Taking Certification Seriously – Why There is No Such Thing as an Adequate Representative in a Securities Fraud Class Action

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IN A SECURITIES FRAUD CLASS ACTION

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ABSTRACT

Securities fraud class actions (SFCAs) arising under Rule 10b-5 are well established as a feature of the legal landscape, but they are a vestige of a largely outdated view of investor behavior and preferences. In the 1960s, most investors were undiversified stock pickers. Today, most investors hold stock through well diversified institutions. As a result, most investors are net losers from SFCAs. Moreover, it is arguable that it is irrational for most investors not to be diversified. A passive investor who fails to diversify assumes unnecessary risk for the same expected return that diversified investors enjoy. Given that federal securities law is intended to protect reasonable investors, it follows that it should be interpreted and applied consistent with the interests of diversified investors where the interests of diversified and undiversified investors diverge. For a diversified investor, gains and losses from securities fraud net out over time. But they lose to the extent of attorney fees and they lose when they are holders (which is most of the time) to the extent that defendant companies must compensate purchasers. In short, diversified investors would prefer that SFCAs be abolished. The one exception arises when insiders gain from the fraud such as by selling their shares before the release of bad news. But the appropriate remedy in such a case is a derivative action by which the company recovers from the wrongdoers.

The thesis here is that the courts should decline to certify securities fraud actions as class actions under FRCP 23 because of the conflicting interests of class members. Undiversified stock pickers – usually a minority of the plaintiff class – may favor SFCAs. But many diversified investors – particularly those who follow a portfolio balancing strategy – would prefer that the courts refuse to certify such actions as class actions because such investors usually lose more on stock they hold than they gain on stock they bought during the class period. To be sure, many diversified investors (including institutional investors) engage in some stock picking (although some such as index funds eschew it altogether). Such an investor might favor certification of actions in which he has bought a large amount of the subject stock during the class period relative to preexisting holdings even though the same investor would favor the abolition of SFCAs generally. Moreover, not even a strict portfolio balancing investor who would oppose certification because she loses more on stock she holds than she gains on stock she bought would dare to opt out of the SFCA if it is certified. Thus, it does no good for the courts to rely on investors to vote with their feet. Investors who opt out of the action effectively pay those who stay in by forgoing compensation for their losses. The bottom line is that the courts should refuse to certify securities fraud actions as class actions unless it is shown that the plaintiff class is composed wholly of undiversified investors. If the action involves allegations that insiders have somehow gained from the fraud or that the corporation itself has been damaged by the fraud, the action should proceed as a derivative action. And given that a derivative action is a form of class action, it is quite clear that the courts have the power under FRCP 23 (and FRCP 23.1) to recast any purported SFCA in such terms.

This is not to say that individual investors should not continue to have standing to sue under Rule 10b-5. Indeed, an investor who seeks to gain control or influence over a target company is likely to be undiversified. If such an investor suffers a fraud in connection with his purchase of target stock, he has standing to sue the wrongdoers if he can make out a claim. Nor does the argument here imply that there is a fundamental problem with remedies under the 1933 Act. In essence, the 1933 Act provides for disgorgement by issuers in cases in which they have effectively misappropriated capital from the market by false pretenses. Similarly, in the context of an SFCA under Rule 10b-5 in which insiders have gained from misappropriation (such as insider trading) during the fraud period or have visited loss on the issuer by damage to reputation or otherwise, the appropriate remedy if for the issuer to seek compensation. In other words, the approach advocated here is wholly consistent with the general scheme of federal securities law.

Keywords: securities fraud, class action, certification, adequate representative, diversified investor, undiversified investor, stock picking, portfolio balancing, insider trading, misappropriation, derivative action, buyer-holder, opt-out, subclass, conflicting interests

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Introduction

Over the last ten years, nearly 2400 securities fraud class actions (SFCAs) have been filed against publicly traded companies in the United States.[1] These actions have resulted in settlements of about $27 billion and attorney fees of about $7 billion.[2] More than one in fifty companies is the target of such an action each year.[3] But for diversified investors – the great majority of investors – SFCAs confer no net benefit. Indeed, for diversified investors SFCAs reduce investment returns. At best, recovery is an expensive rearrangement of wealth from one pocket to another – minus a cut for the lawyers. Accordingly, and as I have argued elsewhere, SFCAs should be dismissed for failure to state a claim for compensable damages – and *a fortiori* for lack of loss causation – except in cases in which insiders have misappropriated stockholder wealth through insider trading or otherwise. Moreover, in such cases, diversified investors would prefer that the action be prosecuted in the name of the corporation seeking recovery by the corporation (whether by the corporation itself or derivatively).

The thesis here is that the courts should decline to certify SFCAs as class actions because the conflicting interests of diversified investors and undiversified investors cannot be reconciled. The usual solution – the formation of subclasses – cannot work because the interests of the subclasses are diametrically opposed. While undiversified investors want the action to proceed, diversified investors prefer dismissal except in cases that properly seek recovery by the corporation. If the SFCA proceeds, diversified investors lose. As a result, it is impossible for anyone to be an adequate class representative. Accordingly, SFCAs are inherently unmanageable.

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[1] *See* Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review,* at 1.

[2] *See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post Reform-Act Securities Settlements, 2005 Review and Analysis,* at 1; Anjan V. Thakor, *The Economic Reality of Securities Class Action Litigation* (Navigant Consulting, October 26, 2005), Exhibit A (finding plaintiff attorney fees of $1.7 billion in connection with settlements totaling $11.9 billion in a sample of 482 class actions). Assuming that this sample is representative of the percentage of settlement awarded as plaintiff attorney fees (approximately 14 percent in the sample), a good estimate of the total plaintiff attorney fees awarded in SFCAs since 1995 is $3.6 billion (14 percent of $26 billion). Assuming that defendant firms have been paid roughly the same amount, it seems a fair estimate that SFCAs have generated about $7 billion in attorney fees over the last ten years. To be sure, defendant firms are paid in all cases, whether or not the plaintiff prevails, but presumably defendant firm fees are a good deal less than plaintiff firm fees in cases in which plaintiffs prevail. Note that plaintiff attorney fees are paid out of the settlement and that accordingly the estimated amount available for investors was $26 billion less $3.6 billion or about $22.4 billion. *See* Thomas Baker & Sean Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market* (2006), http://ssrn.com/abstract=909346.

[3] *See Cornerstone Research, Securities Class Action Case Filings, 2005: A Year in Review,* at 4.

The focus here is on SFCAs arising under the 1934 Act (Rule 10b-5) and relating to trading in outstanding shares. The argument does not apply in connection with actions arising under the 1933 Act and relating to the public offer of shares. SFCAs under Rule 10b-5 usually arise from the failure of a publicly traded company to disclose material information in a timely fashion. The information itself may be either good news or bad news. In other words, an action may be triggered by news that causes the price of a stock to rise (in which case those who sold during the fraud period suffer harm) or by 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.[4] But actions based on bad news are far more common.[5] Thus, the discussion here is based 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 during the fraud period and continue to hold it until corrective disclosure.[6] The standard approach to damages in a bad news case is to award the difference between the price paid by the buyer and the market price after corrective disclosure.[7] And it is the company (or its insurance company) that pays the award.

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[4] *See, e.g.,* Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (good news); Time Warner Securities Litigation, 9 F.3d 259 (2d Cir. 1993) (bad news). There are, of course, many other forms of securities fraud, ranging from those arising in face-to-face dealings to those arising in connection with corporate level mismanagement, but these other actions are seldom amenable to pursuit as class actions. In other words, SFCAs invariably arise as a result of an issuer's failure to disclose material information to the market in a timely fashion.

[5] Actions based on bad news are more common *because* of the way damages are awarded in securities fraud class actions. Because the company pays, the stock price falls further thus enhancing damages through positive feedback and making the SFCA that much more lucrative for the plaintiff lawyers. In a good news case, the SFCA has the effect of muting the price increase through negative feedback and reducing the potential award. Data indicate that of the104 SFCAs filed in 2006, only two involved good news. See Appendices.

[6] The fraud period is the period between an actionable misrepresentation or omission and corrective disclosure. Some may quibble with this characterization in that it can be unclear exactly when the truth comes out. *See* Broudo v. Dura Pharmaceuticals, Inc., 339 F.3d 933 (9th Cir. 2003), *rev'd,* 2005 U.S. LEXIS 3478 (holding that loss causation may be proved by evidence that a stock was overpriced as a result of false statements or omissions at the time of purchase even though the price did not fall with corrective disclosure). *See generally* Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation,* 59 Bus. Law. 1419 (2004). Nevertheless, no one seems to deny that the price of the stock must decline for some reason after the plaintiff purchases, and most would likely agree that the decline must somehow be tied to the original failure of disclosure. Thus, for convenience, I will assume here that a prototypical SFCA involves a prolonged failure of disclosure followed by a corrective disclosure by which the whole truth comes out all at once and with no interim leakage. I should note that I do not distinguish here between misrepresentations and omissions. Both are generally actionable, although there are subtle differences in the relevant law. *Compare* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972), *with* Basic, Inc. v. Levinson, 485 U.S. 224 (1988). In practice, most securities fraud class actions arise from some combination of the two. For example, a company might issue a press release or periodic report that is correct at the time of release. The press release then becomes false or misleading as a result of intervening events, but the company then fails to issue another release to correct the lingering false impression. *See* In Re Time Warner Securities Litigation, 9 F.3d 259 (2d Cir. 1993).

