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Institutional Investors, Shareholder Activism and Class Actions: The Preservation of Market Integrity

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Recent developments in the capital markets have caused an erosion of investor confidence. The ability of securities regulators to restore investor confidence is limited by regulatory resources. In this context, a private right of action is an indispensable means of enhancing investor protection and restoring investor confidence. Moreover, fund managers are subject to a duty of reasonable care which, in appropriate circumstances, may oblige them to prosecute claims against violators of the securities laws. In the global economy, class actions are frequently the optimal method of procuring a remedy for large groups of parties who have been damaged in similar ways. Because of their size and sophistication, institutional investors are particularly well suited to act as lead plaintiffs and to prosecute class-based claims on behalf of aggrieved investors.

Recent developments in North America have caused a significant erosion in investor confidence. The most spectacular of those developments, particularly the Enron, Worldcom and Tyco International scandals, have occurred in the United States, but their effects have been felt beyond American borders.

Moreover, Canadian and other non-U.S. markets have experienced their own troubling revelations as to the integrity of the financial reporting of major issuers. Nortel Networks Corporation recently announced a second restatement of its financial results, the first having occurred in the last year. Nortel also announced that it had dismissed its chief executive officer, chief financial officer and controller.[1] Meanwhile in Europe, Parmalat, one of the continent's largest and most global companies, revealed that an astounding $8 billion to $12 billion in assets have either disappeared or simply never existed.[2]

In light of these happenings, trustees are sometimes called upon to prosecute claims on behalf of their funds against violators of securities laws. Trustees also need to be aware of the business and affairs of a fund and fulfill the duties of care, prudent investment of fund assets and collection of debts owed to the fund.

In this environment of growing investor cynicism, the Ontario Securities Commission (OSC) took the extraordinary step of publishing, in December 2002, OSC Staff Notice 11-719 (Notice 11-719). OSC described the scope and purpose of Notice 11-719 in the following terms:

> The purpose of this staff notice is to provide details of the Ontario Securities Commission's risk-based approach to securities regulation and to outline the benefits of this approach for market participants. For the first time, we are publishing a complete description of the methods and criteria used by staff throughout the OSC to determine whether to conduct detailed reviews of market participants and their activities.
>
> We believe the publication of this information will promote the following outcomes;
>
> - it will educate market participants about best practices;
> - it will assist market participants in identifying unacceptable market conduct; and
> - it will assist our stakeholders in assessing the OSC's efficiency and effectiveness in allocating resources.
>
> Taken together, we believe these outcomes will contribute to improving investor confidence which, at the time of writing, has been shaken by U.S. financial reporting scandals.

OSC's perception that recent events have caused an erosion of investor confidence was confirmed by a survey commissioned by the Toronto Stock Exchange (TSX) and World Investor Link. In 2002, they released a study on share ownership in Canada: *The 2002*

Canadian Shareowners Study (the study). TSX has commissioned periodic surveys of share ownership in Canada for over 20 years.

The study reveals a decrease in share ownership in Canada for the first time since tracking began over 20 years ago. Among the reasons cited by the study are a greater incidence of questionable accounting practices and restatement of earnings by publicly held companies, the collapse of major firms such as Enron, and high-profile stories of insider trading and irresponsible corporate governance on the part of CEOs and other senior executives.

Institutional Investors and Shareholder Activism

New Statutory Right of Action for Misrepresentations in Secondary Markets

On December 9, 2002, Bill 198: Keeping the Promise for a Strong Economy (KPSEA) (Budget Measures) 2002, received Royal Assent as Statutes of Ontario, 2002 Chapter 22. KPSEA includes numerous amendments to the Ontario Securities Act.[3]

Perhaps the most important of these amendments is a new statutory right of action for misrepresentations contained in secondary market disclosures. This right of action is set forth in Part XXIII.1 Civil Liability for Secondary Market Disclosures. The Securities Act currently provides a right of action only to purchasers in the primary market.[4] In the United States, a statutory right of action for purchasers in the secondary markets has existed for many years,[5] but in Canada, secondary market purchasers have been obliged hitherto to base their claims upon common law theories of liability. This means that secondary market purchasers must persuade the court that the defendants owed to them a duty of care and that such purchasers actually relied upon the defendants' misrepresentations. Part XXIII.1 would remove these requirements and facilitate access to justice for secondary market purchasers.

As of the date of this writing, however, Part XXIII.1 has not been called into force. The Ontario government's failure to do so has elicited some reaction from leading institutional investors in Canada.

