SCA Loss Mitigation is Critical for D&O Profitability

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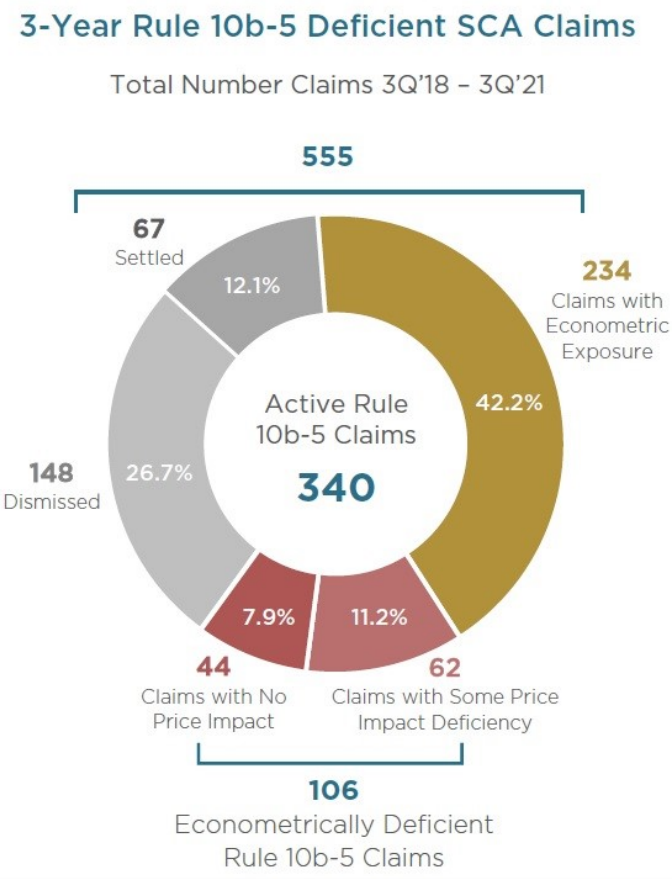
Long-term profitability in the public company directors and officers ("D&O") industry will depend on effective securities class action ("SCA") loss mitigation due to three forces that are shaping the contours of the market. First, D&O profitability driven by a shifting positive rate environment may likely level out in the short term. Second, ample capacity during record-setting U.S. equity markets and a three-year low in stock-drop SCA frequency presents favorable working conditions to mitigate unfavorable loss reserve developments from SCAs filed between 2018 and 2021. Third, potential Exchange Act and Securities Act litigation exposure stemming from environmental, social, and governance ("ESG") risks is still too nascent to quantify in the aggregate until investors and regulators flush out the necessary disclosure and compliance requirements in accordance with the salient regulatory frameworks. In conclusion, targeted SCA loss mitigation is critical for carriers to limit long-term D&O profitability erosion from long-tail claims filed during the last three years.



Loss Mitigation Impact of Deficient Rule 10b-5 SCAs

According to our data and analysis, over the last 3 years a total of 555 Rule 10b-5 Exchange Act claims have been filed. Notably, 44 of these total claims (~8%) do not warrant class certification according to the Supreme Court's decision in Goldman Sachs (2021) because the stock-drops do not have price impact according to Halliburton II (2014).[1][2][3]

Using the statistical methodology accepted by the Supreme Court, claim-specific event study analyses on these 44 claims indicate investors are not entitled to classwide damages because the alleged stock drops are not significant.[4][5] Any settlement monies paid to settle this cohort of deficient Rule 10b-5 SCAs will go directly to cover legal defense costs without any benefit to a purported class of allegedly damaged shareholders.

Claim-specific settlement analysis indicates that the 3-year median and average settlement in Rule 10b-5 SCAs filed since 3Q of 2018, amount to $5.9 million and $15.8 million, respectively.[6] Based on these settlement estimates, the 3-year Rule 10b-5 SCA loss mitigation impact ranges between ~$260 to ~$700 million on the 44 (~8%) deficient (and active) Rule 10b-5 SCAs.[7]

Notably, these estimates exclude defense and cost containment expenses, so the net loss mitigation impact on D&O profitability is even more significant. These estimates also exclude the loss mitigation impact from the partially deficient cohort of 62 Rule 10b-5 SCAs (~11%) of the same vintages. Claim-specific loss mitigation analysis on 106 (~19%) deficient Rule 10b-5 SCAs that are currently active on Federal Court dockets is critical to achieve ~50% loss ratios and sustain profitability during a shifting rate environment.

In sum, the average loss mitigation impact for the 44 deficient Rule 10b-5 Exchange Act claims of vintages between 3Q 2018 and 3Q 2021 amounts to $477 million.[8] Over the ensuing 3-year period, this translates to ~$160 million in annual D&O profit retention.