[7] This description of how damages are calculated is a bit oversimplified, but it is good enough for present purposes. Although there has been no case in which a jury has actually done so, the courts have generally agreed that the jury should determine the correct market price of the subject stock on each day during the fraud period in effect creating a price line that would be compared to the market price day by day to determine the damages for investors who bought on any given day. This approach to calculating damages can be traced back to *Green v. Occidental Petroleum Corp.,* 541 F.2d 1335 (9th Cir. 1976), and it is the formulation upon which Congress relied in connection with the Private

Although some investors may recover substantial sums in a class action, most investors lose from such actions. A diversified investor is equally likely to sell an overpriced stock as to buy one. For such investors, gains and losses wash out over time. In other words, a diversified investor is likely to gain from the timely sale of an overpriced stock about as often as she loses from the untimely purchase of an overpriced stock. But the investor who innocently sells an overpriced stock need not disgorge her (effective) gain. And over time such gains make up for losses. Thus, a diversified investor is effectively insured against securities fraud by virtue of being diversified. For a diversified investor, the cost of SFCAs – in attorney fees and other expenses – constitutes a deadweight loss.

Diversified investors should be opposed to SFCAs for this reason alone. But diversified investors lose even more from SFCAs in cases in which they neither buy nor sell the subject stock – in cases in which they are mere holders of the subject stock. To be specific, the *prospect* of payout by the defendant company causes its stock price to fall more than it otherwise would even in a perfectly efficient market. It 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. [8] In other words, the prospect of payout to the plaintiff class causes the price of the subject stock to fall by an amount in addition to the decrease attributable to the disclosure of new negative information. That in turn increases the potential damages payable by the subject company causing a further decrease in price. And so on. The extent of feedback ultimately depends on the number of shares represented by the plaintiff class. For example, if the holdings of the plaintiff class are equal to 50 percent of the outstanding shares, the decrease in the price of the subject stock will be *twice* what it would have been in the absence of a class action.[9]

For the foregoing reasons, diversified investors should be positively *opposed* to SFCAs except in cases in which insiders have taken advantage of the situation to misappropriate stockholder wealth

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Securities Litigation Reform Act (PSLRA). *See* H.R. CONF. REP. NO. 104-369 at 42. Although this is a common description of the measure of damages, and may well be applied in some cases, it is a gross oversimplification. For example, factors other than fraud may have affected market price before corrective disclosure, or the truth may dribble out. *See* Richard A. Booth, *Windfall Awards Under PSLRA,* 59 Bus. Law. 1043 (2004); Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions,* 48 Stan. L. Rev. 1487, 1490-92 (1996); Michael Y. Scudder, *The Implications of Market-Based Damages Caps in Securities Class Actions,* 92 Nw. U. L. Rev. 435 (1997). Of course, most SFCAs are settled if they are not dismissed. Thus, it is unusual for damages ever to be awarded by a court. Nevertheless, the putative measure of damages will affect settlement negotiations. Moreover, given that the settlement of a class action must be approved by the court, the court itself may well consider the parties' assumptions and estimates as to damages. Accordingly, I use the more neutral word *award* to refer herein to both damages and settlements.

[8] *See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post Reform-Act Securities Settlements, 2005 Review and Analysis,* at 14

[9] The appendix sets forth the formula for calculating the feedback effect in both bad news and good news cases together with charts showing the results for various class sizes. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007). http://ssrn.com/abstract=683197 One of the many problems associated with SFCAs is that there is no reliable way to determine the number of different shares traded during the fraud period, because there is no doubt that some shares are *bought and sold* during the fraud period. *See* Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits,* 56 Bus. Law. 483 (2001).

through insider trading or other forms of misappropriation such as timing and backdating of options. In the absence of insider misappropriation, securities fraud is a zero sum game. Buyer losses are offset by seller gains. Investors in the aggregate – the market – neither gain nor lose. But if insiders use the opportunity to extract gains, investors suffer a genuine loss. In such cases, a diversified investor would prefer to have the issuer recover the ill-gotten gains by means of derivative action or direct action by the issuer. But there is no situation in which a diversified investor would favor a system of securities regulation that includes SFCAs as we know them.[10] In contrast, an *undiversified* investor might favor a class action remedy. An undiversified investor may suffer real harm from securities fraud. An investor who forgoes the benefits of diversification and picks a single stock can lose her entire investment. For such an investor, the benefits of SFCAs may outweigh the costs.[11]

In short, there is a fundamental conflict between the interests of diversified investors and the interests of undiversified investors.[12] Diversified investors would oppose SFCAs while undiversified investors would favor such actions. Diversified investors would favor the prosecution of a derivative action in any case involving insider misappropriation. While undiversified investors would not object to a derivative action to recover for misappropriation, they would favor a class action over a derivative action if they had to choose between the two. To be sure, even a diversified investor might favor the prosecution of class actions in individual cases if *other* investors prosecute such actions. Indeed, a diversified investor really has no choice but to join in any class action that is filed for which he is eligible. If he fails to do so, the compensation that goes to other investors will reduce his returns without any offsetting gain from those cases in which he is eligible to join the plaintiff class. You gotta be in it to win it.

As I have argued elsewhere, the courts could fix things by dismissing any SFCA in which there is no reason to believe that insiders have engaged in misappropriation on the theory that the class has suffered no compensable harm.[13] As for those actions in which it appears that insiders have

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[10] It is ironic that the court (per Justice Ginsburg) begins its recent *Tellabs* opinion with the statement that it "has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecution and civil enforcement actions...." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 2007 US LEXIS 8270. While the Court follows this statement with the qualification that it also recognizes that the system can be abused to impose unjustified costs on innocent companies and individuals, the tea leaves seem to indicate that the justices are not inclined to scrap the system.

[11] It is not completely clear that even an undiversified investor would favor the existing system if she understood that it causes stock price to fall more than it otherwise would. From an *ex ante* perspective such an investor is more likely to be a holder than to be a buyer and is thus more likely to lose as a result of feedback than to gain from being a member of the plaintiff class.

[12] *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions,* 48 Stan. L. Rev. 1487, 1506 (1996).

[13] This argument depends somewhat on the court looking at the class as a class broadly defined as all investors (or at least all buyers) and not as a cherry-picked collection of individuals who would prefer that the action proceed as a direct class action. In other words, the argument requires a court to focus on the *net* effect of the fraud. As a matter of settled law, a court cannot consider the interests of holders, but it can presumably consider the interests of buyer-holders – those who owned some shares in the subject company before the fraud period and then bought additional shares during the fraud period – as explored in detail below. To some extent the courts do consider the net interests of the plaintiff class when (for example) they eliminate the claims of in-and-out traders in estimating damages. The tension between individual claims and net claims is also evident in the varying approaches to materiality. The Supreme

misappropriated stockholder wealth, the court should recharacterize the action as a derivative action.[14]

The thesis here is somewhat different. It is that the courts should decline to certify a securities fraud action as a class action because the conflicting interests of diversified and undiversified investors make it impossible for a class action to be prosecuted consistent with the interests of both groups of investors. Specifically, FRCP 23(a) requires that the court determine that the representative plaintiff(s) will fairly and adequately protect the interests of the class. That is impossible where the interests of class members are diametrically opposed – where one group would favor prosecution of the action and one group would favor dismissal of the action. Thus, this is not a conflict that can be resolved by the formation of subclasses. Moreover, even if an adequate representative can be found, the requirements of FRCP 23(b)(3) relating to class actions for damages will be difficult (if not impossible) to satisfy. In a class action for damages, FRCP 23(b)(3) requires the court to consider: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions, (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class, (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum, and (D) the difficulties likely to be encountered in the management of a class action. All of these factors are problematic. Factor (A) is a problem because some members of the class would prefer that the action be dismissed. Factor (B) is a problem because a derivative action arguably provides complete relief without untoward side effects. Factor (C) is a problem because a derivative action is better handled in state court. And Factor (D) is a problem because (among other things) (1) it is difficult to draw the line between diversified and undiversified investors and (2) undiversified investors must presumably show reliance.

This paper proceeds as follows. Part I discusses the relationship between diversification and the likely trading patterns of diversified investors and seeks to quantify the interests of various types of investors in connection with the prosecution of SFCAs. Part II discusses the application of FRCP 23 in light of the likely interests of various investors and shows that few if any securities fraud actions that seek damages on behalf of individual investors should be certified as class actions.

Court has focused on an idealized reasonable investor in formulating the standard that a fact is material if a reasonable investor would consider it important in deciding how to act. But the court has emphasized that a fact need not be so important that it would change the investor's decision. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976); Basic, Inc. v. Levinson, 485 U.S. 224 (1988). *See also* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083(1991). On the other hand, it is difficult to believe that a fact could be material if does not change the decision of *any* investor or if it does not have *some* effect on the market. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005). Thus, some courts have ruled that for a fact to be material it must affect market price perceptibly. *See* Oran v. Stafford, 226 F.3d 275, 282 (3d Cir. 2000). *But see* No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 934 (9th Cir. 2003).

[14] Whether an action is properly characterized as a direct action (a class action on behalf of individual investors) or a derivative action on behalf of the corporation (and ultimately for the benefit of the stockholders) is a question for the court. *See* Bangor Punta Operations, Inc. v. Bangor & Aroostook R. Co., 417 U.S. 703 (1974); Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004).

I. THE MATHEMATICS OF SECURITIES FRAUD CLASS ACTIONS

In order to understand investor preferences in connection with the remedies provided by federal securities law, it is important to have some sense of the relative frequency with which an investor will be a buyer, a seller, or a holder. Thus, it is useful to consider the mix of situations that a diversified investor would likely encounter in the space of a year.

Diversification and Trading

There are about 10000 publicly traded companies listed on US stock exchanges. And there are about 200 SFCAs filed each year. Thus, about one in fifty companies will be the target of a class action in any given year. Consider an investor with a portfolio consisting of 500 stocks (equally weighted) and turnover of 40% per year.[15] Assuming that the portfolio is worth $1,000,000, this hypothetical investor buys and sells $400,000 in stocks during the course of a year. The investor can expect that ten portfolio companies will be the target of a class action each year. Statistically, the investor will be a buyer in two cases, a seller in two cases, and a holder in six cases.[16] From this analysis alone, the investor would likely see that SFCAs are wasteful. But we can be more specific.

