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Class Action and Financial Markets: Insights from Law and Economics[1]

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Abstract: According to the law and economics approach, pure economic loss is a private loss that is not socially relevant but simply implies a redistribution of wealth. Consequently, wrongful behavior that induces reallocation of costs and benefits with no consequences on social welfare is not considered socially harmful, so is not necessarily subject to compensation.

Since pure economic loss is very often financial, the above reasoning also applies to financial markets. However, the same law and economics arguments suggest that in financial markets, the policy of internalizing pure economic loss by means of class actions can be more far-sighted than simply compensating the victims: the liability system has the particular feature of producing deterrence and driving the market towards an efficient outcome. In this vein, the paper argues that class action intended as a complementary ex-post regulatory device can play a significant role in addressing a failure that ex-ante regulation has not. This is coherent with the law and economics tradition that interprets tort law remedies as a solution for internalizing externality and providing the correct incentive to the markets.

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1. Introduction

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The problem of efficiently regulating financial markets has come to light dramatically and repeatedly in recent years. The failure of the institutional devices designed and set up to safeguard these markets has in fact led to several cases of heavy losses for investors.

In other words, although financial markets appear to be strictly regulated and supervised, something in the current regulatory mechanism went awry and in a number of circumstances the system was unable to cope with the resultant crisis. More importantly, it was totally powerless to avoid or at least limit the considerable harm to the economic system as a whole.

Regulation of financial markets usually rests upon a specific tradition and practice, mostly designed to provide ex-ante constraints using a centralized authority for enforcement. According to the law and economics (henceforth LE) literature, this approach takes into account the social perspective – i.e., the social economic loss - while neglecting the private economic one - known as pure economic loss - which does not affect the social welfare as a whole. The previous rationale assumes that when harm results from the relationship between parties and does not affect total efficiency but simply the transfer of wealth, it may be not compensable.

This assumption, however, mainly relies on a static view of efficiency. From a dynamic perspective the lack of protection of private interests can have consequences on the behavior of agents, which in turn affects dynamic efficiency and leads to suboptimal outcomes. In particular this lack of protection determines a suboptimal level of deterrence for harmful behavior that may in turn affect social losses.

The solution to this problem involves strengthening complementary regulatory instruments based on different principles and focusing on a more fragmented perspective compared with ex-ante regulation. This is not only in general possible, but widely recommended by the literature on regulation (Noll, 1983).

In the case of financial markets, new regulatory devices should push the economic system to develop a kind of "antibody" springing from the private action and that can react to harmful behavior by firms[2]. However, the standard solution provided by tort law - the individual action - is not sufficient to warrant the expected outcome as in many cases imperfections in the judicial framework prevent the litigation of meritorious lawsuits. Under these circumstances, a solution increasingly gaining attention in many national legal systems and potentially designed to restore the balance in tort law is class action (henceforth CA), which empowers consumers to enter the regulatory framework by aligning private and public interests.

[2] As argued by Arthur Levitt, former chairman of the US Securities and Exchange Commission, in the case of securities "[p]rivate actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws". Testimony, before the House Subcommittee on Telecommunications and Finance, Committee on Commerce, FED. NEWS SERV., Feb. 10, 1995, note 5.

In the case of financial markets, the above refers more precisely to the investor's ability to file CAs that may be considered as ex-post regulatory devices permitting the recovery of losses and generating a deterrent effect that promotes dynamic efficiency.

This article aims to face the issue by comparing ex-ante regulation - a centralized and well-defined incentive system normally enforced by a single authority appointed by governments - with an ex-post regulatory system, basically dependent on the action of the consumer who can jointly sue firms that behave unfairly and thus create a deterrent.

The benchmark here is the US experience, in which investors who suffer harm by the misconduct of a corporation or some form of management abuse can self-protect by exploiting private litigation procedures, in cases that normally fall under the SEC's jurisdiction. .

LE arguments suggest that in financial markets the policy of internalizing pure economic loss by means of CAs can be more far-sighted than simply compensating the victims: the liability system has the particular feature of strengthening deterrence and driving the market towards an efficient outcome.

The article is organized as follows: Section 2 summarizes the rationale of pure economic loss with reference to financial markets. Section 3 illustrates the role of traditional regulation and liability intended as an ex-post regulatory system, then discusses the relationships between the two systems. Section 4 extends the analysis by discussing the traditional role of ex-ante regulation in financial markets, while Section 5 focuses on the main economic features of CA. Section 6 discusses the role of CAs in financial markets and country specificity issues, and Section 7 concludes.

2. Financial markets and pure economic loss

Several legal systems recognize the existence of pure economic loss, although solutions have not yet been harmonized and vary considerably from one country to another. The concept here is linked to social welfare analysis. Pure economic loss is a private loss that is not socially relevant but simply implies a redistribution of wealth (Backhaus, 2003). Accordingly, wrongful behavior that induces a reallocation of costs and benefits with no consequences on social welfare is not considered socially harmful, and so is not necessarily subject to compensation[3].

Since pure economic loss is often financial, the above reasoning also applies to financial markets. Undeniably, traditional regulatory devices are designed to deal with social efficiency by

[3] This rationale is strongly supported by LE scholars and explains why in several cases, liability regulations that are mainly conceived to address socially relevant externalities simply do not take pure economic loss into account (Shavell, 1987; Backhaus, 2003).

focusing on economic systems as a whole and pursuing behavior that causes social losses. The regulation of financial markets aims for the stability of economic systems and thus applies to socially harmful behavior, mostly leaving aside or not safeguarding distinct private interests. If social and private harm coincide, i.e. there are no externalities, financial regulation provides remedies for pure economic loss. Otherwise, it widely adopts *de facto* - when not *de jure* - the pure economic loss approach.

