



June 20, 2011

Swiss Financial Market Supervisory Authority FINMA  
Dr. Oliver Zibung  
Einsteinstrasse 2  
CH-3003 Bern

Re: FINMA Discussion Paper, Regulation of the Production and Distribution of Financial Products to Retail Clients

Dear Dr. Zibung:

The U.S. Chamber Institute for Legal Reform (“ILR”) is submitting these comments in response to the FINMA Discussion Paper on regulation of the production and distribution of financial products to retail clients (“FINMA Distribution Report 2010”). ILR is a not-for-profit public advocacy organization affiliated with the U.S. Chamber of Commerce, which is the world’s largest business federation, representing the interests of more than three million companies of every size, sector, and region, including a number of European-based businesses. ILR’s mission is to ensure a simple, efficient and fair legal system, and in particular to limit the incidence of litigation abuse. Because many of ILR’s members have affiliates based in Switzerland or that otherwise conduct substantial business there, ILR is deeply interested in the orderly administration of justice in Switzerland. ILR has participated actively in legal reform efforts in a number of European countries since its founding in 1998. It brings an American perspective to these important discussions that might not otherwise be represented—and that proves valuable to policymakers.

The FINMA Distribution Report 2010 indicates that FINMA is considering whether it would be desirable for Switzerland to authorize class actions as a mechanism for the collective resolution of the claims of retail investors harmed by incorrect or misleading prospectus information, and perhaps other improper financial market practices as well. As the report explains, Swiss law already permits the collective representation of investor interests through joint actions and the bringing of multiple claims. But the Swiss legislature has to this point explicitly chosen not to make the class action mechanism available for investor claims. This choice reflects the view that class actions are alien to Europe’s legal traditions, which have long adhered to the belief that a plaintiff should not be able to bind a large number of other potential plaintiffs who have not affirmatively consented to the representation or participated in the legal process.

Although we cannot speak to the compatibility of investor class actions with Europe’s legal traditions, we are uniquely situated to speak to the practical effects of such suits based on our sustained study of how the class action mechanism functions in the United States. These lessons may be helpful to FINMA as it considers whether and to what extent it would be appropriate for the Swiss legislature to make the class action device available to Swiss investors. We also are familiar with the large body of recent empirical work that U.S. scholars have produced examining the effectiveness of the U.S. securities class action system from a compensatory perspective. Based on our own study, informed by this scholarship, we do not believe that it would be wise for Switzerland to depart from its traditional approach by authorizing class actions for Swiss investors. In particular, we believe that such a course would inevitably result in significant abuse of the Swiss litigation system, the distortion of Swiss financial markets, and the imposition of massive competitive burdens on Swiss companies. Our principle points are as follows:

- Investor class actions are, for three main reasons, fundamentally illogical from a compensatory perspective.
  - First, because of the inherent characteristics of financial markets, such suits cannot be justified as providing appropriate “compensation” for diversified investors, and in fact overcompensate active participants in financial markets.
  - Second, because an investor class action, in practical effect, constitutes a suit against a company’s current shareholders by its former (and sometimes other current) shareholders, such suits merely shift money between innocent investors—and sometimes from one pocket to the other of the same investor.
  - Third, because of how damages are calculated and the inefficiencies of the claims-processing system, investor class actions favor large shareholders—such as institutional investors and hedge funds—over small retail shareholders, who are the theoretical intended beneficiaries of the class action mechanism.
- Investor class actions impose substantial and unjustified costs on businesses, shareholders, consumers, and the economy as a whole. These costs include extraordinarily high settlement and administrative costs, as well as the destruction of massive amounts of shareholder wealth. Investor class actions also severely undermine the attractiveness of the domestic economy as an investment destination. Yet the empirical evidence demonstrates that the merits of the claims involved do not drive the decisions to file and settle most such suits.
- No built-in safeguards will be sufficient to protect against the abuses and distortions that are so prevalent under the U.S. system. The U.S. experience shows that the costs imposed by securities class actions in the United States are inherent to any class action mechanism, and thus largely unavoidable no matter how the particular system is designed.

- The evidence is overwhelming that public mechanisms for investor compensation are much more effective than class actions at compensating investors harmed by financial market fraud. In particular, the U.S. Securities and Exchange Commission’s Fair Funds program has efficiently transferred billions of dollars to injured investors since 2002, and FINMA might consider that program as a possible model in developing its own approach to a more robust regime for public compensation.

## **I. Investor Class Actions Are Inherently Illogical from a Compensatory Perspective**

It is important to recognize at the outset that the U.S. judiciary, not the U.S. Congress, was responsible for recognizing the existence of a private cause of action under section 10(b) of the Securities Exchange Act of 1934, which is the principal basis in American law for shareholder class actions.<sup>1</sup> In taking that step, the judiciary applied principles that American courts had previously developed to provide a remedy for fraud in the context of transactions in material goods between a single seller and a single buyer. Neither Congress nor the U.S. courts have ever undertaken a thorough analysis to determine whether these principles make sense in the very different context of alleged fraud in connection with purchases or sales of securities on public markets.

Scholars have begun to study this issue in recent years. They have found that investor class actions (or “securities class actions”) do not effectively compensate injured investors, particularly small retail investors.<sup>2</sup> This is so for three basic reasons.