Assume that the investor holds $2000 worth of each of the 500 stocks. Assume further that each of the ten stocks affected by a class action would have fallen in price by 10% based solely on the disclosure of bad news (without any feedback effect). Assume yet further that the plaintiff class comprises 50% of the stockholders in each case.[17]
In a world *without* SFCAs, the hypothetical investor would lose 10% of the value of each of eight stocks. He would avoid losses on the two stocks he sold.[18] His total loss in connection with the ten stocks would thus be $1600.

In a world *with* SFCAs, the investor would recover his losses on the two stocks that he bought (less fees and expenses). Assuming fees and expenses equal to 20 percent of recovery -- $80 for each

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[15] In 2006, the asset weighted turnover rate for stock mutual funds was 47% but two-thirds of all funds had turnover rates below 50%. Investment Company Institute, 2007 Investment Company Fact Book 23, http://www.ici.org/pdf/2007_factbook.pdf Thus, 40% seems like a fair estimate for the turnover rate one would expect for a conservative diversified investor who follows a buy and hold strategy and trades for portfolio balancing and tax planning. Marketwide, turnover averages just over 120% per year for US stocks. *See* NYSE Group Turnover 2007, available at: http://www.nysedata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=2990&category=3

[16] This assumes that the average class period is one year. That is roughly correct. See Appendices. If the class period in the hypothetical were (say) two years, the investor could expect to be a buyer in four cases and a seller in four cases. For data on average class size, see Appendices.

[17] Note that this class size is consistent with the population of investors. If diversified investors constitute three-quarters of the investor population (as they do), half of the plaintiff class would be undiversified investors. This also assumes that undiversified investors hold a stock for about one year on average, while diversified investors hold a stock for about two years on average.

[18] It could be said that the investor actually enjoys a gain by selling the two overpriced stocks. But for present purposes of comparison it matters only that sales be treated consistently. For the sake of simplicity, these sales are treated as generating zero loss rather than a gain to the extent of overpricing.

stock – his net loss would be $160. He would avoid losses on the two stocks that he sold. But he would lose $400 on each of the six stocks that he held -- $200 from the fundamental decline in price and another $200 from the feedback effect that results from the payout to the plaintiff class.[19] The investor's total loss would thus be $2560. If the investor opted out of the two class actions in which he was a member of the plaintiff class, he would lose $400 on each of those stocks, for a total loss of $3200.[20] The following chart sets forth these results.

	WITH CLASS ACTION REMEDY / REMAIN IN	WITH CLASS ACTION REMEDY / OPT OUT	WITHOUT CLASS ACTION REMEDY
BUY (2)	(160)	(800)	(400)
SELL (2)	0	0	0
HOLD (6)	(2400)	(2400)	(1200)
TOTAL (10)	(2560)	(3200)	(1600)

Clearly this hypothetical investor would be better off in a world without SFCAs. He would want lead plaintiffs in general to seek dismissal, but only if he could be assured that all lead plaintiffs would do so. In the absence of any such assurance, our investor would be compelled to remain in any class action for which he is eligible. In other words, if they could vote on the matter behind a Rawlsian veil of ignorance (not knowing whether they are buyers, sellers, or holders), diversified investors would vote against class certification. But once a diversified investor knows that she is a member of the plaintiff class, she will want the class action to proceed. What we have here is a collective action problem.[21]

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[19] Again, if the plaintiff class consists of 50% of the outstanding shares, the feedback effect in a bad news case will cause stock price to decline by exactly twice the amount that it would have declined in the absence of a class action. See appendix for formulas and calculations.

[20] If for some reason no class action was filed in those two cases, the investor would lose $200 in each of those two cases for a total loss of $2800. On the other hand, the market might assume that a class action would be filed (at least for some period of time following the bad news) thus enhancing the loss. Presumably the market would rebound promptly if the trial court declined to certify the class action.

[21] One might argue that if the award will be covered by insurance, diversified investors would generally favor class actions. But that will likely result in higher insurance rates for all companies in the future. And that means that a diversified investor will likely lose even more than he would have lost if the defendant company had paid. The bottom line is that diversified investors prefer to self insure against securities fraud. SFCAs are the equivalent of buying an extended warranty on a toaster. There may even be situations in which an undiversified investor would oppose a class action. If the plaintiff class is so large that success of the action threatens to bankrupt the defendant company and dirve the stock price to zero, the plaintiff class may be better off if the action is dismissed and the company survives. In other words, the value of stock in the surviving company may exceed the value of the potential recovery.

Portfolio Balancing and Trading

The foregoing analysis is somewhat unrealistic. In the real world, a diversified investor often buys more of a stock that is already in her portfolio or sells some (but not all) of the shares of a stock in her portfolio simply for purposes of balancing the portfolio.[22] For example, suppose that the investor finds that one of her 500 stocks -- Acme Fireworks is worth just $1500 while another -- Binford Tools – is worth $2500. She sells $500 worth of Binford and buys $500 worth of Acme to rebalance her portfolio. Shortly after these trades, Acme announces a restatement of earnings. Analysts revise their long-term projections for Acme downward by 10 percent. Ordinarily Acme should decrease in price by 10 percent (other things equal). But the stock settles at a price 20 percent lower because of the feedback effect from an anticipated class action. A class action is filed on behalf of investors who bought Acme during the fraud period. On paper, the investor has lost $400 on her Acme investment. But she has standing to sue only with respect to the $500 purchase and hence stands to recover at most $100 less $20 in fees and expenses or $80 net. So her loss on Acme stock will be $320 at the end of the day. In the absence of a class action, the decline would be 10 percent. And the investor would have a lost a total of $200 on her Acme investment.

How would a diversified investor want the representative plaintiff to proceed in a world with class actions? In the previous example, where the diversified investor is assumed to trade all or nothing, he would (reluctantly) want the class representative to proceed with the class action. Not so for a portfolio-balancing investor. She would want the representative plaintiff to seek dismissal of the action or for the court to deny certification. As with the all-or-nothing trader, it would do no good for the portfolio-balancing investor to opt out of the class action. If the action proceeds, she must seek her share of the recovery.

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[22] *See* Paul J. Lim, *When It Comes to Rebalancing, a Little Means a Lot,* New York Times, August 5, 2007, Business Section at 5; J. Alex Tarquinio, *Oops, It May Be Time to Rebalance That Portfolio,* New York Times, May 6, 2007, Business Section at 4:1; Mark Hulbert, *If You Know Options, You're Likely to Know Stocks,* New York Times, August 13, 2006, Business Section at 7:1; PAUL J. LIM, *Cash May Not Be King, but It's Wielding More Power,* New York Times, July 9, 2006, Business Section at 5:1; Paul J. Lim, *Hitting the Reset Button on Your 401(k),* New York Times, January 8, 2006; Business Section at 5:1; Joseph Nocera, *No, You Can't Invest Like Yale. Sorry!,* New York Times, August 13, 2005, Business Section at 1:1; Carla Fried, *3 Men, 3 Strategies, But All Lead to Profit,* New York Times, April 10, 2005, Business Section at 30:1.

The following chart shows the effects of a class action for various combinations of stock held and stock bought (assuming a plaintiff class comprising 50% of outstanding shares).

DOLLAR VALUE OF SHARES HELD	DOLLAR VALUE OF SHARES BOUGHT	RECOVERY NET OF 20% EXPENSES	ENDING VALUE WITH CLASS ACTION	ENDING VALUE WITHOUT CLASS ACTION
2000	0	0	1600	1800
1500	500	80	1680	1800
1000	1000	160	1760	1800
500	1500	240	1840	1800
0	2000	320	1920	1800

If the plaintiff class comprises 20 percent of the outstanding shares (rather than 50 percent), the feedback effect is smaller. The price of the stock will fall by 12.5 percent as a result of feedback (rather than by 20 percent as in the previous example). The following chart shows the effects of a class action under these circumstances.

DOLLAR VALUE OF SHARES HELD	DOLLAR VALUE OF SHARES BOUGHT	RECOVERY NET OF 20% EXPENSES	ENDING VALUE WITH CLASS ACTION	ENDING VALUE WITHOUT CLASS ACTION
2000	0	0	1750	1800
1500	500	50	1800	1800
1000	1000	100	1850	1800
500	1500	150	1900	1800
0	2000	200	1950	1800

In this case, an investor will favor prosecution of the class action if he bought more than 500 shares. In general, as the plaintiff class gets smaller, the feedback effect is reduced, and the conflict between buyer-holders and other class members becomes muted.

The assumption in the foregoing discussion has been that portfolio-balancing investors buy because the value of the subject shares in their portfolios has declined below some target percentage. That can happen in several different ways: (1) the shares may have fallen in value, (2) the remainder of the market may have risen in value, or (3) investors may have added cash to their portfolios. In addition, there is more than one way to balance a portfolio. It is common (especially for larger investors) to hold shares in proportion to market capitalization (or public float). Such an investor will be a buyer when the price of the subject stock rises relative to the rest of the market. Because of the mix of investor strategies, it is quite possible for portfolio-balancing investors to account for a large proportion of the class.[23]

[23] There is a limit on the number of portfolio-balancing investors that can be in the plaintiff class. Assume that 50% of the defendant company shares are represented in a class action and that half of those shares are held either by undiversified investors or all-or-nothing traders and that the other half is held by portfolio-balancing investors. If we assume that a portfolio-balancing investor seeks to hold an equal percentage of each of the shares in his portfolio, then investor purchases (on the average) must equal at least one-third of their holdings to account for such a proportion of the class. There are no more shares to go around.

