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I. Introduction

Should parties be free to opt out of securities regulation[1] by private agreement? Several securities law scholars have called for selective securities law deregulation, couching their arguments in law and economics theory and repeatedly emphasizing the costs of regulation.[2] Yet should economic consid-

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1. The terms "securities regulation" and "securities laws" when used in this Article refer generally to the Securities Act of 1933, the Securities Exchange Act of 1934, the regulations promulgated pursuant thereto, and comparable state securities laws and regulations. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994 & Supp. II 1996); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (1994 & Supp. II 1996).

2. *See, e.g.*, Park McGinty, *The Limited Liability Company: Opportunity for Selective Securities Law Deregulation*, 64 U. CIN. L. REV. 369 (1996); Larry E. Ribstein, *Form and*

erations, such as reducing costs, promoting economic freedom, and maximizing allocative efficiency, effectively trump all other policy concerns? Should we allow investors to waive the protections of the securities laws or are these Faustian bargains[3] that the state should refuse to enforce?[4] Would selective deregulation actually prove to be more efficient, equitable, and predictable than the current regulatory regime?

The proposals calling for selective securities law deregulation are only one of many recent reform initiatives that are testing the limits of private contracting. The current trend toward private governance and reform measures that advocate rules over standards, certainty over flexibility, law over facts, and individualism over community are quietly changing the law in many contexts.[5] The debate, in this and other contexts, is important because it raises basic questions about the proper scope of government and the values to be served by regulation. The debate concerning selective securities law deregulation is particularly significant because it dramatically illustrates a clash of American values. It pits freedom of contract against the fundamental policies that underlie the securities laws, including socially-directed values such as fairness, equity, the protection of investors, the need for public confidence in capital markets, and the deterrence of fraud.

This Article examines the proposals for selective securities law deregulation from both theoretical and practical perspectives. Part II discusses the new conservatism in private law and the current trend toward private ordering. Part III provides an overview of proposed securities law reform measures and outlines the arguments in favor of selective securities law deregulation and allowing parties to contractually opt out of securities regulation. After considering the policies that underlie the securities laws and exploring the effects of permitting parties to contract out of this statutory scheme,

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Substance in the Definition of a "Security": The Case of Limited Liability Companies, 51 WASH. & LEE L. REV. 807 (1994) [hereinafter Ribstein, *Form and Substance*]; Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1 (1992) [hereinafter Ribstein, *Private Ordering*].

3. Faust is a legendary and literary figure who sold his soul to the devil for knowledge, power, and material gain. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 829 (1971).

4. An analogous debate rages in bankruptcy law. Steven Schwarcz posed a similar question in his article *Rethinking Freedom of Contract: A Bankruptcy Paradigm*. Schwarcz asked, "May debtors and creditors contract in advance to change [the statutory] relationship? Or would these contracts be 'Faustian' bargains that the state should not enforce?" Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 516 (1999). In the bankruptcy law context, Schwarcz concluded that "externalities should not render a prebankruptcy contract, or indeed any other contract, unenforceable if each class of affected persons benefits overall, even though some of those persons individually may turn out to be harmed." *Id.* at 603 (footnote omitted).

5. *See* discussion *infra* Part II.

Part IV argues against deregulation and the freedom to opt out of securities regulation.

The proponents of selective deregulation would have us believe that the reform measures simply present a choice of rules over standards, certainty over flexibility, and law over facts. The thesis of this Article is that the reform initiatives have much broader implications – they present a choice of values.[6] The reform initiatives raise fundamental questions about the proper role of government and the purposes served by regulation, and thus require the reexamination of issues that have remained dormant since the New Deal. To understand the difficulties and dangers that the reform initiatives present, it is necessary first to review the events that gave rise to the securities laws and the reasons for their current scope and mandatory nature. Part IV.A begins by providing a brief overview of the history, objectives, scope, and structure of the securities laws.[7] The focus of the Article then shifts to discussing the values served by securities regulation, particularly the securities laws' extra-legal and moral implications.[8] This Article argues that the opting-out initiatives are philosophically inconsistent with the underlying tenets of the securities laws. The adoption of such measures would therefore undermine both the objectives and the basic theoretical framework of the securities laws.[9] The Article also takes issue with the characterization of opting-out proposals as merely logical extensions of contractarian reform measures, arguing instead that the reform initiatives actually represent a misapplication of contractual default theory.[10] In addition, this Article demonstrates that the common law has not been, and in the near future is not likely to be, an adequate substitute for statutory protections.[11] Without convincing evidence that the costs of securities regulation outweigh the benefits, radical alteration of the current regulatory scheme is not justified.[12] Even the limited experiments proposed by the advocates of deregulation pose substantial risks.[13]

This Article also challenges the premise that bright-line rules, such as opting out by entity type or waiver, promote fairness, equity, equality, predictability, efficiency, and utility better than the current regulatory scheme.[14] Part IV.B demonstrates that if our goal is to promote fairness, equity, and equal

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6. *See infra* Part IV.A.
7. *See infra* Part IV.A.1.
8. *See infra* Part IV.A.2.
9. *See infra* Part IV.A.3.
10. *See infra* Part IV.A.4.
11. *See infra* Part IV.A.5.
12. *See infra* Part IV.A.6.
13. *See infra* Part IV.A.7.
14. *See infra* Part IV.B.

treatment, the existing regulatory structure furthers these objectives better than bright-line rules, such as deregulation by private agreement.[15] If our objective is to promote predictability, efficiency, and utility, the current regulatory regime may prove more predictable, more efficient, and more useful than the rules proposed by the advocates of selective deregulation.[16]

Finally, this Article questions whether we should permit parties to waive their rights and bargain away their statutory protections.[17] The proponents of selective deregulation are asking us to abandon long-standing policies favoring investor protection[18] to adopt reforms that are premised on myths, not reality.[19] Part IV.C argues that the reform initiatives would result in the adoption of industry-protective terms that individual investors would have little or no power to change, thereby actually reducing competition. The reform initiatives would also encourage securities-industry professionals to lure investors into Faustian bargains. The reform measures would permit these professionals to take advantage of investors at a time when they lack bargaining power, knowledge, and an appreciation of the rights that they are waiving. Neither the market nor warning legends would adequately protect investors.[20] The inevitable abuses that would flow from such a practice would lead to litigation concerning whether waivers under these circumstances can be knowing, voluntary, and intentional.[21]

This Article does not suggest that legislators, regulators, or courts should disregard commercial reality and economic considerations. Concerns about the costs and regulatory burdens of the securities laws are well founded. Nevertheless, many of these concerns could be addressed with reform measures much less drastic than selective deregulation.[22] Legislators, regulators, and academics should direct their efforts to improving and perfecting the securities laws by taking into account the laws' economic effect, but such reforms must be consistent with the basic theoretical framework of the securities laws. Continued efforts to simplify existing securities regulations, additional initiatives to expand and streamline registration exemptions, and further measures to simplify, reduce, and clarify disclosure requirements would address some of these concerns. Such measures could be designed to deal with the economic concerns raised by the advocates of deregulation, without

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15. *See infra* Part IV.B.1.
16. *See infra* Part IV.B.2.
17. *See infra* Part IV.C.
18. *See infra* Part IV.C.1.
19. *See infra* Part IV.C.2.
20. *See infra* Part IV.C.3.
21. *See infra* Part IV.C.4.
22. *See infra* Part V.

compromising the underlying values of the securities laws, such as investor protection. The answer is not to choose between the free market and government regulation. Rather than swinging the pendulum back and adopting deregulatory measures, legislators and regulators should work toward a more balanced approach by adopting measured solutions that would bridge the gap between philosophical extremes.

II. The New Conservatism in Private Law and the Current Trend Toward Private Ordering

In the last five to fifteen years, private law has become more conservative.[23] There is considerable evidence that we are witnessing a retreat from the progressive principles and activism of the 1960s and 1970s and experiencing a resurgence of conservative, individualist, *laissez-faire* ideology. In contract law, for example, Ralph Mooney observed that many courts have substantially abandoned the liberal, interventionist, egalitarian, policy-oriented contract jurisprudence of the 1960s and 1970s in favor of a more conservative, classical, conceptualist approach that emphasizes freedom of contract and marketplace economics.[24] Mooney's study documents a return to narrow rules of formation, strict application of the parol evidence rule, and limitations on implied obligations such as good faith.[25] In tort law, the retrenchment is evidenced by the tort reform movement, restrictions on strict products liability and other enterprise liability, and the *Restatement (Third) of Torts* on products liability.[26] This jurisprudential and political shift has resulted in the emergence of a new conservatism that prefers rules over standards, certainty over flexibility, law over facts, and individualism over community.[27]

This new conservatism, coupled with the public's disenchantment with government regulation, has inspired numerous campaigns for regulatory

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23. The new conservatism in private law was the topic of a joint program sponsored by the Sections on Contracts, Property Law, and Tort and Compensation Systems at the Association of American Law Schools (AALS) Annual Meeting in San Francisco, California on January 10, 1998. Panelists discussed various developments in contract, property, and tort law that indicate a substantial retrenchment and the emergence of a new conservatism in the substance and form of private law. *See* Association of American Law Schools, 1998 Annual Meeting, *Program*, 99-101, Jan. 6-10, 1998, San Francisco, California [hereinafter *AALS Program*].

24. *See* Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131, 1133-35 (1995). Mooney studied reported contract decisions in nine western states, but indicated the new conceptualism in contract law is a national phenomenon. *See id.* at 1133 n.9.

25. *See id.* at 1135, 1145-46, 1170, 1186.

26. *See AALS Program, supra* note 23, at 100.

27. *See, e.g.*, Mooney, *supra* note 24, at 1133-34; *AALS Program, supra* note 23, at 100.

reform and privatization[28] in various contexts.[29] The current trend toward private governance is evidenced by reform measures as diverse as the privatization of schools[30] and prisons,[31] the growth in private dispute resolution,[32] and the increasing contractualization of family structures.[33] This growing movement is characterized by demands for deregulation, privatization, contractualism, and decentralization.[34] Reform initiatives are often accompanied by calls for the dismantling of the regulatory state and for returning responsibility to individuals and the private sector. Proponents tend to prefer the ordering of the private market to that of public decision-makers and express a commitment to the values of individualism, market integrity, and liberty.[35] Advocates of regulatory reform charge that current regulatory policies jeopardize competition, stifle entrepreneurial activity, suppress economic growth, and inhibit job creation.[36]

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28. The term "privatization" is used here in its broadest sense, to include any arrangement that would shift government responsibilities to the marketplace.

29. *See, e.g.*, Symposium, *The New Private Law*, 73 DENV. U. L. REV. 993 (1996) (exploring current trend toward private governance in provision of public services, labor and employment law, family law, and land use law).

30. Examples include school voucher programs and private companies running public schools. *See, e.g.*, Carol Innerst, *School-Choice Proposals Mount Along With Public's Unhappiness*, WASH. TIMES, July 6, 1997, at A4; Bill Zlatos, *Privatizing Schools Tests Pittsburgh Suburb*, N.Y. TIMES, Aug. 30, 1995, at B6.

31. For example, in some jurisdictions private companies are building and administering prisons. *See, e.g.*, Kristin Bloomer, *Private Punishment: When it Comes to the Business of Running Prisons, There Are Pros and Cons*, S.F. CHRON., May 19, 1997, at A3; Matthew Purdy, *In Jail Business, Nashville Company Leads Crowded Field*, N.Y. TIMES, Jan. 19, 1996, at B4. *See generally* Symposium, *Privatization of Prisons*, 40 VAND. L. REV. 813 (1987) (discussing legal implications of prison privatization programs and reporting statistics on privatization of public services).

32. *See, e.g.*, Katherine Van Wezel Stone, *Mandatory Arbitration of Individual Employment Rights: The Yellow Dog Contract of the 1990s*, 73 DENV. U. L. REV. 1017 (1996) (analyzing trend toward mandatory arbitration of statutory employment rights).

33. *See, e.g.*, Martha M. Ertman, *Contractual Purgatory for Sexual Marginorities: Not Heaven, but Not Hell Either*, 73 DENV. U. L. REV. 1107 (1996) (arguing that privatization and contractualization of family structures may provide means for progressive protection of marginorities).

34. *See* Julie A. Nice, *The New Private Law: An Introduction*, 73 DENV. U. L. REV. 993, 995 (1996).

35. *See id.* at 995-98.

36. *See* Thomas O. McGarity, *The Expanded Debate over the Future of the Regulatory State*, 63 U. CHI. L. REV. 1463, 1481 (1996) (quoting Ed Gillespie & Bob Schellhas eds., *Contract with America: The Bold Plan by Rep. Newt Gingrich, Rep. Dick Armey, and the House Republicans to Change the Nation*, TIMES, 128 (1994), and discussing rationale advanced by Republicans in connection with proposed "Contract With America" and related promises to initiate substantive changes in existing regulatory structure).

Recent corporate and securities law reform initiatives reflect this current trend toward deregulation and private ordering.[37] A number of corporate law scholars have argued that business organizations should be free to opt out of certain corporate and securities law requirements by private agreement.[38] These contractarians who advocate permitting organizations the freedom to opt out of regulatory constraints view business entities as essentially creatures of contract. They argue that business organizations should be free to shape their own contractual arrangements without government interference. Contractarians contend that the primary function of corporate law should be to facilitate private contracting and promote economic efficiency.

Contractarians already have had a significant impact on corporate law scholarship,[39] the direction of the law, and legal reform efforts. For instance, many jurisdictions have enacted statutes that allow shareholders to adopt charter provisions that limit or eliminate the personal liability of directors for monetary damages flowing from a breach of their common law duty of care.[40] Such statutes basically allow shareholders to contract out of common law constraints and adopt a different fiduciary standard. Another example of this

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37. *See, e.g.*, Symposium, *The American Law Institute's Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871 (1993) (examining American Law Institute's *Principles of Corporate Governance* from various theoretical perspectives); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) (exploring ongoing debate over mandatory versus enabling corporate rules); *Symposium on the Future of the Unincorporated Firm*, 54 WASH. & LEE L. REV. 389 (1997) (discussing issues related to freedom of contract and fiduciary duties); *see also infra* note 38 (providing citations to articles discussing securities law reform initiatives).

38. *See* Lucian A. Bebchuk, *Foreward: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1396-98 (1989); *see, e.g.*, Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983) (criticizing insider trading rules and contending that firms, as a matter of contract, should be permitted to allocate property rights in valuable information to managers or to investors because parties' self-interest will lead them to reach optimal allocation by private agreement); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983) (criticizing federal proxy rules for displacing voluntary arrangements and arguing such rules impose costs that probably outweigh any benefits); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984) (criticizing United States Supreme Court's interpretation of insider trading prohibitions and suggesting contract test as means for assigning property rights in information).

39. *See generally* Symposium, *The American Law Institute's Principles of Corporate Governance*, *supra* note 37; Symposium, *Contractual Freedom in Corporate Law*, *supra* note 37.

40. *See, e.g.*, COLO. REV. STAT. ANN. § 7-108-402(1) (West 1997); DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1998); WYO. STAT. ANN. § 17-16-202(b)(iv) (Michie 1997). Many states have amended their corporations statutes to permit shareholders to limit or eliminate director and/or officer liability. See EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES § 2.05, at 16 & n.1 (1984 & Supp. 1997), for citations to state statutes limiting or eliminating director and/or officer liability.

contractarian trend is state limited liability company legislation. All states have adopted legislation that permits businesses to organize as limited liability companies,[41] a form of business organization where members enjoy limited personal liability and maximum flexibility in ordering the internal and external affairs of the entity.[42] The rapid adoption of limited liability company legislation evidences a growing acceptance of the contractarian theory of business associations, because the limited liability company is designed to provide investors the freedom to shape their own contractual arrangements with a minimum of mandatory constraints. "Check-the-box" regulations provide an additional illustration. The "check-the-box" tax classification rule[43] permits limited liability companies and other unincorporated associations to elect partnership tax treatment, even if they have corporate characteristics.[44] The "check-the-box" approach also reflects the view that the law is nothing more than a series of default rules that parties can avoid through appropriate elections. Even more importantly, contractarians have had significant influence on the American Law Institute's *Principles of Corporate Governance*[45] and the Revised Uniform Partnership Act.[46] Such reform efforts relax mandatory requirements and permit those associated with an entity to determine what rules shall govern. They permit parties to shape their own contractual relationships by agreeing to opt out of previously mandatory constraints, such as fiduciary duties, personal liability, and specific tax consequences.

Predictably, contractarian proposals have surfaced in the securities law area. Regulatory reform advocates have presented a number of proposals that challenge the mandatory nature of the securities laws.[47] In particular, some securities law scholars have called for selective securities law deregulation arguing that in certain contexts private parties should be permitted to opt out

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41. *See* 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 1.06 (1996).

42. *See* MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK §§ 1.01, 1.03, at 1–1, 1–3 to 1–5 (1996-97).

43. Treas. Reg. §§ 301.7701-1 to -3 (1997).

44. *See* 1 RIBSTEIN & KEATINGE, *supra* note 41, § 14.06.

45. *See* Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212, 1213, 1225-29 (1993) (discussing influence of law and economics movement on American Law Institute's Corporate Governance Project).

46. *See* Claire Moore Dickerson, *Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111, 141-49 (1993) (discussing contractarian perspectives pervasive in Revised Uniform Partnership Act); Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 535-75 (1993) (criticizing Revised Uniform Partnership Act for its contractarian view).

47. See *supra* notes 2 & 38 for citations to articles challenging the mandatory nature of the securities laws and advocating freedom to contract out of such constraints.

of securities regulation by private agreement.[48] Such reform initiatives represent a logical, but potentially dangerous, extension of the current trend toward private ordering and the growing conservatism in the law.

III. Overview of Selective Deregulation Proposals

Park McGinty and Larry Ribstein are vocal advocates of selective deregulation in the securities law context. Both McGinty and Ribstein have presented specific proposals for securities law reform.[49] Both scholars have argued forcefully that in particular contexts private parties should be permitted to opt out of securities regulation by private agreement. Both oppose mandatory application of the securities laws in specific situations, support selective securities law deregulation, and urge private ordering through the elimination of certain mandatory requirements.[50]

Like other commentators advocating private ordering, McGinty and Ribstein couch their arguments in law and economic theory. They stress policy goals such as the need to respect private preferences, promote economic freedom, reduce regulatory costs, and increase productivity, efficiency, and profitability.[51] Like proponents of the new conservatism, McGinty and Ribstein advocate the adoption of simple, bright-line rules to promote certainty and predictability that would in turn reduce adjudication and contracting costs.[52] They assume that such bright-line rules would also result in controversies being determined by law rather than costly, fact-based, case-by-case analysis. Both McGinty and Ribstein appear willing to sacrifice the interests of the community to protect the economic interests of certain individuals.[53]

A. McGinty's Proposal

In his article, *The Limited Liability Company: Opportunity for Selective Securities Law Deregulation*, McGinty suggests that Congress should amend the securities laws to allow participants in certain business ventures to choose whether to be covered by the securities laws.[54] Specifically, McGinty pro-

48. *See supra* note 2.

49. *See supra* note 2.

50. *See* McGinty, *supra* note 2, at 370-71; Ribstein, *Private Ordering, supra* note 2, at 1, 5.

51. *See, e.g.*, McGinty, *supra* note 2, at 369-70, 423; Ribstein, *Form and Substance, supra* note 2, at 824; Ribstein, *Private Ordering, supra* note 2, at 26.

52. *See, e.g.*, McGinty, *supra* note 2, at 374-75, 434-38; Ribstein, *Form and Substance, supra* note 2, at 808-11, 825-26, 838-41.

53. *See, e.g.*, McGinty, *supra* note 2, at 423, 426, 440-41; Ribstein, *Form and Substance, supra* note 2, at 825-26, 835-36.

54. *See* McGinty, *supra* note 2, at 371, 423.

poses that investors in limited liability companies be permitted to opt out of securities law coverage, if potential investors are notified that the protections of the securities laws will not apply.[55]

McGinty reasons that legal rules, such as the securities laws, impose substantial costs on businesses.[56] Reducing mandatory government regulation obviates the need for activities unrelated to the fundamentals of the business enterprise and therefore allows for more productive business behavior.[57] Decreasing regulatory costs increases a firm's productivity, efficiency, and profitability.[58]

McGinty also contends that, given the flexible definition of the term "security," it is often difficult to predict whether interests in some new business entities will be deemed "securities" and therefore subject to the securities laws.[59] As a result, business planners are forced to behave as though the interests are securities, adding substantial costs to a transaction.[60] Promoters who fail to recognize that the interests may be securities, and hence fail to comply with the securities laws, risk inadvertent exposure and may unintentionally give purchasers a money-back guarantee.[61] McGinty maintains that businesses need clear direction in order to plan their affairs.[62] Uncertainty only adds "dead weight social costs."[63]

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55. *See id.* at 375, 437. McGinty proposes that Congress amend the statutory definitions of the term "security" by adding the phrase "interests in limited liability companies other than excluded LLC interests." McGinty then suggests adding a new term, "excluded LLC interests," to the general definitional sections of the securities laws. "Excluded LLC interests" would be defined so as to allow limited liability companies to exclude themselves from coverage, if they disclose the interests are not protected by the securities laws. *See id.* at 437.