*First*, the very idea of an investor class action fails to account for the fact that investors who are repeat participants in securities markets are as likely to be the beneficiaries of alleged fraud—by selling securities at an artificially inflated price—as they are to be injured by alleged fraud through purchases at an inflated price. By ignoring the former situation, investor class actions in the U.S. provide “compensation” to parties whose “injuries” (to the extent they exist) have been counterbalanced by unjustified profits due to “fraud.” Thus, such class actions systematically *overcompensate* repeat players in securities markets.

*Second*, because the defendant company (and its current shareholders), and not any individual wrongdoer, almost always pays the settlement that terminates most securities class action suits, even legitimate suits inherently do little more than shift money from one innocent investor to another—and sometimes merely transfer money from one pocket to the other of a

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<sup>1</sup> See *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971).

<sup>2</sup> See Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements*, 157 U. Pa. L. Rev. 755, 831 (2009); see also John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 304 (2007) (“[I]t must be recognized that private enforcement of the securities laws in the United States is working imperfectly, achieving little, if any compensation and only limited deterrence because its costs fall largely on innocent shareholders rather than the culpable corporate officers actually responsible for ‘cooking the books’ and other misdeeds.”); Honorable Joseph A. Grundfest, Stanford Law School, Address at the Meeting of the Advisory Committee on the Auditing Profession 4 (Feb. 4, 2008), <http://tinyurl.com/45tesjl> (observing that “[t]he class action securities fraud litigation system is broken. It fails efficiently to deter fraud and fails rationally to compensate those harmed by fraud. Its greatest proponents seem to be the class action counsel and others who profit as a consequence of the irrationally large damage exposures generated by the current regime”).

single investor. Based on this fact alone, one prominent U.S. scholar has observed that “the odds are high that shareholders are made systematically worse off by securities class actions.”<sup>3</sup>

*Third*, because of attorney’s fees and administrative costs, “securities litigation is so costly, relative to the amount of loss spreading achieved, that it is unlikely to be worthwhile even if there were no alternative way of reducing the social disutility arising from the risks of issuer misstatements.”<sup>4</sup>

Significantly, U.S. legal scholars have arrived at a remarkable consensus on these flaws. Two professors from Harvard Law School have succinctly summarized “the conventional legal academic view” in the United States as follows: “securities litigation, at least as practiced within the United States, is seriously compromised. Private securities lawsuits in the United States (1) often provide meager returns to wronged claimants, (2) usually do not visit their costs on the wrongdoing actors inside public firms, because the wrongdoers can usually transfer the costs to others, and (3) often just transfer losses from one innocent group of shareholders to another innocent group, with large fees obtained by the lawyers for both sides.”<sup>5</sup>

The following is a more detailed discussion of the most important structural flaws in the U.S. securities class action system.

**A. *Securities class actions cannot be justified as providing “compensation” for diversified investors, and in fact overcompensate active participants in financial markets.*** Class actions in the financial market context are unnecessary to compensate diversified investors, and indeed may systematically overcompensate active participants in such markets. This outcome is a product of the inherent difference between conventional fraud claims and securities fraud claims.

In the relatively straightforward conventional fraud situation, the same person who engages in the wrongful act also profits from the victim’s loss; thus, a successful fraud claim leads to a return of those illicit profits to the victim. In securities class actions, by contrast, the “gains” from fraud usually were received not by the company officials who allegedly committed the fraud (except in insider trading cases), but rather by innocent investors who allegedly sold securities in the secondary market at inflated prices. Thus, “each loser—the buyer or seller disadvantaged by the fraud—is balanced by another winner: the person on the other side of the trade. . . . Yet for obvious reasons, the law makes no effort to force the winners to disgorge their profits in order to fund the losers’ recovery.”<sup>6</sup>

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<sup>3</sup> See Coffee, *Law and the Market*, supra note 2, at 304.

<sup>4</sup> Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 Wis. L. Rev. 297, 307.

<sup>5</sup> Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, Harvard Law School John M. Olin Center for Law, Economics & Business Discussion Paper Series, Paper No. 638, at 5 (Apr. 2009) (published in the *Journal of Financial Economics*, vol. 93 (2009)), <http://tinyurl.com/49qlvxt>.

<sup>6</sup> Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639, 647 (1996) (hereinafter “*Capping Damages*”).

The consequence of authorizing private claims in this situation is “systematic overcompensation over time to many investors.”<sup>7</sup> In particular, those diversified, active traders—such as large institutional investors—who “lose” on one transaction (*i.e.*, from buying a security at what is alleged to be an artificially inflated price) are both eligible to recover damages in a class action **and** permitted to keep gains received from separate “winning” transactions (*i.e.*, from selling a security at what is alleged to be an artificially inflated price).<sup>8</sup> “[T]he offsetting likelihood of gains and losses from this kind of fraud means that rational investors will not demand broad protection from it *ex ante* in the form of risk premiums. In other words, an offer of full compensation is unnecessary to encourage capital formation efficiently.”<sup>9</sup> As one commentator has explained, “even though a diversified stockholder might sometimes lose [from fraud], she would be opposed in principle to a rule that permits recovery because she is effectively insured against loss by virtue of being diversified. The cost of litigation is a deadweight loss.”<sup>10</sup>

