**Vincent C. Ross Institute of Accounting Research**
**New York University Stern School of Business**

**Ross Roundtable in Cooperation with NERA Economic Consulting**

**On**

# The Inside Scoop on Securities Litigation for 2013

**April 15, 2013**

Claire Eckstein, Research Reporter

Paul Zarowin, Director of the Ross Institute, welcomed everyone to the Roundtable on "The Inside Scoop on Securities Litigation for 2013". The 5th annual collaboration between NERA and NYU has become one of the Institute's highlight events and underscores the role and impact of NYU's Ross Institute of Accounting Research. The trifecta of accounting, economic, and legal professions are intricately joined together. The numerous research studies published in accounting journals have served not only to educate but to assist standard setters, regulators, and members of the professions in their pursuit of efficient markets, justice, and robust economies. The NYU-NERA roundtable creates the perfect venue to bring to "life" the complex elegant theories and mathematical equations of scholarly research.

David Taback (NERA), moderator of the Roundtable, noted that a multi-faceted view of the issues would be provided by the panel of experts that included members of academe, attorneys, and regulatory agencies. Although the investor will not be giving a presentation, his/her cause is being presented by the professions that compile, investigate, and disclose the information providing the publicity that instigates action. The presentations include commentaries on what are considered to be "reasonable beliefs, reliance, and action" by investors in the current economic and regulatory environment.

At the core of securities litigation and the ultimate outcomes are defining and providing evidence of "materiality" and/or "fraud on the market". The definitions:

Materiality:[1] The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Fraud-on-the-market principle:[2] A plaintiff in a claim under the antifraud provisions of the federal securities laws may by presumption establish reliance on a misstatement about a security's value without proving actual knowledge of the fraudulent statement if the security is purchased in an open and developed securities market. The rule is based on the semi-strong form

[1] The FASB promulgated Statement of Financial Accounting Concepts No.2, (1980) defining **a** hierarchy **of** accounting qualitative characteristics.
[2] The rule, although established in 1975 (Blackie v. Barrack, 524 F.2d 891, 9th Cir. Cal.), has recently been applied in high profile controversial cases.

of the "Efficient Market Hypotheses"[3] which asserts that the market price of a security reflects all available public information.

Examples of the application and outcomes of the above were provided by the panel.

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## The Panel: Perspectives on Litigation

**Academic Research:**

An update on the most recent scholarly research was presented pointing out that relative to the triggers of lawsuits and their outcomes, the major factors have been stable. Volatility in earnings and share price, restatements, firm size, and the existence of D & O insurance continue to be major triggers. The correlation between merits and outcomes continue to be argued, with no consensus reached. Before/after scenarios, such as major changes in market conditions, litigation and regulatory reform provide fertile ground for academic research. The major conclusions were:

- Market conditions have the highest probability of triggering legal action. In particular, a sharp market downturn (crash) exposes fraud and courts are more likely to sympathize with the investor.
- Regulatory reform, e.g. Private Securities Litigation Reform Act (PSLRA) studies suggest that the Act made it more difficult to sue, but did not have a major impact on either merits or outcomes.
- Firms reduce the amount of financial statement disclosure following litigation.

The focus of academic research as it relates to litigation has been on the claims of shareholders. Bondholder rights to sue are limited by the bond indenture. Bondholder attempts to file a class-action suit against AIG for "fraud on the market" were denied.[4] In addition to outrage by bondholders, the headline-making controversy sparked a renewed interest among academic scholars[5] to start an in-depth analysis of the history of bondholder litigation.

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**Recent trends in securities litigation:**

The 207 securities class action suits filed last year in federal courts was the lowest number since 2007[6]. The average has been relatively stable in recent years; however, there has been a significant change in mix. Merger objection cases increased over the past 5 years from 4% of cases filed to more than 25% of total filings. Half of the cases filed since 1996 have investor losses of less than $500 million, but account for only 5% of aggregate losses. The aggregate losses of over $10 billion during this time period were the result of a few all-time high settlements.

There has been a dramatic change in the burden of proof required for class certification that has thus far affected two federal court circuits. In March 2013, one month after the Amgen[7]

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[3] Fama, Eugene (1970). "Efficient Capital Markets: A Review of Theory and Empirical Work". *Journal of Finance* **25** (2):

[4] American International Group Inc. Securities Litigation, U.S. District Court for the Southern District of New York, No. 04-8141

[5] "Do Bondholders React Differently than Stockholders to the filing of a lawsuit?", Billings, Klein & Zur (2013)

[6] The full report is available at www.nera.com.

