State Attorneys General, Parens Patriae and the
Securities Litigation Uniform Standards Act of 1998:

A Brief Proposal to Protect Investors in a World of Efficient Capital Formation

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Over the last twenty years state attorneys general have played an innovative law enforcement role in our federated legal system.[1] Part crime-fighters, part public interest advocates, the state attorneys general have frequently utilized new technologies to cooperate in bringing multistate civil suits against violators of federal antitrust and state consumer protection laws.[2] The recent tobacco and Microsoft litigation are just two among many major examples of multistate litigation.[3] State law enforcement officials have not, however, frequently cooperated to investigate and prosecute on a multistate basis violations of state securities laws, popularly known as Blue-Sky Laws.[4] Since 1993 when 39 states successfully cooperated to sue Salomon Brothers Inc. for committing securities fraud in connection with United States Treasury securities auctions and obtained a $4 million settlement award for partial distribution through a trust fund for defrauded investors, no major multistate securities litigation has occurred.[5]

This paper will argue that changes in federal law over the last decade have given rise to a need for as yet unseen collective state law enforcement of securities laws. The Private Securities Litigation Reform Act of 1995 ("PSLRA") erects procedural and substantive barriers that diminish the incentives for private plaintiffs to file securities fraud class action lawsuits and enable defendants to win dismissal of many merited securities fraud claims. The Securities Litigation Uniform Standards Act of 1998 ("SLUSA") precludes parties from bringing class action lawsuits in federal or state court alleging violations of state securities laws. The SLUSA eliminates expansive state law remedies for defrauded investors acting as

[1] See, Jason Lynch, Federalism, Separation of Powers, and the Role of the State Attorneys General in Multistate Litigation, 101 Colum. L. Rev. 1998, 1999 (2001).
[2] See Lynch, supra note 1, at 2005.
[3] See, e.g., Howard M. Erichson, Coattail Class Actions: Reflections on Microsoft, Tobacco, and the Mixing of Public and Private Lawyering in Mass Litigation, 34 U.C. Davis L. Rev. 1 (2000).
[4] See generally, Jonathan R. Macey and Geoffrey P. Miller, Origin of the Blue Sky Laws, 70 Tex. L. Rev. 347 (1991) (providing an overview of state securities laws and the political and economic rational for their enactment in the 19th century).
[5] Salomon Brothers Will Pay $4 million to 39 States and D.C. to Settle Claims, 25 Sec. Reg. & Law Rpt. 53 (1993).

classes. Together the PSLRA and SLUSA seek to balance two important but sometimes competing needs: the need for fairness in capital markets and the need for efficiency in capital formation and corporate investment. In striking a balance between these needs, the PSLRA and SLUSA self-consciously disenfranchises the rights of many groups of defrauded investors.

This paper will argue that Congress should amend the SLUSA to permit state law enforcement officials to bring parens patriae actions under state law on behalf of defrauded investors in much the same way Congress amended the Sherman Antitrust Act to permit parens patriae actions to recover antitrust damages.[6] Such an amendment would enable state law enforcement officials to avail defrauded investors of the expansive, investor-friendly protections of state securities laws. The amendment would accomplish these goals without, this Paper argues, radically re-establishing the balance between fair and efficient capital markets that has been the obsession of the federal securities laws for seventy years. State law enforcement officials do not pose the threat of bringing meritless, strike suits that motivated Congress to act the SLUSA in the first place. State officials, unlike private class action plaintiffs, respond not to economic motivations that encourage frivolous lawsuits but rather to political motivations and considerations of public good that require conservative allocation of precious state litigation resources. By vesting parens patriae authority in responsible state law enforcement officers, Congress would enhance investor protection without greatly increasing the exposure of corporate defendants to vexatious securities litigation.

Part I of this paper discusses federal securities laws. Part II explores Blue Sky Law and compares the protections that state securities law affords investors with the protections that the federal securities laws offers to investors. Part III discusses SLUSA and explains that state law protections are no longer available to class action plaintiffs. Parts IV and V argue that Congress should amend SLUSA to permit state law enforcement officials to bring lawsuits on behalf of defrauded investors and once again avail defrauded investors of the protections of state securities law without greatly compromising the integrity of the capital formation process.