Significantly, the vast majority of transactions on U.S. stock exchanges are engaged in by just such diversified investors—namely, large institutions. Moreover, retail U.S. investors have diversified stockholdings because they primarily hold their shares through well-diversified institutions.<sup>11</sup> But this fundamental flaw in the class action mechanism is not tied to the particular features of the U.S. system; rather, it is inherent in *any* private “remedy” relating to trading in securities. And because there is every reason to believe that institutions are responsible for the bulk of transactions on Swiss exchanges, the very same conclusion would apply to a proposal to introduce a class action device under Swiss law. Simply put, such a device is unnecessary because Swiss investors—like their U.S. counterparts—have offsetting gains and losses due to alleged fraud. Thus, they have no need for this sort of “grotesquely inefficient form of insurance against large stock market losses.”<sup>12</sup>

**B. Financial class actions merely shift money between innocent investors—and sometimes from one pocket to the other of the same investor.** As decades of study in the United States have shown, securities class actions against issuers—even those brought by investors who have sustained real injury—inevitably do little more than shift money from one innocent investor

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<sup>7</sup> *Id.*

<sup>8</sup> See Anjan V. Thakor, *The Unintended Consequences of Securities Litigation* 1, U.S. Chamber Inst. For Legal Reform (2005), <http://tinyurl.com/ydxk4lz>.

<sup>9</sup> Langevoort, *Capping Damages*, *supra* note 6, at 647.

<sup>10</sup> Richard A. Booth, *Direct and Derivative Claims in Securities Fraud Litigation*, 4 *Vir. L. & Bus. Rev.* 277, 298 (2009). For similar analysis, see also Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability, 42 *Wake Forest L. Rev.* 627, 633-34 (2007) (hereinafter “*Without Wheels*”); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 *Colum. L. Rev.* 1534, 1538, 1558-59 (2006) (hereinafter “*Reforming the Securities Class Action*”); Janet C. Alexander, *Rethinking Damages in Securities Class Actions*, 48 *Stan. L. Rev.* 1487, 1502 (1996); Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 339-41 (1991).

<sup>11</sup> See Richard A. Booth, *The Buzzard Was Their Friend—Hedge Funds and the Problem of Overvalued Equity*, 10 *U. Pa. J. Bus. & Emp. L.* 879, 889 (2008) (hereinafter “*Buzzard*”) (observing that approximately 73 percent of all U.S. shares are held through such diversified institutions).

<sup>12</sup> Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 *Stan. L. Rev.* 497, 501 (1991) (hereinafter “*Merits*”).

to another, and sometimes merely transfer money from one pocket to the other of a single investor. The “circularity” problem stems from the fact that the defendant company, and not the individuals guilty of any actual wrongdoing, almost always pays the settlement that terminates most securities class action suits.<sup>13</sup> Indeed, the evidence suggests that, on average, individuals accused of wrongdoing in such suits contribute less than one half of one percent of the typical settlement fund,<sup>14</sup> leading the authors of one study to conclude that, “to a large extent, even culpable officers appear to be shielded from liability in securities class actions.”<sup>15</sup> A prime example is the settlement of securities class action litigation against the Cendant corporation in 2000, which totaled \$3.2 billion at the time of settlement; the company itself paid \$2.85 billion, with no individual contribution (the company’s auditor paid the rest).<sup>16</sup> And a company’s financial burden in such suits is not limited to the settlement amount. Defense expenditures are often 25-30% of the settlement payment.<sup>17</sup>

Even when a company’s insurance covers the settlement and litigation costs, the company ultimately ends up footing much of the bill because insurance premiums inevitably increase to reflect the higher risk of liability. These spiraling expenditures in part explain why insurance costs for a Fortune 500 company are over six times higher in the United States than they are in Europe—where few countries permit securities class action suits, even on an “opt-in” basis.<sup>18</sup>

The billions of dollars in settlement and litigation costs paid by a company, moreover, do not materialize out of thin air. Existing shareholders—the company’s owners—bear the economic burden of these huge payments: “nearly all the money paid out as compensation in the form of judgments and settlements comes, one way or another, from investors themselves.”<sup>19</sup> Yet, as discussed above, existing shareholders as a group do not derive any benefit from any past fraud affecting the value of the company’s stock—rather, those investors who sold their stock at an inflated price while the fraud was ongoing would have reaped that gain. Thus, again unlike the typical common law fraud claim, the compensatory burden in securities class actions falls upon innocent shareholders. One group of innocent shareholders—those who hold the stock at the time of legal judgment against the company or when the claim is settled—ends up paying another group of innocent shareholders—those who are in the litigation class.<sup>20</sup> One prominent

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<sup>13</sup> See Committee on Capital Markets Regulation, *Interim Report* 78 (Nov. 2006), (hereinafter “*Interim Report*”), <http://tinyurl.com/35gayn>; see also Donald C. Langevoort, *U.S. Securities Regulation and Global Competition*, 3 *Vir. L. & Bus. Rev.* 191, 199 (2008) (hereinafter “*Global Competition*”) (“By and large, the money paid in judgments, settlements, and legal fees comes out of either the corporate treasury or an insurance policy, and is thus funded by the company’s shareholders, not the individual wrongdoers.”).

<sup>14</sup> Langevoort, *Capping Damages*, *supra* note 6, at 648 & n.43.

<sup>15</sup> Michael Klausner & Jason Hegland, *How Protective is D&O Insurance in Securities Class Actions*, 23 *Professional Liability Underwriting Society* 4 (Feb. 2010), <http://tinyurl.com/47e8lpl>.

<sup>16</sup> See Donald C. Langevoort, *Without Wheels*, *supra* note 10, at 627, 628 n.2.

<sup>17</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 10, at 1546 & n.38.