Nevertheless, if we consider the static representation of financial markets together with their dynamic structure, which is endogenously affected by the outcomes produced, we find that this attitude is shortsighted. Indeed, the equilibrium with pure financial loss not only concerns the movement of wealth among individuals, but also under-produces deterrence, since many tortfeasors will not be sued (Porrini & Ramello, 2005b). The effect on social welfare is twofold. First, it leads to an excess of wrongful behavior because the tortfeasor's expected ex-ante liability depends on the possibility of being sued. If such behavior only determines pure economic loss, the welfare balance will still not be affected. However, if it brings about ancillary social losses, the lack of deterrence will also affect social welfare. Second, it eventually leads the would-be victims to reduce their participation in underprotected activities – i.e. to under-invest in financial markets - since the opportunity cost is increased by the expected losses[4]. This in turn affects individual preferences and thus leads to a different choice from the optimum one with no pure economic loss.

All in all, this is tantamount to observing that deterrence in financial markets is a public good and that pure financial loss can lead to the (under)provision of such a good. Fortunately, the original balance can be achieved with the filing of CAs which act as an ex-post regulatory device that can increase deterrence.

3. Two types of regulation

Traditional regulation is characterized by a centralized structure whose advantages are based on the fact that it is well-suited to serve as a standards-based control. Centralized search facilities, continual oversight of problems, and a broad array of regulatory tools mean that the regulation system can systematically assess risks by implementing a comprehensive set of policies, although regulatory agencies may not be well equipped to the nature of the underlying problems. Moreover, a

[4] The point here is not about recovering damages for injured parties. The injured can replace their losses through insurance, when affordable (Priest, 1987; Rosenberg, 2002). Nevertheless, the opportunity cost will now also include the insurance rate.

centralized command structure with specialist decisions may be subject to political pressure, to regulatory capture and to various forms of collusion (Glaeser & Shleifer, 2003)[5].

On the other hand, liability is a more decentralized system where the victim files an action claiming a causal link between the defendant's conduct and the claimant's injury. It relies upon a case-by-case adjudication system[6]. A special extended liability system is generated by CA, in which multiple claimants who aggregate their similar cases and are represented by attorneys may find it rewarding to file civil actions against defendants who otherwise would not be sued.

The standard conclusion of the literature, as we shall see in the following section, is that when considering features and weaknesses the two systems should be thought of as complementary rather than alternative.

3.1 Regulation versus liability

The traditional pillar of regulation is represented by an ex-ante centralized scheme, designed to constrain behavior. Its structure generally requires enforcement through an appointed authority acting outside the courts system. The alternative method for solving market failure is with a liability system, which basically entitles a number of individuals to push behavior towards an efficient outcome simply by pursuing their own interests. This solution does not require the burden of a specific administrative structure but can rely on existing organizations.

Ex-ante regulation is frequently applied in civil law countries while common law countries have tended to develop ex-post regulation (La Porta et al., 1998). However, a dialectic process exists between the two systems and in fact it is possible to assert that "[…] the regulation of markets was a response to dissatisfaction with litigation as a mechanism of social control of business" (Glaeser & Shleifer, 2003, p. 401). Certain scholars have justified the increasing presence of ex-ante regulation in our economies since the end of the nineteenth century on the grounds of the inability of tort law to address problems arising in a specific market, because of the progressive technical specialization not afforded by normal courts or because pure liability involves large payments as an albeit infrequent deterrent (Glaeser et al. 2001).

[5] The "capture" or "interest group" theories have dominated a significant part of regulation literature since Stigler (1971). The main idea is that in such cases a firm can inappropriately water down the regulation in order to obtain private benefits – such as a specific price regime – or at least render it irrelevant, while the authority can increase their budget or their bribes. According to this view, several laws passed in the US were in fact justified by strategies of market foreclosure, such as raising rivals' costs (Glaeser & Shleifer, 2003).

[6] We consider here an abstract and uniform legal system that of course does not exist, as different countries have developed different legal systems in accordance with one of the two main traditions (common law and civil law) and added their own idiosyncratic features. We will deal with differences further on in the article. However, in many cases in recent decades, as pointed out by the seminal contribution of John Merryman (1981) and as increasingly supported in the literature (see Ewald, 1995), there has been a process of convergence among different systems: in civil law, for instance, precedent is often considered in the adjudication of new disputes, while in common law statutes and law are becoming as important as earlier decisions.

It is worth noting that while regulation needs to define ex-ante what can or cannot be done and intervenes when specific infringing conduct has been adopted, liability does not need such a system because it shifts the burden to private agents affected by damaging behaviors. This flexibility may represent a more adaptive measure against harmful behaviors when it cannot easily be identified ex-ante. In addition, it decentralizes control, since any would-be claimant will monitor the conduct of the tortfeasor.

Shavell (1984a) argues that administrative costs and differences in knowledge between private parties and regulatory authority favor liability, while incapacity to pay full compensation by private parties and the possibility to avoid the lawsuit favor regulation. In general, a liability system is more efficient where private parties are better informed and where there is only a slight probability of accident. Regulation is preferable where harm is usually large, suffered by many victims or takes a long time to manifest, where accidents are common, and where standards or requirements are easy to find and control.

Moreover, there are differences between regulation and liability when they are considered as alternative strategies for the enforcement of legal rules, in the sense that regulators can be more easily prone to identify and punish alleged violations, while judges are more independent and in a sense more cautious[7].

3.2 Regulation and liability as policy complements

When comparing the two regulatory frameworks, the LE literature suggests that in a world of perfect information, either may be efficient for solving market failures: *ex-ante*, the perfectly informed authority can set up the optimal incentive scheme and the potential tortfeasor will face the proper incentive to take the efficient level of prevention; *ex-post*, the harmed individuals will be able to protect their own interests and receive complete compensation (Calabresi, 1970; Shavell, 1987).

Whenever markets are not perfect from an informational point of view, the two systems may be unable to produce an efficient outcome separately. In this case, the combined solution - i.e. regulation *plus* liability - may be necessary to provide a complete set of incentives for economic agents and to reach at least a second-best solution. In the mentioned work, Shavell (1984b) looks at the joint exploitation of ex-ante and ex-post regulation as the solution for controlling risk, thus solving the puzzle of producing the socially desirable level of prevention.

