Diversified investors lose more than they gain from securities class actions.

The End of Securities Fraud Class Action?

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ver the last 10 years, nearly 2,400 securities fraud class actions (SFCAs) have been filed against publicly traded companies in the United States. Those actions have resulted in settlements of about \$27 billion and attorney fees of about \$7 billion. More than one in 50

companies is the target of such an action each year. Yet for most investors, the awards confer no economic benefit. Indeed, for conservative buy-and-hold investors—the majority— SFCAs reduce investment returns.

At best, an award from an SFCA is nothing more than an expensive rearrangement of wealth from one pocket to another (minus a cut for the lawyers). Diversified investors are equally likely to sell an overpriced stock as to buy one. For diversified investors, gains and losses wash out. Thus, SFCA awards constitute a transfer of wealth from conservative buy-and-hold investors to stock-picking traders. In addition, SFCAs visit serious collateral damage on defendant companies, ultimately reducing returns for holders. The prospect of payout by the defendant company causes its stock price to fall by more than it otherwise would—even in a perfectly efficient market—and triggers a positive feedback mechanism that has the effect of magnifying the potential payout, sometimes with devastating effects. Indeed, about 30 percent of target companies end up bankrupt.

I argue here that a securities fraud class action should be

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dismissed for failure to state a claim unless it appears that insiders (including the company itself) have captured gains from trading during the fraud period. Only those actions that involve insider trading or the equivalent entail genuine financial harm to the plaintiff class because only those actions involve an extraction of wealth from the public market. If the case does not involve insider extraction of gains, it should be dismissed—no harm, no foul. If the case does involve insider extraction of gains, it should be litigated in the name of the corporation, and the corporation should recover any gain extracted by insiders. Treating a securities fraud action as an action by the corporation (whether it is maintained by the corporation itself or derivatively by a representative stockholder) will make stockholders whole and will avoid the collateral damage to the issuer corporation.

HARRY POTTER AND THE DIVERSIFIED PORTFOLIO

An allegory neatly sums up this situation. Imagine a crowded room in which everyone has \$200 in \$1 bills in his pocket. Dobby, the more-or-less invisible house elf featured in the *Harry Potter* books, flits about the room, randomly picking a single bill from the pocket of one person and inserting it immediately into the pocket of another.

How much would you pay to avoid the risk of ending up a dollar short at the end of the day? Not much. Even though a very speedy house elf might redistribute hundreds of dollars, it is highly unlikely that any individual in the room will end up much worse off at the end of the day. Indeed, as a statistical mat-



ter, the most likely outcome is that one will end up precisely where one starts—with \$200. And it is almost impossible that one would end up more than a couple dollars short or long. Thus, for an individual to pay even a dollar for insurance against mischievous house elves would likely cost more than the harm.

Now suppose that a few folks in the room have two \$100 bills in their pockets instead of two hundred \$1 bills. If Dobby's practice is to lift a single bill at a time from any one individual, an individual with two \$100 bills would likely be worried enough to buy elf insurance because the risk of losing \$100 or even \$200 is much greater.

There is a cheap and easy way to avoid the risk: An individual can protect himself by getting change and holding only singles. Analogously, a diversified investor (one who can lose only a little money from any single fraud) should not be too worried about securities fraud, whereas an undiversified investor (one who can lose half his wealth from a single fraud) should be very worried about it. Indeed, undiversified investors might favor hiring a securities guard (so to speak) with sophisticated elf detection equipment. They might even favor taxing all investors to pay for protection. On the other hand, diversified investors would be opposed to any such tax for the same reason that they would decline to buy elf insurance. They would argue that undiversified investors should simply get change for their big bills and stop worrying.

What if Dobby were to keep every second dollar for himself? Even a diversified investor would worry a bit in such circumstances. If Dobby is fast enough, he could subtract significant wealth from the aggregate in the room. Even a diversified investor would favor some form of protection in such circumstances. But a diversified investor would be willing to pay only for protection in cases in which the elf keeps the money. Protection that extends to mere redistribution among investors remains a waste of money.

As our story about Dobby illustrates, there is an inherent conflict between diversified and undiversified investors. Although undiversified investors may see a need for SFCAs, diversified investors should be opposed to SFCAs as a deadweight loss, except in situations in which an insider has kept some of the money by trading on withheld information.

