EQUITY COMPENSATION AND INFORMANT BOUNTIES: HOW TYING THE LATTER TO THE FORMER MAY FINALLY ALLEVIATE THE SECURITIES FRAUD PREDICAMENT IN AMERICA

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I. INTRODUCTION[1]

Recent Supreme Court decisions, including *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[2] and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[3] have brought complex securities fraud issues back into the national limelight.[4] Moreover, growing frustration with the Sarbanes-Oxley Act of 2002[5] and the current financial catastrophe have further intensified securities concerns. Regardless of which side one supports in the ongoing debate regarding appropriate regulation, one thing is certain: securities fraud continues to purge the American markets of billions of dollars per year.[6] With today's political disposition favoring increased government

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1. The scope of this Note is limited to traditional 10b-5 fraud claims. Most commonly, class action claims are against a nationally listed issuer by holders in the secondary markets; this Note is not intended to replace primary market regulation.

2. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

3. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

4. These issues never truly disappeared.

5. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 and 28 U.S.C.).

6. Total estimated "maximum dollar loss" in 2007 was $676 billion. *See* Cornerstone Research Securities, http://securities.cornerstone.com/Research/litigation.htm#MDL [hereinafter Cornerstone

oversight of corporate America, and with a new presidential regime, the time for reevaluating America's procedure for detecting and deterring large-scale securities fraud is swiftly approaching.

This Note presents a new approach to securities fraud that aims to increase early detection, enforcement, and deterrence, while easing some of the traditional concerns surrounding the current enforcement system.[7] Part II reviews the history of private securities litigation from the adoption of the Securities Act of 1933[8] and the Securities Exchange Act of 1934[9] to the Supreme Court's recent decisions in *Stoneridge*[10] and *Tellabs*.[11] Part III highlights important securities fraud legislation implemented over the past twenty years, concluding with a brief presentation of the Securities and Exchange Commission's ("SEC's") current enforcement powers. Part IV presents some of the traditional concerns regarding the current securities fraud enforcement system with an emphasis on its inability to deter fraudulent behavior. Part V illustrates a new approach to securities fraud that will effectively increase early detection and deterrence without exacerbating the traditional problems with the current system.

II. A BRIEF HISTORY OF PRIVATE SECURITIES FRAUD LITIGATION[12]

The historical roots of private securities fraud litigation date back to the Great Depression and the stock market crash of 1929. In response to these financial disasters, Congress passed the Securities Act of 1933[13] ("the '33 Act") and the Securities Exchange Act of 1934[14] ("the '34 Act") (collectively, the "Securities Laws"). Although these Acts provide the groundwork for today's private securities fraud cause of action,[15] they were intended to restore investor confidence through full and fair disclosure of market information, not through fraud detection and prevention.[16] It was

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7. For example, private securities actions and administrative enforcement.

8. 15 U.S.C. § 77a (2006).

9. *Id.* § 78a.

10. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

11. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

12. Private securities fraud litigation refers only to securities class actions, ignoring derivative actions entirely.

13. 15 U.S.C. § 77a. Because this Note aims to curb securities fraud in relation to the secondary markets (also known as accounting fraud and corporate fraud), the provisions of the '33 Act are far less significant than those of the '34 Act.

14. *Id.* § 78a. The '34 Act and its amendments provide the legislative focus of this Note.

15. *See id.* §§ 77k, 78j(b).

16. *See* Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 23 (2002).

not until the promulgation of Rule 10b-5[17] under the '34 Act that the modern securities fraud class action was truly created.[18]

A. RULE 10B-5

Rule 10b-5, as promulgated under Section 10(b) of the '34 Act, states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[19]

Although Rule 10b-5 does not include an express private right of action, an implied right has been recognized in the lower courts since 1946 and was officially recognized by the Supreme Court in 1971.[20]

To avoid dismissal under 10b-5 a plaintiff must plead

> (1) that the defendant made an untrue statement (or omission); (2) of material fact; (3) that the plaintiff relied on the untrue statement (or omission); (4) that the plaintiff sustained damages as a proximate result of the untrue statement (or omission); (5) that the defendant made the untrue statement (or omission) with scienter; and (6) that the conduct occurred in connection with the sale or purchase of a security.[21]

The degree of difficulty in meeting these requirements has been largely dependent on the varying mindsets of both Congress and the Court.

B. THE RISE OF PLAINTIFF'S RIGHTS UNDER 10B-5: *BASIC* AND FRAUD ON THE MARKET

Symbolically, plaintiff's rights reached their peak in the 1964 case of *J.I. Case Co. v. Borak* when the Warren Court recognized that private

17. 17 C.F.R. § 240.10b-5 (2009).
18. *See* JAMES D. COX ET AL., SECURITIES REGULATION 701 (3d ed. 2001).
19. 17 C.F.R. § 240.10b-5.
20. *See In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 494 (S.D.N.Y. 2005) (citing Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971)).
21. Elizabeth Cosenza, *Rethinking Attorney Liability Under Rule 10b-5 in Light of the Supreme Court's Decisions in* Tellabs *and* Stoneridge, 16 GEO. MASON L. REV. 1, 9 (2008).

enforcement of the Securities Laws provides a "necessary supplement" to SEC action.[22] Thus, the Warren Court implicitly embraced the idealistic concept of "private attorneys general" in the securities laws context.[23] The rise of plaintiff's rights under Rule 10b-5 reached its true peak in 1988 when the Supreme Court accepted a pro-plaintiff presumption supported by a young, but favored, macroeconomic theory.[24]

Prior to the Supreme Court's decision in *Basic Inc. v. Levinson*, establishing reliance, or "the . . . causal connection between a defendant's misrepresentation and a plaintiff's injury,"[25] was a significant challenge for many plaintiffs. The reliance element required each individual plaintiff to prove that the defendant's actions *caused* them to take part in the transaction in question.[26] As noted in *Basic*, "[r]equiring proof of individualized reliance from each member of the proposed plaintiffs effectively would have prevented respondents from proceeding with a class action."[27] In short, the traditional reliance requirement destroyed most class members' only opportunity for compensation.[28]

In response to these reliance problems, the respondents in *Basic* argued for the adoption of the fraud on the market theory.[29] In sum:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.[30]

Finding, in part, that the fraud on the market presumption is supported by common sense and probability, the Court embraced the rebuttable presumption,[31] effectively eliminating the reliance element entirely.

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22. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

23. For background information on the concept of private attorneys general, see Jeremy A. Rabkin, *The Secret Life of the Private Attorney General*, LAW & CONTEMP. PROBS., Winter 1998, at 179.

24. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).

25. *Id.* at 243 (citing Wilson v. Comtech Telecomms. Corp., 648 F.2d 88, 92 (2d Cir. 1981); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965)).

26. Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 174 (3d Cir. 2001) (citing Robbins v. Kroger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997)).

27. *Basic*, 485 U.S. at 242.

28. Without the resources of a class, it is inefficient and often financially impossible to proceed individually with a 10b-5 claim.

29. *See Basic*, 485 U.S. at 228.

30. *Id.* at 241–42 (citing Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).

31. *Id.* at 245–47.

"Although the Court in *Basic* treated its adoption of the presumption as primarily a procedural change making securities fraud class actions more manageable, the presumption in fact produced an enormous increase in liability exposure for corporate issuers."[32]

C. The Decline of Plaintiff's Rights Under 10b-5

With concerns about vexatious litigation and strategic plaintiff's attorneys arising as early as 1975, the expansion of plaintiff's rights under Rule 10b-5 was bound to be short lived.[33] The first blow to 10b-5 plaintiffs was delivered by the Supreme Court in 1994,[34] and the trend continues today.[35] Some of the more pertinent examples are highlighted below.