I. FEDERAL SECURITIES LAWS

The cornerstone of the federal securities laws is accurate disclosure of material non-public corporate information. The Securities Act of 1933 (“1933 Act) contains registration requirements for the issuance of securities to public purchasers.[7] The registration requirement compels issuers to prepare securities prospectuses, with the assistance of public auditors, investment bankers and corporate lawyers.[8] The prospectus contains various schedules of information, including audited financial statements with footnotes, projections as to future financial performance of the issuer and other facts and analysis that in theory are useful for retail investors and professional analysts alike to price securities and make investment decisions.[9] The Securities Exchange Act of 1934 (“1934 Act”) requires companies meeting particular corporate asset thresholds and companies with securities trading on national market exchanges to file yearly and periodic disclosure statements containing information akin to that in the 1933 Act registration statement.[10]

A. § 11 Liability

The 1933 and 1934 Acts impose severe civil and criminal penalties on and create private rights of action against designated parties that provide false information in required disclosures, voluntary prospectuses and general corporate announcements. §11 of the 1933 Act enables purchasers of securities to sue issuers and other parties that sign the registration statements for making false or misleading statements in the prospectus.[11]

B. § 12 Liability

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[6] See Beth S. Schipper, Civil RICO and Parens Patriae: Lowering Litigation Barriers through State Intervention, 24 Wm. and Mary L. Rev. 429 (Spring 1983) (proposing that Congress amend RICO to allow for parens patriae actions). Schipper’s article was an important source of thought for this paper.
[7] 15 U.S.C. § 77a -- 77z-3 (2001).
[8] See id. at §§ 77e-77g.
[9] See id. at § 77g.
[10] See id. at § 78m.
[11] See id. at § 77k.

Section 12(2) of the 1933 Act provides for strict civil liability against sellers of securities who use false or misleading written or oral communications to solicit purchasers.[12] The Supreme Court has narrowly interpreted the meaning of sellers to comprise only people, such as securities brokers, directly in privity with purchasers.[13] Section 12(2) does not, therefore, apply to issuers offering securities in the primary market – initial public offering context but rather only to secondary market transactions between broker-dealers and customers.

Section 12(1) of the 1933 Act provides for strict civil liability against sellers who failed to register securities in conformity with the registration requirements of the 1933 Act.[14] The statute of limitations for §11, §12(1) and §12(2) actions is one year from actual discovery, or discovery had the plaintiff exercised reasonable diligence, and three years from the date of the violation.[15]

C. Rule 10b-5 Liability

Rule 10b-5, a rule that the SEC pronounced pursuant to § 10b of the 1934 Act, prohibits the use of deceptive and manipulative devices in connection with the purchase or sale of a security. [16] This prohibition applies to any person who has made false statements in connection with a securities purchase or sale or has engaged in insider trading or other illegal practices.[17] The damage formula under Rule 10b-5 is somewhat complex but prior to the passage of the PSLRA most courts awarded out-of-pocket damages in the amount of the difference between the purchase price at time of sale and the actual value of the security at that time.[18] The statute of limitations for Rule 10b-5 actions is one year from the date of discovery but no more than three years from the date of the violation.[19]

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[12] 15 U.S.C. § 77l.
[13] See Pinter v. Dahl, 486 U.S. 622 (1988); Joseph C. Long, Developments and Issues in Civil Liability under Blue Sky Law, 62 U. Cin. L. Rev. 439, 443--444 (1993).
[14] 15 U.S.C. § 77l.
[15] Id. at § 77m.
[16] 17 C.F.R. § 240.10b-5 (1993).
[17] See Weinroth, supra note 13, at 24--25.
[18] See id.
[19] 15 U.S.C. § 78aa-1.

Unlike §11, §12(1) or §12(2) of the 1933 Act, Rule 10b-5 applies to *issuers* and broker-dealers --- though not aiders and abettors, such as accountants and lawyers.[20] Under Supreme Court precedent plaintiffs bringing Rule 10b-5 claims must prove that the defendants acted with scienter[21] --- intent or extreme recklessness --- and causation and reliance --- that but for the false or misleading statement the plaintiff would not have purchased or sold the securities.[22] No such requirements exist with respect to § 11, § 12(2) or § 12(1) actions.

