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Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions To Participate in Securities Class Action Settlements

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In 2003, securities fraud class action settlements produced $5 billion dollars in cash to be distributed to defrauded investors.[2] Institutional investors own the lion's share of the publicly traded equity securities in this country and therefore were entitled to collect most of that money by simply filing relatively simple claims forms documenting their trading during the class period. Those institutions that choose to do so recouped large sums of money for their beneficiaries.[3]

However, in a pilot study we published two years ago, we reported that nearly two-thirds of the institutional investors with financial losses in 53 settled securities class actions fail to submit claims. As a consequence of this failure substantial sums they were entitled to receive were given to others.[4] Using some back-of-the-envelope calculations, one commentator analyzing our results suggested that each year slightly more than $1 billion dollars is left on the settlement table by non-filing financial institutions.[5] Because we had a small sample of settlements in our sample, we could only reach tentative conclusions about how widespread a problem existed. The pilot study nonetheless portended several disturbing policy implications for securities class actions.

This article presents the results of a much more extensive investigation of the frequency with which financial institutions submit claims in settled securities class actions. We combine an empirical study of a much larger set of settlements with the results of a survey of institutional investors about their claims filing practices. Our sample for the first part of the analysis contains 118 settlements that were not included in our earlier study. The number of settlements examined in this study is, therefore, more than twice as many settlements as we earlier examined. Consistent with our earlier study, we find that less than 30% of institutional investors with provable losses perfect their claims in these settlements.

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[2] Barry B. Burr, More Money: $5.5 billion up for Taking from Securities Litigation, Pensions and Investments (2004); Investors Fail to Claim Up To $1.8 Billion, Daily Herald Reports, Dec. 25, 2003.
[3] For instance, the State of Wisconsin Investment Board has recovered an average of $7 million annually over the past several years because it pursued such claims. Id.
[4] *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 (2001).
[5] *See* Adam. C. Pritchard, Who Cares?, 80 Wash. U. L.Q. 883 (2001).

We then explore the possible explanations for this widespread failure. We suggest a wide range of potential problems from mechanical failures in the notification and recordkeeping processes to more subtle issues such as portfolio managers' beliefs that only investment activities produce significant returns for their clients.

In order to determine which of these problems were the main culprits, we surveyed institutional investors about their claims filing practices, asking them who was responsible for this task, how they performed it, and what, if any, performance monitoring was done. We learned that most institutions relied on their custodian banks to file claims for them in securities fraud class action settlements, that many of these institutions did little monitoring of whether the custodian actually performed these services, and that custodians had financial disincentives to file claims on behalf of their clients. Nevertheless, virtually every respondent reported that they filed claims in all settlements in which they were class members. Our respondents also identified a number of problems with the claims filing process, including difficulties in learning about settlements, monitoring claims, gathering and compiling information necessary to complete claims, and accounting for payments made after they are received.

Accepting for the moment our empirical findings that many institutions have failed to file claims, should their trustees be liable for this failure? What about their custodian banks that agreed to make these claims for the institutions? If so, what is the appropriate standard of liability that we should apply in this situation? We argue that any such failures should be evaluated as potential breaches of the duty of care consistent with the monitoring obligations embraced in Delaware's *Caremark* decision.[6] Applying this standard to our problem, we believe that the trustees of institutional investors must, in good faith, insure that their fund has an adequate system in place to identify and process the fund's claims. Furthermore, they should create a monitoring mechanism to insure that this system is adequate, and if they learn it is inadequate they should take measures to fix the problem. Custodians that file claims on behalf of their institutional clients should perform the various aspects of this job with due care, too, or face potential liability for negligence.

Turning to the even broader policy implications of our findings, we identify several discrete problems that can be addressed to help remedy the current situation. First, we believe that the federal courts should create a centralized information clearinghouse or web site for settlement notices, claims forms and other information about securities fraud class action settlements. This would greatly facilitate institutions learning about settlements and obtaining the materials that they need to file claims. Our first recommendation should also help to improve monitoring by the institutions themselves or, alternatively, they could hire third party claims monitoring services. Second, the federal courts could also mandate the creation and usage of standardized claims forms and trading documentation. Again, this would facilitate the claims filing process. Third, we think that institutional investors that contract with their custodians to handle their claims filing need to improve their monitoring of the process. Finally, we believe that the SEC should strengthen its information gathering from institutional

[6] In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

investors under Section 13(f) so as to make that information both more transparent (e.g., identify beneficial owner of shares when filing on behalf of another) and easily searchable.

We conclude our article with two observations about the implications of our results for the goals of securities fraud litigation. Our first point builds off our survey respondents' statements that they do not allocate any recoveries they receive to the individual fund beneficiaries, but instead to the fund suffering the loss or in some cases to the institutional investors' general fund. Our survey therefore reflects a serious mismatch between the beneficiaries of the settlement and those that have been harmed by the securities violation that gave rise to the settlement. Simply stated, many defrauded beneficiaries are not compensated for their losses, while others are unjustly enriched. Given the enormous importance of institutional investors in the market, this mismatch raises serious doubts about whether securities fraud class actions can be justified as compensatory mechanisms. Rather we believe the more persuasive rational for these cases is the deterrence of fraud. But in order to accomplish that purpose, we think that the current process needs to undergo some changes.

Our second point is that the poor claims records of financial institutions questions whether securities class actions serve their compensatory purpose. We therefore conclude our analysis by reexamining the purpose of securities class actions through the lens of the poor claims performance by financial institutions

The organization of the article is straightforward. Part I provides a description of the legal and institutional environment within which securities class actions thrive. In Part II we describe our data base, the methodology employed, and the results of our study of 118 settlements. The potentially numerous explanations why so many financial institutions fail to participate in class action settlements are developed in Part III and in Part IV we use our survey of financial institutions to isolate the likely reasons that financial institutions are so frequently missing from the line of claimants that forms at the end of securities class actions. In Part V, we examine the legal standards that ought to be applied to determine whether pension fund trustees and custodian banks that fail to file are liable for their failure, and if so, what the damages ought to be for their failure. In Parts VI and VII we address the policy implications of our empirical findings and survey results. We conclude the paper in Part VIII.

I. The Litigation and Settlement Environment

Financial institutions include private and public pension funds, life and casualty insurance companies, mutual funds, bank trust departments, and various endowments. While each owes its existence to a different source of funding than the others (insurance companies derive their funding from policy premia and endowments from munificence), all such financial institutions share a common bond: wise stewardship of the portfolio managed by each financial institution redounds to the benefit of another, be that person a pensioner, policy holder, stockholder, beneficiary, or even a faculty member. For this reason, the managers of each type of financial institution are subject to variously expressed fiduciary obligations that compel their prudent stewardship of their portfolio.

From a different perspective, we can identify financial institutions as perhaps the single most important group of investors when designing securities regulatory policies. Financial institutions own slightly less than one-half of all equity securities[7] and, more importantly from the perspective of securities policy making, their trading dominates in terms of both dollar and share volume the New York Stock Exchange as well as for the large capitalization stocks listed on Nasdaq.[8] Even though we might conclude that retail investors are also important because they provide additional depth to the trading on securities markets, it is the financial institutions whose larger trades and greater frequency of trading "make" prices.[9] The regulatory implications of institutional forces in trading markets are broadly evident, the most dramatic being the architecture of the current disclosure mechanisms for public offerings where we find a healthy respect on the part of the SEC for the impact financial institutions play in the operation of our securities markets.[10] Further, reform efforts since then have also focused on the presence or absence of institutional investors.[11] This paper later explores whether the same sensitivity, or even deference, should be accorded financial institutions when considering possible reforms of private liability under the securities laws.

Reform efforts for securities class actions complement the potential role of financial institutions. A major innovation of the Private Securities Litigation Reform Act of 1995 is the "lead plaintiff" provision.[12] To overcome the concern that securities class actions are "lawyer driven" because they are missing an engaged client who can supervise the action's attorney, the PSLRA amended the securities laws to require that within twenty days of filing the complaint notice must be published inviting members of the class to apply to become the suit's representative. From those that apply to be selected as the lead plaintiff, the PSLRA's reforms call for the court to appoint the "most adequate representative," who is identified by the legislation as the claimant with "the largest financial interest" in the suit.[13] The assumption underlying the lead plaintiff provision is that an investor with a sufficiently large financial stake in the suit will be a more diligent monitor than a person with a miniscule claim in the suit that may well even have been selected by the suit's attorney.[14] The PSLRA details the lead plaintiff to select counsel for the suit, albeit subject to approval of the court.[15] The overall objective of the lead plaintiff provision is well understood: to harness the economic self interest of a class

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12 The literature on lead plaintiffs is now fairly extensive. *See e.g.,*

13 The overall strength of the presumption that the petitioning claimant with the largest loss is the most adequate plaintiff is evident by the fact that the presumption can only be overcome by proof that the petitioner will not adequately represent the class or is subject to unique defenses. *See* Exchange Act Section 78u-4a(3)B)(iii)(II).

14 Congress' consideration of the improving the oversight of the class action's attorney coincided with an important study by Professors Weiss and Beckerman who data revealed, among other interesting facts, that the fifty largest claimants in 82 studied class action settlements had an average allowable loss of $597,000. *See* Elliot Weiss & John Beckerman, Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions, 104 Yale L.J. 2053, 2089-2090 (1995)(the fifty largest claimants accounted for 57.5 percent of all allowable losses among claimants).

15 *See* Securities Act Section 27(a)(3), 15 U.S.C. §77z-2(a)(3) and Securities Exchange Act Section 21D(a)(3), 15 U.S.C. § 78aa(a)(3) (detailing procedures for the appointment of the most adequate plaintiff and the powers of the person so selected).

action member to the suit's attorney. Given the dominance and size of trades by financial institutions, we frequently find financial institutions petitioning and being chosen to be lead plaintiffs.

The class action lawyers are not neutral regarding who the court selects as the lead plaintiff. When there are competing lead plaintiffs, as there frequently are, the selection of lead plaintiff is truly a surrogate for which competing firm will be lead, or increasingly co-lead, counsel for the class action. Absent such designation, the class action attorney assumes the underplayed position of the Maytag repairman. For this reason, there is abundant evidence of alliances formed among once competing law firms whereby they bundle their clients together so that combined they possess the investors with the "largest financial interest."[16]

Settlements are the end game for securities class action suits. Even though several hundred securities class actions are settled annually, fewer than one or two securities class action suits are tried in any year. Pre-PSLRA, because trials were infrequent, there was cause to fear that no effective check existed on the litigants to be sure that the litigation was either well-intentioned or that its settlement reached a justifiable conclusion.[17] This occurred because the plaintiff too frequently was a mere figurehead who lacked any effective control over the suit and the class action attorney was preoccupied with her prospective fee. To be sure, no settlement or dismissal of a class action can occur without the approval of the court. However, the court is also conflicted by a concern for its docket and suffers from a heavy dependence on the suit's attorneys for their justifications for the suit's settlement.[18] A major reason for the lead plaintiff provision's incorporation into the PSLRA is to introduce a self-interested investor-based perspective into the litigation and ultimately settlement process. Absent a real plaintiff, the well recognized concern is that the class action's counsel's natural incentive is to settle the case for too little recovery on the part of the class members.[19] Lead plaintiffs were also seen as a reliable governor on the continuance of the suit when the facts indicated that the suit was improvidently initiated. Despite these lofty visions of the lead plaintiff, there continues to be cause to wonder if the lead plaintiff has met its full anticipated potential. For example, there is little evidence of lead plaintiffs moving to dismiss a class action suit. Their involvement is limited to anointing a firm as lead counsel for the suit.