The Conflict Between Direct and Derivative Actions

There is yet another conflict to consider as between investors who would prefer a class action (with individual recovery for investment losses) and investors who would prefer a derivative action (with recovery by the corporation for misappropriation). As noted above, a diversified investor would favor a derivative action over a class action. An undiversified investor would have no objection to a derivative action as long as it does not preclude a class action. Indeed, it is quite common in the real world for a class action and a derivative action to proceed side-by-side.[24] But the two actions are not completely independent of each other. If insiders have misappropriated stockholder wealth, the misappropriation constitutes a portion of the investment loss. To be sure, misappropriation is likely to account for only a small portion of investment loss. Nevertheless, the recovery for misappropriation should reduce the recovery for investment losses dollar for dollar. Moreover, because derivative recovery by the corporation benefits all investors – including both buyers and holders – buyers may object to netting the derivative recovery from the direct recovery. On the other hand, the amount may be quite substantial in some circumstances. For example, the controversy may involve a large number of backdated options. Moreover, a derivative action may also include a claim that the reputation of the corporation was damaged by the bad faith of insiders and that some or much of the investment loss was attributable to such sources. Indeed, a zealous derivative plaintiff should seek evidence of any such effect, whereas a class plaintiff has every incentive not to do so if there is also a derivative action pending.

This conflict is doubly troubling because the derivative action is in effect a class action on behalf of all stockholders whereas the class action is an action on behalf of buyers only some of whom would object to certification of the class action but who would favor the prosecution of the derivative action. The class action plaintiff is likely to argue that he does not seek to represent holders and should not be required to consider their needs and wants. But many in the class may be buyer-holders who would object to the class action and favor the derivative action but who would not opt out of the class action if it were certified. So it does no good for the representative to argue that class members may vote with their feet. Rather he must come up with a manageable definition of his class. It is not clear that it is possible to do so where there are possibly many class members who would vote against class certification if they could but would nonetheless decline to opt out of the class.

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[24] It appears that the number of side-by-side derivative actions has increased significantly in recent years. *See Cornerstone Research, Securities Class Action Case Filings, 2005: A Year in Review,* at 4.

The Investor Population

The conflict of interests between diversified investors and undiversified investors and among diversified investors who follow differing trading strategies is quite real. About three-quarters of all stock (by value) is held by institutions that are invariably diversified.[25] This is not at all surprising. One would expect most individual investors to invest through institutions, because that is the cheapest and easiest way to achieve diversification. It is less clear how much trading is attributable to stock picking as opposed to other passive strategies such as portfolio balancing. To be sure, even diversified investors may engage in some stock picking as they construct their portfolios. If a diversified investor tends to sell all of a losing stock and to buy a wholly new stock when he trades, he will not oppose an SFCA if he is a member of the plaintiff class (even though he would favor the abolition of SFCAs generally).

Moreover, it is a common strategy for diversified investors to sell winners and losers in tandem in order to minimize taxes. To be sure, one might see this as a form of stock picking if one assumes that the investor sells all of a given stock and uses the funds to buy another different stock. On the other hand, tax law dictates that if one sells a stock to recognize the loss, the funds not be reinvested in the same stock. Otherwise the transaction is ignored for tax purposes.

[25] According to FRB data, as of year-end 2006 there was outstanding $20.603 trillion in (publicly traded) equity of United States companies of which $5.483 trillion was held by households and nonprofit institutions. *See* Federal Reserve Board, *Flow of Funds Accounts of the United States,* Table L.213 (Corporate Equities) (March 8, 2007), http://www.federalreserve.gov/releases/z1/Current/z1.pdf (These figures do not include investment company shares.) Historically, nonprofits have accounted for about nine percent of the equity holdings of the household sector. *See* Federal Reserve Board, *Flow of Funds Accounts of the United States,* Table L.100.a (Nonprofit Organizations) (March 8, 2007) (showing annual data for 1988 through 2000). This sector apparently also includes stock held by other corporations. But assuming that individual holdings equal 91 percent of the household sector (or about $4.990 trillion), non-individuals – institutions – own about $15.135 trillion or about 76 percent of all equities outstanding. Because institutions are fiduciaries, they are generally required to diversify under general principles of trust law or more specific statutes such as the 40 Act and ERISA. *See, e.g.,* Investment Company Act § 5(b) (investment company may not be classified as diversified if it has more than 5 percent of its assets invested in any one issuer). Thus, it seems fair to presume that institutions are diversified. FRB data also indicate that about 9.5 of families hold fifteen or more stocks. *See* Brian K. Bucks, *et al., Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,* 92 Federal Reserve Bulletin, A1, A15 (February 2006), http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf That is a shockingly low number. *See* William N. Goetzmann & Alok Kumar, *Why Do Individual Investors Hold Under-Diversified Portfolios?* NBER Working Paper, April 2005. Nevertheless, if such investors are counted as diversified, total holdings of diversified investors are about $15.609 trillion. Moreover, individuals ultimately hold the interests in the institutions that hold diversified portfolios. Studies indicate that an investor can achieve adequate diversification with as few as 20 different stocks. *See* Franco Modigliani & Gerald A. Pogue, *An Introduction to Risk and Return,* Fin. Anal. J., March-April 1974, May-June 1974. *See also* James M. Park & Jeremy C. Staum, *Diversification: How Much is Enough?* (March 13, 1998), http://ssrn.com/abstract=85428 It is unnecessary for present purposes to know how much diversification is enough. It is sufficient to note that it is costless for an investor to diversify and that the risk of securities fraud (like other types of company-specific risk) can be eliminated through diversification. Most individual investors diversify by investing in mutual funds and similar pooled investment vehicles. Thus, even a very small investor may invest in a fully diversified portfolio of 200 to 300 different stocks. To be sure, funds charge a variety of fees in addition to the direct expenses of holding and trading portfolio securities. But there are comparable fees and expenses involved in maintaining an individual account.

It is also quite common for investors to engage in dollar cost averaging. That is a roundabout way of saying that they invest over time as they accumulate savings. Such a strategy is also consistent with portfolio balancing. Indeed, unless a dollar cost averaging investor chooses new stocks for each new addition of cash to his portfolio, he effectively also engages in portfolio balancing by default.

Recent studies estimate that in the United States in the years since 2000 only about 24 percent of all trading is motivated by stock picking.[26] And that figure appears to be on the decline.[27] Of the 76 percent of trading that is motivated other than by stock picking, it appears that as much as two-thirds is motivated by portfolio balancing strategies.[28]

II. CLASS ACTION REQUIREMENTS

The conflict of interests between diversified investors and undiversified investors and among various diversified investors who follow varying trading strategies poses a serious problem for class action certification. Indeed, the conflict is so fundamental (and unmanageable) that the courts should decline to certify securities fraud class actions that seek damages on behalf of individual investors.

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[26] *See* Utpal Bhattacharya & Neal E. Galpin, *Is Stock Picking Declining Around the World?* AFA 2007 Chicago Meetings Paper (November 2005), http://ssrn.com/abstract=849627 (finding that about three-quarters of trading is motivated other than by stock picking); Martijn Cremers & Jianping Mei, *Turning Over Turnover,* Yale ICF Working Paper No. 03-26, AFA 2005 Philadelphia Meetings (November 2004), http://ssrn.com/abstract=452720. *See also* Meir Statman, *et al., Investor Overconfidence and Trading Volume,* AFA 2004 San Diego Meetings (March 2003), http://ssrn.com/abstract=168472 *But see* Martijn Cremers & Antti Petajisto, *How Active is Your Fund Manager? A New Measure that Predicts Performance,* AFA 2007 Chicago Meetings Paper (January 15, 2007), http://ssrn.com/abstract=891719 (finding that more active managers of nonindex funds outperform less active managers). For a treatment of trading frequency from a legal point of view, see Paul G. Mahoney, *Is There a Cure for "Excessive" Trading?,* 81 Va. L. Rev. 713 (1995). *See also* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation,* 81 Va. L. Rev. 611 (1995); Lynn A. Stout, *Reply: Agreeing to Disagree over Excessive Trading,* 81 Va. L. Rev. 751 (1995).

[27] Bhattacharya and Galpin also find that in the United States in the 1960s about 60 percent of trading was motivated by stock picking. They also predict that the level of stock picking will continue to decline and stabilize at about 11 percent. It is not surprising that securities fraud class actions became established at a time when most investors focused on company-specific factors. *See* Utpal Bhattacharya & Neal E. Galpin, *Is Stock Picking Declining Around the World?* AFA 2007 Chicago Meetings Paper (November 2005), http://ssrn.com/abstract=849627 It is possible that the mix of investors varies from one corporation to the next. For example, it is possible that a particular corporation may attract the disproportionate attention of stock pickers. But for most companies, most trading appears to be motivated by other factors.

[28] Indeed the proportion of portfolio balancing trades is likely quite higher. NYSE data indicates that for most weeks of 2007 program trading accounted for about one-third of volume (on a twice total volume (TTV) basis) with a high of 49% and low of 29%. And in many cases the opposite side of the trade would have been taken by a specialist or market maker. See http://www.nyse.com/press/12_2007.html

Under Rule 23(a) of the Federal Rules of Civil Procedure (FRCP) a class action may be maintained only if:

> (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) *the representative parties will fairly and adequately protect the interests of the class* (emphasis added).

In addition, FRCP Rule 23(b)(3), which governs actions for damages, requires that:

> the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: *(A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action* (emphasis added).

FRCP 23 requires that an action must be certified as class action at an early practicable time. That is, the trial court must determine that the action is an appropriate one to be handled as a class action. If not the action reverts to an individual action on behalf of the named plaintiffs.

