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Extending the Fraud-on-the-Market Presumption Beyond *Basic*: A Case of Poor Analogies and Over-Eager Courts

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I. INTRODUCTION

Analysts play an important role in the securities markets.[1] By providing coverage on a security, they substantially enhance visibility to the investing public.[2] Research reports help to increase market efficiency and integrity.[3] But the information analysts provide and the research they conduct are costly.[4] Because of the nature of their services and the ease in which the information they produce can become a public good, analysts have difficulty funding their research.[5] They have few choices other than to rely on investment banks, brokerage firms, and financial institutions for financial support.[6] The consequence of forming arrangements to subsidize their research is that conflicts of interest become unavoidable, particularly when funding is linked to the success of the subsidizer's business.[7] For example, an analyst's favorable report on an initial public offering of a new security underwritten by his or her investment-bank-employer can boost the new security's hype and increase the employer's sales.[8] Similarly, optimistic buy recommendations issued by an analyst employed by a brokerage firm can increase the employer's customer trading volume and generate commissions.[9] These relationships create incentives that can affect an analyst's choice of which securities to cover, whether to issue a buy or sell recommendation, and how optimistic such a recommendation should be.[10]

Analysts then become a target in securities fraud litigation for their stock recommendations and ratings. Investors have brought numerous class actions to recover losses they allege they suffered as a result of misleading recommendations published by analysts.[11] Analysts who publicly make a material misstatement that are

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1. DeMarco v. Lehman Bros., 222 F.R.D. 243, 246 (S.D.N.Y. 2004).

2. Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. Rev. 39, 46 (2007).

3. *Id.*

4. *Id.* at 48.

5. *Id.*

6. *Id.*

7. *See* Harold S. Bloomenthal, Sarbanes-Oxley Act in Perspective § 9:2 (2010–2011 ed. 2010).

8. *See id.*

9. *See id.*

10. *See* Fisch, *supra* note 2, at 56.

11. *See, e.g.*, Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474 (2d Cir. 2008); Miles v. Merrill Lynch & Co., 471 F.3d 24 (2d Cir. 2006); Hevesi v. Citigroup Inc., 366 F.3d 70 (2d Cir. 2004); Fogarazzo v. Lehman Bros., 263 F.R.D. 90 (S.D.N.Y. 2009); *In re* Healthsouth Corp. Sec. Litig., 257 F.R.D. 260 (N.D. Ala. 2009); *In re* Credit Suisse First Bos. Corp. (Lantronix, Inc.) Analyst Sec. Litig., 250 F.R.D. 137 (S.D.N.Y. 2008); *In re* Credit Suisse-AOL Sec. Litig., 253 F.R.D. 17 (D. Mass. 2008); 60223 Trust v. Goldman, Sachs & Co., 540 F. Supp. 2d 449 (S.D.N.Y. 2007); *In re* Enron Corp. Sec., 529 F. Supp. 2d 644 (S.D. Tex. 2006); DeMarco v. Robertson Stephens Inc., 228 F.R.D. 468 (S.D.N.Y. 2005); LaGrasta v. First Union Sec., Inc., No. 2:01-CV-251-FTM29DNF, 2005 WL 1875469 (M.D. Fla. Aug. 8, 2005); Swack v. Credit Suisse First Bos., 230 F.R.D. 250 (D. Mass. 2005); DeMarco v. Lehman Bros., 222 F.R.D. 243 (S.D.N.Y. 2004); *In re* Merrill

relied upon by and cause losses to investors should pay damages.[12] However, analysts should not be held liable if investors would have purchased the stock regardless of whether the alleged misstatement was known.[13] Nonetheless, by applying the fraud-on-the-market presumption of reliance to actions brought against research analysts, federal courts have provided investors greater leverage to recover from analysts even when the misstatement had no effect on investors' investment decisions.[14]

"Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."[15] To establish a cause of action for fraud, a plaintiff must show that he or she relied on the alleged misconduct.[16] The purpose of the reliance element is to certify that the defendant actually caused the plaintiff's injury.[17] If the plaintiff would have acted differently had the truth been known, there has been reliance.[18] For example, even if a person intentionally made a fraudulent and misleading misstatement to an investor who buys a stock, reliance cannot be established if the investor would have purchased the stock had he or she known the truth. The investor cannot recover any loss based on the misstatement. Absent the reliance requirement, an investor could, in effect, use the court system as an insurance against investment losses.[19]