56. *See id.* at 376.

57. *See id.* at 369.

58. *See id.* at 370.

59. *See id.* at 374.

60. *See id.* at 374-75.

61. *See id.* at 375, 426-28, 430. Section 12 of the Securities Act of 1933 specifies:

> Any person who (1) offers or sells a security in violation of section [5] of this title [the registration provisions] . . . shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Securities Act of 1933 § 12, 15 U.S.C. § 77*l* (Supp. II 1996). Citing section 12, McGinty argues that if an issuer fails to recognize its interests are securities or, for some other reason, fails to comply with the Securities Act's offering requirements, the issuer, in essence, is providing investors with a year-long money-back guarantee or "put," with interest. *See* McGinty, *supra* note 2, at 426-28.

62. *See* McGinty, *supra* note 2, at 373.

63. *See id.*

Finally, McGinty argues that the costs of securities regulation may well outweigh its benefits.[64] First, securities regulation may not improve investors' well-being. Second, recent case law has decreased the benefits of securities law protections. Third, technical requirements create traps for the unwary and encourage opportunism. Finally, vague tests, such as the investment contract test for determining whether an interest is a security, result in arbitrary judicial decisions and increase both the risks and costs for businesses. McGinty, therefore, believes that experimentation in selective securities law deregulation would be worthwhile and that such experimentation could provide a means to empirically test whether the costs of securities regulation outweigh the benefits.[65]

B. Ribstein's Proposals

Ribstein contends that parties should be allowed to contractually opt out of securities law coverage.[66] Ribstein advocates the adoption of a "private ordering approach" that would permit parties to determine for themselves whether the securities laws apply.[67] Under this approach, courts would enforce clear waivers of securities law coverage.[68] Ribstein reasons that the parties to a transaction are better suited than legislators, courts, or regulators to determine the amount of disclosure that is appropriate.[69] Ribstein argues that the costs of the current regulatory system often exceed the benefits,[70] particularly because investors would still be protected from fraud by their right to bring state common law fraud actions.[71] The basic assumptions underlying his thesis are that voluntary transactions are efficient and private preferences should be respected and enforced.[72]

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64. *See id.* at 423-36.

65. *See id.* at 370-71, 441.

66. *See* Ribstein, *Form and Substance, supra* note 2, at 812; Ribstein, *Private Ordering, supra* note 2, at 5, 26.

67. *See* Ribstein, *Form and Substance, supra* note 2, at 812.

68. *See id.* Ribstein acknowledges that courts might refuse to enforce certain waivers, such as if there is uncertainty about an investor's intent to waive the protections of the securities laws or if the investor lacks the capacity to protect his interests. *See id.*

69. *See id.*

70. *See id.* at 834; Ribstein, *Private Ordering, supra* note 2, at 30.

71. *See* Ribstein, *Private Ordering, supra* note 2, at 30, 33.

72. *See id.* at 26 (stating that "[t]he central premise of the private ordering approach is that voluntary transactions in developed markets are presumed to be efficient" and noting "[t]he policy justifications for the private ordering approach relate to the propriety of enforcing contracts").

Alternatively, Ribstein suggests that courts apply an "intermediate private ordering approach."[73] Here, Ribstein urges courts to rely on the form of the investment, rather than the substance of the transaction, in defining a "security."[74] Ribstein proposes that investors and promoters be permitted to effectively waive the securities laws by their selection of business association form.[75] Under this approach, corporate stock and limited partnership interests would continue to be characterized as securities; however, general partnership interests and limited liability company interests would be presumed to be nonsecurities.[76] Use of a corporate or limited partnership organizational form would therefore trigger application of the securities laws; whereas, use of a general partnership or limited liability company organizational form would be treated as a contractual waiver of securities law coverage.[77] Thus, the parties' choice of entity and form of the investment would serve as a proxy for their choice to elect or waive securities law coverage.

Ribstein maintains that his "intermediate private ordering approach" eliminates the need for costly and unpredictable case-by-case analysis, avoids the statutory prohibition against waiver,[78] allows courts to fashion a rule that would apply only to transactions where mandatory disclosure is appropriate, and insures investors will not be misled because investors would be warned by the form of the transaction not to expect the protection of the securities laws.[79] Ribstein argues that emphasizing choice of entity would reduce the cost of regulatory compliance, increase predictability, decrease the amount of litigation, and produce optimal disclosure.[80] Ribstein contends that simple, bright-line rules would decrease both adjudication and contracting costs.[81]

C. Characteristics Shared by the Reform Initiatives

Both McGinty and Ribstein are proposing selective securities law deregulation measures. McGinty is advocating selective deregulation by entity type when he proposes permitting limited liability companies to opt out of securities law coverage by private agreement. Similarly, Ribstein is advocating selective deregulation by entity type when he urges courts to treat choice of

73. *See* Ribstein, *Form and Substance*, *supra* note 2, at 812.

74. *See id.* at 810.

75. *See id.* at 827-28, 832.

76. *See id.* at 810, 814; Ribstein, *Private Ordering*, *supra* note 2, at 41.

77. *See* Ribstein, *Form and Substance*, *supra* note 2, at 814, 832; Ribstein, *Private Ordering*, *supra* note 2, at 24, 41-45, 55, 61.

78. *See infra* Part IV.A.1.c (discussing antiwaiver provisions).

79. *See* Ribstein, *Form and Substance*, *supra* note 2, at 812.

80. *See id.* at 824.

81. *See id.* at 824, 826.

entity as a waiver of securities law coverage. Ribstein's "private ordering approach" would accomplish selective deregulation through waiver by allowing parties to contractually opt out of securities law coverage. McGinty's and Ribstein's proposals would not only free parties from burdensome disclosure requirements, but would liberate them from the duty to comply with the antifraud provisions as well.

Both commentators draw upon the basic tools of the law and economics movement and employ cost-benefit analysis to support their calls for deregulation. In their analysis, they stress policy goals such as reducing costs, promoting economic freedom, and maximizing allocative efficiency. These economically-based policy considerations appear to effectively trump all other concerns. Both commentators apparently view their proposals as first in a series of securities law deregulation measures, thereby suggesting that adoption of these reforms may have broader implications.[82] Consequently, we must consider not only the practical effects of these specific reform proposals, but long-range implications as well.

IV. The Case Against Selective Deregulation

A. The Role of Government and the Values Served by Regulation

Reform measures that would permit parties to opt out of securities regulation by private agreement present both theoretical and practical concerns. Advocates of selective securities deregulation, such as McGinty and Ribstein, would have us believe that these proposals simply present a choice of bright-line rules over standards, certainty over flexibility, and law over facts. But these reform measures have much broader ramifications – they present a choice of values. The proposals require us to choose between the interests of the community and the interests of particular individuals. The reform initiatives also raise fundamental questions about the proper role of government and the purposes to be served by regulation, thereby forcing us to reexamine issues that have remained dormant since the New Deal.[83]

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82. For example, McGinty characterized his selective deregulation proposal as an "experiment" and suggested that it could provide a means to test empirically whether the costs of securities regulation outweigh the benefits. *See* McGinty, *supra* note 2, at 441. In the article *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, Ribstein noted that his analysis had broad implications:

> This Article's analysis has implications that extend beyond [limited liability companies]. The costs of applying an open-ended definition of "security" become increasingly important as legislatures develop new types of firms, including limited liability partnerships. Accordingly, the courts and legislatures must find ways to accommodate the goals of the securities laws with those of financial markets.

Ribstein, *Form and Substance*, *supra* note 2, at 841 (footnote omitted).

83. In a broader context, Thomas McGarity observed that "the regulatory state is at a

For example, McGinty's and Ribstein's preoccupation with economic concerns causes them to lose sight of the purposes of the securities laws and the values to be served by regulation. To understand the difficulties and dangers that these reform initiatives present, it is necessary to first review the events that gave rise to the securities laws and the reasons for their current scope and mandatory nature.

1. *Objectives, Scope, and Structure of the Securities Laws*

a. *History and Purpose of Securities Regulation*

The problems that the securities laws address are not new. These problems are as timeless as the avarice of sellers and the gullibility of buyers.[84] In fact, the genesis of our modern securities laws dates back centuries.[85] Lawmakers in the United States initially enacted the securities laws to eliminate some of the serious abuses found in unregulated capital markets.[86] As with most regulatory regimes, legislators promulgated the securities laws to protect citizens from harm caused by the actions of others.[87]

The first state securities laws were adopted in Kansas in 1911.[88] At that time, Kansas was overrun with individuals promoting fraudulent enterprises. The fraud became so blatant that it was said promoters "would sell building lots in the blue sky in fee simple."[89] The earliest securities legislation was designed to protect individuals from these unscrupulous promoters. By 1929 most states had some form of securities regulation to safeguard their citizens from such dishonest and unethical schemes.[90]

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crossroads." McGarity noted that "[t]he primary significance of . . . the continuing debate over the role of regulation in society has been to reopen previously settled questions and to revive positions that have remained virtually dormant since the New Deal." McGarity, *supra* note 36, at 1463.

84. *See* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1 (2d ed. 1988) ("For the problems at which modern securities regulation is directed are as old as the cupidity of sellers and the gullibility of buyers.").

85. *See id.* at 1-3 (tracing origins of securities laws back to English legislation adopted in 1285 to license brokers and to prohibit unfair sales practices).

86. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

87. *Cf.* McGarity, *supra* note 36, at 1464 (discussing impetus behind most federal regulatory programs).

88. *See* Jeffrey T. Haughey & Kevin M. Veler, Empirical Research Project, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 689, 691 (1982).

89. *See id.* at 691 n.3 (citing Mulvey, *Blue Sky Law*, 36 CANADIAN L. TIMES 37, 37 (1916)). These unscrupulous promoters became known as "blue sky merchants," and the state securities legislation enacted to counter such fraud became known as "Blue Sky Law." *See id.*

90. *See id.* at 697.

Federal involvement in securities regulation began in response to the stock market crash of 1929 and the depression of the 1930s[91] with the adoption of the Securities Act of 1933 (Securities Act)[92] and the Securities Exchange Act of 1934 (Exchange Act).[93] Investigations of the financial markets during that period revealed widespread fraud, manipulation, and victimization of investors.[94]

From the beginning, the central focus of the federal regulatory structure has been disclosure.[95] The goal has been to protect investors by prohibiting fraudulent and manipulative practices and by requiring disclosure of information material to investment decisions so as to provide investors and the marketplace with sufficient information to make informed investment decisions.[96] As the Supreme Court noted, a fundamental purpose of the securities laws is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[97]

The policies that the securities laws have been said to promote include such socially-directed objectives as the protection of investors, the elimination of manipulative and deceptive practices, the promotion of full disclosure, the encouragement of high ethical standards, and the provision of effective sanctions for violation.[98] More simply stated, Americans traditionally abhor

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91. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). Some legal scholars, such as Judge Richard Posner, contend that the securities laws are based on misconceptions about the 1929 market crash and the depression. Posner suggests that the 1929 stock market crash was not the result of fraud, speculation, and other abuses as commonly believed, but instead simply a response to an anticipated decline in economic activity. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 15.8, at 444 (4th ed. 1992).

92. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994 & Supp. II 1996). The Securities Act deals with initial distributions of securities. *See id.*

93. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (1994 & Supp. II 1996). The Exchange Act primarily concerns trading in and regulation of secondary markets. *See id.* § 78b.

94. *See, e.g.*, STOCK EXCHANGE PRACTICES, S. REP. NO. 73-1455, at 1 (1934), *reprinted in* II FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS, LEGISLATIVE HISTORY, 1933-1982, at 1257 (1983).

95. *See* Doran v. Petroleum Management Corp., 545 F.2d 893, 904 (5th Cir. 1977).

96. *See* Randall v. Loftsgaarden, 478 U.S. 647, 648-49 (1986); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

97. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (citing H.R. REP. NO. 73-85, at 2 (1933), *quoted in* Wilko v. Swan, 346 U.S. 427, 430 (1953)).

98. *See, e.g.*, *Tcherepnin*, 389 U.S. at 336 ("One of [the Exchange Act's] central purposes is to protect investors through the requirement of full disclosure . . . ."); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("[A]mong [the Exchange Act's] chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."); *Capital Gains*, 375 U.S. at 186 ("A fundamental purpose, common to the [securities laws], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*

those who do not play by the rules.[99] The securities laws are intended to foster fair play and insure the integrity of the markets.[100] As Judge Charles Clark noted in a much cited passage, "The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do."[101]

b. Scope of the Securities Laws

To achieve its goal of investor protection, Congress broadly drew the scope of the securities laws. Congress intentionally defined the word "security" in general terms to include within its definition the many types of instruments that fall within the ordinary understanding of what constitutes a security.[102] The statutory definition, therefore, includes well-known investment vehicles, such as stocks, bonds, notes, and debentures.[103] But recognizing the

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and thus to achieve a high standard of business ethics in the securities industry."); Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) ("[T]he whole statute discloses a broad purpose to regulate securities transactions of all kinds and, as part of such regulation, . . . the elimination of all manipulative or deceptive methods in such transactions . . . .").

99. *See* ABA Task Force on Regulation of Insider Trading, Committee on Federal Regulation of Securities, *Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, *reprinted in* III SECURITIES LAW ADMINISTRATION, LITIGATION, AND ENFORCEMENT 215, 220 (Franklin E. Gill ed., Section of Business Law American Bar Association 1991).

100. *See id.* Section 2 of the Exchange Act expressly sets forth the legislative purpose and perceived need for securities regulation. Section 2, in part, states:

> [T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide regulation and control of such transactions and of practices and matters related thereto . . . in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and *to insure the maintenance of fair and honest markets in such transactions* . . . .

Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1994) (emphasis added).

101. Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943).

102. *See* FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. REP. NO. 73-85, at 11 (1933), *reprinted in* I FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS, LEGISLATIVE HISTORY, 1933-1982, at 138, 148 (1983).

103. Section 2(a)(1) of the Securities Act defines a "security" as

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating

boundlessness of human ingenuity, Congress also included descriptive phrases, such as "investment contract" and "any interest or instrument commonly known as a 'security,'"[104] which are expansive enough to encompass essentially any instrument that might be sold as an investment.[105] Courts have construed these general terms broadly to effectuate the remedial purposes of the legislation and to afford investors the full protection of the laws.[106] In addition, by focusing on the substance of each transaction, rather than its form, and by emphasizing economic reality, courts have been able to expand the scope of the securities laws.[107] As a result, the securities laws have been able to reach many novel, uncommon, and irregular devices.[108]

> to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (Supp. II 1996).

While there are some minor differences, the basic definition of a "security" in the Securities Act, the Exchange Act, and under most state securities laws is virtually the same. Section 3(a)(10) of the Exchange Act defines a security in substantially the same manner as the Securities Act except (i) it does not contain a reference to "evidence of indebtedness," (ii) it excludes from the definition short-term "commercial paper," and (iii) it uses a slightly different approach to classify oil and gas interests. *Compare* Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1994), *with* 15 U.S.C. § 77b(a)(1). Moreover, the United States Supreme Court stated that the definition of "security" will be treated as identical for purposes of both the Securities Act and the Exchange Act. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975); Tcherepnin v. Knight, 389 U.S. 332, 335-36, 342 (1967).

In addition, most jurisdictions have adopted definitions of the term "security" modeled after the definition in the Securities Act. Thirty-five jurisdictions have adopted securities acts based on the 1956 version of the Uniform Securities Act, which was amended in 1958. *See* UNIF. SEC. ACT (1956) (amended 1958), 7B U.L.A. 211 (Supp. 1998). Nine jurisdictions have adopted securities acts based on the 1985 revision of the Uniform Securities Act, which was amended in 1988. *See* UNIF. SEC. ACT (1985) (amended 1988), 7B U.L.A. 143 (Supp. 1998). The definitions of the term "security" in these Uniform Securities Acts were deliberately modeled after the definition in § 2(1) of the Federal Securities Act. *See* UNIF. SEC. ACT (1956) § 401(l) (amended 1958), 7B U.L.A. 583 cmt. 1 (1985); UNIF. SEC. ACT (1985) § 101 (amended 1988), 7B U.L.A. 153 cmt. 17 (Supp. 1998). *Compare* 15 U.S.C. § 77b(a)(1), *with* UNIF. SEC. ACT (1985) § 101(16) (amended 1988), 7B U.L.A. 150 (Supp. 1998), *and* UNIF. SEC. ACT (1956) § 401(l) (amended 1958), 7B U.L.A. 580-81 (1985).

104. *See supra* note 103. These general catch-all phrases are not defined in the federal securities acts or the Uniform Securities Acts. As a result, the courts have been left to define these terms.

105. *See* Reves v. Ernst & Young, 494 U.S. 56, 60-61 (1990).

106. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

107. *See Howey*, 328 U.S. at 298-99.

108. *See* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

The most commonly applied descriptive phrase is the term "investment contract." Courts have held that the phrase embraces all arrangements when one invests money in a common enterprise with the expectation of receiving a return primarily based on the efforts of others.[109] Courts have used the investment contract test to reach a wide variety of instruments, from interests in conventional investment vehicles (like limited partnerships,[110] franchises,[111] and certain general partnerships[112]) to more unusual investment opportunities (such as schemes involving fruit trees, chinchillas, self-improvement courses, and cemetery lots[113]). With the recent proliferation in new forms of business associations,[114] the investment contract test has become increasingly important.[115] For over fifty years, this broad definition of the term "security," coupled with the judicially-created investment contract test, has proven extremely flexible, adaptable, and capable of protecting investors

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109. *See Howey*, 328 U.S. at 298-99.

110. *See, e.g.*, Mayer v. Oil Field Sys. Corp., 721 F.2d 59, 65 (2d Cir. 1983); Goodman v. Epstein, 582 F.2d 388, 406-09 (7th Cir. 1978).

111. Courts have held that conventional franchising agreements generally do not constitute securities under the investment contract test if the franchisee exerts meaningful efforts. If the franchisee has not been granted realistic authority to exercise significant managerial rights and responsibilities, courts have held an investment contract exists and the interests constitute securities. *See, e.g.*, SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577 (2d Cir. 1982).

112. *See* Williamson v. Tucker, 645 F.2d 404, 417-25 (5th Cir. 1981) (discussing circumstances under which joint venture and general partnership interests may be found to be investment contracts and hence securities).

113. For citations to cases holding that investments in fruit trees, chinchillas, self-improvement courses, and cemetery lots were investment contracts and therefore securities, see 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.5 (3d ed. 1995).

114. Recently, there has been an explosion of new business organization forms and numerous variations of each form. For example, organizers of a small business can choose from over ten different entity forms: a general partnership, a limited liability partnership, a limited partnership, a limited liability limited partnership, a limited liability company, a limited partnership association, a corporation taxed under subsection C of the Internal Revenue Code, a corporation taxed under subsection S of the Internal Revenue Code, a professional corporation, a cooperative, or a statutory business trust. *See* Dale A. Oesterle & Wayne M. Gazur, *What's in a Name?: An Argument for a Small Business "Limited Liability Entity" Statute (With Three Subsets of Default Rules)*, 32 WAKE FOREST L. REV. 101, 101-02 (1997).

115. As lawmakers create new forms of business organization and variations emerge, scholars, courts, and practitioners generally apply the investment contract test to determine whether an interest in the new entity constitutes a security. *Cf.* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT § 7.01 (1997) (discussing application of investment contract test to determine if limited liability partnership interests constitute securities); Elaine A. Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 DENV. U. L. REV. 425, 441-65 (1996) (discussing application of investment contract test to determine if limited liability company interests constitute securities).

despite the many challenges presented by ever-changing business environments.

c. Mandatory Nature of Securities Regulation

To prevent overreaching and manipulation by sellers, Congress afforded investors special protections and expressly prohibited waiver of these protections.[116] The securities laws, therefore, are mandatory in nature. If a transaction involves the offer or sale of a "security," the transaction is subject to the securities laws and investors are granted special protections. For example, the antifraud provisions[117] apply to every sale of a "security."[118]

Congress also feared that sellers might attempt to maneuver buyers into waiving their rights under the securities laws. To counterbalance the often superior bargaining power of sellers and to insure that investors maintain an equal footing with sellers, Congress included explicit antiwaiver provisions in the securities laws.[119] Both the Securities Act and the Exchange Act prohibit individuals from waiving their rights under the securities laws. These provisions void any condition, stipulation, or provision waiving compliance with the securities laws.[120] As a result, a purchaser of a security could not, for

116. *See* Wilko v. Swan, 346 U.S. 427, 432, 435, 438 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

117. The antifraud provisions bar material omissions and misrepresentations in connection with the sale of a security. The antifraud provisions are found in the Securities Act of 1933 §§ 12(a)(2), 17(a), 15 U.S.C. §§ 77*l*(a)(2), 77q(a) (1994 & Supp. II 1996), and the Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994); *see also* UNIF. SEC. ACT (1985) § 501 (amended 1988), 7B U.L.A. 188 (Supp. 1998); UNIF. SEC. ACT (1956) § 101 (amended 1958), 7B U.L.A. 516 (1985).