By letter dated April 10, 2003, the Ontario Teachers' Pension Plan urged the Ontario government to act upon Part XXIII.1. In such letter, the Teachers' Pension Plan stated:

> We are particularly interested in seeing the proclamation of [Part XXIII.1] because [it] would be the only legitimate legislation dealing with corporate governance in Ontario or Canada for that matter. The civil liability scheme contained in section 185 is a statutory framework for which we at Teachers have long hoped would be enacted.
>
> The civil liability scheme for investors is important to us because it allows a broad group of investors to re-enforce the aspects of securities legislation that the regulator may not wish to address for various reasons . . .

By letter dated December 2, 2003 the Canadian Coalition for Good Governance (CCGG) seconded the admonitions of the Ontario Teachers' Pension Plan. CCGG is a group comprised of 28 large pension funds and money managers in Canada with total net assets under management of approximately Can $500 billion.

These letters not only demonstrate Canada's institutional investors are concerned with the integrity of our capital markets, but they also suggest that institutional investors are increasingly inclined to use, in appropriate cases, their statutory rights of action to preserve market integrity. For this they are to be commended.

As suggested in the letter of the Ontario Teachers' Pension Plan, the ability of securities regulators to enforce our securities laws is limited. Moreover, in appropriate cases, the management of a pension or mutual fund may have a duty to the fund's stakeholders to prosecute claims against violators of the securities laws.

Effectiveness of OSC as Enforcer of the Securities Act: The Problem of Limited Regulatory Resources

Whatever the effect of Notice 11-719 may have been on investor confidence, the policies disclosed in the notice demonstrate forcefully that a civil right of action is indispensable to the preservation of market integrity.

Under Section 5 of Notice 11-719 (Enforcement Case Selection and Criteria), OSC states:

> The OSC's Enforcement branch is responsible for the equitable and effective enforcement of Ontario's securities laws. In practice, this means investigating potential breaches on a case-by-case basis, and *initiating proceedings in only the most serious cases*.
>
> Enforcement staff receive referrals of potential offences from a number of sources, including public complaints, media reports, and their own market surveillance activities. *The volume of referrals prevents us from devoting investigative resources to every one of them. We must therefore pursue those potential breaches that appear to have caused (or may continue to cause) the greatest harm to the integrity of Ontario's capital markets, taking into account both the likelihood of a successful resolution and the resources likely to be required to achieve such an outcome.* (Emphasis added.)

Section 5 of Notice 11-719 then sets forth a list of factors OSC staff consider in determining whether investigation and enforcement are warranted. These include:

1. The number of investors affected and the value of their losses
2. Whether regulators from other provinces or countries have requested OSC's assistance
3, Whether the activity is pervasive
4. Whether a disposition would be likely to have precedential value for future cases
5. Whether the behavior appears to have been conspiratorial, covert or planned
6. Whether the activity has received sufficient public profile or media attention to affect public confidence in the integrity of our capital markets.

Section 5 also sets forth a list of factors militating against OSC action. These include:

1. That the continued pursuit of the

case would require an extraordinary commitment of resources, disproportionate to the conduct in question
2. That the activity appears to have been inadvertent
3. That appropriate alternative remedies are available.

The unavoidable inference of a policy of selective enforcement is that numerous breaches of Ontario's securities laws are not investigated or prosecuted by OSC. Although it is impossible to know with certainty the number of breaches that go unpunished, we may infer that only a minority of Securities Act breaches are the subject of an OSC enforcement proceeding, because OSC states repeatedly in Notice 11-719 that it allocates its limited resources only to the most serious breaches of Ontario's securities laws.

The deterrent effects of selective enforcement can be enhanced by combining the enforcement selection criteria with a practice of random investigation. Certain branches of OSC in fact have adopted a practice of random investigation, but not the enforcement branch.[6]

It by no means follows that OSC has been remiss in the fulfillment of its mandate. All regulatory bodies must act within the financial constraints imposed upon them by legislatures and the pertinent legislative scheme. Indeed, OSC is to be commended for having adopted an enforcement scheme that endeavors to extract maximum value from every regulatory dollar, and for having disclosed its enforcement policies to the maximum extent practicable.

However, the efficient allocation of regulatory resources does not necessarily result in optimal deterrence of wrongful behavior. Optimal deterrence requires not only that regulatory resources be allocated efficiently; it also requires that those resources be adequate.