Proving reliance becomes problematic when investors file class-action lawsuits for securities fraud against publicly held companies.[20] For a class action to proceed in federal court, the case must be certified by a court. The class must satisfy the requirements for certification under Federal Rule of Civil Procedure 23 ("Rule 23").[21] In a class action for damages, Rule 23 requires that questions of law or fact common to the members of the class predominate over any questions affecting only individual members.[22] To establish a claim for fraud, a class must prove reliance on the misrepresentation.[23] However, if a class were to show that each member relied on the

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Lynch & Co., 273 F. Supp. 2d 351 (S.D.N.Y. 2003); *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

12. *See, e.g.*, *Millowitz*, 544 F.3d at 481.

13. *See* Basic Inc. v. Levinson, 485 U.S. 224, 248–49 (1988).

14. *See Millowitz*, 544 F.3d 474; *In re Credit Suisse-AOL*, 253 F.R.D. at 28; *In re* Bos. Scientific Corp. Sec. Litig., 604 F. Supp. 2d 275, 286 (D. Mass. 2009).

15. *Millowitz*, 544 F.3d at 480–81 (quoting *Basic*, 485 U.S. at 243) (internal quotation mark omitted).

16. *See id.*

17. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

18. *See* Gariety v. Grant Thorton LLP, 368 F.3d 356, 367 (4th Cir. 2004).

19. Basic Inc. v. Levinson, 485 U.S. 224, 252 (1988) (White, J., concurring in part and dissenting in part); *cf. Gariety*, 368 F.3d at 367.

20. *Basic*, 485 U.S at 242.

21. Fed. R. Civ. P. 23.

22. *Id.*

23. *See Basic*, 485 U.S. at 243.

misrepresentation, individual issues would predominate over the commonality of the class and defeat certification.

To fill this gap, the U.S. Supreme Court in *Basic Inc. v. Levinson* established a presumption based on the economic fraud-on-the-market theory.[24] Under this doctrine, investors are presumed to rely on a material misrepresentation publicly made about a stock that trades in an efficient market.[25] The assumption is that all public information is incorporated into the stock price.[26] Thus, a public misstatement that affects the price will also affect the decisions of investors relying on that price, even if the investors were not aware of the misstatement at the time.[27] Since *Basic*, courts have presumed reliance in class-action lawsuits filed by investors against the companies and executives for misrepresentation and reckless disclosure.[28]

Recently, federal courts have extended the presumption beyond the context in *Basic*.[29] Although *Basic* was a class action brought by investors against a company and its executives for misrepresentation, courts have taken the position that the application of the presumption in class actions against research analysts and other non-issuers should be no different.[30] While acknowledging that statements made by analysts qualitatively and inherently differ from those made by publicly held companies, these courts came to this conclusion without assessing whether the information published

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24. *Id.* at 247. The Supreme Court has found a rebuttable presumption of reliance in two circumstances. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159 (2008). The *Basic* Court established a rebuttable presumption of reliance in the context where the misstatements in issue become public. *Id.* The second context where a rebuttable presumption of reliance will apply is where a defendant owes an investor a duty to disclose and breaches that duty by making a misstatement or omission of material fact. *Id.* The aggrieved investor in such an instance need not provide specific proof of reliance. *Id.*; *see* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).

25. *Basic*, 485 U.S. at 241.

26. *Id.* at 244.

27. Joseph M. McLaughlin, McLaughlin on Class Actions § 5:26 (6th ed. 2009).

28. *See* Edward Brodsky & M. Patricia Adamski, Law of Corporate Officers and Directors: Rights, Duties and Liabilities § 12:18 (2009).