118. The authors of a leading casebook on securities regulation observed:

> Sections 3 and 4 of the Securities Act provide certain specific exemptions from the broad registration and prospectus requirements of § 5, although the antifraud provisions of both the [Securities Act] and [Exchange Act] remain applicable. Read literally, section 3 seems to exempt the securities themselves from the operation of the Act, unless the Act elsewhere provides otherwise. On the other hand, the various clauses of § 4 clearly are transaction exemptions, rather than securities exemptions.

See RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 317 (7th ed. 1992).

119. *See* Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 253 n.9 (1987) (Blackmun, J., dissenting).

120. *See* Securities Act of 1933, 15 U.S.C. § 77n (1994) ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."); Securities Exchange Act of 1934, 15 U.S.C. § 78cc(a) (1994) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."); *see also* UNIF. SEC. ACT (1985) § 802(b) (amended 1988), 7B U.L.A. 208 (Supp. 1998) ("A provision

example, agree to waive his right to bring an action for violation of the antifraud provisions, if material omissions or misrepresentations were made in connection with the sale of the security. Thus, the protections of the securities laws are mandatory and not waivable by investors.

2. *Reform Initiatives Present a Choice of Values*

With this background, it is clear that the reform initiatives calling for selective securities law deregulation present a choice of values. Congress enacted the securities laws to promote socially-directed values, such as fairness, equity, the protection of investors, the deterrence of fraud, and the promotion of ethical standards.[121] Proponents of the reform measures advocate selective deregulation and the elimination of certain mandatory constraints to promote conservative values, such as freedom of contract and private ordering.[122] The debate, therefore, reflects the tension between individualism and the more socially-directed concerns of modern communitarians.[123] As such, this controversy parallels similar debates in politics, philosophy, sociology, and economics.[124] Essentially, the debate turns on one's view of the appropriate degree of regulation which in turn depends on one's view of the values to be served by regulation.

McGinty, Ribstein, and other proponents of the law and economics movement believe that the primary role of regulation is to facilitate contracting, reduce costs, and enhance economic efficiency.[125] They prefer private decision-making through individualized market transactions over conventional government regulation. Government intervention in the market is generally disfavored, although they are willing to recognize a limited role for government in enforcing contracts, protecting private property, and addressing market imperfections. Advocates of this approach urge the use of cost-benefit analysis to assess the desirability of any regulation.

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in a contract entered into or effective in this State, binding a person acquiring a security to waive compliance with this [Act] or a rule or order of the [Administrator] under this [Act] is nonenforceable.").

121. *See* discussion *supra* Part IV.A.1.a.

122. *See* discussion *supra* Part III.

123. *See, e.g.*, Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685 (1976) (characterizing substantive dichotomy as individualism and altruism).

124. *Cf.* Lawrence E. Mitchell, *Private Law, Public Interest?: The ALI Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871, 872, 879-80 & n.42 (1993) (observing that contemporary corporate law debate over mandatory versus enabling rules parallels similar debates in other disciplines and citing numerous authority in such fields).

125. *See* McGarity, *supra* note 36, at 1484-98 (describing reform positions that McGarity characterizes as "anti-interventionists" and "free marketeers").

Others view government regulation as a means to advance the public good, promote social discourse, and foster collective interests.[126] They believe that government intervention is justified on fairness, equity, or other grounds apart from repairing broken markets. Proponents of a more communitarian approach contend that regulation should reflect good public policy, beyond simple utilitarianism and allocative efficiency. Regulation should protect citizens from the adverse consequences of profit-maximizing activities, rather than deify individual preferences. They maintain that the law can and should shape human preferences, not merely reflect them.

The controversy, thus, centers on the goals to be achieved through regulation.[127] If the purpose of regulation is simply to facilitate contracting, reduce costs, and enhance efficiency, then possibly the contractarian proposals to allow parties to opt out of the securities laws should be adopted. If, on the other hand, the purpose of securities regulation is to serve a more publicly-directed purpose, such as increasing public confidence in capital markets, deterring fraud, or protecting investors, then the reform measures would be improvident.

Proponents of selective deregulation, such as McGinty and Ribstein, would have us believe that these reform measures simply present a choice between costly, vague tests and efficient, bright-line rules. These reform initiatives, however, have much broader implications. The debate involves more than a choice between standards and rules – it involves a choice of values. The securities laws have social, as well as economic, consequences.[128] Laws and regulations are symbolic. Laws can reveal and reshape our communal attitudes and values.[129] Laws establish standards and define ethical behavior. The securities laws, therefore, have a public dimension that must be considered before adopting these reform proposals.

By prohibiting fraud and mandating disclosure, the securities laws protect investors and promote honesty, trust, and ethical behavior in commercial

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126. *See id.* at 1498-1527 (describing reform positions that McGarity characterizes as "modern mugwumps," "good government reinventionists," and "unrepentant protectionists").

127. *Cf.* Mitchell, *supra* note 124, at 879 (noting that debate over American Law Institute's *Principles of Corporate Governance* turns on values to be served by regulation and contrasting contractarian values of enhanced efficiency with more publicly-directed purposes).

128. *Cf.* Marleen A. O'Connor, *How Should We Talk About Fiduciary Duty? Directors' Conflict-of-Interest Transactions and the ALI's Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 954, 955, 968-69 (1993) (arguing that fiduciary law serves to provide "a system of moral education that promotes and reinforces trust and honesty in commercial transactions").

129. *See* CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 7 (1997) (discussing how law shapes preferences); Laurence H. Tribe, *Constitutional Calculus: Equal Justice or Economic Efficiency?*, 98 HARV. L. REV. 592, 595 (1985) (discussing how legal decisions define and reshape values).

transactions.[130] The securities laws set standards that serve to socialize, to educate, and to direct individuals toward more morally appropriate forms of behavior. The antiwaiver provisions and the mandatory nature of the securities laws[131] send a strong signal that certain behavior will not be tolerated in any transaction involving a security. Untrue statements of material facts, omissions of material information, and any act or practice that constitutes fraud or deceit are prohibited in connection with the purchase or sale of any security.[132] The securities laws, thereby, promote specific values and pressure parties to behave in a selfless fashion.

Permitting parties to opt out of the securities laws would undercut this message. Selective deregulation would signal that economic efficiency, individual cost considerations, and personal preferences are more important than social consequences. It would suggest that maximizing economic efficiency effectively trumps all other values in public policy-making. Symbolically, such reforms would make a powerfully negative statement about society's concern for investor protection and ethical standards. Permitting parties to opt out would undermine the socializing and educational value of the securities laws. The same standards would no longer apply to all securities transactions.[133] Such reforms would signify that ethical and behavioral standards are negotiable. Opting out would send the message that legal constraints are optional – unnecessary obstructions that can be contracted around with the assistance of skillful and well-paid lawyers.[134] These reform measures suggest that laws should be viewed as a menu that one should be able to simply opt out of on the basis of economic considerations, when the costs and burdens are individually viewed as too great. Selective deregulation elevates personal preferences and economic considerations, but ignores the

130. *See supra* Part IV.A.1.a (discussing purposes of securities regulation).

131. *See supra* Part IV.A.1.c (discussing antiwaiver provisions and mandatory nature of securities laws).

132. *See supra* note 117.

133. If McGinty's or Ribstein's opting-out proposals were adopted, certain investment transactions would be free from securities regulation. For example, under McGinty's proposal, passive investors in limited liability companies would be permitted to opt out of securities law coverage. *See supra* Part III.A. Neither the disclosure requirements nor the antifraud provisions of the securities laws would apply to such transactions. As a result, passive investments in stock and limited partnership interests would be subject to the securities laws, but passive investments in limited liability company interests would be free from securities regulation. Different standards and regulations would apply depending on the form of the transaction.

134. For instance, once courts began presuming that general partnership interests were not securities, unscrupulous promoters began hiring savvy transactional lawyers to structure their transactions as general partnerships. *See infra* note 235. If McGinty's or Ribstein's opting-out proposals were adopted, sophisticated promoters who could afford costly legal advice would structure their transactions, when feasible, to avoid securities regulation.

extralegal and moral implications of the securities laws. Is this the message that we, as a society, wish to send?

3. *Opting-Out Proposals Undermine a Coherent Theoretical Framework*

Opting-out initiatives in the securities regulation context are also philosophically inconsistent with the underlying tenets of the securities laws – its mandatory nature[135] and its policy of full disclosure.[136] Selective deregulation measures offer only limited, piecemeal solutions to perceived problems with the securities laws.[137] Adoption of such proposals would undermine the coherent, consistent, dominant, and underlying philosophy of the securities laws. The proponents of selective deregulation are asking us to incorporate contractarian principles, such as opting out and waiver, into a securities law whose hallmark has been its mandatory nature. They are asking us to amend a securities law premised on a philosophy of full disclosure to create exceptions where the philosophy of *caveat emptor*[138] would reign.[139] Reforms based on philosophically incompatible positions would weaken the basic theoretical framework of the securities laws by sending mixed normative messages.[140] These reform measures cannot be evaluated in isolation. Such reforms clearly conflict with the central principles of the securities laws; therefore, their adoption would undermine the basic theoretical framework of the securities laws.

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135. *See supra* Part IV.A.1.c.

136. *See supra* Part IV.A.1.a.

137. The proposed reforms are piecemeal in that they are limited and scatter-shot in nature. McGinty advocates selective deregulation by entity type. *See supra* Part III.A. Ribstein advocates selective deregulation by entity type and contractual waiver. *See supra* Part III.B. Under these proposals, only certain transactions would be exempt from securities regulation. The proposals do not affect all transactions. The proposals, therefore, are piecemeal, rather than global, in nature.

138. "*Caveat emptor*" is a Latin term for "let the buyer beware." WEBSTER'S NEW WORLD DICTIONARY 96 (1995).

139. In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the United States Supreme Court stated that "[a] fundamental purpose, common to [the securities laws], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *Id.* at 186. Both McGinty's and Ribstein's proposals would result in certain transactions being exempt from securities regulation, meaning exempt from both the disclosure and antifraud requirements. Without regulation, the philosophy of *caveat emptor* would govern and the buyer in such transactions would be forced to beware.

140. For example, both contractarians and communitarians have criticized the American Law Institute's *Principles of Corporate Governance* for failing to adopt a philosophically consistent corporate model. The drafters, in attempting to blend different corporate approaches, failed to satisfy any constituency. As a result, the *Principles* have been roundly criticized for lacking a coherent underlying philosophy and sending mixed normative messages. *See* Mitchell, *supra* note 124. *See generally* Symposium, *The American Law Institute's Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871 (1993).

4. Reform Measures Represent a Misguided Attempt to Extend Contractual Default Theory

By drawing analogies to contractual default theory and characterizing securities regulations as default rules, the advocates of selective securities law deregulation attempt to portray opting-out proposals as simply a logical extension of the contractarian reform measures that have already had a significant impact on corporate law.[141] Rather than representing a logical extension of contractual default theory, opting-out initiatives in the securities law context constitute a misapplication of contractual default theory. The proponents of these opting-out initiatives fail to appreciate the distinctions between default rules and immutable rules. Moreover, treating securities regulations as default rules would thwart the purposes of the securities laws. In addition, the over-inclusive nature of these opting-out proposals would grant fraudulent promoters a license to mislead and invite the unscrupulous to prey upon the most vulnerable investors.

At first glance, the reform initiatives appear to merely represent an application of contractual default theory in the securities regulation context. In contract law, default rules establish contractual rights and obligations when an agreement is silent with respect to certain topics.[142] Default rules generally provide supplementary terms when the parties have not agreed otherwise.[143] The parties, however, are free to opt out of these standard default provisions if they strike a different bargain.[144] For example, if a contract by a merchant for the sale of goods is silent with respect to warranties, a warranty of merchantability is implied.[145] The parties, however, may waive the warranty or opt for a different provision by express agreement.[146]

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141. *See* McGinty, *supra* note 2, at 369-71 (drawing analogies between experimentation in deregulating business organizations and permitting limited liability companies to opt out of securities law coverage). *See generally supra* Part II (regarding current trend toward private ordering in corporate law context).

142. The term "default rules" became popular when Ian Ayres and Robert Gertner used it in their seminal article, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). Ayres and Gertner noted that default rules also have been called "background, backstop, enabling, fallback, gap-filling, off-the-rack, opt-in, opt-out, preformulated, preset, presumptive, standby, standard-form and suppletory rules." *Id.* at 91 & n.25. For a small sampling of the literature on contractual default theory, see generally *Symposium on Default Rules and Contractual Consent*, 3 S. CAL. INTERDISC. L.J. 1 (1993).

143. *See* Steven J. Burton, *Default Principles, Legitimacy, and the Authority of a Contract*, 3 S. CAL. INTERDISC. L.J. 115, 116 (1993).

144. *See, e.g.*, U.C.C. § 1-102(3) (1995) ("The effect of provisions of this Act may be varied by agreement . . . .").

145. *See id.* § 2-314(1).

146. *See id.* §§ 2-314, 2-316.

Proponents of opting out in the securities law context appear to be suggesting that we view securities regulations as default rules that apply only when the parties to certain transactions have not agreed otherwise. Under these reform initiatives, parties would be free to opt out of securities regulations by private agreement. McGinty's and Ribstein's proposals, for example, permit parties to waive all securities regulations, both the disclosure and the antifraud requirements, with one broad stroke by private agreement, as if such regulations were only default rules.[147]

Nevertheless, even in contract law, default theory is not without constraints. The freedom to contract itself is limited. For example, some contracts are unenforceable on public policy grounds, such as contracts that restrain trade.[148] These contractual constraints often have been cast as immutable rules applicable to all contracts that may not be varied by private agreement.[149] The duty to act in good faith, for instance, is an immutable part of every contract.[150] The parties to a contract may not disclaim their obligations of good faith, diligence, reasonableness, or care.[151] Immutable rules frequently set minimum standards or basic requirements that apply to all contracts. These contractual constraints are designed to protect parties to the contract[152] or parties outside

147. McGinty proposes that investors in limited liability companies be permitted to opt out of securities law coverage if potential investors are notified that the protections of the securities laws will not apply. *See* McGinty, *supra* note 2, at 371, 375, 437. *See generally* Part III.A. Ribstein proposes that parties be allowed to contractually opt out of securities law coverage through choice of entity or through waiver. *See* Ribstein, *Form and Substance*, *supra* note 2, at 810, 812, 827-28, 832; Ribstein, *Private Ordering*, *supra* note 2, at 5, 7, 26. *See generally* Part III.B.

148. *See* E. ALLAN FARNSWORTH, CONTRACTS ch. 5 (2d ed. 1990 & Supp. 1995); JOHN E. MURRAY, JR., MURRAY ON CONTRACTS § 98 (3d ed. 1990). Public policy grounds that courts have cited to justify nonenforcement include moral values (policies against impairment of family relationships and against gambling), economic grounds (policies against restraint of trade and restraints on alienation of property), and the need to protect government institutions (policies against improperly influencing government officials). *See* FARNSWORTH, *supra*, § 5.2, at 351.

149. *See, e.g.*, U.C.C. § 1-102(3) (stating that good faith, diligence, reasonableness, and care may not be disclaimed by agreement); *id.* § 1-105(2) (limiting party's right to choose applicable law); *id.* § 2-718(1) (stating that liquidated damages clauses are allowed only when amount involved is reasonable); *id.* § 2-719(3) (stating that consequential damages clauses may not operate in unconscionable manner).

150. *See id.* § 1-203 ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.").

151. *See id.* § 1-102(3) (stating that "obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement").

152. Several of the nonvariable provisions in the Uniform Commercial Code are intended to prevent one party from taking undue advantage of another. *See, e.g.*, *id.* § 1-203 (protecting against bad faith); *id.* § 2-302 (protecting against unconscionable contracts).

the contract[153] from the socially deleterious effects of unregulated contracting.[154] These rules limit freedom to contract on the grounds that parties internal or external to the contract cannot adequately protect themselves or others without government intervention.

The securities laws are analogous to immutable rules, not default rules. As previously discussed, a fundamental purpose of the securities laws is to protect those who cannot protect themselves.[155] Lawmakers promulgated the securities laws specifically to protect the public from harm caused by others. Legislators also enacted the securities laws to eliminate some of the serious abuses found in unregulated capital markets and to restore the integrity of the market.[156] The securities laws, thus, are intended to protect the parties to the transaction and to protect the public in general by establishing basic ground rules that apply to all securities transactions.[157] As such, the securities laws constitute immutable rules.[158] As immutable rules, the regulations governing securities transactions should not be subject to waiver by private agreement.[159] The reform initiatives, therefore, represent a misapplication of contractual default theory and may not be justified on such grounds.

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153. Several Uniform Commercial Code provisions are designed to protect the interests of third parties. *See, e.g., id.* § 2-403(1) (protecting good faith purchasers for value); *id.* § 2-702(3) (protecting rights of buyers in ordinary course and other good faith purchasers). Earlier drafts of Section 1-102 of the Uniform Commercial Code provided that "[e]xcept as otherwise provided by this Act the rights and duties of a third party may not be adversely varied by an agreement to which he is not a party or by which he is not otherwise bound." 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 3-11, at 183 (4th ed. 1995). The subsection, however, was deleted, reportedly because it was deemed unnecessary. *See id.*

154. *See* Ayres & Gertner, *supra* note 142, at 88-89; Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 763 (1983).

155. *See* Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943).

156. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975).

157. *See generally supra* Part IV.A.1.a.

158. Arguably, not all securities regulations constitute immutable rules. A case can be made that some securities regulations should be treated as merely default rules, such as certain disclosure requirements. For example, one may argue that parties should be permitted to opt out of specific written disclosure requirements by private agreement. McGinty's and Ribstein's proposals, however, would permit parties to certain transactions to opt out of *all* securities regulations, both the antifraud provisions and the disclosure requirements. With one election, the parties would be allowed to not only opt out of regulations analogous to default rules (such as the disclosure requirements), but also would be allowed to opt out of securities regulations analogous to immutable rules (such as the antifraud provisions) as well. In this author's view, such a broad and over-inclusive election would undermine public policy and run counter to the intent of the securities laws.

159. Congress recognized the need for mandatory constraints in securities transactions and adopted the antiwaiver provisions that expressly forbid waiver to protect one party from taking undue advantage of another. *See supra* Part IV.A.1.c.

Moreover, default rules are not designed to protect parties internal or external to the contract from harm. Default rules, for example, are not suited to protecting against fraud.[160] Default rules enacted to prevent fraud are not likely to achieve their purposes because unscrupulous promoters are the most likely to include waiver provisions in their agreements and those individuals that the rules are designed to protect are the most likely candidates to be duped into waiving such protections. Consequently, treating securities laws that prohibit fraud as default rules would undoubtedly fail to achieve the desired results.

The over-inclusive nature of the opting-out elections proposed by McGinty and Ribstein also offer unscrupulous promoters an opportunity to mislead investors. The reform initiatives would permit parties to opt out of all securities regulations, both the antifraud provisions and the disclosure requirements. It is in an investor's interest to demand honesty.[161] Most investors would probably want promoters to warrant that their representations are truthful. The antifraud provisions of the securities laws provide investors with such assurances. But an overly broad election option allows fraudulent promoters to persuade investors that by opting out of the securities laws and its disclosure requirements the enterprise will save unnecessary expenses and thereby produce increased profits. Most investors will never realize that they are waiving the antifraud requirements as well. The over-inclusive nature of the election grants fraudulent promoters a license to mislead and invites the unprincipled to prey upon the most vulnerable investors.

5. Common Law Remedies Are Inadequate

The advocates of selective securities law deregulation assume that the common law provides adequate protection against fraud.[162] Nevertheless,

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160. Russell Korobkin noted in his article, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998):

> Default rules, by their nature, are not instruments well-suited to protecting third-parties from deleterious effects of contracts, or to protecting the parties from each other. For example, it would make little sense for lawmakers to enact *default* rules prohibiting fraud in contract negotiations in order to protect contracting parties, or prohibiting contracts for illegal services in order to protect nonparties, rather than enacting substantively identical *mandatory*, or "immutable," rules which private parties are not free to change. Default rules enacted for such purposes would likely fail to achieve their desired purpose and instead, would merely increase transaction costs.

Id. at 610-11 (footnote omitted).

161. *See* Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 949, 952 (1991).