II. STATE SECURITIES LAWS

A. The Uniform Securities Act

1. Introduction

State securities laws, or Blue Sky Laws, took form between 1911 and 1917 in the western United States and were the product of diverse political and economic interest groups seeking not only to protect retail investors from stock fraud but to protect western banks and savings institutions from speculative out-of-state securities issuers promising to provide higher returns on investment than savings accounts.[23] Current Blue Sky Laws reflect the efforts of the National Conference of Commissioners on Uniform State Laws to establish uniform securities laws in all the states.[24] The Uniform Securities Act, which 39 states have adopted, contains four parts --- securities registration requirements, to which various, comprehensive exemptions apply; securities dealer registration requirements; anti-fraud provisions, akin to Rule 10b-5, to which no exemptions apply; and, definitions, administration and penalties.[25]

2. Jurisdiction

[20] See Central Bank v. First Interstate Bank, 114 S.Ct. 1439 (1994).
[21] See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
[22] See Basic v. Levinson, 485 U.S. 224, 243 (1988).
[23] See Macy et al., supra note 4, at 350.
[24] See, e.g., David O. Blood, There Should Be No Reliance in the "Blue Sky", 1998 B.Y.U.L. Rev. 177 (1998).
[25] Peter M. Fass and Derek A. Wittner, Blue Sky Practice: For Public and Private Limited Offerings 1-2 (2001-2002 Ed. 2001).

The Uniform Securities Act registration provisions apply to offers and sales of securities that occur within the context of transactions that occur or have a connection to the state whose laws plaintiffs or securities administrators seek to invoke.[26] Section 414 reads:

> For the purpose of this section, an offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer ---
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> (1) originates from this state or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer) …. (d) For the purpose of this section, an offer to buy or to sell is accepted in this state when acceptance (1) is communicated to the offeror in this state and (2) has not previously been communicated to the offeror, orally or in writing, outside this state; and acceptance is communicated to the offeror in this state, whether or not either party is then present in this state, when the offeree directs it to the offeror in this state reasonably believing the offeror to be in this state and it is received at the place to which it is directed (or at any post office in this state in the case of a mailed acceptance). [27]

If an offeror to purchase or sell a security sends a written letter or phones a party out of state, the law of the state to which the offeror directed his offer applies.[28] Because the Uniform Securities Act contains registration and anti-fraud provision, the offeror must ensure that he complies with both provisions unless an exemption to the registration requirements applies. In such a case, only the anti-fraud provision apply to the offeror. The law of the state from which the offer originates, in addition from which the offer directs, also applies to the offeror.[29]

3. State Securities Administrator Enforcement Jurisdiction

[26] Id.
[27] Unif. Secs. Act § 414 (1958) (amended 1988).
[28] Id.
[29] Id.

Almost all states have securities commissions that are responsible for licensing and enforcing broker-dealer registration requirements[30]; enforcing compliance with securities registration statements;[31] and enforcing the anti-fraud provisions of state securities laws. As to violations of the anti-fraud provisions of the Uniform Securities Act, administrators may order administrative proceedings and issue judgments consisting of cease-and-desist orders; censures of licensed broker-dealers; and civil penalties for knowing violations of the Uniform Securities Act. The Uniform Securities Act empowers state courts to give teeth to administrative orders and issue their own judgments enforcing Blue Sky Laws. If the administrator proves that a person has violated Blue Sky Law, state courts may issue temporary and permanent injunctions; impose civil penalties; issue declaratory judgments; order violators to pay restitution to investors; and order such other relief as the court considers just.[32] State courts may also order the appointment of a receiver for the protection of the assets of the defendants who may be subject to prosecution in other states. The Uniform Securities Act authorizes courts to punish persons who knowingly violate administrative orders or file documents, such as registration statements, with the administrator that the defendant knows to contain false or misleading statements and empowers administrators to refer violators to the state Attorney General or District Attorney for criminal prosecution.