The true battleground for securities class action litigation is the pretrial motions. The most serious obstacle confronting the class action is withstanding the defendant's

[16] The lead plaintiff provision provides that the plaintiff or plaintiffs with the largest allowable loss is presumed to be the most adequate plaintiff. This does not require that the lead plaintiff must be a single investor as the statute permits and attorneys frequently advance aggregation of diverse investors who collectively are the lead plaintiff. *See generally* Heck, Comment, Conflict and Aggregation: Appointing Institutional Investors as Sole Lead Plaintiffs Under the PSLRA, 66 U. Chi. L. Rev. 1199 (1999). For an interesting illustration and discussion of the tournament and alliances that arises among competing counsel, *See* In re Razorfish, Inc. Sec. Lit., 143 F.Supp. 2d 304 (S.D.N.Y. 2001)(reviewing efforts of several law firms to "cobble" together a diverse group of investors so as to have a client with the largest allowable loss).

[17] The literature concerning the weak incentives for all the participants in class actions is extensive. *See e.g.*,

[18] Consider the candor of one federal judge who remarked, "[T]he court starts from the familiar axiom that a bad settlement is almost always better than a good trial." In re Warner Communications Sec. Lit., 618 F. Supp. 735, 740 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986).

[19] For a close analysis of this problem, *see* John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working, 42 Md. L. Rev. 215 (1983).

motion to dismiss. The PSLRA abandoned nearly a half century of notice pleading under the federal rules and substituted a requirement that the complaint must not only plead facts with particularity but also with respect to any action involving an allegation of fraud the complaint's facts must create a "strong inference" of a violation.[20] This heightened pleading requirement is coupled with another PSLRA reform - the denial of discovery until all pretrial motions have been resolved.[21] Hence, the facts needed to establish a strong inference of fraud must come from sources quite independent of the plaintiffs' lawyer perusing the defendants' records. Once the complaint has crossed the heightened pleading requirement, however, the air is ripe with the odor of settlement. There is little for either side to gain by proceeding to trial and the risks to the contingency fee attorney of proceeding and losing dominate whatever optimism she has for how the facts with play to a jury. Thus, we find few trials of securities cases. Settlement is the norm.

Disbursements from the settlement are carried out by the claims administrator who is either appointed by the court or simply retained by the suit's attorneys. The most substantial efforts of the claims administrator is collecting and reviewing the proof of claims submitted to it. But before receiving such submissions, the claims administrator engages in a good many steps designed to give notice of the settlement.[22] Because of the way in which stocks are both owned and traded, the claims administrator faces multiple challenges in assuring that potential claimants in fact receive notice of the settlement.

In the abstract, the logical place to begin the process of identifying possible claimants is by obtaining from the issuer's transfer agent a list of the security's registered holders. However, because most investors hold their securities in street names, the list in most instances reports that ownership is with CEDE & Co., the depositary for most brokers. Even acquiring this information is problematic in the case of a bankrupt issuer or through merger or otherwise has ceased to exist which is frequently the case in settled securities class actions. When the issuer continues to exist, the claims administrator must penetrate the CEDE listing using the DTC Participant List, a database of over 2000 brokers that participate in the Depositary Trust Company. Using this database, the claims administrator sends notices of the settlement to brokers asking each broker to assist it in identifying customers it believes possibly are included within the settlement. The brokerage firms customarily cooperate either by returning to the claims administrator printed or electronic version of customers' addresses or labels with the customers' addresses. A few brokers prefer not to share the customer addresses so they obtain from the claims administrator a sufficient quantity of settlement notices and forward them directly to the appropriate customers.

During this process, potential claimants who are institutions frequently are even less visible. Trading and ownership by institutions frequently is much less transparent than that of the typical retail investor. This occurs in part because institutions, particularly

[20] The heightened pleading requirement applies only to claims involving allegations of a violation that has as one of its elements a state of mind on the part of the defendant (e.g., not a violation that can arise from mere negligence). *See* Securities Exchange Act Section 21D(b)(1)(2), 15 U.S.C. § _.

[21] *See* Securities Act Section 27(b)(1), 15 U.S.C. §77v(b)(1) and Exchange Act Section 21D(b)(3)(B), 15 U.S.C. § .

[22] The procedures followed by claims administrators are based on our conversations with several administrators as well as documents filed by claims administrators in connection with the final disposition of the settlement funds they are charged with distributing. *See e.g.*,

mutual and hedge funds, value trading anonymity more so than do retail customers (due to the size of their holdings in individual companies), but more frequently the problem of identifying institutions is because of their reliance on an extensive network of advisors who execute trades through brokers in the advisor's name and not that of the institution. Simply stated, with the institution, there is generally introduced yet another layer of market professionals whose goodwill and cooperation is needed for the settlement notice to reach the ultimate beneficiary of the settlement.

To be sure, just as the broker is under a duty to forward the settlement notice to its customers whose share ownership is recorded in street name, the advisor has a similar obligation to forward the notice to its institutional client. But this web of obligations is far from certain in its ultimate effect of imparting notice to the institution. Thus, a further step taken by claims administrators is publishing notice in the national financial press, such as *The Wall Street Journal*, *USA Today*, and *Investors Business Daily*. Furthermore, other services exist that advertise class action settlements. For example, our survey revealed that many institutions learned of the suit and settlement through their subscription to *Class Action Alert*. We were also advised that some law firms provide these services to institutional investors, perhaps in hopes of gaining their future business.

II. Study Methodology and Results

In order to obtain a sample of securities fraud settlements, we asked three settlement administrators to help us identify a group of securities fraud class action settlements and provide us with the settlement notices from these cases.[23] We used these notices to gather a wide variety of information about these cases, including the identity of the lead plaintiff for post-PSLRA cases, and the class period for each case.

We then generated two additional types of data. First, for each settlement in our sample, we used SEC Form 13F[24] data to determine which institutions traded stock in the company during the class period. After we generated this list of the institutional investors, we compared this with our claims data to see if these institutions filed claims in the securities class action settlements. In our earlier work, we set forth the results of this comparison for the relatively small number of cases that we obtained from two of the three claims administrators.

In this paper, we present the results for the much larger sample that we received from Claims Administrator 3. All of the settlements listed here involved purchaser classes. As before, we create a list of Form 13F filers that reported purchases during the sample period and compare it with the names of the beneficial owners that filed claims in the settlement. Using the results of this comparison, we calculate the percentage of Form 13F traders that file claims in each settlement.

[23] A more detailed explanation of our methodology is found in Cox and Thomas, supra note , at 871-874.

[24] Securities Exchange Act Section 13(f), 15 U.S.C. §78m(f) and Rule 13f-1, 17 C.F.R. § 240.13f-1(2004) require institutional investment managers who have at least $100 million to file Form 13F within 45 days of each fiscal quarter detailing the holdings of certain (i.e., those subject to the early warning provision of Section 13(d)(1) of the Securities Exchange Act, 15 U.S.C. §78m(d)(1)).

Table 3 sets forth this information by sample company, as well as data on the average, median, minimum and maximum size of the claim for each institution that filed a claim. We note that we have incomplete information on several of the settlements (indicated by the letters NA and in such instances they are not included in the totals for any of the columns).

Table 1 ADMIN THREE DATA ON SETTLEMENTS; 13F DATA ON FILING

Case	Institutions Filing	Institutions Trading	Percent Filing	Mean Loss	Median Loss	Minimum Loss	Maximum Loss
1	87	240	36.25%	1,938,373	239,274	11,907	33,289,462
2	5	22	22.73%	802,682	473,280	22,943	1,808,569
3	5	19	26.32%	798,489	302,572	11,940	2,079,067
4	25	83	30.12%	318,412	122,539	10,058	2,327,380
5	76	191	39.79%	427,208	130,981	13,125	8,014,688
6	45	169	26.63%	270,952	92,055	11,400	2,925,315
7	30	137	21.90%	398,678	40,508	11,700	8,286,060
8	3	20	15.00%	388,944	105,230	33,962	1,027,641
9	75	206	36.41%	2,013,118	412,937	10,200	60,367,425
10	51	348	14.66%	1,154,575	127,603	11,768	32,526,854
11	54	134	40.30%	1,539,851	452,786	10,315	23,312,885
12	36	92	39.13%	2,643,492	80,794	11,625	64,772,109
13	10	21	47.62%	278,114	250,133	12,649	670,611
14	10	28	35.71%	654,397	291,906	24,400	2,719,875
15	9	26	34.62%	1,042,362	278,322	15,100	7,175,025
16	70	236	29.66%	996,198	174,944	10,604	13,204,931
17	22	41	53.66%	973,664	519,792	12,506	5,525,283
18	51	142	35.92%	914,650	102,951	13,722	16,448,536
19	10	145	6.90%	156,530	73,245	14,900	604,632
20	69	145	47.59%	731,021	194,130	15,840	11,708,774
21	16	46	34.78%	356,911	268,349	22,863	1,222,040
22	8	47	17.02%	39,886	33,195	10,600	91,729
23	24	69	34.78%	1,097,354	358,055	14,383	6,208,669
24	17	48	35.42%	1,968,882	467,362	12,980	12,714,092
25	15	51	29.41%	1,103,994	275,298	13,283	12,409,544
26	21	82	25.61%	228,325	75,353	10,603	2,089,880
27	45	117	38.46%	1,504,321	197,746	10,363	14,799,408
28	9	62	14.52%	230,788	155,844	52,500	489,225
29	14	69	20.29%	273,330	86,388	11,625	1,714,650
30	12	47	25.53%	259,980	98,796	10,751	1,229,699
31	35	116	30.17%	1,803,769	482,900	25,594	35,953,038
32	12	80	15.00%	122,245	50,813	10,000	710,500
33	16	43	37.21%	1,017,996	175,621	11,790	4,338,355
34	15	60	25.00%	306,287	112,375	10,150	1,012,704
35	32	138	23.19%	722,891	174,839	10,500	5,889,279