<sup>18</sup> See *Interim Report*, *supra* note 13, at 78.

<sup>19</sup> Langevoort, *Capping Damages*, *supra* note 6, at 648.

<sup>20</sup> See *Interim Report*, *supra* note 13, at 79.

U.S. scholar has aptly analogized this “perverse” system “to punishing the victims of burglary for their failure to take greater precautions.”<sup>21</sup>

A related issue that compounds the circularity problem is that, upon the issuance of any corrective disclosure, the price decline in a company’s stock often includes the anticipated cost of an eventual settlement or judgment in the class action that is sure to follow. In other words, average shareholders who hold the company’s stock at the time of such a disclosure—a large percentage of whom will be in the litigation class—“inevitably bear a fraction of the cost of the litigation and settlement that is borne by the corporation . . . and the plaintiff class is, in effect, suing itself.”<sup>22</sup>

The “circularity” problem (and related considerations) is a fatal—and unavoidable—flaw of the U.S. securities class action system. And, as the above discussion indicates, that flaw has nothing to do with any feature unique to the U.S. approach to class actions. Rather, circularity is an inherent problem with any mechanism that permits investors to sue a securities issuer for allegedly engaging in fraudulent conduct in connection with secondary market transactions in its securities. Moreover, even if investors can sue the responsible individuals rather than the issuer, they still will almost always pursue the issuer because it generally has the deeper pockets. Accordingly, a Swiss class action device would inevitably result in the same type of ineffective “pocket-shifting” as the U.S. class action system—and is fundamentally undesirable for that reason.

**C. Securities class actions favor large over small investors.** A related problem with securities class actions is that they systematically favor large institutions and active traders over small, usually “buy-and-hold” investors. This is perverse. The underlying rationale for the class action mechanism is the desire to open up the legal system to those individual investors with claims that are too small to justify a stand-alone lawsuit. Yet the U.S. experience demonstrates that this is not the consequence of authorizing these suits and that, in fact, small investors are least likely to receive substantial compensation pursuant to a class action settlement.

Part of the reason is that individual retail investors generally buy stock and hold it for the long run, thus reducing the likelihood that they acquired shares during the “class period”—the period of time within which the buyer must have purchased the stock to be legally entitled to participate in a U.S. class action.<sup>23</sup> By contrast, investors that trade very frequently, such as hedge funds, are more likely to benefit from class actions because they are more likely to have purchased stock within a given class period. Large institutional investors are also more likely to benefit because they are almost always optimally diversified. Thus, as discussed above, they are just as likely to derive benefits from actual fraudulent conduct when they sell some of their shareholdings at fraud-inflated prices as they are to suffer harm when they buy other shares at fraud-inflated prices.<sup>24</sup>

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<sup>21</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 10, at 1562.

<sup>22</sup> Grundfest, *supra* note 2, at 2-3.

<sup>23</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 10, at 1559-60; *Interim Report*, *supra* note 13, at 80.

<sup>24</sup> See Alexander, *Rethinking Damages*, *supra* note 10, at 1502; Coffee, *Reforming the Securities Class Action*, *supra* note 10, at 1560; see also *Interim Report*, *supra* note 13, at 80.

Of course, many individual investors in the United States effectively hold their stock through large institutions, either because they own shares in mutual funds or have a future entitlement to their pensions. The evidence shows, however, that these institutions do a very poor job of ensuring that class action settlements actually benefit the individual investors who are the real victims. In a 2005 study, for example, two U.S. academics found that most institutional investors (70 percent of their sample) with provable losses in securities class action settlements never perfected their claims and that not a single institutional investor (out of 23 surveyed) allocated money recovered from settlements to the accounts of those investors who had actually been defrauded.<sup>25</sup> As a result, “there is a mismatch between those investors who suffered losses and those who benefit from the recovery.”<sup>26</sup> Based on their research, the authors of the study express great “skept[ic]ism that class actions can be seen as purely or substantially compensatory.”<sup>27</sup>

Finally, even when small investors directly participate in a U.S. class action that results in a settlement, the process by which settlement funds are distributed is so costly, difficult, and inefficient that it is impossible for many of them to collect their money at all, let alone in a timely fashion. Recent academic research confirms that the significant problems besetting the class action settlement notice-and-claims process are responsible for very low response rates from claimants.<sup>28</sup>

Thus, U.S. “securities litigation systematically may transfer wealth from [small] buy and hold investors” to larger investors and more active traders.<sup>29</sup> “This is illogical.”<sup>30</sup> And while the relevant practices and procedures under Swiss law will likely differ in some respects from those in the United States, any class action model that Switzerland implements is almost certain to be just as inherently incapable of ensuring recovery for small investors. Presumably, Switzerland would adopt some version of the “class period,” causing small investors who buy and hold their securities to face the same difficulties proving their entitlement to recovery under Swiss law as they do under U.S. law. And institutional investors in Switzerland are likely to be just as ineffective as they are in the United States at ensuring recovery for the small investors who hold securities through them.

### **III. Securities Class Actions Impose Substantial and Unjustified Costs on Companies, Investors, and the Economy as a Whole**

The evidence from the United States makes clear that securities class actions impose massive, and growing, costs on the U.S.’s judicial system and businesses—costs which ultimately are borne by taxpayers, investors, and consumers. At the same time, the merits of

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<sup>25</sup> See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 *Stan. L. Rev.* 411, 449-50 (2005).

<sup>26</sup> *Id.* at 449.