162. *See* McGinty, *supra* note 2, at 438 (stating that "common-law rules provide significant substantive protections"); Ribstein, *Private Ordering, supra* note 2, at 33 (stating that "the antifraud rules do not vary substantively from state common law fraud protection").

history teaches us that the common law failed to supply sufficient safeguards against the abuses found in unregulated capital markets.[163] Congress enacted the federal securities laws after extensive investigative hearings and upon finding that "the common law and state legislation afforded the public insufficient protection against plain fraud both in the issuance of securities and in postissuance trading."[164] State and federal securities laws were, in large part, a response to the perceived inadequacies of the common law.[165] The federal securities laws, for example, were intended to broaden the protections granted investors under the common law.[166] Courts have stated repeatedly that the antifraud provisions of the securities laws are not limited to situations that would give rise to a common law cause of action.[167] Since the 1930s, legislators, courts, and governing administrative agencies have expanded the protections of the securities laws well beyond traditional common law fraud cases.[168]

The common law has not been, and in the near future is not likely to be, an adequate substitute for statutory protection. The federal securities laws, coupled with the Uniform Securities Acts, provide a national standard – a benchmark that promotes uniformity.[169] The common law, on the other hand,

163. *See supra* Part IV.A.1.a.

164. Robert A. Prentice, *The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5*, 47 EMORY L.J. 1, 58 n.266 (1998) (quoting 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 27-28 (3d ed. 1989)); *see also* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 18 (1983) ("[T]he mandatory corporate disclosure system was adopted because of the widely held belief that securities fraud was prevalent and that state laws often could do little to prevent or punish it.").

165. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) ("[A]n important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry.").

166. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 244 n.22 (1988) ("Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law . . . ." (citation omitted)); Bateman Eichler v. Berner, 472 U.S. 299, 310 (1985) (stating that United States Supreme Court has "eschewed rigid common-law barriers in construing the securities laws").

167. *See* 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3429 & n.79 (3d ed. 1991) (citing numerous cases in support of proposition that antifraud provisions of securities laws are not limited to situations that would give rise to common law causes of action).

168. *See* Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 YALE L.J. 715, 729-30 (1997) (discussing how courts and Securities and Exchange Commission have expanded protections of securities laws beyond paradigmatic fraud case by citing examples such as extending protections to investors in secondary market and creating liability for insider trading).

169. When adopting the federal securities acts, Congress specifically preserved the state securities laws rather than preempting the field. *See* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 237-38 & n.1 (1958). This action resulted in a dual system of federal and state regulation. To minimize the diversity in state laws and to promote uniformity, the vast majority

is far from uniform. Common law actions for fraud overlap with various other common law theories and remedies, such as deceit, misrepresentation, breach of warranty, negligence, breach of fiduciary duty, and rescission.[170] The common law also varies from state to state, varies over time, and varies in equity. Even within a jurisdiction, a common law rule will tend to be more elastic than a rule based on statutory interpretation.[171] Under a common law regime, courts may expand current theories and develop new theories to redress perceived wrongs. Such variations and elasticity create uncertainty and risks that increase the cost of raising capital.[172] Under a common law regime, it would be difficult for firms and investors to predict what the law requires.[173] Parties will not know until long after the fact whether they have

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of jurisdictions have adopted, in whole or in part, securities laws based on the Uniform Securities Acts. *See* UNIF. SEC. ACT (1956) (amended 1958), 7B U.L.A. 211 (Supp. 1998) (adopted by 35 jurisdictions); UNIF. SEC. ACT (1985) (amended 1988), 7B U.L.A. 143 (Supp. 1998) (adopted by nine jurisdictions). The Uniform Securities Acts were intended to coordinate state and federal legislation, as well as provide consistency from state to state. *See* LOSS & COWETT, *supra*, at 237-38. The drafters of the Uniform Securities Acts, whenever feasible, used phrases that had acquired fixed meanings from having been construed by courts and administrators. *See id.* at 237. In drafting the Uniform Securities Acts, they borrowed heavily from federal legislation. Much of the terminology and many of the concepts are drawn from the federal securities laws. For example, the antifraud provisions of the Uniform Securities Acts are substantially identical to Federal Rule 10b-5. *See* UNIF. SEC. ACT (1956) § 101 (amended 1958), 7B U.L.A. 516 cmt. (1985); UNIF. SEC. ACT (1985) § 501 (amended 1988), 7B U.L.A. 188 cmt. 1 (Supp. 1998). The definition of the term "security" in the Uniform Securities Acts was deliberately modeled after the definition of a "security" in the Federal Securities Act. *See supra* note 103. Given the similarity in concepts, terminology, and definitions, many state courts have held that federal case law interpreting statutory provisions that parallel state securities laws are highly persuasive and therefore such federal precedent is often followed. *See, e.g.*, State v. Gunnison, 618 P.2d 604, 606-07 (Ariz. 1980); People v. Milne, 690 P.2d 829, 833 (Colo. 1984). Because many of the concepts and terminology in the Uniform Securities Acts are drawn from the federal securities laws and most jurisdictions have adopted versions of the Uniform Securities Acts, the federal securities laws provide a standard and promote uniformity.

170. *See* ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD § 2.7(1) (Sept. 1997); 9 LOSS & SELIGMAN, *supra* note 167, at 4123 ("The remedies at common law and in equity are breach of warranty, rescission . . . and the tort action of deceit.").

171. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 302 (1991).

172. *See id.*

173. Proponents of opting out will no doubt counter that parties are currently permitted to opt out of securities law coverage by forming general partnerships that are not considered "securities" and hence are not governed by the securities laws. Investors in general partnerships, therefore, have long relied on the common law for protection against fraudulent conduct. As a result, courts have developed a well-established and predictable body of common law to address such situations.

The environment that these opting out proposals will create, however, is distinguishable from the environment created by narrow exceptions for certain general partnership interests.

violated the law. As a result, some firms may incur significant expenses to reduce their potential exposure, such as overdisclosing, seeking the advice of counsel or taking costly precautions, that may prove unnecessary in retrospect. The uncertainty may also encourage disappointed investors to litigate. In this new environment, the likelihood of success in litigation would be more difficult to assess and therefore settlements would be harder to reach. Statutory rules, such as federal and state securities laws, reduce such risks, increase certainty, and promote uniformity, thereby lessening the aggregate costs of enforcement and compliance.

It is ironic that the advocates of selective securities law deregulation, who base their arguments on economic efficiency and reduced transaction costs, are willing to trade a statutory structure that at least provides some measure of certainty and predictability for an unpredictable and potentially widely variable common law regime. The proponents of opting out criticize what they consider the unpredictability of securities law coverage arguing that arbitrary judicial interpretation of the definition of a "security" increases both the risks and costs for businesses.[174] Their dissatisfaction with judicial interpretation of a definition does not support returning to a common law regime that would result in a hodgepodge of state laws that could wreak greater havoc. It is curious that at a time when uniformity is viewed as a goal of paramount importance,[175] the proponents of opting out wish to return to a

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The opting out proposals are not supported by the same rationale nor do they provide the same safeguards. While courts have held that certain general partnership interests are exempt from securities law coverage, the exemption applies only if the investors in the general partnership are not in need of the protections provided by the securities laws – meaning when the investors are capable of protecting their own interests. *See* Williamson v. Tucker, 645 F.2d 404, 417-25 (5th Cir. 1981) (discussing when general partnership interests constitute securities). Interests in general partnerships are exempt from securities law coverage only if the investors are sophisticated, experienced, and knowledgeable business people, who are active participants in the venture, who do not rely solely on the efforts of others, who retain substantial and meaningful managerial control over the enterprise, and who are capable of intelligently exercising their partnership powers. *See id.* The proposed selective securities law deregulation measures place no such restrictions on investors who wish to opt out of securities regulation. Under the reform measures, there is no requirement that the investors who waive securities law coverage be capable of protecting themselves.

The body of common law that developed to protect sophisticated investors in general partnership ventures did not have to address fraudulent schemes involving unsophisticated, unknowledgeable, and powerless investors. As unscrupulous promoters begin to prey on these disadvantaged investors, courts will need to develop a new body of common law to address these situations and remedy perceived wrongs. Whereas unsophisticated investors could rely on the safety net of the securities laws to protect their interests, if opting out measures are adopted, courts must develop a new body of common law to redress any wrongs.

174. *See* McGinty, *supra* note 2, at 423, 436.

175. Congress passed the National Securities Market Improvement Act of 1996, in part, to promote uniformity and reduce duplicative state regulation. *See* 1 LOSS & SELIGMAN, *supra*

system governed by a crazy-quilt of common law. Rather than proposing reform measures that would jettison the securities laws, we should be encouraging efforts aimed at coordination and cooperation that would reduce regulatory burdens by lessening duplication, variations, and costs.[176]

Harry Schulman noted shortly after enactment of the Securities Act that, after certain policy questions are answered, "there is little in the civil liability provisions which, in a less scientific and less systematic manner, could not or would not have been quietly developed over a period of years by courts on the basis of their own common-law precedents."[177] So why, at this point in our history, should we trade a sophisticated, well-established body of securities law for the confusion, complexities, and uncertainties of a common law that over a period of time may well yield the same substantive law?

Admittedly, the United States Supreme Court has rendered a number of restrictive decisions under the federal securities laws that have reduced the level of investor protection, particularly in nonpublic offerings.[178] These rulings, however, do not mean that the securities laws should be discarded as no longer useful.[179] This is akin to throwing the baby out with the bath water. First, there continues to be situations where the federal securities laws provide advantages over state securities laws or common law actions.[180] Second, the

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note 167, at 60-61. The related conference report stressed the need for state and federal coordination. *See id.* This theme is echoed in much of the recent academic and political discussions concerning securities law reform. A return to common-law remedies based on state law runs counter to the current movement calling for national uniformity in securities regulation.

176. *See infra* Part V.

177. Harry Schulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 253 (1933).

178. *See, e.g.*, Gustafson v. Alloyd Co., 513 U.S. 561, 567-78 (1995) (limiting applicability of section 12(2) to purchasers of securities acquired in public offering by issuer or its controlling shareholders); Central Bank v. First Interstate Bank, 511 U.S. 164, 191 (1994) (holding that section 10(b) of Exchange Act does not provide for aiding and abetting liability in private actions); Lampf, Pleva, Lipkind, Prupis & Petitrow v. Gibertson, 501 U.S. 350, 361-64 (1991) (determining applicable statute of limitations for private actions under section 10(b) of Exchange Act).

179. McGinty contends that the dramatic reduction in federal securities law protections against fraud for investors in nonpublic offerings justifies his call for permitting investors in limited liability companies to opt out of securities law coverage. Specifically, he argues that the United States Supreme Court's ruling in *Gustafson* that restricted section 12(2) liability to public offerings, coupled with the *Blue Chip Stamps*, *Ernst & Ernst*, *Santa Fe Industries*, and *Central Bank* decisions that increased the plaintiff's burden for showing Rule 10b-5 liability, have significantly diminished the advantages of the federal securities laws over state common-law claims. *See* McGinty, *supra* note 2, at 423, 425.

180. Marc Steinberg offers examples of several situations in which plaintiffs may benefit from pursuing federal, rather than state law, claims. To illustrate, Steinberg notes a number of limitations on the availability of class action treatment in state securities law and common-law fraud cases. In addition, variations in state securities laws, like those in New York, may make

proposals for selective securities law deregulation would not only allow parties to opt out of the federal securities laws, but would permit parties to opt out of state securities law coverage as well.[181] In some cases, state securities acts provide broader protection against fraudulent conduct than the federal securities laws.[182] Some state courts have chosen not to follow Supreme Court precedent when interpreting their state securities laws or have adopted more expansive tests which may provide plaintiffs with a cause of action where such a right might not be found under federal law.[183] Restrictive rulings in the federal context do not support scrapping all state securities laws and returning to common law causes of action. Moreover, such state law variations in interpretation are relatively minor when compared with the hodgepodge of state rulings that could result with a return to common law.

Finally, there is general consensus in the academic community that fraud in the securities market is undesirable.[184] Fraud erodes investor confidence and reduces allocative efficiency.[185] Accurate information is necessary to insure that investors make optimal choices, to preserve investor confidence, and to safeguard the integrity of the market. Therefore, the issue is not regulation versus free market. The issue is what type of regulatory structure should be imposed. The preceding discussion suggests that there is reason to believe

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the federal securities laws more attractive for plaintiffs in certain situations. *See* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 229-30 (2d ed. 1996).

181. *See* McGinty, *supra* note 2, at 437-38 (recommending that Congress add provision to federal securities laws to allow investors in limited liability companies to opt out of federal securities law coverage and then add preemption provision stating that federal and state securities laws do not apply to any excluded limited liability interest).

182. For example, some state securities laws provide that successful plaintiffs may recover reasonable attorneys' fees and punitive damages. Many state securities acts contain longer statute of limitations periods. Some state securities acts provide for damages based on negligent misrepresentations or omissions made in initial offerings as well as in secondary trading markets. A number of state statutes also extend liability for aiding and abetting. *See* STEINBERG, *supra* note 180, at 231-33.

183. Some state courts have adopted more expansive tests for defining the term "seller." Many state courts have held that reliance need not be demonstrated under state securities statutes, thereby facilitating class certification. In a number of states proving loss causation is not required. *See id.* at 233-34.

184. Lynn Stout noted, "When securities scholars get together, they often find they agree on very little. But there is one thing they do agree on: fraud is very, very bad for securities markets." Lynn Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 713 (1996); *see also* Greenfield, *supra* note 168, at 733-34 (noting that "[n]o serious movement exists either in politics or in academe calling for the end of government protection against securities fraud").

185. *See* Stout, *supra* note 184, at 713; *see also* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-80 (1984) (discussing value of rules against fraud).

that a common law regime would be less satisfactory than the current regulatory scheme.

6. *Is Repudiation of the Securities Laws Warranted?*

Advocates of selective securities law deregulation also charge that the costs of the current regulatory structure may well exceed its benefits.[186] Yet, no one knows whether the costs of securities regulation outweigh the benefits. Neither the costs nor the benefits are easily measurable.[187] Scholars have conducted numerous studies, but such studies have been questioned and criticized.[188] Neither the critics of mandatory securities regulation nor its supporters have been able to validate their respective claims regarding the ineffectiveness or effectiveness of securities regulation.[189] Even advocates of deregulation, such as McGinty, admit that the effectiveness of the securities laws is subject to debate.[190] In the face of such inconclusive findings, is radical alteration of the regulatory scheme justified?[191] Certainly the burden of persuasion

186. *See* McGinty, *supra* note 2, at 423-36 (discussing "whether the costs of securities law coverage outweigh its additional benefits over and above the pre-existing common-law protections against fraud and deceit"); Ribstein, *Form and Substance*, *supra* note 2, at 823-32 (discussing "whether the benefits of achieving the objectives of the securities laws exceed the benefits of a clear rule that the securities laws do not apply").

187. *See* EASTERBROOK & FISCHEL, *supra* note 171, at 309. In their book, *The Economic Structure of Corporate Law*, Frank Easterbrook and Daniel Fischel identify certain costs and benefits associated with securities regulation. *See id.* at 310-14. They point out that not only are the direct and indirect costs and benefits of securities regulation difficult to measure, but the problem in determining the costs of securities regulation is that "we do not know what things firms would disclose, and to whom, in the absence of the securities laws." *Id.* at 310. Consequently, it is impossible to determine the incremental costs and benefits associated with securities regulation because we have no benchmark to use to draw comparisons. *See id.* at 310-14.

188. *See, e.g., id.* at 311-14; Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983); *see also* McGinty, *supra* note 2, at 424 n.209 (citing notable critiques of securities regulation and related responses).

189. After reviewing the literature and various empirical studies, Easterbrook and Fischel stated:

> Our principal conclusion is that neither the supporters nor the opponents of the fraud and disclosure rules have made a very good case . . . . It is fair to say, we think, that there is no good evidence that the disclosure rules are beneficial. On the other hand, there is no good evidence that the rules are (a) harmful, or (b) very costly. . . . We are left, for the moment at least, with logical argument rather than proof. And the logical arguments are themselves inconclusive. . . . We cannot say that the existing securities laws are beneficial, but we also are not confident that their probable replacements would be better.

Easterbrook & Fischel, *supra* note 185, at 672, 713-15.

190. *See* McGinty, *supra* note 2, at 423-24.

191. Easterbrook and Fischel observed, "Rules of law may be beneficial in ways we do not understand, and if all we can say is that we cannot identify either benefit or detriment from a

rests with the proponents of change. Such conflicting findings support sustaining the status quo, rather than serving as a call for experimentation or change.

7. Risks Posed by Experimentation

Proponents of selective securities law deregulation attempt to mask the revolutionary and far-reaching nature of their proposals by characterizing their reform initiatives as experiments. McGinty, for instance, describes his opting-out proposal as an experiment in deregulation – just a logical extension of other experiments in deregulating business organizations.[192] McGinty proposes what he terms a limited experiment because under his proposal only limited liability companies would be permitted to opt out of securities law coverage.[193] McGinty assumes that the experiment would be the subject of "massive empirical testing" and suggests that it "could provide a jumping off point for empirically testing the larger question of whether securities regulation generally . . . benefits more than it costs."[194]

Nevertheless, even experiments pose substantial risks.[195] McGinty, himself, acknowledges that if securities law protections are lifted, unscrupulous promoters may prey on innocent victims.[196] Although McGinty proposes a sunset provision and urges us to monitor the impact of the legislation,[197] such measures would not aid unsophisticated investors victimized by fraudulent promoters during the course of the experiment if the experiment fails.[198]

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given set of rules, the injunction to leave well enough alone has great force." Easterbrook & Fischel, *supra* note 185, at 714-15.

192. *See* McGinty, *supra* note 2, at 370-71, 422. McGinty viewed the limited liability company form of organization itself as a "major experiment" in deregulation. *Id.* at 370.

193. *See id.* at 441. McGinty argued that because the limited liability company "is still an emerging form, the experiment is limited in the number of firms that can opt out of securities law coverage." *Id.*

194. *Id.*

195. In his article *Whither Socialism,* Daniel Farber discussed the risks inherent with experimental proposals to privatize public schools. Among the possible risks are (i) the proposal will not work in practice, (ii) the experiment will be difficult, if not impossible, to monitor, and (iii) the experiment may not be reversible if it fails. Daniel A. Farber, *Whither Socialism,* 73 DENV. U. L. REV. 1011, 1014 (1996). The arguments presented in this subsection on experimentation are based, in part, on the general concerns expressed by Farber.

196. *See* McGinty, *supra* note 2, at 441. McGinty appears untroubled by the possible increase in fraud. He noted that "the proper benchmark against which to measure the costs from the increased fraud is the transaction costs that [limited liability companies] would absorb if they continue to be subject to the current securities law regime." *Id.*

197. *See id.*

198. McGinty stated that "[n]aturally, if after the trial period Congress (or the states) resumed regulating excluded [limited liability company] interests under the securities laws, any

Nor would the experiment necessarily be limited simply because only limited liability companies would be permitted to opt out of securities law coverage. We know dishonest promoters are quick to adapt.[199] We could expect a surge in the number of limited liability company offerings.[200] Clearly, the limited liability company would become the organizational form of choice for any questionable investment endeavor.

Also, if a selective deregulation proposal truly is to be an experiment, we would need to plan accordingly. McGinty seems to assume that government agencies or private parties would monitor and empirically test the effects of the legislation.[201] McGinty fails to outline how such legislation would be monitored or evaluated. Is the government willing to invest in or capable of undertaking the task? Should evaluation be left to private parties whose analyses may be colored by self-interest? Is measurement even feasible?

First, we would be asking the government to undertake a task that it has performed poorly in the past – monitoring the effect of legislation in a systematic way.[202] Few regulatory reforms are systematically monitored or quantita-

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such regulation should operate prospectively." *Id.* at 441 n.255. Assuming no grandfather clause or retroactive legislative component, such reregulation would impose a penalty under the securities laws on promoters for continuing conduct, but would not provide relief for promoters' past conduct. We have no way to estimate possible losses to investors during the experimental period. State securities agencies have estimated that telemarketing scams alone are "bilking people out of anywhere from $30 to $60 million each month," and many of these scams are being funded by pension and retirement funds. Jim McTague, *Crime Story Reruns: Regulators Say Cable-TV Investment Scams Are Rampant*, BARRON'S, Sept. 5, 1994, at 15; *see* Ellen E. Schultz, *IRA Money May Attract Shady Deals*, WALL ST. J., Dec. 7, 1994, at C1. As a result, potential losses may prove quite costly.

199. *See, e.g., Electronic Commerce: New Forms of Traditional Fraud Emerging on the Internet, Study Shows*, 29 Sec. Reg. & L. Rep. (BNA) No. 19, at 644-45 (May 9, 1997) (discussing Deloitte & Touche study concerning fraudulent schemes on internet).

200. As limited liability company legislation began to sweep the country, several legal commentators took the position that interests in limited liability companies were not securities. Fraudulent promoters quickly began packaging their investment products as limited liability companies in an attempt to avoid the securities laws. *See, e.g.*, John R. Emshwiller, *New Kind of Company Attracts Many – Some Legal, Some Not*, WALL ST. J., Nov. 8, 1993, at B1; John R. Emshwiller, *SEC Sets Sights on Certain Limited Liability Companies*, WALL ST. J., Mar. 31, 1994, at B2; McTague, *supra* note 198, at 15. Federal and state actions under the securities laws against fraudulent limited liability company promoters helped stem the tide. *See* Welle, *supra* note 115, at 431-39, 495-98, 502-05 (describing federal and state actions against fraudulent limited liability company offerings). McGinty's experiment in deregulation and Ribstein's "intermediate ordering approach" would create a new wave of limited liability company formations.