The Uniform Securities Act authorizes administrators to cooperate with administrators in other states in bringing civil and criminal actions against defendants.[33]

4. Registration Requirements

The Uniform Securities Act requires issuers of non-exempt financial instruments fitting the statutory definition of securities to file with the administrator a registration statement.[34] Depending on the circumstances of the securities offering, issuers may either register through notification[35], qualification[36] or coordination[37]. Although a discussion of

[30] Id. at §§ 205, 212.
[31] Id. at §§ 301, 306.
[32] Unif. Secs. Act § 603.
[33] Id. at § 704.
[34] Id. at § 301.
[35] Id. at § 303.

the details of these registration forms are beyond the scope of this Paper, it is important to note that registration by notification, qualification and coordination requires issuers to disclose material corporate information including details of the security offered, the financial condition of the company, the management and directors of the company and like information. Registration by coordination enables qualified issuers to utilize their 1933 Act registration statements for purposes of state law registration.

Note that in recent years a number of exemptions have come into existence that relieve issuers of the sometimes onerous state registration requirements. The so-called marketplace exemption is one of the most comprehensive of state law exemptions.[38] The marketplace exemption exempts issuers whose securities are traded on national market exchanges from state registration requirements as to those securities.[39] Although the marketplace exemption has eroded the ability of state administrators to specify registration requirements different from those that federal law requires, sellers of exempt securities cannot theoretically engage in fraudulent practices with respect to the securities sale without facing Blue Sky Law liability.[40] By their terms the exemptions in § 402 apply to § 301 and § 403 --- not § 101, the general anti-fraud provision in the Uniform Securities Act.

5. Anti-Fraud Provisions

Section 101 of the Uniform Securities Act provides that:

> It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly
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> (1) to employ any device, scheme, or artifice to defraud,
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> (2) to make any untrue statement of a 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 are made, not misleading, or

[36] Id. at § 304.
[37] Unif. Secs. Act § 305.
[38] Id. at § 402(a)(8).
[39] Id.

> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[41]

This language is almost identical to that in Rule 10b-5.[42] In addition to § 101, § 404 provides:

> § 404. Misleading Filings.
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> It is unlawful for any person to make or cause to be made, in any document filed with the [Administrator] or in any proceeding under this act, any statement which is, at the time and in the light of the circumstances under which it is made, false or misleading in any material respect.[43]

Section 102 of the Uniform Standards Act prohibits persons who receive consideration for providing advice as to the value of securities from employing fraudulent and manipulative schemes in connection with such advice.[44]

6. Elements of a Cause of Action for Securities Fraud under State Law

Section 410(a) creates civil liability for persons who violate various provisions of the Uniform Securities Act including the registration requirement. Persons, such as those who mistakenly relied upon exemptions, who sell non-exempt unregistered securities will face liability under § 410(a). Section 410(a)(2) provides that any person who:

> offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security. Damages are the amount that would be recoverable upon a tender less

[41] Id. at § 101.
[42] 17 C.F.R. § 240.10b-5.
[43] Unif. Secs. Act § 404.
[44] Id. at § 102.

> the value of the security when the buyer disposed of it and interest at six percent per year from the date of disposition.[45]

This provision enables purchasers of securities whose seller employed materially erroneous sales literature and sales pitches to rescind their purchasers or, if the purchasers sold the security, to receive rescissory damages. Defendants do enjoy the benefit of a due diligence defense by which defendants may prove that they did not and, through the exercise of reasonable care, could not have known about the erroneous statements or omissions. This defense would be useful for, for example, an outside director of an issuer who could not have known by the exercise of the functions of a member of the board of directors that a legal opinion in a prospectus was erroneous or that financial statements contained technical accounting errors.

With respect to causation and reliance most state courts require plaintiffs individually to demonstrate that the plaintiff relied on the false or misleading statement in making the decision to purchase or sell the security.[46] These courts hold that the fraud-on-the-market theory, which federal courts interpreting the federal securities laws adopt, does not apply to state law causes of action based on fraud or negligent misrepresentation.[47] Because each plaintiff must demonstrate reliance, the reliance requirement greatly complicates the ability of plaintiffs to bring class action lawsuits under state law.[48]

State courts have enabled successful plaintiffs to recover reasonable attorneys' fees.[49] Many state laws provide that the statute of limitations for securities fraud is as long as five years.[50] Texas, for example, provides that a plaintiff must bring an action within three years of discovery through the exercise of due diligence and not more than five years after the fraud occurred.[51] Plaintiff pleading common law fraud enjoy the benefit of equitable tolling. Contrast this limitations period to that under federal law, which

