestimate their skills; the endowment effect, the tendency of individuals to insist on a higher price to sell something they already own than to buy the same item if they do not already own it; loss aversion, the tendency for people to be risk averse for profit opportunities, but willing to gamble to avoid a loss; anchoring, the tendency for people to make decisions based on an initial estimate that is later adjusted, but not sufficiently to eliminate the influence of the initial estimate; framing, the tendency of people to

²⁸ According to the ICI/SIA survey, in 2005, the average length of individual stock ownership outside employer plans was 18 years, and the average length of individual stock ownership inside employer plans was 16 years. *See* Investment Company Institute & Securities Industry Association, *supra* note 3, Figures E.3 & E.4, at 5 & 6.

²⁹ *See id.* at Figure F.4, at 20.

³⁰ *See id.* at Figure F.5, at 21. In previous surveys, only 19% (1998) and 20% (2001) of trading retail investors engaged in more than 12 trades in one year. *See id.*

make different choices based on how the decision is framed such as whether it is framed in terms of the likelihood of a good outcome or in terms of the reciprocal likelihood of a bad outcome; and hindsight, the tendency of people to read the present into assessments of the past.³¹

Thus, for example, excessive trading by some retail investors has been traced to overconfidence.³²

B. The Retail Investor and False Corporate Disclosure.

Retail investors, like all investors in the stock markets, can be defrauded by false corporate disclosure. In a typical false corporate disclosure case, a company issues a materially false or misleading statement in press release or a mandatory disclosure document. Sometimes the company issues false bad news, but more often the company issues false good news, perhaps in an attempt to mislead investors into thinking that things are much better than they really are at the company. Following this kind of false statement, the company's stock price will be artificially inflated. When the company's fraud is eventually uncovered and disclosed to the public, the company's stock price will then fall. What remedy is available to retail investors who have been defrauded by the issuance of false corporate disclosure?

Although retail investors could theoretically bring their own individual actions for fraud, false corporate disclosure cases are almost always brought as class actions.³³ The

³¹ See Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 724 (2003).

³² See, e.g., Brad M. Barber & Terrance Odean, *The Courage of Misguided Convictions*, 55 FIN. ANALYSTS J. 41, 47 (1999). (stating that “[t]here is a simple and powerful explanation for high levels of trading on financial markets – overconfidence”).

³³ Rule 23 of the Federal Rules of Civil Procedure authorizes the class action. Rule 23(a) states that “[o]ne or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members of is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.” See FED. R. CIV. PROC. 23(a). Rule 23(b) then sets forth several other requirements that must be met to maintain a class action. Federal securities fraud class actions are typically brought under Rule 23(b)(3), which requires the court to find that “questions of law or fact common to members of the class

conventional wisdom is that false corporate disclosure cases give rise to a large number of defrauded investors who have suffered small individual damages. Thus, it would not make economic sense for these investors to file individual suits. As we know, the class action procedural mechanism was created to provide a remedy in this type of situation.³⁴ In a class action alleging false corporate disclosure, a defrauded investor brings suit on behalf of all similarly situated investors. However, the named plaintiff is not in control of the action. Instead, it is understood that these securities fraud class actions are lawyer-driven.³⁵

C. The Anti-Fraud Provisions of the Federal Securities Laws.

1. Rule 10b-5.

False corporate disclosure class actions usually allege that the defendants violated the general anti-fraud provision of the federal securities laws, Rule 10b-5.³⁶ To recover under Rule 10b-5, a plaintiff must plead and prove that the defendant made a false or misleading statement of material fact “in connection with” the purchase or sale of a

predominate over any questions affecting individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.” See FED. R. CIV. PROC. 23(b).

³⁴ As two scholars succinctly described:

The most compelling [use of the class action] occurs when someone inflicts a small harm on each member of a large group of people. In such a case, any one victim would have to spend more money to hire a lawyer than he could recover by winning a lawsuit, so he would not sue. The class action enables the claims of all the individual victims to be aggregated, thereby spreading the lawsuit’s costs among all class members and creating a potential recovery that is large enough to make the suit economically viable. Although the individual who is harmed only wins a small amount, the public benefit is substantial. The costs of a large public harm are borne by the person or firm responsible for it, and incentives to commit future transgressions are removed.

See John Bronsteen & Owen Fiss, *The Class Action Rule*, 78 NOTRE DAME L. REV. 1419, 1419 (2003).

³⁵ The lack of a “real” plaintiff in securities fraud class actions was recognized by leading class action attorney William Lerach, who famously stated, “I have the greatest practice in the world. I have no clients.” See William P. Barrett, *I Have No Clients*, FORBES, Oct. 11, 1993, at 52.

³⁶ Rule 10b-5 provides that it is unlawful for any person to make an “untrue statement of material fact or . . . omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.” See Securities Exchange Act of 1934, Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007).

security.³⁷ In addition, private actions brought under Rule 10b-5 require the following additional elements: (1) reliance, (2) causation, (3) damages, and (4) scienter.³⁸ In order to have standing to bring the action, the plaintiff must have purchased or sold the securities during the class period.³⁹ Put another way, an investor who has been defrauded into *holding* securities cannot recover under Rule 10b-5.

2. The Private Securities Litigation Reform Act of 1995.

Class actions brought under Rule 10b-5 are subject to two highly-specialized statutes, the Private Securities Litigation Reform Act of 1995 (the “Reform Act”) and the Securities Litigation Uniform Standards Act of 1998 (the “Uniform Act”). The Reform Act was enacted in response to a widely-held perception⁴⁰ in Congress and the business community that Rule 10b-5 encouraged strike-suits and nuisance litigation. According to these critics, professional plaintiffs – encouraged by law firms such as Milberg Weiss – raced to the courthouse to file suit under Rule 10b-5 whenever a company’s disclosure was followed by a drop in the company’s stock price, even when there was no evidence of fraud at the time the complaint was filed. The critics claimed that the corporate defendants chose to settle even non-meritorious actions because the settlement amount

³⁷ *See id.*

³⁸ For a good discussion of the elements necessary for plaintiffs to recover for violations of Rule 10b-5, see THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 12.4, at 469-72 (5th ed.).

³⁹ For additional discussion of the standing requirement, see *infra* Part III.A.2.

⁴⁰ For example, the Statement of Managers prepared in connection with the Reform Act provides:

Congress has been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets. The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in the issuer’s stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

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

would cost the defendant less than the litigation expenses associated with discovery requests. The only people coming out ahead, argued these critics, were the plaintiff's lawyers, who received large fees out of the settlement proceeds to the detriment of the members of the class and the corporation's innocent shareholders.

The Reform Act was a series of mostly procedural reforms intended to make it more difficult for plaintiffs to successfully bring private securities fraud actions – particularly false corporate disclosure actions – under Rule 10b-5. In the Reform Act, Congress created several special rules of procedure that apply whenever private securities fraud actions are brought in federal court. The reforms included a heightened standard for pleading scienter⁴¹ and a related automatic stay of discovery.⁴² These kinds of reforms were intended to weed out non-meritorious actions at the pleading stage, thereby discouraging strike suits.

In addition, the Reform Act included several provisions targeted at the plaintiff law firms, who were understood to be the real parties in control of securities fraud class actions. For example, the Reform Act imposed limitations on attorney's fees⁴³ and restricted individuals from acting as professional plaintiffs.⁴⁴ Perhaps most importantly,

⁴¹ Under the Reform Act's heightened pleading standard, plaintiffs are required to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Securities Act of 1934 § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2) (2000).

⁴² The Reform Act provides:

In any private action arising under this sub-chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds, upon the motion of any party, that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

Securities Act of 1933 § 27(b), 15 U.S.C. § 77z-1(b) (2000); Securities Exchange Act of 1934 § 21D(b)(3)(B)(vi), 15 U.S.C. § 78u-4(b)(3) (2000).

⁴³ According to the Reform Act, attorneys fees and expenses "shall not exceed a reasonable percentage of the amount of any damages." *See* Securities Act of 1933 § 27(a)(6), 15 U.S.C. § 77z-1(a)(6) (2000); Securities Exchange Act of 1934 § 21D(a)(6), 15 U.S.C. § 78u-4(a)(6) (2000).

⁴⁴ The Reform Act states that "a person may be a lead plaintiff . . . in no more than 5 securities class actions . . . during any 3-year period." *See* Securities Act of 1933 § 27(a)(3)(B)(vi), 15 U.S.C. § 77z-1(a)(3)(B)(vi) (2000); Securities Exchange Act of 1934 § 21D(a)(3)(B)(vi), 15 U.S.C. § 78u-4(a)(3)(B)(vi) (2000).

the Reform Act adopted a “lead plaintiff” provision,⁴⁵ which requires courts to presume that the plaintiff entitled to control the class action (and therefore appoint class counsel) is the member of the class with the greatest loss, as opposed to the first plaintiff to file the action.⁴⁶ By reducing the incentive to file first, the Reform Act sought to encourage law firms to investigate claims before bringing actions. Similarly, by reducing the significance of the professional plaintiff, the Reform Act attempted to impose increased plaintiff monitoring of the performance and fees of class counsel.

3. The Securities Litigation Uniform Standards Act of 1998.

The Reform Act tried to correct the causes of nuisance litigation by creating special procedural rules that apply only to private securities fraud actions. Because these rules are procedural in nature, they apply only if the securities fraud action is filed in federal district court. Soon after the Reform Act was enacted, it became apparent that the Reform Act could be evaded if plaintiffs chose to file a complaint under state law⁴⁷ in state court.⁴⁸ When Congress discovered that the Reform Act could be so easily circumvented, they responded by enacting the Uniform Act.⁴⁹

⁴⁵ See Securities Act of 1933 § 27(a)(3), 15 U.S.C. § 77z-1(a)(3) (2000); Securities Exchange Act of 1934 § 21D(a)(3), 15 U.S.C. § 78u-4(a)(3) (2000).