201. *See* McGinty, *supra* note 2, at 441.

202. In the environmental area, for example, critics charge that the government has failed to monitor the effectiveness of certain environmental legislation. *See* Daniel A. Farber, *Environmental Protection as a Learning Experience*, 27 LOY. L.A. L. REV. 791, 802-03 (1994). Two

tively evaluated.[203] Studies often take years to complete.[204] Analysis is time consuming and expensive. Such studies are frequently criticized, may yield contradictory findings, or simply may cause further debate.[205] Moreover, the effect of the legislation may be hard to measure accurately.[206] Securities regulation provides many protections that are not easy to quantify. Also, when we privatize matters, we make them less visible and more difficult to monitor, thereby compounding the problem. In addition, by limiting the scope of deregulation, characterizing the measure as an experiment, and subjecting the legislation to a sunset provision, the economic impact of the legislation may be skewed.[207]

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leading environmental economists observed that despite the potential importance of some promising alternative regulatory methods, little effort has been spent evaluating the impact of these programs. *See id.* at 802. A leading scholar in administrative law has called for better monitoring of the effects of legislation, better follow up on specific regulatory measures, and better systems for assessing data related to such legislation. *See id.* at 802-03.

203. Although many of the recent corporate deregulation initiatives have been quite controversial, few have been monitored rigorously or had their effects evaluated quantitatively. The limited liability company and limited liability partnership legislation that swept the country was not the product of careful assessment of the legislation's economic and social effects in other jurisdictions, but instead was motivated by brazen state self-interest, primarily fear of losing revenue to other states. *See* Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1272 (1995) (noting that in "virtually every state, those responsible for drafting and/or enacting [limited liability company] legislation cite motives which relate to attracting business and revenue to the state, or avoiding the loss of such business and revenue to other states"); *see also* Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL'Y 13, 15 (1995) ("The recent surge of interest in [limited liability companies] raises important issues concerning . . . the responsiveness of state legislatures to interest group politics and competition for investment capital.").

204. For example, after more than a year of practice under the Private Securities Litigation Reform Act of 1995, the Securities and Exchange Commission (SEC) stated in its report to the President and Congress that it was "too soon to draw any firm conclusions" about the effects of the legislation, it was "too early to assess with confidence many important effects," "objective data that could be used to evaluate the effectiveness . . . are still very limited," and more time was needed. *Litigation Reform: SEC Adopts Staff Conclusion No Legislative Changes Now Needed*, 29 Sec. Reg. & L. Rep. (BNA) No. 16, at 523-24 (Apr. 18, 1997).

205. To illustrate, the SEC issued a report to the President and Congress detailing its evaluation of the first year of practice under the Private Securities Litigation Reform Act of 1995. The Uniform Standards Coalition immediately responded, taking issue with the report's conclusions and citing two other studies in support of the Coalition's position. *See id.* at 524.

206. *See supra* Part IV.A.6 (discussing difficulties in assessing effectiveness of securities regulation); *see also* EASTERBROOK & FISCHEL, *supra* note 171, at 314 (identifying certain difficulties associated with studying effects of securities legislation).

207. As previously indicated, deregulation may cause a surge in the formations of limited liability companies, if limited liability companies are the only form of organization deregulated. *See supra* note 200 and accompanying text. Selective deregulation proposals could artificially

What happens if the experiment fails? It may be difficult, if not impossible, to reverse. Constitutional and political constraints limit a legislature's power to reverse an experiment.[208] McGinty implicitly acknowledges possible retroactivity problems by noting that if Congress resumed regulating limited liability company interests under the securities laws, "any such regulation should operate only prospectively."[209] But if Congress resumed regulation solely on a prospective basis,[210] defrauded investors could only bring securities law actions for continuing conduct or future conduct. Defrauded investors would be precluded from bringing securities law claims for past actions, even if the experiment proved to be a complete failure that vastly increased the amount of fraud.

Political barriers also may block reversal of the experiment or make reversal more difficult. Given the current deregulatory climate and national political mood, it may prove much easier to deregulate than to reregulate. Unless the experiment is an abject failure, the decision to deregulate may be irreversible. Rather than being a benign experiment, the proposed legislation poses substantial risks, may not yield the benefits promised, may actually result in harm, and yet may prove irreversible.

B. Advantages of Standards Over Rules

The arguments for and against selective deregulation echo the jurisprudential debate over the relative merits of legal forms – rules versus standards.

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and inappropriately distort choice of entity decisions. Some promoters may decide to package their investments as limited liability companies for no other reason than to avoid application of the securities laws. Promoters may miscalculate the value of deregulation and fail to adopt more appropriate or more beneficial organizational forms. In addition, if the market views the reform measure as an experiment, the true economic impact of deregulation would not be reflected accurately in the price of the securities. While market actors routinely consider the possibility of legal change among the factors and risks assessed in pricing an investment, a sunset provision indicates a mandatory review and therefore signals an increased probability of reregulation. The sunset provision would affect the pricing of the securities. Price adjustments might be very different if the measure was not characterized as an experiment or subject to a sunset provision. The sunset provision also could cause people to rush to complete their transactions prior to possible reregulation in order to avoid application of the securities laws to their initial offering. The limited nature of the reform measure, the characterization as an experiment, and the sunset provision may each serve to distort the economic impact of the legislation and undermine the usefulness of the experiment in analyzing the effects of deregulation.

208. The ex post facto clause, due process, the contract clause, and takings concerns restrict a legislature's ability to impose retroactive legislation. *See* JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW §§ 11.8 to 11.14 (5th ed. 1995) (discussing constitutional limits on retroactive legislation).

209. *See* McGinty, *supra* note 2, at 441 n.255.

210. This assumes no grandfathering provisions or retroactive legislative component.

The basic thesis of the rules versus standards construct[211] is that law translates social policies and political principles into legal directives that decisionmakers apply to specific facts and cases.[212] These legal directives take various forms that can be classified as "rules," as "standards," or as some hybrid combination. A legal directive is a "rule" when it requires the decisionmaker to respond in a determinate way to certain facts. A legal directive is a "standard" when it requires the decisionmaker to directly apply principles or policies to a particular situation. For example, assume a state legislature wishes to improve the safety of its highways by prohibiting driving at excessive speeds.[213] The legislature could adopt a rules-based law that declares it unlawful to exceed a specified speed. Alternatively, the legislature could adopt a standards-based law that simply declares it unlawful to drive at unreasonable speeds. The scholarly debate over rules versus standards primarily centers on the relative merits of these legal forms and attempts to identify when decisionmakers should promulgate rules versus standards.[214]

Why adopt a rule over a standard or a standard over a rule? Rules are said to confine the decisionmaker to the facts at hand and reduce judicial discretion, thereby increasing consistency and predictability, which decreases the costs of litigation and allows private parties to order their affairs more productively.[215] But rules may also produce errors of over- or under-inclusiveness. Standards, on the other hand, are said to decrease the errors of over- and under-inclusiveness by giving the decisionmaker more discretion than do rules.[216] Standards allow decisionmakers to take into account the totality of the circumstances, to adapt to changing circumstances, and to treat like cases alike. Whether rules or standards better promote fairness, equity,

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211. Duncan Kennedy generally is credited with popularizing the current distinction between rules and standards in his seminal article *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976). For detailed descriptions of the differences between the two forms and the tradeoffs between the use of rules versus standards, see generally Kennedy, *supra*; Carol Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985); Kathleen M. Sullivan, *The Supreme Court, 1991 Term – Forward: The Justices of Rules and Standards*, 106 HARV. L. REV. 22 (1992).

212. This brief synopsis of the rules versus standards dichotomy is drawn from Kathleen M. Sullivan's succinct summary and excellent analysis of constitutional rules and standards in her article *The Supreme Court, 1991 Term – Forward: The Justices of Rules and Standards*. *See* Sullivan, *supra* note 211, at 57-62.

213. Isaac Ehrlich and Richard Posner used this example to illustrate the difference between rules and standards in their article *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 257 (1974).

214. *See supra* note 211.

215. *See* Sullivan, *supra* note 211, at 58, 62-66.

216. *See id.* at 58-59, 66-69.

equality, predictability, efficiency, and utility constitutes a central theme of the debate.

In keeping with their market-conscious and conservative spirit, the proponents of selective deregulation in the securities law context favor rules over standards, certainty over flexibility, questions of law over questions of fact, and individualism over community.[217] The core of their argument is that the flexible definition of the term "security," with vague standards such as the "investment contract test," results in costly and unpredictable case-by-case analysis and arbitrary judicial decisions.[218] They, therefore, advocate the adoption of bright-line rules, such as deregulation by entity type or private agreement, to promote certainty and predictability, which they believe will in turn reduce adjudication and contracting costs.[219]

But do bright-line rules, such as opting out by entity type or waiver, promote fairness, equity, equality, predictability, efficiency, and utility better than the current regulatory scheme with its flexible definition of the term "security"? The following sections analyze the arguments for bright-line rules offered by the proponents of selective deregulation and evaluate them in light of these policy considerations and the particular problems presented in the securities regulation context.

1. Fairness, Equity, and Equal Treatment

Advocates of selective deregulation criticize the open-ended definition of a "security" that is found in federal and state securities laws.[220] They argue that vague tests, such as the investment contract test,[221] invite judicial discre-

217. *See supra* Part III.

218. *See* McGinty, *supra* note 2, at 374-75, 423, 434-36; Ribstein, *Form and Substance*, *supra* note 2, at 808-11, 824-25, 838.

219. *See* McGinty, *supra* note 2, at 374-75, 434-38; Ribstein, *Form and Substance*, *supra* note 2, at 824-26, 838.

220. The statutory definition of a "security" sets forth a list of specific instruments that are considered securities, such as stocks, bonds, notes, and debentures, but also includes a number of catch-all phrases for instruments that do not fit into conventional categories, such as "investment contract," "instrument commonly known as a 'security,'" and "certificate of interest or participation in any profit-sharing agreement." *See supra* note 103 (providing text of Securities Act of 1933 section 2(a)(1)). These catch-all phrases are not defined in the securities acts. As a result, the courts have been left to define these terms. *See supra* Part IV.A.1.b.

221. In *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946), the United States Supreme Court established a four-prong test to determine whether an interest is an investment contract. The Court stated that an investment contract "means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party . . . ." *Id.* Courts have used the *Howey* investment contract test and its case-by-case approach to reach a wide variety of conventional and unconventional investment vehicles. *See supra* Part IV.A.1.b.

tion that results in arbitrary and biased rulings.[222] They urge courts and legislators to adopt clear and explicit rules, such as deregulation by entity type or private agreement, to force courts to act consistently by treating like cases alike, thereby reducing the likelihood of bias and arbitrary decisions.[223] The proponents of deregulation essentially are echoing the classic fairness and equal treatment arguments cited to defend the use of rules over standards: rules are fairer than standards since rules promote equal treatment and reduce the dangers of arbitrariness and bias.[224]

Yet rules can also produce unjust and arbitrary results. Bright-line rules produce errors of under-inclusiveness that can result in guilty behavior escaping sanctions, produce unequal treatment in similar cases, provide opportunities to evade prosecution, and conceal bias.

a. Rules Permit Undesirable Conduct to Escape Punishment

Because a rule, by definition, constitutes an abstraction, it captures the background principles and policies incompletely, and therefore produces errors of under- and over-inclusiveness.[225] Even proponents of bright-line rules, such as opting out by entity type, concede that such rules are under-inclusive and some objectionable conduct will go unpunished.[226] For instance, if limited liability companies are permitted to opt out of securities law coverage, fraudulent promoters who package their investment schemes as limited liability companies could escape prosecution under the securities laws. In addition, passive investors in limited liability companies who might benefit from mandatory disclosure may no longer be entitled to such disclosure.[227]

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222. *See* McGinty, *supra* note 2, at 423, 434-36 ("[V]ague tests for determining . . . securities status leave the question largely to judges' unpredictable policy preferences. When extra-legal normative positions weigh heavily on the decision-making process, the parties' fates will essentially be arbitrary . . . .").

223. *See* Ribstein, *Form and Substance*, *supra* note 2, at 840 (urging enactment of explicit rules, rather than vague standards and open-ended definitions, to increase predictability and reduce costs).

224. *See* CASS R. SUNSTEIN, LEGAL REASONING AND POLITICAL CONFLICT 112-13 (1996); Sullivan, *supra* note 211, at 62.

225. *See* SUNSTEIN, *supra* note 224, at 129-30; Sullivan, *supra* note 211, at 58.

226. *See* Ribstein, *Form and Substance*, *supra* note 2, at 826-27.

227. Such bright-line rules could also prove over-inclusive. For example, under Ribstein's proposal, corporate stock and limited partnership interests would continue to be characterized as securities and therefore would be subject to the securities laws, while general partnership interests and limited liability company interests would be characterized as nonsecurities and thus would be free from securities regulation. *See* Ribstein, *Form and Substance*, *supra* note 2, at 809-10, 814, 827-28; Ribstein, *Private Ordering*, *supra* note 2, at 41-42. Under this approach, all investors in corporations and limited partnerships would be protected by the securities law, regardless of their need for protection. As a result, sophisticated and knowledgeable investors

The proponents of opting out by entity type artificially differentiate between entities to create a clear rule, but in doing so they sacrifice the objectives of the securities laws – the protection of investors.

b. *Rules Prevent Equal Treatment*

Under-inclusiveness also prevents equal treatment, if equal treatment means treating like cases alike.[228] For example, in determining the scope of the securities laws, courts have focused on the economic realities of the transaction and emphasized the substance of the transaction, rather than its form.[229] Using this approach, courts have found that investments in some general partnerships and limited liability companies constitute investment contracts, and therefore the investors in these enterprises merit the protection of the securities laws.[230] The current regulatory structure affords courts the

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in corporations or limited partnerships who have significant managerial control over an entity would be protected by the securities laws whether they need or want such protection.

228. *See* SUNSTEIN, *supra* note 224, at 113; Sullivan, *supra* note 211, at 66.

229. *See, e.g.*, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

230. Both general partnership interests and limited liability company interests typically meet the first three prongs of the *Howey* investment contract test. Investments in both entities generally involve an investment of money in a common enterprise with the expectation of profit. In the vast majority of situations, the key issue is whether profits are expected from the efforts of a promoter or a third party. *See supra* note 221 (describing four prongs of *Howey* investment contract test).

In *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), the United States Court of Appeals for the Fifth Circuit, applying the *Howey* investment contract test, noted that a general partnership interest may be a security if the investor is so dependent on a promoter or a third party that he in fact is unable to exercise meaningful managerial control. *Id.* at 424. The *Williamson* court described three situations in which a general partnership interest may constitute a security: (1) if the agreement among the parties leaves so little power in the hands of the investors that the arrangement distributes power as would a limited partnership; (2) if the investor is "so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising" his managerial powers; (3) if the investor is "so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful" managerial power. *Id.* The *Williamson* court also recognized that other factors could give rise to dependence on the promoter or manager so that the exercise of control would be effectively precluded. *Id.* at 424 n.15. A number of other federal circuits have adopted the Fifth Circuit's approach. *See* McGinty, *supra* note 2, at 399-405 (reviewing decisions in other circuits).

Whether a limited liability company interest constitutes a security also turns on whether profits are expected from the efforts of others. *See* Welle, *supra* note 115, at 445-54. The SEC and at least 23 state securities commissions have taken the position that certain limited liability company interests may be securities under the *Howey* investment contract test and its progeny. *Id.* at 441. At least 16 states have taken action under state securities laws against entities offering or selling limited liability company interests. *Id.* at 429. In at least 12 states, state flexibility to treat similar cases alike in order to protect investors who warrant protection.[231] But under some opting-out proposals investors in these entities could be denied the protection of the securities laws simply because of the form of the transaction, even if they are the type of investors that the securities laws were designed to protect.[232] Why should investors in certain general partnerships or limited liability companies be singled out and denied protection, while other investors, with investments meeting the same criteria, are afforded the protection of the securities laws? By narrowly focusing on the form of the transaction, such rules fail to recognize the similarities and differences between transactions and consequently produce arbitrary and unjust results. If fairness and equality mean treating like cases alike, such rules prevent equal treatment.

c. *Rules Encourage Evasion*

In addition, bright-line rules tempt the unscrupulous to construct imaginative schemes to exploit technicalities and evade the law.[233] As Duncan Kennedy noted, rules "allow the proverbial 'bad man' to 'walk the line,' that is, to take conscious advantage of underinclusion to perpetrate fraud with impu-

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courts or regulators have ordered promoters of limited liability companies to cease and desist from offering or selling limited liability company interests in violation of state securities laws, based on findings of sufficient evidence to conclude such interests were securities. *Id.* The SEC has filed at least seven actions alleging violations of the federal securities laws for selling interests in limited liability companies. *Id.* at 428. Federal and state prosecutors have been extremely successful in obtaining injunctions and cease and desist orders against certain limited liability company promoters based on violations of the securities laws. *Id.* at 432-39.

231. For over 30 years, the United States Supreme Court broadly interpreted the definition of a "security." In opinions such as *Joiner*, *Howey*, *Tcherepnin*, and *Forman*, the Court broadened the definition of a "security" by emphasizing substance over form, focusing on the economic realities of the transaction, and considering the remedial purposes of the securities acts. *See* Douglas M. Branson & Karl S. Okamoto, *The Supreme Court's Literalism and the Definition of "Security" in the State Courts*, 50 WASH. & LEE L. REV. 1043, 1048-51 (1993). Although the Court adopted a more literal approach in cases such as *Landreth* and *Gould* that dealt with corporate stock, the economic realities test is still alive and well under the investment contract line of cases and state courts continue to apply purpose-based and economic reality-based tests to determine what constitutes a security. *See id.* at 1052, 1066-68, 1088-91.

232. Under McGinty's proposal, limited liability companies would be permitted to opt out of securities law coverage, while presumably other forms of business organizations would not be afforded the right to opt out. *See* McGinty, *supra* note 2, at 371, 375, 437. Under Ribstein's "intermediate private ordering approach," corporate stock and limited partnership interests would continue to be treated as securities; however, general partnership interests and limited liability company interests would be presumed to be nonsecurities. *See* Ribstein, *Form and Substance*, *supra* note 2, at 810, 814-15; Ribstein, *Private Ordering*, *supra* note 2, at 41-45.

233. *See* SUNSTEIN, *supra* note 224, at 133; Kennedy, *supra* note 211, at 1773.

nity."[234] In the securities law context, selective deregulation by entity type would encourage every dishonest promoter to structure his transaction as a limited liability company or a general partnership to avoid prosecution under the securities laws.[235] Selective deregulation by entity type or private agreement would invite unprincipled promoters to prey on the unsophisticated and uninformed. These proposals would create incentives to exploit situations where access to information or knowledge is unequally distributed.[236] Such bright-line rules, in fact, serve as a blueprint for fraud. Rather than deterring fraud, these proposals would facilitate fraud.

d. Rules Mask Bias

Bright-line rules also have political and social implications. Morton Horwitz wrote that the rule of law is a conservative doctrine that "enables the shrewd, the calculating, and the wealthy to manipulate its forms to their own advantage."[237] Bright-line rules based on technical, definitional legalisms or waiver of rights benefit the economically privileged who are well-educated, legally savvy, or can afford the advice of counsel. In the securities law context, rules work to the advantage of issuers and promoters and to the detriment of investors. For example, opting-out legislation based on legalisms, such as the form of the transaction, or technicalities, such as waivers set forth in fine print, would create traps for the uneducated, unsophisticated, uninformed, or unwary. Rules of this sort magnify the disparity in bargaining power between

234. Kennedy, *supra* note 211, at 1696.

235. Professors Branson and Okamoto observed that once courts began presuming that general partnership interests were not securities, "[e]very promoter who knew what she was doing, or who had a decently schooled transactional lawyer, structured their deal as a general partnership." Branson & Okamoto, *supra* note 231, at 1081. As limited liability company legislation began to sweep the country, several commentators argued that limited liability company interests would not and should not be treated as securities. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 41, § 14.02, at 14–5 (May 1994) (proposing at least presumption against "security" characterization for limited liability company interests or proposing that limited liability company interests be characterized as nonsecurities because limited liability company interests are closely held); Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992) (arguing that limited liability company interests normally do not satisfy definition of security). State regulators charged that as a result many unscrupulous promoters began packaging their investment products as limited liability companies in an attempt to avoid federal and state securities laws. *See* John R. Emshwiller, *New Kind of Company Attracts Many – Some Legal, Some Not*, WALL ST. J., Nov. 8, 1993, at B1; John R. Emshwiller, *SEC Sets Sights on Certain Limited Liability Companies*, WALL ST. J., Mar. 31, 1994, at B2.

236. *See* Sullivan, *supra* note 211, at 66.