36	25	145	17.24%	199,067	118,472	10,075	799,955
37	40	90	44.44%	1,323,568	546,197	27,171	11,231,263
38	3	24	12.50%	96,708	78,023	13,484	198,617
39	10	40	25.00%	252,150	220,834	21,095	830,332
40	21	77	27.27%	305,215	153,750	10,589	1,127,500
41	2	16	12.50%	46,202	46,202	37,699	54,705
42	40	85	47.06%	995,358	419,912	11,898	7,775,718
43	73	198	36.87%	465,905	105,750	10,363	9,438,575
44	45	91	49.45%	858,625	237,500	12,625	12,679,950
45	58	162	35.80%	1,633,779	349,323	10,500	26,700,814
46	31	93	33.33%	647,646	138,443	12,512	6,675,624
47	17	51	33.33%	447,146	127,600	15,990	3,500,000
48	26	56	46.43%	875,682	559,122	18,998	4,804,085
49	2	15	13.33%	70,044	70,044	17,588	122,500
50	16	131	12.21%	385,371	168,393	12,275	1,787,270
51	16	49	32.65%	898,633	369,257	19,793	4,098,965
52	9	21	42.86%	384,100	197,148	22,863	990,039
53	17	44	38.64%	854,210	788,832	17,432	2,139,050
54	14	37	37.84%	997,459	721,925	26,161	2,780,042
55	57	126	45.24%	1,762,263	495,891	10,544	18,404,236
56	14	57	24.56%	708,137	272,353	14,230	3,313,173
57	0	3	0.00%	NA	NA	NA	NA
58	16	78	20.51%	313,450	231,645	17,550	955,404
59	1	11	9.09%	207,000	207,000	207,000	207,000
60	17	48	35.42%	726,707	243,771	26,478	3,211,050
61	5	13	38.46%	472,613	554,625	18,275	850,000
62	14	44	31.82%	826,697	267,413	71,363	4,828,552
63	21	65	32.31%	1,376,085	373,171	15,757	21,477,801
64	20	53	37.74%	631,615	292,957	14,165	3,065,586
65	41	91	45.06%	2,649,033	610,400	12,315	55,306,114
66	26	76	34.21%	1,049,458	154,814	12,028	10,128,841
67	49	128	38.28%	694,324	157,825	10,680	5,155,358
68	3	19	15.79%	465,589	252,939	228,014	915,813
69	4	21	19.05%	99,941	91,394	11,651	205,325
70	45	107	42.06%	2,005,097	662,093	12,463	12,940,277
71	132	245	53.88%	5,541,965	633,915	10,123	155,885,624
72	3	22	13.64%	464,578	100,942	50,132	1,242,660
73	13	44	29.55%	733,225	152,580	11,348	6,018,931
74	0	22	0.00%	NA	NA	NA	NA
75	1	12	8.33%	10,500	10,500	10,500	10,500
76	11	35	31.43%	112,005	70,750	16,320	309,955
77	17	38	44.74%	916,865	280,955	54,375	4,795,292
78	2	29	6.90%	754,340	754,340	89,902	1,418,778
79	2	29	6.90%	259,461	259,461	43,247	475,674
80	24	84	28.57%	285,032	87,245	10,253	2,344,929
81	24	74	32.43%	685,447	176,031	11,905	6,043,538
82	1	18	5.56%	31,075	31,075	31,075	31,075
83	1	16	6.25%	2,622,923	2,622,923	2,622,923	2,622,923
84	11	51	21.57%	109,288	46,394	14,714	313,981
85	44	143	30.77%	2,066,510	142,664	11,613	67,291,180

86	13	36	36.11%	133,386	102,664	41,938	370,156
87	2	11	18.18%	459,162	459,162	85,779	832,545
88	27	99	27.27%	618,554	323,388	14,632	7,066,264
89	4	27	14.82%	161,922	147,813	51,063	301,000
90	37	163	22.70%	336,473	109,058	10,863	4,246,474
91	19	56	33.93%	1,078,353	253,754	15,054	11,399,104
92	41	144	28.47%	387,208	125,450	13,050	7,428,200
93	17	33	51.52%	1,057,035	345,039	26,853	4,317,676
94	0	9	0.00%	NA	NA	NA	NA
95	42	110	38.18%	2,989,015	387,642	11,450	49,066,864
96	5	27	18.52%	376,590	163,013	68,850	980,988
97	95	213	44.60%	684,700	237,607	11,122	9,373,186
98	42	108	38.89%	4,962,839	633,925	15,181	75,226,325
99	8	18	44.44%	159,531	102,173	13,570	445,963
100	22	74	29.73%	1,195,357	221,113	19,600	6,651,309
101	25	58	43.10%	1,259,327	308,997	14,733	9,679,460
102	12	67	17.91%	288,193	40,875	13,500	2,593,563
103	11	78	14.10%	184,232	92,098	21,306	482,720
104	21	63	33.33%	2,244,347	1,061,877	15,785	19,342,542
105	21	89	23.60%	351,910	60,500	14,400	3,384,000
106	21	89	23.60%	557,668	206,185	15,070	2,262,413
107	16	52	30.77%	1,538,348	1,309,047	13,294	4,527,484
108	6	37	16.22%	239,140	184,793	48,750	738,745
109	0	7	0.00%	NA	NA	NA	NA
110	47	116	40.52%	474,472	164,947	10,500	7,066,611
111	31	99	31.31%	509,413	224,037	10,117	3,839,542
112	36	139	25.90%	453,745	105,296	11,680	3,701,560
113	10	44	22.73%	411,550	180,846	31,150	2,718,405
114	11	44	25.00%	1,973,029	392,312	26,664	7,123,741
115	44	118	37.29%	600,364	191,940	13,649	6,514,878
116	10	39	25.64%	1,051,964	174,585	13,287	9,001,675
117	1	7	14.29%	137,955	137,955	137,955	137,955
118	2	35	5.71%	42,336	42,336	32,620	52,052
Total	2,817	9,056	NA	NA	NA	NA	NA
Mean	24	77	28.09%	848,376	277,405	47,124	10,070,578
Median	17	58	29.70%	625,085	193,035	13,685	3,600,780
Min.	0	3	0.00%	10,500	10,500	10,000	10,500
Max.	132	348	53.88%	5,541,965	2,622,923	2,622,923	155,885,624

Several key points emerge from these data. First, on average roughly 28% of eligible institutional investors file claims in these settlements. The median value is almost identical at 29.7%. This falls squarely within the 25-33% range that we found in our earlier research.

The average mean loss is very substantial in these cases – almost $850,000. This is substantially higher than that for the other two samples we previously analyzed (the first group had an average loss of $102,644, while the second set showed average losses of $461,074). This indicates that our results are robust even in a sample of significantly larger settlements. We also present data on median settlement values. We find the average median loss is roughly $275,000, which is substantially lower than the $850,000 average value reported in the table. Nevertheless, even the median loss is a large number that would seem to indicate that many institutions have suffered significant losses in these cases.

Of course, what most likely should guide the decision whether to file a claim is not the loss suffered, but the recovery expected. Here, we can only draw on our earlier data for a small sample of cases which shows that average recovery rates are about one-third of losses. Applying this value to the numbers shown in the previous paragraph would give an average mean recovery of around $280,000, or an average median recovery of over $90,000. To our eyes, this would seem to be a significant return on the small costs (in terms of time and money) of filing a claim in a securities fraud class action settlement. We would again (as in our earlier work) caution against putting too much stock in the precise numbers, but we do think that they indicate a substantial return to filing claims and a large number of non-filing institutions. Of course, the institutions with the largest holdings would realize far more than this from filing claims.

Thus, our data provides an inescapable and startling conclusion; financial institutions with significant provable losses fail at an alarming rate, approximately 70 percent, to submit their claims in settled securities class actions. Moreover, not only are their losses significant, but the sums of money they likely would share in are both in the aggregate, and on an average individual fund basis, not trivial.

III. Potential Explanations for Slumbering

No doubt there are multiple explanations why institutions have such a dismal record for submitting their claims in settled securities class actions. Our conversations with participants in the process and theory are the basis for us to formulate several hypotheses which we develop below.

A. Sleeping with the Enemy

The agency cost implicit in business organizations is well understood. Because managers seek to maximize their own utility, their actions do not always redound to the benefit of the firm's owners or others for whom the managers are stewards of assets that are not owned by the managers. Indeed, managers, because they typically own a small percentage of the firm, have a natural incentive to pursue strategies that benefit themselves disproportionately vis-à-vis the firm's owners. Agency costs are not confined to smoke stack industries. They persist across all organization forms including financial service firms such as trusts, endowments, and mutual funds.[25]

[25] This topic has been best explored in the context of whether financial institutions are likely to play a significant role in the governance of their portfolio companies. *See e.g.,* Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 U.C.L.A. L. Rev. 811 (1992)(examining a variety of regulatory and cultural forces that impact the ability of various types of financial institutions to monitor the stewardship of their portfolio companies); Bernard S. Black, The Value of Institutional Investor Monitoring: The Empirical Evidence, 39 U.C.L.A. L. Rev. 895 (1992)(finding from a review o diverse empirical studies that there is a

Over the last decade, regulatory efforts have sought to unleash the disciplining force of financial institutions so as to improve the stewardship of corporate managers. The thesis of these reforms is that financial institutions because of their significant ownership interest and financial acumen can be expected to be vigilant and responsible monitors of managers. Thus, in 1992, the SEC greatly liberalized the proxy rules to permit financial institutions to not only announce their positions on matters submitted to the stockholders,[26] but also to encourage other financial institutions to follow a common course in voting their proxies.[27] The SEC also abbreviated the disclosures that are required for significant holders of publicly traded shares, thus reducing some regulatory friction facing institutions who wish to hold more than five percent of a firm's voting shares but who do not seek to control that firm.[28]

More recently, the SEC mandated that mutual funds disclose annually how they vote their fund's proxies on matters coming before the shareholders of their portfolio companies.[29] The aspiration for this development is not so much to assure the advisor vote in the elections conducted by portfolio companies but that when exercising this franchise they do so with a regard for the interests of the fund's holders.[30] That is, the regulatory objective is the belief that greater transparency is more likely to align the advisor's voting decisions with those of the fund's beneficiaries. Implicit in this aspiration is the belief that advisors are likely to march to a quite different beat than do the fund's holders. There is also the collateral benefit of reducing the likelihood that advisors will garner rents from portfolio companies by currying favor with their managers in how they exercise their power to vote the portfolio's shares.