The civil right of action is therefore an indispensable supplement to the enforcement powers of OSC. But the availability of that right of action will deter market abuses only to the extent that private parties invoke it for the protection of their shareholder rights.

The Duty of a Fund Manager to Prosecute Claims

Quite apart from the deterrent effects of the private right of action, fund managers in certain circumstances may be subject to a duty to prosecute claims, on behalf of the fund, against violators of securities laws.

The duties to which managers of mutual and pension funds are subject derive from several sources. Generally speaking, the legal form of a mutual or pension fund is that of a trust. The fund manager/administrator, or "trustee," is subject to a fiduciary duty of reasonableness. This duty, initially articulated by the courts of equity, was expressed as being more than an obligation of honesty and good faith dealing—It also entailed a degree of care.[7] The standard of care to which a trustee is subject is an objective one and, in the words of Dickson J. in *Fales v. Can. Permanent Trust Co.,*[8] the trustee must show "vigilance, prudence and sagacity." Although a trustee is not required to be omniscient, he or she is obliged honestly to exercise his or her best judgment and to take the same care of the trust property as if it had been his or her own.[9]

The rule fashioned by the courts of equity has been codified into law. Section 27(1) of the Trustee Act of Ontario states that "In investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments."[10] Similarly, Section 22(1) of the Pension Benefits Act of Ontario, which governs Ontario's pension funds, states that "[t]he administrator of a pension plan shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person."[11]

It is important to note that the standard of care that a trustee is required generally to observe is subject to modification. The instrument creating the trust, or declaration of trust, may authorize the trustee to rely upon experts in the execution of certain of his or her functions. In addition, the declaration of trust might absolve the trustee of liability for any act taken in good faith. The terms of the trust might also specifically limit the trustee's capacity to take certain actions, such as the prosecution of legal claims. In any given case, the scope of the trustee's duties can be determined only through careful examination and consideration of the terms of the specific trust. The observations that follow are therefore of a general nature and their application to a specific set of facts may depend in large part upon provisions of the relevant trust instrument.

First, the duty of care to which trustees are subject is not simply a negative duty; it is a positive one.[12] A trustee does not fulfill his or her duty of care merely by refraining from certain types of conduct, but must take, in appropriate circumstances, affirmative action to protect the interests of the trust beneficiaries.

In the shareholding context, this means, among other things, that the trustee must take steps to remain apprised of the business and affairs of the issuer to the extent necessary to enable the trustee to protect the trust's investment.[13]

More importantly, courts have recognized that the trustee's positive duty may sometimes include the prosecution of legal claims. It has been held, for example, that it is the duty of the trustee to collect debts owing to the estate and that, if nonjudicial enforcement efforts are unsuccessful, the trustee is obliged to initiate legal proceedings to ensure enforcement of the debt.[14]

In addition, where the trust instrument explicitly or implicitly grants authority to invest the trust assets, trustees generally have a duty to invest the trust's funds prudently.[15] From an economic perspective, litigation is fundamentally the same as any form of conventional investment. A legal action is accompanied by an expected return. That expected return is a function of (1) the range of possible litigation outcomes and (2) the probability of each of those outcomes occurring. Arguably, a fund manager who neglects to prosecute a meritorious claim that is economically attractive is no less remiss in the performance of his or her functions than a fund manager who commits the fund's assets to imprudent investments.

Why Should Institutional Investors Be Activist Shareholders?

There are essentially three reasons why pension and mutual fund managers should seek proactively to protect shareholder rights:

1. Recent events have caused the investing public to question the extent to which our capital markets are truly transparent, and specifically to question the integrity of business elites. Activist institutional investors will help to restore investor confidence in market transparency and in those who occupy positions of influence in the business community.
2. The limited resources of securities regulators are inadequate to achieve optimal deterrence of market abuses. The private right of action has the potential to act as an essential supplement to the deterrent effects of regulatory oversight and enforcement, but only if private parties actually employ that private right of action to obtain compensation for market abuses.
3. Managers of pension and mutual funds owe a duty of reasonableness to their stakeholders and, in appropriate cases, that duty may extend to the prosecution of claims against violators of the securities laws.

The importance of these considerations is enhanced by the central role that funds now play in the allocation of capital in the global economy. For example, the study reveals that, in 2002, 69% of the portfolio of the average Canadian shareowner was invested in mutual funds (down from 70% in 2000). Generally, mutual and pension fund stakeholders do not have a right of action against issuers whose stock they hold through the fund. That right of action resides exclusively in the fund itself. If we are to ensure that the massive, collective assets of fund stakeholders are adequately protected, it is the fund's management that will be required to take action against issuers and their insiders who violate the securities laws.