⁴⁶ Specifically, the lead plaintiff provision requires the court to “appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members . . .” See Securities Act of 1933 § 27(a)(3)(B)(i), 15 U.S.C. § 77z-1(a)(3)(B)(i) (2000); Securities Exchange Act of 1934 § 21D(a)(3)(B)(i), 15 U.S.C. § 78u-4(a)(3)(B)(i)(2000). The provision then requires the court to adopt a presumption that the most adequate plaintiff is the person or persons who “has the largest financial interest in the relief sought by the class.” See Securities Act of 1933 § 27(a)(3)(B)(iii)(I)(bb), 15 U.S.C. § 77z-1(a)(3)(B)(iii)(I)(bb) (2000); Securities Exchange Act of 1934 § 21D(a)(3)(B)(iii)(I)(bb), 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2000).

⁴⁷ For example, a plaintiff could file an action for violations of the anti-fraud provisions of the applicable state blue sky laws and/or state common law.

⁴⁸ The plaintiff could not bring an action in state court under Rule 10b-5 because the Securities Exchange Act of 1934 provides that federal courts have exclusive jurisdiction over claims arising under the Exchange Act. See Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (2000).

⁴⁹ According to the “findings” provision of the Uniform Act:

- (1) the Private Securities Litigation Reform Act of 1995 sought to prevent abuses in private securities fraud lawsuits;

The Uniform Act expressly preempts state securities fraud⁵⁰ class actions, including false corporate disclosure cases, involving nationally-traded securities.⁵¹ If the Uniform Act applies, plaintiffs must bring their claims under Rule 10b-5 in federal district court. Although the Uniform Act preempts most securities fraud class actions, certain state claims continue to survive.⁵² For example, because the Uniform Act applies only to class actions,⁵³ investors can bring individual actions on their own behalf under state law in state court. In addition, the Uniform Act does not apply to derivative

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- (2) since enactment of that legislation, considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts;
 - (3) this shift has prevented the Act from fully achieving its objectives;
 - (4) State securities regulation is of continuing importance, together with Federal regulation of securities, to protect investors and promote strong financial markets;
 - (5) In order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally-traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.

See H.R. CONF. REP. NO. 105-803, at 1-2 (1998).

⁵⁰ It is somewhat of an oversimplification to state that the Uniform Act preempts “fraud” actions. While the Uniform Act clearly preempts securities fraud claims, several courts have interpreted the Uniform Act to preempt claims that do not sound in fraud. For a discussion of the types of non-fraud claims that have been preempted by the Uniform Act, see Jennifer O’Hare, *Preemption under the Securities Litigation Uniform Standards Act: If It Looks Like a Securities Fraud Claim and Acts Like a Securities Fraud Claim Is It a Securities Fraud Claim?* 56 ALA. L. REV. 325, 348-52 (2004). However, for ease of reference, I will continue to describe the Uniform Act as preempting state securities fraud claims.

⁵¹ The Uniform Act’s preemption provision states:

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging –

- (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or
- (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

See Securities Act of 1933 § 16(b), 15 U.S.C. § 77p(b); Securities Exchange Act of 1934 § 28(f)(1), 15 U.S.C. § 78bb(f)(1). According to the Uniform Act, a “covered security” includes “nationally-traded securities.”

⁵² For a discussion of the claims that are not preempted by the Uniform Act, see O’Hare, *supra* note 50, at 339-341.

⁵³ The Uniform Act preempts “covered class actions.” A covered class action is much broader than a Rule 23 class action and includes (1) actions brought on behalf of more than 50 persons, (2) actions brought on a representative basis, and (3) a group of joined or consolidated actions. See Securities Act of 1933 § 16(f)(2), 15 U.S.C. § 77p(f)(2); Securities Exchange Act of 1934 § 28(f)(5), 15 U.S.C. § 78bb(f)(5).

actions⁵⁴ brought by shareholders on behalf of the corporation or actions brought by state governments or state pension plans.⁵⁵ Thus, these actions survive preemption.

III. The Treatment of Retail Investors Under Rule 10b-5.

Rule 10b-5 appears to protect *all* investors from securities fraud. The language of the rule is focused on illegal conduct, not on the persons harmed by the illegal conduct. Specifically, Rule 10b-5 states that “[i]t shall be unlawful for any person . . . to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.”⁵⁶ On its face, then, Rule 10b-5 does not distinguish between different types of investors, whether those investors are unsophisticated retirees or powerhouse public pension funds like CalPERS.⁵⁷

Presumably, then, retail investors and institutional investors seeking redress for securities fraud should receive the same protections under law. But that is not the case.⁵⁸

As described below, in several important respects, retail investors and institutional

⁵⁴ See Securities Act of 1933 § 16(f)(2)(C), 15 U.S.C. § 77p(f)(2)(C); Securities Exchange Act of 1934 § 28(f)(5)(C), 15 U.S.C. § 78bb(f)(5)(C).

⁵⁵ See Securities Act of 1933 § 16(d)(2), 15 U.S.C. § 77p(d)(2); Securities Exchange Act of 1934 § 28(f)(3), 15 U.S.C. § 78bb(f)(3).

⁵⁶ See Securities Exchange Act of 1934 Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007).

⁵⁷ CalPERS, the California Public Employees Retirement System, is the largest public pension fund in the United States and is well-known for its shareholder activism. See, e.g., Brad M. Barber, *Monitoring the Monitor: Evaluating CalPERS’ Activism*, Nov. 2006, available at SSRN: <http://ssrn.com/abstract=890321>.

⁵⁸ A commentator has reached a similar conclusion as to the differing treatment received by sophisticated investors and unsophisticated investors under the federal securities laws. See C. Edward Fletcher, III, *Sophisticated Investors under the Federal Securities Laws*, 1988 DUKE L. J. 1081 (providing an exhaustive analysis of how the federal securities laws treat sophisticated investors). This commentator argues that it may be appropriate for the federal securities laws to provide less protection to sophisticated investors, particularly under Rule 10b-5. See *id.* at 1141-47. In reaching this conclusion, the author assumes that unsophisticated investors should be afforded *greater* protections under federal law in general and the Rule 10b-5 in particular. Of course, my paper shows that courts have not, in fact, afforded greater protections under Rule 10b-5 to retail investors, who are often unsophisticated.

investors are treated differently under the antifraud provisions of the federal securities laws. Moreover, as compared to institutional investors, retail investors appear to receive disfavored treatment under the anti-fraud provisions of the federal securities laws.

A. Differing Treatment under Rule 10b-5.

1. Retail Investors Who Are Members of Securities Fraud Class Actions Are Disfavored by the Federal Securities Laws.

A class action for violations of Rule 10b-5 can be brought on behalf of investors who purchased securities during the class period; *i.e.*, after the company issued a false corporate disclosure, but before the company made corrective disclosure.⁵⁹ Retail investors who purchased securities during the class period, and therefore qualify to be members of a securities fraud class action, will find that they are disadvantaged in several important ways.

a. The Lead Plaintiff Provision.

First, while Rule 10b-5 does not distinguish between retail investors and institutional investors, the Reform Act does make such a distinction, through the lead plaintiff provision. As discussed above,⁶⁰ the lead plaintiff provision includes a rebuttable presumption requiring the court to appoint the plaintiff with the greatest financial stake as the party who will make decisions on behalf of the rest of the class. The rebuttable presumption is neutral on its face; the statute's language does not distinguish between retail investors and institutional investors. But in practice, the lead plaintiff provision benefits institutional investors because, not surprisingly, the plaintiff

⁵⁹ This statement assumes that the company issued false positive news. If a corporation issued false negative news, then a class action would be brought on behalf of investors who sold their securities during the class period.

⁶⁰ See *supra* notes 45-46 and accompanying text.

with the greatest financial stake is usually an institutional investor. This result was intended by Congress; the Reform Act's legislative history states that the purpose of the lead plaintiff provision was "to increase the likelihood that institutional investors will serve as lead plaintiffs."⁶¹

Recent empirical studies have demonstrated that this result has occurred. While institutional investors initially were slow to take advantage of the lead plaintiff provision, they now are much more aggressive in seeking appointment.⁶² Thus, for example, institutional investors were lead plaintiffs in 41% of securities class action filed in 2003, and were lead plaintiffs in 47% of the securities class actions filed in 2004.⁶³ The trend has continued.⁶⁴

In applying the lead plaintiff provision, courts prefer institutional investors over retail investors. Following a sweeping study of judicial opinions concerning the appointment of a lead plaintiff,⁶⁵ Professors James Cox and Randall Thomas concluded that courts "found in [the institutional investor's] favor in the vast majority of cases in which an institutional investor was competing for the position of lead [plaintiff]."⁶⁶

⁶¹ See H. REP. NO. 104-369, *supra* note 40.

⁶² See Stephen J. Choi, et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L. Q. 869, 877-78 (2005); James D. Cox & Randall S. Thomas, *Private Securities Litigation Reform Act: Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587 (2006); Michael A. Perino, *Institutional Activision Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* (October 2006), St. John's Legal Studies Research Paper No. 06-0055, available at SSRN: <http://ssrn.com/abstract=038722>.

⁶³ See 2004 PRICEWATERHOUSECOOPERS LLP, SECURITIES LITIGATION STUDY 15 (2004) (available at www.10b5.com/2004_study.pdf).