In practice, the courts have not strictly applied the requirements of Rule 23. But the Second Circuit recently ruled that a trial court must determine that all of the requirements for a class action have been met in order to certify the class. It is not enough for the trial court to find that there has been some showing that the action satisfies the standards set forth in Rule 23. Rather the court must find by a preponderance of the evidence – that it is more likely than not – that the action satisfies the requirements of Rule 23.[29] As the Second Circuit stated:

> A district judge is to [sic] assess all of the relevant evidence admitted at the class certification stage and determine whether each Rule 23 requirement has been met, just as the judge would resolve a dispute about any other threshold prerequisite for continuing a lawsuit. Finally, we decline to follow the dictum in *Heerwagen* suggesting that a district judge may not weigh conflicting evidence and determine the existence of a Rule 23 requirement just because that requirement is identical to an issue on the merits.[30]

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[29] In re Initial Public Offering Securities (IPO) Litigation, 471 F.3d 24 (2d Cir. 2006). *See also* Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 2007 U.S. App. LEXIS 11525 (5th Cir. 2007); Regents of the University of California v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372; 2007 U.S. App. LEXIS 6396 (5th Cir. 2007).

[30] In re IPO Securities Litigation, 471 F.3d at 42. *See also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 2007 US LEXIS 8270.

In other words, according to the Second Circuit, the courts must take seriously the requirements of Rule 23 in deciding whether an action may proceed as a class action. Few securities fraud actions are likely to pass muster.[31]

Adequate Representation

One of the four requirements that must be met in all class actions (whether or not for damages) is that the named plaintiffs *will fairly and adequately protect the interests of the class.* Given their conflicting interests, it is impossible for a stock-picking investor to be an adequate representative for a portfolio-balancing investor or *vice versa.* A portfolio-balancing investor would not likely file a class action in the first place, and if later designated as the representative plaintiff, he would seek to have the action dismissed or decertified. To be sure, this would be a peculiar turn of events. Presumably, the plaintiff files the action because he wants compensation for his losses.[32] And in a sense, the action belongs to the plaintiff who files it. But under PSLRA, the court must designate the lead plaintiff and must ordinarily designate the class member with the most at stake (if that class member wants the job).[33] Similarly, an undiversified investor cannot be an adequate representative for a portfolio-balancing investor because an undiversified investor would presumably proceed with the action contrary to the interests of portfolio-balancing diversified investors.[34]

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[31] *See also* Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 2007 U.S. App. LEXIS 11525 (5th Cir. 2007); Regents of the University of California v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372; 2007 U.S. App. LEXIS 6396 (5th Cir. 2007).

[32] On the other hand, the recent controversies about paying class action plaintiffs (which led to the indictment of William Lerach, Melvyn Weiss, and others) suggests otherwise. *See* Richard A. Booth, *Why Pay a Fraud Plaintiff to Sue?,* washingtonpost.com, June 26, 2006.

[33] Incidentally, this suggests that the courts should favor the interests of the most numerous population of stockholders, namely, diversified stockholders and indeed portfolio-balancing diversified stockholders.

[34] It is not clear how the courts would react to a representative plaintiff who sought dismissal or decertification. As a matter of procedure, a prospective representative plaintiff must seek the job and must presumably disclose to the court any plan to oppose certification or seek dismissal. That would clearly bear on whether the prospective representative could fairly and adequately represent the interests of the class. In effect, the court would be required to decide whether to certify the class at the same time that it appoints the representative plaintiff even though ordinarily the representative plaintiff is responsible for filing the motion to certify. On the other hand, if the case involves allegations of misappropriation, the appointment of the representative plaintiff might turn on the question whether to characterize the action as a class action (direct action) or derivative action. Moreover, a derivative action is always a possible outcome because even in the absence of misappropriation, one can always sue the directors and officers for breach of the duty of candor and consequent damage to the reputation of the corporation if there is an actionable failure of disclosure that can support a claim arising under federal securities law. Leaving aside questions unique to derivative actions (such as whether demand has been made on the board of directors), it is not clear that a court must choose between the two (despite the argument here). So it seems likely that most courts would permit both actions to proceed out of an abundance of caution. In short, it is not clear how one could prevail on a court to decide how to characterize the action at the time the representative plaintiff is appointed if there is misappropriation involved even though it is arguably more important to do so in such a case. Ironically, it would seem much easier for a prospective representative who opposes to certification to prevail over one who favors certification because the alternatives are mutually exclusive. On the other hand, the court might well opt for the prospective representative who favors certification on the theory that the defendant will argue against certification. But that alternative effectively assumes the conclusion that (begs the question whether) the representative plaintiff is in fact representative. It is equivalent to gerrymandering the class to include only those who would favor the action and suggests that the real question is whether common questions

Traditionally, the courts have been unreceptive to the argument that a representative plaintiff might seek to undermine the claims of some class members.[35] In most cases, it is difficult to see how one subgroup would gain from a loss by another subgroup. At worst, the representative plaintiff might seek to emphasize the losses suffered during a particular part of the class period, increasing damages for some investors and decreasing damages for others depending on when they bought the subject stock.[36] On the other hand, the federal courts have generally recognized that one individual cannot serve as the representative plaintiff in both a class action (direct action) and a derivative action.[37]

The conflict between diversified and undiversified investors is fundamentally different from the somewhat worrisome possibility that a representative plaintiff might seek to shift around the damages within the class period. Rather the conflict is between investor classes that would want the action to go forward and those that would prefer to see it dismissed or converted into a derivative action.

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predominate. One might think that defendant companies themselves would advocate the conversion of SFCAs into derivative actions. One problem with that strategy is that directors and officers insurance does not cover derivative claims.

[35] *See* Parker Freeland v. Iridium World Communications, Ltd., 233 F.R.D. 40 (D.D.C. 2006), *citing* In re Gaming Lottery Sec. Litig., 58 F. Supp. 2d 62 (S.D.N.Y. 1999). *See also* In re Baan Co. Sec. Litig., 2002 U.S. Dist. LEXIS 27875 (D.D.C. 2002); In re Oxford Health Plans, Inc. Sec. Litig., 191 F.R.D. 369 (S.D.N.Y. 2000); In re Lucent Techs. Inc. Sec. Litig., 194 F.R.D. 137 (D.N.J. 2000). *But see* In re Seagate Tech. II Sec. Litig., 843 F. Supp. 1341 (N.D. Cal. 1994).

[36] Judicial skepticism about intraclass conflicts may be the result of implicit recognition that plaintiff lawyers will invariably seek to maximize aggregate damages.

[37] *See* Zarowitz v. BankAmerica Corp., 866 F.2d 1164 (9th Cir. 1989) (plaintiff could not serve as derivative plaintiff where his interest in increasing the value of his stock "through a larger derivative suit recovery is dwarfed by his interest in pursuing his litigation with the Bank"); Owen v. Modern Diversified Ind., Inc., 643 F.2d 441 (6th Cir. 1981) (plaintiff could not serve as derivative plaintiff where there was "a strong possibility that [the] derivative action would be used merely as a device to obtain leverage" in plaintiff's individual suit); Davis v. Comed, Inc., 619 F.2d 588, 593-94 (6th Cir. 1980); Ryan v. Aetna Life Ins. Co., 765 F. Supp. 133 (S.D.N.Y. 1991); Kamerman v. Steinberg, 113 F.R.D. 511 (S.D.N.Y. 1986) (class certification denied where plaintiffs also brought derivative claims); Horowitz v. Pownall, 582 F. Supp. 665, 666 (D. Md. 1984) (finding conflict where "the proposed class and plaintiff would be in direct competition with each other for the damages that the directors and officers would be required to pay in compensation for their illegal actions"); Petersen v. Federated Development Co., 416 F. Supp. 466 (S.D.N.Y. 1976) (assumption that plaintiff bringing individual and derivative claims cannot fairly represent shareholders); Caan v. Kane-Miller Corp., 1974 U.S. Dist. LEXIS 13019 (S.D.N.Y., 1974) (individual and derivative actions may not be maintained simultaneously); Ruggiero v. American Bioculture, Inc., 56 F.R.D. 93 (S.D.N.Y. 1972) (class and derivative actions may not be pursued simultaneously). *But see* Mayer v. Development Corp. of America, 396 F. Supp. 917, 931 (D. Del. 1975) (individual action against corporation is not absolute bar to derivative action). See also Principe v. Ukropina (In re Pacific Enters. Sec. Litig.), 47 F.3d 373 (9th Cir. 1995) (expressing concern in connection with approval of settlement about law Milberg Weiss firm's dual representation of class and derivative plaintiffs). Interestingly, Delaware courts have had little trouble with this conflict in actions arising under state corporation law. Compare Colonial Sec. Corp. v. Allen, 1983 Del. Ch. LEXIS 393; Youngman v. Tahmoush, 457 A.2d 376 (Del. Ch. 1983) with SCOPAS TECH. CO. v. LORD, 1984 Del. Ch. LEXIS 556 (interest in his personal claims outweighed his interest in pursuing the derivative action with the same vigor as the personal claims).

The problems with adequacy of representation standing alone should be enough to deny certification. But they are not the only problems that arise under FRCP 23(b)(3).

Subclasses and Manageability

The usual way to fix the problem of conflicting interests is to form subclasses each with its own representative plaintiff. But subclasses are no solution to the conflicts inherent in securities fraud class actions.

Based on the foregoing discussion there are arguably three subclasses that should be formed in any securities fraud class action. Class I consists of undiversified investors. Class II consists of diversified investors who trade all-or-nothing when they trade. Class III consists of diversified portfolio-balancing investors who are buyer-holders. Although Class II would favor the abolition of SFCAs generally, they would nevertheless favor individual class actions in which they are members of the plaintiff class.[38] As for Class III, most class members would likely oppose certification (because they would likely lose more from a successful action than they would gain), but they would want to join in the class action if it is certified.

