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PART I

General Report

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Global Securities Litigation and Enforcement

MARTIN GELTER*

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* I am grateful for comments on this general report given at various stages of development, including those of participants of the Murphy Conference at Fordham Law School (May 2014), the International Congress of Comparative Law at the University of Vienna (July 2014), a lecture at the Hellenic-American Union in Athens (June 2015), a seminar at the University of Pennsylvania Law School (November 2015), participants of a Fordham faculty workshop (April 2016), the annual Paule Gauthier Lecture at Université Laval (April 2016), a seminar at the University of Padova (May 2016), as well as suggestions by Pierre-Henri Conac, Maurizio Bianchini, Gheorghe Buta, Eugenio Cárdenas, Kyung-Hoon Chun, Piet Delport, Jill Fisch, Frank Gevurtz, Yuliya Guseva, Robin Hui Huang, Nemika Jha, Mariola Lemonnier, Jelena Lepetić, Loes Lennarts, Emmanuel Mastromanolis, Aiman Nariman Mohd-Sulaiman, Viviane Muller Prado, Ville Pönkä, Joti Roest, Neshat Safari, Ivan Tchotourian, Umakanth Varottil, and Stefan Weber.

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1. Introduction

Securities markets have become an important topic during the past decades. The liberalization of capital flows, globalization and economic integration have facilitated cross-border investment.[1] The internet has increased the speed of information flow, which has helped individuals and institutional investors alike to select investment opportunities that they would not have dreamed of a few generations ago. Additionally, increasing numbers of individuals are saving for their retirement in pension plans that attempt to diversify investment risk and hence invest across different securities markets around the globe.

Capital markets are far from a perfect instrument for savings and investment, and they are the subject of recurring scandals, bubbles and

[1] E.g. J. Coffee, 'Racing toward the Top: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance', *Columbia Law Review* 102 (2002), 1757, 1759; M. Siems, *Convergence in Shareholder Law* (Cambridge University Press 2008), 263–76; A. Dignam and M. Galanis, *The Globalization of Corporate Governance* (Ashgate 2009), 96–143; J. Armour, M. Bengtzen and L. Enriques, *Investor Choice in Global Securities Markets* (ECGI Law Working Paper No. 371/2017), available at https://ssrn.com/abstract=3047734, 5–7.

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collapses, as well as debates among policymakers and academics. In the early 2000s, the 'internet bubble' and the spectacular collapses of once-great firms such as Enron and WorldCom in the wake of financial fraud have led to discussions and reforms in many jurisdictions, as have the 2008 financial crisis and the subsequent 'Great Recession'. One aspect of particular concern to lawyers and legal scholars is the accuracy of information on which investment decisions are made. Issuers are subject to a host of disclosure requirements, and in addition, often disclose information voluntarily. Whatever one's position is regarding the Efficient Capital Market Hypothesis (ECMH),[2] there is widespread agreement that accurate information can help to improve the market's allocative efficiency and investor confidence, as well as reduce managerial agency cost by improving monitoring.

Ensuring that issuers make disclosures and the accuracy of these disclosures stand at the core of securities law. False disclosures can be addressed by means of regulatory action, civil litigation, and criminal penalties, and by combinations of these strategies. Historically, the US has been at the vanguard of the development of all three. The Great Depression led to the enactment of the Securities Act of 1933 and Securities Exchange Act of 1934, which created the SEC as an independent regulator. Over the decades, but especially since 1990, the US model has spread around the world,[3] possibly contributing to convergence in corporate governance.[4] With its powerful regulatory role, the SEC has often been the model.