[7] "The stronger incentives of the regulators have the benefit of bringing about more aggressive enforcement than can be achieved through courts. Yet these incentives also have the potential cost of excessively aggressive enforcement when regulators motivated to find violations penalize innocent suspects. There is thus a trade-off between enforcement by judges facing relatively weak but unbiased incentives and enforcement by regulators facing stronger but possibly biased incentives" (Glaeser et al., 2001, p. 854-855).

In a similar vein Kolstad et al. (1990) point out that economics has mostly studied the regulatory frameworks separately and underlines the distinct inefficiency of each of them, whereas the solution of overlapping ex-ante regulation and liability is widespread. The general problem is to define ex-ante the proper standard which can drive firms to choose a level of prevention differing from the socially optimal one. The liability system is then frequently used to correct the previous shortcoming by integrating what is missing .

Other scholars go further in supporting complementarity as the only way to overcome single imperfections. Schmitz (2000) further extends the previous conclusions, suggesting that the joint use of the two systems may solve the problem of the limited efficiency of liability caused by enforcement errors and by the injurers' efforts to avoid lawsuits.

Finally, Gleiser and Shleifer (2003) show that when the probability of an accident and of being caught by a regulator are independent, and there is a possibility of capture, the combined "regulation and liability" solution is usually more effective than regulation alone. Moreover, the introduction of regulation in a liability framework does not involve abandonment of liability.

4. Ex-ante regulation in financial markets: the stability objective

The above arguments apply to financial markets, since the vulnerability of regulation alone has been repeatedly revealed by recent failure . The capture, or at least the excessive indulgence of regulators, has been emphasized by commentators [8].

Whether these failures should be considered pure financial losses or not, they clearly stress that the lack of protection of private investors' interests, even when they do not directly impair the present social welfare, can affect the deterrence level and more dynamically future social welfare. Relying upon the ex-ante regulatory system based mainly on the "command and control" approach with no participation of investors has led the market to systematically neglect signals of the oncoming failure and to under-provide deterrence for would-be injurers.

In most industrialized countries, the stability objective was first enshrined in regulations

[8] Focusing on the role of the SEC in the US Enron case and on the ambiguous appointment of Harvey Pitt as chairman, Paul Krugman (2002) meaningfully wrote: "The truth is that key institutions that underpin our economic system have been corrupted. The only question that remains is how far and how high the corruption extends." Similar comments have recently been extended to the forced replacement of the Pitt heir at SEC, William Donaldson, holder of a strong "reputation for integrity," with Christopher Cox, ironically defined "Pitt-like" (Chait, 2005). According to some commentators the expectations were self-enforced, as Cox "[…] was slow to recognize the deteriorating position of brokerage firms. In that sense, he bears joint responsibility with the secretary of the Treasury and the Federal Reserve chairman" (Westbrook, 2009).

The Italian ex-ante regulatory system as a whole was just as violently criticized in the Parmalat case. Scarpa (2004) stressed a similar fault in supervision of the financial market by the CONSOB (Commissione Nazionale per le Società e la Borsa) – the Italian SEC equivalent. And the Bank of Italy was accused of not having exercised its proper role in the bond issues – under art. 129 of the Consolidated Banking Law - and in the Parmalat risk classification (Ferrarini & Giudici, 2005).

issued in the aftermath of the 1930s as a reaction to the Great Depression, the most serious case of market failure in modern history. Therefore, even though the national regulations for the safeguard of stability developed independently, under separate institutional frameworks, all systems nevertheless show common traits. The persistent *leitmotif* of regulatory policies has been to avoid failures that could trigger a domino effect, causing other financial institutions to fail in turn and culminating in the collapse of the entire market, with extremely serious repercussions on the economic system as a whole (Goodhart & Illing, 2002).

To some extent, it can even be asserted that the goal of stability has long absorbed regulators' attention at the expense of the efficiency of financial markets, for example by roughly sidestepping competition (Porrini & Ramello, 2005a). To reach this objective, national legislators have generally provided devices resting upon ex-ante regulation and supervision.

Two main lines of institutional design have been adopted by various countries. On the one hand, there are nations whose regulatory framework is based on a distinction between banking and financial market operators, such as the United States, where the Banking Law and Securities and Exchange Acts were enacted almost simultaneously, but as completely separate legislation. On the other hand, there are countries where the financial market rests heavily upon the banking sector, which acts as a pivot in collecting savings in the form of deposits and as a financial intermediary for investors. Accordingly, a consolidated banking law further conditions the financial market with a regulation characterized by the priority of stability over transparency.

In the 1980s, the European Commission started building a common regulatory system in which a very important role was to be played by directives, starting with the First Banking Coordination Directive, and continuing with a series of directives aimed at harmonizing the financial regulatory systems of member states.[9].

Thus, despite the recent thrust toward increased competitiveness, regulation in Europe remains very strong, basically still due to the issue of financial market stability which requires the adoption of supervision mechanisms for ascertaining and limiting the risks to which financial institutions are exposed. This is closely related to the evolution of financial markets and activities forced by the financial innovation process, by European Monetary Union and by the introduction of the euro. In fact, the tendency of investors to shift towards securities instead of investing all their savings in banks, and the corresponding increased market share of financial intermediaries other than banks, have fostered the need for financial (not only banking) regulation and supervision[10].

[9] A fundamental step in the recognition of competition as a primary objective of financial regulation is contained in the Second Banking Coordination Directive, which provides for principles such as home country control, harmonization of prudential supervision and mutual recognition. Ref. Banking Directives (first 77/780 and second 89/646) as well as the Own Funds (89/299 and 91/633) and Solvency Ratio Directives (89/647 and 94/7).

[10] The main stage of harmonization was clearly represented by European Monetary Union, with the creation of the European System of Central Banks built around the European Central Bank, which is responsible - together with the

Nowadays, financial policy recognizes the need for competition among markets, intermediaries and products; the need to protect investors and depositors from the risks associated with privately-issued securities through the enhancement of transparency and the monitoring of behavior; and the need to maintain stability of financial system. The achievement of these somewhat contrasting goals by means of just one regulatory device appears to be quite unlikely.