The first problem that a court must address is how to define the subclasses. Whether an investor should be deemed to be a member of one class or the other would presumably depend on the extent to which the investor is diversified and his trading habits. It seems likely that the universe of investors will be distributed along a continuum from those who own a single stock to those who are effectively indexed. It is difficult to say where one should draw the line.[39] As for trading habits, it seems likely that many investors will engage in some portfolio balancing and some all-or-nothing trading (if only for tax purposes).[40]

The named plaintiff might argue -- consistent with case law -- that he seeks only to represent the interests of buyers and that he does not seek to represent buyer-holders who might object to the class action and favor a derivative action. In other words, he might argue that he seeks only to serve the interests of buyer-holders *as buyers.* To the contrary, FRCP 23 requires that the named

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[38] On the other hand, some Class II members may vote against the class action if the cost of filing a claim is likely to exceed the recovery. Interestingly, it appears that mutual funds and other institutional investors often forgo the opportunity to file claims in successful securities fraud class actions. *See* James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?,* 80 Wash. U. L.Q. 855, 855 (2002). Although one might be tempted to argue that this constitutes some kind of evidence that institutional investors have recognized that securities fraud class actions are counterproductive, the fact is that failure to file a claim when others file is irrational (irrespective of whether one favors SFCAs) and amounts to a subsidy running from funds to claimants. On the other hand, it may be that mutual fund investments tend to be concentrated in particular stocks and that failure to file a claim is more common in cases in which most other investors are also mutual funds, suggesting a form of consciously parallel behavior. *See* Adam C. Pritchard, *Who Cares?* 80 Wash. U. L.Q. 883 (2002) (replying to Cox and Thomas). In any event, there has been a flurry of lawsuits recently against mutual funds that failed to file claims in SFCAs. *See* Jonathan D. Glater, *Suits Contend Mutual Funds Fail to Collect in Settlements,* New York Times, January 19, 2005 at C1.

[39] The question is how much diversification is enough?

[40] It would likely be necessary to conduct extensive discovery of potential class members to determine who should be in what class. In the end, these factors would likely render the action unmanageable and preclude class certification.

plaintiff represent the interests of the plaintiff class. Indeed, the courts have held that a representative plaintiff is a fiduciary.[41] It follows that the named plaintiff may not ignore the interests of class members simply because some are inconsistent with others. Similarly, it is difficult to see how a class action may legitimately proceed if the class is gerrymandered to exclude class members with inconvenient interests.

The named plaintiff might also argue that anyone who objects to the class action can opt out. The problem is that those opposed to certification will remain in the action if it is certified. If the action is successful, those who opt out effectively pay those who remain in the action, but they receive none of the benefit. So it does no good to argue that class members may vote with their feet by opting out.

The formation of subclasses gives rise to further problems.

First, Class I consists of undiversified investors who are by definition stock pickers. A stock-picker presumably considers company-specific fundamentals in making an investment decision and should be required to prove reliance.[42] In contrast, a diversified investor cares little about company-specific fundamentals. She is a price-taker who relies on the integrity of the market. The logic of fraud on the market applies only to diversified investors. Accordingly, a court could properly certify Class II or Class III (who would really rather see the action dismissed), but it should not certify Class I.[43]

Second, Class III (buyer-holders) would prefer that its representative plaintiff prosecute a derivative action (to recover for misappropriation and damages) rather than a class action (to recover individual investment losses). But a derivative action benefits all stockholders. For purposes of a derivative action, the subclass of diversified investors should include undiversified stockholders.[44]

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[41] *See, e.g.,* City of San Jose v. Superior Court of Santa Clara County, 12 Cal. 3d 447 (1974); Heckmann v. Ahmanson, 168 Cal.App.3d 119 (1985).

[42] See Basic, Inc. v. Levinson, 485 U.S. 224 (1988). It is ironic that the Supreme Court decision in *Basic* – which more or less gave rise to the modern securities fraud class action by accepting the idea of fraud on the market – is most consistent with a portfolio-balancing investor as a model and that a portfolio-balancing investor would likely oppose most class actions. Thus, the *Basic* doctrine more or less self-destructs.

[43] *See* In Re Initial Public Offering Securities Litigation, 471 F.3d 24 (2d Cir. 2006). Even though they are diversified, Class II (diversified investors who trade all-or-nothing) may be seen as engaging in a form of stock picking that is somewhat inconsistent with a philosophy of diversification. On the other hand, a diversified investor is free to engage in some stock-picking with impunity. Although one cannot expect to beat the market with any consistency, neither is one likely to be beaten by the market if one is well diversified.

[44] There is some authority for individual recovery in a derivative action. *See* Perlman v. Feldmann, 219 F.2d 173 (CA2 1955). But such a remedy seems to be limited to situations in which wrongdoers would otherwise recover for their own wrongdoing. Id. And influential courts have questioned the idea even in such circumstances. *See* Bangor Punta Operations, Inc. v. Bangor & Aroostook R. Co., 417 U.S. 703 (1974). Individual recovery would accomplish little unless members of the direct class can be excluded. Moreover (and more to the point), the representative plaintiff in a derivative action should seek to maximize derivative damages and (implicitly) to minimize class action damages. Presumably the derivative class will always be larger than the direct class (barring the requirement of some sort of election between the two with individual recovery). Thus, the derivative action will tend to dilute recovery in the direct action.

On the other hand, if undiversified investors are permitted to proceed with a class action, diversified investors will want to join the plaintiff class even though they would really prefer that the class action be dropped altogether. In short, subclasses are unstable in this setting.

The problems with subclasses are even more apparent if one considers the practicalities of notice. In a class action for damages under FRCP 23(b)(3), class members must be given notice of the action and must be given the opportunity to opt out. FRCP 23(c)(2) (B) provides:

> For any class certified under Rule 23(b)(3), the court must direct to class members the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice must concisely and clearly state in plain, easily understood language: (1) the nature of the action, (2) the definition of the class certified, (3) the class claims, issues, or defenses, (4) that a class member may enter an appearance through counsel if the member so desires, (5) that the court will exclude from the class any member who requests exclusion, stating when and how members may elect to be excluded, and (6) the binding effect of a class judgment on class members under Rule 23(c)(3).

The rule does not specify when or how notice must be given or who must pay for it. In most cases, notice will not go out until after the court has heard an (unsuccessful) motion to dismiss the action and a (successful) motion to certify the action.[45]

In most cases, the parties attempt to identify investors who have purchased stock during the class period and to limit notice to such investors (if only to minimize expenses).[46] But it is arguable that notice should go to all stockholders who held stock as of the end of the class period because one possible outcome is that the court will convert the action into a derivative action.[47]

Presumably the notice should include an explanation of why one would choose one class or the other (and maybe even a copy of this article).[48] There is no way to know in advance how many investors will fall into each class.[49] Some investors may choose to remain in all three classes by

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[45] Presumably, the motions to dismiss will also include a motion by a special litigation committee (SLC) of the board of directors to dismiss the derivative action. This motion may entail some delay because the SLC must conduct an investigation into the merits of the action.

[46] In most cases, it is also necessary to notify investors who bought and sold during the class period because (for example) they may have suffered a loss that is attributable to a leak of the bad news.

[47] Notice is not required under such circumstances but it is permitted. Notice is required only for actions seeking damages payable to individual class members.

[48] Although FRCP 23 says nothing about class members choosing classes, the right to opt out may amount to the same thing.

[49] One of the intractable problems with SFCAs is that there is no way to know how many different shares have been damaged because many of the same shares may have been bought and sold during the class period. As in a game of musical chairs, many players may change position, even though only one comes up short. *See generally* Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits,* 56 Bus. Law. 483 (2001). In short, under current practice the courts do not usually know how many shares are represented by the plaintiff class (or thus the aggregate amount of damages that would be awarded if the plaintiff

declining to opt out of any class.[50] Theoretically, the court could require potential class members to choose one and only one class, but that would be inconsistent with the possibility that the action would be converted into a derivative action that is effectively prosecuted on behalf of all stockholders regardless of the class they declare.[51] It might also be seen as a thinly veiled device to convert the action into an opt-in class action. FRCP 23(b)(3) contemplates only opt-out actions, which the courts have interpreted to prohibit opt-in class actions. Moreover, if the action proceeds as a derivative action, it does not really matter whether a stockholder chooses that class. Accordingly, savvy investors may strategically opt out of Class III because there is nothing to lose by doing so.

On the other hand, it might be possible to deem failure to submit a claim as an election to opt out of the action. Although such a device skates close to the edge of converting the action into an opt-in action, class members will eventually be required to submit claims. It is difficult to see how requiring such claims to be submitted sooner rather than later would be prejudicial. Indeed, such a procedure would have the advantage of collecting necessary information about the extent of claims and would discourage strategic behavior on the part of investors.

Undoubtedly, the plaintiff bar (or least those who make a living from SFCAs) will object that class members might be reluctant to respond if they do not know how much money is involved. Moreover, if failure to respond is deemed to constitute a decision to opt out of the class action, and a large number of investors fail to respond, the court could decline to certify the action. Then again, even if the action has been certified as a class action, the court retains the power to decertify the action. And one of the recognized grounds for doing so is that a large number of class members have chosen to opt out.[52]

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wins). *A fortiori,* it would not seem necessary for the court to know know up front how many investors compose each subclass. Needless to say, ignorance of the potential damages makes settlement negotiations difficult. It has also led to the invention of some highly questionable models that purport to estimate the number of damaged shares. *See id.* Alessi argues that notice should go out and that class members should be required to file claims (together with documentation) *before* the court approves any settlement because that is the only way to determine accurately the number of damaged shares. It seems odd that such is not the usual practice anyway. One would think that a class member should be required to declare before knowing the outcome. But that might necessitate the expense of notice on two occasions – once to solicit claim forms and (possibly) a second time to approve the settlement. Indeed it has become a common practice in class actions outside SFCAs to send multiple rounds of notice.

[50] There is some precedent for overlapping classes in other settings such as civil rights cases in which there may be subclasses of women and African-Americans with many who are members of both classes. The courts have not generally found such overlap to be problematic as long as each subclass is adequately represented.