Private enforcement of securities law by investors who suffered harm from false disclosures is the flipside of the coin. Here, too, the US has often been the model, although litigation has not spread as far as regulatory standards. Securities class actions rose to prominence after the Supreme Court's decision in *Basic* v. *Levinson* in 1988[5] that established

[2] See in particular Section 4.2.5.3.
[3] C. Jordan, *International Capital Markets* (Oxford University Press 2014) ¶¶ 1.01–1.23.
[4] H. Hansmann and R. Kraakman, 'The End of History for Corporate Law', *Georgetown Law Journal* 89 (2001), 439, 451–53, 456–57; Siems, *Convergence in Shareholder Law*, 37–45, 126–36; see generally R. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function', *American Journal of Comparative Law* 49 (2001), 329–57; J. Gordon and M. Roe (eds.), *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004); F. Gevurtz, 'The Globalization Of Corporate Law: The End of History or a Never-Ending Story?', *Washington Law Review* 86 (2011), 475–521.
[5] *Basic* v. *Levinson* [1988] 485 US 224.

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the fraud-on-the-market theory.[6] As capital markets grew internationally during the 1990s and 2000s, institutional investors increasingly sought to flex their muscles even in jurisdictions where they had previously been of comparatively little significance. Consequently, policymakers around the world have attempted to expand avenues for investor litigation under securities law as a possible way of shoring up capital markets. Given the usefulness of its class action model for plaintiff attorneys, the US managed to some extent to attract international securities litigation as well. However, the tide seems to have turned. In the *Morrison* case,[7] the US Supreme Court has limited the possibility for investors to sue non-US issuers in the US. This stands somewhat in contradiction to technological developments; investors today can purchase securities in faraway markets at a mouse click, which exposes them to risks in jurisdictions where investor protection may be inadequate.[8]

On the domestic front, in the 2014 *Halliburton* case[9] the US Supreme Court was asked to overrule the fraud-on-the-market theory, which would have severely curtailed securities class actions and maybe even have effectively eliminated the class action mode as we know it. In the end, the court only decided to permit defendants to show a lack of price distortion resulting from false disclosures before class certification. John Coffee, one of the most prominent observers of US securities law, has described this as a trend toward a 'Death by One Thousand Cuts'.[10] By contrast, many other jurisdictions are seeking to improve investor protection and are considering an expansion of investor litigation under securities law as part of the regulatory mix. Changes in the law may well be both a curse and a blessing, since the changing legal structures may help us learn which legal factors are most important for capital market development.

This chapter provides a snapshot of legal mechanisms targeting false and misleading disclosures under securities law around the world, referencing the country reports included in this book. The second section provides a general perspective on the significance of securities law

[6] See Section 4.2.5.3.
[7] *Morrison* v. *National Australia Bank*, 130 S.Ct. 2869, 2886 (2010).
[8] C. Brummer, 'Post-American Securities Regulation', *California Law Review* 98 (2010), 327, 334; see also R. Stulz, 'Securities Laws, Disclosure, and National Capital Markets in the Age of Financial Globalization', *Journal of Accounting Research* 47 (2009), 349, 351 (noting that the location of a stock exchange is irrelevant, but that the enforcement of law matters).
[9] *Halliburton* v. *Erica P. John Fund, Inc.* [2014] 134 S. Ct. 2398.
[10] http://clsbluesky.law.columbia.edu/2014/06/30/death-by-one-thousand-cuts/

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around the world and briefly touches upon the academic debates on the relative merits of public and private enforcement. The third section begins the comparison by looking at public enforcement mechanisms. What should the overall structure of securities regulation look like? In this area, the past decades have seen a growing convergence toward the US model of an independent regulator as well as on disclosure regulation (as opposed to merit regulation). The fourth section discusses civil liability and shareholder litigation. We first look at the substantive grounds for liability, in the context of which the recognition of the fraud-on-the-market theory or a functional equivalent seems to be a necessary condition for a strong litigation mechanism to emerge. Subsequently, the chapter looks at procedural aspects of enforcement around the world, given that mechanisms bundling the claims of a multitude of investors and a litigation cost structure that creates incentives to sue appear to be necessary factors for widespread litigation. However, as we will see, several countries have developed alternative mechanisms that might provide substitutes for securities class actions while avoiding some of their pathologies. Finally, we also look at the international dimension of liability, in particular conflict of law rules, which may help us to explain which countries are likely to become attractive locations for lawsuits now that the US seems to be withdrawing from the scene. The fifth section summarizes and concludes.