The Rate Environment Will Not Sustain Long-term D&O Profitability

According to Ken Brandt, CEO of TransRe, significant rate improvements seen in the casualty sector over the last couple of years "aren't driven by lack of insurance capacity," he told The Insurer.[9] "It's being driven by poor results, it's being driven by troubling social inflation, it's being driven by a loss emergence and that's all within an environment of pretty anemic investment yields."[10]

According to S&P Global Market Intelligence, between 2017 and 2021, D&O direct premiums written have almost doubled totaling approximately $6.1 billion between 1Q and 2Q of 2021.[11] As the top-line levels out from a tapering transitionary market in today's flat yield environment, SCA loss mitigation stands out as the most effective lever to limit measurable erosion of D&O profitability before litigation frequency picks up.

Record-Setting Equity Markets and Low Litigation Rates

During 3Q of 2021 and 4Q's kick-off, liquidity permeates the capital markets leading public corporations trading in the U.S. markets to reach $50 trillion in aggregate market capitalization.[12] This is about $20 trillion more than one year ago (~67% increase in market cap during a global pandemic…) and the Federal Reserve is reluctant to restrict the money supply by keeping the federal funds rate at 0.25% while inflation is running high.[13] Both the S&P 500 and the Dow Jones Industrial Average tapped record highs in October, which explains the 3-year low in the litigation rate of stock-drop SCAs against U.S. issuers. [14][15]

Table 1: U.S. SCA Rule 10b-5 Exposure of U.S. Issuers

Quarter	U.S. Rule 10b-5 Exchange Act Filings [1]	U.S. SCA Rule 10b-5 Exposure (000s) [2]	Aggregate Market Cap. of U.S. Issuers (000s) [3]	U.S. SCA Rule 10b-5 Exposure Rate [4]	U.S. SCA Rule 10b-5 Litigation Rate [5]
4Q'20	34	$97,758,984	$39,492,171,257	0.25%	0.97%
1Q'21	34	$33,570,039	$43,675,658,369	0.08%	0.94%
2Q'21	31	$30,485,243	$47,322,716,862	0.06%	0.81%
3Q'21	22	$38,669,792	$49,534,308,488	0.08%	0.55%

[1] Identified first-filed SCA complaints that allege violations of Rule 10b-5. Excludes non-U.S. issuers that trade on U.S. exchanges through ADRs.
[2] U.S. SCA Rule 10b-5 Exposure is equal to the claimed market cap. losses that may surpass back-end price impact statistical thresholds.
[3] The average aggregate market cap. of U.S. issuers for the corresponding quarter.
[4] The ratio of *U.S. SCA Rule 10b-5 Exposure* to the aggregate market cap of U.S. issuers ([4] = [2] / [3]).
[5] = Number of defendant U.S. issuers divided by the aggregate number of U.S. issuers.

Frothy public company valuations and strong earnings fuel the U.S. equity markets and restrict short-term opportunities for securities class action plaintiff attorneys to file fraud-on-the-market claims. When ESG matures, it may have an effect on litigation frequency; limiting severity will depend on the execution of data-driven countermeasures provided by *Goldman Sachs*.

Investors and Regulators Are Still Flushing Out ESG Implications

The pool of investors is getting broader as new avenues for companies to access the public capital markets are paved and consumer-friendly tech platforms enable easy and instant on-line stock trading for retail players. This new cohort of market participants in the U.S. equities market may not be considered equally as sophisticated as institutional investors with fiduciary duties to their clients.[16]

According to the Securities and Exchange Commission ("SEC") Staff Report on Equity and Options Market Structure Conditions in Early 2021, "[c]onsideration should be given to whether game-like features and celebratory animations that are likely intended to create positive feedback from trading lead investors to trade more than they would otherwise."[17]

The new regime at the SEC now oversees a new breed of retail investor that trades via new digital platforms, a revived IPO market (over 302 new IPO filings through SPACs) and is tasked with designing the regulatory framework for a post-pandemic era shaped by ESG.[18]

According to attorneys at Kaufman Dolowich & Voluck, LLP, "[w]ith the SEC's focus on ESG disclosure and issues of materiality, alleged ESG-related material misstatements and omissions could lead to SEC enforcement proceedings and civil securities under Section 10(b) of the Securities Exchange Act of 1934. And to the extent companies might incorporate ESG disclosures into public offering documents, any alleged ESG-related misstatements in that context could lead to issuer securities actions under Section 11 of the Securities Act of 1933."[19]

SCA losses stemming from ESG-related litigation may harm D&O profitability because they will likely be incurred years past the current favorable rate environment. SCA loss mitigation will limit unfavorable development overhangs of more current SCA vintages on future and potential ESG-related claims. Undoubtedly, non-compliance with ESG risk disclosures will lead to costly litigation, but the timing and related magnitude cannot yet be determined or quantified until investors and regulators flush out market-wide implications.