⁶⁴ The most recent PriceWaterhouseCoopers study reported that unions or pension funds were lead plaintiffs in 68 of the 168 securities class actions filed in 2005, which amounts to approximately 41% of the cases filed. The study did not report the number of other types of institutional investors serving as lead plaintiffs; *i.e.*, mutual funds and private pension funds. Therefore, the overall percentage of cases having institutional investors as lead plaintiffs in 2004 is probably slightly higher. See 2005 PRICEWATERHOUSECOOPERS LLP, SECURITIES LITIGATION STUDY 21 & 8 (2005).

⁶⁵ See Cox & Thomas, *supra* note 62, at 1587 (analyzing 129 reported opinions).

⁶⁶ The study's authors note two caveats to this statement:

Retail investors who attempt to join together to aggregate⁶⁷ their damages so that the group will have the largest losses may also find it hard to prevail.⁶⁸

At first glance, the lead plaintiff provision seems like a positive development for retail investors. Institutional investors appear to have the economic incentive and expertise to more effectively manage a securities fraud class action and monitor the performance and fees of class counsel than the typical retail investor. However, recent empirical studies show that the performance of institutional lead plaintiffs has been mixed.⁶⁹ Thus, it is not entirely clear that preferring institutional lead plaintiffs to individual lead plaintiffs is a positive development for retail investors.

In addition, critics of the lead plaintiff provision have argued that the rebuttable presumption favoring institutional lead plaintiffs could harm small investors. One obvious concern is that the lead plaintiff provision acts to deprive retail investors from obtaining any real control over the class action.⁷⁰ An additional concern is that

First, courts were willing to select groups of individuals over institutions in situations where the institutions did not have large shareholdings in the company that was the subject of the litigation, especially where the court exhibited concerns about the typicality of the institutional investor as a class representative. Second, in several cases, courts accepted groups of institutions and individuals over their competitors where they found such groups to have the largest stake in the defendant company.

See id. at 1619.

⁶⁷ *See* Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel under the PSLRA*, 64 *LAW & CONTEMP. PROBS.* 53, 65-78 (2001).

⁶⁸ *See* Choi, et al., *supra* note 62, at 878 (stating that there is an “evolving judicial preference for a single institutional lead plaintiff over a large group of individuals”).

⁶⁹ *See id.* at 902 (finding “mixed results” as to the effects of institutional investors serving as lead plaintiffs); Cox & Thomas, *supra* note 62, at 1636 (concluding that “institutional lead plaintiffs add value for shareholders, although perhaps not as much as was expected by the architects of . . . the lead plaintiff provision”); Perino, *supra* note 62, at 3 (finding that “public pension funds do act as effective monitors of class counsel”).

⁷⁰ As one noted commentator observed:

To the extent that the Reform Act allows small shareholders to file suit but permits institutional investors to take control of the litigation away from the filing plaintiff, it preserves for the small investor only the opportunity to incur the costs associated with drafting and filing a complaint and eliminates meaningful access to the judicial system.

See Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 *ARIZ. L. REV.* 533, 547 (1997).

institutional investors have conflicts of interest that might prevent them from obtaining the best recovery for the class, which includes retail investors.⁷¹ For example, an institutional investor might own a large amount of the defendant company's stock during the pendency of the class action, but may have suffered comparatively small damages from the fraud. Because this institutional investor is a current shareholder of the company, it would be in this institutional investor's interest to limit the settlement amount.⁷² These concerns were raised at the time the Reform Act was enacted⁷³ and remain concerns today.⁷⁴

b. The Materiality Standard.

Retail investors may also find that judicial application of Rule 10b-5's materiality standard can disfavor their claims. To recover under Rule 10b-5, the plaintiff must demonstrate that the defendant made a false or misleading statement of "material" fact.⁷⁵ According to the seminal case of *TSC Industries, Inc. v. Northway*, information is material if "there is a substantial likelihood that a reasonable investor would consider it

⁷¹ For a discussion of potential conflicts of interest by institutional lead plaintiffs, see *id.* at 545-49. See also Craig C. Martin & Matthew H. Metcalf, *The Fiduciary Duties of Institutional Investors in Securities Litigation*, 56 BUS. LAW. 1381, 1409-1412 (2001).

⁷² As one commentator has noted, "With respect to the desirability of large payments of compensatory damages, the interests of continuing shareholders will thus generally conflict with those of class members who have sold their shares and who, consequently, have no interest in the continued health of the business." Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1505 (1996). Ironically, such a lead plaintiff might actually benefit many retail investors, those who purchased their stock before the false corporate publicity and continued to hold the stock through the securities fraud class action. See *infra* Part III.A.2.

⁷³ H.R. REP. NO. 104-369, *supra* note __ (recognizing that "potential conflicts . . . could be caused by the shareholder with the 'largest financial stake' serving as lead plaintiff"). According to the Conference Report, the danger that an institutional investor might have a conflicts of interest is alleviated because the lead plaintiff presumption can be rebutted by evidence showing that the lead plaintiff cannot adequately represent the interests of the class. See *id.*

⁷⁴ See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1561-62 (2006) (stating that the interests of retail investors "are unlikely to be given serious consideration in securities litigation today because control of the securities class action was presumptively assigned by the PSLRA to large diversified investors, who often have highly contrary interests").

⁷⁵ See *supra* Part II.C.1.

important in deciding how to [act].”⁷⁶ The *TSC Industries* definition is an objective test. In determining materiality, courts are not supposed to determine what a particular investor would consider important, or what the judge would consider important, but rather what a theoretical “reasonable investor” would consider important. Of course, that begs the question of what *kind* of reasonable investor: a reasonable retail investor? Or a reasonable institutional investor?

Courts rarely address the distinction between retail investors and institutional investors in analyzing materiality. This failure is strange, considering that a reasonable retail investor and reasonable institutional investor undoubtedly receive and process information in very different ways. Retail investors are more likely to receive information from fewer sources, and through less “reliable” sources, such as Internet chat rooms and message boards. Moreover, since retail investors are typically less sophisticated than institutional investors, they may not be able to fully appreciate the information they review. In addition, while institutional investors may have teams of experts analyzing the importance of a particular disclosure, retail investors generally rely on themselves. Nonetheless, courts apply a unitary materiality standard that can disfavor many retail investors.

A good example of how the application of the materiality standard can disfavor retail investors is the puffery defense. “Puffery” is a statement that is so vague, optimistic, or promotional in nature that the court concludes, as a matter of law, that no reasonable investor could find it important in making an investment decision.⁷⁷ Retail investors – who are typically less sophisticated than institutional investors – may in fact

⁷⁶ *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 448-49 (1976).

⁷⁷ See Jennifer O’Hare, *The Resurrection of the Dodo: The Unfortunate Reemergence of the Puffery Defense in Private Securities Class Actions*, 59 OHIO ST. L.J. 1697, 1698 (1998) (defining puffery).

be defrauded by false statements of corporate optimism that would be discounted by more sophisticated investors. However, these retail investors would be unable to recover under the federal securities laws because a court would likely conclude that the optimistic statement constituted puffery. In other words, according to the puffery defense, no reasonable investor could have considered the information important in deciding whether to purchase or sell a security.

But retail investors *can* be affected by what courts might see as immaterial puffery. Behavioral finance scholars have theorized that it may be perfectly reasonable for retail investors to find “puffery” to be important to their investment decisions. For example, Professor Donald Langevoort has argued that cognitive biases, especially investor overconfidence, can lead individual investors to make trading decisions based on puffery.⁷⁸ He analyzed the familiar false corporate disclosure case: a company with a history of successes, but which hits bad times, continues to make generalized statements that things are going well, even though they aren’t. In such a case, a court might be tempted to dismiss the optimistic statement as puffery, but Professor Langevoort cautions against this conclusion. As he points out, “behavioral finance suggests that investors do extrapolate too readily and see in past successes too much likelihood of future gains. Indeed, prospective future gains are probably the impetus for continuing buying activity among investors, especially if analysts are also recommending the stock or estimating continued earnings growth.”⁷⁹ He also notes that if the company’s optimistic statements attracted significant media coverage, investors would be even more likely to be

⁷⁸ See Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 185 (2002).

⁷⁹ See *id.*

influenced by them.⁸⁰ Thus, cognitive biases may lead retail investors to place importance on information that would be defined as puffery by many courts.⁸¹

Some courts seemed to have recognized that the application of the *TSC Industries* definition of materiality may disadvantage defrauded retail investors. Professor Margaret Sachs has recently examined judicial application of the materiality standard in enforcement actions brought against fraudulent schemes that are specifically aimed at vulnerable investors, such as unsophisticated or elderly investors.⁸² In these schemes, unscrupulous promoters use over-the-top claims of sky high returns and low risk to induce these targeted retail investors to part with their money. The Securities and Exchange Commission has regularly brought enforcement actions in these types of cases, but this puts the federal district courts in a difficult position. On the one hand, the statements pretty clearly constitute puffery, which should cause the judges to dismiss the actions. On the other hand, the judges undoubtedly recognize that many investors did in fact find the puffery to be important in their investment decisions. A straightforward application of the materiality standard would mean that the defendants could not be stopped from defrauding investors. Professor Sachs shows that some courts have misapplied the *TSC Industries* materiality standard to permit the enforcement actions to go forward.⁸³

⁸⁰ *See id.*

⁸¹ While overconfidence may be the most significant cognitive bias undercutting the puffery defense, it is not the only one. Loss aversion is another. *See* David A. Hoffman, *The “Duty” To Be a Rational Shareholder*, 90 MINN. L. REV. 537, 586 (stating that “[i]nvestors whose stock has lost value are risk seeking and more likely to act on positive disclosures with weak information content”). Other biases that may lead retail investors to consider “puffery” in their investment decisions include information overload, source blindness, and herd behavior. *See id.* at 587.

⁸² *See* Margaret Sachs, *Materiality and Social Change: The Case for Replacing “The Reasonable Investor” With “The Least Sophisticated Investor” in Inefficient Markets*, 81 TUL. L. REV. 473 (2006).