Even though financial institutions are not monolithic in their mission or operations, many do face a similar source that could conflict their managers fulfilling their fiduciary responsibilities by claiming their rightful share of settlement funds.[31] Banks, mutual funds, and insurance companies, three of the five largest classes of financial institutions, are each vendors of financial services and products. Their customers include corporations and accounting firms who are the grist of securities class actions. And, to the extent that public pension funds and endowments appear not to have the same conflicts as other types of institutions, those conflicts appear when the public pension fund or endowment depend on outside money managers who have such

need for a strong shareholder voice to address problems such as excess cash accumulations, harmful acquisition strategies, and executive compensation, but not addressing whether institutional investors can be expected to effectively provide that voice); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. J. 1277 (1991)(arguing that institutions' preference for liquidity and access to insiders restricts their willingness to involve themselves as monitors); Jayne W. Barnard, Institutional Investors And The New Corporate Governance, 69 N.C.L. Rev. 1135 (1991)(reviewing the changing role of institutional investors to suggest they are poised to improve corporate performance through their impact on the composition and processes followed by boards of directors); Ed Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L. J. 445 (1991); Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990)(examining among other points the various conflicts of interest that different types of financial institutions face that interferes with their being an effective monitor of managers);

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[31] *See generally* authorities cited *supra* note _.

conflicts.[32] Care must be taken by these financial service providers to assure they do not align themselves with protagonists of their clientele.[33] This easily explains why we find no recorded case where a bank, mutual fund or insurance company has served as a lead plaintiff in a securities class action. Why should a firm step forward to lead the assault on executives who have issued misleading reports if such visibility could pose problems in soliciting banking, insurance or pension services from other executives who likely share the common view in executive suites that most securities class action suits are strike suits?[34] Standing shoulder to shoulder with "class action lawyers" does not win one friends in the executive suites of America or at the club. Moreover, there is only the thinnest social divide between executives of banks, insurance companies and mutual funds and executives of industrial firms. These are groups of individuals who understand one another and who are aware of the price to be incurred by failing to honor that understanding.[35]

It may well be that the social and commercial forces that prevent banks, mutual funds and insurance companies from stepping forward to be a lead plaintiff at least weaken the commitment of their managers to assure the firm reaps the full advantage of securities class action litigation. That which is distasteful socially and harmful to business is easily accorded a low priority on the fund executive's agenda. Such benign neglect is understandable for several other reasons as well. A firm that believes its financial success arises from it managing funds for others (i.e., a mutual fund advisor) or playing the actuarial game (i.e., an insurance company) is not likely to place a high value on establishing and monitoring procedures to assure it participates in settlements affecting its portfolio companies. Instead, submitting claims is likely to be viewed as subsidiary to what the firm's real operations believed to be. Also, the rewards to the firm of having a reasonably designed and administered system to submit claims are likely to be slight relative to the firm's other metrics of success, so that monitoring the claims process earns little, if any, executive attention.[36] As a result, this is not a metric of success that gets measured, managed, or ultimately rewarded. When added to the cultural baggage class actions enjoy in the executive suites, it is hard to fathom who would be a champion for reviewing the firm's internal procedures for submitting proof of claims in settled securities class actions.

B. A Rolling Stone Gathers No Moss

The data we have collected in our on-going studies of securities class action settlements reflects that the average length of a class action is _ months and that

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[32] *See* Black, Shareholder Passivity Reexamined note _, *supra* at 596-597, who makes this point in reference to private pension funds.

[33] Thus, we find that many types of financial institutions are not themselves the proponents of a bylaw or other proposal that will alter the governance of their portfolio companies, although they will at times vote in favor of such a proposal that is advanced an another less conflicted institution. *See* Black, Agents Watching Agents note _, *supra* at 883-884. More pointedly, "For a conflicted institution, crossing the street in a crowd is safer than crossing alone." *See* Black, Shareholder Passivity Reexamined, note _, *supra* at 606.

[34] We recognize that an institution may be averse to participating in individual class action recoveries if they believe that a particular case is just extorting money from a company.

[35] *Cf.* James D. Cox and Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 Law & Contemp. Prob. 83 (1985)(examining the social and psychological forces, among which is being of the same social strata, that can impede the decision to sue another).

[36] For the view that pension fund trustees' and managers' tenure is largely invariant to the overall performance of the fund, *see* Barnard note _, *supra* at 1140-1141.

settlement notices are not circulated until _ months after the end of the class action period. This represents an average total time of _ years that may have elapsed since an institution traded the security that qualified it to participate in the settlement. If we assume that institutions on average purchased or sold in the middle of the class action period, the length of time between the trade that qualifies it for membership in the class and the settlement is a very long time, namely _ months. This observation has serious implications for whether the institution is likely to file a claim in settlement.

Most financial institutions do not manage their own funds but instead oversee a stable of investment advisors. A well managed fund periodically reviews the performance of its advisors, terminating its relationship with under-performing advisors and substituting in their places those who emerge from on-going beauty contests. Moreover, institutions and their advisors with some frequency change their custodian banks. Such changes are important because often it is the custodian bank that is expected to file claims for institutions as well as handle many of their back office duties.

A departing investment advisor or custodian bank does not customarily forward to the institution, or its successors, the trading records for the portfolio it had previously handled. Therefore, a succeeding advisor, custodian, or the institution itself will not have at hand sufficient information to evaluate whether it has a provable claim that can be submitted to the settlement administrator but will need to depend on its predecessors to provide these data.

Furthermore, the settlement administrator's notice of a settlement may well be sent to the terminated investment advisor, or custodian, and not to the institution or its current advisors or custodian bank. As described earlier, one customary approach of claims administrators for imparting notice is relying upon the CEDE list of beneficial ownership. [check time period for the relevant CEDE list] This step likely identifies the advisor or custodian so that the notice will be forwarded to it. Whether this produces a submitted claim necessarily depends on the cooperation of the earlier terminated advisor, or bank, as well as that advisor, or bank, having retained reliable records covering its former client's trading. The problems of forwarding the notice are exacerbated by the passage of time between the date of the trade that qualifies the institution's claim for participation in the settlement and when the settlement notice is published. As seen above, several years customarily separate the institution's trade that qualifies it as a member of a class and the circulation of the settlement notice. Although it is sound practice for an advisor to retain records pertinent to its current clientele, the appeal of retaining such records for former clients is much weaker.

A further consideration is what rewards can the terminated advisor expect for its efforts in identifying whether a former client has a claim to be submitted and assembling the information needed to submit that claim. Certainly one can attribute some goodwill with it doing so, but the weight the institution assigns to such responsible behavior on the part of its former advisor pales in comparison with the dominant consideration in selecting advisors generally, namely portfolio performance, in which the advisor has already been found wanting. Similar considerations would apply for a former custodian bank.

C. Voting With Their Feet

Securities class actions, even in the post-PSLRA era, continue to have a negative public image. Frankly, they are damned by the company they keep.[37] They are perceived as resulting in small sums for class members and generous fees for the suits' attorneys. Our own data supports the conclusion that settlements in absolute dollars are fairly sizeable, but relative to the losses suffered by the class' members settlements yield small percentage recoveries, with the bulk of such suits yielding a few cents on each dollar of provable losses.[38] To the extent these perceptions are shared by an institution's managers, they weaken the commitment to systematic oversight of the institution's commitment to submitting claims when it is the beneficiary of a settled class action.

A further consideration is how the institution's managers likely frame their evaluation of what commitment to make toward installing procedures for submitting and monitoring claims in settled securities class actions. Here we can expect very different commitment levels if the question is evaluated in the context of whether it is cost effective to install a reliable process for identifying probable claims, obtaining the relevant documentation to submit a claim, and submitting the claim. These costs are low because they involve low-skill administrative tasks that do not require the efforts of a professional. Nor does it require a significant number of personnel, especially if these tasks are largely contracted out to a custodian bank. Compared to the low investment that we believe would be necessary to staff reasonably a protocol to assure submitting claims in settled actions our data suggests that the expected returns of such staffing would not just cover the costs of such a procedure but would likely yield a fairly high positive return on those costs. However, institutional managers who instead assess the desirability of identifying and submitting claims within the context of the overall activities of the fund can easily conclude that there are far better places to expend the fund's resources. That is, managers who view their objective to be well-performing traders (i.e., to beat the market) are less likely to value operations that are removed from that role.[39] For example, a few fund managers commented, rather casually to us, that they did not value submitting claims because the expected gains of doing so were dwarfed by both the size of the fund's assets and the average yearly returns earned by the fund through wise investment strategies.[40]

[37] *See* James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 Ariz. L. Rev. 497, 497-499 (1997)(reviewing some of the reasons the public holds class action awards in low esteem).
[38] *See* James D. Cox and Randall S. Thomas (with assistance of Dana Kiku), SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke L. J. 737 , 769, 771 (2004).
[39] Hence, Professor Black observes that a problem of the money manager culture is their focus on trading rather than diligent pursuit of strategies that could improve the governance and performance of their portfolio companies. *See* Black, Agents Watching Agents note _, *supra* at 885-886.
[40] Such responses are not inconsistent with the view that money managers and fund managers do have strong market-based incentives to improve the overall performance of their fund. *See e.g.,* Black, Agents Watching Agents, note _, *supra* at 877-881 (identifying bonuses and reputational advancement as two considerations of both private and public fund managers). Because the relative gains through diligent pursuit of settlement funds are not likely to have a material impact on either the money or fund manager's income or reputation it is understandable that devoting limited executive time to oversight of settlement submissions will be crowded out by strategies the manger believes he or she can pursue that will result in more significant rewards. At the same time, Professor Black observes that managers of public pension funds are less likely to have the same market-based incentives. *Id.* at 878. If this were the

D. Who's On First

The current operating environment for monitoring notice of settlements likely includes a good amount of incompleteness in terms of relative responsibilities. Despite the admirable and non-trivial efforts of claims administrators to reach possible claimants, the system in large part depends on there being a watchful eye on the part of the institutions. Notices directed to custodians, advisors or brokerage firms may not be received or, if received, may not be forwarded to the individual person who has responsibility for determining whether the institution has a provable claim and wishes to submit it to the claims administrator.

This oversight might also be due to a failure of the institution to clearly specify in its contract with its custodian, advisor, or broker the procedures to be followed with respect to handling possible claims. Moreover, the institution's external agent may not have a definitive protocol to follow when receiving a notice from the claims administrator. The problems arising from a lack of such specification are exacerbated in the case where the custodian, advisor or brokerage firm has an unclear obligation to peruse the financial press and other publications for notices of settlements. The situation is ripe with the possibility of mutual misunderstandings whereby the institution believes its interest is being addressed by its custodian and advisor, when in fact the custodian or advisor believes it is not its responsibility to monitor settlement notices.

There also is the distinct possibility that breakdowns occur within the institution. Lines of authority, once clearly established, may, with the passage of time and personnel, become blurred or forgotten. One can imagine that institutions could assign to one of its staffers responsibility for handling all matters related to the institution's possible securities claims. This is not likely to be either the sole or primary obligation of the employee. When an employee is evaluated on other functions those tasks that are evaluated will of course enjoy a higher order of attention by the employee in terms of how the employee allocates his time. And, as employees come and go to that position there may be further blurring of that position's responsibilities with respect to monitoring custodians, advisors or publications for possible provable claims the institution has.

In sum, all the above problems have a common source, a lack of monitoring by the management of the institution. Each institution should periodically evaluate whether its procedures and personnel are performing reasonably. This is an area where complacency can easily take hold, especially since the institution's managers likely prize money management more highly than the pursuit of settlements. We also speculate that the system for imparting notice and identifying possible claims may well exacerbate cultural and economic forces such as those described above. That is, the greater the friction and uncertainty that attends the process institutions must follow to submit a claim the more likely it is that the institution's managers will succumb to the above forces that

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case, we would expect that such managers may indeed allocate more of their time to assuring that their fund has reasonably designed procedures to pursue their rightful share of settlements. And, the market incentives are weakest for institutions like banks and insurance companies that emphasize to their client base their "stability" rather than simply their performance. *Id.* at 882.

cause them to slumber. Thus, any solution must address those features of the claims process that pose uncertainty or difficulty on the part of claimants.

IV. Survey Results

To try to unpack how institutional investors deal with the claims filing process, we surveyed different groups of institutions about their practices in the area. Initially, in early 2002, we designed a short survey that focused on three main issues: how did institutional investors get notice of settlements, did they know of any settlements that they did not get notice of, and how did they determine whether or not to file a claim in the settlements that they heard about? We asked the Council for Institutional Investors (CII) to distribute the survey to its membership[41] and also distributed copies to a large number of smaller public pension funds at a conference of Police and Fire pension funds. We received back only twelve completed surveys, three from CII members and nine from the Police and Fire pension funds.