Conclusion: SCA Loss Mitigation is Critical to Sustain D&O Profitability

Public company D&O underwriters are operating with ample capacity and are pricing to close the gap on years of mispricing from new and unforeseen risk exposures that led to the current transitionary market. Brokers are restructuring D&O programs with lower limits and passing on rate hikes while attempting to maintain insureds at ease. Claim handlers continue to wrestle with enduring long-tail Exchange Act claims, federal and state Securities Act claims, and shareholder derivative suits without respite.

Social inflation and litigator-friendly mediators contribute to D&O profitability erosion that can only be mitigated through targeted SCA loss mitigation. Interrelated market and regulatory conditions, such as record U.S. equity markets, low Exchange Act litigation frequency, investor and regulatory lag on ESG implementation, present the opportune time to *move the needle* toward lower loss ratios. The professional syndication of SCA risk is the bedrock of D&O insurance and mitigating long-tail losses is critical to sustain profitability.

[1] SAR SCA Claims Database, as of October 29, 2021.

[2] Opinion of the Supreme Court, *Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System*, No. 20-222 (2021). An alleged misrepresentation or omission in a Rule 10b-5 claim has no price impact when an event study analysis demonstrates that the related residual stock price decline did not exhibit a statistically significant return in response to alleged fraud-related information that rectified the claimed wrong-doing.

[3] Opinion of the Supreme Court, *Halliburton v. Erica P. John Fund*, No. 13-317 (2014).

[4] Opinion of the Supreme Court, *Dura Pharmaceuticals, Inc. v. Broudo*, No. 03-932 (2005).

[5] The Department of Justice and the Securities and Exchange Commission stated to the Supreme Court in *Goldman Sachs*, that "[t]o assess whether a particular event or news report caused a change in a stock's price, event studies isolate company-specific (as opposed to market or industry-wide) price movements in the stock and evaluate whether such movements were statistically significant around the time of the event or report. When event studies reveal no statistically significant movement in a company's stock price at either the time that an alleged misstatement was made or the time when it was corrected, it is relatively straightforward to conclude that the alleged misstatement had no price impact." *See*, Brief for the United States as Amicus Curiae Supporting Neither Party, in *Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System*, No. 20-222 (2021).

[6] SAR SCA Claims Database, as of October 29, 2021.

[7] The low end of the loss mitigation impact estimate amounts to $259.6 million which is the product of the median settlement dollar amount ($5.9 million) and the number of Rule 10b-5 claims that exhibit a complete absence of back-end price impact (44). The high end of the loss mitigation impact amounts to $695.2 million which is the product of the average settlement dollar amount ($15.8 million) and the same number of deficient SCAs (44). These estimates exclude the costs of legal defense.

[8] Average loss mitigation impact of $477 million equals $259.6 plus $695.2 million divided by two.

[9] "TransRe's Brandt: Casualty ceding commission "not very sustainable," The Insurer, September 2, 2021.

https://www.theinsurer.com/reinsurance-month/transres-brandt-casualty-ceding-commissions-not-very-sustainable/17969.article

[10] *Id.*

[11] "Lawsuits push directors and officers premiums higher as ESG, pandemic risks rise," Hailey Ross and Jason Woleben, S&P Market Intelligence, October 13, 2021.

[12] SAR Securities Class Action (SCA) Rule 10b-5 Exposure Report – 3Q 2021.

https://bit.ly/SAR_3Q_2021_Exposure_Report

[13] "Time for Fed to taper bond purchases but not to raise rates, Powell says," Lindsay Dunsmuir and Ann Saphir, Reuters, October 22, 2021.

https://www.reuters.com/business/feds-powell-says-its-time-taper-bond-purchases-not-raise-rates-2021-10-22/

[14] SAR Securities Class Action (SCA) Rule 10b-5 Exposure Report – 3Q 2021.

https://bit.ly/SAR_3Q_2021_Exposure_Report

[15] "S&P 500, Dow Notch Record Highs Ahead of Tech Earnings," Jacob Sonenshine and Jack Denton, Barron's, October 25, 2021.

https://www.barrons.com/articles/stock-market-today-51635153925

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[16] *See*, Order Denying Motion for Class Certification, *Crago v. Charles Schwab & Co. Inc. et al.*, Case No. 16-cv-03938 where the Court of N.D. Cal. denied class certification because plaintiffs could not prove commonality to successfully invoke the presumption of reliance.

[17] "Staff Report on Equity and Options Market Structure Conditions in Early 2021," Securities and Exchange Commission, October 14, 2021.

https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf

[18] SPACinsider https://spacinsider.com/

[19] "A changing boardroom climate: insurance planning with ESG in mind," Michael L. Zigelman, Patrick M. Kennell, Mathew Lee, September 24, 2021.

https://www.reuters.com/legal/legalindustry/changing-boardroom-climate-insurance-planning-with-esg-mind-2021-09-24/

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