237. Morton J. Horwitz, *The Rule of Law: An Unqualified Human Good?*, 86 YALE L.J. 561, 566 (1977) (book review).

parties familiar with legal formalities and parties without legal assistance or prior experience.[238] Moreover, in virtually every dispute, it is the investor who invokes the protection of the securities laws. These proposals would reduce the legal rights of investors, reduce their success in litigation, and reduce their chances of recovery by eliminating causes of action under the securities laws. Hence, these seemingly neutral rules actually mask an underlying bias with important political, as well as social, implications.[239]

If our goal is to promote fairness, equity, and equal treatment, the current regulatory structure furthers these objectives better than bright-line rules, such as deregulation by entity type or private agreement. Congress purposefully defined the term "security" in broad and general terms so as to reach even novel, irregular, and uncommon instruments that possess the same characteristics as investment contracts or other securities.[240] This open-ended definition decreases errors of under-inclusiveness by making it more difficult for objectionable conduct to escape punishment. Flexible tests, such as the investment contract test, help thwart attempts to evade the law through technicalities and legal formalism.[241] The investment contract test also permits particularized case-by-case analysis that affords courts the flexibility to treat like cases alike. In addition, a fact-specific, purpose-based approach allows courts to take into account individual circumstances and therefore is more likely to yield fairer, more equitable results. Consequently, the current regulatory structure is actually fairer, less arbitrary, and more equitable than the bright-line rules proposed by the advocates of selective deregulation.

2. *Predictability, Efficiency, and Utility*

Legal academics, particularly those associated with the law and economics movement, charge that the current definition of a "security," with its judicial gloss, creates uncertainty that increases costs and produces economic inefficiencies. They contend that tests, such as the investment contract test, with its case-by-case analysis and focus on the economic realities of the transaction, make it difficult to predict whether an interest is a "security," and

238. *See* Kennedy, *supra* note 211, at 1699-1700.

239. *See* SUNSTEIN, *supra* note 224, at 132.

240. *See* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

241. In defining the statutory term "investment contract," the United States Supreme Court purposefully adopted a case-by-case approach that looked at the substance of the transaction rather than its form. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298-301 (1946). In doing so, the Court stated, "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Id.* at 301. This language appears particularly relevant today in light of current deregulatory proposals that would compromise investor protection by elevating form over substance.

therefore whether the transaction is governed by the securities laws.[242] They assert that this uncertainty increases both transaction and litigation costs for businesses. First, such uncertainty forces some businesses to behave defensively and comply with the securities laws, which may add unnecessary costs to the transaction.[243] Second, if the outcome of litigation is difficult to predict, parties may have divergent views about whether the securities laws apply. These divergent views increase negotiation costs and make it difficult to make and price contracts.[244] Third, uncertainty, together with diverging expectations, also increases the likelihood of litigation when a dispute arises and decreases the probability of settlement.[245] Fourth, such fact-specific, purpose-based, multi-factored tests are difficult to apply, making litigation costly and imposing a heavy burden on the courts.[246]

Proponents of bright-line rules contend that clear rules are more efficient.[247] They argue that bright-line rules, such as deregulation by entity type or waiver, increase certainty and predictability, which enhances private ordering by permitting parties to order their affairs more productively.[248] They assert that parties are entitled to know in advance whether the law applies, so that they can form expectations and plan their affairs accordingly.[249] In addition, rules constrain the scope of factual inquiry, making litigation less costly and eliminating the need for complicated, time-consuming, and repetitive lawsuits.[250]

Rules, however, may not be as virtuous as they first appear. Rules may not in fact provide greater certainty or predictability. At least in the context of securities regulation, fact-specific, multi-factored, purpose-based tests may produce greater certainty and predictability than the bright-line rules suggested by the advocates of selective deregulation. In addition, the proposed bright-line rules could serve to erode investor confidence, and thereby actually undermine the efficient workings of the securities market. Moreover, while economic efficiency, judicial economy, and reducing the cost of regulation are laudable goals, what about justice? The economic advantages that bright-line

242. *See* McGinty, *supra* note 2, at 374; Ribstein, *Form and Substance*, *supra* note 2, at 809.

243. *See* McGinty, *supra* note 2, at 374, 418; Ribstein, *Form and Substance*, *supra* note 2, at 830.

244. *See* Ribstein, *Form and Substance*, *supra* note 2, at 809, 831.

245. *See* McGinty, *supra* note 2, at 418; Ribstein, *Form and Substance*, *supra* note 2, at 809, 829-30.

246. *See* Ribstein, *Form and Substance*, *supra* note 2, at 825, 829-30.

247. *See* Rose, *supra* note 211, at 590, 609.

248. *See* Kennedy, *supra* note 211, at 1688; Sullivan, *supra* note 211, at 62.

249. *See* SUNSTEIN, *supra* note 224, at 101, 114, 191; Kennedy, *supra* note 211, at 1688.

250. *See* Sullivan, *supra* note 211, at 58, 62-63.

rules offer may be only fleeting, so is it worth sacrificing justice and investor protection in the interim?

a. Rules Do Not Necessarily Improve Certainty or Predictability

Rules do not inevitably settle all cases in advance or provide greater certainty or predictability.[251] Language is imprecise.[252] In addition, language is a product of context and culture.[253] As a result, rules may leave gaps, the language may create ambiguities, understandings may be disputed, meanings may shift over time, or circumstances may change.[254] All these factors undermine any certainty or predictability that a rule might offer. What at first appears to be a clear rule often becomes muddied by interpretation and changing circumstances.[255]

There are numerous examples of this phenomenon in the securities law context. For instance, the definition of a "security" in the federal securities laws expressly includes the term "any note."[256] However, changes in the use of notes by the financial community over time and significant variations in the character of these instruments caused a change in the meaning of the term "note."[257] Hence, the United States Supreme Court held that the phrase "any note" in the federal securities acts should not be interpreted to mean literally "any note," but must be interpreted in light of what Congress was attempting to accomplish.[258] The Court therefore looked behind the label at the surrounding circumstances, including the offering context, to determine if the instrument labeled a "note" should be deemed a "security."[259] To aid in this determination, the Court established a four-factor "family resemblance" test to identify when a "note" is a "security."[260] Another example involves the definition of the term "stock." In *Landreth Timber Co. v. Landreth*,[261] the

251. *See* SUNSTEIN, *supra* note 224, at 121.

252. *See* Rose, *supra* note 211, at 609.

253. *See* SUNSTEIN, *supra* note 224, at 122.

254. *See id.* at 122, 125, 131-32.

255. *Cf.* Rose, *supra* note 211, at 580-90 (providing three examples in property law context).

256. *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (Supp. II 1996); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1994); *supra* note 103 (providing text of Securities Act's definition of "security").

257. *See* Reves v. Ernst & Young, 494 U.S. 56, 62-63 (1990) (indicating that term "note" should be interpreted in light of purposes of securities laws); Landreth Timber Co. v. Landreth, 471 U.S. 681, 694 (1985) (discussing broad interpretation of term "note"); *see also* 2 LOSS & SELIGMAN, *supra* note 167, at 875 n.18 (tracing changes in meaning of term "note").

258. *See Reves*, 494 U.S. at 63.

259. *See id.* at 64-70.

260. *See id.* at 66-67.

261. 471 U.S. 681 (1985).

United States Supreme Court held that if an instrument bears the label "stock" and possesses the characteristics typically associated with stock, the instrument is a "security."[262] The Court noted that an instrument's label is not determinative.[263] The Court identified five characteristics typically associated with stock to be used in determining when an instrument bearing the label "stock" is a "security."[264]

In these and other cases,[265] seemingly precise and specific language nevertheless produced uncertainty. Courts promulgate multi-factored, fact-specific, purpose-based tests to define terms, so that what was once a sharp-edged rule now resembles a standard. If history is any predictor, legislation permitting parties to opt out of securities regulation by choice of entity or waiver will fare no better in this game of interpretation. For example, if limited liability companies are permitted to opt out of securities law coverage by private agreement, courts will find themselves needing to define what constitutes a "limited liability company."[266] After years of litigation, a four-part or five-part test will emerge to determine when an entity is a "limited liability company." Until then, there will be uncertainty, and even after a test

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262. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985); *see also* Gould v. Ruefenacht, 471 U.S. 701, 704 (1985) (applying standard from *Landreth*).

263. *See Landreth*, 471 U.S. at 686; *see also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848-51 (1975) (stating that emphasis should be on "economic reality").

264. *See Landreth*, 471 U.S. at 686; *see also Gould*, 471 U.S. at 704; *Forman*, 421 U.S. at 851.

265. Another illustration involves certificates of deposit. In *Marine Bank v. Weaver*, 455 U.S. 551 (1982), the United States Supreme Court excluded certain certificates of deposit from the coverage of the federal securities laws, even though the definition of a "security" expressly includes the term "certificate of deposit." *See id.* at 557-59. The Court looked behind the label and examined the factual context surrounding the transaction. *See id.* at 558. The Court held that a bank-issued certificate of deposit was not a security because it was federally insured and the purchasers therefore did not need the extra layer of protection provided by the federal securities laws. *See id.* at 558-59.

266. Since a limited liability company is a creature of state law, many variations and permutations exist. In addition, the limited liability company is a relatively new form of business association, so it is still evolving. 1 RIBSTEIN & KEATINGE, *supra* note 41, § 1.02, at 1–2. If it is not clear what constitutes "stock," a "note," or a "certificate of deposit," then what constitutes a "limited liability company" is sure to produce similar confusion. Moreover, the United States Supreme Court has stated than an instrument's label is not determinative. *See supra* text accompanying note 263. Courts therefore will need to identify the characteristics usually associated with a "limited liability company" or decide which state's law will serve as a template to describe the features of a typical "limited liability company." Fraudulent promoters attempting to use limited liability companies to escape the reach of securities laws are likely to push the boundaries by using limited liability companies for unintended purposes or organizing limited liability companies as an investment vehicle with hundreds, or even thousands, of members. *See* Welle, *supra* note 115, at 431-32 & n.29 (noting that some limited liability companies already have hundreds of members). Such uses would call into question whether these entities are truly "limited liability companies" and could result in refining the definition further.

becomes generally accepted, parties will hold differing views about how courts should interpret each factor. Gray areas at the boundaries of the law will materialize. In addition, any waiver provision will generate an enormous amount of litigation.[267] Consequently, bright-line rules do not insure either certainty or predictability. Over time, these bright-line rules would evolve into standards, so what have we ultimately gained in return for the values we have sacrificed?

b. Standards May Provide Greater Certainty and Predictability

At least in the securities law context, fact-specific, purposed-based tests, such as the investment contract test, may be more useful, efficient, and predictable than the bright-line rules that the advocates of selective deregulation propose.[268] Congress purposefully defined the term "security" in broad and general terms so as to include within the definition the countless assortment of instruments that fall within the ordinary understanding of what constitutes a security.[269] This broad and general definition recognizes the boundlessness of human ingenuity and the dynamic, ever-changing nature of the securities market. For over fifty years, courts have used the investment contract test and its case-by-case approach to reach a wide variety of investment vehicles, both conventional and unconventional.[270] Accordingly, investors have come to understand that the securities laws apply to any arrangement, no matter how new or unusual and no matter what the label, where one invests in a common enterprise with an expectation of deriving profits substantially from the efforts of others.[271]

The investment contract test's basic definition of a security has served this country well for over half a century. The test captures the essence of what is meant by the term "security" by describing in general terms the types of arrangements that are ordinarily considered securities. In *United Housing Foundation, Inc. v. Forman*,[272] the United States Supreme Court observed that the investment contract test "embodies the essential attributes that run through all of the Court's decisions defining a security."[273] As a result, the investment

267. *See infra* Part IV.C.4.

268. *Cf.* Rose, *supra* note 211, at 609 (noting that standard, such as "commercial reasonableness" that relies on socially understood conventions, is more predictable to commercial traders than certain bright-line rules, such as mailbox rule).

269. *See Marine Bank*, 455 U.S. at 555-56, 559; United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847-48 (1975).

270. *See* HAZEN, *supra* note 113.

271. *See supra* note 221 (describing elements of four-prong *Howey* investment contract test).

272. 421 U.S. 837 (1975).

273. *Forman*, 421 U.S. at 852.

contract test, and its definition of a "security," provides a basic standard – an overarching definition to guide both issuers and investors. The test has become an accepted and socially understood convention in the business community, and has proven flexible enough to adapt to constantly-changing business environments. The advocates of selective deregulation, however, propose bright-line rules that would create exceptions to the investment contract test. To change the investment contract test, by creating exceptions based on choice of entity or waiver, would only generate confusion and place unrealistic demands upon investors.

The proponents of selective deregulation are asking us to replace reliance on a common understanding and a basic rule of thumb with bright-line rules that would muddy investor understanding. With selective deregulation by entity type, the rules would differ by entity.[274] The investment contract test could no longer be used as a general guide. Investors would have to memorize what investment forms constitute securities. Is it fair to expect investors, or lawyers for that matter, who often fail to understand the differences between various forms of business organizations,[275] to recognize which forms are subject to the securities laws and which are not? With waiver, is it reasonable to expect the average investor to read and to fully comprehend the implications of waiver provisions set forth in the fine print of some investment document? Are waivers reasonable given that antiwaiver prohibitions have been in effect for almost sixty-five years?[276] These bright-line tests would catch unsophisticated investors and practitioners by surprise and create a bonanza for fraudulent promoters. Rather than promoting predictability, efficiency, and utility, such bright-line rules would undermine common understandings, disrupt investor expectations, and complicate the law. In the securities law context, there appears to be a great deal more certainty and clarity in socially understood conventions, such as the investment contract test, than in legalistic, bright-line rules based on technicalities.

c. Rules May Erode Investor Confidence

The reform proposals, particularly selective deregulation by entity type, directly conflict with prior case law and could erode investor confidence. Congress initially enacted the securities laws to restore investor confidence

274. *See supra* note 232 (describing McGinty's and Ribstein's proposals for deregulation by entity type).

275. *See Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605, 617-18 (Larry E. Ribstein & Mark A. Sargent eds., 1997) (discussing current confusion caused by too many different entity statutes and noting that lawyers and their clients need time to digest all changes or else need much simpler legislative scheme).

276. *See supra* Part IV.A.1.c. (discussing antiwaiver provisions).

in the capital markets.[277] Congress intended the securities laws to govern the various types of instruments ordinarily and commonly considered to be securities in the commercial world.[278] The United States Supreme Court therefore has stated on numerous occasions that the investing public's expectations are relevant to determining whether an instrument is a security.[279] The Court also has held that certain instruments are securities based on such public expectations.[280]

Given the many years the investment contract test has been employed, an investor would be justified in assuming the securities laws apply to passive investments of all types, whatever the label. If an investor in a general partnership or limited liability company intended to rely on the efforts of others, clearly such interests would constitute securities under the investment contract test.[281] A reasonable investor, therefore, would be justified in believing that the securities laws apply to the transaction. No countervailing factors would lead a reasonable person to question her characterization of the interest as a security. The investor's reasonable expectations would support a finding that such interests were securities. The exceptions and waivers proposed by the advocates of selective deregulation would conflict with the investor's reasonable expectations. Such exceptions and waivers would result in investor confusion and create traps for the unwary that could erode investor confidence and undermine the efficient workings of the securities market.[282]

d. And What About Justice?

Clearly, economic efficiency, judicial economy, and reducing the cost of regulation are important goals, but should they effectively trump all other policy concerns? Slashing investors' legal rights – and their chances of recovery through litigation – would undoubtedly reduce the amount of litigation.[283]

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277. *See* Marine Bank v. Weaver, 455 U.S. 551, 555 (1982).

278. *See id.* at 555-56.

279. *See* Reves v. Ernst & Young, 494 U.S. 56, 66-67 (1990); Landreth Timber Co. v. Landreth, 471 U.S. 681, 687, 693-94 (1985); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 850-51 (1975).

280. *See Reves*, 494 U.S. at 66 (stating that Court "will consider instruments to be 'securities' on the basis of such public expectations"); *Landreth*, 471 U.S. at 687, 694 (citing public's expectations and finding that common stock is "security").

281. *See supra* note 230 (discussing application of investment contract test to general partnership interests and to limited liability company interests).

282. *See* Easterbrook & Fischel, *supra* note 185, at 673-77 ("Fraud reduces allocative efficiency."); Stout, *supra* note 184, at 713 ("[F]raud . . . erodes investor confidence.").

283. *Cf.* Joseph R. Grodin, *Are Rules Really Better Than Standards?*, 45 HASTINGS L.J. 569, 570 (1994) (responding to proposal to reduce appellate court dockets and noting that "[i]t is indisputable that cutting back on people's legal rights, and hence on their chance of legal

In fact, a significant amount of litigation could be avoided by just repealing the securities laws. But do we want to sacrifice investor protection for the sake of bright-line rules, convenience, cost cutting, and docket control, particularly if such rules primarily benefit the economically privileged?[284] Do we want to inform investors that the application of equitable principles takes too long and costs too much, so they no longer have a claim?[285] In the securities law context, these opting-out proposals only serve certain pocketbooks, not justice.

e. *Any Economic Advantage May Be Fleeting*

Finally, any economic advantage that may be gained from adopting rules may be lost if judges find the rule's over- or under-inclusiveness unpalatable and devote their time to devising end-runs around the rule.[286] As Duncan Kennedy so vividly described, rules become corrupted when judges are "simply unwilling to bite the bullet, shoot the hostages, break the eggs to make the omelette and leave the passengers on the platform."[287] In response, judges create exceptions, manipulate facts, distinguish cases, grant equitable relief, consider intent, or develop new common law theories to remedy the injustice. Kennedy observed, "Each successful evasion makes it seem more unjust to apply the rule rigidly in the next case; what was once clear comes to be surrounded by a technical and uncertain penumbra that is more demoralizing to investment in form than an outright standard would be."[288]

In the securities law context, exceptions and waivers based on entity classification would encourage every fraudulent promoter to structure his transaction as a limited liability company or general partnership to avoid the securities laws. Private ordering would invite unscrupulous promoters to prey on the unsophisticated and uninformed. The effect of these proposals is to leave those investors who are least able to protect themselves vulnerable to the schemes of clever promoters. If these bright-line rules permit such egregious conduct to go unpunished, courts will be encouraged to create exceptions or develop equitable theories to redress these wrongs. Judges will be unwilling

success, will cut back on their incentive to litigate").

284. *Cf.* Rose, *supra* note 211, at 593 ("[I]t would corrode our moral understanding of ourselves as a society if we were to permit gross unfairness to reign simply for the sake of retaining clear rules and rational ex ante planning, particularly if those rules covertly serve the wealthy and powerful.").

285. *Cf.* Grodin, *supra* note 283, at 570 (responding to proposal to reduce appellate court dockets). Grodin noted that "to tell a party that he is going to lose because the *courts* have decided that the application of otherwise appropriate principles would take too much of *their* time is not likely to be seen as a manifestation of justice." *Id.*

286. *See* Sullivan, *supra* note 211, at 63.

287. Kennedy, *supra* note 211, at 1701.

288. *Id.*; *see* SUNSTEIN, *supra* note 224, at 126.

to sit idly by while the elderly are fleeced of their pension funds. Dramatic and disproportionate losses to investors will pressure courts to act.[289] As judges attempt to remedy the injustice that these bright-line rules produce, the law will become muddied by interpretation, equitable second-guessing, and exceptions. As a result, any benefits these bright-line rules might offer will be only fleeting.

If our objective is to promote predictability, efficiency, and utility, the current regulatory structure may further these goals better than bright-line rules, such as deregulation by entity type or private agreement. Bright-line rules do not insure either certainty or predictability. Fact-specific, purpose-based tests that reflect socially understood conventions may actually provide more certainty and clarity than legalistic, bright-line rules based on technicalities. The rules proposed by the advocates of selective deregulation may, in fact, produce economic inefficiencies. But even if economic efficiency, judicial economy, and reducing the cost of regulation are important objectives, are they more important than justice? In addition, any economic advantages offered by these bright-line rules may be only transitory, so should we forsake other values for merely temporary gains in efficiency? For these reasons, the current regulatory structure may prove more predictable, more efficient, and more useful than the bright-line rules proposed by the advocates of selective deregulation.

C. The Dangers of Permitting Waiver

Legislators enacted the securities laws to protect the rights of investors.[290] Should investors be permitted to bargain away these statutory protections? Should parties be free to waive their rights and contract out of this statutory scheme? Advocates of selective securities law deregulation contend that participants in certain business ventures should be permitted to choose whether to be covered by the securities laws.[291] Under the reform initiatives, parties would be free to waive the protections of the securities laws through choice of entity or by private agreement.[292] In defense of these measures, the

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289. Carol Rose observed, "A strong element of moral judgment runs through the cases in which mud [standards] supersedes crystal [rules]." Rose, *supra* note 211, at 597. According to Rose, dramatic or disproportionate loss appears to drive courts to muddy rules with exceptions, equitable second-guessing, and post hoc discretionary judgments. *See id.* at 578-79, 597, 600.

