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Don't leave money on the table

European institutional investors have paid little attention to securities class actions as a way of recovering investment value. Such inaction is costing them dear, warn Professor Michael Mainelli, Chartered FCSI and David Seidel.

Pension funds, asset managers, and family offices often fail to appreciate the importance of actively managing their rights in securities class actions against companies where some form of corporate misconduct has reduced share value. The majority of securities class actions are in the United States, but are still important to institutional investors globally. Whether resolved by settlement or judgment, provided investors take positive steps they can recover part of the loss on their investments. Institutional investors should develop and implement a robust securities class action strategy, but few have the resources to do so. Fortunately there are now outsourcing solutions that enable investors to increase recoveries from securities class actions whilst managing legal, financial and reputational risks in a cost-efficient and cost effective way.

Collective redress aims for judicial efficiency. In order to avoid a multitude of smaller, singular and nearly identical claims, one representative plaintiff sues in an all-encompassing lawsuit for themselves and on behalf of others in a defined class – ie, those who suffered loss from the same situation. On average shareholders launch 175 securities class actions in the US each year. Although collective redress procedures are available in other jurisdictions - such as Canada, Australia, the Netherlands, Germany and United Kingdom – America is where the majority of securities class actions are determined.

In securities class actions, plaintiff shareholders sue a company (the 'Defendant') in which they have invested. A basis for the claim can be negligence in operations, or misrepresentations in filings, or misrepresentations to the press. The conduct is alleged to have had an impact on the share price, causing investors to buy, retain or sell shares in the Defendant at an inappropriate time. When the true position finally emerges, the market corrects itself and share prices fall. Investors take court action to recover some of the loss to their portfolio, compensation that would not otherwise have been available.

Settlement is the norm

Most securities class actions do settle, approximately 3.75 years on average after the claim is filed. The Defendant then establishes a pool of money for the benefit of the defined class of affected shareholders. In 2013, significant settlement pools were agreed by Citigroup (US £590m), Merck (US $686m) and Bank of America Merrill Lynch ($2,425m). There are settlement pools of approximately US$1bn quarterly.

The defined class is given a limited time to file a proof of claim with the settlement administrator. Such 'wait and file' recoveries are passive in nature as a shareholder need not be involved with the litigation *per se*. Once the deadline has passed, the administrator pays filing investors their proofs of claim their share of the pool. If an investor fails to file a proof of claim, its share is redistributed among those who did.

Institutional investors include pension funds, investment funds, insurance companies or family offices (the 'fund') and are run by trustees or managers (the 'trustees') who act in the best interests of beneficiaries and stakeholders. When a fund's anticipated loss is large enough, it should consider opting out of the class in favour of bringing its own lawsuit. Trustees need to ensure that a separate claim is warranted and that the legal, financial and reputational risks are minimised. Research indicates that funds opting out at appropriate times recover multiples more than in the main securities class action. By bringing their own lawsuit, trustees need to be aware that the fund cannot remain anonymous as in a class action.To minimise the financial and reputational risks a number of funds involved in the same case can work together. Not only are they not alone in taking action, bargaining power is increased and the costs of litigation can be reduced. Some argue funds' duties require positive action whenever a potential benefit arises. The better view is that trustees need to consider and analyse each potential issue that affects the fund, recognising that investment value is also affected by factors outside the market. Having a robust securities class action strategy can assist trustees and funds in recovering some portfolio value lost because of corporate malfeasance. Simultaneously, corporate governance may be improved. For many years, securities European funds and trustees have paid little attention to having a robust securities class actions policy. That must change in the UK. The Financial Conduct Authority is now querying funds about their approach to securities class actions and governance interventions.

Proofs of claim

Holdings data is often retained by a custodian and the filing of proofs of claim is not part of the custodian's core business. The importance of filing proofs of claim cannot be underestimated. A recent case study revealed that over a five year period the custodian of one Fund failed to file proofs of claims in 341 of the 773 settlements. Adopting a 'wait and file' strategy is an issue for many European funds who do not have the in-house expertise to seek out and maximise recoveries. Since June 2010, passive recoveries are not always available to non-American investors. The US Supreme Court established the 'F-cubed' rule which provides that: (1) non-American investors, including funds, cannot participate in any US securities class action, where (2) the Defendant is not American and (3) the shares are not traded on American stock exchange.

Nevertheless, options are available. A number of European funds are pursuing state law actions against BP plc in Texas. There are also other class actions in Canada and the Netherlands. Another option used in the Royal Bank of Scotland rights case is to start litigation locally as a group action in the UK.

Quantifying a fund's precise recoveries for any year is difficult. Several factors are involved including: (a) the number of actions resolved; (b) the settlement amounts; (c) timing for the release of funds; (d) the extent of affected holdings; and (e) the number of proofs of claim filed. However, industry experience suggests potential average annual recoveries of approximately two basis points of the total equities portfolio, or, five basis points on the US equities portfolio.

At the very least trustees should seek recovery on settlements rather than leave money on the table for others. This could translate into better fund performance and better benefits for fund beneficiaries. There may also be a knock-on effect on fund management fees.

In the end, securities class action strategies should incorporate active and passive claims management whilst ensuring that trustees know when each is required. It is a specialist area and few European institutional investors have the in-house expertise. Generally, their internal legal departments concentrate on financial services issues and it would be inefficient to divert staff resources to work on matters outside their expertise or pay the cost of external legal advice.

Many American law firms offer claims monitoring services, but, they have an inherent conflict beyond filing proofs of claim. With contingency fee incentives, US law firms have a financial interest in promoting their own litigation over competing firms. Most claims monitors limit themselves to passive claims management. They too may not have the in-house expertise when active steps may be required. Cost effective, expert outsourcing to a specialist third party is available. Queries and solicitations can be easily referred to an outsourced, specialist intermediary for assessment. A third-party outsourcer can enhance trustees' ability to report to beneficiaries, and showcase how seriously trustees take their responsibilities.

Recovering investment value

Securities class actions have long been a potential source of recovering investment value. Perhaps because of an aversion to litigation, trustees and funds in Europe have paid little attention to securities class actions. In view of the amounts at stake, this passive view needs reconsideration. Independent outsourced solutions offer expertise and cost-efficiency with little risk. At a minimum,

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institutional investors might analyse how much they've lost in recent years by virtue of inaction. That alone may spur them to get a grip on the value lying on the table of securities class actions.

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David Seidel is Chief Executive and Chief General Counsel of the Institutional Investors Tort Recovery Association, a member organisation dedicated to managing the interests of pension funds, insurance companies, asset managers, family offices and others with substantial holdings in securities around the world (outside the United States) in relation to their securities class actions.

Date for your diary: Michael and David will take part in a CISI CPD seminar, entitled European institutional investors and securities class actions, on 8 October in the City of London. Bookings for the event will be taken from early August.

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Flowchart– passive vs active recoveries from settlements