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[45] Id. at § 410(a)(2).
[46] See Mark I. Steinberg, Corporate Law Symposium: The Emergence of State Securities Laws: Partly Sunny Skies for Investors, 62 U. Cin. L. Rev. 395, 420 (1993).
[47] The fraud-on-the-market theory posits that investors who buy or sell a security need not have actually relied on the fraudulent or negligent action in order to receive damages.
[48] See Steinberg, supra note 46, at 420.
[49] See id. at 421.
[50] See id. at 422.
[51] See id. at 421. See generally, Keith A. Rowley, The Sky is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies, 50 Baylor L. Rev. 99 (1998) (outlining the securities fraud cause of action under the Texas Securities Act).

provides a one-year / three-year limitations period for § 11, § 12(2) and Rule 10b-5 liability and no equitable tolling.[52]

Many states enable purchasers or sellers to collect damages for secondary market transactions in which plaintiffs bought from or sold stock to broker-dealers, as distinct from issuers, who *negligently* made false or misleading statements in the course of the selling or buying effort.[53] None of the provisions in the 1933 and 1934 Acts provide for private liability for negligent misstatements or omissions in the context of secondary market transactions. Rule 10b-5 requires that the defendant acted with *scienter* not merely *negligence.* Section 12(2) does not generally apply to secondary market transactions.[54] In addition, many state courts do not follow the United States Supreme Court decision in Pinter v. Dahl restricting the sellers liable under § 12(2) to persons who stood to gain financially from the promoting securities. Importantly, state courts also permit plaintiffs to bring actions against persons, such as accountants and lawyers, who materially aided and abetted fraudulent securities transactions.[55] The United States Supreme Court rejected aider and abettor liability in Central Bank v. First Interstate Bank.[56] Plaintiffs will, therefore, be able to utilize state law to reach defendants who, because they were aiders and abettors lacking scienter, were not subject to liability under federal law.

To recapitulate, federal law is more permissive than state law in that federal law does not require plaintiffs to demonstrate that particular plaintiffs in a class action lawsuit prove reliance. State law tends to be more protective than federal law, however, in that the former generally provides for long statutes of limitations and equitable tolling; liability for aiders and abettors; and liability for negligent, as distinct from intentional, misrepresentations in secondary markets. One may hypothesize numerous circumstances under which plaintiffs would be more likely successfully to prosecute claims for securities fraud under state law rather than federal law. For example, upon revelation that a company has misrepresented to investors its financial strength issuers often file for bankruptcy protection, automatically staying investor lawsuits. Unless plaintiffs can demonstrate that the lawyers, accountants or investment bankers with which the issue

[52] See Steinberg, supra note 46, at 421.
[53] See id. at 424.
[54] See id.
[55] See id. at 424.
[56] 114 S.Ct. 1439 (1994).

worked in bringing securities to market intentionally sought to deceive investors, plaintiffs have no federal securities law cause of action against the only existing "deep-pockets." State law, in contrast to federal law, would permit lawsuits against accountants and lawyers on the basis of evidence that the latter parties acted merely with negligence. One commentator writes: "The state securities laws are likely to be invoked by plaintiffs with greater frequency. Due to their more flexible construction, many of the state statutes provide the plaintiff with a right of action where such right may be lacking under federal law."[57]

C. The Private Securities Litigation Reform Act

The PSLRA, a 1995 change in the federal securities laws, increased the extent to which state law exceeded federal law with respect to investor protection. Congress enacted the PSLRA in response to a rising tide of private securities litigation in the early 1990s.[58] The PSLRA sought to re-establish a proper balance between the rights of plaintiffs to seek remedies for violations of their rights under federal law and the ability of companies to raise and invest capital free of frivolous lawsuits.[59] This Paper will highlight just a few of the provisions of the PSLRA that complicate the ability of plaintiffs to bring federal securities law claims in federal courts.