Individual Claims or Class Proceedings: The Optimal Method for Obtaining Relief

Class Proceedings Generally

In our complex modern economy, where the delivery of goods and services can be affected on a broad scale, the decisions of corporate and governmental actors sometimes prejudice large numbers of individuals in similar ways. Frequently, the damage sustained by each member of the group is inadequate to render economical the prosecution of individual claims. This means not only denial of relief to victims who are obliged to act individually, but also a failure to deter wrongful behavior. In addition, because the number of individuals damaged in such situations is large, the prosecution of their claims on an individual basis would result in a massive expenditure of limited judicial resources.

Class proceedings can resolve these dilemmas. By spreading the cost of litigation across a large number of plaintiffs, we render the prosecution of such claims economical. This enhances access to justice and deterrence of wrongful behaviour. Further, by resolving factual or legal questions that are common to the plaintiffs in a single proceeding, we conserve precious judicial resources.[16]

These considerations have prompted several Canadian jurisdictions to adopt comprehensive class proceedings legislation. As of the date of this article, those jurisdictions are Quebec (1978), Ontario (1993), British Columbia (1995), Manitoba, Newfoundland, Saskatchewan and the Federal Court (each 2002). In addition, in *Western Canadian Shopping Centres Inc. v. Dutton,*[17] the Supreme Court of Canada effectively read the provisions of comprehensive class action legislation into the traditional civil procedure rule relating to representative proceedings, thus enabling courts in the remaining jurisdictions to adjudicate class-based claims and to achieve the purposes of that legislation.

Although the specific provisions of class proceedings legislation vary from one jurisdiction to another, a representative plaintiff generally must demonstrate that the proposed class proceeding satisfies five criteria:

1. The pleadings must disclose a cause of action.
2. There must be an identifiable class.
3. The proposed representative must be appropriate.
4. There must be common issues.
5. The class proceeding must be the preferable procedure.

If the proposed class proceedings satisfy these requirements, the court "certifies" the proceeding as a class proceeding. The certification order will state, among other things, the issues of law and/or fact that are common to the claims of all class members and the definition of the class. Issues of law or fact that are not certified as common issues must be resolved on an individual basis.

The Duties of the Representative Plaintiff

As is the case with any proposed representative plaintiff, an institutional investor that proposes to act as a representative of all members of the plaintiff class must be appropriate. In the common law provinces, this means that the proposed representative:

1. Will fairly and adequately represent the interests of the class
2. Has produced a plan for the proceeding that sets out a workable method of advancing the proceeding and notifying class members of the action
3. Does not have, with respect to the common issues, an interest that is in conflict with the interests of the other class members.

Quebec's legislation requires simply that the proposed representative be in a position to represent the class adequately.[18] In addition, Quebec's legislation permits corporations, partnerships and associations to act as representatives only if (1) the entity had less than 50 employees at all times during the 12 months preceding the certification motion, and (2) a designated member of the entity falls within the class definition and the interests of that member are connected to the objects of the entity.[19] Thus, an institutional investor may be precluded from acting as a representative in a Quebec class proceeding. In the common law provinces, the circumstances under which legal entities may

act as representative plaintiffs are not restricted.

Fairly and Adequately Represent the Interest of the Class

In general, the representative must simply have a common interest with other members of the class, and must intend to prosecute the claims vigorously.[20]

The proposed representative is not required to have a perfect understanding of the facts alleged,[21] nor of the civil litigation process or the legal issues.[22] The representative plaintiff is not required to be "typical" in order adequately to represent the class.[23] In short, the law does not require the representative plaintiff to be the best possible representative.

In any event, institutional investors tend to be considerably more sophisticated than individual investors with respect to (1) the business and affairs of the defendant-issuer and (2) the legal issues raised by the alleged wrongdoing of the issuer. That sophistication generally will militate in favour of the appointment of the institutional investor as class representative.

Workable Plan

Although the plan must be comprehensive and must provide adequate detail to accommodate the complexity of the litigation,[24] the plan need not specify every step that must be taken from the commencement of the litigation to its termination.[25] The plan should set forth the procedural steps required to resolve the litigation, a schedule and a discussion of the proposed case management program.

Because the formulation of a satisfactory litigation plan requires class proceedings expertise, institutional investors, like any potential representative plaintiff, should seek representation from counsel experienced in the prosecution of class-based claims.