[7] Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, No. 11-1085. Although a full discussion of the Amgen case was not included in the Roundtable presentations, given the profound impact of the Supreme Court

ruling invoked the "fraud on the market theory", securities class action law suits increased and went back to the highest levels (2008) reported by NERA in recent years. As a caveat, there is high volatility from month to month, and the increased litigation in March may be circumstantial.

In recent years motions to dismiss have been granted more frequently. For cases filed in 2005 or earlier 45% of motions to dismiss were granted; this increased to 50% thereafter. An even larger increase occurred in the fraction of cases voluntarily dismissed by plaintiffs up to 22% for post-2005 cases and 10% for earlier matters. Resolutions and dismissals went up proportionately in recent years, but last year there was a sharp decline in resolutions. At this time, the drivers are not known. There is an open question as to whether the decline is related to an increase in the backlog of cases.

**Settlement Amounts:**

The median settlement amount of $12 million in 2012 was an increase of 50% over the previous year. The $7.5 million median settlement in 2011 was approximately equal to previous years' median settlements, excluding the spike of $11 million in 2010. NERA has documented statistically robust relationships between motion status and settlement values[8] with settlement amounts increasing significantly as the motion progresses. It is predicted that in cases where motions were dismissed the Amgen case will have the greatest impact.

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**The Courts:**

Major factors that drive trends in securities litigation include regulation and the macroeconomy. Wishful thinking and unconventional wisdom led some to believe that the PSLRA, which enacted some limitations on investor litigation, created opportunities for committing fraud. However, the fact that the Supreme Court had become more sympathetic with investors on major securities issues created unexpected consequences for perpetrators of fraud. New SEC rules on recording stock options have also made it increasingly difficult to mask fraud. A market crash and declining economy are a dream come true for perpetrators of creative accounting since large write-offs and unusual declines in earnings are less subject to scrutiny during these periods. Firms can blame declines in earnings and stock price on the depressed market. Murky accounting records join the "big bath" and emerge sanitized. Thus, downward trends in litigation will be observed in depressed markets.

In the Matrixx[9] case the Supreme Court unanimously reaffirmed the "total mix" standard for assessing materiality under the federal securities laws. Determining reckless disregard for the truth or intent to defraud requires considering any and all allegations collectively. The "total mix" of information must be taken into context even in the absence of statistically significant supporting evidence.

The fact that a plaintiff no longer has to provide evidence of a material misstatement or omission made by a firm has made it much easier for plaintiffs to file a suit. The decision is an important reminder that there is no clear litmus test for materiality, which "is a 'fact-specific' inquiry that requires consideration of the source, content, and context of any and all alleged misstatement or omission".[10] However, defendants scored some points with the SEC ruling that

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decision, on what some predict to be the future of litigation, a few excerpts of the decision are provided as an endnote.

[8] "Dynamic Litigation Analysis: Predicting Securities Class Action Settlements as a Case Evolves"www.nera.com

[9] *Matrixx Initiatives, Inc. v. Siracusano*, No. 09-1156 (U.S. March 22, 2011).

[10] ibid

3rd party plaintiffs who had been involved in a scheme, but had not personally made false or misleading statements, cannot be held liable under existing rules.

The controversy over what constitutes an opinion versus a statement of fact continues to be debated. Are statements e.g. about goodwill and the adequacy of reserves opinions or statements of facts? Plaintiffs argue that opinions rendered in cases where defendants recklessly conceal facts undermine the opinions. Thus, consistent with the principle of full and fair disclosure such cases would be actionable.

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**Securities & Exchange Commission:**

- **Litigation and Settlements:** Trends in the number and types of cases and their settlement values shift over time. This is a result of both a change in focus based on the past and current issues reflecting the state of the economy. The usual suspects continue to be investigated, e.g. misstatements, market timing, option backdating, inadequate disclosure, etc. However, the focus has recently shifted to individual accountability; 75% of SEC settlements in 2012 were with individuals. The top ten settlements with individuals in 2012 ranged from $46 to $285 million. These cases included financial services, misrepresentation, misappropriation, illegal securities offering, insider trading and Ponzi schemes, with an increase in insider trading settlements of 93% since 2011.[11] Median settlement values for individuals reached a new post Sarbanes-Oxley Act high for the third year in a row. They have doubled since 2009 to an all time high of $221,000. In the past few months high-profile cases have led to very large settlements; BP $525 million and SAC capital over $600 million. SAC Capital was the 3rd largest and BP the 5th largest settlement in the history of the SEC.