1. Most Adequate Plaintiff in Class Action Lawsuits

The PSLRA requires federal courts to certify the appointment of a "most adequate plaintiff" in a class action lawsuit.[60] The most adequate plaintiff is responsible for appointing lead legal counsel. Federal law presumes that the most adequate plaintiff is the plaintiff with the largest financial stake in the lawsuit --- most often a large institutional investor. Because the first plaintiff to file a lawsuit will not necessarily and often is not the most adequate plaintiff who has the right to appoint legal counsel, the PSLRA reduces the incentives of lawyers to investigate possible securities fraud claims and seek plaintiffs to file suits. The PSLRA enables the most adequate plaintiff to change legal counsel and thus eliminate possible financial

[57] Steinberg, supra note 46, at 428.
[58] Thomas W. Antonucci, The Randolph W. Thrower Symposium: The Role of the General Counsel: Comment: The Private Securities Litigation Reform Act and the States: Who Will Decide the Future of Securities Litigation?, 46 Emory L.J. 1237, 1239 (1997).
[59] See Antonucci, supra note 58, at 1242.

returns from initial lawsuit preparation.[61] State law does not provide for a rebuttable presumption that large financial institutions, as most adequate plaintiff, have the right to appoint legal counsel and does not, therefore, deter lawyers from engaging in potentially productive pre-filing risk-taking behavior.

2. Heightened Pleading Requirement

The PSLRA contains a pleading requirement that complaints must "with respect to each act or omission alleged to violate (Rule10b-5) state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[62] In filing a complaint alleging a cause of action under Rule 10b-5, plaintiffs cannot boldly assert that the defendants acted with scienter unless the plaintiffs possess evidence compelling a reasonable person to believe that scienter existed.

3. Stay of Discovery

Unless the PSLRA with its heightened pleading requirements stayed discovery during the pendancy of a motion to dismiss, the PSLRA would not greatly alter the pleading behavior of plaintiffs --- who would simply file complaints, take discovery, identify specific facts giving rise to an inference of scienter, amend the complaint, and survive the motion to dismiss for failing to meet the pleading requirements under the PSLRA. The PSLRA provides for a stay of discovery during the pendancy of the motion to dismiss.[63]

4. Proportionate Liability

Prior to the PSLRA defendants, whether they were issuers, officers and directors of issuers, accountants or lawyers for the issuer, were joint and severally liable for

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[60] See 15 U.S.C. §§ 77z-1(a)(3) -- 78u-4(a)(3) (1994 & Supp. 1996) (cited in Antonucci, supra note 58, at 1243--1244).
[61] See Antonucci, supra note 58, at 1240.
[62] 15 U.S.C. §§ 78u-4(b)(2) (cited in Antonucci, supra note 58, at 1245).
[63] See Antonucci, supra note 58, at 1246.

damages under the federal securities laws. If an issuer filed for bankruptcy and the officers and directors were insolvent, which they may often become after revelation of a financial scandal, plaintiffs could still receive damages *in whole* from the remaining deep pockets such as the accountants for the issuer.[64] The PSLRA provides that accountants and other defendants are liable *only to the extent of their contribution to the fraud*. State law does not limit damages to the extent of the contribution of the defendant to the fraud.[65]

III. THE SECURITIES LITIGATION UNIFORM STANDARDS ACT

The PSLRA erects obstacles to plaintiffs seeking to bring federal securities laws claims in federal court and limits damages for securities fraud. Because these obstacles do not exist under state law, evidence indicates that subsequent to passage of the PSLRA plaintiffs brought an increasing number of lawsuits in state court.[66] The SLUSA provides:

> (a) No class action based upon the statutory or common law of any State or subdivision thereof may be in any State or Federal court by any private party alleging ---
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> (1) an untrue statement or omission of a material facts in connection with the purchase or sale of a covered security;
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> (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.[67]

[64] See id. at 1253 -- 1255.
[65] See id. at 1254.
[66] See id. at 1259.
[67] Pub. L. No. 105-353, 112 Stat. 3227, sec. 101(a)(1)(b) (1998).