[51] To be more precise, a derivative action benefits stockholders who continue to hold the stock on the date of judgment (or some earlier date when it becomes apparent how the litigation will turn out). A derivative action confers no benefit on an investor who has sold her shares. Thus, one conceivable argument for the status quo is that SFCAs allocate compensation to the stockholders who were in fact damaged by the fraud (including those who have sold their shares in the meantime). On the other hand, if derivative actions became the norm, the market would likely anticipate the outcome and compensate investors accordingly as of the date of corrective disclosure or shortly thereafter (not to mention eliminating the adverse effects of feedback).

[52] If a large number of plaintiff class members choose to opt out of the class action, that is presumably a good indication that the class action is not superior to other ways of resolving the dispute or at least that the class members themselves do not see it as so. It is not clear that the court must look into *why* so many potential class members have opted out. The fact seems to speak for itself. This suggests that it might be appropriate to poll the potential class to

Competing Litigation

One of the four factors to be considered by a court in connection with a class action for damages under Rule 23(b)(3) is: *(B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class.* Although this factor has rarely mattered much, it could be quite significant if a court attempted to form subclasses and one of the subclasses sought to prosecute a derivative action rather than a class action for damages.

Again, a diversified investor would usually prefer a derivative action rather than a class action. But if the action is filed as a class action, can the court convert it into a derivative action? [53] The answer is quite clearly yes.

First, the characterization of an action is a matter for the court. It is not up to the representative plaintiff to decide what form the action will take.[54]

Second, FRCP 23 itself seems to contemplate both types of actions. To be sure, FRCP 23.1 expressly addresses derivative actions. But FRCP 23(b)(2) also speaks to the issue in that it states that a class action may be maintained if:

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determine if a class action should proceed as a class action or as a derivative action. Such a vote of the potential plaintiff class (including all subclasses) would be a better way to get an accurate reading of investor preferences than the opt-out system. With a vote, potential class members could register their preferences without the need to sacrifice class membership if the action goes forward. That is, a diversified investor could vote NO in the hope that the action will be dismissed. If the action goes forward, he may remain in the class and get his share of any recovery. If the only choice is to opt out, one must take the risk that others will choose to remain in the action. Then one must commence an individual action to get a share of the pot. But in most cases the expense of doing so will far outweigh the potential recovery. In short, voting would be much more sensible than the opt-out system we have. For a discussion of similar advantages in connection with stockholder voting as compared tender offers as a way of assessing stockholder preferences, see Richard A. Booth, *The Promise of State Takeover Statutes,* 86 Mich. L. Rev. 1635 (1988); Richard A. Booth, *The New Law of Freeze-Out Mergers,* 49 Mo. L. Rev. 517 (1984). One potential problem with voting is that under FRCP 23 only buyers may be class members in an action for damages, and a court might well limit the vote to potential class members. Moreover, a diversified investor who is opposed in principle to SFCAs may nonetheless vote FOR an individual class action because he gets to vote only when he might gain from the action. Indeed, a diversified investor may figure that he really must vote in favor of the class action (painful as it is to do so) because other diversified investors (who may not understand their interests so well) will vote in favor of other actions in which they stand to gain. So even if the matter is put up to a vote, many investors will vote YES even though they oppose class actions in principle because they must remain in the actions for which they are eligible in order to recoup the losses he suffers from actions in which he is not a class member. On the other hand, buyer-holders will likely vote against the class action. The one group that will invariably vote against a class action are (non-buyer) holders. But it is not clear that they can vote unless the vote is one of all potential class members including those who might be class members (so to speak) in a derivative action. One way that the vote could be conducted would be to permit all stockholders to vote either for a class action or a derivative action. Although nonvoters might complicate the results by affording in effect a third alternative of no action, non-votes (or abstentions) could safely be ignored since a stockholder may always file a derivative action anyway.

[53] The question is somewhat academic in that there is nothing to stop a diversified investor from filing a derivative action wholly independent of a pending class action.

[54] *See* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004).

> the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole.

A derivative action is really two actions in one: an equitable action to compel the corporation to sue and an action by the corporation (usually at law) seeking damages or restitution from those who did the corporation wrong. Thus, FRCP 23 apparently overlaps with FRCP 23.1.

The question is: Should the court certify an action under Rule 23(b)(3) when it could also certify an action under Rule 23(b)(2)? Clearly, a derivative action represents the greater number of stockholders in that it represents both buyers and holders. To be sure, under *Blue Chip Stamps* holders have no standing to sue for damages and thus may not be class members in an action for damages. But a holder may maintain a derivative action. Indeed *only* a holder may maintain a derivative action.

It is also arguable that the derivative action is the default rule. In other words, the burden is on the party that would maintain a class action to show why it should not be maintained as a derivative action.[55]

To be sure, a derivative action does not afford any remedy to buyers for investment losses. But it is not clear that there should be any such remedy. Again, such a remedy comes at the expense of holders. And the courts have been generally dismissive of arguments that a representative plaintiff might seek to undermine the claims of some class members, because in most cases it is difficult to see how one subgroup would gain from a loss by another subgroup. But as shown above, the conflict between diversified and undiversified investors is different.

In contrast, both buyers and holders benefit from a derivative action. To be sure, the recovery is likely to be smaller in a derivative action because the amount at issue is likely to be smaller and because the recovery is spread over a larger number of stockholders. Moreover, buyers effectively recoup some of their losses because there is no feedback effect in a derivative action as there is in a class action. Again, if the plaintiff class is 50 percent of the stockholders, the feedback effect will double the price decrease. So if such an action is styled as a derivative action rather than a class action, buyers effectively recover half their losses anyway.

So the question is which class to favor. The answer is quite easy. In case of conflict, the law should favor diversified investors. First, it is clear that diversified investors constitute the larger population of investors.[56] Second, investors should be presumed to be diversified. It is irrational for passive investors – most investors – not to diversify because by doing so one can eliminate the company-specific risk that goes with picking stocks and investing in individual companies without any reduction in expected return. The ultimate goal for an investor is to maximize return at a given level of risk. It is therefore irrational for an investor to fail to reduce risk if it is costless to do so.

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[55] *See* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004).

[56] *See* note 23 *supra.*

Federal securities law is intended to protect reasonable investors.[57] Reasonable investors diversify. It follows that investors should be presumed to be diversified.[58] If there is a need to choose, the choice is clear. The law should presume that a reasonable investor is a diversified investor. The interests of diversified investors should trump those of undiversified investors.[59]

Forum Issues

One final consideration follows from the conclusion that a derivative action for misappropriation or damages is superior to a class action: Such actions based as they are on fiduciary duty are much more appropriate to state court than they are to federal court. One of the four factors listed in FRCP 23(b)(3) is *(C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum.* As I have argued elsewhere, the Delaware Court of Chancery – which is the court where most such actions would be litigated – is uniquely well suited to such litigation precisely because it is a court of equity.[60] Accordingly, the federal courts should defer to the state courts in cases sounding primarily in fiduciary duty.

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[57] *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). Denying a remedy to undiversified investors creates an added incentive to diversify. Thus, it may be more accurate to characterize the effect as eliminating a subsidy for undiversified investors. On the other hand, many courts have permitted action against trustees for losses on imprudent investments even though the losses are more than offset by gains from other investments and even though trust law requires diversification. *See* Restatement (Second) of Trusts § 213 (1959). *See generally* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Investor Rule,* 62 N.Y.U. L. Rev. 52 (1987) (criticizing the so-called anti-netting rule).

[58] One might even say that federal securities law should ignore the interests of undiversified investors just as the definition of materiality ignores the interests of stockholders who merely *might* be interested in the disclosure of a particular item of information. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). One could also argue that an investor who *voluntarily* assumes *unnecessary* risk by failing to diversify when possible should be denied a remedy on grounds similar to assumption of risk in tort. But as I have argued elsewhere, such an investor might have a claim against her broker or investment adviser. *See* Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk,* 54 Bus. Law. 1599 (1999) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=200388 *See also* Richard A. Booth, *Damages in Churning Cases,* 20 Sec. Reg. L. J. 3 (1992) (discussing measure of damages in investor disputes with brokers). This is not to say that an undiversified investor should have no remedy if she is a victim of securities fraud. Some investors are rationally undiversified. For example, it is not irrational for an investor who seeks to exercise control over the issuer through the ownership of stock to fail to diversify. But such an investor has no need for a class action. Moreover, if such an investor has a claim it is likely to be one against a counterparty to a purchase or sale and not one against the issuer. The point here is that a class action by masses of passive investors against the issuer makes no sense.

[59] The situation is different in a good news case where the plaintiff class consists of sellers. Sellers are no longer stockholders and thus cannot maintain a derivative action. But good news cases are much less common than bad news cases in large part because they give rise to negative feedback that has the effect of muting the price increase that goes with the disclosure of good news. Again in a bad news case, the prospect of payout to buyers reduces the value of the defendant company and magnifies the potential award to the plaintiff class. In a good news case, where the price rises, the prospect of payout reduces the price increase to a minimum of half what it would otherwise be. Again, diversified investors need no remedy in such circumstances because gains and losses wash out over time. They would be better off in a world without class actions. But it is not nearly so troublesome to afford a class action remedy in such circumstances. After all, the buyers in such a case will enjoy a windfall and should not object too strenuously to giving up a part of it.

[60] *See* Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud,* 3 J. Bus. Tech. L. 185 (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=975949.

Conclusion

Securities fraud class actions (SFCAs) arising under Rule 10b-5 are well established as a feature of the legal landscape, but they are a vestige of a largely outdated view of investor behavior and preferences. In the 1960s, most investors were undiversified stock pickers. Today, most investors hold stock through well diversified institutions. As a result, most investors are net losers from SFCAs. Moreover, it is arguable that it is irrational for most investors not to be diversified. A passive investor who fails to diversify assumes unnecessary risk for the same expected return that diversified investors enjoy. Given that federal securities law is intended to protect reasonable investors, it follows that it should be interpreted and applied consistent with the interests of diversified investors where the interests of diversified and undiversified investors diverge. For a diversified investor, gains and losses from securities fraud net out over time. But they lose to the extent of attorney fees and they lose when they are holders (which is most of the time) to the extent that defendant companies must compensate purchasers. In short, diversified investors would prefer that SFCAs be abolished. The one exception arises when insiders gain from the fraud such as by selling their shares before the release of bad news. But the appropriate remedy in such a case is a derivative action by which the company recovers from the wrongdoers.

