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Securities class actions in the US banking sector: Between investor protection and bank stability☆

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ABSTRACT

This paper investigates whether securities class actions (SCAs) can play a role in banking supervision, both as a warning signal of insolvency and as an instrument of market discipline to encourage bank managers to carefully evaluate risk. Two groups of US banks are compared over the 2000–2008 period. One includes banks that have faced at least one SCA, while the other is composed of non-targeted banks (control group). Results indicate that collective private litigation procedures are more frequently directed at financially fragile intermediaries exhibiting inadequate governance standards. Furthermore, banks which have been subjected to SCAs are likely to reduce their excessive risk positions. This supports the idea that SCAs could be efficiently employed as a complement to public supervisory activity in the banking sector.

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1. Introduction

Financial markets and the banking sector, in particular, are strongly regulated due to their public relevance. Integrity, transparency and stability[1] of the financial industry rest on two pillars: *ex ante* regulation – such as deposit insurance schemes, capital and disclosure requirements – and *ex post* enforcement provided by government supervision authorities. Since the introduction of Basel II, however, increasing attention has been devoted to a third pillar concerning market discipline,[2] and several arguments are put forward its potential regulatory effects.

The events connected to 2007–2008 crisis have then fueled the debate concerning the proper regulation of both financial markets and the banking industry. Although it is recognized that the recent breakdown has been a complex phenomenon generated by the interaction of several features, some authors assess that most of the losses have been due to negligence and insufficiently cautious management, which harmed both investors and the overall banking stability (Cukierman, in press; Zingales, 2008). Therefore, it is unquestionable that the ensuing complex financial turmoil could have been less costly if it had been managed by a more effective regulatory framework. Moreover, given the evidence that the existing public regulatory framework has not been fully effective in guaranteeing investor protection, the debate on the role of market actors and the regulation of market intermediaries has become a pressing concern.

The literature on banking usually refers to market discipline as a set of monitoring and disciplining devices that do not pertain to the official regulator, but to market investors whose stakes are influenced by the behavior of financial intermediaries (De Ceuster and Masschelein, 2003). In particular, the suitability of a mixed model based on ex ante public regulation and decentralized market supervision has found theoretical and empirical justification in the academic literature on market discipline (Barth et al., 2004; Caprio, 2004; Demirgüç-Kunt and Huizinga, 2004; Hamalainen et al., 2005).

A more general – and slightly unusual – justification to the complementarity of *ex ante* (public) and *ex post* (private) regulation is provided by the law and economics disciplinary field. Particularly, it is claimed that the joint use of these two disciplining mechanisms is desirable when sole safety regulation determines insufficient reg-

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[1] See the definition of Allen and Wood (2006).

[2] As discussed in Section 2.2, our argument on the regulatory effects of Securities Class Actions well fits in the literature on market discipline, which constitutes the third pillar of Basel II agreements.

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ulatory effects (Shavell, 1984), so that private litigation is given a certain weight to complement the public supervision in deterring infringements of investors' rights.

Typically, in the United States, when investors are damaged because of corporate misconduct or suffer from some form of management abuse, they can protect themselves by employing private litigation procedures such as securities class actions (SCAs, hereafter). SCAs mainly concern the financial market regulation, and usually investors proceed by SCA in the field of the SEC jurisdiction. However, when the corporation facing an SCA is a bank, the public interest in both market integrity and transparency is joined by another public interest: banking safety. In fact, bank directors' wrongdoings can simultaneously harm investors and threaten the solvency of individual banks, ending up threatening the stability of the whole sector. According to Bethel et al. (2008), for example, a big wave of SCAs is likely to characterize the next years as a consequence of the 2007–2008 credit crisis. These will be a means to identify where market participants and banks failed to evaluate risk, as well as appraise the integrity of the information chain.

According to this scenario, it seems quite plausible that SCAs in the banking sector can play some complementary role, not only as potential shields to protect investors, but also enhancing banking supervision through the enforcement of market discipline in addition to the public action of supervisors. This perspective, which turns out to be substantially underexplored by the empirical literature, seems particularly relevant in the current debate on banking and financial supervision and regulation.

This paper focuses on the issue of whether SCAs are significant warning signals of bank instability ("Red Flag" hypothesis) or/and they represent a strong incentive for managers to be more cautious in evaluating risks, so as to pursue sounder and more stable policies ("Safety Incentive" hypothesis). Both these hypotheses are empirically tested by comparing two panels of US banks in the period 2000–2008. The first includes banks that have been taken to court, namely those who have faced at least one SCA. The second group consists of control banks, meaning those who have never been involved in an SCA.