COSTS WITHOUT BENEFITS

An SFCA typically arises from the failure of a publicly traded company to disclose material information in a timely fashion. The information itself may be either good or bad news. In other words, a securities fraud action may be triggered by good news that causes the price of a stock to rise (in which case, those who sold during the fraud period suffer harm) or bad news that causes the price of a stock to fall (in which case, those who bought during the fraud period suffer harm). There are notable examples of both types of fraud, but bad news fraud is far more common because of the way damages are awarded. Thus, the discussion here is based generally on the premise that securities fraud involves the failure to disclose bad news in a timely way.

In a bad news case, the plaintiff class consists of all who purchased the stock in question after an actionable misrepresentation or omission and who hold the stock until some time after corrective disclosure. The standard approach to damages in a bad news case—somewhat oversimplified for present purposes—is to award the difference between the price paid by the buyer and the market price after corrective disclosure. There are serious problems with this measure of damages. Although it is easy to calculate damages if there is a single plaintiff, the calculation of aggregate damages has proved to be exceedingly difficult in the context of a class action. Many shares may be bought and sold repeatedly during the fraud period. Trading volume is likely to be many times the number of damaged shares. But there is no way to determine up front how many different shares traded. This intractable problem has led to serious uncertainty in the context of settlement negotiations. It has also led to the invention of several suspect trading models designed to estimate aggregate damages that can fairly be characterized as junk statistics.

To make matters worse, the issuer pays the damages. Accordingly, the prospect of the SFCA award itself causes the market price of the stock to fall by an additional amount on top of the amount by which it fell as a direct result of the corIf they could do so, diversified investors would get together and agree to ban SFCAs except in cases in which insiders (or the company itself) extract wealth from the market by trading during the fraud period. In short, SFCAs do no apparent good for anyone other than lawyers, but they do considerable harm to defendant companies. And they do nothing to recoup the gains extracted by elfin insiders.

These problems can be avoided altogether if the courts treat securities fraud claims as belonging to the company rather than to the stockholders. If the fraud does not involve insider trading, there is no harm to diversified stockholders in the aggregate and no award is necessary. If the fraud does involve insider trading, investors are fully compensated if the company

Diversified investors need no remedy in cases of simple securities fraud, and are net losers of the costs of litigation.

rective disclosure. That additional decrease in price will cause an increase in damages, which in turn will cause a further decrease in price. In other words, SFCAs trigger a positive feedback mechanism that magnifies the decrease in market price and the potential award to plaintiffs—sometimes by several multiples of the decrease that would have occurred as a simple result of the disclosure of new information in the absence of the threat of a class action. Feedback will arise even in a perfectly efficient market. To be sure, the market may overreact to bad news and fall by more than it should. But overreaction is beside the point for present purposes. The point is that even if the market is working perfectly, feedback magnifies damages. Feedback is inherent in the class action system.

For conservative buy-and-hold investors who do not happen to trade during the fraud period, the loss from feedback is a significant cost in addition to the cost of litigation. It makes damages far worse in bad news cases, and it reduces gains in good news cases. Moreover, issuers are deprived of capital to which they would have had access in a market undistorted by SFCAs. For diversified investors who do happen to trade during the fraud period, there are no benefits from SFCAs that are worth the candle. They are already effectively protected against securities fraud in the absence of insider trading or the equivalent. Such simple securities fraud is a zero-sum event. For every buyer-loser there is a seller-winner. A diversified investor is equally likely to be on the winning side of a given trade as on the losing side. For a diversified investor who owns 200 to 300 different stocks with a modest turnover of about 60 percent per year (as is the case with a typical mutual fund), gains and losses are likely to be quite small and to net out quickly. Diversified investors need no remedy in cases of simple securities fraud. Indeed, diversified investors are net losers to the extent of the costs of litigation. recovers the insider gain. And because the company recovers, such an approach avoids the problem of feedback and eliminates the need to determine the number of damaged shares. To be sure, this solution requires the company to sue insiders who may have engaged in improper trading. But if the company fails to sue, stockholders can maintain a derivative action.