2. Capital Markets and the Role of Securities Law

Securities law is an element of larger debates about corporate law and governance. Probably the predominant issue since the late 1990s has been the ‘law and finance’ or ‘law matters’ theory. The question addressed by both economists and legal scholars has been whether law is a major factor that influences the development of a large capital market on the one hand, and ownership structure on the other.

This theory is often linked to the question of ‘legal origins’, i.e., of whether legal systems standing in a particular legal tradition are more amenable to a large capital market as well as prominent dispersed ownership structures than others. Advocates of the ‘legal origins’[11] theory (developed initially by a research group of economists originally based

[11] R. La Porta, F. Lopez-de-Silanes and A. Shleifer, ‘The Economic Consequences of Legal Origins’, *Journal of Economic Literature* 46 (2008), 285.

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at Harvard and sometimes abbreviated as LLSV) have suggested that the common law is superior to civil law in this respect.[12] Others have contested these claims, particularly by criticizing the literature's problematic cross-country descriptions of laws, which have in many cases turned out to be flawed.[13] On the more conceptual level, the larger problem has been that the mechanism linking the common law to investor protection has not been clear. For many decades, if not a century, comparative law scholars have argued that civil and common law methods as such were not that different after all.[14] Yet other authors have pointed out that political factors better explain differences between different corporate governance systems, at least in developed economies.[15]

Securities law and its enforcement is very likely a mechanism that plays a role here, maybe even more so than corporate law. According to 'law and finance' theorists, the protection of minority investors reduces agency cost between majority and minority shareholders, and fosters minority investors' trust and confidence in the market. Thus, corporate ownership can more easily disperse, and securities markets grow. However, from the US perspective, the emphasis on state corporate law seemed puzzling. If there is any legal reason for the development of US capital markets, it is most likely not state corporate law, which on its face does not appear to provide strong investor protections, but rather securities law, which is vigorously enforced by the SEC and around which bountiful shareholder litigation revolves. This argument runs counter to the 'legal origins' component of the 'law matters' thesis, since US securities law did not develop out of the adversarial common law system. Investor protection through the actions of private market intermediaries such as investment banks and the New York Stock Exchange, was the

[12] E.g. R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, 'Legal Determinants of External Finance', *Journal of Finance* 52 (1997), 1131; R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, 'Law and Finance', *Journal of Political Economy* 106 (1998), 1113; R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'Corporate Ownership Around the World', *Journal of Finance* 54 (1999), 471.

[13] H. Spamann, 'The "Antidirector Rights Index" Revisited', *Review of Financial Studies* 23 (2010), 467, see also S. Cools, 'The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers', *Delaware Journal of Corporate Law* 30 (2005), 697.

[14] E.g. M. Siems, 'Legal Origins: Reconciling Law & Finance and Comparative Law', *McGill Law Journal* 52 (2007), 57, 62–70.

[15] M. Roe, 'Corporate Law's Limits', *Journal of Legal Studies* 31 (2002), 233; Mark J. Roe, *Political Determinants of Corporate Governance* (Oxford University Press 2003), 162.

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main frontline before the Great Depression.[16] Modern securities law was first enacted in 1933 and 1934, and was subsequently fleshed out by further amending legislation as well as detailed SEC rules. In short, it does not look like common law at all, but almost like a caricature of civil law legislation.

The 'law and finance' research group followed up with a study titled 'What works in Securities Law?' that applied their empirical method to securities litigation in 49 countries worldwide.[17] Their main finding was that desirable securities market outcomes were primarily driven by *private* enforcement of securities law; in other words, a country with a developed level of securities litigation was more likely to be characterized by large capital markets and dispersed ownership than a comparable country that did not share this characteristic. This seemed to save the theory of common law superiority, since such litigation appeared to be prevalent most of all in common law countries, particularly the US, and it emphasized the important role of an adjudicative system shaped by private incentives to sue as well as the case law developed in the federal courts; in other words, after all it did seem to be a common law mode of enforcement that was responsible for market development.