<sup>27</sup> *Id.* at 451.

<sup>28</sup> Francis E. McGovern, *Distribution of Funds in Class Actions – Claims Administration*, 35 *J. Corp. L.* 123 (2009).

<sup>29</sup> *Interim Report*, *supra* note 13, at 80; see also Coffee, *Reforming the Securities Class Action*, *supra* note 10, at 1560.

<sup>30</sup> Booth, *Buzzard*, *supra* note 11, at 901.

such suits have little if anything to do with their filing and settlement. Rather, claimants' lawyers file securities class actions virtually any time the stock price of a company declines; and companies almost invariably settle such suits for a monetary payment to the claimants—even if the companies have done nothing wrong—because the costs of fighting the case to a verdict are prohibitively high. For Switzerland to allow investors to pursue their claims through a class action mechanism would almost certainly impose similar costs on Swiss taxpayers, investors, and consumers.

Securities class actions account for a very significant portion of litigation in the United States. 3,315 issuers have been named as defendants in U.S. securities class action lawsuits since 1995, which averages out to over 200 suits per year.<sup>31</sup> The prevalence of such suits appears particularly stark when compared to the role of class actions in other areas of U.S. law—such as tort, contract, employee benefits, and employment rights. Securities class actions overwhelm these other categories, accounting for approximately half of all class actions filed in the United States and representing more than four times more filings than any other single category.<sup>32</sup>

Class actions are particularly pervasive in the financial market context because such suits are extremely lucrative for some claimants and their attorneys, regardless whether the claims are meritorious. Over 60 percent of the U.S. securities class actions resolved since 1996—essentially all of the suits that are not dismissed early on because they lack merit on their face—have settled for a monetary payment from the defendant to the claimants.<sup>33</sup> And the amounts transferred in these settlements have been “enormous.”<sup>34</sup> The total value of U.S. securities class action settlements in 2009 was \$3.83 billion,<sup>35</sup> and the average such settlement between 2003 and 2010 amounted to \$42.8 million.<sup>36</sup> Indeed, the ten largest U.S. securities class action settlements have all exceeded \$1 billion.<sup>37</sup>

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<sup>31</sup> See Stanford Law School Securities Class Action Clearinghouse Statistics (last updated June 20, 2011), <http://tinyurl.com/4qzbnhl>. In 1995, the U.S. Congress enacted legislation—the Private Securities Litigation Reform Act—that was intended to rein in the abuses associated with such suits, including “nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and ‘manipulation by class action lawyers of the clients whom they purportedly represent.’” *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (quoting H.R. Rep. 104-369, at 31 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730). The PSLRA’s modest safeguards, such as a heightened pleading standard, have failed to have a meaningful effect on the prevalence or vexatiousness of such suits.

<sup>32</sup> *Interim Report*, supra note 13, at 74.

<sup>33</sup> See Dr. Jordan Milev, Robert Patton, & Svetlana Starykh, *Trends 2010 Year-End Update: Securities Class Action Filings Accelerate in Second Half of 2010; Median Settlement Value at an All-Time High* 13, NERA Econ. Consulting (Dec. 14, 2010), <http://tinyurl.com/6jcjvje>.

<sup>34</sup> *Interim Report*, supra note 13, at 74.

<sup>35</sup> See Laura E. Simmons & Ellen M. Ryan, *Securities Class Action Settlements: 2009 Review and Analysis* 1, Cornerstone Research (2010), <http://tinyurl.com/4h29v8h>.

<sup>36</sup> Milev et al, supra note 33, at 17.

<sup>37</sup> The top ten (\$MM) are: (1) Enron Corp. (2007): \$7,242; (2) WorldCom, Inc. (2005): \$6,158; (3) Cendant Corp. (2000): \$3,561; (4) Tyco International, Ltd. (2007): \$3,200; (5) AOL Time Warner Inc. (2006): \$2,650; (6) Nortel Networks (I) (2006): \$1,143; (7) Royal Ahold, NV (2006): \$1,100; (8) Nortel Networks (II) (2006): \$1,074; (9) McKesson HBOC Inc. (2008): \$1,043; (10) American International Group, Inc. (2010): \$1,010. See *id.* at 21.

The frequency of these settlements, and their enormous size, would not present a concern if the defendant companies had actually defrauded the investors in the class. In fact, however, the evidence suggests the contrary. It shows that the merits of the case by and large do not drive either a claimant's decision to file a securities class action suit or a defendant's decision to settle one. Filings are triggered by declines in stock price and the amount of the defendant's insurance coverage, not the existence of credible evidence of fraud.<sup>38</sup> Indeed, securities class action lawsuits increasingly are a matter of course in the United States when a company's stock price falls in the wake of bad news<sup>39</sup>—even though an unforeseeable business reversal is overwhelmingly more likely than fraud by the company to have been responsible for the decline. The event need not even be adverse to precipitate a suit. For example, claimants in the United States now routinely challenge the prices and terms of merger-and-acquisition deals immediately upon their announcement.<sup>40</sup>

The evidence likewise shows that factors other than the legitimacy of the claims generally drive the decision of a defendant company to settle a class action suit.<sup>41</sup> Contesting a securities class action can result in significant and unpredictable costs that most companies cannot afford to sustain.<sup>42</sup> In particular, battling these cases can divert management's time and attention, lead to the incurring of massive legal bills, and run the risk that a jury will impose potentially catastrophic liability on the company. Exacerbating these problems is the difficulty of "[d]istinguishing fraud from mere business reversals."<sup>43</sup>

