The bulwark of private enforcement

Tom Dubbs and Ethan Wohl argue that private litigation is an effective way of ensuring that financial markets function well and can be trusted

The present credit crisis and economic turmoil naturally prompt the question: what can we do to prevent similar market run-ups and collapses in the future?

Modernising market regulation to keep pace with new forms of investments is undoubtedly part of the solution. Recent legal and finance scholarship, however, suggests that robust and effective enforcement is even more important than the regulations 'on the books'.

Regrettably, the current crisis illustrates government agencies' limited ability to aggressively police market abuses at a time when a free-market, anti-regulation philosophy still prevails. This points to the need for a truly independent market regulator. The American system addresses this need with a unique solution – the private investor-led class action.

The history of market regulation teaches that effective law enforcement can control fraud – and other abuse-driven market failures. The 'investment pools' and other market manipulation schemes that aided and abetted the 1929 crash were addressed through Great Depression-era legislation. The U.S *Sarbanes-Oxley* Act of 2002 appears to have reduced the accounting fraud that facilitated overheated 'dot-coms', and new conflict of interest rules have imposed some constraints on the most extreme forms of self-interested stock promotion by sell-side analysts. More transparency and supervision of swaps and other derivatives, as well as better oversight of credit rating agencies, if implemented, will likely have a salutary effect on avoiding a direct repeat of the present crisis.

Still, what can be done to anticipate and even the next round of misconduct? Private litigation could at least be part of the answer.

It is not fashionable at the moment to assert the superiority of the American securities regulation regime, but – at least historically – investors have highly

valued the U.S. system. One recent study found that overseas firms cross-listing on American stock exchanges received a 37 per cent valuation premium compared to peer firms that did not cross-list, and other studies have found that cross-listing firms reduce their cost of capital significantly.

Several researchers have explained these benefits by postulating a 'bonding hypothesis' – that by voluntarily submitting themselves to the enhanced disclosure obligations and minority protections imposed under U.S. law, companies commit to adhering to higher standards that reduce agency costs and the associated discount investors apply to their shares.

Role of legal systems

The study of cross-listing premia is part of an effort among financial economists to understand the role that legal systems play in financial development. Many economists have observed that countries with common law systems (such as the UK and the U.S.) have developed stronger financial systems than countries with civil law systems.

This is because, supposedly, common law systems have superior minority shareholder protections, which lower the cost of capital and increase companies' access to more affordable financing. Economists have not, however, identified particular legal rules that explain the 'superior' performance of the common law.

One noted law professor recently suggested that the key distinction is how laws are enforced, rather than their particular characteristics. The professor has found that common law countries spend far more on securities regulation activities than do civil law countries, with the U.S. far exceeding other common law countries in lawsuits, even when adjusted for relative market size.

Academic research has established that legal systems matter, but that laws are only as good as their enforcers. Recent events, however, teach that government agencies cannot be relied on to counter market momentum during a boom. Rather, at just the time when enforcement is most needed to constrain excesses, watchdogs are muzzled by the same forces that permit the excesses themselves: the claim that a 'paradigm shift' has changed the rules, coupled with primacy of a world view that deems regulation a drag on wealth creation by private actors whose enlightened self-interest renders government oversight unnecessary. The leading regulators during the period just passed have now – belatedly – acknowledged their errors. In a Congressional hearing last October, Alan Greenspan admitted that "those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself especially, are in a state of shocked disbelief". Chris Cox, former chairman of the Securities and Exchange Commission (SEC) Amercian agency, admitted: "we have learned that voluntary regulation does not work".

Error of 'hands off' philosophy

The Bernard Madoff fraud grimly illustrates regulators' inability to maintain vigorous oversight at a time when the prevailing wisdom dictates deference to the market. As chairman Cox publicly admitted, "credible allegations regarding Mr. Madoff's wrongdoing, going back to at least 1999, were repeatedly brought to the attention of SEC staff," and the agency's failure to detect the fraud reflected "apparent multiple failures over at least a decade".

People knowledgeable about the SEC have widely argued that the failures resulted from inappropriate deference to a prominent member of the financial community and a hands-off philosophy, rather than a lack of competence.

Maintaining enforcement intensity in times of prosperity and complacency thus requires an actor who is not subject to the political and social pressures of a government regulator. The United States is alone in having such an actor: the private investor. Unlike any other country, the U.S. allows shareholders, assisted by counsel with the resources and incentives to prosecute claims against well-financed defendants, to bring lawsuits on an aggregate basis, thereby creating significant deterrence and providing redress for injuries too dispersed to be litigated individually. Private class actions are a major component of the U.S. securities regulation regime.

In fact, the US dollar amount of annual sanctions imposed by private enforcement activity far exceeds the penalties imposed by government regulatory bodies.

Private litigation is hardly immune from political pressure – over the past 25 years, legislation has raised the barriers to securities fraud claims and judicial decisions have limited the remedies for other forms of corporate wrongdoing. Even when the governing standards remain unchanged, prevailing views as to the value of investor lawsuits influence the decisions judges reach in the cases that come before them. Nonetheless, while the tribunal and governing rules may tilt one way or the other over time, private investors and their counsel stand apart in vigorously challenging misconduct in times of excess, uninfluenced by political ideology.

While investor lawsuits alone cannot prevent market abuses, effective private litigation creates significant deterrence while also providing compensation for injured investors. It thereby contributes to a sense of fairness and helps to restore the trust that is essential for well-functioning markets to return.

Tom Dubbs is a senior partner and Ethan Wohl is an associate at Labaton Sucharow