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Securities Portfolio Monitoring And Class Action Recovery For Canadian Institutional Investors

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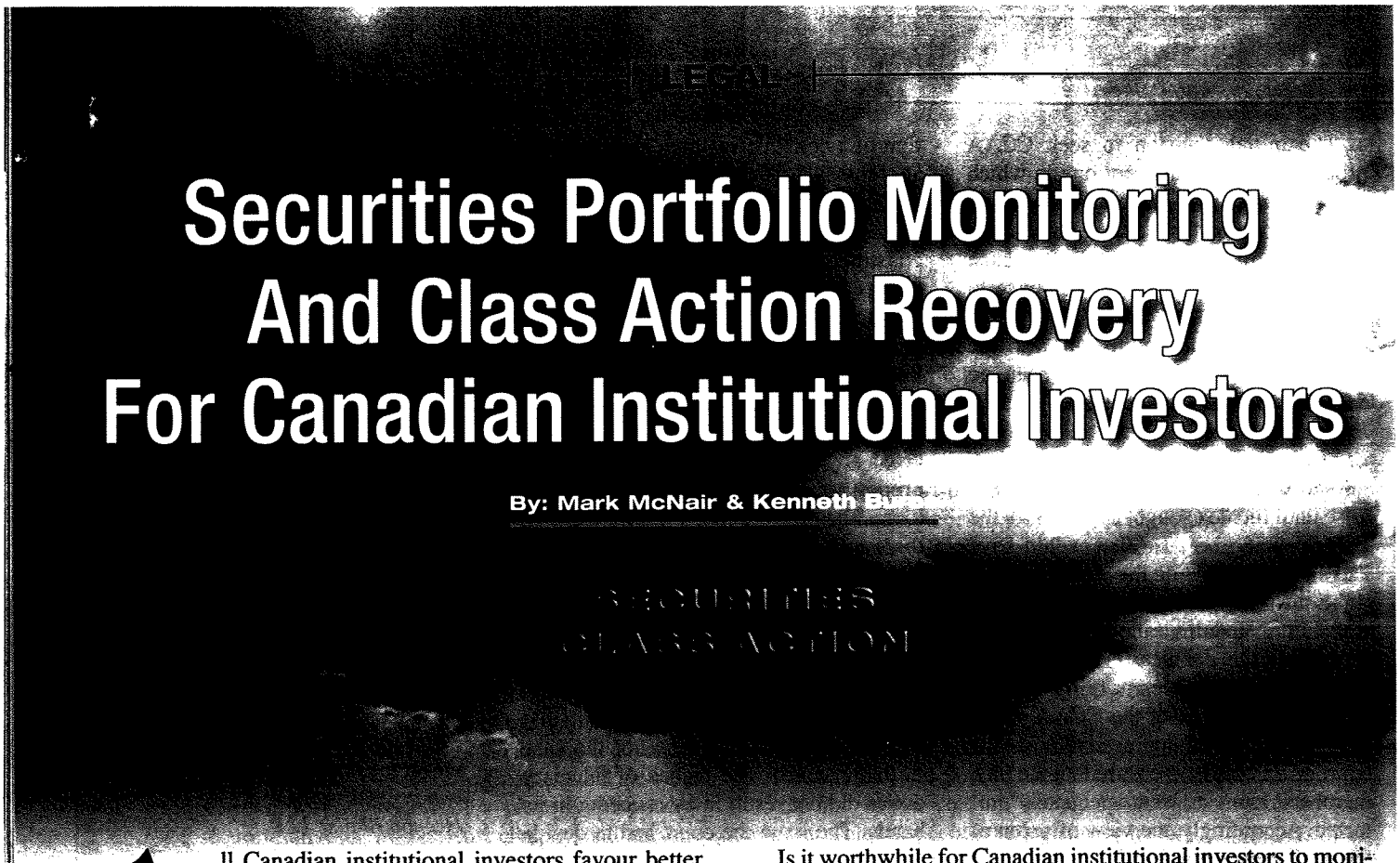


All Canadian institutional investors favour better corporate governance and many work hard to engage corporations and improve governance. Sometimes the benefits of these laudable efforts are hard to measure. But when corporate controls fail, it is easier to quantify how Canadian funds have been negatively affected. The cost to Canadian investors – whether the events giving rise to a loss occurred in the United States, Canada, or elsewhere – can be very significant. Many institutional investors' portfolios have suffered large losses as a direct result, among other things, of false financial reports and the failure of corporate officers to live up to their fiduciary responsibilities.