SUBSIDIZING UNDIVERSIFIED INVESTORS

Admittedly, an undiversified investor may suffer significant harm from securities fraud. An investor who forgoes the benefits of diversification and picks a single stock can lose his entire investment. But it does not follow that an undiversified investor should have a remedy if he voluntarily assumes the unnecessary risk that goes with failure to diversify. Through diversification, an investor can eliminate the risk that goes with investing in a single stock without any sacrifice of expected return. An investor can eliminate more than 99 percent of company-specific risk with a portfolio of as few as 20 stocks. And with 200 to 300 stocks, all company-specific risk is gone. The only risk that remains is market risk—the risk that the market as a whole will rise or fall.

Moreover, most investors have no real choice but to diversify. The fact that company-specific risk can be avoided means that the market sets the price of individual securities as if no such risk exists. If market prices did reflect company-specific risk, portfolio investors would buy up stocks and hold them in portfolios that eliminate company-specific risk. The price of stocks would rise and eliminate any return attributable to company-specific risk. Undiversified investors would need to pay higher prices for individual stocks even though the return remained the same. It follows that an investor who buys a single stock as a stand-alone investment takes more risk than necessary to achieve the expected return from that single stock. Finally, it is costless to diversify. Complete diversification is available cheap even for the smallest investors, through mutual funds or folios at fees that are less than those that go with a brokerage account.

In short, it is so cheap and easy to diversify that it is simply unnecessary for investors to take company-specific risk. Moreover, there is no downside to diversification. Given that the fundamental goal of investing is to generate the greatest possible return at the lowest possible risk, it is irrational for an investor who can do so not to diversify.

The Supreme Court has clearly stated that securities law should be interpreted consistent with the needs of reasonable investors. It follows that in the context of a securities fraud class action, investors should be presumed to be diversified and such actions should be dismissed for lack of harm. At the very least, the law should recognize that there is serious conflict of interest between diversified and non-diversified investors. Diversified investors are effectively insured against simple securities fraud. They need no remedy, and there is no reason for a diversified investor to sue as long as other investors decline to sue. But if one investor sues, then all investors must do the same—a classic market failure. Thus, the cost of litigation operates as a tax on returns for the benefit of investors who decline to diversify. In other words, the current system subsidizes undiversified investors. Accordingly, diversified investors should favor a rule that prohibits legal action in such circumstances. Given that domestically about two-thirds of all stock is held by diversified institutional investors with much of the remainder held by diversified nonprofit institutions, it seems clear that diversified investors should prevail simply based on their numbers.

The clincher is that non-trading, buy-and-hold investors are the biggest losers. All investors suffer their share of attorney fees. But non-traders see the value of their stock in defendant companies fall by more—often much more—than it would but for SFCAs. Even if we are comfortable with wasting a few billion on attorney fees because buyers and sellers come out even in the end, there is no good reason why holders should suffer losses that may be several times greater than they would be but for SFCAs. Yet, as the Supreme Court recently affirmed, holders have no standing to sue under federal law and are barred from suing under state law. One could not design a system that makes much less sense.

FRAUD WITH INSIDER TRADING

Again, diversification affords full protection only from zerosum simple securities fraud. But some cases of securities fraud are not zero sum. If bad news fraud is accompanied by insider or company sales, there will be a net transfer of wealth from outside investors to insiders or the company. That is, if insiders sell on nonpublic bad news, outsiders who buy will lose. But not all of the gains will go to other outside investors who happen to sell. Some of the gains will go to insiders. In other words, outside investors as a class will be net losers as a result of the fraud. Similarly, outside investors may suffer a net loss if the company sells shares without disclosing bad news. And, in cases of good news fraud, outside investors will lose if insiders or the company buys stock or if the company grants stock options. To be sure, a diversified investor will be less concerned about the costs of fraud than an undiversified investor. But on average and over time, even diversified investors lose from fraud with insider transactions because some amount of capital is diverted from the public market to insiders.

It does not follow, however, that individual investors who happen to buy or sell during the fraud period should be able to recover the difference between trade price and post-disclosure market price. In a market undistorted by the effects of SFCAs, most of the price difference will be attributable to new information about the company. Relatively little of the price difference will be the result of wealth extraction by insiders. In the absence of insider trading, market price will change when new information comes to light. Insider trading makes it change by a bit more (or a bit less) than it would. But for diversified investors, that is the bit that matters. Thus, to permit investors who trade during the fraud period to recover the full difference between trade price and post-disclosure market price is far too generous because it compensates them for damage they did not suffer-the part of the price change that would have occurred at some point anyway when the truth came out.