1. *Central Bank*

Prior to *Central Bank of Denver v. First Interstate Bank of Denver*, the federal judiciary recognized a private right of action against aiders and abettors under Rule 10b-5.[36] In recognizing this private right, the lower courts reasoned that without legislative expression to the contrary, "the statute must be flexibly applied so as to implement its policies and purposes."[37] In *Central Bank* the Supreme Court held that the absence of an explicit private right of action for aiding and abetting was "legislative expression to the contrary."[38] In addition, the Court found that extending a private right of action for aiding and abetting liability, where none existed, would improperly impose liability on secondary actors who "do not engage in the proscribed activities at all, but who give a degree of aid to those who do."[39] Finally, the Court reasoned that recognizing liability for secondary violations would mistakenly remove the element of reliance and that aiding and abetting liability could be properly handled under the authority of the SEC.[40] Consequently, the Court abolished the implied private right of

32. A. C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 948 (1999) (footnote omitted).

33. *See* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 498–99 (1997).

34. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

35. For the Court's most recent decision, see *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

36. *See, e.g.*, *Cent. Bank*, 511 U.S. at 194 (identifying aiding and abetting actions in the federal circuit courts). Aiding and abetting liability is also commonly referred to as secondary liability.

37. *Id.* at 169 (citing Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680–81 (N.D. Ind. 1966)).

38. *Id.* at 169 (citing *Brennan*, 259 F. Supp. at 680–81).

39. *Id.* at 176.

40. *Id.* at 180, 183.

action for aiding and abetting under Section 10(b) and Rule 10b-5.[41]

2. The Private Securities Litigation Reform Act ("PSLRA") of 1995[42]

In direct response to growing concerns regarding "strike suits,"[43] strategic plaintiffs, and the testimony of corporate officers supporting those concerns,[44] Congress passed the PSLRA over a presidential veto in 1995. The intent of the PSLRA was to amend the Securities Laws to "end frivolous securities fraud lawsuits by imposing both procedural and substantive hurdles upon securities plaintiffs,"[45] but it was the "super heightened" pleading standards and the bar to discovery that have had the greatest impact on private securities fraud class actions.[46]

To meet the heightened requirements of the PSLRA, a plaintiff must plead scienter with particularity and is barred from seeking discovery until the defendant's motion to dismiss is resolved.[47] Specifically, the plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[48] Prior to the PSLRA, intent could be "averred generally," and prior to a motion to dismiss, plaintiffs were able to conduct discovery to further uncover the alleged fraud.[49] After passage of the PSLRA, plaintiffs must essentially prove their case prior to a motion to dismiss by identifying specific statements made by the accused.[50] If a plaintiff cannot meet these heightened standards, the class action will not be certified and the plaintiff's class is foreclosed from proceeding with the lawsuit.[51]

41. *Id.* at 191.

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

43. A "strike suit" is a meritless suit filed in an attempt to extract settlement from a defendant that would rather pay the settlement than pay the costs associated with defending the litigation. Andre Douglas Pond Cummings, *"Ain't No Glory in Pain": How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets*, 83 NEB. L. REV. 979, 1007 (2005).

44. *See Private Litigation Under the Federal Securities Laws: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 104–51 (1993).

45. *See* Cummings, *supra* note 43, at 1007.

46. *See id.* at 1009–11; James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 741 (2003).

47. Scienter is defined as the specific intent to defraud. *See* 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(2), 78u-4(b)(3)(B) (2006).

48. *Id.* § 78u-4(b)(2).

49. *See* Cummings, *supra* note 43, at 1011.

50. *Id.*

51. *Id.* at 1010–11.

3. *Tellabs*

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Court set up a process for evaluating a motion to dismiss for failure to adequately plead a "strong inference" of scienter under the PSLRA.[52] First, a court must accept all the allegations in the complaint as true.[53] Next, a court must examine the entire complaint to determine if all of the alleged facts, taken as a whole, give rise to a strong inference of scienter.[54] Finally, in evaluating whether the complaint gives rise to a strong inference of scienter, a court must consider all plausible competing inferences.[55] An inference of scienter need not be irrebuttable, but "[a] complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts."[56] Although the clarified standard under *Tellabs* is not as strict as a "smoking gun" standard, it is much stricter than the "averred generally" standard that existed prior to the PSLRA.[57]

4. *Stoneridge*

The Court's decision to eliminate a private right of action for aiding and abetting liability in *Central Bank* did not resolve the broader question regarding the limits of secondary actor liability under the Securities Laws. The Supreme Court's cautionary statement regarding the limits of its holding in *Central Bank*[58] fostered confusion in the lower courts and allowed aiding and abetting actions to proceed under the theory of scheme liability.[59] The Supreme Court put to rest any confusion regarding the

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52. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314–24 (2007). This process helps clarify the true effect of the PSLRA's heightened pleading requirements on securities fraud class actions.

53. *Id.* at 322.

54. *Id.* at 322–23.

55. *Id.* at 323.

56. *Id.* at 324.

57. It should also be noted that the Court's decision in *Tellabs* does not affect the PSLRA's other heightened pleading standards, such as the identification and explanation of misleading statements, or the discovery bar. *See generally Tellabs*, 551 U.S. 308 (determining the standard for scienter). *See also* Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

58. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators . . . ." (citation omitted)).

59. *See, e.g.*, *In re* Charter Commc'ns, Inc., Sec. Litig., 443 F.3d 987 (8th Cir. 2006), *cert.*

viability of secondary liability under Rule 10b-5 with its decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[60]

In *Stoneridge*, the plaintiffs alleged that secondary actors (the "Vendors") had knowingly entered into a "continuous fraudulent scheme intended to artificially boost [Charter Communication's] reported financial results" by entering into sham transactions aimed to inflate Charter's reported operating revenues and cashflows.[61] During the course of the *Stoneridge* litigation, the Court entertained fifteen amicus briefs in support of scheme liability and fifteen briefs opposing scheme liability.[62] In the end, the Supreme Court determined that reliance, an essential element of a Section 10(b) private right of action, was missing from the complaint, and the private right of action under scheme liability met the same fate as the private right of action for aiding and abetting.[63] Although *Stoneridge* arguably left the door to secondary liability under Section 10(b) slightly cracked,[64] it followed the course set in *Central Bank* and, in all practicality, eliminated the possibility of pursuing any implied private right of action against secondary actors under Section 10(b) of the '34 Act.

The Warren Court's once warm embrace of private securities plaintiffs as "private attorneys general" has faded over time, and moral sentiment has shifted against private securities litigants. Even after the unprecedented corporate scandals of 2002,[65] private plaintiffs have continued to face roadblocks when attempting to seek relief under Section 10(b) of the '34 Act, and the depiction of private securities plaintiffs as vexatious litigants remains today's prominent conception.

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granted sub nom. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 549 U.S. 1304, *aff'd in part*, 128 S. Ct. 761 (2008).

60. *Stoneridge*, 128 S. Ct. 761.

61. *See In re Charter Commc'ns*, 443 F.3d at 989.

62. An evaluation of the merits of scheme liability is outside the scope of this Note. For arguments on both sides of the issue, see Barbara Black, Stoneridge Investment Partners v. Scientific-Atlanta *(8th Cir. 2006) What Makes It the Most Important Securities Case in a Decade?* (U. of Cincinnati Coll. of Law Pub. Law & Legal Theory Research Paper Series, Paper No. 07-21, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020102. This Note does recognize that for a period of time, at least in the lower courts, scheme liability provided an implied private right of action against secondary actors under Rule 10b-5.

63. *See Stoneridge*, 128 S. Ct. at 773–74.

64. *See id.* at 773.

65. The Enron and WorldCom scandals are only two of the most famous examples of corporate scandal to hit the American markets in 2002.

III. THE SEC AND LEGISLATIVE RESPONSES TO SECURITIES FRAUD CONCERNS

Despite the curtailing of private plaintiff's rights in both the legislature and judiciary over the past two decades, when relating to the SEC, the legislative response to securities fraud concerns has been to consistently increase the authority of the SEC.[66] Although there have been many amendments to the Securities Laws affecting the authority of the SEC, this Note will only review, in part, the passage of the Securities Enforcement and Penny Stock Reform Act of 1990 (the "Enforcement Act"), the Sarbanes-Oxley Act ("SOX") of 2002, and the current enforcement authority of the SEC.