Although the directives have accelerated the convergence between national financial regulatory systems, there are still differences that reflect the underlying domestic financial sectors. It seems reasonable to believe that in the near future, certain gaps will be filled by European Economic and Monetary Union[11]. Whatever the outcome of this process may be, it is reasonable to expect a common ex-ante regulatory framework that is typically more sensitive to the goal of stability.

Accordingly, decentralized ex-post regulatory instruments will once more be relevant to address the uneasy task of efficiency in a financial market, which is affected not just by following certain rules but also by avoiding a catalogue of behaviors harmful to investor. Notably, the kind of solution such as securities CA affects not just the individual utility but also the integrity of the market, by promoting investor confidence, and of the economic system as a whole if it is effective in lowering systemic risk (Weiss & Beckerman, 1995).

5. Law and economics of class action: compensation and deterrence

This section aims to outline the role of CA from a LE perspective, particularly looking at their role in improving the incentive system to the optimal level of prevention in the financial market. In this perspective, CA can be seen as a system of private provision of a public good, by means of the incentive provided to plaintiffs or to lawyers .

5.1 Origins and essential procedural features

CA is a device nominally introduced in the US legal system in 1938 through Rule 23 of the Federal Rules of Civil Procedure, in order to remedy the existing imbalance between plaintiffs and defendants in several areas of regulation by broadening the potential liability of defendants. The full implementation of the system into civil procedure dates to 1966, when the new version of Rule 23 was issued by the Supreme Court (Hensler et al., 2000).

The simple goal of CA is to enable the vindication of claims that otherwise would never be

national central banks - for the monetary policy of the entire Union.

[11] National regulators do not have the necessary wide view of all the risks run and activities performed by groups operating in different countries, and some form of international financial supervision must be set up to safeguard the evolving process of financial integration.

litigated, no matter how meritorious (Rodhe, 2004), although a broader political agenda has been involved since the beginning - ranging from civil rights (e.g., segregation) to health protection, consumer protection, environmental matters, etc. (Hensler et al., 2000).

CA is a legal device for tackling torts in a broad array of cases, including securities fraud (e.g. breach of fiduciary duties, failure to disclose important features to the plaintiff, giving false information, or insider trading)[12].

However, despite the idiosyncratic domain of application, CA presents a core of common procedural features that rest on two precise pillars: (i) the aggregation of separate claims united by design and not by substantive theory, and (ii) the indirect representation of absent parties.

CA is a form of representational lawsuit that eliminates duplications by binding upon individuals with related claims, even if they were not originally named party to the proceedings, and by giving a lawyer - the so-called “class counsel” - control over all of them. Accordingly, once the judgment has been given, it extinguishes all claims included in the class and not just those of the parties named. This means that everyone falling within the class is considered an absent class member and thus included *de jure* in the lawsuit (Dam, 1975).

From a procedural point of view, CA is a form of indirect representational litigation, since lawyers are not appointed directly by all claimants but through a specific set of procedures established by law. The action is filed by an individual (or a group) and then the class is certified by a judge (Haymond & West, 2003). It is important to note that indirect representation is a mechanism that alters the typical principal-agent relationship between claimant and lawyer, seriously challenging the efficiency of judicial activity. Hence, it demands a specifically designed set of incentives in order to work properly (Klement & Neeman, 2004). However, the same kind of indirect representation is also found in regulation, where the authority acts on behalf of interested parties as a *parens patriae,* pursuing the public interest by means of a specialized bureaucracy[13].

By contrast, CA is a solution to this under-representational problem, which affects overall access to justice and the vindication of certain claims (Tidmarsh, 1998). Indirect representation

[12] These were formerly litigated under Section 10(b) of the Securities Exchange Act of 1934 and under Rules 10-5 and 23 of the Federal Rules of Civil Procedure. The idiosyncratic nature of securities class actions and the particular features of these kinds of lawsuits called for a dedicated statue, issued in 1995 as the Private Securities Litigation Reform Act (PSLRA) and designed to reduce the risk of “frivolous” litigation –i.e. a suit that, under specifici circumstances, permits to extract a positive settlement from the defendant despite the expected outcome would be negative- and therefore to make securities class actions more efficient. It implements specific features including changes related to pleading, discovery, liability, class representation, awards and expenses. In particular, the PSLRA established the role of “lead plaintiff” to empower the investors with the largest financial stake in the litigation - very often institutional investors (Weiss & Beckerman, 1995).

[13] Further, indirect representation is not a novelty in lawsuits in either civil law or common law systems, since it occurs whenever there is the risk of systematically preventing specific categories of individuals from protecting their own rights. In other words, indirect representation occurs when a party is unable to file a lawsuit personally because of incompetence, lack of money or for other reasons. This is the case for example with children or the mentally ill, but it also applies to consumers who cannot afford law enforcement on their own.

merely serves to exploit the possibility of aggregating related claims without bearing the costs of coordinating a huge number, often a "mass," of potential plaintiffs. On the whole, CA makes it possible to exploit a different and more efficient litigation technology and empowers an entrepreneurial subject - the attorney - to file a lawsuit on behalf of victims. Hence, CAs can address a market failure of the judicial system stemming from the suboptimal level of demand for legal services for exogenous reasons. This is, in itself, an important economic feature in their favor.

CAs nonetheless present additional economic virtues worth recognizing. In particular:

(a) they promote economies of scale in the judicial market on both the demand side (by creating a temporary "public company in litigation") and the supply side (by tackling a large number of claims in a single trial);

(b) they promote efficiency in risk allocation by allowing it to shift to the subject more able to bear it. This typically happens when the contingent fee reward scheme is adopted, shifting the risk to the attorney in exchange for a share of the expected damages;

(c) they make specific individuals, who eventually become defendants, internalize the externalities arising from their behavior on the class members. Put another way, they set up a deterrent by creating a specific incentive mechanism. This feature is fundamental to providing ex-post regulation.

These three aspects will be further disentangled in the following sub-sections.