290. *See* REGULATION OF SECURITIES, S. REP. NO. 73-47, at 1 (1933), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS, LEGISLATIVE HISTORY 1933-1982, at 89 (1983) ("The purpose of this bill is to protect the investing public and honest business."); *see also supra* Part IV.A.1.a (discussing purposes of securities laws).

291. *See, e.g.*, McGinty, *supra* note 2, at 371, 423.

292. *See, e.g.*, Ribstein, *Form and Substance*, *supra* note 2, at 812.

proponents of private ordering cite core conservative principles, such as freedom of contract, individualism, and self-reliance. They also stress policy considerations, such as the need to respect private preferences, protect individual autonomy, facilitate private contracting, promote economic freedom, reduce regulatory costs, and increase productivity, efficiency, and profitability.

The advocates of selective deregulation, however, fail to adequately appreciate the extent to which their proposals conflict with the underlying tenets of the securities laws. Adoption of reform initiatives that permit waiver of securities law coverage would require not only repeal or modification of the securities laws' antiwaiver provisions, but also a rejection of the legislative policies embodied in the securities laws as they are currently written. The proponents of selective deregulation are asking us to abandon long-standing policies favoring investor protection to adopt reforms that are premised on myths, not reality. The reform initiatives would result in the adoption of industry-protective waiver terms that individual investors would have little or no power to change, thereby actually reducing competition. The reform initiatives also would encourage securities-industry professionals to lure investors into Faustian bargains at a time when they lack both bargaining power and knowledge. Neither the market nor disclosure statements would protect investors adequately. In the end, the reform initiatives would only generate more litigation on new issues: whether waivers under such circumstances can be knowing, voluntary, and intentional.

1. Legislative Policy Argues Against Allowing Waiver

Legislators feared that sellers might attempt to maneuver buyers into waiving their rights under the securities laws. To prevent overreaching and to counter the often superior bargaining power of sellers, lawmakers included explicit antiwaiver provisions in the securities laws.[293] These provisions prohibit individuals from waiving their statutory rights. Both federal and state securities laws void any condition, stipulation, or agreement that waives compliance with the securities laws, thereby making any agreement to waive the substantive protections of the securities laws unenforceable.[294] The antiwaiver statutes demonstrate that legislators considered the protection of investors to be of paramount importance.[295] Enactment of the antiwaiver

293. *See* Wilko v. Swan, 346 U.S. 427, 432, 435, 438 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989); *see also supra* Part IV.A.1.c. (discussing antiwaiver provisions).

294. *See supra* note 120 (providing text of statutory antiwaiver provisions).

295. *See* Darrell Hall, Note, *No Way Out: An Argument Against Permitting Parties to Opt Out of U.S. Securities Laws in International Transactions*, 97 COLUM. L. REV. 57, 61 (1997).

provisions also indicates that lawmakers already have considered whether investor protection should take precedence over contractual freedom. The inclusion of antiwaiver provisions in the securities laws provides compelling evidence that legislators determined that investor protection was their primary concern and the public policies reflected in these laws should not be thwarted by private agreements.[296]

Any agreement to opt out of the securities laws clearly violates the antiwaiver provisions. Such an agreement would constitute an impermissible waiver of substantive rights that would serve to thwart legislative intent. Adoption of the reform initiatives, therefore, would require not only the repeal, modification, or preemption of state and federal antiwaiver provisions, but a change in legislative policy as well.

Reform initiatives that would permit opting out of securities regulation either by choice of entity or by private agreement unquestionably conflict with the antiwaiver provisions.[297] The opting-out initiatives certainly are contrary

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This conclusion is bolstered by the legislative history of the federal securities laws. For example, the Senate Report stated in no uncertain terms that investor protection was of primary concern:

> The aim [of the Securities Act] is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

REGULATION OF SECURITIES, S. REP. NO. 73-47, at 1 (1933), *reprinted in* I FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS, LEGISLATIVE HISTORY 1933-1982, at 89 (1983).

296. *See* Roby v. Corporation of Lloyd's, 996 F.2d 1353, 1364 (2d Cir. 1993).

297. In his articles, Ribstein urged courts to adopt what he called an "intermediate private ordering" approach. *See* Ribstein, *Form and Substance, supra* note 2, at 812. Under this approach, courts would construe the term "security" so as to permit private ordering by characterizing general partnership interests and limited liability company interests as nonsecurities. *See id.* at 810; Ribstein, *Private Ordering, supra* note 2, at 26, 42. Ribstein argued that opting out of securities law coverage by choice of entity, therefore, avoids the statutory prohibitions against waiver. *See* Ribstein, *Form and Substance, supra* note 2, at 812.

Ribstein basically proposed that choice of entity constitutes an election of securities law coverage tantamount to a contractual waiver. Ribstein in essence urged a form of judicial activism to exclude certain types of business associations from securities law coverage. But any attempt to develop bright-line rules, such as the *per se* exclusion of certain types of business transactions from securities law coverage, or to move away from the case-by-case analysis dictated by the *Howey* investment contract test would conflict with precedent, violate the antiwaiver provisions by seeking to do indirectly what could not be done directly, and thwart legislative intent. As McGinty noted, the case law does not support permitting investors to to legislative intent as it is embodied in the existing securities laws. Moreover, they run counter to legislative policy that favors investor protection over contractual freedom. Adoption of the opting-out initiatives would constitute more than a dramatic shift in legislative policies – it would constitute a complete reversal in legislative judgment. It would require legislators to renounce long-standing policies that favor investor protection to adopt a regime premised on the principle of *caveat emptor*.[298] Such reforms not only would undermine investor protection but could well lead to investor exploitation. The advocates of selective deregulation fail to adequately appreciate the extent to which their proposals conflict with the fundamental policies that underlie the securities laws. As legislators astutely recognized by adopting the antiwaiver provisions, the standards of fair play that the securities laws establish must be mandatory and applicable to all if the laws' goals of protecting the investing public and safeguarding the integrity of the market are to be accomplished.

2. *Economic Freedom and Contractual Freedom Are Myths*

The arguments favoring waiver of securities law coverage are premised largely on myths. The proponents of private ordering employ myths and imagery to make their case for allowing contractual waiver of securities law coverage.[299] They seduce us with catch phrases such as "freedom of contract."

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waive the protections of the securities laws through choice of entity. *See* McGinty, *supra* note 2, at 420-21. McGinty observed that "the presumption concerning coverage runs only in one direction: if one purchases an interest in stock, one thereby obtains securities law protections, whether one wants them or not." *Id.* at 420. With respect to waiver, McGinty noted that "[i]n the other direction, recent legal trends have reduced the credibility of the proposition that by choosing a certain form of investment, one can waive securities coverage." *Id.* at 421. Additionally, statutory authority and the case law with respect to waiver clearly prohibit any measures designed to allow parties to waive the substantive protections of the securities laws through private agreement. *See* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 481-82 (1989) (drawing clear distinction between waiver of substantive and procedural provisions).

298. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("A fundamental purpose, common to [the securities laws], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . . .").

299. In his book *Philosophical Investigations*, Ludwig Wittgenstein wrote, "A *picture* held us captive. And we could not get outside it, for it lay in our language and language seemed to repeat it to us inexorably." LUDWIG WITTGENSTEIN, PHILOSOPHICAL INVESTIGATIONS ¶ 115 (3d ed. 1968). Wittgenstein also observed, "Philosophy is a battle against the bewitchment of our intelligence by means of language." *Id.* at ¶ 109.

The proponents of selective deregulation hope to bewitch us with language and capture us with their pictures. The language they use has tremendous emotional and psychological appeal. For example, commentators have noted that the phrase "freedom of contract" seems to capture our collective imagination and hold us captive, even though it has little to do with

They draw us in with references to free markets, individual autonomy, and self-reliance. They capture our imagination with their utopian vision of perfectly competitive markets composed of fully-informed, autonomous actors freely making utility-maximizing choices. They produce emotional, almost visceral, reactions by making powerful appeals to deeply ingrained American values, such as the need to respect private preferences, the importance of freedom of choice, and our long history of promoting economic freedom. They paint a vivid picture that captures our imagination, but the picture does not reflect reality.

a. The Myth of Economic Freedom

Those who advocate permitting parties to opt out of securities law coverage are asking us to embrace their romantic vision of unregulated markets and to welcome the reform initiatives as a first step on our return to a system of *laissez faire*. The notion of *laissez faire*, however, is a myth.[300] No market can exist without legal rules.[301] As Cass Sunstein observed, markets "are not a product of nature. On the contrary, markets are legally constructed instruments, created by human beings hoping to produce a successful system of social ordering. . . . Markets are (a particular form of) government intervention."[302] Without the law of property, there would be no private property rights. Without the law of contract, there would be no freedom to contract.[303] Markets depend on government regulation. The market left to its own devices will produce harmful, inefficient, unjust, and sometimes even disastrous results.[304] Legislative controls, such as the securities laws, are necessary to prevent exploitation, to discourage unfair dealings, and to correct market failures.[305] The law's coercive force creates orderly markets, which in turn facilitates individual transactions. To argue that deregulation is somehow a return to a natural state is more than misleading.

The securities laws were enacted to restore order, to foster fair play, and to insure the integrity of the financial markets.[306] The widespread fraud,

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reality. *See* Karl Johnson, *Commercial Law*, 13 N.M. L. REV. 293, 293 (1983); Mooney, *supra* note 24, at 1134-35, 1187.

300. *See* CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 5 (1997).

301. *See id.*

302. *Id.* at 384.

303. *See id.* at 5.

304. *See id.* at 271; *see also* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 7 (1993) (cataloguing conventional forms of market failure, such as monopoly, externalities, and informational failures, which author discussed in greater detail in later chapters).

305. *See* SUNSTEIN, *supra* note 300, at 282.

306. *See supra* Part IV.A.1.a.

manipulation, and victimization of investors during the 1930s demonstrated that some form of market regulation was needed to protect investors from the predatory behavior of securities-industry professionals.[307] Congress recognized that individual investors were at a distinct disadvantage in dealing with securities-industry professionals who possessed greater knowledge, experience, information, and economic power.[308] Congress hoped to level the playing field by prohibiting fraudulent practices and by requiring full disclosure.[309] The securities laws were intended to safeguard investors from overreaching by industry professionals who held inherently superior bargaining positions.[310]

b. The Myth of Contractual Freedom

Now, in the name of contractual freedom, the advocates of deregulation wish to permit parties to waive coverage of the securities laws. They want to allow investors to bargain away their substantive protections. Given the gross inequality in bargaining power, knowledge, and interest between buyers and sellers of securities, without regulation, buyers would be at the mercy of sellers. Freedom of contract in an unregulated securities market is a naive myth.[311] The classical ideal of "freedom of contract" depends entirely on an obviously unrealistic model of contract formation where all transactions are negotiated by sophisticated, fully-informed parties of equal bargaining power, capable of protecting their own self interests and of arriving at mutually beneficial agreements that will maximize utility for both parties. It is premised on the notion that contractual obligations are freely and voluntarily assumed through the course of negotiations. Unfortunately, this model and its underlying assumptions do not reflect reality.[312]

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307. *See, e.g.*, STOCK EXCHANGE PRACTICES, S. REP. NO. 73-1455, at 1 (1934), *reprinted in* II FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS, LEGISLATIVE HISTORY 1933-1982, at 1257 (1983).

308. *See* Wilko v. Swan, 346 U.S. 427, 435 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

309. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 251 (1987) (Blackmun, J., dissenting).

310. *See id.* at 253 n.9 (Blackmun, J., dissenting).

311. Betty Mensch wrote, "Freedom of contract has been conclusively labelled a naive myth, but the forms of that mythology still bind." Betty Mensch, *Freedom of Contract as Ideology*, 33 STAN. L. REV. 753, 754 (1981) (book review). Mensch noted that "the supposed freedom of the past was false, both in theory and in social practice. . . . [T]he resurrection of old myths will not make the modern problem go away." *Id.* at 768.

312. Commentators such as Karl Johnson go so far as to say, "'Freedom of Contract' is nonsense and an utter fiction . . . ." Johnson, *supra* note 299, at 293.

Reform Initiatives Would Result in Industry-Protective Terms. If the reform initiatives are adopted, securities-industry professionals and savvy industry counsel quickly would realize the benefits that issuers, promoters, and dealers would reap if investors waived securities law coverage. Issuers and their attorneys, when feasible, would structure their transactions so as to avoid securities regulation.[313] If parties are permitted to opt out of securities regulation by private agreement, waiver provisions would become standard terms in investment contracts. If parties are permitted to opt out by choice of entity, entities exempt from securities law coverage would become the organizational forms of choice.

Even in highly competitive markets, standard terms tend to expand within and across industries.[314] Companies adopt form contracts with standard terms to reduce the costs of contract formation, to minimize uncertainty and liability, to obtain a strategic advantage in the bargaining process, and to control the relationship.[315] In an effort to protect their client's interests, attorneys tend to draft up to the limits permitted by law.[316] Over time, more and more risks are shifted to the purchaser, and the forms accumulate these seller-protective provisions.[317] Eventually, competitors in an industry begin to offer the same terms, which then become an industry standard.[318] As waiver provisions

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313. *See supra* note 235.

314. *See* David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 36. In his article, Schwartz traced the increased use of pre-dispute arbitration clauses that have found their way into standard form contracts in the securities, health care, insurance, banking, and finance industries. *See generally id.* These clauses also are appearing more frequently in employment contracts. *See id.* at 53-54.

315. *See* Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1227 (1983); Schwartz, *supra* note 314, at 57.

316. *See* Rakoff, *supra* note 315, at 1205 ("[T]he professional draftman's goal is to protect his client as fully as possible.... [T]he temptation, and indeed the art, is to draft up to the limit allowed by law ...."); Schwartz, *supra* note 314, at 58 ("[T]he drafter of legal documents, motivated to protect (even overprotect) his client's interests, inevitably tends to 'draft up to the limit allowed by law'....").

317. Karl Llewellyn observed in the 1930s that, even in highly competitive markets, standardized contracts resulted in the "accumulation of seller-protective instead of customer-protective clauses." Karl N. Llewellyn, *What Price Contract? – An Essay in Perspective*, 40 YALE L.J. 704, 734 (1931).

318. Although customers do sometimes shop terms, Todd Rakoff noted that the terms customers shop for are determined "largely by immediacy of impact (cash or credit), by ease of comparability (size of down payment), and, to a certain extent, by the customs and practices of the trade (warranty terms in some industries at some times)." Rakoff, *supra* note 315, at 1226. Consequently, firms tend to compete on terms that capture the customer's attention, such as price, rather than on nonfinancial terms. *See id.* at 1227. Moreover, if all firms in the market impose the same nonfinancial terms, shopping becomes impossible.

become commonplace or as the industry begins to favor certain organizational forms, individual investors will find themselves unable to negotiate for different terms, such as securities law coverage.

Individual Investors Have Little or No Power to Alter Such Terms.[319] Investment terms often are presented on a take-it-or-leave-it basis. An individual investor, more often than not, lacks the economic power to individually alter the terms of the offer. Many investors, in fact, may not even focus on certain nonfinancial terms in the subscription agreement or formation documents until it is time to actually sign the forms. Realizing that they have little or no power to separately negotiate new terms, investors often fail to read the forms they sign. Usually the investor is not represented by counsel and therefore may not fully understand the legal significance of what he is signing.[320] Even if the investor reads and understands the terms, attempts to change provisions typically will be met with resistance, including responses such as the terms are dictated by counsel, the clause is an industry standard, we cannot make an exception for one investor, or we do not have the authority to change the terms.

For investors presented with form contracts, freedom of contract is more myth than reality. If terms are offered on a take-it-or-leave-it basis, it is difficult to characterize the obligations as voluntarily assumed or to defend the act as an expression of individual autonomy.[321] No one's freedom is enhanced by allowing one party to dictate terms to another, especially when the terms foisted upon the weaker party result in the waiver of important substantive rights.[322]

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319. The implications and inevitable consequences that flow from the use of standard form contracts is examined in numerous law review articles, most notably in seminal articles such as Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943), and Rakoff, *supra* note 315. *See* Johnson, *supra* note 299, at 293-94, 300-03 (discussing effect of standardized forms on contracting process); Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 515-30 (1991) (modeling mortgagor-mortgagee interaction and discussing effect of standard forms on these transactions); Schwartz, *supra* note 314, at 55-60 (discussing factors that have led to proliferation of pre-dispute arbitration clauses in standard form contracts).

320. Karl Johnson colorfully described these standard form agreements as "nothing but mysterious incantations to the uninitiated . . . which even if understood render the effort to understand a cruel and futile exercise, for the terms they contain are fixed and unalterable." Johnson, *supra* note 299, at 293.

321. Michael Trebilcock wrote, "[T]o hold parties bound to standard form contracts which they had entered into but which they had not read or understood does not rest comfortably with a theory of contractual obligation premised on individual autonomy and consent. Clearly, in many, perhaps most cases, meaningful consent is absent." TREBILCOCK, *supra* note 304, at 119.

322. *See* Rakoff, *supra* note 315, at 1235-38 (concluding that "enforcing boilerplate terms trenches on the freedom of the adhering party").

Waiver Constitutes a Faustian Bargain That Should Not Be Enforced. The reform initiatives would encourage securities-industry professionals to lure investors into Faustian bargains. Like Faust who entered into a contract with the Devil well in advance of its unfortunate consequences, the reform initiatives would allow investors to strike a bargain with the Devil at a time when the investor cannot adequately appreciate the significance of the act.[323] The reform initiatives would invite securities-industry professionals to take advantage of investors at a time when they are at a substantial disadvantage due to disparities in bargaining power, knowledge, information, and experience.[324]

Under the proposed reform initiatives, investors could be asked to waive securities law coverage at the time of investment. The reform initiatives, therefore, allow an individual to *prospectively* waive his right to recover for future harm, before any problems or disputes arise.[325] Investors could be asked to waive their rights during this honeymoon period when the venture looks extremely profitable and the possibility of a dispute appears remote.[326] In fact, most investors would not even consider making an investment if the possibility of a dispute appeared likely.[327] Many, if not most, investors will not understand fully the effect of the waiver.[328] Most investors have had little or no experience with the types of disputes that give rise to securities law claims. Consequently, investors tend to be relatively uninformed about the

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323. *Cf.* Schwarcz, *supra* note 4, at 593-94 (drawing analogy between Faust's bargain with Devil and waiver provisions included in initial loan agreements).

324. *Cf.* Schwartz, *supra* note 314, at 114 (discussing disparities in bargaining power and information in context of pre-dispute arbitration agreements).

325. *Cf. id.* at 39, 110-21 (arguing that pre-dispute arbitration clauses constitute prospective waivers of substantive rights).

326. In addition, securities-industry professionals are likely to persuade investors that by opting out of the securities laws and related disclosure requirements the enterprise will save unnecessary expenses and thereby increase potential profits.

327. Moreover, long-term business relationships require a measure of trust and confidence. Drawing attention to possible risks and focusing on the negative, such as exploring the possibility of fraud, could trigger emotional reactions and as practitioners say "queer the deal." *See* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1677 (1989); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1555 (1982); Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193, 224 (1988).

328. Some investors may not even be aware that they have waived their right to securities law coverage. For example, investors who purchase securities in the secondary market may be bound to waiver terms agreed to by the initial investors. Investors purchasing securities in the secondary market, therefore, may not know that the securities laws do not apply. Consequently, such purchasers may not discount the price of the security to reflect waiver. *See* Ribstein, *Private Ordering, supra* note 2, at 27.

likelihood or degree of future harm or the kinds of claims that they are waiving.[329] Individual investors generally are not represented by counsel, unless the individual is making a fairly substantial investment. Also, an individual investor is unlikely to take the time or incur the expense to research the implications of a waiver provision. Obtaining such information in many cases may not be cost-effective or even reasonable.[330] It is unrealistic to expect an investor who lacks experience, legal advice, and information to fully appreciate the consequences of waiving his statutory right to the protections provided under the securities laws. On the other hand, securities-industry professionals will seek prospective waivers because they have had past experiences with securities law claims and are well aware that disputes arise.[331] Securities-industry professionals generally employ legal counsel to advise them and it is their lawyers who understand the effect of such waivers and therefore will recommend obtaining waivers from investors.

An individual's ability to assess the risks and costs associated with waiver is complicated further by multiple perceptual distortions that lead to judgment errors.[332] Behavioral research indicates that people discount the importance of future events – particularly events far in the future.[333] An investor is likely to discount even further the significance of a waiver in offering documents. Not only will the consequences occur in the future, but the need for securities law coverage is uncertain. Studies also demonstrate that human beings fail to accurately estimate the likelihood of low probability,

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329. Frank Easterbrook and Daniel Fischel observed, "When a person is confronted with a problem or risk for the first (or only) time in his life, the chance of error is greatest. Choices that are made repeatedly and tested against experience are more likely to be accurate . . . ." Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1434 (1989).

330. *See* Schill, *supra* note 319, at 526 ("Gathering sufficient data to make reasonably accurate estimates of relatively rare events is both costly and time-consuming.").