A. THE SECURITIES ENFORCEMENT AND PENNY STOCK REFORM ACT OF 1990

Prior to the passage of the Enforcement Act, the SEC's authority to prosecute violations of the Securities Laws was severely limited.[67] In many cases, the SEC's authority was restricted to either filing an injunctive action in federal court, or pursuing an administrative action, under which remedies were limited to a forced correction of an issuer's filing.[68] Yet the passage of the Enforcement Act meant unprecedented increases in the SEC's enforcement authority under the Securities Laws.

The principle objective of the Enforcement Act was "to achieve the appropriate level of deterrence . . . and thereby maximize the remedial effects of [the SEC's] enforcement actions" through the introduction of increased flexibility into the SEC's enforcement mechanisms.[69] To achieve the desired level of flexibility, the Enforcement Act granted the SEC the authority to proceed with the following actions against anyone who "is violating, has violated, or is about to violate"[70] the Securities Laws:

66. For examples of legislative enactments increasing the authority of the SEC under the Securities Laws, see Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, sec. 3, § 21A(a), 102 Stat. 4677, 4677–78 (codified at 15 U.S.C. § 78u-1(a)(1)–(2) (2006)); Securities Enforcement and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified in scattered sections of 15 U.S.C.); and Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 and 28 U.S.C.). Furthermore, it should be noted that the authority of the SEC was not reduced with the passage of the PSLRA.

67. Cox et al., *supra* note 46, at 746.

68. *See id.*

69. H.R. REP. NO. 101-616, at 13 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379, 1380. *See also* Cox et al., *supra* note 46, at 747.

70. 15 U.S.C §§ 77h-1(a), 78u-3(a).

(1) obtain cease-and-desist orders through administrative actions,[71] (2) in connection with a cease-and-desist order, force a respondent to disgorge any improper gains,[72] (3) seek a judicial order that bars an individual from serving as an officer or director of an SEC reporting company,[73] and (4) request the presiding court to impose civil monetary penalties.[74] These changes are illustrative of the broad increases in SEC authority under the Enforcement Act, but were not the only changes brought about by its passage.[75]

B. The Sarbanes-Oxley Act of 2002

Congress passed SOX in the wake of the accounting and corporate governance scandals of 2002.[76] Although President George W. Bush proudly dubbed SOX "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt,"[77] Congress may already be reconsidering many of its provisions in response to complaints about onerous disclosure requirements.[78] Nevertheless, portions of SOX did expand the SEC's enforcement arsenal and are examined below.

Some of the most basic changes created by SOX involved granting direct authority to the SEC to administratively bar certain individuals from engaging in specified activities. For example, whereas the Enforcement Act allowed the SEC to seek a judicial order barring a violator from serving as an officer or director of an SEC reporting company, SOX granted the SEC the direct authority, in connection with a cease-and-desist proceeding, to administratively impose an order "to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated Section 10(b) or the rules or regulations thereunder," from serving as an officer or director of a

71. *Id.*

72. *Id.* §§ 77h-1(e), 78u-3(e).

73. *Id.* § 78u-3(f).

74. *See id.* § 78u-3(e).

75. For example, the Enforcement Act also established civil remedies in administrative proceedings under the Investment Advisers Act of 1940. *Id*.

76. Sarbanes-Oxley Act of 2002, Pub. L. No 107-204, 116 Stat. 745 (codified in scattered sections of 15 and 28 U.S.C.).

77. Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.

78. *See* Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives For Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 98 (2007). The provisions of SOX that have received scrutiny are not particularly relevant to this Note. Furthermore, "[t]he problem with SOX's focus on internal controls and governance regulations is that it may do little to *actually* reduce corporate and financial fraud." *Id*. at 109.

company that has securities registered under Section 12 of the ’34 Act.[79] Furthermore, SOX granted the SEC direct authority to deny any person the privilege of appearing or practicing before the SEC if that person is found, after proper process, (1) to lack the proper qualifications to represent others, (2) to be short of character or integrity, (3) to have engaged in improper or unethical conduct, or (4) “to have willfully violated, or willfully aided and abetted the violation of,” any of the Securities Laws or rules promulgated thereunder.[80]

In addition, SOX granted the SEC the authority to set up a fair fund for investors harmed by violations of the Securities Laws.[81] If the SEC obtains an order requiring disgorgement against any person or entity for the violation of the Securities Laws (as defined under the ’34 Act), or reaches a settlement in connection with the disgorgement, and a civil penalty is also obtained, at the direction of the SEC the civil penalty shall be added to the disgorgement fund to benefit the victims of such violations.[82] Although the fair fund provision does state that the penalties received are “for the benefit of the victims of such violation,”[83] it does not specify the manner in which the funds are to be allocated. Moreover, the limits on the SEC’s use of the fair fund have yet to be tested.

In an indirect and rather meek attempt to increase the SEC’s enforcement powers, SOX included informant antiretaliation provisions.[84] SOX “makes retaliatory interference with employment a crime and creates a civil cause of action against employers who ‘discharge, demote, suspend, threaten, harass, or in any other manner discriminate against’ a whistleblower who reveals corporate or financial fraud.”[85] Informants may file a complaint in federal district court only after exhausting their administrative remedies under SOX.[86] If informants can prove an antiretaliation claim they will be entitled to relief including reinstatement, back pay with interest, and reimbursement of litigation costs,[87] but SOX

79. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1105, 116 Stat. 745, 809–10. These prohibitions are commonly referred to as officer and director bars.

80. *Id.* § 602, 116 Stat. at 794.

81. *Id.* § 308, 116 Stat. at 784–85.

82. *Id.*

83. *Id.*

84. *Id.* § 806, 116 Stat. at 802–04.

85. Rapp, *supra* note 78, at 110 (citations omitted). *See also* Sarbanes-Oxley Act §§ 806, 1107, 116 Stat. at 802–04, 810.

86. Sarbanes-Oxley Act § 806, 116 Stat. at 802–04; Rapp, *supra* note 78, at 110.

87. Sarbanes-Oxley Act § 806(c), 116 Stat. at 803–04.

does not provide antiretaliatory punitive damages.[88] These particular SOX provisions were created in response to the Enron scandal.[89] As reported by Senator Patrick Leahy, "[C]orporate insiders are the key witnesses that need to be encouraged to report fraud and help prove it in court."[90] Inside information is critical to the efficient enforcement of the Securities Laws.

C. A SUMMARY OF THE SEC'S CURRENT ENFORCEMENT ARSENAL[91]

Under today's Securities Laws, the SEC has the authority to initiate a wide variety of actions when a potential violation is about to occur, is occurring, or has occurred.[92] These actions range from initiating investigations[93] to providing informant bounties.[94] Although many of these powers have already been mentioned, for convenience, the most relevant powers are briefly described below.

1. Investigations and Judicial Actions

The SEC has full discretion to initiate investigations as it deems necessary to determine whether any party has violated, is about to violate, or is violating any of the provisions of the '34 Act or any of the rules and regulations thereunder.[95] Moreover, the SEC is authorized to publish information in relation to violations and to investigate facts, conditions, practices, or manners as it deems necessary to effectively enforce such provisions.[96] In connection with an investigation, the SEC and its agents may (1) administer oaths, (2) subpoena witnesses, (3) take evidence, and (4) compel the production of any records it finds relevant or material.[97] If a party fails to obey a subpoena, the SEC may invoke the aid of a court of competent jurisdiction to assist with enforcement.[98]

The SEC may also pursue injunctive action, civil penalties, and

88. *See id.*
89. Rapp, *supra* note 78, at 94.
90. Legalweek.com, The Truth Is Out There (Aug. 20, 2002), http://www.legalweek.com/legal-week/news/1161634/the-truth.
91. This section focuses on the SEC's enforcement powers that are particularly relevant to this Note.
92. Cox et al., *supra* note 46, at 746. For a full examination of the SEC's authority, see the Securities Laws in their entirety, beginning at 15 U.S.C. §§ 77a (2006).
93. 15 U.S.C. § 78u(a).
94. *Id.* § 78u-1(e).
95. *Id.* § 78u(a).
96. *Id.*
97. *Id.* § 78u(b).
98. *Id.* § 78u(c). Enforcement may include punishment and fines as determined by the court.