5.2 Class action and "judicial economy"

The first virtue refers to what has been defined in the literature as "judicial economy." At first glance, a CA can be simply viewed as a litigation technology enjoying increasing return to scale, and that therefore gives a multitude of claimants incentive to file a lawsuit that otherwise would cost them more than the expected benefit (Bernstein, 1977). However, CA achieve efficiency in two distinct way: it reduces the average cost by aggregating claimants and it can reduce the court's cost by concentrating a multitude of lawsuits in one.

Some scholars have pointed out that the increase in efficiency can be reduced for three distinct though somewhat related reasons. Primarily, the class counsel can adopt rent-seeking behavior in order to maximize revenue, which can increase costs for claimants. Increased costs usually occur when lawyers' fees are based on hourly billing rather than results. However, this is an agency failure that can be resolved by setting up the right incentive scheme, such as contingent fees [14].

Secondly, CAs last longer than other trials, up to eleven times more than a standard lawsuit

[14] Moreover the lawyer's opportunistic behavior can emerge also in individual lawsuits while this does not seem to be a major problem so far in securities CAs (Eisenberg & Miller, 2006).

(Willging et al. 1996). This may be due to the lawyer's rent-seeking behavior as above, but also to technical reasons. However, since a class is normally made up of hundreds if not thousands of claimants, the amount of time required to settle each lawsuit, if filed, would be considerably longer than in a single action.

Finally, it can be argued that the possibility of CA increases the number of lawsuits that are filed, which implies additional costs for the judicial system. This observation can be questioned if we consider social efficiency rather than legal costs. As we emphasized above, CAs are legal devices designed to solve the problem of suboptimal legal protection and deterrence, so an increase in lawsuits in this case would be welfare enhancing[15].

Furthermore, since CAs can promote dynamic efficiency in economic systems by setting up a deterrence mechanism which decrease harmful behaviors. In this respect, CAs are more than a device that redistributes wealth among parties.

5.3 Plaintiffs, risk shifting and the role of the class counsel

CA's second merit is its utility in managing risk and changing the balance of expected benefits. Individuals often do not file lawsuits for purely economic reasons, as the expected reward may be lower than the costs incurred[16]. Those figures depend on three elements: litigation costs, the compensatory damages to be obtained, and the probability of winning the case. For the sake of simplicity, a formal representation - considering a risk-neutral subject - could be the following: $E(R)=p(D-L)-(1-p)L$, where $0<p<1$ is the probability of winning, D represents the awarded damages and L the litigation costs. It can be seen that $E(R)$ is increasing in D and p, while decreasing in L. As observed previously, the aggregation of several claims increases judicial economy by lowering the average costs of litigation. It is obvious that if $D-L<0$ in an individual action, the lawsuit will not be filed.

In general, CA alters the claimant's expected reward in several ways: by spreading the litigation cost over the class, thus rendering $D-L>0$, and in the case of contingent fees, since the claimant will not pay the lawyer directly, by setting the second term of the equation at 0[17]. In addition, it generally raises the probability of winning since the lawyer is specialized in this kind of

[15] If there is a problem of under-deterrence, either the problem won't be solved and there will be a cost in terms of efficiency, or it will be solved through ex-ante regulation, which of course is equally costly. In the absence of class actions, therefore, their cost would be replaced by that of one of the other options.

[16] Class actions, of course, do not seek compensatory damages only but also punitive damages that can be higher than the pure economic loss. Nonetheless, circumstances such as the inability to properly measure the harmcan justify the awarding of punitive damages (on class action and punitive damages see Parisi & Cenini, 2008).

[17] In a class action the lawyer supports the cost of the legal action by gaining the residual right to obtain a significant part of damages as a contingent fee. The contingent fee will impair the damage recovery of claimants and will still imply a pure economic loss, albeit reduced. This is consistent with the arguments of other scholars (Rosenberg, 2002).

suit and has greater resources to invest in the technical needs of the trial[18]. Additionally, it fosters the emergence of an entrepreneurial attorney, who is better equipped to face the risk of the litigation and accordingly has more incentive to file the lawsuit than the single victim. The standard equation here is that the attorney fosters the protection of victims' rights in exchange for a share of the awarded damages, as a reward for risk. On the whole, this possibility alters the cost-benefit ratio for the individual and provides the incentive to proceed[19].

It can be shown that lump sum fees - such as the lodestar method[20] - and contingent fees can both be designed in order to extract part of the awarded damages. However, while lump sum fees imply a certain cost for the plaintiff and can therefore discourage her from filing the lawsuit, contingent fees because they cancel the certain cost are better suited for shifting the risk.

5.4 Internalization of harms and production of deterrence

CA also modifies the risk portfolio of the defendants, who in the case of multiple litigation are in a better position to handle risk than the claimant. They enjoy risk diversification, as opposed to the individual claimant, who is faced with just one risky event. In such a case the defendant minimizes the risk through a portfolio of independent litigations and has an expected outcome that will be the average of successes and failures. Of all possible lawsuits, some will not be filed, and the likelihood that a given party will or will not sue further influences the defendant's overall chances. The individual claimant, on the other hand, bets everything on a single lawsuit. Accordingly, her risk is not diversified and is on average greater.

By concentrating a number of suits in one, CA rebalances probabilities as both claimants and defendants face a more similar risk from the start[21]. If we then consider that risk can be transferred by the claimants to the attorney in exchange for a significant part of expected compensatory damages, there is a further interesting remark: lawyers generally present a higher risk tolerance than single class members and are in a similar position to the defendant in terms of handling it. Hence, they can play a similar role to entrepreneurs in the market, who exchange risk for expected returns.

Incidentally, this is precisely the feature that renders CAs more effective than traditional suits: they increase the incentive to sue for harmful behavior. This leads to their fundamental economic virtue - the deterrence effect - which economically speaking is a public good (Rosenberg, 2002;

[18] It is worth noting that in this case as well, there may be an agency problem between claimants and lawyer that must be properly addressed. See e.g. Klement & Neeman (2004).

[19] Ref. Dam (1975), Eisenberg & Miller (2006) and Cassone & Ramello (2011).