⁸³ *See id.* at 497-501. Professor Sachs identified three ways courts are misapplying the *TSC Industries* standard of materiality. One approach is to find statements promising unbelievable returns to be material

2. Retail Investors Often Do Not Have Any Private Remedies for Securities

Fraud.

The above discussion⁸⁴ provides examples of ways in which retail investors who are members of a securities fraud class action receive disfavored treatment under Rule 10b-5. Many defrauded retail investors, however, will not even qualify to be members of the class action in the first place. As discussed above,⁸⁵ the overwhelming majority of retail investors follow a “buy and hold” strategy. While this may be a solid approach for achieving long-term financial gains, it is not the best approach for obtaining a remedy under the anti-fraud provisions of the federal securities laws. This is because investors who have been defrauded into holding their securities do not have standing to recover under Rule 10b-5.

In *Blue Chip Stamps v. Manor Drug Stores*, the United States Supreme Court held that standing under Rule 10b-5 was limited to actual purchasers and sellers.⁸⁶ This purchaser/seller standing rule means that only investors who purchased stock during a period of false positive corporate disclosure, or, conversely, who sold stock during a period of false negative corporate disclosure, can recover under Rule 10b-5. In *Blue Chip Stamps*, the Court recognized that this standing rule could “prevent[] some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5.”⁸⁷ However, the Court pointed out that the potential unfairness of the purchaser-seller standing requirement was mitigated because state law, as opposed to federal law,

because the statements are “related to the very substance of the act of investing.” *See id.* at 498. Another approach is to concentrate on the falsity of the statement, while giving little or no analysis to the materiality of the false statement. *See id.* at 499. The final approach is to ignore the contextual nature of the *TSC Industries* materiality standard. *See id.* at 500.

⁸⁴ *See supra* Part III.A.1.

⁸⁵ *See supra* notes 26 -28 and accompanying text.

⁸⁶ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975).

⁸⁷ *See id.* at 738.

permitted investors to recover if they had been defrauded into holding their securities.⁸⁸

Thus, *Blue Chip Stamps* foreclosed defrauded holders of securities from recovering under Rule 10b-5.

Retail investors are likely to be holders within the meaning of the *Blue Chip Stamps* standing requirement. Because retail investors tend to purchase securities and then hold them for long periods of time, retail investors are likely to have purchased their securities before the start of the class period.⁸⁹ Thus, these retail investors will not be able to join a securities fraud class action. Commentators have noted that retail investors are the “clear losers” under this system.⁹⁰ Thus, for the vast majority of retail investors, Rule 10b-5 is simply irrelevant as a remedy for securities fraud.⁹¹

Retail investors who have been defrauded into holding their securities are also foreclosed from recovering under state law. Although some states do permit holding claims,⁹² the United States Supreme Court recently held that the Uniform Act preempts class actions claiming that investors had been defrauded into holding their stock.⁹³ In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, the Supreme Court was asked to decide whether fraud that induced investors to hold securities constituted fraud “in

⁸⁸ See *id.* at 739 n.9.

⁸⁹ See Coffee, *supra* note 74, at 1560 (stating that “because of their typically longer holding period, individual ‘buy and hold’ investors are more likely to have purchased their stock before the class period commenced”); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 649-50 (1996) (noting that investors following a buy and hold strategy “make it somewhat more likely that they will be non-trading shareholders of an issuer defendant (and suffer their share of the resulting loss) than members of the plaintiff class who stand to gain from the settlement or judgement”).

⁹⁰ See Coffee, *supra* note 74, at 1560. (stating that “[t]he clearest loser is the small investor who buys and holds for retirement – exactly the profile of the American retail investor”).

⁹¹ Of course, Rule 10b-5 may still be relevant to retail investors to the extent that it deters securities fraud. However, many scholars agree that securities fraud class actions brought under Rule 10b-5 offer only limited deterrence value. See, e.g., *id.* at 1547-56.

⁹² For a discussion of states that permit holding claims, see Joshua Ratner, Note, *Stockholders’ Holding Claim Class Actions under State Law after the Uniform Standards Act of 1998*, 68 U. CHI. L. REV. 1035, 1039-40 (2001). Subsequent to that Note, the California Supreme Court has also recognized holding claims. See *Small v. Fritz Cos.*, 65 P.3d 1255, 1264-65 (Cal. Sup. Ct. 2003).

⁹³ See *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71, ___; 126 S.Ct. 1503, 1514 (2006).

connection with” the purchase or sale of a security within the meaning of the Uniform Act. According to the Supreme Court, it did. Thus, the Court concluded that the preemptive force of the Uniform Act reached holding claims. The *Dabit* Court was patently unsympathetic to the argument that its decision would mean that many investors would be left without any remedy at all. The Court stated:

[W]e do not here revisit the *Blue Chip Stamps* Court’s understanding of the equities involved in limiting the availability of private remedies under federal law; we are concerned instead with Congress’ intent in adopting a preemption provision, the evident purpose of which is to limit the availability of remedies under state law.⁹⁴

Thus, following *Dabit*, federal law ensures that many retail investors are without an effective private remedy, either under federal or state law.⁹⁵

Certainly, institutional investors also engage in “buy and hold” strategies, and to the extent that they do, they will also be limited by the actual purchaser or seller standing requirement. Thus, it could be argued that retail investors, as such, are not disfavored under the anti-fraud provisions of the securities laws, but rather that *holders* of securities – whoever they are -- are disfavored under the federal securities laws. That may be true, but retail investors suffer disproportionately from the *Blue Chip Stamps* standing requirement and the *Dabit* decision. First, the standing limitation rather uniquely impacts retail investors, because they are much more likely to hold securities than institutional

⁹⁴ See *id.* at ___ n. 13.

⁹⁵ To add insult to injury, these investors must then watch the value of their stock decline as the company settles class actions brought on behalf of defrauded purchasers who *are* permitted to recover under Rule 10b-5. As we know, private securities fraud class actions lead to wealth transfers. See, e.g., Alexander, *supra* note 72, at 1503 (stating that “[i]t is often said that settlements are, in large part, a transfer of wealth from current shareholders to former shareholders”). When a company settles a private securities fraud class action, wealth is transferred from investors who are shareholders at the time the settlement is paid (current shareholders) to defrauded investors who purchased during the class period (class members). If a current shareholder is also a class member, then wealth is essentially transferred from the current shareholder back to himself. However, if a current shareholder is not a member of the class – for example, because the current shareholder purchased his stock before the company issued the false corporate disclosure and continues to hold the stock – then wealth is transferred away from the current shareholder. This is precisely the situation of the typical retail investor.

investors. In addition, a typical retail investor who has been defrauded into holding securities will feel the bite of the fraud more than an institutional investor. Retail investors directly invest in the stock of relatively few companies.⁹⁶ If a retail investor is unlucky enough to hold stock in a company that has violated Rule 10b-5, the overall value of his stock portfolio will be undoubtedly significantly impacted. A more diversified investor would still be harmed, but the extent of the harm would be reduced because he had not disproportionately invested in the defrauding company's securities. Finally, as discussed below,⁹⁷ an institutional investor who has been defrauded into holding securities can circumvent both the *Blue Chips Stamps* standing requirement and the *Dabit* decision by bringing an individual action under state law in state court. Retail investors generally do not have that opportunity.

3. The Reform Act and the Uniform Act Create a Two-Tiered System of Investor Remedies for Securities Fraud That Disfavors Retail Investors.

As discussed above,⁹⁸ the combined effect of the Reform Act and the Uniform Act makes federal district court the “exclusive venue for most securities class action lawsuits.”⁹⁹ Thus, retail investors, who ordinarily have to use the class action vehicle to recover damages for securities fraud,¹⁰⁰ must pursue their claims under federal law in federal court, where they will be subject to the Reform Act. Institutional investors, however, are in a very different position.

Because institutional investors may have suffered substantial losses from a company's securities fraud, they may find it economically feasible to “opt out” of a class

⁹⁶ See *supra* notes 23-25 and accompanying text.

⁹⁷ See *infra* Part III.A.3.

⁹⁸ See *supra* Part II.C.3.

⁹⁹ See H.R. CONF. REP. NO. 105-803, *supra* note 49.

¹⁰⁰ See *supra* notes 33-35 and accompanying text.

action¹⁰¹ in order to file their own individual action.¹⁰² Why would an institutional investor choose to opt out of a securities fraud class action filed in federal district court?

The answer must be that the institutional investor believes it will get a better recovery if it directly pursues its own claim, as opposed to relying on the class action.¹⁰³ The institutional investor might believe it has stronger negotiating skills than the class counsel, so that the institutional investor has a better chance of obtaining a larger settlement by negotiating directly with the defendants. Or perhaps the institutional investor would prefer to work with its own lawyers, as opposed to the class counsel.

But there is another reason why the institutional investor might believe that it can obtain a larger settlement by opting out of the federal securities class action. Opting out permits the institutional investor to circumvent the Uniform Act; it enables the

¹⁰¹ The Federal Rules of Civil Procedure permit members of a class to opt out of the class action. Rule 23 states that all members of a class must be notified that “the court will exclude from the class any member who requests exclusion.” See FED. R. CIV. P. § 23(c)(2)(B). Rule 23 also permits a court to “refuse to approve a settlement unless it affords a new opportunity to request exclusion to individual class members who had an earlier opportunity to request exclusion but did not do so.” See FED. R. CIV. P. § 23(e)(3).