No Conflict of Interest

A representative plaintiff whose interest in a common issue conflicts with that of other members of the class is not an appropriate representative. In *Berdah v. Nolisair International Inc.*,[26] the proposed representative in an action against an airline was rejected because she was the only traveler in the class who had not obtained a full refund for her ticket. In *Samos Investments Inc. v. Pattison*,[27] an investor case, the court declined to certify based in part upon concerns as to conflicts within the proposed class: Some members would have had an incentive to downplay certain conduct before a certain date, while others would have been obliged to demonstrate malfeasance during the relevant period.

It does not follow, however, that any difference between the situation of the proposed representative and that of other members of the proposed class will result in a determination that the proposed representative suffers from a conflict. The conflict must relate to a common issue. In *Anderson v. Wilson*,[28] the court held that plaintiffs who had not been infected with Hepatitis B through an EEG procedure, but who had received notice of a possible infection, were properly a subclass, but concluded that the proposed representative, who had been infected, could represent the subclass. The court found that most of the facts relating to the issues to be tried were common to all and that the proposed representative suffered from no conflict.

The Advantages of Acting as a Lead Plaintiff

The principal alternative to acting as a representative plaintiff in a class proceeding is individual litigation.

Many of the obligations of individual litigants, on the one hand, and representative plaintiffs, on the other, are overlapping. Both individual litigants and representatives must advance claims that are nonfrivolous; must generally disclose all relevant evidence in their possession or control; and must otherwise commit the time and energies necessary to act as a party to litigation.

A representative, however, is also obliged to act in the interests of the class as a whole. From the representative's perspective, perhaps the most important implication of this duty arises in the context of settlement. In weighing whether to accept or to propose terms of settlement, the representative must have due regard to the interests of the other members of the class. Class action settlements are subject to court approval, and a settlement that fails to address adequately the interests of other class members is liable to be rejected by the court.

Consequently, a prospective representative may be reluctant to proceed on a class basis because it wishes to retain complete discretion as to the terms, if any, of settlement. The cost of preserving that discretion could be considerable, however. That is because class proceedings offer three substantial advantages to the prospective representative.

Influence

In cases of securities fraud, even if an institutional investor declines to act as a representative, a class proceeding might very well materialize at the behest of an individual or another institutional investor. By declining to act as a representative, the institutional investor diminishes its opportunity to influence the conduct of the class proceeding. If the institutional investor also opts out of the class, it will have no opportunity to influence the conduct of the litigation.

This loss of influence could have negative repercussions not only for the institutional investor, but for all members of the class. In general, it is in the interests of the class that it be represented by as sophisticated a plaintiff as possible. In the field of investment, the most sophisticated potential plaintiff will generally be the institutional investor. A sophisticated plaintiff is, by definition, better able to assess the risks and costs of proceeding to trial and the attractiveness of proposed terms of settlement.

Litigation Costs

Class actions are generally conducted on a contingency basis, and class counsel often assume responsibility for funding the litigation. Therefore, an institutional investor that elects to seek relief by means of a class proceeding, limits or eliminates its downside exposure in the event that the action is unsuccessful. In cases where the defendant is a well-financed issuer whose stock is publicly traded, that downside exposure will likely be considerable.

Not only is the unsuccessful, individual litigant obliged to pay the costs of prosecution, but it is obliged to pay the defence costs as well. Since public companies tend to engage the most capable defence counsel, the costs of the adversary's defence can amount to hundreds of thousands, or even millions, of dollars. From the perspective of the aggrieved institutional investor, pursuing the issuer by way of a class proceeding often constitutes the most effective risk-management strategy.

Leverage and Certainty

An institutional investor who acts on behalf of a broad range of investors will generally enjoy far greater leverage than the individual litigant. In a class proceeding, the cost to the issuer of an adverse determination is vastly in excess of the cost associated with an individual claim. The result is that the issuer's incentive to negotiate and settle is enhanced considerably.

Critics of class actions sometimes characterize the enhanced leverage of the representative plaintiff as a form of blackmail. However, because issuers generally have far greater resources and sophistication than individual litigants, there is a serious imbalance of power in the litigation process. The function of the class proceeding is precisely to redress that balance. In general, class proceedings are no more coercive than collective bargaining.

In the context of settlement, class proceedings are not only a stick; they are also a carrot. By settling claims with an entire class of claimants, the defendant reduces and sometimes eliminates the costs, uncertainty and risks arising from a multiplicity of potential individual claims.

Endnotes

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