Our first question concerned how these investors got notice of settlements in securities fraud class actions. Three-quarters of the respondents replied that their primary (or exclusive) source of information was their custodian bank, with smaller numbers reporting they had been contacted by the claims administrators or the company directly, or that an employee of the fund had read about the settlement in the financial press.[42] However, only four of the twelve respondents had an employee who was responsible for checking the financial press for settlement notices.

We then asked the investors if there had ever been a settlement in which they later learned they had not received a notice of settlement. Seven of the twelve institutions replied this had "never" occurred, two investors said it had happened "a few" times, two responded they had not received a notice "some" times, and one investor did not reply to this question. Interestingly, one respondent that claimed it had never missed a settlement notice also replied that it had never received any such notices.

Turning to the claims filing process, we asked two questions: who filed claims for the institution? And when did they decide to file claims?[43] Each of the CII respondents stated that their custodian banks filed all claims that they were entitled to make. The Police and Fire funds were more diverse in their responses: two delegated claims filing to their custodians, while the other seven had internal employees, such as a plan administrator, chief accountant, or staff attorney, who made these filings. They were also less likely to file all claims irrespective of their value, but rather before filing a claim they considered the size of the fund's loss, its estimated recovery, the size of the overall

[41] They included a paragraph about the survey in their newsletter. This short note directed interested members to our web site where they could fill out the survey.

[42] These categories are not mutually exclusive and typically investors reported two or three sources of information about settlements.

[43] The reader should be aware that the discussion in this section relates only to securities that are held beneficially by the institutions. Some institutions hold only a small percentage of their equity holdings beneficially because they have large holdings in commingled or indexed funds which are managed by outside money managers. These outside managers are expected to file claims for the benefit of these funds with the investors in the fund ultimately benefiting. However, this does not present a problem for the purposes of section II supra because the institutions would not report these holdings on their Schedule 13F.

settlement, the importance of the stock in their portfolio, the time and effort involved in filing a claim, and any publicity surrounding the case.

The results of this initial survey were useful to us in several ways. First, they highlighted the importance of the custodian bank in the claims filing process, both as a source of information about settlements and as the party responsible in many instances for filing the claims themselves, particularly at the larger public pension funds. Second, this survey brought out two very different approaches taken by institutions to claims filing: one set of institutions outsourced the entire process of gathering notices and filing claims to a third party, the custodian bank, while the second set of institutions relied largely on internal employees to gather and file claims. Finally, we were also intrigued by the difference in claims filing at the different size institutions with the larger public pension funds filing all claims, irrespective of their value, and the Police and Fire funds taking a more textured approach which considered the costs and benefits of making a claim.

With these points in mind, we designed a second, much longer questionnaire on institutional claims filing practices. At various points during 2003, we mailed this questionnaire to several hundred institutions, including all of the members of CII and several other institutional investor organizations. This questionnaire focused on whether the institution used an internal or external claims filing process and how that process worked, the factors affecting the institutions decision to file claims, the costs of filing claims and how they are allocated, claims monitoring by institutions, allocation of any recoveries to the fund, and the institutions understanding about their duty to file claims.

We received 23 replies to this questionnaire;[44] twenty from public pension funds, two from private pension funds, and one from a bank. Given the proprietary nature of the information that we were requesting and the length of the questionnaire, it is perhaps not surprising that the response rate was so low. However, we are only trying to get a descriptive view of how the claims filing system works, and not seeking to draw statistical inferences from the data that we collected, so we do not view the small percentage of replies as a serious problem.

Our initial questions revisited the question of whether there had been class action settlements that occurred where the responding institution had later learned that they had not received notice of the settlement. Eighteen of the respondents claimed there were no such instances, one institution stated it had learned of one such matter,[45] and three fund representatives said that they "Do not know." Only one respondent said that because of delays with the mails they had received some notices too late to ask their custodian to file claims.

We cannot draw strong conclusions from these responses for several reasons, although we note that they seem to conflict with our earlier empirical results. First, the

[44] Because we did multiple mailings with overlapping mailing lists, some institutions received more than one questionnaire. In two cases we received more than one reply from the same institution, undoubtedly because of the repeat mailings. We thank those diligent funds for taking the time to reply twice to our questionnaire, but felt we had to exclude their second reply from our sample.
[45] It stated that as a result it had instituted new monitoring procedures to insure this failure would not occur again.

investors responding to our questionnaire are self-selected and likely to be those who have better practices in the area. Thus, they may well be abnormal in terms of their approach to filing claims. Second, given the widespread distribution and press coverage of our earlier findings, those institutional investors that did not file claims are likely to have learned that they have legal duties to do so. This may have quickly led those funds to changes in the way in which they handled claims filing. This could account for why we see a relatively high rate of non-filing in the earlier time period covered by our claims administrator data versus the very low rate of self-reported failures found later. Third, it is possible that the different fund employees responding to our survey are unaware of any failures to file claims, or receive notice, especially if their employer delegates such functions to its custodian bank and does not monitor that bank's activities (more on this later). Finally, it is possible that the survey respondents were worried about potential legal liability for failing to file claims and therefore chose not to report any such failures. We view this as unlikely given the confidential and anonymous nature of the responses. Moreover, we address the liability standards for such failures in section below, and find that the likelihood for such liabilities would be low in most instances.

The second section of the questionnaire was designed to determine which funds used custodian banks to file their claims and which had internal staff that handled these duties. Of the twenty public pension funds that responded, seventeen delegated these duties to their custodian bank, one employed a private law firm to file its claims and the remaining two funds had internal processes for claims filing. Both private pension funds employed their trustee bank to act as their custodian and it filed all of their claims for them. The bank respondent acted as its own claims filing agent, apparently handling both its clients' filing duties and those for its own accounts.

Of the seventeen public pension funds that have their custodian bank filing their claims, we found that fourteen of them, and both private pension funds, have little involvement in that process other than receiving a report from the custodian, usually once a month, about pending claims and monies received from settlements. [46] The custodian banks filed all of their client fund's claims as part of a larger set of services that they provided them and without charging them a separate fee.[47] These funds therefore reported no costs associated with claims filing.

The remaining three funds that used custodians had active internal monitoring systems for tracking settlement notices, claims made and monies recovered from each settlement. Each of these had specific personnel assigned to this task. The costs associated with these activities were allocated as general administrative or investment expenses of the fund, or considered part of the regular duties of the employees involved.

The two public pension funds that handled all of their claims internally had elaborate protocols on how to manage the process. Each assigned specific employees to receive and process settlement notices, to interface with their custodian banks to obtain the

[46] Two of these public funds stated that they had recently retained an independent claims filing service that independently monitored their custodians' claims filing activities.
[47] One respondent noted that they were in the process of negotiating a new agreement with their custodian bank, and that under its terms the custodian would charge a separate fee for claims filing services.

information that they needed to file claims, and computer tracking systems for all pending settlements. Finally, the remaining fund had contracted with a private law firm to coordinate filing claims with its custodian banks and to monitor all of its recoveries from class action settlements.[48] This firm gave the fund's personnel access to its settlement tracking system to permit the fund to monitor its recoveries.

Section three of the questionnaire gathered information on a wide variety of practices at the funds. First, we returned to the question of whether the respondents filed all claims in class action settlements, and if not, what factors led them to choose to file claims. Every pension fund respondent but one (we discuss the bank respondent separately below) stated that they filed all claims, with a few adding the qualifier that they excluded cases in which they were ineligible or had opted-out of the class. The one remaining pension fund stated that their custodian bank had full discretion to file claims, although they were expected to do so in every case in which the fund had suffered a loss. Subject to all of the same qualifications we pointed out above with respect to this question in our first survey, we note that these replies are inconsistent with the data reported in section II. We also note that the unqualified responses we received, if accepted at face value, mean that funds do not take into account the cost of filing in deciding whether to make claims. This could lead to inefficient behavior where the cost of filing the claim exceeds the potential recovery.

Interestingly, our one bank respondent did not adopt such a blanket approach to claims filing. Rather it cited three factors -- size of estimated recovery, size of loss suffered, and size of overall settlement – as the most important considerations behind its decision about whether to file a claim. It also noted that the costs involved in filing a claim could be substantial, including technology storage and retrieval costs, the costs of compiling data, staff time and any overtime charges when deadlines needed to be met, and the direct costs for supplies, postage and shipping. Although this respondent was not (to our knowledge) the custodian bank for any of our other respondents, it does suggest that the custodians are more conscious of the cost-benefit balance involved in claims filing.

This raises a question about those funds that delegate all claims filing duties to their custodian banks. We cannot be sure how the banks treat the instruction to file <u>all</u> claims. Might it be that custodians only file cost-justified claims, ignoring the instruction to file all claims? Of more concern, if the custodian receives a fixed fee for its services, but it pays all of the costs of filing claims without reimbursement from the fund, as seems to be the norm with most respondents, then the bank's financial interests would seem to be to do as little claims filing as possible. This could lead to potential conflicts with their client funds' interests. This potential problem could become a real one if the client fund does little or no monitoring of the claims filed on its behalf. Minimal fund monitoring does seem to have been the norm amongst our respondents, although we note that hiring independent third party monitors, or having an active internal monitoring system at the fund, would address this issue.

[48] The contract was competitively bid and included provisions that the law firm would act as the fund's counsel if it chose to serve as lead plaintiff in a securities fraud class action.

We then asked what our respondents felt was the most difficult aspect of filing claims in securities class actions. Those funds that had delegated claims filing to their custodian bank without much monitoring almost uniformly reported that there was nothing difficult about the process. The other responses identified three types of problems: learning about settlements and monitoring claims; gathering and compiling the information necessary to perfect claims; and accounting for the payments when they are received.

Those respondents who noted the difficulty in learning about settlements suggested the creation of a central clearinghouse, or website, for information about all securities fraud class action settlements. This would facilitate institutions determining when they have claims in different cases. We note that the independent claims filing monitoring services all have created proprietary databases which they use for this purpose.

The funds that mentioned the second problem, gathering and compiling information for claims filing, recommended that filing requirements be simplified and automated using standardized forms. The one bank respondent also made similar proposals. In addition, one respondent suggested that claims administrators should accept electronic data from known institutional investors with digital signatures.

The final problem, how to account for the payments received, was one that we had inquired about in a separate question in the survey. Ideally, we would want to have any recovery that the fund makes credited to the accounts of those persons that held interests in the fund at the time of the loss suffered in proportion to their share of those losses. Administratively, however, this would require the pension funds to engage in some complex calculations about who were the particular beneficiaries were at that point in time, what percentage of the recovery they were entitled to receive, and then allocate what are likely to be very small amounts of money to each of them, including those who have left the fund. Given the difficulty of this exercise, we expected that funds would adopt some form of simplified allocation system to determine where to place these funds. We were not disappointed in our speculation.