[20] This method relies upon an expected amount of hours calculated by the court multiplied by a reasonable hourly rate, sometimes also multiplied by a factor reflecting some particular feature of the case.

[21] If we consider the probability of an individual's filing a suit as ranging from 1 to 0, this decision being statistically independent, the probability of filing a class action by at least one class member increases and will be close to 1 for a sufficient number of class members, as it will be given by the joint probability. This value will further increase as external subjects, namely lawyers, also promote the action in order to be named class counsel.

Cassone & Ramello, 2011). If a judicial system without CA permits a higher degree of impunity because of the lower incentive for injured parties to sue an infringing firm, the would-be defendants will be less inclined to adopt virtuous behavior. Accordingly, this situation is likely to overproduce externalities over the would-be claimants. CAs are a way to push for the internalization of such externalities in the same vein as a Pigovian tax[22] .

Since CAs basically extend liability, they should be seen as a way of pursuing deterrence by means of a versatile decentralized judicial system, thus complementing ex-ante regulation. It is worth noting that CAs by means of private incentives – i.e., the recovery of private losses – are designed to produce an optimal level of public good, that is to say deterrence (Coffee, 2006).

This is why even though CAs are not perfect and have been fiercely criticized by a number of opponents, to the point of starting what has been termed a "holy war" in the 1970s[23], they are viewed as an effective means of serving efficiency. Where introduced in financial markets, they have certainly been successful for decades at extending liability and enforcing the protection of widely dispersed consumers, thus making it possible to deter specific harmful behavior that otherwise would not be addressed. Further they play the non-ancillary role of preserving certainty for investors and thus promoting the integrity of markets and of the economic system as a whole.

6. Class action, financial markets and social welfare: a different interplay between law and economics

The trouble with enforcing liability in financial markets is the asymmetry between the parties: the claimants are usually highly fragmented and widespread, while the defendants are players with extensive resources and skills. This situation often leads the would-be claimant not to file a lawsuit because the expected cost of doing so exceeds the expected benefits. In such a case, private harm will not be compensated - implying pure economic loss - but the market will face an under-deterrence for possible harmful behavior, to the detriment of social welfare.

6.1 Investor protection and the economic system: insights from the US experience

The asymmetry described can be redressed simply by permitting collective lawsuits in the form of CAs. In the US financial market, securities CAs aim to expand the opportunity for action of large

[22] Named after the British economist Arthur C. Pigou, it is a tax intended to correct market failure by levying on a given economic agent exactly the same amount corresponding to the negative externality produced (Baumol, 1972)

[23] Epstein (2003, p. 1) defines class action as "one of the most ubiquitous topics in modern civil law" and asserts that "[t]he reason for the omnipresence of class actions lies in their versatility." However, class actions, like all juridical tools, are not *per se* a panacea for every possible situation. Critical concerns have been repeatedly addressed by scholars; among others, see Choi (2004) and Klement and Neeman (2004). For a a broad survey see the edited book by Backhaus, Cassone and Ramello (2011).

numbers of dispersed shareholders. Thanks to securities CAs, each shareholder can take part in a single lawsuit with all the injured parties instead of pursuing a lonely action against a corporation[24]. Indeed, individual action in this sector is rare since the expected benefit for the individual claimant is often outweighed by the cost, while CAs redress this balance (Coffee, 2006).

As previously argued, the extended liability regime combined with ex-ante regulation can better achieve efficiency, although this does not necessarily imply that CA in financial markets is without shortcomings. The perception that many US securities CAs were based on frivolous claims was specifically addressed by Congress with the enactment of specific measures, which increased the importance of merit-related factors in determining which companies could face securities CA[25].

However, the merits still outweigh the costs and there are several reasons for making this assertion. Most countries do not allow securities CAs, with the exception of the US, which interestingly still has the largest and most lively capital market in the world despite the infamous market failures. The two factors are not unrelated. According to certain scholars, at least part of the success of the US capital market "may be attributed to the ability of lawyers to organize a class action against corporate officers and directors" (Strahan, 1998, p. 29).

This can be explained on two different although complementary grounds. First, the extension in liability created by CAs reduces the opportunity for tortfeasors of profiting from wrongful behaviors and produces new incentives for efficiency. In other words, the potential tortfeasor will only be able to (legally) maximize profit within the market if harmful behavior can no longer produce the expected benefits.

Second, the more comprehensive tort system and the increased certainty of investment protection give more energy to the financial sector and the economic system as a whole. A great body of evidence shows that a common factor in country-to-country differences in the concentration of ownership in publicly traded firms, in the breadth and depth of capital markets, in dividend policies, and in firm's access to external finance is how well investors, both shareholders and creditors, are protected by law from expropriation by the managers and controlling shareholders of firms (La Porta et al., 2000).

This affects not only the performance of firms or the market, but of the economic system itself; empirical evidence shows how the effectiveness of investor protection and hence the integrity of financial markets has a positive influence on GDP growth (Haidar, 2009; Chiou, Lee & Lee, 2010).

[24] For an in depth discussion of securities class actions, see for instance Choi (2004), Coffee (2006), and Dyck et al. (2007).
[25] Ref. note 11.

One could of course wonder whether these results depend on ex-ante regulation rather than ex-post, since investor protection depends on both. However, because the literature has shown an unavoidable complementarity between ex-ante regulation and the court system in promoting efficiency, it is reasonable to assert that the incompleteness of tort law is a crucial reason for weaker protection, as otherwise ex-post regulation would be triggered even when the ex-ante system is not working properly. Hence, the degree of protection depends crucially on the effectiveness of tort law and the court system[26].

The empirical evidence thus far available on CA in the US financial markets seems to support the above arguments (Miller & Eisenberg, 2006; Dyck et al., 2007). The counterfactual is scant and comes essentially from Europe, where requests for introducing CA are increasingly gaining momentum (Backhaus et al., 2011).