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The true measure of the loss to investors in the aggregate is the amount extracted by insiders. In a perfectly efficient market, stock prices will be just a bit lower after such a fraud than they would have been in the absence of the fraud whether it is good news fraud or bad news fraud. In other words, the true damage to the market comes from something like dilution. The rather obvious remedy is for the perpetrators to disgorge their gains to the company. In a perfectly efficient market, disgorgement should have the effect of increasing market price by exactly the extra amount by which it fell from the fraud. Thus, a class action is the wrong way to fix the problem. An action by the company or a derivative action would do the job far better.

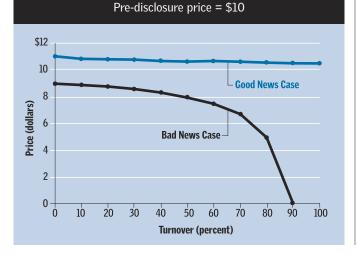
FEEDBACK IN BAD NEWS CASES

Aside from the fact that the standard approach to damages overcompensates diversified investors, a class action invariably does more harm than good. The issuing company pays the award to the plaintiff class, reducing the aggregate value of the issuing company and its stock by the amount of the payment. Because of the feedback effect, that reduction may be several multiples of the loss that would have obtained from corrective disclosure in the absence of feedback.

Suppose that Acme Corporation has 10 million shares outstanding and that the current market price is \$10 per share. The market capitalization of Acme is thus \$100 million. Acme management learns that a key customer is about to cancel a major contract, which will have the effect of reducing profits by 10 percent. Accordingly, the price of Acme stock is expected to fall to \$9 per share. For some reason, management decides to withhold the information from the market for several months. During that period, six million Acme shares are traded. To avoid unnecessary complications, assume that during the fraud period there has been no leak of information or insider trading and that all of the six million shares traded are different shares that have been traded just once.

FIGURE 1

Effect of Turnover on Market Price After Corrective Disclosure



When Acme finally discloses the bad news to the public, the price of its stock will fall by 10 percent plus some amount that reflects the likelihood that Acme will become the target of a class action suit. Given that 60 percent of Acme shareholders bought during the fraud period and that the loss in value is \$1 per share, one would expect that the damages payable to the buyers will total \$6 million. The problem is that if Acme pays out \$6 million in damages, its aggregate value is further reduced by that amount, which in turn causes the market price to drop further, which in turn increases the per-share damages. And so on. In other words, the process repeats itself through a positive feedback mechanism that causes the market price to fall a bit more with each iteration. The proverbial bottom line in this case is that if the market is working perfectly, the price will equilibrate at \$7.50 per share. What should have been a 10 percent decline in price will have been magnified to become a 25 percent decline in price because of the prospect of SFCA damages.

There are two distinct problems created by the feedback effect of SFCAs. First, it constitutes an excessive penalty against the defendant company. Indeed, in a simple SFCA there is no clear reason to penalize the company at all. The decrease in the value of its stock from the disclosure of the new information is probably penalty enough. Second, SFCAs invariably result in the transfer of wealth from diversified buy-and-hold investors to undiversified stock-picking traders. Thus, SFCAs encourage irrational investment strategies. In the case of bad news fraud, the award goes to some of the current shareholders who bought in at a too-high price, thus redistributing wealth within the corporation from older to newer shareholders.

In a good news case, feedback has the opposite effect. Rather than magnifying the decrease in stock price, feedback in a good news case has the effect of dampening the increase in stock price. The difference between a good news case and a bad news case is striking. Assuming a 10 percent change in stock price and 60 percent turnover, the price rises in the good news case by only 6.25 percent whereas it falls in the bad news case by 25 percent (see Figure 1). Moreover, as the number of shares traded increases, the price change becomes ever smaller in the good news case and ever larger in the bad news case. In a good news case, the price change reaches a limit equal to half of the hypothetical percentage decrease. But in a bad news case, there is no downside limit at all. If enough shares trade, the price of the stock will fall to zero.

It is thus not at all surprising that bad news cases are far more common than good news cases. And cases with long class periods are more serious than those with short class periods. The system makes it so.