equitable relief in any federal district court of competent jurisdiction when a party has violated, is violating, or is about to violate any of the provisions of the ’34 Act.[99] Injunctive actions may include stop orders, restraining orders, and officer and director bars.[100] Civil penalties are laid out in a three tier system with penalties contingent upon the underlying violation,[101] and equitable relief may take any form that is appropriate or necessary for the benefit of investors.[102] The above remedies are not exclusive and may be brought in addition to any other authorized action.[103]

2. Cease-and-Desist Proceedings

If desired, the SEC may pursue similar remedies, outside of the judicial system, through an independent administrative action.[104] If it is determined, after proper notice and opportunity for a hearing, that a violation has occurred, is occurring, or is about to occur, the SEC may (1) issue a temporary cease-and-desist order, (2) enter an order requiring accounting and disgorgement of any ill-gotten gains,[105] or (3) issue a temporary or permanent officer and director bar.[106] In addition, the SEC may publish any and all findings made in connection with a cease-and-desist proceeding.[107]

3. Informant Bounties

The SEC may pay an award of up to 10 percent of all penalties imposed and recovered as a result of actions commenced by the SEC or Attorney General, under Section 21A of the ’34 Act (Civil Penalties for Insider Trading), to persons who provide information leading to the imposition of such penalty.[108] The payment of informant bounties has no minimum threshold and is left to the sole discretion of the SEC.[109] In fact, “the SEC is widely believed to have paid only a single bounty to a

99. *Id.* § 78u(d).
100. *See id.*
101. Penalties max out at $100,000 for natural persons and $500,000 for any other person (including entities). *Id.*
102. *Id.* § 78u(d)(5). Disgorgement of ill-gotten gains is a common form of equitable relief.
103. *Id.* § 78u(d).
104. *Id.* § 78u-3.
105. Recoveries under accounting and disgorgement may go to the United States Treasury, or may be deposited into a fair fund as provided in SOX. *Id.* § 78u-1(d)(1); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 308(a)–(b), 116 Stat. 745, 784.
106. 15 U.S.C. § 78u(d).
107. *Id.* § 78u-3.
108. *Id.* § 78u-1.
109. *Id.*

tipster."[110] Most importantly, however, these bounties are only available for insider trading informants, not Section 10(b) informants generally.[111]

4. Appearance Before the Commission

As provided in SOX, the SEC has direct authority to deny any person the privilege of practicing before the SEC if that person is found, after proper process,

> (1) not to possess the requisite qualifications to represent others; (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder.[112]

This provision is particularly relevant because it allows the SEC to impose and enforce a potentially career-ending penalty against secondary violators of the Securities Laws.

The current system provides the SEC with more resources, authority, and enforcement options than ever before. Nevertheless, these improvements have not provided enough antifraud weapons to finally thwart securities fraud in America.[113]

IV. TRADITIONAL PROBLEMS WITH THE CURRENT SYSTEM

As private plaintiff's rights under Section 10(b) have been restricted and the SEC's enforcement authority has been increased, one thing remains certain: securities fraud is still a major threat to the American markets.[114] Although securities fraud has been the target of continuous legislative reform, there are many underlying issues that have not been fully addressed and that continue to prevent the current system from effectively ameliorating the securities fraud problem in America.

A. SECTION 10(B) CLASS ACTION ISSUES

There are four major problems with the securities fraud class action

110. Rapp, *supra* note 78, at 117–18.

111. Nevertheless, the antiretaliation provisions provided in SOX do apply to all securities fraud whistleblowers. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 806, 1107, 116 Stat. 745, 802–04, 810.

112. *Id.* § 602(a)(1)–(3), 116 Stat. at 794.

113. In 2007, the total estimated "maximum dollar loss" to the American markets, as a result of Securities Laws violations, was $676 billion. *See* Cornerstone Research, *supra* note 6.

114. *See id.*

that inhibit its ability to reduce securities fraud in America: (1) the lack of serious deterrent value,[115] (2) the potential for abuse,[116] (3) the inability to pursue actions against all bad actors,[117] and (4) the inability to produce new information and detect unknown fraud.[118] Although the compensation rationale for securities class actions may create an additional problem,[119] preventing and deterring fraudulent behavior is the focus of this Note. Therefore, the compensation rationale will not receive any further attention.

1. Lack of Deterrence—Circularity Problem[120]

The circularity problem begins with issues arising out of the concept of entity liability.[121] The inanimate character of a business entity (most commonly a corporation) ensures that securities violations can be "committed only by its personnel, [but] it is the entity, and not its actors, that provides [recovery] funds."[122] Moreover, "its responsible officers and directors only rarely contribute to the recovery."[123] This structure has created two similar but independent issues that are commonly classified as the "circularity problem."

The first issue arises when diversified investors end up on both sides of the class action.[124] As current owners of the entity and class members, some plaintiffs may end up indirectly providing for their own recovery.[125] "The degree of circularity . . . depends on what percentage of the company is owned by the members of the class action.[126] Nevertheless, the deterrent effect of a class action is surely undercut when its members are providing a portion of their own recovery.

115. *See, e.g.*, Cox, *supra* note 33 (discussing class actions as a deterrent to securities fraud); Rapp, *supra* note 78 (examining how the current system does not do enough to incentivize whistleblowing).

116. *See* John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983). The PSLRA was enacted in direct response to concerns about abusive securities litigants. *See supra* text accompanying notes 42–46.

117. *See supra* notes 36–41, 58–64 and accompanying text.

118. *See* Rapp, *supra* note 78, at 109.

119. John C. Coffee, Jr., *Reforming the Securities Fraud Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545–48 (2006).

120. The circularity problem has received plenty of academic attention. *See, e.g.*, Cox, *supra* note 33, at 509.

121. This concept dates back to, and is closely related to, the concept of vicarious liability.

122. Cox, *supra* note 33, at 509. Recovery funds refer to settlement funds and judicial awards.

123. *Id.*

124. *See id.*

125. *Id.*

126. *Id.*

The second issue arises when the members of the class action do not include any current owners.[127] In this case, the class does not provide any portion of its own recovery. Instead, the recovery is picked up by the entity, and thus the burden is indirectly placed on the entity's current shareholders.[128] This effectively results in one innocent shareholder group paying for the recoveries of another innocent shareholder group.[129]

Both of the circularity issues have the same effect on the ability of the securities class action to deter potential securities violations. The circularity problem destroys deterrent value by removing corporate insiders—the actual bad actors—from the economic consequences of their actions. As such, corporate insiders are regularly involved in suits, but rarely contribute to recoveries.[130]

2. Lack of Deterrence—Insurance

Insurance plays both a positive and negative role in securities class actions. In fact, corporate insurance helps to alleviate some of the issues presented by the circularity problem.[131] Rather than innocent shareholders providing the recoveries for other innocent shareholders or themselves, insurance introduces new money into the equation.[132] More importantly, this new money is provided by shareholders who have invested in the insurance company based on its ability to assess the risk of paying out under the policy.[133] In short, this new money comes from outside shareholders who have accepted the risk of losing it.[134] Yet this positive side effect of corporate insurance provides only half of the role that insurance plays in securities class actions.

There is ample evidence that insurance is an overriding factor in class action settlements.[135] "Perhaps the greatest condemnation of the securities class action is the evidence that approximately 96 % of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds."[136] This realization brings us back to the deterrent issues presented by the circularity

127. This scenario is often described as a simple wealth transfer. Coffee, *supra* note 119, at 1557.
128. *Id.*
129. *See id.* at 1557–58.
130. Cox, *supra* note 33, at 509.
131. *See id.* at 512–13.
132. *See id.*
133. *See id.* at 513–14.
134. *Id.*
135. *Id.* at 512.
136. *Id.*

problem—insurance policies remove corporate insiders from the financial consequences of their actions. In a typical case, "the likelihood is that the insurer will cover everything—that is, the settlement plus litigation expenses."[137] In the end, the corporation's shareholders bear the cost of insurance premiums, and corporate violators are able to walk away without contributing anything.[138] This structure does very little to deter the parties actually responsible for securities violations.[139]

3. Potential for Abuse

Securities fraud defendants are faced with a strong set of incentives favoring settlement, even when a plaintiff's case is weak.[140] These incentives take the form of high litigation costs, lost productivity, the possibility of huge judgments, uncertain legal standards, and agency costs.[141] Officers and directors may also push for settlement so that insurance proceeds will stay in play even though intentional wrongdoing is alleged.[142] In response, potential plaintiffs, and especially their attorneys who profit from high fees, are incentivized to file class actions whenever a stock price dips significantly or there is any other indication of fraud.[143] Eventually, concerns regarding evidence of successful strike suits—meritless suits that extract settlement from innocent defendants—became so serious that Congress enacted the PSLRA in 1995.[144] Yet corporate America continues to voice concern regarding securities class action abuse and costs.[145]

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137. Coffee, *supra* note 119, at 1553.