What we learned from the questionnaires was that our respondents had come up with two basic allocation techniques for funds they recovered in these settlements. Some funds deposited the monies recovered into the portfolio that had suffered the loss, unless that fund had been terminated (usually because the money manager was terminated) in which case the money was deposited into their general accounts for benefit payments. The second common method was to put the monies directly into the fund's general account for the benefit of all beneficiaries.[49] No funds said that they allocated monies directly to member accounts.[50] Although it is hard to see a better practical solution to this problem, it does raise a concern about whether securities fraud class action settlements are indeed compensating those who were injured by the fraud.

[49] For the defined benefit plans, this resulted in a credit to the employers' accounts.
[50] One respondent also assured us that the recovered monies did not get put into a bonus pool for fund employees.

We next asked our respondents if they believed that institutional investors, or their custodian banks, had a fiduciary duty to file claims in securities class actions and if so, what the source of that duty was. The respondents that answered this question uniformly stated yes. Some of the replies focused on the duties of the custodian bank to file claims, which the respondents believed arose out of fiduciary and/or contractual duties. The remaining answers discussed the institution's duty to file claims. Here the respondents consistently pointed to trust principles, either under common law, state law or ERISA, as the source of a duty to file claims. We interpret these replies as reflecting a strong awareness on behalf of these institutions of their obligations to file claims.

Finally, we asked if the respondents had any additional information that they wanted to provide us. Two funds emphasized the value of the independent claims monitoring services that have emerged in the past few years. We agree that this has been a very positive development that should help institutional investors monitor their custodian banks' activities. These services can also file claims on behalf of the institutions. If custodian banks continue to move toward charging a separate fee for claims filing services, then institutions may want to look at the cost-effectiveness of the different services.

A couple of other respondents stated that the current claims notification system is not reliable. Given the many twists and turns involved in getting notices of settlement from the company, or claims administrator, to the beneficial owners,[51] it seems inevitable that many notices will go astray. One simple solution to the problem would be to require all beneficial owners to provide issuers with current address information. This would permit the company to quickly generate a mailing list of all of its shareholders for use in distributing settlement notices. An alternative but less satisfactory response to this problem would be for courts to require all claims administrators to post settlement notices on a centralized website or information clearinghouse.

Finally, one respondent explained to us that most investment staff view claims filing as unworthy of much attention for two reasons: first, they consider their time better spent investing money rather than trying to recover these funds; and second, they view securities litigation as simply taking money from one pocket (as owners) and putting it into another pocket (as victims) while paying a percentage of it to the lawyers. While we can certainly understand why investment managers may feel this way, our response would be that they should nevertheless hire a claims filing service to handle their claims as this maximizes the value of their beneficiaries' investment.

V. Liability Rules

Taken as a whole, our results suggest a widespread failure to file claims in securities fraud class actions, although our survey respondents claim otherwise. While our data set does not permit us to undertake a full scale institution-by-institution review of all

[51] We documented this process in our earlier paper, see Cox and Thomas, supra note , at . Here we would simply point out that the process shares many of the same flaws as our current corporate voting systems with the added problem that there is no statutorily defined obligation to forward settlement notices, only a vague fiduciary standard.

potential securities fraud class action claims that would be needed to conclusively resolve the conflict between these two sets of data, for purposes of this section we will assume that at least some institutions have failed to file claims in securities fraud class action settlements at some point in the past. If this is true, what are the legal implications for these derelict funds?

The first important issue is what is the appropriate legal standard to apply in this situation? As we discussed in our earlier work,[52] we believe that institutional investors have a legal duty to file claims in securities fraud class action settlements. There is amazing uniformity about the fiduciary obligations of institutional investor's obligations to its investors in this area: these institutions cannot abandon without reason a claim to recover funds in a securities fraud class action settlement.[53] While an institution could consistent with its fiduciary obligation to maximize the value of its beneficiaries' assets decide not to file a claim on the basis of comparing the costs to submit the claim with the expected award from the settlement, we would generally expect this to be a one-sided calculation in favor of filing for any actively trading institution. Moreover, as we noted in section IV above, our survey respondents appear to be well aware of this duty.

A. Institutional Investors

The asserted cause of action that might be brought against the institutional investors' trustees would be that by failing to cause their fund to file all cost-justified claims in securities fraud class action settlements they have breached their duty of care to be active monitors of their fund's performance. If this were not just the complaint but also the governing standard, what, if anything, do the trustees need to do to satisfy their fiduciary duties to file claims?

The Delaware Chancery Court has previously addressed a similar type of problem in *In re Caremark International Inc. Derivative Litigation*.[54] In approving a derivative law suit settlement, then-Chancellor Allen addressed the plaintiff shareholders' claim that the board had breached its duty of care by failing to monitor its operations for potential violations of federal law. The Chancellor rejected the defendant's claim that a board had no duty to monitor whether the corporation was operating within the boundaries of the law to accomplish its purposes. Instead, he found that the directors had a duty to make "a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations…" so that it can satisfy its duty of care.[55] If the directors failed to attempt in good faith to insure that the firm had an adequate information and reporting system, the Chancellor stated that this could render them "liable for losses caused by non-compliance with applicable legal standards."[56] Moreover, if the directors put a system in place, and subsequently learned that it was inadequate, then they would have a duty to make a good faith determination

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[53] Cox and Thomas, supra note , at .

[54] In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

[55] Id. at .

[56] Id. at .

about how best to correct the system's failure. It appears to us that swept within the monitoring obligations of trustees and directors of financial institutions is an obligation to have reliable systems in place to collect for their fund any sums the funds are entitled to (provided, of course, the expected benefits justify the costs of presenting a claim).

Trustees at funds without claims filing systems, or with systems suffering from systematic failures, who do not act to address their problems, face a threat of potential liability for the amount of monies that they left on the table. We believe that in order to satisfy their oversight responsibilities, the trustees of institutional investors must, in good faith, insure that their fund has an adequate system in place to identify and process the fund's claims. Furthermore, they should establish a monitoring mechanism to insure that this system is adequate, and if they learn it is inadequate they must take measures to fix the problems.

This is not an onerous standard.[57] For those institutions that have in good faith already contracted for their claims filing duties to be carried out by their custodian banks, it would appear they have put in place a reasonably designed system. However, any system requires periodic review so that we further suggest that there is a need to engage in routine monitoring activities to insure that the custodian is doing its job.[58] Our survey responses tell us that the norm in this situation is for the custodian to send the fund a periodic statement about recoveries without much additional monitoring by the fund. From a best practices perspective, we would urge the funds using custodian banks in this manner to do more to monitor them either through periodic audits or by hiring an independent third party claims monitor. However, unless a fund was aware that its custodian was performing its claims filing duties badly, *and* the fund's trustees consciously decided to do nothing about it, the current practice would likely be sufficient to protect fund trustees from liability. A fund that relies on custodians to file their claims but has employees that actively monitor their custodian's activities should face little legal liability risk, too, so long as the trustees respond actively and in good faith if evidence emerges that the claims process is malfunctioning.

Our analysis is similar for those funds that handle all of their own claims filing internally, relying on custodians or others solely to provide them with the transaction data necessary to perfect the claim. If the fund's trustees have acted in good faith in setting up the internal process, and there is no evidence that the system is failing, then they should be protected from liability. For these funds, best practices should include the creation of written protocols which describe the steps in their process, and which set forth clear lines of responsibility for each of the various steps that must take place to insure claims are filed on a timely basis. For funds using internal processes, having periodic outside

[57] As Chancellor Allen wrote in *Caremark,*
"In order to show that the Caremark directors breached their duty of care ..., plaintiffs would have to show either (1) that the directors knew or (2) should have known that violations of the law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of…"
[58] The custodian bank can further delegate these duties to a sub-agent so long as it is "usual in managing a client's investments and is not unreasonable or inconsistent with the express terms of the customer service agreement." John J. Quirrel, The Law of Pension Fund Investment (1990), at 29.

audits, or ongoing monitoring, of their systems may be particularly important to make sure that they work effectively.

One final point concerns the potential liability of trustees that choose not to file claims in cases where they have potential conflicts of interest, such as, mutual funds that fail to file claims because they do not want to antagonize potential clients for their services. Here we see the possibility that the trustees will have breached their duty of loyalty by placing their own financial interests ahead of their beneficiaries.[59]

B. Custodians

Custodial liability for failure to file claims could arise from one of two sources: first, contractual duties arising from any agreement between the investor and the custodian and, second, the custodian's general fiduciary duties to their clients. As to the former, if the parties' contract specifies that the custodian is responsible for handling any aspect of the claims filing process, and the custodian fails to perform those services with reasonable care and diligence in accordance with the contract, then it could be held liable under general contract law.[60] It is likely that the contractual requirements, either explicitly or implicitly, would include as well the professional obligation that the agents they must exercise "… the degree of care that is expected of the reasonable, average member of the profession …."[61]

The fiduciary duty's source is the agency relationship between the fund and the custodian. The custodian holds legal title to the securities that its customer, the institutional investor, owns beneficially, and must manage this property for the benefit of the institutional investor. Its control over the property of another creates fiduciary obligations under the duty of care and loyalty in performing its duties. In regards to the claims filing process, we are primarily concerned with the duty of care prong of their fiduciary obligations.[62]

Some custodians will only hold title for the securities of their customers without having any active involvement in the claims filing process. Such custodians need only concern themselves with insuring that their customers receive notice of class action settlements.[63] This obligation would certainly include forwarding any notice it receives from the claims administrator. Absent a contractual undertaking to do so, it is not likely

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[59] See In re Honeywell International ERISA Litigation, 2004 U.S. Dist. LEXIS 21585 (Sept. 14, 2004) at *44-45 (upholding against motion to dismiss allegations that plan fiduciaries breached their duty of loyalty to their beneficiaries by investing in firm stock where their compensation partially depended on inflating the price firm's stock); In re Enron Corporation Securities, Derivative & "ERISA" Litigation, 284 F. Supp. 2d 511 (S.D.Tex. 2003) (similar).

[60] John J. Quarrel, The Law of Pension Fund Investment (1990), at 27-28 (…the degree of care and skill which the law of contract demands of an agent is similar to the normal duty of care in negligence. .")

[61] Id. at 28.

[62] The duty of care in this instance overlaps with that imposed by contract.

[63] With respect to the gathering of notices, we can envision three situations where a custodian might incur liability. The first would arise if the custodian did not receive notice about the settlement directly from the class agent, but should have known about the settlement because a notice was published in the financial press. As a result, the custodian did not send notice of the settlement to the beneficial owners of the securities. Second, the custodian may have received the notice of settlement or otherwise become aware of the settlement, but never acted to send this notice along to its eligible customers. Finally, a custodian could receive notice of the settlement and try to mail such notice to its eligible customers, but be unable to do so because it lacks address information for former customers who have changed their address.

that such a custodian's obligation should be expanded to an affirmative obligation of actively reviewing publications such as *Wall Street Journal* for notices of settlements. However, custodian banks may take on the additional function of screening publications for possible settlements involving their clients, filing claims, or providing adequate information to the party that files the claims on behalf of the institutional investor.[64] In such a case, they would also assume fiduciary obligations with respect to their performance of these tasks.[65]

A pension fund that brought an action for breach of contract or fiduciary duties would need to establish that the failure to file constituted the proximate cause of a lost recovery. They would also need to come up with an estimate of the lost recovery, which would likely be far less than the amount of the full damage claim that was not filed.[66] However, assuming these elements could be established, the custodian's damages for breach of this duty could be determined by the amount of the lost recovery.[67]

VI. Easy Steps to Assure that Institutions Receive their Fair Share

Our survey revealed several ways in which the present system needs to be modified so as to both more efficient and reliable in the way notice of claims is imparted. We considered each of these issues and offer the following recommendations.