¹⁰² This individual securities fraud action could be filed in either federal court or state court. If it is filed in federal court, the Reform Act would still apply; the Reform Act generally applies to all securities fraud actions, whether brought as class actions, or on an individual basis. Thus, the heightened pleading standard for scienter and the automatic stay of discovery would apply to an individual action brought by an institutional investor in federal district court. One exception would be the lead plaintiff provision, which by its terms only applies to class actions. Compare, e.g., Securities Act of 1934 § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2) (2000) (stating that “in any private action . . .”) with Securities Act of 1933 § 27(a)(3)(B)(i), 15 U.S.C. § 77z-1(a)(3)(B)(i) (2000); Securities Exchange Act of 1934 § 21D(a)(1), 15 U.S.C. § 78u-4(a)(1) (2000) (stating that “provisions of this subsection shall apply to each private action arising under this Act that is brought as a plaintiff class action . . .”) (emphasis supplied). Therefore, as discussed below, the institutional investor might find it advantageous to file in state court.

¹⁰³ Whether an institutional investor will actually obtain a better recovery by opting out of a class action is unclear. Institutional investors who have opted out often state that their recovery was much greater than the recovery they would have received if they had remained in the class action. See, e.g., Josh Gerstein, *Time Warner Settles With Institutions for \$400 Million*, N.Y. SUN, March 1, 2007 (quoting lawyer for institutional investor as saying that its opt out recovery was “between 16 and 24 times what we would have gotten through the class”); Stephen Taub, “Opt Out” Plaintiffs Settle With WorldCom, CFO.COM, Oct. 19, 2005 (stating that institutional investors claimed to have received “three times more money than they would have received had they joined in the class action”). However, class action lawyers and lawyers representing the institutional investors who have opted out of the class action often disagree as to whether the institutional investor received larger recoveries in the individual action. See, e.g., Stephen Taub, *Class Action and “Opt Out” Lawyers Duke It Out*, COMPLIANCE WEEK, Nov. 8, 2005.

institutional investor to bring its action under state law in state court.¹⁰⁴ Because the Uniform Act preempts only state class actions,¹⁰⁵ individual actions can be brought in the friendlier environs of state court. Moreover, the Uniform Act expressly permits state and local public pension funds to file state *class* actions in state court.¹⁰⁶ In either situation, the state action will not be subject to the restrictive procedural provisions of the Reform Act. Specifically, state rules of civil procedure do not impose heightened pleading standard for scienter, nor do they provide for an automatic stay of discovery. Without the heightened pleading standard and automatic stay of discovery, the institutional investor will be more likely to survive a motion to dismiss and therefore has increased leverage in settlement negotiations.

Moreover, state securities law tends to be much more attractive to defrauded investors than Rule 10b-5. For example, many state blue sky laws provide buyers with an express private right of action for rescission if the seller offered or sold the security by means of a false or misleading statement of material fact.¹⁰⁷ For plaintiffs, there are

¹⁰⁴ In addition, some institutional investors have opted out of federal securities class actions to bring individual actions Rule 10b-5. Although there may be several reasons why the institutional investor might choose federal law over state law, the most obvious explanation is that the statute of limitations for the state claims may have expired. Note also that some institutional investors have opted out of federal securities class actions to bring individual actions under federal securities law in state court. These federal claims are brought under Section 11 and Section 12 of the Securities Act of 1933, which are not required to be brought in federal district court. The plaintiffs can then combine the '33 Act claims with state law claims.

¹⁰⁵ See *supra* note 53 and accompanying text.

¹⁰⁶ The Uniform Act provides that:

nothing in this section may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

See Securities Act of 1933 § 16(d)(2), 15 U.S.C. § 77p(d)(2); Securities Exchange Act of 1934 § 28(f)(3), 15 U.S.C. § 78bb(f)(3).

¹⁰⁷ For example, the Uniform Securities Act provides that “[a] person is liable to the person buying the security from the person for the consideration paid for the security . . . if the seller offers or sells a security . . . by means of any untrue statement of material fact or any omission of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . .” See Uniform Securities Act (1956) § 410(a)(2). Later versions of the Uniform Securities Act are similar. See Uniform Securities Act (1985) § 605; Uniform Securities Act (2002) § 509.

several advantages to this statute. The plaintiff need not show reliance or causation or damages. Moreover, the plaintiff need not show that the seller acted with scienter.¹⁰⁸ But the statute is not a cure-all for defrauded plaintiffs. Because the blue sky statute requires privity with the seller for the buyer to recover, the statute cannot be used by purchasers who purchased stock on the open market. Still, for purchasers who are able to establish privity – such as purchasers who received stock in connection with a merger or purchasers who bought stock directly from the issuer – the statute is much more attractive than Rule 10b-5. Clearly, institutional investors who are able to take advantages of this state statute are in a much stronger negotiating position than retail investors who can look only to Rule 10b-5 to recover. For example, the State of Alaska opted out of the AOL-Time Warner federal securities fraud class action to pursue an individual state securities fraud action pursuant to the Alaska version of this rescission statute.¹⁰⁹ Published reports indicate that the State of Alaska settled its claim for 83 cents on the dollar, far more than what was received by members of the federal securities class action.¹¹⁰

In addition to state statutory claims, state common law claims can also be more attractive than claims brought pursuant to Rule 10b-5. For example, state common law may permit investors to bring suit for negligent misrepresentation if a company has

¹⁰⁸ The Uniform Securities Act (1956) appears to be a strict liability offense, while the 1985 and 2002 versions of the Uniform Act provide the seller with a due diligence defense.

¹⁰⁹ The Alaska statute provides that “[a] person is liable to the person buying the security from the person for the consideration paid for the security . . . by means of an untrue statement of a material fact, or omits to state a material fact, the omission of which makes a statement misleading.” See ALASKA STAT. § 45.55.930(a)(2) (Michie 2007).

¹¹⁰ Josh Gerstein, *Time Warner Case Finds a Surprise*, N.Y. SUN, Dec. 7, 2006 (stating that the State of Alaska’s settlement “appears to be far superior to the payout in the nationwide settlement, which has not been calculated officially but is likely to be a few cents on the dollar, according to lawyers involved in the litigation”).

issued false corporate disclosure.¹¹¹ Because a plaintiff need only show that the defendant acted unreasonably, as opposed to recklessly or knowingly, the plaintiff may find it much easier to prevail with a claim for negligent misrepresentation.

State common law also may permit plaintiffs to bring claims that are not permitted under the federal securities laws. As discussed above,¹¹² investors who have been defrauded into holding securities are not permitted to recover under Rule 10b-5. Several states, however, do permit holding claims.¹¹³ Moreover, while the Supreme Court held that there is no private right of action for aiding and abetting a violation of Rule 10b-5,¹¹⁴ almost all states permit plaintiffs to recover against defendants who have aided and abetted a violation of state securities law.¹¹⁵

Thus, put simply, the institutional investor bringing an individual securities fraud action under state law in state court should be able to obtain a better settlement than if the institutional investor remained in the federal securities class action. This opportunity is not just theoretical; opt outs have seemingly occurred in all of the recent big securities fraud cases. Institutional investors have already begun opting out of class actions to pursue their own individual actions under state law in state court.¹¹⁶ And plaintiff law

¹¹¹ See ALAN R. BROMBERG & LEWIS LOWENFELS, 1 BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 2:200, at 2-430.

¹¹² See *supra* notes 89-91 and accompanying text.

¹¹³ See *supra* note 92 and accompanying text.

¹¹⁴ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994).

¹¹⁵ See BROMBERG & LOWENFELS, *supra* note 111, at § 2:200. According to testimony given by the SEC in connection with the passage of the Uniform Act, 49 states permit aiding-and-abetting liability. See TESTIMONY OF U.S. SECURITIES AND EXCHANGE COMMISSION BEFORE THE SENATE SECS. SUBCOMM., Oct. 29, 1997, at 19.

¹¹⁶ For example, the Retirement Systems of Alabama opted out of the WorldCom securities fraud class action to pursue its own individual action under state law in state court. It ultimately settled with the investment bank defendants for \$111 million. See Susanna Craig, *Bear Stearns Continues Its Contrarian Ways – Securities Firm Resists Settling a Lawsuit Linked to WorldCom for a Fight in Alabama*, WALL STREET JOURNAL, at C1 (Nov. 8, 2004). Similarly, the California State Teachers' Retirement System opted out of the AOL-TimeWarner securities class action to pursue its own individual action under state

firms, who have recognized an attractive new litigation opportunity, have been aggressive in educating institutional investors about the potential benefits of opting out to file individual actions under state law in state court.¹¹⁷ Retail investors simply do not have this opportunity. Together, the Reform Act and the Uniform Act have created a two-tiered system of investor remedies for securities fraud, one that gives privileged treatment to institutional investors.

4. Summary.

Retail investors who have been defrauded by false corporate disclosures will be disappointed by the remedies provided by Rule 10b-5. If retail investors happened to have purchased the company's stock during the period of fraud, they might recover something in a federal securities fraud class action, assuming they are able to overcome the significant obstacles imposed by the Reform Act. But these retail investors will often lose the opportunity to manage the class action to an institutional investor and may find that courts are unsympathetic to claims based on misleading optimistic corporate statements. If retail investors did not purchase the company's stock during the period of fraud, but were defrauded into holding their stock – a far more likely situation for retail investors – they have no remedy at all, either under federal law or state law. In addition, if they continue to hold stock in the company when the company settles the securities fraud class action, these retail investors will suffer again, as money is drained from the

law in state court. It ultimately settled for \$105 million. *See CalSTRS Settles AOL/TimeWarner Securities Fraud Suit* (Feb. 7, 2007) (available at <http://calstrs.com/newsroom/2007/news020707.aspx>).