JDS Uniphase is one of the few companies to have litigated a securities class action to a verdict in U.S. court in the last decade. Its experience should, in our opinion, give FINMA significant reason for pause before recommending the imposition of a class action regime on the country's financial markets and economy. Although a U.S. jury *exonerated* the company in 2008, the case lasted for five years and cost the company \$50 million in legal fees.<sup>44</sup>

Faced with the prospect of such costs (or, even worse, a massive judgment imposed by an unpredictable jury), it is no surprise that companies—even those that have not violated the law—almost invariably decide to cut their losses and settle at the litigation's early stages. Indeed, only a small handful of U.S. securities class actions—twenty-two as of November 2010—have been tried to a verdict in the past decade (with only seven of those verdicts resulting in a decision in

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<sup>38</sup> See Patrick M. Garry et al., *The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform*, 49 S.D. L. Rev. 275, 287 n.98 (2003-2004) (citing studies).

<sup>39</sup> See Kevin Lacroix, *A Closer Look at the 2010 Securities Lawsuit Filings*, D&O Diary, Jan. 3, 2011, <http://tinyurl.com/4j9hwvk>.

<sup>40</sup> See Dionne Searcey & Ashby Jones, *First, the Merger; Then the Lawsuit*, Wall St. J., January 10, 2011.

<sup>41</sup> See, e.g., *id.* (citing studies); Baker & Griffith, *supra* note 2, at 831; Alexander, *Merits*, *supra* note 12, at 528-34.

<sup>42</sup> See *Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009: Hearing Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong., at 3 (Sept. 17, 2009), <http://tinyurl.com/4thqkpv> (statement of Adam C. Pritchard, Professor, University of Michigan Law School) ("Given the trading volume in secondary markets," the upshot of application of the fraud-on-the-market theory is that "the potential recoverable damages in securities class actions can be a substantial percentage of the corporation's total capitalization, easily reaching hundreds of millions of dollars, and sometimes billions.").

<sup>43</sup> *Id.*

<sup>44</sup> See Ashby Jones, *JDS Wins Investor Lawsuit, Bucking a Trend*, Wall St. J., June 2, 2008.

favor of the plaintiffs).<sup>45</sup> Thus, although Switzerland differs from the United States in that a judge rather than a jury would determine liability in any investor class action that goes to trial, that does not provide much reason for comfort. The costs of such suits are largely imposed before the case ever reaches the courtroom door.

Because of how the system operates in practice, securities class actions have unfortunately become a regular and burdensome tax on doing business in the United States. The costs are significant. We have already noted the enormous amounts that companies pay—billions of dollars annually—to settle claims that often lack merit. Moreover, securities class action suits impose significant costs on the legal system itself, “disproportionately claim[ing] judicial time and attention.”<sup>46</sup> The relatively high administrative costs of these lawsuits are a deadweight loss that falls squarely on the shoulders of American taxpayers,<sup>47</sup> and that Swiss taxpayers would have to bear as well if the Swiss legislature determines to implement this mechanism.

These costs are not restricted to companies that are sued. As already noted, insurance costs for a Fortune 500 company are over six times higher in the United States than they are in Europe—a differential attributable largely to the existence of class actions in the United States.<sup>48</sup> Transferring this litigation threat to Switzerland will inevitably result in the imposition of these higher insurance costs on all Swiss companies with publicly-traded securities.

Securities class actions also destroy massive amounts of shareholder wealth. A study published in 2010 reported that securities class actions brought against companies “are highly disruptive,” and on average have a negative effect on the share price of the target company even over the long-run.<sup>49</sup> Another 2010 study by scholars from three U.S. law schools reported that “[a]lthough uncertainty persists about the precise connection between settlements and financial distress, there is no uncertainty that firms involved in securities class action litigation experience statistically greater risks of financial distress than their cohort firms.”<sup>50</sup> This study also noted that “the burdens of ongoing embroilment in [a] securities class action contribute to the firm experiencing value-decreasing pressures.”<sup>51</sup> The only systematic effort to quantify these costs—a study of almost 500 lawsuits filed between 1995 and 2005—found that “at least \$24.7 billion in shareholder wealth was wiped out just due to litigation.”<sup>52</sup>

These costs, beyond their immediate effect on businesses and shareholders, also have negatively impacted the attractiveness of the United States as an investment destination, thus

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<sup>45</sup> Milev et al., *supra* note 33, at 15.

<sup>46</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 10, at 1540.

<sup>47</sup> *See id.*

<sup>48</sup> *See* note 18, *supra*, and accompanying text.

<sup>49</sup> *See* Rob Bauer & Robin Braun, *Misdeeds Matter: Long-Term Stock Price Performance after the Filing of Class-Action Lawsuits*, 66 *Fin. Analysts J.* 74, 83, 91 (2010) (noting exceptions for suits alleging a breach of the duty of loyalty by insiders and suits based on allegations of accounting fraud).

<sup>50</sup> Lynn Bai et al., *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Target Firms*, 158 *U. Pa. L. Rev.* 1877, 1913 (2010).

<sup>51</sup> *Id.*

<sup>52</sup> Thakor, *supra* note 8, at 14.

undermining the international competitiveness of the U.S. economy and its capital markets. Significantly, at least three independent reports issued over the last five years have identified securities class action litigation as an issue of major concern deserving the immediate attention of U.S. policymakers. The reports all found evidence that such suits were driving away foreign investors, causing job losses, and reducing the pool of capital available for U.S. businesses.