- **Insider Activity:** The Division of Trading and Markets establishes and maintains standards for fair, orderly, and efficient markets. The Division regulates the major securities market participants, including broker-dealers, self-regulatory organizations (such as stock exchanges, FINRA, and clearing agencies), and transfer agents. There has been dramatic and continuous growth in this division since the enactment of the Dodd-Frank Act. Investigating issues related to complex financial instruments requires specialized expertise. The division keeps growing in tandem with the increasing complexity, sophistication, and innovative structuring of financial instruments. Although there is interaction and sharing of information within the divisions, maintaining efficiency requires "degrees of separation".

- **The "Market Access Rule**"[12] is considered by most investors to have been a huge step in the right direction. The rule requires individuals who have or provide others with market access to an exchange or alternative trading system to establish, document and maintain a system of risk management controls and supervisory procedures. This will hopefully provide the antidote to the reckless hitting of "enter" on keyboards turning zealous fingers into weapons of mass destruction. The exchanges have been hit by technological mishaps which many believe have become

[11] The Galeon Group insider trading scandal resulted in a $93 civil penalty, a $10 million justice department penalty and a sentence of 11 years in prison for Raj Rajaratnam.

[12] http://www.sec.gov/news/press/2010/2010-210.htm

dominated by high-frequency traders. These incidents have created a dramatic movement away from the major exchanges and into "dark pools".

- **Dark Pools:** The portion of all stock trading taking place away from the public exchanges has hit new highs. As mentioned above, this is in part because of the recent mishaps and volatility of the major exchanges. Dark pools do not require buyers and sellers to publicly announce their intention to trade stocks, allowing traders and investors to hide behind a veil that only the operator of the pool can penetrate. There are numerous caveats that investors should consider, one being that it is not an efficient market if orders never see the light of day. On the flip side, these private pools are required to protect privileged trading information. Failure to do so has led to successful litigation for failure to provide confidentiality and liquidity.

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**Insider Trading:**

Insider Trading is the only claim that a private litigant has the statutory right to bring under SEC Rule 10-b. Congress created a statutory right of action for insider trading but failed to define it. Criminal conduct, on the other hand, is clearly defined by statute. However, there is no provision in the U.S .Code[13] defining conduct related to insider trading. None the less, criminal prosecution of individuals for misconduct that is neither backed by statute in the U.S. Code nor clearly defined by the SEC has resulted in both imprisonment and the largest fines in SEC history.

The criminalization of insider trading is based on:

- The classical theory of agency law: An agent cannot profit from the principal without his permission. Thus, insiders are barred from misappropriating information that they have by reason of their position.

- Misappropriation theory: The Supreme Court extended the agency theory ruling that the source of information does not have to be the issuer. The misappropriation extends to anyone who has the duty of confidentiality or loyalty to the source of information.

There is no basis for the rampant misconception that insider trading rules were designed to equalize the playing field. However, there can be little argument that the ambiguity created by the Supreme Court has created confusion and misunderstanding. Some investors have become unwittingly ensnared in trading deemed illegal by virtue of a "judgment" call. The term "unwittingly" cannot be ascribed to the sophisticated investor who uses the opaque rules to create intricate pathways of information that transform the opaque veil into a dark curtain.

Penetrating the dark curtain and uncovering the pathways of information has not been an easy task. In cases where the information is brought to light, but the information was used to halt trading, there can be no indictments for trading. In some of these cases indictments were obtained by enforcing mail and wire fraud statutes. Good news? Materiality is not an issue in mail and wire fraud. This opens up a Pandora's Box for investors and inevitably will both constrain and change their investing behavior. It is the individuals who have recently become the focus of SEC investigations and successful litigation. It is the individual who is most likely to trade on information received from sources he/she had no reason to investigate. There will

[13] Title 18

undoubtedly be major economic consequences both in terms of market impact and changes in investor behavior as a direct result of expanding the definition of insider trading.

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**Banks under siege?**

Representatives of the banking industry claim to be under siege by simultaneous multi-pronged investigations involving numerous regulators and issues, with each regulatory agency demanding priority status. Deference no longer exists; a logical pecking order based on agency hierarchy is being ignored. The lack of coordination by the various agencies and duplication of efforts is taking its toll on members of the industry responsible for assisting in investigations.

On a more positive note, the banks won a major victory in the Libor[14] case when Judge Buchwald[15] ruled that the banks' alleged conduct did not breach federal antitrust laws partly because the Libor-setting process was never intended to be competitive and therefore could not breach anti-trust laws. The plaintiffs argued that the banks engaged in an anti-competitive conspiracy to suppress reported Libor rates during 2007 and 2008. The Court ruled that even if the banks had subverted the Libor process by putting in false estimates, any losses suffered by the plaintiffs would have resulted from the banks' misrepresentation and not from harm to competition. On the charges of Racketeering, the judge said that RICO laws do not apply to securities cases.