A. Establish a Centralized Information Clearinghouse

As described earlier, presently claims administrators pursue a variety of approaches to impart notice, but none of the strategies we examined entail a publishing notice of settlements in a common location. For example, some claims administrators publish notice in the national press but not always in the same newspaper. Notice of settlements is also observed by prospective claimants in *Class Action Alert.* However, our perusal of that publication suggests that that not all settlements appear therein. Our survey results support the view that institutions would benefit by greater certainty where they could access information that would enable them to determine whether they are the beneficiaries of a settlement. Therefore, our first recommendation is that that all settlement notices, claim forms, and information on how to file claims should be available to anyone through a centralized web site.

Accomplishment of this objective need not be difficult or expensive. Securities fraud class action settlements must be approved by federal courts. It would seem a simple

[64] Those custodians that also handle their clients' claims filing duties face an additional set of potential liabilities if they are negligent in performing their duties. Assuming that the custodian has received timely notice, and timely instructions from its client to file a claim in the settlement, then it needs to insure that it generates the appropriate documentation of trading activities within the class period, completes the paperwork associated with filing the claim, and returns the claim materials to the settlement administrator before the filing deadline. A negligent failure to perform any of these functions could lead to custodian liability for breach of contract and/or breach of fiduciary duties.

[65] [one interesting question is the obligation of a former custodian – this can be developed]

[66] In our earlier paper, we found that actual recoveries were only about one-third of provable losses in the small sample of cases where we had sufficient data to make these calculations. Cox and Thomas, supra note , at .

[67] A custodian bank could seek to limit its potential liability on claims of this type by inserting an appropriate clause into its contract with its clients. An interesting question would then arise concerning whether such a limitation would also apply to damages for breach of fiduciary duty. See Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994) (rejecting argument that board of directors could limit its fiduciary obligations by contract).

matter for courts to condition their approval upon the settlement administrator posting on a centralized web site all of this information. Each settlement could be assessed a modest fee to pay for the creation and maintenance of such a web site. The web site could be operated by a court, private company, or educational institution. It would also be possible to link to that website an automatic forwarding of new postings to those who wish to subscribe to the service so that institutions could receive notice automatically of new settlements.

The creation of this type of information clearinghouse would greatly increase the availability of information about settlements for institutional investors, custodians and individual investors. Given the numerous anecdotes and stories that we heard about the difficulties in insuring that notice reaches all of the many potential filing parties, it seems like a low cost solution to what many participants claim is a major problem.

B. Standardize Trading Documentation and Claims Forms

A second recurrent complaint by our survey participants was that each settlement utilized different claims forms, required different forms of proof that the institution was a class member, and sought different documentation of the amount of investors' claims. Each of these problems could be easily addressed by the creation of a set of standard claims forms that embody a uniform set of requirements for proof of class membership and size of claim. Such standardized forms could also be made available on the centralized information website. Creating the forms would be a relatively trivial matter for the main participants in the process once the federal courts mandated their adoption.

There should be no difficulty in forms being so standardized. Processing claims arising in connection with securities regulation settlements involve the same issues case after case. The dominant and recurring issues are the dates of trading by the claimant and proof to support the underlying trading. Standardizing the information and format to follow to file claims would reduce the custodians' and investors' costs without creating any additional work for settlement administrators. If an unusual settlement arose, for which the existing forms would not be appropriate, the settlement administrator could ask the court for permission to use an individually tailored form, but we think that this would be an unusual situation.

C. Institutions Need to Improve Their Monitoring of Claims Filing

The majority of our survey respondents did very little monitoring of their custodians or advisors to determine if they were forwarding settlement notices and, for those contracting out claims filing services, filing claims. All institutions should seriously reevaluate their systems and, based on our experience, we believe most institutions should consider adopting more aggressive monitoring systems to insure that they are receiving their share of the settlement monies available. A step toward fulfilling this oversight is an annual review by the institution's trustees of the past year's claims experience. This would not only reinforce the trustee's obligations to monitor this activity but surely would set in place internal procedures to complement the heightened scrutiny of this aspect of the institution's activities.

The creation of a centralized information source on securities class action settlements suggested earlier would make this much easier as it would permit an institution to assign a staff member to conduct a periodic search of the website for cases involving the investor's portfolio companies. Alternatively, some institutions may hire an independent third party claims service to perform this monitoring function for them. In any case, of the utmost importance is that institutions develop procedures so assure that records of trading are passed on to successive advisors or custodians, or better yet, to the institution itself. As seen earlier, one of the great problems confronting institutions in presenting their claims is the substantial passage of time that transpires between when the trade giving rise to the claim occurred and when notice of a settlement is imparted. During this interval, which as seen earlier is often measured in years, custodians or advisors are likely to have changed. It is difficult of us to believe that an ex-advisor or ex-custodian has the same commitment to its former client as it has to its current clients. Thus, if the institution assured itself that the relevant trading records are forwarded to it whenever it has terminated either the custodian or advisor, the institution could thereby responsibly monitor settlement notices for possible claims it could submit.

D. The SEC Should Strengthen Institution's 13F Filing Requirements

We believe the core factor explaining the institution's poor claims record is that in most instances notice of a settlement is not *directly* imparted to the institution. Our survey results reflect a heavy dependence on publication of notice by the institutions or on their advisors or custodians to learn of a settlement. As seen earlier, notice is not imparted directly to the institutions because they, like their retail customer counterparts, hold shares in street names. Moreover, institutions are more likely to rely on discretionary trading by their advisors so that is another force for shares being recorded in another's name. As a result, several layers of records must be penetrated if the notice is to reach the ultimate beneficiary of a settlement.

One sweeping response to this problem would be to require each issuer to maintain reliable records of their beneficial owners. This would essentially mandate a NOBO list for all public companies. Such a regulatory response would have the collateral effect of facilitating stockholder communications among themselves, not to mention proxy contests, since such list could be accessed by any stockholder of the company. This development would not be well received by the company's management since under the all-important Delaware corporate law stockholders are not entitled to the NOBO list unless the company currently has that list in its possession.[68] Moreover, institutions are not likely to support less anonymity regarding their holdings and trading.

[68] *See* Shamrock Assoc. v. Texas Am. Energy Corp., 517 A.2d 658 (Del.Ch. 1986). Moreover, the stockholders cannot compel the list to be prepared and obtained. *Compare* RB. Assoc. of N.J., L.P. v. Gillette Co., 1988 WL 27731 (Del.Ch. 1988) (no obligation of management to obtain NOBO list upon request of stockholder) *with* Sadler v. NCR Corp., 928 F.2d 48 (2d Cir. 1991)(interpreting New York statute to require company to compile NOBO list).

A much less intrusive change is simply to tweak the current Form 13F filing methodology so that it is consistent with the objectives Congress sought to achieve in 1968 when section 13(f) reporting requirements were mandated. [Insert brief review of the objectives of 13(f)].

Form 13F filings currently fail to fulfill this congressional mandate. One fundamental concern is the overall level of compliance with section 13(f)'s disclosure requirements. Our review of the Lexis data base reveals no SEC enforcement action for non-compliance with Section 13(f) in the legislation's 36 year history. Either there is remarkable compliance with the provision or a similar level of inattention to this provision by the SEC. The former is necessary if Form 13F is to be the linchpin for improved notice of securities class action settlements. Even if there is a solid record of timely and accurate filings of Form 13F, the SEC needs to improve the ability of third parties to access the information collected through Form 13F.

Currently the SEC licenses the Spectrum Data Bases the right to publish in electronic and paper format information the SEC gains through Form 13F. There are two major problems with the current Spectrum data base. First, the software system used by Spectrum does not allow users to search the data base by the twin parameters of a time period and a specific issuer. For example, in undertaking our own efforts in accessing Form 13F filings, after discussing with Spectrum's technical staff, we had to abandon any effort to assemble the data we needed electronically and instead undertake extremely time consuming hand reviews of printed copies of Spectrum data. This software glitch renders the Form 13F filings impractical as a source claims administrators could use for imparting notice. We therefore suggest that the SEC reevaluate its own capacity to make this information available through its EDGAR database and to incorporate into that electronic data base search protocols for Section 13(f) filings that would better accommodate the likely informational needs of claims administrators and others. Moreover, the SEC should assume responsibility for making available the Form 13F information rather than requiring users of that information to incur substantial subscription fees to access that data base. Even if SEC believes it most appropriate to continue its licensing of this information to a third party vendor, it should at least insist that the licensed vendor modify its electronic operating system so as to permit searches that claims administrators are likely to make using that data base.

A second problem with the information collected on Form 13F is that it does not identify who is the beneficial owner of the reported shares. The obligation imposed by Section 13(f) extends to the entity that invests as well as its advisor. Frequently Form 13F is filed by the institution's advisor who lists the shares held by it for all its clients. Thus, Form 13F does not presently lead a third party user of that data to who beneficially owns the shares being reported on Form 13F. It may well be that the beneficial owner wishes anonymity. Indeed, the SEC rules embrace a process for certain information to be filed confidentially with it.[69] We believe that with only modest effort on the part of the SEC that it should be possible to require the beneficial owner of shares being reported on an advisor's filings to be confidentially identified. The next shoe to drop in this

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procedure is, consistent with the institution's likely concern for confidentiality, for the SEC to develop an electronic system whereby notices can be forwarded through it from the claims administrator to the institution that beneficially owns the holdings reported by its advisor's Form 13F filing. Such a development would assure notice is directly imparted to the beneficial owner so that at least better monitoring of the advisor's discharge of its obligations to present claims.

E. Claims Filing Systems Should Be Improved

At present, there are a wide variety of claims filing systems being employed by institutional investors, some very effective, others quite haphazard. A more standardized and systematic approach needs to be put in place. Government regulators can play an important role in bringing about this change. Almost all institutional investors are subject to some type of regulation by the federal government. The SEC, Department of Labor and Federal Comptroller of the Currency could use their regulatory powers to facilitate better monitoring by establishing clear guidelines concerning claims filing practices and duties for the fiduciaries under their respective regulatory jurisdictions. Alternatively, institutions could copy some of the more successful systems that are in place currently, or draw on their own experience in processing proxy information and casting their votes as a potential model for how they can create a better claims filing system.

VII. The Social Welfare Implications of Our Data and Survey

Our survey and data raise two points that have important policy implications. The first arises out of the manner in which institutions distribute recoveries from securities fraud class action settlements. As discussed earlier, all of the institutions that responded to our survey allocated any settlement funds they received either to the particular portfolio that held the affected securities or placed their recovery into a general fund. To be sure, from a practical standpoint, it is hard to see what else they could do. Nevertheless, regardless of which of these two options are pursued, the end result is the same: the ultimate beneficiaries of the recovered settlement are unlikely to be (except in the case of endowments) the same in identity or proportion as those who actually suffered the loss. This observation bears on our second and larger point, namely whether securities class actions can be seen as compensatory.