THE FIX FOR FEEDBACK

It is easy to fix the feedback problem. Diversified investors can be made whole by issuer recovery of insider gains. Consider a case of bad news fraud accompanied by insider selling before disclosure. If the company recovers the insider gains, the value of the company is increased by the amount the insider extracted from the market (ignoring attorney fees and other costs of recovery) and diversified investors end up precisely where they would have ended up in a simple fraud case. The feedback effect does not arise because the recovery goes to the company. Thus, securities fraud actions involving insider trading should be litigated in the name of the issuer, either by the issuer directly or by means of a derivative action by a stockholder.

This solution does not require any change in statutory law. Rather, actions alleging simple securities fraud should be dismissed for failure to allege damages. Actions alleging securities fraud accompanied by insider trading of some variety should be classified as derivative rather than direct. It is well fraud period, insiders may increase their proportionate ownership of the company, effectively banking gains for a later day, without ever trading. And that constitutes an extraction of wealth from the public market.

It may be appropriate to permit SFCAs in this one context. If handled properly, SFCAs relating to fraudulent repurchases need not give rise to a feedback problem because the number of damaged shares, and hence aggregate damages, can be determined with precision. The number of damaged shares is the number of shares repurchased by the company, and the aggregate damage to the public is that number mul-

Securities litigation triggers a positive feedback mechanism that compounds the harm suffered by non-trading shareholders.

settled that the question whether an action is derivative or direct is one for the court. If the real harm from securities fraud is akin to insider trading, then it seems clear that the cause of action belongs to the company. After all, the offense of insider trading is based first and foremost on the misappropriation of information from the company. And even if one grants that insiders also owe a duty to investors not to trade on material, nonpublic information, the primary duty is one owed to the company.

OFFERINGS, REPURCHASES, AND OTHER PROBLEMS

Some SFCAs involve offerings. As with securities fraud with insider trading, when a company issues stock without disclosing negative material information about the company's business, the company effectively extracts capital from the market without giving the market the opportunity to determine a fair price. Obviously, if the company has sold stock fraudulently, it makes no sense for the company to recover. The appropriate remedy is disgorgement. That is essentially the remedy mandated by the 1933 Securities Act. But under the 1933 Act the total award is limited to the amount of the offering. Accordingly, there is no possibility of feedback in such cases. It is quite appropriate in such a case for aggrieved investors-whether diversified or not-to recover from the company itself. As long as recovery is limited to those investors who bought the stock improperly issued by the company, such a remedy has none of the untoward consequences described above.

Issuer recovery also presents difficulties if the fraud involves the repurchase of stock by the issuing company. Suppose that a company issues an unduly gloomy press release—depressing its own stock price—and then proceeds to buy back shares. It would hardly make sense for the company to recover damages in such a case. Indeed, the company would need to sue itself to do so. Even if there is no insider trading during the tiplied by the price increase following corrective disclosure (adjusted for dilution).

One obvious response is that companies will not police their own. There are two answers. First, if companies fail to pursue insiders who gain at outsider expense, there will still be plaintiff law firms around to file such actions. Second, and perhaps more important, many companies may be deterred from pursuing claims against their own agents because of the grossly disproportionate consequences of SFCAs. Indeed, it is not too strong to say that the current system of enforcement by SFCA effectively precludes any effective form of self-policing. Treating securities fraud as a claim belonging to the company would eliminate the devastating collateral consequences of SFCAs that constitute a significant impediment to self policing.

CONCLUSION

The purpose of securities law is to protect reasonable investors. Reasonable investors diversify. Therefore, the securities laws should be interpreted consistent with the needs of diversified investors. A diversified investor is protected against simple securities fraud by being diversified and needs no remedy at law. Moreover, the cost of litigating a securities fraud class action is a deadweight loss. And because of feedback inherent in the system, defendant companies decline in value by more than they should, thus harming conservative buy-andhold investors in order to afford an unnecessary remedy to buyers who would gladly forgo it if all would refrain from legal action. In short, diversified investors are not merely indifferent to securities litigation. A diversified stockholder should be opposed to private actions for damages based on securities fraud unless insiders have extracted a gain. Even then, a diversified stockholder would favor a private action for damages only to the extent that it sought restitution from the perpetrator to the issuer. This is not a case in which the cure is worse than the disease. The cure is the disease. R