138. *See* Pritchard, *supra* note 32, at 957.

139. *See id.* at 958–59.

140. *See id.* at 952–58.

141. *Id.*

142. As a matter of law and insurance provisions, liability for fraud and unfair self-dealing is not covered. *See* John. C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 715 (1986). This problem is augmented by the fact that the plaintiff's class, largely driven by the plaintiff's attorneys, also faces pressure to settle (making certain insurance will cover the proceeds). After all, settlement ensures that attorney's fees will not be lost in an adverse judgment. For more information on the incentives of the plaintiff's attorney, see Pritchard, *supra* note 32, at 948–52.

143. *See* Pritchard, *supra* note 32, at 948–49. *See also* Bucy, *supra* note 16, at 28.

144. *See* Cummings, *supra* note 43, at 1007.

145. *See* COMM. ON CAPITAL MKTS. REGULATION, THE INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 11 (2006). *See also* U.S. CHAMBER OF COMMERCE, THE COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY—REPORT AND RECOMMENDATIONS 30–31 (2007).

4. Inability to Produce New Information and Detect Unknown Fraud

Overcoming a securities fraud conspiracy can only succeed if insiders bring unknown information to the attention of enforcement authorities.[146] Yet the nature of a securities fraud class action, especially after the passage of the PSLRA, makes it virtually impossible for the class to discover new information or detect fraud. In order to avoid early dismissal under the PSLRA, a class action must plead scienter with particularity and identify specific misleading statements made by the accused.[147] Moreover, the class must meet this threshold prior to engaging in discovery.[148] Although these procedural changes were intended to curb abusive litigation,[149] they have also restricted the ability of plaintiffs to discover new evidence of fraud.[150] In short, securities fraud class actions can only address fraudulent behavior that has already become publicly known.

5. Lack of Deterrence—Inability to Pursue Actions Against All Bad Actors

The final shortcoming of the securities fraud class action to act as a deterrent is its inability to reach all bad actors. In 1994, the Supreme Court eliminated the implied private right of action for aiding and abetting under Section 10(b).[151] The Court's action severely restricted civil liability for secondary violators of the Securities Laws, but it did not eliminate it altogether. Class action plaintiffs embraced scheme liability,[152] an alternate theory to aiding and abetting liability, and continued to file complaints against secondary violators in federal district courts.[153] In response, the Supreme Court recently rejected the theory of scheme liability and effectively eliminated a private right of action against all secondary violators under Section 10(b).[154] As a result, the threat of a securities fraud class action has virtually no deterrent effect on potential secondary violators.

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146. Rapp, *supra* note 78, at 109.
147. *See supra* Part II.C.2
148. *Id.*
149. *See supra* notes 140–144 and accompanying text.
150. *See supra* notes 47–51 and accompanying text.
151. *See supra* Part II.C.1
152. For a discussion of scheme liability, see Cosenza, *supra* note 21, at 38–45.
153. *See supra* notes 58–64 and accompanying text.
154. *Id.*

B. WHY THE SEC CANNOT EFFECTIVELY DETER SECURITIES FRAUD

Although common sense reveals that the SEC cannot deter all securities fraud, the SEC faces two serious limitations that prevent it from deterring fraud more efficiently and effectively. These same deficiencies hinder the SEC's ability to uncover fraud before it becomes public. Although one of the deficiencies, limited resources,[155] will (by definition) always exist, the other, the inability to acquire inside information,[156] can be successfully addressed legislatively.

1. Detection and Enforcement Problems—Limited Resources

The limited resource problem has been thoroughly studied and is well understood.[157] In fact, one of the benefits of SOX was that it directly increased the financial resources of the SEC.[158] Still, the SEC must divide its limited resources between enforcement actions and mandatory filing reviews.

"SEC staff reviews [of registrant filings may] be seen as the first line of defense against ongoing disclosure violations."[159] Yet the SEC cannot keep up with the pace at which mandatory filings have increased.[160] As a result, the percentage of filings that have actually been examined by SEC staff has continued to decline.[161] For example, in 2001 the SEC announced that its goal was to fully review each of its issuer's annual reports once every three years, or 33 percent of all filings per year; however, it only

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155. *See* Cox et al., *supra* note 46, at 751–60.

156. *See generally* Rapp, *supra* note 78 (arguing that the SEC cannot uncover securities fraud conspiracies without the aid of inside information).

157. Cox et al., *supra* note 46, at 757. *See, e.g.*, *Major Human Capital Challenges at the SEC and Key Trade Agencies: Testimony Regarding Critical Resource and Staffing Issues Facing the SEC: Testimony Before the S. Subcomm. on Oversight of Government Management, Restructuring & the District of Columbia, Comm. on Governmental Affairs*, 107th Cong. 1 (2002) (testimony of SEC Executive Director James M. McConnell) ("[T]he Commission must have the resources it needs to fulfill its multiple missions and to maintain the public's full confidence in our capital markets."); *Major Human Capital Challenges at the SEC and Key Trade Agencies: Hearing Before the S. Subcomm. on Oversight of Government Management, Restructuring & the District of Columbia, Comm. on Governmental Affairs*, 107th Cong. 6 (2002) [hereinafter *Major Challenges at SEC: Hearing*] (statement of Richard J. Hillman and Loren Yager) ("[L]imited resources have forced [the] SEC to be selective in its enforcement activities and have lengthened the time required to complete certain enforcement investigations." (citations omitted)).

158. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 601, 116 Stat. 745, 793–94.

159. Cox et al., *supra* note 46, at 757.

160. *See id.*

161. *See id.*

achieved a full review of 16 percent, or about half of its original goal.[162] Thus, the vast majority of annual reports receive only a partial review, at best. The ability to detect disclosure violations is vital to stopping fraud in its earliest stages, but detecting these violations is unlikely to be successful if resources allow for only partial review.

In the enforcement arena, the SEC responds to severe resource restraints by prioritizing its actions.[163] The SEC regularly prioritizes its cases in terms of "(1) the message delivered to the industry and public about the reach of [the] SEC's enforcement efforts, (2) the amount of investor harm done, (3) the deterrent value of the action, and (4) [the] SEC's visibility in certain areas such as insider trading and financial fraud."[164] An additional but no less important concern is the need to protect investors from ongoing violations.[165] Yet the very existence of a priority system means that some cases will be pursued at the expense of others. In sum, resource limitations prohibit the SEC from identifying and pursuing an unknown number of securities violations.

2. Detection Problems—Whistleblower Disincentives and the Inability to Acquire Inside Information

Again, "[o]vercoming an internal conspiracy can only succeed if insiders bring information about ongoing corporate and securities fraud to the attention of regulators."[166] In fact, many of the corporate scandals of 2002 came to light because of an inside tip.[167] Even so, Congress took a very limited approach with SOX when it came to encouraging insiders to come forward with unknown information.[168] Rather than giving the SEC the authority to reward insiders for coming forward with new information, SOX provided potential whistleblowers with rather weak antiretaliation provisions.[169] As a result, the SEC's ability to provide informant bounties remains strictly limited to insider trading violations.[170] The SEC needs the ability to encourage corporate whistleblowing to efficiently enforce the

162. *Id.*

163. *Id.* at 751.

164. *Id.* (citing *Major Challenges at SEC: Hearing*, *supra* note 157, at 49).

165. *Id.* at 753.

166. Rapp, *supra* note 78, at 109.

167. *Id.*

168. *Id.* at 110.

169. *Id. See also supra* notes 84–90 and accompanying text.