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**Academe versus the real world: Conflicting evidence?**

The disparate findings between academic research and the "real world" are both significant and of import not only as they relate to identifying the drivers of litigation, but in the analysis, interpretation, and understanding of evidence provided by empirical research. As pointed out above:

Academic research: Evidence based on scientific analysis of empirical data:

- Market conditions have the highest probability of triggering legal action. In particular, a sharp market downturn (crash) exposes fraud and courts are more likely to sympathize with the investor.
- The correlation between merits and outcomes continue to be argued, with no consensus reached

Legal and regulatory professions: Evidence based on real-world experience:

- A market crash and declining economy are a dream come true for perpetrators of creative accounting since large write-offs and unusual declines in earnings are less subject to scrutiny during these periods. Firms can blame declines in earnings and stock price on the depressed market.
- From the perspective of the legal profession, the merits of a case play a major role in the entire process.

What are the reasons for these conflicting views?

**Breadth versus depth?** The rigors of academic research require large sample sizes, econometric models that include many explanatory variables, and analysis of the data within

[14] Case 1:11-md-02262-NRB Document 286 Filed 03/29/13

[15] http://www.bloomberg.com/news/2013-03-29/banks-win-dismissal-of-substantial-portion-of-libor-suit.html

specified time intervals (*windows).* Inferences are based on the statistical significance of the explanatory variables.

**Quantitative versus qualitative?** The evidence based on "real world" experience is not constrained by the parameters of academic research. Qualitative factors, which may by definition be statistically insignificant variables, could none the less be economically significant in terms of their impact on outcomes. Significant factors come to light as a result of rigorous investigations, one-on- one conversations, and a host of other techniques used by professionals to gather and document evidence.

The ultimate goal of research is to assist in providing a roadmap to building a better future. The Roundtable has once again provided fertile ground for the academic and real-world pursuits to come together and join in their search for innovations that will enhance their interpretations of past events and ultimately lead to a more complete understanding of the world that will reconcile these different views and find the pathways to a brighter future.

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**The courts: What lies ahead?**

There is a bi-prong issue that depending on the outcome has the potential of creating a maelstrom of consequences across all sectors of our economic and social landscape.

- Revisiting and perhaps disputing the Holy Grail of academic research --the "Efficient Market Hypotheses" (EMH).
- Reconsideration of the EMH based "fraud on the market doctrine"

If the courts decide that the EMH is flawed, and thus the market prices of shares do not reflect all publicly available information—the "fraud on the market doctrine" will no longer be a valid argument for taking legal action. The fact that at least four Supreme Court justices are questioning the continued viability of the fraud-on-the-market presumption is very significant. "…Without that presumption it would be substantially more difficult, if not impossible, for plaintiffs to obtain class certification in securities cases." If this presumption is revisited, it could dramatically change the landscape of U.S. federal securities class actions.

*The entire legal landscape may be on the brink of a quantum leap…*
*destination unknown.*

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[1] **Excerpts from the Supreme Court decision in *Amgen v. Connecticut Ret. Plan & Trust Funds*, 133 S. Ct. 1184 (2013).**

The Supreme Court Justice, Ruth Bader Ginsburg's, majority opinion identified "the pivotal inquiry" to be "whether proof of materiality is needed to ensure that the *questions* of law or fact common to the class will 'predominate over any questions affecting only individual members' as the litigation progresses. The court stated that "the answer to this question is clearly 'no'.

First, the court reasoned that because the materiality determination is "'an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor…[it] can be proved through evidence common to the class.'" In other words, since any plaintiff's subjective view of the importance of the information in question is irrelevant, the court's determination of whether the alleged statements are material will by necessity apply to the entire class. Second, "A failure of proof on the *common* question of materiality ends the litigation and thus will never cause individual questions of reliance or anything else to overwhelm questions common to the class".

It is of import to make note of the "dissents" (Justices Clarence Thomas, Anthony Kennedy and Antonin Scalia) as these arguments will undoubtedly play a major role in the future of court decisions. "…[a]ll of the elements of [the fraud-on-the-market] rule, including materiality, must be established if and when it is relied upon to justify certification." Scalia's dissent also noted that "[c]ertification of the class is often… the prelude to a substantial settlement by the defendant because the costs and risks of litigating are so high… from the arguably regrettable to the unquestionably disastrous."