Primary Tool

The primary tool for investors to redress corporate fraud has been securities class action litigation. In the United States, securities class action litigation has resulted in the recovery of tens of billions of dollars for investors. For example, this September a settlement was announced in a securities class action case against the Bank of America for $2.425 billion. Moreover, besides such U.S. litigation, similar securities litigation is on the rise elsewhere in the world. This increase has been particularly notable in Canada where, among other things, there has been litigation related to alleged fraud by Canadian-listed Chinese companies such as Sino-Forest. As a recent U.S. Supreme Court case, 'Morrison V. National Australia Bank,' held that U.S. securities laws do not apply to purchases on a foreign stock exchange except in limited circumstances, we can expect this trend to continue.

Obviously, all Canadian investors want their share of the billions of dollars that are recovered each year in settlements. No one wants to 'leave money on the table.' But beyond this fiduciary concern, many institutional investors in our electronic age increasingly want to know more about how they are affected by all developments, including efforts to recover losses through securities litigation.

Is it worthwhile for Canadian institutional investors to monitor their investment portfolio? Of course, with respect to returns and asset allocation, their portfolios are closely scrutinized, but should they also monitor their portfolios to track litigation filed against companies whose securities they hold? This article explores securities litigation and portfolio monitoring from the perspective of Canadian pension funds, while recognizing the large differences in Canadian plans as to their assets, investment portfolio, and governance objectives. Several Canadian pension plans of various sizes have played an active role in securities litigation for years and, therefore, must have well-established monitoring systems in place. Their efforts have resulted in significant recoveries for all investors and presumably their involvement in this area will continue.

On the other end of the spectrum, monitoring isn't applicable for those Canadian funds that hold only pooled assets. Most other Canadian pension funds either have not considered portfolio monitoring or believe their time should be focused on other matters.

Securities litigation typically takes many years, but for most institutional investors there are two specific times when it may be prudent to track or monitor what is happening. The first is at the outset when a case is initially filed and the second is at the end when the case settles. A quick review of the securities litigation process should explain why many investors appreciate information regarding newly-filed and newly-settled cases.

Securities Litigation Process

Securities class actions are collective legal actions to recover damages suffered by investors who paid inflated prices for securities due to a company's misrepresentations or omissions. In the U.S. and Canada, investors are generally covered by a class action unless they 'opt out' (although some Canadian provinces require non-residents to 'opt in') and pursue their own action.

Under U.S. and Canadian securities laws, securities class action lawsuits are brought on behalf of those shareholders of a company who purchased during a specified period, the so-called 'class period.' The theory is that investors who purchased stock during this period did so at 'an artificially inflated price' because its market price was based on false and misleading financial data or other representations disseminated by the company during the class period. All investors who purchased stock during the class period may initiate or participate in the class action, except if they sold out their stock before the truth was disclosed (meaning the company finally reveals the true financial data or other information that was false) or if they sold their stock during the period for a profit.

In 1995, the U.S. Congress adopted the Private Securities Litigation Reform Act (PSLRA) with the objective of having those investors with the largest losses control securities litigation. To this end, the PSLRA established a time line for all cases which provides institutional investors an opportunity to decide if they want to participate. Specifically, the required publication of a notice that a case has been filed must be published after a U.S. federal securities case is filed. This starts a 60-day window for all investors. Before this window expires, any investor who wishes to assume the role of lead plaintiff must move for appointment as lead plaintiff. Typically, all such motions are filed on the 60th day. Sometimes, two or more investors will file a lead plaintiff motion together as a group depending on the size of their individual losses. The court then selects the lead plaintiff(s), which are presumptively the plaintiff or group of plaintiffs with the largest financial loss, bearing in mind that measuring the 'largest' financial interests may depend on how one calculates the loss.

As one can readily see, with this time line set, it is almost a necessity for an institutional investor to have its portfolio monitored so that it is in a position to act if, and when, it desires to have a role. The securities litigation process varies among Canadian provinces, but investors contemplating litigation in Canada also need to have data on how they are affected as quickly as possible when cases are filed so that they can consider their options.

The second critical time for most investors is when it is announced that a case has settled. When there is a settlement, a proof of claim must be filed with the settlement administrator on the investor's behalf by the deadline or the investor will forfeit any money it would receive under the settlement. Likewise, if an investor desires to opt out and pursue its own action, it must notify the court in a timely manner.

Portfolio Monitoring

Portfolio monitoring provides investors with data as to how they have been affected by alleged corporate fraud. Monitoring can provide this information in a timely manner and automatically. Assuming electronic access to trading data is available, law firms and others can provide institutional investors with data regarding their transactions in newly-filed and newly-settled cases.

Institutional investors, assuming they don't want to undertake the task themselves, have two options for portfolio monitoring. One option is to hire a third-party claims advisory service and the other option is to engage external securities litigation counsel.