6.2 The long and winding road of European class action

It is important to clarify that there is no uniform proposal for an "European class action", nor a specific design for collective securities litigation, although many member states are involved in lively debate on the subject especially as regards an attempt to improve financial regulatory mechanisms. Discussion began with the Green Paper on the Rights of Consumers[27], which then led to Directive 98/27/EC and more recently to the Green Paper on Consumer Collective Redress[28], which has broadened the scope of consumer protection. However, despite these stimuli, nothing has happened at the Communitarian level. The CA debate has never brought any significant results, under the pretext of the differences between civil and common law systems[29].

On the other hand, countries that have tried to introduce collective litigation systems in very limited domains and with severe constraints have so far seen no impact in terms of outcomes, with a few exceptions. Furthermore, securities cases are very often excluded from laws that to some extent mimic collective litigations.

The evidence so far is poor and very fragmented. The champion is the United Kingdom, which introduced CA into its legal system in 2000. Since then, "[a]round 60 such cases have been launched […] – without any egregious examples of abuse" (The Economist, 2007, p. 15). But critics will call this an exception, since the UK is a common law country and the transplant is therefore fairly simple compared with the case of civil law system.

[26] In many countries the regulatory system has been designed by mimicking the US model, so we expect fewer differences in ex-ante regulation. This is true not just for securities but also for antitrust laws, communications agencies, etc.

[27] June 11, 1993.

[28] November 27, 2008.

[29] See e.g. Ferrarini and Giudici (2005, pp. 48-49) It has been emphasized that the European legal system is less concentrated, and so less suitable for this kind of action than in US while strong criticism concerns the adoption of contingent fee.

Finland is one of the few other countries to introduce a class-action like device, in 2007 after almost twenty years of preparation, and it has seen negligible results that do not affect securities at all. The Finnish law actually focuses on consumer and product liability cases; securities are thus excluded as stock owners are not consumers (Välimäki, 2011).

Portugal introduced a collective action law almost twenty years ago. The scope is very broad, and encompasses public policy to the point that its effectiveness in reaching its statutory goals is dubious (Garoupa & Gouveia, 2011). Similar concerns have been raised about the Swiss class-action-like system (Baumgartner, 2007).

All these failures have given critics fodder to argue against the transplantability of CA in many European countries, although they have not been able to provide an alternative solution to the under-protection of consumers and investors.

However, beyond the political and academic debate, an interesting phenomenon has started to emerge among European consumers: victims have spontaneously begun to look for arrangements "on a shoestring" to compensate for the incompleteness of national tort law.

A good example is the Italian Parmalat case, which shows tentative implementations of a *de facto* CA to fight the under-provision of compensation by the national legal system. Italy do not permit CA, but accepts quasi-collective mechanisms driven by consumer associations. These plaintiffs have no standing to recover damages and can only obtain cease-and-desists or orders to protect consumer interests. Consequently, the dispersed investors have no choice but to file an individual lawsuit at their own risk and expense. In the Parmalat case, owing to the very high costs and the extremely low probability of recovering damages, investors attempted to use CA by relying upon the US legal system. Many Italian investors joined the CA filed in January 2004 in the US, just a few days after Parmalat went bankrupt, against several firms' representatives and auditors. Asset managers in the US also filed a second CA against some banks, the former management and the auditors (Ferrarini & Giudici, 2005).

This forum shopping so far has proved to be very hazardous, as witnessed by the New York Court decision not to certify non-US residents within the class[30]. Hence, the remaining strategy for Italian investors was to build a quasi-collective lawsuit: about 10,000 investors trying to avoid an individual suit joined the criminal trial filed in Milan in October 2004 as civil claimants[31]. The main idea behind this strategy is to use the criminal proceedings and the public prosecutor respectively as a *sui generis* CA and class counsel, and in some way to enjoy the benefit of the consolidated

[30] See the report by the major Italian financial newspaper, Il Sole24Ore ("Parmalat, esclusi dalla class action azionisti non americani") at **http://www.ilsole24ore.com/art/SoleOnLine4/Finanza%20e%20Mercati/2008/08/parmalat-class-action-esclusi-azionisti.shtml?uuid=81877382-7034-11dd-a1e6-015d01033f80&DocRulesView=Libero**

[31] Figures as of June 2005 (Colonnello, 2005).

lawsuit. Nevertheless, the individual incentives of the public prosecutor and the nature of the criminal trial are considerably different from those of CA, and liability litigation is just an externality of criminal proceedings.

It is remarkable to discover that similar attempts to force the availability of CA have been made under various circumstances. One example is the Lufthansa Cargo Airline settlement, on behalf of many European victims in the US, which agreed to pay $85 million to members of the CA suit (The Economist, 2007). Also, in a number of US securities CAs litigated under the PSLRA, many European financial institutions were acting as the lead plaintiff while they cannot even file such a lawsuit in Europe (Gelderman, 2006).

All in all, a preliminary glance at the old continent shows a puzzling picture, confirming that Europeans suffer from the incompleteness of consumer protection and are sending strong signals to legislators to show that they feel under-protected. The creation of *sui generis* solutions, to “mimic” CA where not existent or not effective or to join a US lawsuit, is somehow defying the sovereignty of national jurisdiction and creates a puzzle that can only be solved by lawmaking.

In Italy and Germany, legislators seem to have grasped the message from victims and have recently introduced class-action-like devices. Thus far, however, these measures are very different from and more limited than the US model, so the outcome is likely to be substantially different from what is expected.

Germany, in 2005, enacted the Capital Markets Model Case Act (“Kapitalanlegerthe Musterverfahrensgesetz” or “KapMuG”), which is specifically designed to complement ex-ante regulation for investor protection. The KapMuG is again a *sui generis* CA, as it allows similar claims in capital markets to be gathered around a test case. Further, unlike US CA, it only applies to parties who have already filed suit and does not allow indirect representation. Hence, while it tries to exploit aggregation and the consequent economies of scale, it lacks many of the defining features of CA.

In 2009, after years of delay, a sort of CA was introduced in Italy that should be used for many harms, including securities fraud[32]. Due to its very recent implementation it is too early to make an assessment. However, expectations are limited by the restrictions imposed, e.g. the fact that only consumer associations can file lawsuits on behalf of a group of consumers. Hence the entrepreneurial activity of the class counsel will be significantly curtailed, and the law basically extends the power of consumer associations. From this viewpoint, the new device can be at most be considered an extension of ex-ante regulation[33].