170. *See supra* Part III.C.3. Yet the current structure of insider trading bounties, especially when the history of actual distribution is considered, is unlikely to be effective in encouraging insiders to come forward with information.

Securities Laws because the disincentives to come forward with inside information are severe. [171]

a. Retaliation

One of the largest disincentives facing potential whistleblowers is corporate retaliation, despite the antiretaliation provisions of SOX. Most corporate employers and their attorneys know exactly how they can legally retaliate against a whistleblowing employee.[172] Although some of these methods became illegal after the passage of SOX, retaliation may include (1) "attacking the [whistleblower's] motives, credibility, [or] professional competence"; (2) "build[ing] a damaging record against [the whistleblower]"; (3) threatening the employee with "reprisals for whistleblowing"; (4) "reassign[ing]" the employee to an isolated work location; (5) "publicly humiliat[ing]" the employee; (6) "set[ting] . . . up [the whistleblower] for failure" by putting them in impossible assignments; (8) "reorganiz[ing]" the company so that the whistleblower's job is eliminated; and (9) "blacklist[ing]" the whistleblower so he or she will be unable to work in the industry.[173]

Setting up a whistleblower for failure, and then documenting the whistleblower's poor performance, is a perfectly legal retaliatory measure.[174] SOX does not protect whistleblowers in cases where valid reasons for termination exist (such as inferior work performance).[175] Moreover, if the fraud is large enough, the whistleblower who exposes it may be out of a job simply because the corporation has collapsed entirely.[176]

b. Social Retaliation

Whistleblowing can lead to social isolation and loneliness.[177] SOX may have included provisions aimed at protecting potential whistleblowers from corporate retaliation, but the law is entirely incapable of protecting

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171. *See* Rapp, *supra* note 78, at 118–26.

172. *See* Leonard M. Baynes, *Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 875, 895–96 (2002).

173. *Id.* at 895 (footnotes omitted).

174. *Id.*

175. *Id.*

176. This was the fate of Sherron Watkins, the whistleblower responsible for the exposure of the Enron scandal. She remained out of work for five years. Rapp, *supra* note 78, at 119–20. Whistleblowers may also face serious financial disincentives if they are undiversified holders of their employer corporation's stock.

177. *Id.* at 120.

whistleblowers from social retaliation.[178] Social retaliation may range from the "cold shoulder" to complete social rejection.[179] These concerns are compounded by the fact that potential whistleblowers will likely be considering whether to inform on some of their closest friends and coworkers. This factor alone may provide a stronger disincentive than the potential loss of employment and financial consequences that follow.[180] If the underlying fraud is large enough, coworkers may blame the whistleblower, rather than the actual violators, for the corporation's eventual downfall.[181] Regardless of its form, social retaliation can have an immense impact on its victims both physically and psychologically.[182]

c. Psychological and Emotional Stress

The psychological stress associated with being a whistleblower can come from a variety of factors.[183] It can come from social retaliation (as mentioned above), self-doubt, dealing with federal investigators and bureaucrats, and identifying oneself as different from a peer group.[184] Whistleblowing cases can drag on for years, during which time those closest to the whistleblower may increase psychological strain by openly expressing their doubts about the actions taken by the whistleblower.[185] In fact, the psychological and emotional stress of whistleblowing can become so severe that it causes many to lose their families.[186]

d. Industry Blacklisting

While SOX provides at least some protection against retaliation from a whistleblower's current employer, it does nothing to prevent discrimination by potential future employers.[187] As such, future employers are free to penalize a one-time whistleblower as a lifelong whistleblower.[188] In order to avoid becoming the next "victim," corporations may avoid hiring the whistleblower at all costs.[189] Thus, corporate informants may become victims of industry-wide informal black

178. *See id.* at 122.
179. *Id.* at 120.
180. *See id.* at 121–22.
181. *Id.* at 122.
182. *Id.* at 121.
183. *See id.* at 122–24.
184. *Id.* at 122–23.
185. *Id.* at 123.
186. *Id. See also* C. FRED ALFORD, WHISTLEBLOWERS: BROKEN LIVES AND ORGANIZATIONAL POWER 19 (2001).
187. Rapp, *supra* note 78, at 124.
188. *Id.*
189. *See id.*

lists.[190] One academic aptly describes the decision to be a whistleblower as "the liquidation of an individual's investment in her career."[191]

In brief, potential whistleblowers face a variety of intense disincentives that prevent them from coming forward with inside information. In order to overcome these disincentives, and entice insiders to expose internal schemes, the SEC must be able to provide serious rewards for potential informants. The SEC does not have the proper authority to provide these rewards under the current securities enforcement system.

C. SUMMARY OF THE CURRENT SYSTEM'S DEFICIENCIES

The current system is unable to overcome America's securities fraud problem because it is ill equipped to handle the following problems: (1) financially targeting those actually responsible for the Securities Laws violations,[192] (2) detecting fraud in its earliest stages,[193] (3) effectively enforcing all violations after detection,[194] and (4) encouraging corporate whistleblowers to come forward with inside information.[195]

V. A SUPPLEMENTAL PROPOSAL—EQUITY SET-ASIDES AND MODIFIED QUI TAM BOUNTIES

To effectively deter securities fraud in America, the expected outcome of a potential violation must be negative for the individual that commits the violation—not the entity. Yet it appears that under the current system[196] the potential benefits[197] of committing a fraud outweigh the potential costs.[198] I therefore submit a proposal for legislative and administrative changes that will alter the expected outcome of a potential violation by empowering the SEC to enlist the aid of private citizens in detecting, enforcing, and

190. *Id.*

191. *Id.* at 125. *See also* William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799, 1819 (1996).

192. *See supra* Parts IV.A.1–2, 5 & IV.B.1.

193. *See supra* Parts IV.A.4 & IV.B.1–2.

194. *See supra* Parts IV.A.5 & IV.B.2.

195. *See supra* Part IV.B.2.

196. In the short term, at the very least.

197. Potential benefits include (1) retaining one's job, (2) buying time to get a corporation back on track, (3) inflating short-term stock prices, and (4) illegally liquidating equity while prices are still high. In the short term, the likelihood of experiencing these benefits is fairly high.

198. Potential costs include (1) being caught, (2) facing enforcement, and (3) being held financially responsible. In the short term, the likelihood of experiencing these costs is very low. *See supra* Part IV.

deterring securities fraud in America. This proposal is intended to increase the effectiveness of the current Securities Laws without adding any exorbitant costs. It is not intended to remove or replace any of the existing structures.

A. EQUITY COMPENSATION SET-ASIDES

The first step in my proposal requires enacting compelled equity "set-asides" for all officers (and top management generally) of SEC reporting corporations.[199] These set-asides would require corporations to withhold a certain percentage (for example, 70 percent[200]) of all officer equity holdings under the corporation's equity incentive/compensation packages.[201] The corporation would hold these rights independently and release them to the officers according to a set schedule. If an officer is found, after proper administrative process, to have knowingly[202] violated the Securities Laws at any point during which the officer's equity rights are being withheld, then the full amount of that officer's equity set-aside will be disgorged to the SEC,[203] regardless of the actual damages caused to investors.[204] Alternatively, once an officer, who has not knowingly committed a violation of the Securities Laws, is removed from duty, whether voluntarily or not, the corporation will begin the equity release schedule. Crafting the proper equity release schedule is up for debate. However, the corporation should release the officer's equity over time to ensure that the officer is not able to conceal a securities violation, resign, and liquidate holdings before the violation is detected.[205] Finally, it is

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199. This Note will leave the task of defining a specific legal structure for the equity set-asides for another paper.

200. The precise percentage is fairly arbitrary. Nevertheless, it should be large enough to warrant the attention of managers but flexible enough to allow for some equity liquidation.

201. Some corporations already impose insider trading plans (also known as 10b-5 trading plans) that include retention requirements for officers, directors, and key employees. The purpose of these plans is to allow these individuals to trade in the corporation's stock without violating insider trading laws.

202. Under my proposal, knowledge will be the legal standard for disgorgement. This relatively high standard should help reduce the potential for plaintiff abuse.