First, a 2007 study commissioned by New York Senator Charles E. Schumer and New York Mayor Michael R. Bloomberg to identify reasons for the decreasing competitiveness of U.S. capital markets reported that “the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business—and driven away potential investors.”<sup>53</sup> According to the report, “[w]hen asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem.”<sup>54</sup>

Second, a 2007 poll by the Financial Services Forum of 334 senior executives of companies based in the United States, United Kingdom, Germany, France, India, China, and Japan provided further evidence of the effect of securities class actions on foreign investment. One out of three companies that considered going public in the United States rated litigation as an “extremely important factor in their decision,” and “nine out of 10 companies who de-listed from a U.S. exchange” from 2003-2007 “said the litigation environment played some role in that decision.”<sup>55</sup>

Third, the Interim Report of the Committee on Capital Markets Regulation declared in 2006 that “the United States is losing its leading competitive position” compared to markets abroad, in large part due to escalating “liability risks.”<sup>56</sup> Indeed, according to the report, “[f]oreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market.”<sup>57</sup>

FINMA may have the impression that it will be able to design a securities class action system with sufficient built-in safeguards to protect against the abuses and distortions that are so prevalent under the U.S. system.<sup>58</sup> In our view, however, the lessons of the U.S. experience would not support any such optimism. Rather, that experience shows that the costs imposed by securities class actions in the United States are inherent to any class action mechanism, and thus largely unavoidable no matter how the particular system is designed. The massive recoveries available in such suits create a strong temptation for claimants to bring them any time a company’s stock price declines as a result of a business reversal. And the expense that companies must incur in defending such suits, combined with the potential for crippling liability, creates an overwhelming pressure on a defendant to settle by paying money to the claimants—even if it has not actually done anything wrong. Thus, no amount of procedural tinkering and

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<sup>53</sup> McKinsey & Co., Report Commissioned by Mayor Michael R. Bloomberg & Senator Charles E. Schumer, *Sustaining New York’s and the U.S.’ Global Financial Services Leadership* ii (2007), <http://tinyurl.com/yf3uu6o>.

<sup>54</sup> *Id.* at 75.

<sup>55</sup> Financial Services Forum, *2007 Capital Markets Survey* 6-8 (2007), <http://tinyurl.com/4d3jaf8>.

<sup>56</sup> Interim Report, *supra* note 13, at ix, 2-3, 29-34.

<sup>57</sup> *Id.* at 11, 71.

<sup>58</sup> *Id.*

fine-tuning can avoid the abuse and disruption that result when the class action mechanism is applied in the context of financial transactions. The only way to avoid those harms is to forego reliance on the class action mechanism altogether. As we show in the next section, moreover, Switzerland can make that choice without necessarily compromising the laudable and important goal of compensating injured investors.

#### **IV. Public Mechanisms Are More Effective than Class Actions at Compensating Investors**

One of the primary functions of any system of financial market regulation is, of course, ensuring that defrauded investors have an effective and accessible mechanism for recovering compensation from those who have injured them. Even if FINMA is concerned that the existing compensatory mechanisms under Swiss law are not adequate, class actions are not the appropriate cure for the problem. Instead, Switzerland would better serve investors, businesses, and other stakeholders by developing a more robust *public* mechanism for compensating injured investors.

If FINMA decides to follow this approach, it may wish to consider the “Fair Funds” mechanism administered by the U.S. Securities and Exchange Commission (“SEC” or the “Commission”) as a possible model. Each year, the SEC collects substantial civil penalties and disgorgements from securities law violators—in FY 2010, these recoveries amounted to a total of \$2.8 billion.<sup>59</sup> The Commission originally was required to remit these penalties to the U.S. Treasury; however, in 2002, in an effort to enhance the SEC’s role in compensating defrauded investors, Congress authorized the Commission to place such recoveries into so-called “Fair Funds” for distribution to investors harmed by the punished conduct.<sup>60</sup> Either a court or the SEC, after a period for public comment, must approve any plan for the distribution of a Fair Fund. This procedure ensures proper identification of the eligible beneficiaries and accurate calculation of their shares of the fund.

As one U.S. commentator has noted, the SEC has “embraced [the Fair Funds mechanism] enthusiastically,” establishing such funds “in a number of high-profile cases involving financial fraud by corporate defendants, and [taking] pride in the large amounts of money it has obtained for distribution to investors.”<sup>61</sup> The SEC has transferred significant amounts to date: since 2002, it has created 128 Fair Funds, and returned \$6.9 billion to injured investors.<sup>62</sup> Thus, Fair Funds appear to be functioning as a relatively effective and low-cost alternative to private securities litigation. Indeed, the Supreme Court has suggested as much, referring in one recent case “to SEC collections under the Fair Fund provision as a policy ground for not expanding outside actors’ . . . liability to private parties [for securities fraud].”<sup>63</sup> Congress confirmed the success of

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<sup>59</sup> See Government Accountability Office (“GAO”), *SEC’s Financial Statements for Fiscal Years 2010 and 2009*, GAO-11-202, at 17 (Nov. 15, 2010).

<sup>60</sup> Sarbanes-Oxley Act, Pub. L. No. 107-204, § 308(a), 116 Stat. 745 (codified at 15 U.S.C. § 7246(a)).