Using data from the Stanford University Securities Class Action Clearinghouse and Bankscope, we find that SCAs provide useful signals of financial weakness. Results also suggest that they are likely to correct the excessive risk positions of some intermediaries. Therefore, it seems that SCAs can play a role in the regulation of the banking sector. In this view, public supervisors and policymakers might successfully exploit this factor in order to make regulation and supervision more effective than it currently is.

The paper is organized as follows: Section 2 provides a background on SCA as a form of market discipline and debates their potential role in banking supervision. Section 3 describes the paper's methodology. Data and evidence on SCAs in the banking sector are presented in Section 4. We discuss the results of the empirical analysis in Section 5. Finally, Section 6 reports conclusions.

2. Securities class actions: a role in banking regulation and supervision

2.1. SCAs: pros, cons and the regulatory perspective

In the United States and in some other countries[3] private litigation can play a crucial role as a complement in deterring infringements of investors' rights. According to Rubenstein (2004), Ferrarini and Giudici (2005), and Burch (2008), collective procedures of private litigation in the financial sector could represent a strong mechanism of "private" enforcement of regulation and supervision. Particularly in the US, SCAs are a synonymous of private enforcement: private attorneys working on behalf of investors seeking damage compensation can promote the public interest and law enforcement.

However, as well depicted by Black (2009), the debate about pros and cons of SCAs shows no signs of abating. According to their supporters, SCAs can have a powerful effect, because lawyers can represent groups of small stakeholders and legally proceed on behalf of them in order to obtain damage compensation. Finally, SCAs may also perform a public function in improving deterrence: the threat of legal action imposes aggregate social costs on the defendants and, finally, enhances the internalization of negative externalities.[4]

Even after several radical reforms (such as the Private Securities Litigation Reform Act in 1995 and the Securities Litigation Uniform Standards Act in 1998) aimed at correcting procedural design, detractors criticize the effectiveness of SCAs in both compensating investors and deterring frauds. According to this part of the literature, SCAs does not effectively compensate victims since the net redress often does not counterbalance losses, either due to the huge amount of legal fees or because of unfair settlements.[5] Furthermore, in the case of SCAs, the compensatory objective looses its strength due to the so called "circularity problem". In fact, either the amount settled or damage compensation are finally borne by shareholders/investors themselves, since it is their own corporation which usually pays by using a combination of corporate funds and corporate insurance.[6] Commentators claim that the circularity problem dilutes also the potential deterrence of SCAs because individual wrongdoers rarely pay for their misconduct.[7]

Despite the fact that SCAs are very controversial procedures, a change in perspective provides them with a new rationale. Some authors, indeed, suggest that the main justification for SCAs is their "corporate governance" effect. According to Fisch (2009) and Mitchell (2009), an SCA can be a means of making requirements of corporate disclosure requirements and transparency more effective. Moreover, SCAs may improve the corporate governance of public companies by providing shareholders with a residual form of accountability to monitor corporate decisions. In the same vein, Strahan (1998) and Ferris et al. (2007) find that the incidence of SCAs is higher in firms characterized by a higher likelihood of agency conflicts. In particular, according to the former, SCAs are useful to manage residual agency problems by producing managerial turnover, although the same does not apply in terms of effects on the governance structure. The latter finds also that SCAs are associated with significant improvements in the proportion of outside representation in boards of directors and other changes in terms of board compositions. In general, the literature suggests that SCAs are likely to represent an effective corporate governance

[3] See the web-site Global Class Action Exchange of the Stanford Law School, Stanford University. Despite the fact that SCA characterize the US experience, understanding whether collective private litigation can enhance banking regulation is relevant also for other countries. In Europe, in particular, two separate debates are ongoing: on the one hand, the introduction of collective procedures has long been a hot issue (Laidlaw, 2009; Nagareda, 2008; Poncibò, 2009). On the other hand, the crisis adds issues concerning possible reforms of the banking regulation. A perspective which links together these two topics could offer new horizons to the debate.

[4] See Miller (1998), Silver (2000), and Wright (1969). Legal scholars often speak about the private subject who acts on behalf of the class in order to enforce liability as a "Private Attorney General". See Coffee (1986), Hensler and Pace (2000), Kalven and Rosenfield (1941), and Rubenstein (2004).

[5] See Coffee (1995), Garry (2004), Hay (1997), Macey and Miller (1991), Miller (1979), and the cases analysis in Hensler and Pace (2000).

[6] See Black (2009), Cox (1997).

[7] See the previous footnote.

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