Leading law firms in the securities litigation practice area have monitoring services which they typically provide at no cost to develop good will with the plan. As such services are free, some public pension plans have more than one law firm monitor their portfolio.

Three matters should be stressed regarding portfolio monitoring.

First, a portfolio monitoring program is easy to introduce. Besides a simple agreement where the law firm agrees to provide these services confidentially and at no cost, the only other required step by a pension fund is to send a letter to its custodian authorizing the law firm to access its transactions electronically. Once in place, well-designed monitoring reports should only take a few minutes to review, thus portfolio monitoring shouldn't be a drain on staff time or resources.

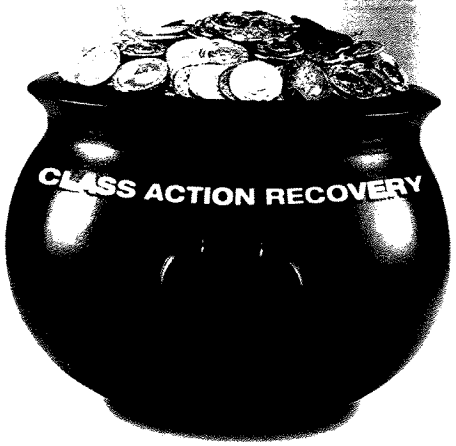
Second, portfolio monitoring provides data promptly and automatically, which at times can be very valuable. As more and more Canadian pension funds are concerned with corporate governance, monitoring provides critical information very quickly as to how the pension fund has been affected after a corporate scandal hits. Not only can this data be disseminated to trustees and others as deemed appropriate, but the fund is in a much better position to consider its options whether it be in the area of governance or litigation.

Likewise, as the amounts recovered from securities class action cases are often very significant, receiving monitoring reports regarding settled cases can be helpful. Custodians presumably are doing a very good job for Canadian pension funds submitting their claim forms in a timely manner. Nevertheless as fiduciaries, many pension fund administrators find it helpful to have such data so that they can intelligently review with their custodian how they are handling their settlements and spot-check as they deem appropriate.

Finally, administrators may wish to see a legal analysis of new cases and guidance regarding available options if the pension fund has significant losses. While many pension funds don't expect to get involved in litigation on a regular basis, if an unusual situation develops it is important to already have counsel on hand. However, the monitoring agreement should clearly provide that the pension fund should not be obligated to get involved in any litigation a law firm might recommend. Similarly, a fund should be reluctant to accept a provision requiring the fund to employ the monitor if the fund desires to pursue litigation.

Considering Litigation

Canadian institutional investors are in a somewhat unique position. Most have very significant investments in the U.S. which has a history of successful securities litigation and they should be



receiving an ongoing stream of funds from settlements in U.S. class action cases. At the same time, these investors have larger investments in Canada where shareholder litigation is historically less common, but is nevertheless growing.

Thus monitoring securities litigation developments is important not only in the U.S., but in Canada as well. Likewise, with respect to their legal options, many Canadian funds may find legal guidance is appropriate, in respect of both their U.S. and Canadian securities holdings. Moreover, because of situations involving dual listed stocks, Canadian investors may or may not have the option of accessing U.S. courts to recover their loss. Thus monitoring programs that provide guidance and recommendations from Canadian counsel, as well as U.S. counsel, may best serve the needs of many Canadian pension plans.

As noted above, occasionally a pension fund will be asked by their monitoring counsel to consider being a lead plaintiff in a legal action. It is also important to note that just because the fund has a large loss on a certain security does not mean that a legal claim will be available, nor that counsel will recommend the pension fund file a lead plaintiff motion. Counsel may not believe the case is particularly strong or may be aware of other funds with significantly larger losses that are likely to step forward.

If the fund selects monitoring counsel that are selective and understand their objectives, then the fund should rightfully expect few matters will be brought to its attention.

Lead Plaintiff

Occasionally whether the matter is in the U.S. or Canada, counsel may suggest that a fund consider joining with another fund to file a lead plaintiff motion. As one would suspect, this is done primarily to increase the chance of the group being selected. However, as with corporate governance, some pension funds prefer to work with other funds. Chemistry is important and prior to submitting any lead plaintiff motion, the funds should have discussions to see if they are in agreement as to how the case will be prosecuted.

The growth of securities litigation in places outside the U.S., including Canada, in particular, makes portfolio monitoring more compelling for Canadian investors. When alleged corporate fraud results in market losses, it is always beneficial for funds to know how they have been affected. Portfolio monitoring should make sense as a tool in a pension fund's fiduciary toolbox. **BPM**

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