A COMMENT ON "CAPPING DAMAGES," BOUNTY HUNTERS AND MODIFYING BEHAVIOR

Simon Lorne*

I will start, as most of you are used to, with the standard disclaimer that any views I express, particularly on as charged a topic as this one, reflect my views alone, not those of the Chairman, not those of the other commissioner, and not those of the other members of the SEC staff. Let me also, in keeping with the disclosure nature of the agency, point out that as Dean Seligman indicated, I have announced that I am leaving the SEC in about a month and the odds are pretty good that when I am on the other side I will care more about defendants' positions than plaintiffs' positions, and if I have a bias, that may be reflected to some degree in my comments.

I think Don Langevoort's paper and comments[1] are quite useful in a number of respects in helping to advance our thinking about the role of securities litigation and what we want to get out of it. As Don suggests, with perhaps an undue degree of humility, some of the thoughts have been initiated elsewhere. He also suggests, quite rightly and quite correctly, that as a result of the political process, many of those thoughts have been ignored in the current legislation. And one of the things I have become more aware of during my stay in Washington, I might say more painfully aware, is how the political process works or doesn't work and what goes on. One of the problems that we have with the legislation as we see it today is that there was existing relatively modest legislation in the hopper designed to do no more than provide proportionate liability instead of joint and several liability for accountants, when an election took place in 1994 that changed the landscape significantly. And part of that election was something you will recall entitled the "Contract with America," an element of which was securities litigation reform. And part of the promise made by the House was that those measures would be processed within a hundred days. A hundred days wasn't time to start to review the literature, reviewing thoughts such as those of Don Langevoort and others, and analyzing where the problem was and where we should go. A hundred days was time to take a bill that existed, throw a few more things on top of it and get it out. That is basically what happened and so the structure of what we have—I'm not going to talk about safe harbor provisions and those kinds of things—but the structure

* General Counsel, United States Securities and Exchange Commission. J.D., University of Michigan Law School, 1970; A.B., Occidental College, 1967. The views in this Comment are solely those of the author and do not represent the position of the United States Securities and Exchange Commission.

1. Donald C. Langevoort, *Capping Damages for Open-Market Securities Frauds*, 38 ARIZ. L. REV. 639 (1996).

of what we have, basically, was legislation that already existed on which a few more ornaments could be hung. This hurried time frame was not susceptible to fundamentally rethinking the process, which is in fact what Don suggests.

One of the rhetorical devices used by some in the debate about the role of private litigation, and used by me, is to argue that there are investors on both sides of the equation. Some of us associated with the Securities and Exchange Commission will say rhetorically that when one wants to protect investors, one shouldn't look merely at the investors who happen to be the plaintiffs, one should look also at the investors who are the shareholders of the defendant, and so you've got investors on both sides of the issue and you can't stand on one side—typically the plaintiff's side—and say that's the investor's side. I think Don's paper suggests quite clearly, particularly with reference to the most recent NERA study, Dunbar Three as he refers to it, that in fact, that rhetorical argument is false. In fact, sixty-eight percent of the damages according to that study are paid by directors' and officers' insurance and it is a very significant leap, I would submit, to identify those insurance payments with premiums and bring it back to the shareholder defendants again.

I would suggest that one of the problems we've got in the debate is that in fact we don't have investors on both sides. We've got investors on one side and we've got a socialization on the other side. And so when one tries to balance the equities one should be looking at a standard that is spreading the risk among broad-based society. One has a debate much more like the Medicare debate, if you will, in which we have observable victims on one side and broad faceless society on the other side and the tone of that debate tends to change things somewhat.

It seems to me it's very useful for Don to focus on the compensatory versus the deterrent role played by securities litigation. And implicit in Don's thought, is to start to focus on whether we really want one approach to solve both compensatory issues and deterrent issues, at least in the non-privity cases. I think he is absolutely right to separate the open market fraud cases from the privity cases and to suggest that in the privity cases—the cases where there are buyers and sellers and a zero sum game—we should stay in something like the present system but look at a different system where we don't have a zero sum game. If you start to do that, one of the things you do, as Don points out, is look at the compensatory side of it as being an insurance question and the current system as being a fairly ineffective kind of insurance system. And that opens the door for thoughts that Don does not pursue: whether there are other kinds of insurance approaches that would work more effectively.

Perhaps something like what we have with the FDIC is the right kind of approach in the securities markets and we ought to tax every securities transaction and provide an insurance kind of remedy. That kind of thinking is useful but terribly difficult, but I think it is worth exploring. One of the problems you obviously get if you start going down that road is the difficulty of distinguishing between losses attributable to fraud and losses attributable to market risk. Unlike deposits insured by the FDIC, here you are supposed to "deposit" the money, recognizing that there is some possibility that it won't be there when you go to take it out. You are knowingly taking a market risk. And so the notion of insurance doesn't work as easily, but there are legitimate thoughts that could go along those lines to satisfy the compensatory side. I think

Don properly suggests that we could look at the deterrence side separately and in theory this makes sense. I think as political reality it is terribly, terribly difficult.

One of the possibilities suggested on the deterrence side is a thought I have heard put forward by only one other source, and that was, surprisingly, a fairly wealthy corporate officer. That is the suggestion of significantly greater penalties not against the issuer, but against the individuals responsible—officers of corporations. As a matter of theory, I think that would work. Having lived through Washington and the debate when there was discussion about accounting changes for stock options, as a matter of political reality I would not want to spend a lot of time on it.

And so one looks for other kinds of deterrence. Certainly the possibility of expanding fines and getting to the right number is a possibility. It could be a politically realistic possibility. I would suggest that in fact, that possibility is really doing nothing more than setting up a bounty system in lieu of direct enforcement by the SEC. I should, still being an official of that agency, stand here and tell you that the right way to approach this is just give a lot more money to the SEC and let the SEC do the job. I suspect that is not politically realistic. And so we come back, I think, to the possibility of the bounty hunter system which at its core is what Don's proposal gets to. A bounty hunter system—and perhaps it's good to talk about bounty hunters in a state like Arizona—works simply because we can't afford the right police force and by working with a bounty system we can get another group to act in a quasi-police function.

The proposal would separate deterrence from compensation and would have that deterrence function performed by a private group, compensated by issuers rather than the government. You would see that cost in the price of your bubble gum, or whatever else you might buy, instead of seeing it in your tax bill. It may be that's an effective way to do it. I would suggest that in a conference like this that is in many ways very valuably focused on theoretical constructs and theoretical alternatives to the kind of legislation we have sitting on the President's desk, I don't think the bounty hunter system is the theoretically most attractive way to go. I think you probably get undue expenses and that those undue expenses indirectly are borne by all of us—by consumers, by suppliers, by labor, by shareholders—in ways that we don't recognize very well. But it is entirely conceivable to me that when you get away from the theoretical objection and look at ways to get to a practical approach, this may be a way to sneak that fast ball past the batter.