<sup>61</sup> Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 *Bus. Law.* 317, 318 (2008) (footnote omitted).

<sup>62</sup> See GAO, *SEC Fair Fund Collections and Distributions*, GAO-10-448R, at 31 (Apr. 22, 2010).

<sup>63</sup> Black, *supra* note 61, at 319 (citing *Stoneridge Partners, LLC v. Scientific-Atlantic, Inc.*, 552 U.S. 148, 166 (2008)).

the program when it enacted legislation last year expanding the scope of penalties that may be distributed through a Fair Fund.<sup>64</sup>

The Fair Funds mechanism has clear advantages over the U.S. private securities litigation system. Certain restrictions that U.S. law imposes on private claimants who bring securities fraud suits do not apply to the SEC. Unlike such claimants, the Commission need not have been a purchaser or seller of securities<sup>65</sup> and need not establish that it relied on the fraudulent statements<sup>66</sup> or sustained a loss because of them.<sup>67</sup> Moreover, the SEC, unlike private claimants, can bring actions against aiders and abettors,<sup>68</sup> and it enjoys a longer statute of limitations than private claimants. The SEC also takes the position that certain restrictions on the level of permissible damages under U.S. law do not apply to Fair Funds distributions.<sup>69</sup>

Most importantly, the Commission—as a government agency staffed by experts and charged with a public purpose—can ensure that funds are distributed only when recovery is justified on the merits, rather than for the more self-interested reasons that generally motivate private litigants and their lawyers. In particular, a government entity such as the Commission can account for the problems of overcompensation of diversified investors and circularity discussed above in seeking penalties and making disbursements to investors, thus making sure that the focus is on protecting innocent investors and ensuring that compensation goes to those who are entitled.

Finally, and perhaps most importantly, attorneys' fees and other costs do not reduce the amount available for Fair Funds distributions.<sup>70</sup> In the United States, claimants' lawyers take approximately 25 to 33 percent right off the top of the average recovery in private litigation, with attorneys' fees that approach 50 percent of the settlement value not infrequent.<sup>71</sup> In 2010, aggregate attorneys' fees in securities class actions totaled \$1.353 billion.<sup>72</sup> Despite the differences between the Swiss and U.S. approaches to attorneys' fees and other aspects of lawyer compensation, similar cost-saving advantages of public over private compensatory mechanisms presumably would apply in the Swiss context as well.

More generally, the evidence from cross-border studies shows that a robust scheme of public enforcement is far more effective than private litigation at achieving the goals of securities regulation.<sup>73</sup> As two prominent academics at Harvard Law school found in a comprehensive study of the issue, “[r]esource-based public enforcement is regularly associated with deeper

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<sup>64</sup> See Dodd-Frank Act, Pub. L. 111-203, § 929P(b), 124 Stat. 1376, 1381 (2010).

<sup>65</sup> See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737-38 (1975) (holding that only a purchaser or seller of securities can bring a private action under Rule 10b-5).

<sup>66</sup> See *Stoneridge*, 552 U.S. at 159.

<sup>67</sup> See 15 U.S.C. § 78u-4(b)(4).

<sup>68</sup> See *id.* § 78t.

<sup>69</sup> See Black, *supra* note 61, at 335.

<sup>70</sup> See Paul S. Atkins, Comm’r, SEC, *Remarks before the ILR* (Feb. 16, 2006) (observing that “we do not allow any of the funds from the SEC action to be paid to private lawyers”), <http://tinyurl.com/6yxhbt4>.

<sup>71</sup> See Langevoort, *Without Wheels*, *supra* note 10, at 628 n.2; Coffee, *Reforming the Securities Class Action*, *supra* note 21, at 1545-46.

<sup>72</sup> See Milev et al., *supra* note 33, at 235.

<sup>73</sup> Jackson & Roe, *supra* note 5, at 28.

securities markets,”<sup>74</sup> while liability in private lawsuits is often “negatively correlated with robust capital markets, at times significantly.”<sup>75</sup> Indeed, their results show that “[a]llocating more resources to public enforcement is positively associated with robust capital markets, as measured by market capitalization, trading volume, the number of domestic firms, and the number of initial public offerings.”<sup>76</sup> As another prominent academic stated in summarizing this work, “public enforcement [of the securities laws] typically dominates private enforcement.”<sup>77</sup> This is unsurprising. As discussed above, such suits “often do not penalize the relevant actors, can distort incentives, and can be inefficacious.”<sup>78</sup> And they also virtually always settle for reasons unrelated to the merits and without any determination regarding the wrongfulness of the defendant’s conduct.<sup>79</sup>

We hope that these hard-won lessons from the U.S. experience with securities class actions will be helpful to you as FINMA continues to consider whether to implement its own class action mechanism for retail investors. We thank you for your consideration of this submission, and would be happy to discuss these issues further with you and your staff.

Sincerely,

Lisa A. Rickard  
President  
U.S. Chamber Institute for Legal Reform

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<sup>74</sup> *Id.*.

<sup>75</sup> *Id.* at 31.

<sup>76</sup> *Id.* at 2.

<sup>77</sup> Coffee, *Law and the Market*, *supra* note 5, at 302 (quoting Howell E. Jackson & Mark J. Roe, *Public Enforcement of Securities Laws: Preliminary Evidence* 37 (Aug. 8, 2007) (unpublished manuscript)).

<sup>78</sup> Jackson & Roe, *supra* note 5, at 2.

<sup>79</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 10, at 1534.