The fact that class action recoveries by institutions are not allocated to the individual fund beneficiaries connects with a larger question: whether class actions are capable of serving a compensatory function. For example, if an alleged fraud occurs seven years prior to a settlement, which is not uncommon, many if not all of the institutions receiving payments from the settlement will have experienced significant turnover in their beneficiaries during that time period. Many investors who had money invested in the fund, or who were employed at the company or governmental entity for which the fund invests, may well have withdrawn their money by the time of the settlement. These injured beneficiaries (and in the case of mutual funds, investor-beneficiaries) will not share in the benefit from these payments; instead the payments are a windfall for the other fund beneficiaries.[70] In short, there is a mismatch between those investors that suffered losses and those that benefit from the recovery.

Even larger windfalls arise, and a growing awareness of the non-compensatory feature of securities class action settlements is posed, by our finding that approximately seventy percent of the institutions with provable losses fail to present their claims. Against such a record it is difficult to envision the securities class action as serving a compensatory purpose, except for the diligent minority. When this observation is coupled with evidence that the settlement amount in any class action represents a very small part of the losses suffered by the class members, it is even more difficult to attribute a compensatory mission to the securities class action. Indeed, there is a perverse irony in the institutions' dismal record in presenting their claims. By the institutions letting billions slip through their fingers they essentially enhance the amounts recovered by those investors who present their claims. That is, their slumbering actually enhances the compensatory quality of securities class actions for those that do file claims.

Securities class actions are a zero sum game. In any given case, whether more or less claimants appear does not affect the size of the settlement. And, per our experience, the settlement amount is fixed and well below the provable losses suffered by the class.[71] To be sure, the settlement is reached in the shadow of the law and with some sensitivity to the losses suffered by the class. An awareness that more claimants than customary will appear, perhaps because of wide adoption of the reforms counseled above, could change the settlement negotiations so that larger settlements arise to appease the claimants. This likely would be the case, but we still suspect that settlements are finite, even in the face of unquestioned skullduggery and huge provable losses, by the amount of available insurance or cash from the issuer.

With settlements being so bounded, we can see that the failure of many class members to claim their share of the settlement redounds to a larger payment to the more diligent. That is, our data reports a significant wealth transfer from the slumbering institutions to the diligent claims submitters. Billions have slipped through their fingers only if we thought that they would be compensated at the same percentage of loss recovery as is currently experienced by claimants. But if the institutions were to dramatically improve their claims record, it likely would reduce the percentage recovered by all claimants. By improving their record of presenting claims more institutions would be receiving funds where heretofore they have not, we might ponder what impact this development would have on future settlement amounts.

Would settlement amounts be greater if the institutions more frequently presented their claims? This is a matter we can only speculate. The incentives of the suits' lawyers (both for plaintiffs and defendants) and the presiding court strongly tilt in favor of

[70] One commentator on this paper pointed out that if an institutional investor regularly files claims, there is likely to be a consistent flow of recoveries that will accrue to beneficiaries of the fund. Thus, on average, all beneficiaries will be receiving some level of compensation for their losses. However, there will still be a mismatch between the specific settlements' payments and the specific beneficiaries who were originally harmed. We believe that this still leaves open the question of the compensatory function being played by these cases.

[71] *See* Cox and Thomas, *supra* note _.

settlement. A dramatic shift upwards in the number of claimants in settled suits may well cause some drift upward in settlement amounts. However, the degree of such increase would be moderated by the limited amount of available insurance to fund the settlement as well as critical assessments of the likelihood that claimants may object to the settlement due to the low recovery (an even lower per share recovery if institutions slumber less). The latter consideration is more likely to be heavily discounted due to the friction that objectors face. For example, few settlements are rejected in the face of objectors, objectors bear their own cost to appear, and absent their decision to intervene they lack standing to appeal approval of the settlement so that their threat to the settlement is accordingly less credible. [check this point]

Thus, we are very skeptical that class actions can be seen as purely or substantially compensatory. Frankly, we believe that the losses suffered by the class members are generally so immense that in most cases it would be financially crippling to the corporation if the settlement compensated investors fully or nearly so for their losses. It is well understood that in most securities class actions the defendant corporation whose misleading report caused investors to trade rarely, if ever, benefits at a level commensurate with the loss its misleading report has caused.

For example, consider Issuer A whose managers materially inflate earnings in its annual report for two successive years (as well as their interim financial reports). The managers carried out this scheme to enable them to reap the rewards of their stock options and bonuses, both being dependent on the increasing the value of the company's shares. When the lie is discovered, the stock declines twenty percent and a class action is filed on behalf of 1500 investors who purchased Issuer A shares at prices inflated by the misleading reports. To simplify the example, assume the 1500 investors held their shares through settlement and collectively represent twenty-five percent of Issuer A's outstanding shares. Assume further that the provable losses suffered by the class members are $1 billion (reflecting that the company's market capitalization is $20 billion). It should be apparent that if Issuer A were to pay for the sins of its managers, the class members would indirectly absorb twenty-five percent of such payment. Thus, with the consequent decline in the value of Issuer A due to such payment it would appear that the class members would not be restored to the financial position they had before purchasing Issuer A shares.

Moreover, the settlement reflecting the class' provable losses would be disproportionate to the gain garnered by the executives, unless their options approached the settlement amount which appears difficult to imagine. The real harm falls on the Issuer A stockholders who bear a significant burden for the faults committed by the managers acting in the managers' interests and not in the interests of the corporation. Finally, the settlement ignores the windfall that has been reaped by the former Issuer A stockholders who disposed of their shares to members of the class at price higher value ($1 billion) than they would have received had the Issuer A's financial reports been truthful. In this context, we might ask how compensation could ever be the sole objective of the securities laws?

The complementary consideration to compensation is deterrence. Compensation and deterrence do not work at cross purposes; they instead should be seen as supporting each other. If class actions are not fulfilling a compensatory function, then we need to pay more attention to whether they deter fraud. Issuer response to the deterrent effects of class actions could be detected by their adopting internal procedures to prevent reporting violations. In this regard, we believe that the focus in these cases must shift from trying to force company's resources to compensate class members to instead meting out a sanction to the issuer of sufficient size as to deter others from failure to monitor their reporting mechanisms so as to deter fraudulent reporting. Such a sanction can be as it is now a small percentage of the losses suffered by the class. And of course, a greater emphasis should instead be placed upon pursuing the actual wrongdoers, typically the officers.[72] Traditionally, these individuals have escaped liability in securities fraud class actions, as plaintiffs' attorneys have agreed to settlements without insisting on the officers being held accountable. Deterrence would be more effective if companies knew it was in their best interests not to protect the real culprits.

What would it take to increase the deterrence effect of securities fraud class actions against individual officers? At a minimum, the officers should be liable for the amount of any benefit that they obtained from the fraud times some multiplier of those damages to reflect the likelihood that their fraud would escape detection and the amount of the plaintiffs' attorneys fees for bringing the action.[73] Their employers should be prohibited from providing them insurance or indemnification for these damages. The company should have no liability for the officers' fraud unless there were tangible benefits to it arising from the fraud.

Two other important issues would need to be satisfactorily resolved in such a system: first, how to incentivize the plaintiffs' bar to bring such actions?; and second, how to minimize the number of frivolous suits that are filed. These two issues are intimately intertwined: entrepreneurial attorneys are more likely to bring too many suits, including strike suits, if there are high potential financial payoffs and low barriers to filing, while higher barriers and lower payoffs are likely to cut down on the number of cases, including meritorious ones.

The knowledgeable reader has by now recognized that these same issues have recurrently arisen in the federal securities area.[74] Unfortunately moving toward a deterrent-based litigation regime will not eliminate these tradeoffs. PSLRA's current system of pleading standards, while easily criticized, is less easily improved upon. At present, there is simply no way to calculate accurately the costs and benefits of either raising or lowering barriers to filing fraud cases, nor for that matter increasing or decreasing the returns to attorneys for filing them. We therefore recommend that if a

[72] *See* James D. Cox, The Social Value of Representative Suit Litigation, 65 Brook. L. Rev. 3 (1999).
[73] Employers could impose these penalties in employment contracts by inserting appropriate language into the definition of what constitutes termination for cause and then requiring the officer to reimburse the company for any penalties assessed for securities fraud violations.
[74] See, e.g., Stephen J. Choi, Do the Merits Matter Less After the Private Securities Litigation Reform Act?, Working Paper 2004 (analyzing the impact of PSLRA on the filing of meritorious cases); Lynn A. Stout, Type 1 Error, Type II Error, and the Private Securities Litigation Reform Act, 38 *Arizona Law Review* 711-15 (1996)(discussing the tradeoffs between screening out good suits and letting in bad ones inherent in PSLRA's restrictions on filing securities fraud cases).

deterrent oriented system is put in place that we continue to employ the existing PSLRA for several years in order to see how the new system develops.

Our second concluding point is a response to a short article by Professor Pritchard that commented on our earlier paper. Professor Pritchard asked the question whether we should care that not all institutions file claims; he concluded that we should not.[75] His main point was that even a few billion dollars is small change to institutional investors because they manage trillions of dollars for investors.

We think it does matter that many institutional investors don't file claims. For one thing, under current law, pension fund trustees are held to a standard of maximizing the value of their assets under management for others. If this concept is to have any real content, we cannot start adding qualifiers like the duty of care applies "only if really big money is involved."[76] Fiduciaries do, and should, be required to take all cost-justified measures to increase the value of beneficiary assets.

Moreover, we think it is important that institutional investors are involved in the settlement process and more generally in securities fraud class actions. If the system needs reform, as both we and Professor Pritchard agree, the more institutional investors are active participants, the more pressure will be placed on the system to improve. The claims filing process needs fixing, and the institutions are in the best position to push for needed changes. If the current system and its related practices continue, we will continue to document apathy among institutional claimants and lose some of the impetus for making the provisions of the PSLRA work to the benefit of all investors.

VIII. Conclusion

To summarize our results, we find some significant problems in the current claims filing system. Using a much larger sample of settlements than in our earlier paper, we determine that a large majority of institutional investors failed to file claims in securities fraud class action settlements during the 1990's. While our follow-up surveys indicate that the respondent institutions believe that they are adequately responding to this problem, and we see some positive developments in the marketplace with the formation of several third party independent monitoring services, we think that there is still room for improvements in the process.

We recommend that the courts mandate the creation of a centralized information website about securities fraud class action settlements, plus standardize claims forms and informational requirements for perfecting a claim. We think that institutions can do a better job of monitoring claims filing, especially after the creation of a centralized information source. Finally, we call on the SEC to strengthen its requirements for Form 13F to make this information more transparent and accessible.

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[75] Adam C. Pritchard, Who Cares?, 80 Wash. U.L.Q. 883 (2001).

[76] If this logic did apply, then presumably fiduciaries would no longer need to devote time and resources to making recovering collateral when borrowers default, file claims in bankruptcy, or go after fee payments to fund managers when they are not made unless "big money" was involved. At the same time, it is important to remember that fiduciaries only have a duty to file cost-justified claims.