The thesis here is that the courts should decline to certify securities fraud actions as class actions under FRCP 23 because of the conflicting interests of class members. Undiversified stock pickers – usually a minority of the plaintiff class – may favor SFCAs. But many diversified investors – particularly those who follow a portfolio balancing strategy – would prefer that the courts refuse to certify such actions as class actions because such investors usually lose more on stock they hold than they gain on stock they bought during the class period. To be sure, many diversified investors (including institutional investors) engage in some stock picking (although some such as index funds eschew it altogether). Such an investor might favor certification of actions in which he has bought a large amount of the subject stock during the class period relative to preexisting holdings even though the same investor would favor the abolition of SFCAs generally. Moreover, not even a strict portfolio balancing investor who would oppose certification because she loses more on stock she holds than she gains on stock she bought would dare to opt out of the SFCA if it is certified. Thus, it does no good for the courts to rely on investors to vote with their feet. Investors who opt out of the action effectively pay those who stay in by forgoing compensation for their losses. The bottom line is that the courts should refuse to certify securities fraud actions as class actions unless it is shown that the plaintiff class is composed wholly of undiversified investors. If the action involves allegations that insiders have somehow gained from the fraud or that the corporation itself has been damaged by the fraud, the action should proceed as a derivative action. And given that a derivative action is a form of class action, it is quite clear that the courts have the power under FRCP 23 (and FRCP 23.1) to recast any purported SFCA in such terms.

This is not to say that individual investors should not continue to have standing to sue under Rule 10b-5. Indeed, an investor who seeks to gain control or influence over a target company is likely to be undiversified. If such an investor suffers a fraud in connection with his purchase of target stock, he has standing to sue the wrongdoers if he can make out a claim. Nor does the argument here imply that there is a fundamental problem with remedies under the 1933 Act. In essence, the 1933 Act provides for disgorgement by issuers in cases in which they have effectively misappropriated capital from the market by false pretenses. Similarly, in the context of an SFCA under Rule 10b-5 in which insiders have gained from misappropriation (such as insider trading) during the fraud period or have visited loss on the issuer by damage to reputation or otherwise, the appropriate remedy if for the issuer to seek compensation. In other words, the approach advocated here is wholly consistent with the general scheme of federal securities law.

APPENDIX

BAD NEWS CASE

PRE-DISCLOSURE MARKET VALUE (10M shares)	$100M = 10/share
POST-DISCLOSURE THEORETICAL VALUE	90M = 9/share
DAMAGES TO BUYERS (60% absolute turnover)	6M = .60/share
NET MARKET VALUE POST (tentative)	90M – 6M = 84M = 8.40/share

But if market value post is 84M, then damages should be 16M x .60 = 9.6M.
Now market value post is 90M less 9.6M = 81.4M = 8.14/share.
Process repeats to limit of $15M in total damages to buyers.

DAMAGES TO BUYERS	15M / 600K shares = $2.50/share
NET TO HOLDERS	90M – 15M = 75M = $7.50/share
NET TO BUYERS	$7.50/share plus $2.50/share

GENERAL RULE FOR BAD NEWS CASES:

total decrease in market value = theoretical decrease / (1 - % of shares damaged)

Note that the formula makes it clear that the greater the percentage of shares damaged (the greater the turnover of *different* shares), the greater the total decrease in market price (and the greater the aggregate damages or settlement value). Indeed, in a case in which all of the shares have turned over, the total decrease in value is theoretically infinite. To be sure, a company cannot decline in value to less than zero. But SFCA damages can wipe out 100 percent of a company's market capitalization even though some stockholders did not trade. The following chart sets forth the results at various levels of absolute turnover.

BAD NEWS CASE EXAMPLES

Assume hypothetical pre-damages decrease of $10M:

If 20% of shares are damaged, total award is $2.5M or $1.25/share.

If 40% of shares are damaged, total award is $6.67M or $1.67/share.

If 50% of shares are damaged, total award is $10M or $2.00/share.

If 60% of shares are damaged, total award is $15M or $2.50/share.

If 80% of shares are damaged, total award is $40M or $5.00/share.

If 90% of shares are damaged, total award is $100M or $10.00/share.*

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* Note that $100M is more than entire value of company at $9 per share.

GOOD NEWS CASE

PRE-DISCLOSURE MARKET VALUE (10M shares)	\$100M = 10/share
POST-DISCLOSURE THEORETICAL VALUE	110M = 11/share
DAMAGES TO SELLERS (60% absolute turnover)	6M = .60/share
NET MARKET VALUE POST (tentative)	110M – 6M = 104M = 10.40/share

But if market value post is 104M, then damages should be 4M x .60 = 2.40M.
Now market value post is 110M less 2.4M = 107.6M = 10.76/share.
Process repeats to limit of 3.75M in total damages to sellers.

DAMAGES TO SELLERS	3.75M / 600K shares = .625/share
NET TO HOLDERS	110M – 3.75M = 106.25M = 10.625/share
GROSS TO SELLERS	10/share + .625/share = 10.625/share

GENERAL RULE FOR GOOD NEWS CASES:

total increase in market value = theoretical increase / (1 + % of shares damaged)

One can calculate the total percentage increase in market price in a good news case using the following formula:

total increase in market value = expected increase / (1 + % of shares damaged)

Note that the formula makes it clear that the greater the percentage of shares damaged (that is the greater the turnover of *different* shares – absolute turnover), the smaller the total increase in market price (and the smaller the aggregate damages or settlement value). The following chart sets forth the results at various levels of absolute turnover.

GOOD NEWS CASE EXAMPLES

Assume hypothetical pre-damages increase of $10M:

If 20% of shares are damaged, total award is $1.67M or $.833/share.

If 40% of shares are damaged, total award is $2.86M or $.714/share.

If 50% of shares are damaged, total award is $3.33M or $.667/share.

If 60% of shares are damaged, total award is $3.75M or $.625/share.

If 80% of shares are damaged, total award is $4.44M or $.556/share.

If 100% of shares are damaged, total award is $5.00M or $.500/share.*

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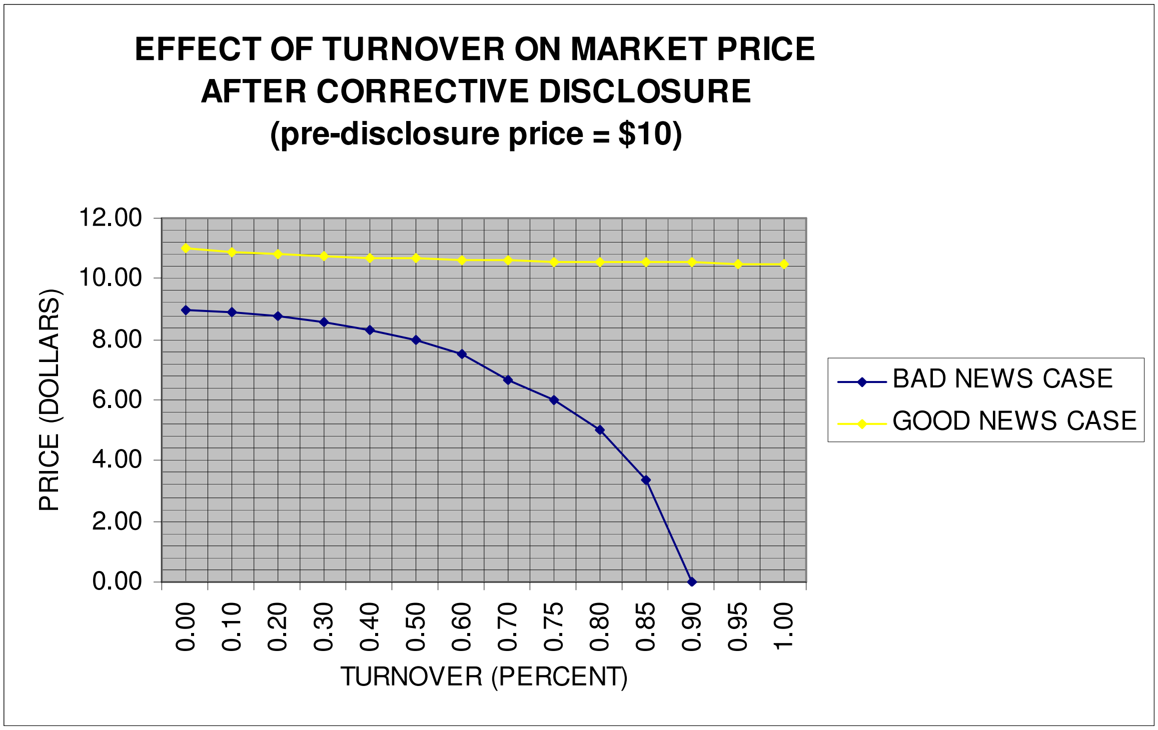
* Note that $5M is exactly half of the hypothetical increase.



EFFECT OF TURNOVER ON MARKET PRICE
AFTER CORRECTIVE DISCLOSURE
(pre-disclosure price = $10)
PRICE (DOLLARS)
12.00
10.00
8.00
6.00
4.00
2.00
0.00
0.00
0.10
0.20
0.30
0.40
0.50
0.60
0.70
0.75
0.80
0.85
0.90
0.95
1.00
TURNOVER (PERCENT)
BAD NEWS CASE
GOOD NEWS CASE