The SLUSA precludes plaintiffs from bringing *class action* lawsuits under *state securities law* in *state court*. The SLUSA defines class action lawsuits as:

> Any single lawsuit, or any group of lawsuits filed in or pending in the same court involving common questions of law or fact, in which ---
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> (A) damages are sought on behalf of more than 25 persons;
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> (B) one or more named parties seek to recover damages on representative basis on behalf of themselves and other unnamed parties similarly situated; or
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> (C) one or more of the parties seeking to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated; or
>
> (D) one or more of the parties seeking to recover damages did not personally authorize the filing of the lawsuit.[68]

Plaintiffs seeking to bring class action lawsuits asserting violations of state securities anti-fraud laws, such as § 101 of the Uniform Standards Act, are unable to do so under the SLUSA. The SLUSA, in effect, federally preempts state securities anti-fraud laws in class action lawsuits. Importantly, the SLUSA exempts certain types of actions from coverage of the Act. For example, states bringing actions on their own behalf or as members of a class comprised solely of other States are also exempt from the Act.[69]

IV. THE ROLE OF THE STATE ATTORNEY GENERAL / SECURITIES ADMINISTRATOR IN THE POST-SLUSA / PSLRA WORLD

The PSLRA and the SLUSA together reduce the number of plaintiffs who can successfully bring class action lawsuits alleging violations of federal *or* state securities

[68] Id. at sec. 101(a)(1)(f)(2)(A)(i)(I).
[69] Id. at sec. 101(a)(1)(e).

laws. The last few decades has seen an expansion of exemptions from state law registration requirements for securities.[70] Combined with the erosion of state law registration requirements, the preclusion of class action lawsuits under state securities law constitutes a major erosion of state sovereignty over the financial well-being of in-state investors. States can no longer legislate effective anti-fraud securities laws that provide greater protection for classes of defrauded purchasers than the federal securities laws. Class action plaintiffs who are unable to overcome the procedural hurdles of the PSLRA are parties whose rights federal law has ceased to vindicate.

The erosion of state sovereignty in the securities law area is not an irreversible phenomenon. State attorneys general and securities administrators should play a more active role in enforcing securities laws criminally and civilly pursuant to state law enforcement powers under the Uniform Securities Act. This enforcement role should transcend typical police functioning and enter the realm of public advocacy: enforcement officials should assume the role of private class action plaintiff attorneys in investigating and filing parens patriae lawsuits against persons who violate Blue Sky Laws and meet the jurisdictional requirements of the Uniform Securities Act. The proceeds of such lawsuits should go to state funds to compensate defrauded investors.

By aiding in availing defrauded investors of the protections of state securities law, this enforcement role for state officials would help to ensure that capital markets are fairer than they currently are. The benefits of parens patriae lawsuits under Blue Sky Laws are many. Because the PSLRA diminishes damages recovery, raises the pleading standards and eliminates discovery during the pendancy of the motion to dismiss, the

[70] See, e.g., Unif. Secs. Act § 404(a)(8).

PSLRA has reduced the potential benefits to plaintiffs attorneys of bringing lawsuits in proportion to the benefits. By assuming many of the informational costs of pursuing lawsuits, state law enforcement officials provide legal representation to persons who would not otherwise receive representation. By assuming the costs of investigating, conducting legal research, taking discovery, doing document review and otherwise prosecuting a civil lawsuit pursuant to the investigatory powers of state law enforcement officials under the Uniform Securities Act, state enforcement officials would assume costs that would otherwise prohibit individual plaintiffs from bringing lawsuits on their own behalf. By sharing information with private plaintiff attorneys, state law enforcement officials would facilitate individual private lawsuits and enable plaintiffs who, because the SLUSA bars them from acting *as a class*, can now act *individually*. Perhaps more important than the organizational benefits of more active state law enforcement efforts is the fact that the very nature of such state law enforcement efforts support a public policy argument that the SLUSA should not apply to state parens patriae actions under the Blue Sky Laws.

V. Jurisdictional Basis of State Attorney General / Securities Administrator Authority to Bring Lawsuits on Behalf of Defrauded Investors

The SLUSA prohibits plaintiffs from bringing class action lawsuits alleging violations of state securities laws on behalf of defrauded investors. Unless the SLUSA recognizes an exception to this prohibition for parens patriae actions, state law enforcement officials will be unable to aid classes of defrauded purchasers in availing themselves of the protections of state securities law.

The SLUSA does explicitly exempt certain actions from coverage of the law. The SLUSA provides: “PRESERVATION OF STATE JURISDICTION. – The securities commission (or any agency or office performing like function) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.”[71] The SLUSA also preserves certain state actions:

> Notwithstanding any other provisions of this section, nothing in this section may be construed to preclude a State…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….[72]

This language is ambiguous as to whether it would prohibit state law enforcement parens patriae actions. The terms “on [the state’s] own behalf” in the statute may mean that the only preserved state actions are those in which the state is a plaintiff seeking to recover damages for securities that the state purchased on its own behalf. No federal courts have had occasion to interpret the terms “on [the state’s] own behalf” in the SLUSA.