¹¹⁷ Sometimes, the plaintiff law firms have been too aggressive in encouraging institutional investors to opt out of a class action. Milberg Weiss, for example, was publicly criticized by a federal district judge for certain actions it took in pursuing opt outs from the WorldCom securities fraud class action. *See In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), Opinion and Order, at 15-17 (S.D.N.Y. Nov. 17, 2003) (stating that “Milberg Weiss does not appear to have presented a forthright description of the advantages and disadvantages of both the individual action and class action options”). *See also* Anthony Lin, *Milberg Weiss Taken to Task for Conduct in WorldCom Case*, N.Y. L.J., Nov. 19, 2003.

company to pay class members. And in either situation, retail investors can only stand by and watch as defrauded institutional investors are permitted to pick and choose which law and forum offers them the most attractive chance for recovery. The typical retail investor does not have this opportunity.

B. Is the Disfavored Treatment of Retail Investors under Rule 10b-5 Intentional?

As discussed above,¹¹⁸ the antifraud provisions of the federal securities laws have the effect of disfavoring retail investors in several significant ways. But is the disfavored treatment intentional? It does not appear so. Instead, retail investors often seem to be simply overlooked. With the institutionalization of stock ownership, the focus of the federal securities laws in general, and of Rule 10b-5 in particular, has been on the role played by institutional investors. Not much attention is given to the plight of the defrauded retail investor: not by Congress, not by the courts, and not by legal scholars. Only the SEC has recognized – in a limited fashion -- that a retail investor is a specific type of investor who sometimes needs special protections under the antifraud provisions of the federal securities laws.

In recent years, Congress has generally evidenced more of a concern with protecting corporations and other deep pocket defendants than with protecting defrauded investors, whether the defrauded investors are institutional investors or retail investors. The Reform Act is an obvious example. Although the legislative history recites that one of the primary purposes of the Reform Act is to “protect investors,”¹¹⁹ Congress is not referring to *defrauded* investors. Instead, the focus of Congressional concern is on the “innocent shareholders” of corporations that are forced to pay settlements in frivolous

¹¹⁸ See *supra* Part III.A.

¹¹⁹ H.R. REP. NO. 104-369, *supra* note 40, (stating that “[t]he overriding purpose of our Nation’s securities laws is to protect investors and to maintain confidence in the securities markets”).

actions. As the Conference Report states, “[i]nvestors are always the ultimate losers when extortionate ‘settlements’ are extracted from issuers.”¹²⁰ In fact, in the Conference Report, there is only one indirect reference to the defrauded retail investor: in the discussion of the lead plaintiff provision. In this discussion, the Conference Report notes that institutional investors will be able to represent the interests of “small investors” more effectively than an investor with a small stake in the outcome of the class action.¹²¹ Because Congress had been persuaded that securities fraud class actions were generally non-meritorious, it is understandable that the Reform Act’s legislative history does not reveal more of a concern for defrauded investors.

The Uniform Act reflects a similar disinterest in defrauded investors. The Uniform Act’s legislative history is silent as to how preemption of state securities fraud laws might affect retail investors, or, indeed, institutional investors. Instead, consistent with the Uniform Act’s goal of making federal courts the exclusive venue for securities fraud class actions, the legislative history is focused on the costs of parallel state and federal litigation.¹²² The dissenting views of certain Senators do evidence a concern that “in too many cases, investors will be left without any effective remedies at all.”¹²³ However, these dissenting Senators did not draw any distinction between retail investors and institutional investors, nor did they recognize that institutional investors would be able to opt out of federal securities class actions to avoid both the Reform Act and the Uniform Act, leaving retail investors the truly disadvantaged class of defrauded investors.

¹²⁰ *See id.*

¹²¹ *See id.*

¹²² H.R. CONF. REP. NO. 105-803, *supra* note 49.

¹²³ *See* S. BANKING REP. NO. 105-182, Additional Views of Senators Sarbanes, Bryan, and Johnson (1998) (concluding that the Uniform Act will “harm innocent investors, undermine public confidence in the securities markets, and ultimately raise the cost of capital for deserving American businesses”).

A possible exception to Congressional apparent indifference towards defrauded investors is the passage of the Sarbanes-Oxley Act of 2002.¹²⁴ The Sarbanes-Oxley Act was a legislative response to the notorious accounting and securities fraud scandals typified by Enron and WorldCom, in which defrauded investors suffered billions of dollars in losses. Following these scandals, commentators wondered whether Congress was responsible in part for these massive frauds, pointing out that the Reform Act had significantly undermined the ability of the securities fraud class action to deter fraud.¹²⁵ With these criticisms, and the then-existing political environment, it is not at all surprising that the Sarbanes-Oxley Act's legislative history evidences more of a concern for defrauded investors. However, Congress did not choose to ease the burdens placed on plaintiffs bringing securities fraud class actions.¹²⁶ Instead, Congress chose a different approach, enacting laws designed to improve the accuracy and reliability of financial statements and other corporate disclosures, which Congress hoped would lead to increased investor protection.¹²⁷ But, once again, the legislative history of the Sarbanes-Oxley Act contains no specific reference to retail investors.

¹²⁴ Pub. L. No. 107-205, 116 Stat. 745 (2002).

¹²⁵ See, e.g., Stephen Labaton, *Now Who, Exactly Got Us Into This?*, N.Y. TIMES, Feb. 3, 2002 (stating that Congress “actually helped create a legal climate for Enron and Arthur Anderson to push the envelope”); Gary Weiss, Commentary: *Congress Will Huff and Puff . . . And Do Little*, BUS. WK., Feb. 25, 2002 (stating that “Congress must share the blame for Enron because [the Reform Act] chipped away at investor protections”).

¹²⁶ Congress did make one concession to the complaint that the securities fraud class action had been stripped of its bite. The Sarbanes-Oxley Act lengthened the statute of limitations period for federal securities fraud class actions. Under the Sarbanes-Oxley Act, the statute of limitations period for federal securities fraud is the earlier of two years following discovery of the fraud or five years following the fraud, regardless of when the fraud was discovered. See 28 U.S.C.A. § 1658(b). Prior to Sarbanes-Oxley, the statute of limitations for federal securities fraud actions was the earlier of one year following the discovery of the fraud or three years following the fraud, regardless of when the fraud was discovered. See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361 (1991).

¹²⁷ For a good discussion of the Sarbanes-Oxley Act, see Lawrence Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 917 (2003).

Securities fraud class actions have been disfavored by most federal courts for a long time,¹²⁸ but that does not necessarily mean that courts have purposely disfavored retail investors, as compared to institutional investors. After all, institutional investors will be members of the class action as well, and will probably be the most numerous members of the class and will have suffered the greatest losses. But, like Congress, courts do not generally recognize a retail investor as being any different from any other kind of investor.

The SEC has recognized that not all investors are alike, and that the federal securities laws may need to treat retail investors differently.¹²⁹ Sometimes, the differing treatment can be seen in the SEC's disclosure rules, such as the "Plain English" initiative¹³⁰ or Regulation FD.¹³¹ At other times, the differing treatment can be seen in exemptions from the registration requirements under the Securities Act of 1933, such as Regulation D.¹³²

¹²⁸ The Supreme Court's decision in *Blue Chip Stamps* is commonly thought to mark the beginning of a period of judicial hostility towards securities fraud class actions. See, e.g., Daniel J. Morrissey, 83 NEB. L. REV. 732, 739-41 (2005) (tracing the history of the Supreme Court's hostility towards federal securities fraud class actions).

¹²⁹ Indeed, the SEC often presents itself as being an advocate for the retail investors. As Professor Don Langevoort has noted, "[t]he Commission's main 'brand message' is about its role in empowering retail investors as a class." See Langevoort, *supra* note 78, at 174.

¹³⁰ Under these rules, certain parts of a corporation's prospectus must be written in "plain English;" *i.e.*, in a "clear, concise, and understandable manner." See Securities Act of 1933 Rule 421(a), 17 C.F.R. § 230.421 (a) (2007). See generally Kenneth B. Firtel, Note, *Plain English: A Reappraisal of the Intended Audience of Disclosure under the Securities Act of 1933*, 72 S. CAL. L. REV. 851 (1999) (evaluating the SEC's goal of making mandatory disclosure understandable to the "average investor").

¹³¹ Prior to the promulgation of Regulation FD, the SEC was concerned that corporations were disclosing material information first to institutional investors, analysts, and other privileged investors, and only later disclosing the same information to individual investors. In an attempt to "level the playing field," Regulation FD generally prohibits corporations from disclosing material information on a selective basis. See Regulation FD: Selective Disclosure, 17 C.F.R. §§ 243.100-103 (2007).

¹³² For example, under Regulation D, non-accredited investors generally must receive a disclosure document, while accredited investors do not have to be provided with a disclosure document. Although the definition of accredited investor includes certain types of wealthy retail investors, the definition primarily encompasses institutional investors. In addition, the SEC has interpreted Regulation D's ban on general advertising and solicitation to require that promoters pre-screen potential investors for suitability. Finally, one of Regulation D's exemptions imposes a "sophistication" requirement on all purchasers in the

The SEC has also recognized that retail investors are particularly vulnerable to securities fraud and thus may need special protections. For example, the SEC has created an “Office of Investor Education and Assistance,” which, according to the SEC’s website “provide[s] a variety of services to address the problems and questions you may face as an investor.”¹³³ A review of the information contained on the OIEA site demonstrates that the OIEA is attempting to meet the specialized needs of retail investors,¹³⁴ especially as to securities fraud.¹³⁵ In addition to investor education, the SEC has attempted to protect retail investors from securities fraud by instituting an aggressive enforcement policy that focuses on specific types of securities fraud targeted at especially vulnerable retail investors.¹³⁶ However, the SEC has not evidenced the same kind of concern for retail investors, or, indeed, for any investors, who seek a private remedy for securities fraud.¹³⁷

Regulation D offering. In these ways, the SEC provides increased protections under the federal securities laws to the typical retail investor.