However, soon thereafter a study by Howell Jackson and Mark Roe cast doubt on these findings.[18] Using La Porta et al.'s data and supplementing them with additional variables, Jackson and Roe suggested that it is not primarily private enforcement that correlates with securities market growth, but rather quantifiable measures of public enforcement, such as the size of the regulators' staff, its financial endowment relative to the size of the countries' GDP, and the purchasing power of its inhabitants. According to their findings, common law countries also tend to employ

[16] J. Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', *Yale Law Journal* 111 (2001), 1, 25–39.

[17] R. Porta, F. Lopez-de-Silanes and A. Shleifer, 'What Works in Securities Law?' *Journal of Finance* 61 (2006), 1; but see M. Siems, 'What Does Not Work in Securities Law: A Critique on La Porta et al.'s Methodology', *International Company and Commercial Law Review* 16 (2005), 300 (criticizing La Porta et al.'s way of coding law); J. Coffee, 'Law and the Market: The Impact of Enforcement', *University of Pennsylvania Law Review* 156 (2007), 229, 250–51 (summarizing criticism of the article).

[18] H. Jackson and M. Roe, 'Public and Private Enforcement of Securities Laws: Resource-based Evidence', *Journal of Financial Economics* 93 (2009), 207. For a survey of more recent empirical literature, see H. Jackson and J. Zhang, 'Private and Public Enforcement of Securities Regulation', in J. Gordon and W.-G. Ringe (eds.), *Oxford Handbook of Corporate Law and Governance* (Oxford University Press: forthcoming).

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a heavier hand in regulating the securities market or at least more active enforcers.[19]

At least from the internal perspective of the US debate about securities litigation it would be surprising – and maybe in stark contrast to the factual historical pattern – to claim that US capital markets owe their development to the relatively recent phenomenon of securities litigation. Much of the American legal literature seems to agree that securities class actions in the US have little – if no – beneficial social effects. A major problem is circularity. Typically, the defendant in securities class actions is the issuer.[20] Consequently, shareholders pay for the remedy with a decrease in share price. If shareholders are diversified and thus equally exposed to risk in all firms, it is thus unlikely that they would want liability in the first place for purposes of compensation. If anything, liability redistributes from buy-and-hold investors to institutional shareholders that rearrange their portfolio more often.[21] The deterrent effects of securities class actions are equally controversial, in particular because it is not clear what the social cost of securities fraud is.[22] It is clear, however, that in aftermarket cases social costs have nothing to do with damages awarded to shareholders. Thus, a cloud of uncertainty remains over the question whether damage awards are insufficient or excessive from a deterrence perspective. However, it does not seem too controversial that whatever incentives they may set are typically not passed through to the actual perpetrators of securities fraud, namely managers, in part because issuing firms are the only defendants plausibly contributing to an award except in cases of criminal liability. It is equally established that most damages are paid by D&O insurers, who in practice do not exercise a monitoring function over the issuing firms' information disclosure policies, which largely eliminates any incentive effects there may be.[23] The claim that

19 E.g. Coffee, *University of Pennsylvania Law Review* 156 (2007), 261.

20 See Section 4.1.

21 For a summary of the literature, see M. Gelter, 'Risk-shifting Through Issuer Liability and Corporate Monitoring', *European Business Organization Law Review* 14 (2013), 497, 501–04.

22 See generally U. Velikonja, 'The Cost of Securities Fraud', *William and Mary Law Review* 54 (2013), 1887.

23 See T. Baker and S. Griffith, 'How the Merits Matter: Directors' And Officers' Insurance And Securities Settlements', *University of Pennsylvania Law Review* 157 (2009), 755, 796–99 (discussing the role of D&O insurers in the settlement process); T. Baker and S. Griffith, 'The Missing Monitor in Corporate Governance', *Georgetown Law Journal* 95 (2007), 1795, 1807–17 (showing that D&O insurers do very little to reduce agency cost).

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