203. These equity rights will be used to pay qui tam informants (as described in Part IV.B.2), pay SEC costs in connection with the enforcement action, and increase the SEC's fair funds under SOX. I recognize that using equity to "pay" costs and increase fair funds will naturally involve liquidation problems. I do not believe that these liquidation issues are severe enough to undercut the purposes of this proposal.

204. Some may find this "penalty" draconian because it is not tied to the amount of harm caused to investors. However, many criminal laws are not tied to the amount of harm caused to the victim.

205. Officers are still considered insiders for six months following removal from service under the insider trading laws. Therefore, their ability to liquidate would already be legally limited.

important to note that officers who do not knowingly violate the Securities Laws will lose nothing under their equity plan, except some liquidity flexibility.[206]

B. MODIFIED QUI TAM BOUNTIES

A number of academic commentators have presented arguments in favor of introducing qui tam–style[207] bounties into the securities markets.[208] Most recently, Geoffrey Rapp of the University of Toledo argued for the introduction of a qui tam–style bounty system that ties informant rewards to the SEC's fair funds under SOX.[209] Like Rapp's approach, my modified qui tam proposal will make some use of the fair funds provisions in SOX, but it is novel in two ways: (1) it ties informant bounties to disgorgements under the equity set-aside provisions created above, and (2) it introduces an entirely new administrative process for awarding qui tam bounties.

1. Qui Tam Rights Under the False Claims Act and Prior Proposals

The False Claims Act[210] ("FCA") allows private parties (known as "relators") who successfully allege and prove fraud against the government to collect a percentage of the recovery.[211] These percentages range from 15 to 30 percent of the government's recoveries and are designed to produce "lucrative bounties" for successful relators.[212] The goal of these bounties is to overcome the disincentives that relators face when deciding whether to come forward with information.[213] The average recovery for a successful

206. Equity compensation packages were created in an effort to align the interests of corporate managers with the shareholders they work for (sharing the goal of increasing the corporation's stock prices). Withholding equity rights under these plans may help to better align these interests by encouraging managers to increase long-run stock prices rather than short-term.

207. Qui tam refers to *qui tam pro domino rege quam pro se ipso in hac parte sequitur*, which means "he who pursues this action on our Lord the King's behalf as well as his own." JOHN T. BOESE, CIVIL FALSE CLAIMS AND QUI TAM ACTIONS 1-7 (3d ed. 2007). To oversimplify, qui tam bounties are large rewards intended to entice those with inside information to come forward and expose fraud against the government. *See id.* at 1-8 to 1-10.

208. *See* Pamela H. Bucy, *"Carrots and Sticks": Post-Enron Regulatory Initiatives*, 8 BUFF. CRIM. L. REV. 277, 318–22 (2004); Bucy, *supra* note 16, at 43–62; Rapp, *supra* note 78, at 126–53.

209. Rapp, *supra* note 78, at 147–49.

210. 31 U.S.C. §§ 3729–3731 (2006).

211. Bucy, *supra* note 16, at 45–46. Recovery refers to judgments or settlements in favor of the government.

212. Rapp, *supra* note 78, at 130.

213. *Id.* at 132.

relator under the FCA exceeds one million dollars.[214] Moreover, the qui tam provisions of the FCA have proven to be successful and have recovered billions of dollars for the federal government.[215] As a result, the qui tam provisions of the FCA provide the foundation for prior arguments in favor of extending qui tam bounties into the securities fraud arena.[216]

Furthermore, many prior arguments favoring qui tam bounties in a securities context have closely followed the unique procedure for pursuing qui tam actions under the FCA.[217] The procedure begins with the filing of a sealed complaint in federal court.[218] This complaint is not made public and is not served on the defendant.[219] While the action is stayed, the Department of Justice ("DOJ") is served a copy of the complaint and a written disclosure of all the material information and evidence in possession of the relator.[220] The complaint remains under seal while the DOJ decides whether to intervene.[221] If the DOJ intervenes, it assumes responsibility for the lawsuit, but the relator remains a plaintiff.[222] Once the government intervenes, the relator's role becomes much less significant; however, the relator does retain certain objection rights.[223] If the DOJ does not intervene, the relator may proceed as the sole plaintiff in the case.[224]

Under the FCA, qui tam rewards are tied to the size of the recoveries in favor of the government and whether or not the DOJ decides to intervene.[225] If the DOJ intervenes, the relator may be awarded up to 25 percent of any judgment or settlement but is guaranteed at least 15 percent.[226] If the DOJ does not intervene, the relator may receive up to 30 percent but is guaranteed at least 25 percent.[227] Prior arguments for qui tam bounties in a securities context have either followed the above structure

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214. *Id.* at 131. *See* Elletta Sangrey Callahan et al., *Integrating Trends in Whistleblowing and Corporate Governance: Promoting Organizational Effectiveness, Societal Responsibility, and Employee Empowerment*, 40 AM. BUS. L.J. 177, 194 (2002).

215. *See* Bucy, *supra* note 16, at 48–54.

216. *See, e.g.*, Bucy, *supra* note 208, at 318–22; Bucy, *supra* note 16, at 76–79; Rapp, *supra* note 78, at 126–34.

217. *See, e.g.*, Bucy, *supra* note 208, at 318–22; Bucy, *supra* note 16, at 74–76; Rapp, *supra* note 78, at 126–34.

218. Bucy, *supra* note 16, at 49.

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* at 49–50.

223. *Id.* at 50.

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

almost exactly,[228] or have suggested completely different methods for incorporating qui tam rights and bounties.[229]

Qui tam informants reveal important inside information of which law enforcement is unaware.[230] In addition to generating information, the qui tam model provides incentives for whistleblowers to come forward even when other insiders are deliberately suppressing information about the fraud.[231] "Revelations of this nature could contribute to market efficiency in a way that securities fraud cases based on recycled information do not."[232] Furthermore, the "FCA demonstrates that bounty schemes can be effectively integrated into anti-fraud [systems]."[233] Therefore, a qui tam–style bounty program should be adopted to encourage informants to come forward with inside information.

2. A New Approach

Under my proposal, qui tam informants, if successful, will be entitled to bounties but will not have traditional qui tam rights.[234] The modified qui tam process will begin at the SEC and remain entirely administrative throughout. Informants with inside information regarding 10(b) violations will begin by providing the SEC with a "complaint" and a written disclosure of all the material information and evidence the informant possesses. Upon receipt of the information, the SEC will have a limited period of time to privately review the complaint and disclosures. After reviewing the information, the SEC will have the sole discretion to decide whether to move forward with an enforcement action under the complaint. If the SEC decides to pursue action, the complaint and disclosures may be made public in connection with the enforcement action. Otherwise, all information provided by the informant, including the informant's identity, will remain confidential indefinitely.

Although qui tam informants will not have any control over enforcement actions, bounties will be contingent upon the success of the SEC's actions. If the SEC is successful in its cease-and-desist proceeding, or if the SEC is successful in obtaining related settlements, the informant

228. *Id.* at 110–11.
229. *See* Rapp, *supra* note 78, at 134–53.
230. *Id.* at 131–32.
231. *Id.* at 136.
232. *Id.* at 132.
233. *Id.* at 154.
234. A qui tam informant will not have the right to pursue enforcement independently. If the SEC decides not to pursue a modified qui tam enforcement action, then the action is over.

will be entitled to bounties in connection with the related disgorgements. First, informants will be entitled to a flat percentage (for example, 50 percent) of the officer set-aside equity disgorgements as described above.[235] Second, if the fraud is extreme and the value of the equity bounty will be drastically reduced as a consequence of the action, the SEC should have the discretion, as Rapp argues, to pay a bounty directly out of the fair fund provisions in SOX. Fair fund bounties should only serve as a backup provision to equity bounties because fair fund disbursements are (1) granted at the expense of harmed investors and (2) are often not provided by the actors who actually committed the underlying offenses. If the modified qui tam system functions as intended, then the equity bounties should provide a sufficient financial incentive in the majority of cases.