¹³³ According to the SEC’s website, the Office of Investor Education and Assistance “cannot tell you what investments to make, but we can tell you how to invest wisely and avoid fraud.” *See* <http://www.sec.gov/investor.shtml> (last visited March 5, 2007).

¹³⁴ For example, the OIEA site provides information on choosing brokers and investment advisers and provides a link to “Rulemaking of Interest to Individual Investors.” *See id.* The site also provides dedicated links which set forth specialized information for particular types of retail investors, such as senior citizens. *See* <http://www.sec.gov/investor/seniors.shtml> (last visited March 5, 2007).

¹³⁵ For example, the website contains links to numerous publications devoted to helping retail investors avoid securities fraud. Topics include “Avoiding Internet Investment Scams: Tips for Investors,” “How to Avoid Fraud,” and “Stock Market Fraud ‘Survivor’ Checklist.” *See* http://www.sec.gov/investor/pubs_subject.shtml#fraud (last visited March 5, 2007).

¹³⁶ *See* Sachs, *supra* note 82, at 477-78 (noting that SEC enforcement actions have been filed “on behalf of [vulnerable retail] investors deceived by palpably implausible representations”).

¹³⁷ The SEC has filed amicus briefs with the United States Supreme Court that support the defendant’s position in all of the recent high-profile private securities fraud class actions. *See, e.g.,* Telllabs, Inc. v. Makor Issues & Rights, Ltd., Brief for the United States Supporting Petitioners (available at <http://sec.gov/litigation/briefs/2007/telllabsbrief.pdf>) (arguing for a stricter pleading standard for scienter); Merrill Lynch v. Dabit, Brief for the United States As Amicus Curiae Supporting Petitioner (available at http://www.usdoj.gov/osg/briefs/2005/3mer/1ami/2004-1371_mer.ami.html) (urging the preemption of holding claims by the Uniform Act); Dura Pharmaceuticals, Inc. v. Broudo, Brief for the United States As Amicus Curiae (available at <http://www.sec.gov/litigation/briefs/2003-0932.pet.ami.inv.pdf>) (urging a stricter standard for pleading loss causation).

Most legal scholars have not given much attention to the plight of the retail investor who has been defrauded by false corporate disclosures.¹³⁸ Aside from some recent work that considers how the “reasonable investor” materiality standard may disadvantage retail investors,¹³⁹ there is very little scholarship addressing retail investors and the antifraud provisions of the federal securities laws.¹⁴⁰ In fact, there is very little legal scholarship addressing retail investors at all.¹⁴¹ I suppose that this disinterest should

¹³⁸ Of course, there has been significant work done on retail investors who have been defrauded by their brokers. See, e.g., Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 PACE L. REV. 1 (2004) (assessing the fairness of the arbitration process); Jill I. Gross, *Securities Mediation: Dispute Resolution for the Individual Investor*, 21 OHIO ST. J. ON DISP. RESOL. 329 (2006) (arguing that mediation is a fair alternative to arbitration for disputes between retail customers and their brokers); Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C.L. REV. 123 (2005) (arguing that arbitration must be reformed in order to provide a fair mechanism for resolving disputes between retail customers and their brokers).

¹³⁹ See Hoffman, *supra* note 81, at 605 (concluding that when courts presume immateriality, they are “help[ing] wealthy defendants at the expense of ‘less rational’ and often poorer, plaintiffs”); Langevoort, *supra* note 78, at 185 (recognizing that ignoring investor biases in applying the TSC materiality standard “would only invite a high incidence of exploitation”); Sachs, *supra* note 82, at 476 (arguing that the TSC materiality standard “has an Achilles’ heel – its inability to address the fraud that deceives certain unsophisticated investors”).

¹⁴⁰ There are several notable exceptions to this general statement. Professor Lisa Fairfax has written on the particular problem of affinity fraud, *i.e.*, securities fraud that “targets members of an identifiable group perpetrated by a member within the group.” Affinity fraud ordinarily targets retail investors. See Lisa M. Fairfax, “*With Friends Like These . . .*”: *Toward a More Efficacious Response to Affinity-Based Securities and Investment Fraud*, 35 GA. L. REV., 63, 71 (2001) (arguing for increased punishments for affinity fraud). In addition, several articles have addressed the securities fraud implications of false recommendations made by research analysts to the investing public, *i.e.*, retail investors. See, e.g., Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 57 (2006); John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. L. REV. 1, 69-70 (2003) (noting that retail investors are more likely to rely on sell-side research analysts than institutional investors).

¹⁴¹ I have found relatively few law review articles that focus on retail investors. Of those articles, several address the issue of ensuring that retail investors receive equal access to information. See Peter L. Cholakis, Comment, *Company Disclosures of Earnings Projections: Should Individual Investors Be Allowed Into the “Ball Park?”*, 39 SANTA CLARA L. REV. 819 (1999); Brian C. Eddy, Note, *Internet Road Shows: It’s Time to Open the Door for the Retail Investor*, 25 J. CORP. L. 867 (2000); Satu S. Svahn, Note, *Greater Investor Outreach at the Click of a Mouse: The Internet and Closed-Circuit Roadshows Should Reach Retail Investors*, 65 BROOK. L. REV. 249 (1999); Linda J. Yi, Note, *Road Shows on the Internet: Taking Individuals For a Ride on the Information Highway*, 52 DUKE L.J. 243 (2002). Other articles focus on the suitability of particular types of investments for retail investors. See Jeffrey J. Haas, *Small Issue Public Offerings Conducted Over the Internet: Are They “Suitable” for the Retail Investor?*, 72 S. CAL. L. REV. 67 (1998); Felix Salmon, *Stop Selling Bonds to Retail Investors*, 35 GEO. J. INT’L L. 837 (2004). The remaining articles address a wide variety of issues relating to retail investors. See Howell E. Jackson, *To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns*, 28 J. CORP. L. 671 (2003); Eric C. Otness, Comment, *Balancing the Interests of Retail and Institutional Investors: The Continued Quest for Transparency in*

not be surprising, as most of the “action” in federal securities regulation focuses on institutional investors.

IV. What Should Be Done To Address the Disfavored Treatment of Retail Investors under Rule 10b-5?

Even if retail investors are not purposefully disfavored by the antifraud provisions of the federal securities laws, the fact remains that they *are* disfavored. What, if anything, should be done to address their disadvantaged position under Rule 10b-5?

1. Do Nothing.

An argument could be made that nothing should be done to address the disfavored treatment of retail investors under Rule 10b-5. After all, the typical defrauded retail investor ordinarily suffers a relatively small amount of damages. If this disfavored treatment costs a retail investor only \$100 or so, why get upset? Moreover, as Professor Richard Booth has argued, investors can largely protect themselves from false corporate disclosures through diversification.¹⁴² Thus, if retail investors choose to ignore the benefits of diversification, they should not be able to recover under Rule 10b-5.

These may be valid points, but before policymakers decide to ignore the disfavored treatment of retail investors, they should consider several additional concerns. Disfavored treatment could lead retail investors to question the fairness of the federal securities laws, contributing to a loss of investor confidence in U.S. markets.

Today's Fragmented Equity Markets, 96 NW. U. L. REV. 1607 (2002); S. Eric Wang, *Investing Abroad: Regulation S and U.S. Retail Investment in Foreign Securities*, 10 U. Miami Bus. L. Rev. 329 (2002). In addition to these articles which expressly focus on retail investors, a few articles address issues affecting retail investors through discussions of investor sophistication. See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000) (proposing that investors be licensed in order to participate in the securities markets); Fletcher, *supra* note 58, at 1085 (proposing that “ a court may properly treat sophisticated investors differently from other investors when the claim at issue involves either explicit congressional permission or a judicially created right of action”).

¹⁴² Richard A. Booth, *The End of Securities Fraud Class Action?*, 29 REG. 46 (2006).

Specifically, if retail investors become aware of the two-tiered system of investor remedies, they might think twice about investing in the stock market. This is not merely an academic concern. In other areas of securities regulation, policymakers have long recognized that a perception that the securities markets do not provide a “level playing field” for all investors creates the danger of a loss of investor confidence.¹⁴³ While it is impossible to determine whether the disfavored treatment described above would cause retail investors to abandon the stock market, it is a legitimate concern.¹⁴⁴

Another concern is that disfavored treatment under the antifraud provisions of the federal securities laws would encourage retail investors to shift from direct investments to indirect investments. In other words, retail investors would shift money that had been directly invested in stocks into mutual funds. These former retail investors would then gain the benefits of the privileged status awarded to institutional investors by antifraud provisions of the federal securities laws. Of course, this would lead to an even higher level of institutionalization of stock ownership. Not only would retail investors come out

¹⁴³ For example, one reason the federal securities laws prohibit insider trading is that the lack of a level playing field undermines investor confidence in the securities markets. As one commentator summarized: [T]he consensus among the American public, Congress, and the SEC is that is that insider trading is ‘unfair’ and erodes investor confidence in the market. This consensus has given rise to a set of insider trading laws that attempt to preserve investor confidence in the market and level the playing field between insiders and public shareholders.

See Jesse M. Fried, *Insider Abstention*, 113 Yale L.J. 455 (2003).

The SEC promulgated Regulation FD for similar reasons. In Regulation FD’s adopting release, the SEC stated that:

We believe that the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security’s price change dramatically and only later are given access to the information responsible for that move rightly question whether they are on a level playing field with market insiders.

See Securities and Exchange Commission, *Selective Disclosure and Insider Trading*, Release No. 34-43154, Aug. 15, 2000.