One may make a strong argument on policy grounds that Congress would not have intended for the SLUSA to apply to parens patriae actions. Congress found that:

> [S]ince enactment [of the PSLRA], considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts….[T]his shift has prevented the [PSLRA] from fully achieving its objectives….[I]n 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, while preserving the appropriate enforcement powers of State regulators….[73]

[71] Pub. L. No. 105-353, 112 Stat. 3227, sec. 101(a)(1)(e).
[72] Id. at sec. 101(a)(1)(d)(1)(A).
[73] Id. at sec. 2.

In the Joint Explanatory Statement of the Committee of Conference Congress wrote that the SLUSA is "designed to protect the interests of shareholders and employees of public companies that are the target of merit less 'strike' suits. The purpose of these strike suits is to extract a sizable settlement from companies that are forces to settle, regardless of the lack of merits of the suit, simply to avoid the potentially bankrupting expense of litigation." [74] The legislative history of the SLUSA indicates that Congress sought to establish a proper balance between the rights of shareholders to seek remedies for securities fraud and the rights of companies to issue securities free of the risk of litigation. Congress apparently reasoned that that the PSLRA and the SLUSA were necessary to strike the proper balance between these two rights. Congress feared that plaintiffs law firms were manipulating plaintiffs into bringing meritless lawsuits and that the procedural barriers of the PSLRA and the pre-emption provisions of the SLUSA would reduce meritless lawsuits with minimal damage to the rights of plaintiffs with merited claims.

State law enforcement officials bringing parens patriae actions do not have the same economic motivations as plaintiff attorneys. State law enforcement officials do not seek personal economic gain through litigation. These officials cannot become rich through parens patriae actions. State budgets constraints discourage state law enforcement officials from bringing lawsuits that will yield little political return, in particular, those lawsuits that will consume resources and yet win no tangible judgments. If the purposes of the SLUSA were to discourage meritless "strike" suits, by either

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[74] H.R. Rep. No. 105-803, Joint Explanatory Statement of the Committee of Conference (1998).

interpreting the SLUSA or amending the law to permit parens patriae actions, the federal courts or Congress would not undermine the ultimate purposes of the SLUSA. State securities administrator parens patriae actions do not pose the threat of meritless lawsuits: state securities administrators or state attorneys general do not have the economic or political incentives to manipulate plaintiffs and bring vexatious suits.

Given the fact that strong policy reasons militate in favor of exempting parens patriae actions from the SLUSA, federal courts may interpret the SLUSA accordingly. In the absence of permissive federal court interpretations, Congress should amend the SLUSA to permit parens patriae lawsuits under state law in much the same way that Congress amended the Sherman Act to permit parens patriae actions to recover antitrust damages.[75]

By doing so Congress would enable state law enforcement officials to enable investors as classes once again to enjoy the protections of state securities law. In addition, by filing lawsuits on behalf of defrauded investors, state enforcement authorities would act on behalf of persons who lack the organizational and financial wherewithal to bring lawsuits themselves.

VI. Conclusion

At the same time as the PSLRA greatly reduces the number of federal law class action lawsuits, the SLUSA reduces the number of state law class action lawsuits to zero. In so doing, both laws deprive defrauded investors of remedies under either federal or state law. SLUSA is particularly harmful to defrauded investors; it deprives such people of expansive, investor-friendly state securities laws. In enacting the PSLRA and the

SLUSA Congress sought to strike the proper balance between the desire for fairness to investors and the demand for cheap capital financing. This paper proposes that Congress amend the SLUSA to permit state law enforcement officials to do in the securities law area what such officials currently do in the antitrust and consumer law areas: bring coordinated parens patriae lawsuits on behalf of disenfranchised defrauded investors.[76] Such an amendment would once again avail investors of the expansive protections of state securities law and yet, this paper argues, by doing so through the medium of public-minded state officials does so in a way that does not require a democratic re-determination of the proper balance between investor fairness and inexpensive capital formation.

[75] See Schipper, supra note 6, at 429--433.
[76] See id.