[32] “Azione Risarcitoria Collettiva” governed by art. 140 *bis* of the Italian consumers' code and in force since January 1, 2010.

[33] The same e.g. applies to the law in France

6.3 Country specificities, legal transplants and effectiveness: further comments

One of the stronger arguments against the enactment of the US model and justifying laws that in many ways contradict the rationale behind CAs is the presumed difficulty of transplanting a common law institution into a civil law system. This has been the insistent refrain of the European debate.

Thus, the main question concerning CA appears to be straightforward: does the legal system matter? The answer is simple, though not trivial: of course it does, but this is true for any legal change, not only for introducing CA. The real point here, beyond the technicalities required for making the new device workable, is whether there is a political consensus for attaining the objectives embedded within the change.

This is why hesitation over legal transplants tends to blur the focus. First, there is evidence that every legal system, even those with common roots, develop idiosyncratic features even though their technologies and economic endowments are similar (Field, 1991; La Porta et al., 2008). Hence the opposition could be applied to any law - property laws, contract laws, etc. - or any procedure that tries to harmonize different legal systems.

Second, legal transfer from common law to civil law countries has already been accomplished in many cases – such as the antitrust law and regulatory acts in numerous fields – showing that it is often possible to adapt legal bodies successfully between one system and another.

Finally, it is well documented that the growth of law as a general process is primarily explained by the transplantation of legal rules, so the debate over implementing CA is moot (Ewald, 1995). Rather, faced by the under-enforcement of liability, which in turn stimulates the flourishing of harmful conduct, a national legal system must either opt for CA or indicate an alternative choice, since criticism alone is useless.

A similar sticking point is that financial systems vary across different nations. In a sense the two objections are related, since there are causal links between the socio-economic environment and legal development, and also between the legal framework and financial development (Field, 1981). Empirical investigations have tried to measure the differences deriving from the legal tradition of various countries and the level of protection for creditors and investors: civil law countries, for instance, offer less protection and weaker enforcement, together with a high concentration of firm ownership.

The quality of investor protection is linked to the development of capital markets in the sense that countries with poorer investor protection, measured in terms of specific commercial regulations as well as the quality of enforcement, have capital markets that are less developed[34]. Hence,

[34] La Porta et al. (1998 p. 1114) remark that "[l]aw and the quality of its enforcement are potentially important determinants of what rights security holders have and how well these rights are protected. Since the protection investors

empirical evidence suggests that rules associated with common law are in general superior in fostering larger and broader capital markets, especially compared with countries based on the civil law tradition (La Porta et al., 2008; Chou, Lee & Lee, 2008).

These findings, rather than challenging the introduction of CA in legal systems different from the US, are actually another argument in favor of legal transplant: CA is even more important in those systems that are "genetically predisposed" to the under-protection of investors. For instance, the possibility for stronger creditor and investor protection by means of CA could improve the expectations of small and large investors, attracting capital and investments to the country with a beneficial effect on the economic system as a whole (La Porta et al., 2000).

Naturally, the proper implementation of any legal device will require some fine-tuning for the specific legal framework. In the case of CA, this means protecting its defining features - free aggregation of claimants, indirect representation, risk-shifting mechanisms, and the entrepreneurial activity of the attorney - which jointly provide the proper incentive for litigating meritorious claims that otherwise would not be filed.

If any of the characterizing features are missing, the result will be significantly disempowered CA and a watered down outcome in terms of both victims' protection and social welfare. This is precisely what has happened with European laws that under the "class action" label have introduced the hesitant fortification of consumer laws or some form of feeble claimant aggregation, while neglecting much of what defines a real CA.

While this timid attempt can be explained on the grounds of either technical difficulties in issuing the new laws or the aim to cheat citizens by passing off dross for gold, the main risk behind this attitude is to provide detractors with strong yet bogus arguments against the effectiveness of CA.

7. Concluding remarks

The proposal in the LE vein to pair regulation and liability in the financial markets and to reinforce the latter by means of CA rests upon the idea that, apart from the traditional centralized systems, markets must be able to spontaneously develop "antibodies" to problems that regulation does not address. This is also healthy for the economic system.

Regulation in general is designed to avoid specific market failures and is thus fully justified according to principles of efficiency. In other words, when the market alone is not able to reach an efficient outcome, this can be achieved by regulation which defines the boundaries that constrain

receive determines their readiness to finance firms, corporate finance may critically turn on these legal rules and their enforcement."

economic action. The aim of regulation is to maximize social welfare by outlining a well-defined framework to drive proper behavior by the regulated agents. The typical strategy rests upon the "command and control" approach, which tries to ensure that the recommendations are respected and, if necessary, punishes non-compliance. The merits of institutional regulation are fully recognized by the literature and are not in question here.

However, regulation alone may be unable to address all the multiform externalities that arise in markets. The exclusion of a significant number of economic agents from protecting their own interests can produce under-deterrence for would-be injurers, with a severe effect on the economy. From this perspective, then, the standard pure economic loss approach contains certain elements of fallacy, since even when harmful behavior does not in itself impair the social welfare, it may do so indirectly by preventing the market from developing those powerful antibodies against dangerous conduct that liability is able to develop. In this respect, the possibility of filing CAs directly pursues the private interests of individuals trying to recover pure economic loss, while it indirectly produces a public good - i.e. deterrence - that affects social welfare.

This would seem to apply especially to the financial sector. In many circumstances, the existence of CAs as complementary ex-post regulatory devices can play a significant role in addressing a failure that ex-ante regulation has not. The presence of this complementary regulation may indeed explain, at least partially, the greater success of the US capital market compared to others and recommends a more robust endorsement to the European countries that so far, with few exceptions, have endorsed this model only timidly.

While in many countries legislators are still discussing or hesitantly introducing watered-down versions of CA, investors themselves are helpfully driving the agenda toward increased protection.

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