¹⁴⁴ See Marc I. Steinberg, *Curtailing Investor Protection Under the Securities Laws: Good for the Economy?* 55 S.M.U. L. REV. 347, 353 (2002) (stating that “[t]he extent to which [investors] 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”).

ahead under the antifraud provisions of the federal securities laws, they would also presumably gain the benefits of diversification.

However, such reallocation from direct stock ownership to indirect ownership could harm the securities markets. It is widely recognized that retail investors provide needed liquidity to U.S. stock markets.¹⁴⁵ If a market is comprised only of institutional investors, there will be relatively few potential buyers and sellers. Thus, institutional investors wanting to sell their presumably large holdings might be unable to find buyers.¹⁴⁶ Similarly, institutional investors wanting to purchase stock in companies may not be able to find a seller. Such an imbalance would undermine the efficiency of the stock markets.

2. Address Specific Areas of Disfavored Treatment of Retail Investors.

A second approach would be to attempt to correct one or more of the three specific areas of disfavored treatment identified above: (1) that retail investors who are members of a securities fraud class action are disfavored by the rebuttable presumption contained in the lead plaintiff provision and by the “reasonable investor” materiality standard; (2) that retail investors – as holders of securities -- often do not have any remedies for securities fraud; and (3) that the Reform Act and the Uniform Act have created a two-tiered system of remedies for securities fraud. Although this approach might succeed as to one or two identified areas of disfavored treatment, I am not

¹⁴⁵ See *id.* (stating that “[a]lthough institutional holdings comprise a majority of participation [in U.S. markets], individual holdings play significant roles in providing needed capital and liquidity to business enterprises and markets”).

¹⁴⁶ The difficulty in finding buyers may also be aggravated by the signals received by the market when an institutional investor chooses to sell its holdings. The market would perceive the sale as lack of confidence in the company and its future. See Gregory La Blanc & Jeffrey J. Rachlinski, *In Praise of Investor Irrationality*, in *THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR* 542 (Francesco Parisi & Vernon L. Smith, eds.) (2005) (stating that in a market dominated by institutional investors, “[a]ny current investor is thus essentially an insider and any decision to sell is a signal of the investor’s lack of confidence”).

optimistic that it will improve the overall treatment of retail investors under the federal securities laws.

First, the good news. The rebuttable presumption in the lead plaintiff provision is the one example where retail investors are expressly disfavored under the antifraud provisions of the federal securities laws. But this is not necessarily a bad thing. As discussed above,¹⁴⁷ there may very well be good reasons for preferring institutional investors over retail investors as lead plaintiffs. Still, concerns remain that large institutional investors may have very different objectives than small retail investors, creating the danger that institutional investors might be willing to compromise the interests of retail investors. However, if courts are receptive to arguments by retail investors that the presumption ought to be rebutted because the institutional investor would not adequately represent the class, then the concern that the lead plaintiff provision treats retail investors unfairly is reduced. Some courts have shown a willingness to appoint co-lead plaintiffs to ensure that retail investors are fairly represented in the class action. More courts need to follow this lead.

There is some hope that courts are becoming more sensitive to the danger that the “reasonable investor” materiality standard can negatively impact retail investors. As discussed above,¹⁴⁸ a few courts seem to have misapplied the *TSC Industries* standard, perhaps deliberately, to permit securities fraud claims to go forward, even though the misleading statements pretty clearly constituted puffery and were therefore immaterial as a matter of law. However, I doubt that this more liberal approach to the materiality standard will become widely accepted by courts. First, the judicial misapplication of the

¹⁴⁷ See *supra* Part III.A.1.b.

¹⁴⁸ See *supra* notes 82-83 and accompanying text.

materiality standard seems to have arisen primarily in SEC enforcement actions, not private class actions. In an enforcement action, a court may be willing to bend the materiality standard to ensure that the SEC is able to stop cases of egregious fraud. Enforcement actions, after all, are considered meritorious. But securities fraud class actions are another matter altogether. Securities fraud class actions are generally viewed by courts as frivolous, non-meritorious, and vexatious. I doubt that courts would bend the materiality standard to permit a securities fraud class action to survive a motion to dismiss.¹⁴⁹ Nor do I advocate courts purposefully misapplying the law in order to achieve a more “just” result. Such an approach would simply inject confusion into our understanding of the materiality standard. Instead, in determining whether a statement constitutes puffery in a securities fraud class action, courts should carefully consider the context of the disclosure,¹⁵⁰ as well as the teachings of behavioral finance,¹⁵¹ before dismissing the claim as a matter of law.

Moreover, it is extremely unlikely that the federal securities laws will be amended to permit investors who have been defrauded into holding securities to recover under the antifraud provisions of the federal securities laws. The potential unfairness of the

¹⁴⁹ Theoretically, courts could amend the *TSC Industries* materiality standard to recognize that statements of corporate optimism can be considered important by retail investors. One noted scholar has already proposed an alternative materiality standard. Professor Sachs suggests that information would be considered material if “(1) there is a substantial likelihood that it would be regarded as important by ‘the least sophisticated investor,’ and (2) the defendant made it with actual knowledge of its likely deceptive effect.” See Sachs, *supra* note 82, at 502. However, because the plaintiff would have to plead and prove a more rigorous scienter level, this “least sophisticated investor” materiality standard would generally be useful only in enforcement actions. See *id.* at 503. Therefore, it would not offer much assistance to retail investors hoping to recover under the antifraud provisions of the federal securities.

¹⁵⁰ See O’Hare, *supra* note 77, at 1736-1740 (setting forth a proposed framework for addressing the materiality of vague statements of corporate optimism).

¹⁵¹ As one commentator has argued, “Whether certain behaviors are or are not ordinary and reasonable need not be resolved by informed judicial hunches. Courts [can] . . . use experimental evidence of human behavior to help guide the relevant decision maker to a better understanding of how individuals actually act.” See Hoffman, *supra* note 81, at 607.

purchaser-seller holding requirement has been recognized since *Blue Chip Stamps* was decided more than 30 years ago.¹⁵² And only last year, the Supreme Court again foreclosed holders from recovering, this time under state law.¹⁵³ Securities fraud class actions are viewed with suspicion by the courts, by Congress, and by the SEC. Academics are torn as to whether private enforcement of Rule 10b-5 provides a benefit, with some even advocating that the securities fraud class action should be eliminated.¹⁵⁴ In this kind of environment, it is doubtful that pointing out that the standing requirement effectively makes Rule 10b-5 irrelevant to most retail investors would persuade policy makers to change the law. This is one type of disfavored treatment that will not be remedied.

Finally, what should be done about the two-tiered system of investor remedies for securities fraud, which provides institutional investors with a choice of law and forum? Although I believe that this disparate treatment between retail investors and institutional investors is troubling, I am not in favor of amending the securities laws to preclude institutional investors from “opting out” of federal securities fraud class actions to take advantage of more attractive state laws and forums. While the opportunity to pick and choose securities fraud remedies offers institutional investors a significant advantage over retail investors, the solution is not to take that opportunity away from institutional investors. That would only make it more difficult for defrauded institutional investors to obtain damages for their losses. To level the playing field, retail investors would have to

¹⁵² See *supra* note 87 and accompanying text.

¹⁵³ See *supra* notes 92-95 and accompanying text.

¹⁵⁴ See, e.g., Joseph A. Grundfest, *The Class Action Market*, WALL ST. J., Feb. 7, 2007, at A15 (stating that “[a]s long as the government’s enforcement activities remain sufficiently vigorous, the private class action securities fraud lawsuit can be viewed as an expensive, wasteful and unnecessary sideshow that generates little deterrence and offers questionable levels of compensation”).

be given the same opportunity to seek redress in either forum, but that is obviously not going to happen. After all, the Uniform Act was enacted for the very purpose of preventing defrauded investors from bringing class actions in state court.

Moreover, to take this opportunity away from institutional investors, the Uniform Act would have to be amended to preempt *all* securities fraud actions, not just *class* actions. Preempting all securities fraud actions would be an extreme response and would raise significant federalism issues that are beyond the scope of this paper. In *Dabit*, for example, the Supreme Court’s conclusion that holding claims were preempted by the Uniform Act was based in part on the fact that individual claims could still be brought under state law.¹⁵⁵ Therefore, the Court reasoned, the presumption against preemption “carrie[d] less force.”¹⁵⁶

V. Conclusion.

For most retail investors, Rule 10b-5 does not provide an adequate remedy for securities fraud. Moreover, policymakers have been so focused on privileging institutional investors that they have simply overlooked retail investors, effectively creating a two-tiered system of investor remedies for securities fraud.

This failure to consider retail investors as a discrete subgroup of investors has harmed retail investors, and has created the potential for serious unintended consequences. Because Rule 10b-5 does not provide an effective remedy, retail investors will have no choice but to view false corporate disclosures as just another cost of

¹⁵⁵ See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, ___, 126 S.Ct. 1503, 1514 (2006).

¹⁵⁶ In fact, according to the Supreme Court, the Uniform Act:

does not actually pre-empt any state cause of action. It simply denies plaintiffs the right to use the class action device to vindicate certain claims. The Act does not deny any individual plaintiff, or indeed any group of fewer than 50 plaintiffs, the right to enforce any state-law cause of action that may exist.

See id.

investing, not much different than brokerage fees. If these costs get too high, retail investors may pull their money out of the stock market. Or retail investors may respond to their disfavored status by moving their money into mutual funds. Put another way, disfavored treatment under the antifraud provisions of the federal securities laws imposes a penalty on retail investors who choose to invest directly in the stock market.

If policymakers wish to discourage the average investor from investing directly in the stock market, then they should do so expressly. If this is not their intention, then policymakers need to become much more aware of the plight of the defrauded retail investor when considering reforms to private securities fraud litigation and in determining enforcement initiatives.