331. *Cf.* Paul D. Carrington, *Regulating Dispute Resolution Provisions in Adhesion Contracts*, 35 HARV. J. ON LEGIS. 225, 226 (1998) (arguing that dispute resolution clauses are more valuable to "repeat players" who know from experience that disputes will ensue).

332. Easterbrook and Fischel have stated, "Sometimes people's perceptual apparatuses do not work well. They underestimate the chance that certain risks (floods, earthquakes, failures of the products they buy) will come to pass and as a result may not choose rationally when confronted with choices about such risks . . . ." Easterbrook & Fischel, *supra* note 329, at 1434.

333. *See* Schwarcz, *supra* note 4, at 594; *see also* Coffee, *supra* note 327, at 1676 ("[I]ndividuals systematically underestimate future risk . . . [and] tend to discount excessively the risk of future exploitation."); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1542 (1998) ("[B]ehavioral research shows that people's judgments about their future experience at the time of decision can be mistaken . . . ."); Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1184-86 ("People's judgments about their experience at the time of decision can be mistaken; they may have a hard time assessing what the experience will actually be like.").

high loss events,[334] such as securities fraud. In addition, human beings tend to be unrealistically optimistic and overconfident about their own judgment.[335] They overestimate their prospects for success and underestimate their prospects for failure.[336] These perceptual distortions result in people incorrectly believing that bad events are less likely to happen to them than to others.[337] They falsely believe in their own immunity from harm. These self-serving biases causes people to underestimate the probability of loss and thus undervalue the rights forfeited. The reform initiatives would permit securities-industry professionals to take advantage of these disparities in bargaining power, knowledge, information, and experience, and to use cognitive distortions to solicit waivers at a time when an investor is most vulnerable. Rather than encouraging these Faustian bargains, we should be protecting investors from such predatory conduct.

3. *Neither the Market Nor Legends Will Adequately Protect Investors*

Advocates of private ordering argue that investors are protected by an efficient market. They contend that as long as there are informed investors, the market will discount the price of the security to reflect the absence of securities law protections, thereby protecting the uninformed investor.[338] This theory assumes that there is an efficient market, meaning knowledgeable and sophisticated investors with perfect information actively trading in the security.[339] Not all securities are actively traded. Relatively few firms are followed by securities analysts and widely traded. Most businesses are small.

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334. *See* Schill, *supra* note 319, at 525 & n.120 (citing numerous authority discussing people's tendencies to ignore or discount low probability, high loss events when purchasing insurance).

335. *See* Jolls et al., *supra* note 333, at 1524, 1537; Sunstein, *supra* note 333, at 1182.

336. *See* Schill, *supra* note 319, at 528 & nn.129-30 (discussing these perceptual distortions in context of defaults on mortgage loans).

337. *See* Jolls et al., *supra* note 333, at 1524, 1541; Sunstein, *supra* note 333, at 1178, 1183.

338. *See, e.g.*, Ribstein, *Form and Substance*, *supra* note 2, at 828; Ribstein, *Private Ordering*, *supra* note 2, at 27-28.

339. This also assumes that knowledgeable and sophisticated investors can accurately price the risks and costs associated with waiving all future disclosure rights and all potential securities law claims with respect to a venture for the indeterminate future. But accurate pricing is only feasible if parties understand what rights are being waived. Pricing necessarily will be inaccurate in the context of a long-term, open-ended relationship in which the firm is seeking blanket approval in advance for future transactions. For example, investors may trust current management in the current business environment, but they cannot reasonably predict the actions of future management under possibly different business conditions in the indeterminate future. *See* Coffee, *supra* note 327, at 1667-71.

Their securities are closely held and are not traded in an active market. There are many small offerings and private offerings. The securities of such firms are not priced by knowledgeable and sophisticated investors, such as underwriters, institutional investors, or promoters who have been engaged in numerous transactions. The price may not even represent the consensus of many investors, let alone informed investors. As a result, the price of these securities may not be discounted to reflect the cost of waiver. The market will not protect investors who purchase securities that are thinly traded, rarely traded, or never traded in an active market. Nor will the market protect investors who purchase securities that are not priced by sophisticated and knowledgeable investors. The market, therefore, will not protect a vast number of investors.

Proponents of selective deregulation believe that disparities in bargaining power, knowledge, information, and experience can be rectified by giving clear notice to investors that the interests they are purchasing are not protected by the securities laws.[340] Commentators have suggested, among other things, that such notice be written in an entity's formation documents and on each certificate evidencing an interest.[341] They also have suggested that the Securities and Exchange Commission (SEC) could promulgate regulations dictating minimum disclosure requirements.[342] Other commentators have suggested requiring waiver terms in the offering documents to be clearly and conspicuously highlighted in bold or all capital letters.[343]

Mandated disclosures will not solve the problems related to disparities in bargaining power, knowledge, information, and experience. Generic consumer disclosures have proven less than effective.[344] It is difficult to craft concise and understandable disclosure statements setting forth generic risks that capture the reader's attention.[345] We have all, at one time or another, disregarded or discounted generic warnings about risks. How many hundreds of times have you failed to read legends and boilerplate language printed in

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340. *See* McGinty, *supra* note 2, at 437 ("Giving clear notice to investors, this regime would allow both [the issuer] and investors to reach a more voluntary equilibrium over how much disclosure and securities regulation they wanted.").

341. *See id.*

342. *See id.*

343. *See* Ribstein, *Private Ordering*, *supra* note 2, at 31.

344. *See, e.g.*, *Re-Examining Truth in Lending: Do Borrowers Actually Use Consumer Disclosures?*, 52 CONSUMER FIN. L.Q. REP. 3 (Winter 1998).

345. *See* Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1459 (1983) ("Decisionmakers face substantial practical problems in correctly ascertaining the odds, developing concise and comprehensible formats for disclosure, and conveying the essential facts in such a way that consumers will pay attention to them.").

bold on products and in documents? Why would boilerplate disclosure statements about the risk of waiver prove any more effective?

Even if we provide investors with adequate information about the risk of waiver, investors still may not appreciate or be capable of accurately evaluating the risk. The problem is not just one of insufficient information; the problem is people's inability to process such information and to assess one's own risk.[346] For example, consumers have been bombarded with information about the dangers of smoking, yet people continue to smoke because they fail to appreciate the dangers they themselves face from smoking.[347] Even factually informed people tend to minimize risks, believing that risks are less likely to materialize for them than for others.[348] Self-serving biases, excessive confidence in one's own judgment, and overoptimism undermine the efficacy of generic disclosure statements and warning legends.[349] Consequently, efforts to educate may not be able to counteract these strong and pervasive cognitive and motivational distortions.

Moreover, if the investor has no bargaining power, what will be gained by education? David Schwartz noted that we could require individuals to attend an all-day seminar on the legal implications of waiver provisions.[350] However, if the individual does not have the opportunity to bargain or shop for terms, he has no choice but to consent to the waiver provision. The market failure caused by lack of bargaining power, imperfect information, inadequate knowledge, and inexperience cannot be corrected with generic warning labels and legends. Important substantive rights are at stake. Investors will not be asked simply to waive a single benefit; investors will be asked to waive all rights and benefits provided by the securities laws. Are we willing to permit individuals to contract out of a statutory scheme designed to protect their rights when we know that such waivers may be neither knowing nor voluntary?

4. *Waivers Will Only Generate More Litigation*

Permitting parties to waive coverage of the securities laws will only generate more litigation. It is ironic that the advocates of selective deregulation, who criticize the costly and time-consuming litigation spawned by the current regulatory regime, urge adoption of reform measures that will undoubtedly produce even more lawsuits. The advocates of selective deregula-

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346. *See* Jolls et al., *supra* note 333, at 1542; *cf.* Schill, *supra* note 319, at 531-32 & n.141 (discussing problem of cognitive distortions in context of inability of mortgagors to estimate their own probability of default).

347. *See* Jolls et al., *supra* note 333, at 1542.

348. *See* Sunstein, *supra* note 333, at 1184.

349. *See* Schill, *supra* note 319, at 531-32 & n.141.

350. *See* Schwartz, *supra* note 314, at 131.

tion criticize the current regulatory structure for requiring expensive, time-consuming, fact-based, case-by-case analysis, and they object to the uncertainty that such an approach creates.[351] But reform measures that allow parties to waive their legal rights are likely to generate even more time-consuming, fact-based, case-by-case litigation. The reform measures they propose will simply create a new playing field for additional litigation.

In a case involving the alleged waiver of federal securities laws claims, the United States Court of Appeals for the Ninth Circuit defined waiver as "'the voluntary or intentional relinquishment of a known right. It emphasizes the mental attitude of the actor.' Since waiver is a voluntary act, there must be knowledge of the right in question before the act of relinquishment can occur."[352] The court then went on to say that the "waiver of rights under the [securities laws] should be limited to those cases where it is intended, and that therefore the right in question must be found to be actually known before waiver becomes effective."[353] Thus, according to the Ninth Circuit, a waiver of securities law claims must be knowing, voluntary, and intentional.[354]

If the reform initiatives are adopted, we can look forward to a raft of litigation concerning what constitutes a knowing, voluntary, and intentional waiver of securities law coverage. In this and in other contexts, courts have not been consistent in their holdings as to what facts are sufficient to support a finding of waiver.[355] For example, courts have differed as to what constitutes knowledge of a right.[356] Is it enough for the issuer simply to give the investor notice that he is waiving his rights, or does the issuer have to explain to the investor the rights that the investor is waiving? Must the issuer explicitly and painstakingly describe the rights that the investor is sacrificing? Must

351. *See* McGinty, *supra* note 2, at 374-75, 423, 434-36; Ribstein, *Form and Substance*, *supra* note 2, at 808-11, 824-25.

352. Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964).

353. *Id.*

354. Both federal and state securities laws void any agreement to prospectively waive compliance with the securities laws. *See supra* note 120 and accompanying text. Courts, however, have found that the prohibition against waiver does not preclude the waiver of claims in connection with settlement agreements, provided that the party has knowledge of the claims released. *See, e.g.*, Petro-Ventures, Inc. v. Takessian, 967 F.2d 1337, 1343 (9th Cir. 1992); Murtagh v. University Computing Co., 490 F.2d 810, 816-17 (5th Cir. 1974). The United States Supreme Court also has concluded that pre-dispute arbitration agreements do not violate the antiwaiver provisions. *See* Rodriguez De Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 479-84 (1989); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 238 (1987). The securities law cases involving waiver tend to arise in these contexts.

355. *See Royal Air*, 333 F.2d at 571.

356. Some courts have found that facts sufficient to give a party notice of a potential claim is all that is needed to fulfill the knowledge requirement. Other courts have found that actual knowledge of a right is a prerequisite to waiver. *See id*; *see also* ARNOLD S. JACOBS, 5D LITIGATION AND PRACTICE UNDER RULE 10B-5 § 237.02 (1994).

the investor actually understand what rights he is waiving? What is required for a voluntary waiver? Is it enough that the investor is given an opportunity to read the agreement, or must the waiver terms be negotiable?

Moreover, courts tend to disfavor waivers of statutory rights.[357] Judicial hostility toward waivers has caused courts scrupulously to investigate whether the relinquishment of the right was knowing, voluntary, and intentional.[358] The suspicious attitude that courts have demonstrated reflects their concern that waivers invite overreaching. Some courts, therefore, have scrutinized agreements purporting to limit a party's legal rights. In determining whether a waiver is knowing and voluntary, courts have looked beyond the contract language and considered the totality of the circumstances.[359] Citing such cases, courts may be asked to consider, among other things, (i) the clarity and specificity of the waiver language; (ii) the investor's education and business experience; (iii) the amount of time that the investor had for deliberation before signing the waiver; (iv) whether the investor knew, or should have known, his rights upon execution of the waiver; (v) whether the investor was encouraged to seek, or in fact received, benefit of counsel; and (vi) whether there was an opportunity to negotiate the terms of the agreement.[360]

Some investors will claim that they did not understand the rights that they were waiving, that crucial information was withheld, or that they were deceived. Other investors may charge that waivers were obtained through fraudulent or collusive actions.[361] Courts and lawmakers undoubtedly will be asked to carve out exceptions. For example, consumer advocates may seek the imposition of some type of suitability standard to protect investors who, because of lack of education, experience, or sophistication, are incapable of protecting themselves.[362] Advocates of private ordering may seek court rulings, rules, or regulations that specify notice, knowledge, and disclosure

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357. *See* Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156, 180 (9th Cir. 1976) (Trask, J., concurring in opinion in part, but dissenting from judgment).

358. *See Murtagh*, 490 F.2d at 816.

359. *See, e.g.*, Torrez v. Public Serv. Co., 908 F.2d 687, 689 (10th Cir. 1990) (deciding whether employee's signing of release at time of his employment termination constituted knowing and voluntary waiver of his right to bring employment discrimination action); Cirillo v. Arco Chem. Co., 862 F.2d 448, 451 (3d Cir. 1988) (deciding whether release signed in exchange for enhanced retirement package constituted valid waiver of statutory rights under Age Discrimination in Employment Act).

360. These factors are drawn from the factors set forth in *Torrez*, 908 F.2d at 689-90, and in *Cirillo*, 862 F.2d at 451.

361. *See, e.g.*, Binstein v. Haven Indus., Inc., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,585, at 94,495 (S.D.N.Y. 1978); Rosen v. Dick, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,786, at 96,604 (S.D.N.Y. 1974).

362. *See* Ribstein, *Private Ordering*, *supra* note 2, at 31-32 (suggesting that suitability standard, similar to accredited investor standard, may represent appropriate compromise).

requirements that would detail what the issuer must state to constitute an enforceable waiver. If the court opinions on waiver to date are any indication, courts will fail to agree on one uniform standard.[363] These issues will provide fodder for the courts and take years to resolve. For these reasons, the reform initiatives will merely spawn new rounds of litigation on new issues. The reform initiatives will not reduce litigation; the reform initiatives will increase litigation.

V. Shifting Preferences and a Call for Balance

Thomas McGarity observed that history may be "viewed as a cycle of reform, resistance, and reaction – swinging like a pendulum, but like a pendulum attached at its apex to a point that is itself lurching forward and backward."[364] America historically has alternated between public-oriented and private-ordering regimes.[365] The economist Albert O. Hirschman demonstrated that reliance on either regime generates disappointment and a desire for change that results in shifting preferences.[366]

While legal commentators have convincingly attacked the existence of a clear public/private distinction,[367] the continuing calls for deregulation and privatization evidence an underlying shift in our legal and political culture.

363. *See* Miriam A. Cherry, Note, *Not-So-Arbitrary Arbitration: Using Title VII Disparate Impact Analysis to Invalidate Employment Contracts That Discriminate*, 21 HARV. WOMEN'S L.J. 267, 291-98 (1998) (describing various standards courts have applied in numerous contexts to determine if waiver is knowing and voluntary).

364. McGarity, *supra* note 36, at 1471-72.

365. *See* ALBERT O. HIRSCHMAN, SHIFTING INVOLVEMENTS: PRIVATE INTEREST AND PUBLIC ACTION 132 (1982). Hirschman observed that "a fairly regular alternation between liberalism and conservatism – with each phase lasting from 15 to 20 years – was found to have been a distinctive *and* positive characteristic of American politics since Independence." *Id.*

366. *See id.* at 10-11. Hirschman observed that "acts of consumption, as well as acts of participation in public affairs, which are undertaken because they are expected to yield satisfaction, also yield disappointment and dissatisfaction. . . . [A]ny pattern of consumption or of time use carries within itself, to use the hallowed metaphor, 'the seeds of its own destruction.'" *Id.* at 10.

367. *See generally* Symposium, *The Public/Private Distinction*, 130 U. PA. L. REV. 1289 (1982). Legal commentators have attacked the public/private dichotomy, arguing that all contract rights and property-based rights are themselves the product of state action and public choice. As a result, there is no clear distinction between public and private acts. *See* Duncan Kennedy, *The Stages of the Decline of the Public/Private Distinction*, 130 U. PA. L. REV. 1349, 1351-52 (1982) (describing collapse of public/private distinction). Scholars from the Critical Legal Studies movement contend that not only is the public/private distinction indefensible, but it is an obscuring mechanism through which the state permits individuals to believe their choices are private, when in fact all choices are the product of previous state action. *See* Nancy Ehrenreich, *The Progressive Potential in Privatization*, 73 DENV. U. L. REV. 1235, 1239-40 (1996) (summarizing position of Critical Legal Studies movement).

Reform proposals advocating deregulation reflect public disappointment with government regulation. This public dissatisfaction has resulted in a shifting preference for private-ordering and market-oriented approaches.

Admittedly, securities regulation may have gone too far in attempting to protect investors by imposing complicated, costly, and sometimes burdensome regulations to achieve its objectives. In some situations, the costs may have exceeded the benefits. The answer, however, is not deregulation. Reforms short of selective deregulation could restore the balance and address concerns. Congress[368] and the SEC[369] have begun to deal with these concerns by adopt-

368. Renewed congressional interest in securities regulation is evidenced by the recent passage of two major pieces of securities legislation. The National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C.), was intended to redraw the boundaries between federal and state regulation of the securities industry by preempting state regulation of the mutual fund industry, limiting state oversight of investment advisory firms, and reducing the role of the states in regulating the primary offerings of larger corporations. *See, e.g., Annual Review of Federal Securities Regulation*, 52 BUS. LAW. 759, 760-64 (1997); Robert G. Bagnall & Kimble Cannon, *The National Securities Markets Improvement Act of 1996: Summary and Discussion*, 25 SEC. REG. L.J. 3 (1997).

Congress also adopted the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.). The stated goal of this legislation was to redress perceived abuses in connection with shareholder litigation under section 10(b) of the Exchange Act and the regulations promulgated thereunder. *See* H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31. The legislation effected both substantive and procedural changes in the federal securities laws. *See, e.g.*, John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996); Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71, 81-88 (1997); *Symposium on the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 975 (1996).

369. *See, e.g.*, Brian M. McNamara & Robert A. Barron, *Quarterly Survey of SEC Rulemaking and Major Appellate Decisions*, 26 SEC. REG. L.J. 234, 239-40 (1998) (SEC adopted so-called "Plain English Rules" to give issuers guidance on to how make disclosure documents clear, concise, and understandable); Brian M. McNamara & Robert A. Barron, *Quarterly Survey of SEC Rulemaking and Major Appellate Decisions*, 25 SEC. REG. L.J. 450, 455-457 (1998) (SEC eliminated forty-four rules and four forms and amended other rules and forms to simplify offering requirements); Robert A. Barron, *Control and Restricted Securities*, 25 SEC. REG. L.J. 210, 210-12 (1997) (SEC adopted amendments to reduce holding period for restricted securities under Rule 144, which should result in more venture capital funds for start-up companies and other private businesses); Brian M. McNamara & Robert A. Barron. *Quarterly Survey of SEC Rulemaking and Major Appellate Decisions*, 25 SEC. REG. L.J. 108, 110-14 (1997) (SEC revised its rules to streamline financial statement reporting requirements for acquired and to-be-acquired businesses); *Small Businesses: SEC Adopts Small Offering Exemption Corresponding to California Exemption*, 28 Sec. Reg. & L. Rep. (BNA) No. 19, at 606 (May 10, 1996) (SEC adopted Rule 1001, which is new exemption from federal registration requirements intended to assist small businesses in raising capital); *Small Businesses: SEC Raises Total Assets Threshold Triggering '34 Act Registration, Reporting*, 28 Sec. Reg. & L.

ing reform measures to reduce costs and regulatory burdens. Additional initiatives are under review.[370]

Moreover, public dissatisfaction with current regulatory programs and a preference for market-oriented solutions do not mean that the market itself, left to its own devices, will provide the optimum solution. The answer is not to swing the pendulum back and adopt reactionary reform proposals, such as selective deregulation, that would result in a return to the business-oriented, *laissez-faire* principles that dominated this country during the late nineteenth century. Rather than blindly surrendering to this reactionary cycle, we must examine the source of dissatisfaction, evaluate the various regulatory reform proposals in light of the values to be served by regulation, and search for a solution that strikes a reasonable balance between the extremes.[371]

Rep. (BNA) No. 19, at 606 (May 10, 1996) (in change aimed at easing regulatory burdens on small businesses, SEC raised threshold amount of assets company must have before it is required to report under Exchange Act).

370. The SEC is considering a number of new initiatives designed to make substantial changes in the regulation of the securities industry, including a number of initiatives to assist small businesses. The agency has advocated the repeal or simplification of a large number of existing regulations and is studying the feasibility of shifting the focus of the Securities Act away from a system of registered offerings and toward a system of company registration. *See generally* Brian J. Lane, *Current Issues and Rulemaking Projects*, ALI-ABA Course of Study, WL SC67 ALI-ABA 249 (June 4, 1998).

371. As Hirschman observed, oscillating back and forth between extremes can be overdone and is unlikely to be constructive. *See* HIRSCHMAN, *supra* note 365, at 132-34.

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