3. Optional Provision for Increased Deterrence

If greater deterrence is desired, a simple addition to the above proposal can achieve that effect. The SEC has the authority to impose a temporary or permanent officer and director bar against a violator of the Securities Laws.[236] The SEC can also strip secondary violators of the privilege of practicing before it.[237] To achieve greater deterrence and ensure that these tools are used effectively, simply make these bars permanent and mandatory for all fraudsters successfully pursued in modified qui tam actions. Although this provision may seem especially harsh, it may be an effective way to deter secondary violators from knowingly participating in securities violations.

C. EFFECTS OF THE MODIFIED QUI TAM PROVISIONS

The adoption of equity set-asides and modified qui tam bounties will have various effects on the current securities enforcement system. Overall, qui tam bounties should drastically increase the SEC's ability to detect, enforce, and deter fraud without intensifying any of the traditional concerns regarding securities fraud class actions.

1. Detection

The SEC currently faces securities fraud detection issues due to

235. The specific percentage is up for debate, but the reward needs to be guaranteed and valuable; therefore, the SEC should not have any discretion in adjusting the percentage or deciding whether or not to pay the bounty.

236. *See supra* Part III.C.2.

237. *See supra* Part III.C.4.

resource limitations that prevent it from fully reviewing filings and investigating discrepancies. In addition, the current antiretaliation provisions of SOX do not do enough to entice insiders to come forward with information. As previously discussed, potential SEC informants (or whistleblowers) face a variety of acute disincentives to coming forward with inside information.[238] Although some of these disincentives are not financial in nature, there is ample evidence that they can be overcome when an informant is presented with potential "lucrative bounties."[239] Thus, giving the SEC the ability to provide lucrative equity bounties to qui tam informants will alleviate detection problems by bringing forth important inside information at minimal additional costs to the SEC.

Moreover, because the modified qui tam bounties are largely tied to equity rights in the corporation under question, informants are incentivized to come forward with information before a scheme becomes large enough to severely impact the value of potential bounties. For example, the informant who receives equity bounties by coming forward with information upon discovery will recover more quickly, and suffer less, from drops in market prices than an informant who allows the fraud to grow large enough to cause long-term damage to the corporation. This unique informant incentive will assist the SEC in detecting securities violations before they become the full-blown scandals seen in 2002.

2. Enforcement

Modified qui tam bounties will increase the SEC's ability to enforce securities violations by easing problems associated with resource limitations without leading to the abuses seen in private securities class actions. First, SEC qui tam actions will require less time and money to investigate than regular enforcement actions because insiders will provide the informational foundation for the actions. As such, the SEC will be able to spend more resources on additional detection and enforcement. Second, the SEC's financial costs associated with reviewing and pursing qui tam enforcement proceedings will be refunded through the equity set-aside program outlined above.[240] Therefore, the SEC will have more funding to spread between its multiple functions. Finally, modified qui tam actions are unlikely to experience abuse problems because the SEC has full discretion

238. *See supra* Part IV.B.2.

239. *See supra* notes 210–15 and accompanying text.

240. Once again, there may be some liquidity issues here, but none that cannot be properly addressed. *See supra* note 206 and accompanying text.

to turn away insignificant information.[241] All in all, modified qui tam bounties will assist the SEC in detecting and enforcing securities violations.

3. Deterrence

The SEC's increased ability to detect and enforce securities fraud violations alone will increase the deterrent effect of the current enforcement system. The modified qui tam bounties and equity set-aside provisions outlined above will greatly increase deterrence by financially targeting those actually responsible for committing violations. The equity rights provided by a corporation's equity incentive plans are often the largest form of compensation received by upper management. The possibility of having these rights stripped away for committing a securities violation that has yet to injure a single investor will make officers think seriously before moving forward with potential violations. Moreover, officers will not be able to skirt their financial responsibilities through entity liability or corporate insurance. If a person is found to have *knowingly* violated the Securities Laws, their equity is gone. These are the types of direct consequences that create true deterrent value for potential fraudsters.[242]

4. Piggybacking and Class Actions

Potential securities fraud plaintiffs are likely to "piggyback" on modified qui tam enforcement actions by filing complaints based on information disclosed in connection with the enforcement proceedings. Even so, piggybacking plaintiffs should not be a cause for concern because piggyback cases, by nature, are legitimate fraud cases. These cases cannot form the basis for illegitimate settlement extractions because the underlying securities violation has already been determined to exist. Piggyback cases will simply serve as an additional vehicle for injured investors to seek compensation.[243]

D. POTENTIAL CRITICISMS

The modified qui tam bounty system created above is vulnerable to two potential criticisms. First, many future commentators may argue that

241. Informants who come forward with baseless claims stand to gain very little financially, if anything at all.

242. For optional provisions to increase deterrence even further, see *supra* Part V.B.3.

243. The compensation received may be limited assuming the fraud is uncovered in its early stages.

the modified qui tam system will create overdeterrence and thus impede the efforts of American corporations to recruit talented management. Second, commentators are likely to be concerned about the social welfare implications of rewarding informants for "snitching" on their employers. As disconcerting as these concerns may initially seem, further consideration reveals that they are far less troubling than they appear.

1. Overdeterrence

Future commentators are likely to come forward with sensationalized claims that overdeterrence will discourage exceptional candidates from accepting upper management positions at American corporations. Yet these concerns are largely unwarranted because officers are sufficiently protected from equity disgorgements, the driving deterrent factor under the modified qui tam system, by the knowledge standard built into the equity set-aside provisions. Only potential officers who plan to knowingly involve themselves in securities violations should be deterred from accepting positions. Otherwise, an officer stands to lose nothing except some liquidity flexibility. Therefore, the modified qui tam system should not deter legitimate candidates from seeking and accepting upper management positions at American corporations.

2. Social Welfare

Some critics have argued that providing monetary rewards for informants may reduce legitimate reasons for coming forward with information by "commodifying the act."[244] Yet the number of insiders coming forward with information and the social benefits that follow are likely to increase with the introduction of rewards.[245] Thus, "to the extent that whistleblowing provides information beneficial to societal interests, it is irrelevant whether the information was provided out of greed or conscience."[246] Motive should serve only as a secondary consideration to overall public welfare.[247] Even without the actual occurrence of whistleblowing, the increased deterrent effect of modified qui tam bounties alone may outweigh motive concerns. Moreover, "[m]any legal scholars and social scientists now agree that the public good trumps whatever

244. Rapp, *supra* note 78, at 134.
245. *Id.*
246. Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 319 (1992).
247. *Id.* at 319–20.

ethical drawbacks may exist with 'for-profit' whistleblowing."[248] In short, if the disclosed information increases overall public welfare, then an appeal to self-interest is not so wrong that the government should reject its use.[249]

E. OVERALL EFFECT OF EQUITY SET-ASIDES AND MODIFIED QUI TAM BOUNTIES

The introduction of equity set-asides and modified qui tam bounties will have a positive net effect on the securities fraud enforcement system. My proposal will enable the SEC to detect, enforce, and deter more securities fraud violations by increasing the SEC's ability to entice insiders to come forward and disclose fraudulent schemes. Moreover, equity set-asides and modified qui tam bounties will not create an enforcement system vulnerable to abusive actions and will not significantly increase SEC costs. Finally, my proposal will create significant deterrence by holding the individuals who commit securities violations financially responsible.

VI. CONCLUSION

The current securities fraud enforcement system is unable to adequately detect, enforce, and deter securities fraud because (1) the SEC faces serious resource limitations, (2) class action lawsuits are incapable of uncovering fraudulent activity, and (3) the individuals who actually commit the securities violations are rarely held financially responsible. As a result, many securities fraudsters may perceive that the potential benefits of committing securities fraud outweigh the potential costs. There is an enforcement mechanism that can change these perceptions. The adoption of my proposal, which includes modified qui tam bounties tied to equity compensation disgorgements, will increase the SEC's ability to detect, enforce, and deter securities fraud violations. Furthermore, individual violators of the Securities Laws will no longer be protected from the financial consequences of their decisions. Ultimately, my proposal should significantly reduce the securities fraud problem in America by effectively making the expected outcome of a securities violation negative for those with the authority to commit such violations.

248. Rapp, *supra* note 78, at 134.
249. Callahan & Dworkin, *supra* note 246, at 314–20.