29. *See, e.g.*, Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 481 (2d Cir. 2008) (holding that it "does not matter, for purposes of establishing entitlement to the presumption, whether the misinformation was transmitted by an issuer, an analyst, or anyone else"); Miles v. Merrill Lynch & Co. (*In re* Initial Pub. Offering Sec. Litig.), 471 F.3d 24, 43 (2d Cir. 2006) ("It is also doubtful whether the *Basic* presumption can be extended, beyond its original context, to tie-in trading, underwriter compensation, and *analysts' reports*." (emphasis added)); Hevesi v. Citigroup Inc., 366 F.3d 70 (2d Cir. 2004) (holding that the fraud-on-the-market doctrine under *Basic* extends to opinions expressed by research analysts); *In re* Credit Suisse First Bos. Corp. (Lantronix, Inc.) Analyst Sec. Litig., 250 F.R.D. 137, 139 (S.D.N.Y. 2008) (holding that the presumption of reliance *might* apply to research analysts, but not deciding the issue); *In re* Credit Suisse-AOL Sec. Litig., 253 F.R.D. 17 (D. Mass. 2008) (declining to adopt a higher class-certification standard for research analyst cases); DeMarco v. Robertson Stephens Inc., 228 F.R.D. 468, 475 (S.D.N.Y. 2005) (same); LaGrasta v. First Union Sec., Inc., No. 2:01-CV-251-FTM29DNF, 2005 WL 1875469 (M.D. Fla. Aug. 8, 2005) (recognizing generally that "reliance may be presumed where securities are traded on the open market"); DeMarco v. Lehman Bros., 222 F.R.D. 243, 245 (S.D.N.Y. 2004) (concluding "that the fraud-on-the-market doctrine may in certain conditions apply to analyst reports").

30. *See Millowitz*, 544 F.3d 474; *In re Credit Suisse-AOL*, 253 F.R.D. 17; *Robertson Stephens*, 228 F.R.D.at 475.

in research reports can affect the price of a stock.[31] Statements made by issuers, who owe a general duty to investors and must abide by U.S. Securities and Exchange Commission (SEC) disclosure regulations, are authoritative, relatively certain, and highly likely to be relied upon by investors.[32] On the contrary, recommendations made by analysts, who do not have a general duty to the market, are statements of opinion, subjective, uncertain, and likely to dissipate among the sea of opinions on the particular stock.[33] The market may also discount or disregard information emanated from analysts in consideration of potential conflicts of interest that are common in the financial research industry.[34] Thus, even if plaintiffs can show the *Basic* standard is met, the market may not incorporate the allegedly misleading information into the price. If incorporation does not occur, the misstatement does not affect the market price, and reliance should not be presumed.

By certifying a class nonetheless, the courts have bypassed the reliance requirement and failed to adhere to federal law.[35] Every investor who owned the stock after the alleged misrepresentation was made and held the stock until after the truth was revealed has a cause of action for loss.[36] Due process concerns of defendants inherent in class certification are magnified and unaddressed by such application because it results in an imbalanced allocation of the parties' evidentiary burden that unfairly gives the plaintiffs the upper hand.[37] Justice White's suspicion expressed in *Basic* that the fraud-on-the-market presumption would "lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers" will materialize.[38] Even if a judgment is not reached, the pressure on defendants to settle becomes extreme because class certification will fail to prevent plaintiffs from "unfairly bully[ing] defendants into settling 'non-meritorious cases . . . to avoid both [the] risk of liability and litigation expense.'"[39] The end result for research analysts could be an unwarranted chill on their insights and recommendations.

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31. *See, e.g.*, *In re Credit Suisse-AOL*, 253 F.R.D. at 29.

32. *See* Roberta S. Karmel, *When Should Investor Reliance Be Presumed In Securities Class Actions?*, 63 Bus. Law. 25, 49 (2007); *Lehman Bros.*, 222 F.R.D. at 246. *See generally* McLaughlin, *supra* note 27.

33. *See Lehman Bros.*, 222 F.R.D. at 247.

34. *See* Fisch, *supra* note 2, at 66.

35. *See generally* Basic Inc. v. Levinson, 485 U.S. 224, 242–43 (1988); Fed. R. Civ. P. 23.

36. *See Basic*, 485 U.S. at 256 (White, J., concurring in part and dissenting in part); Karmel, *supra* note 32, at 49. ("[E]xtending the fraud-on-the-market doctrine to statements by third parties, who are not required to speak by SEC regulations and do not owe a duty to investors or shareholders, seems to encourage too much questionable litgation.").

37. *See id.*

38. *Id.* at 262 (quoting SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968)). Thus far, only three cases have applied the presumption beyond class actions against issuers; however, as this note contends, this relatively new expansion is likely to lead to increased litigation.

39. *In re* Credit Suisse-AOL Sec. Litig., 253 F.R.D. 17, 22 (D. Mass. 2008) (quoting Brown v. Am. Honda (*In re* New Motor Vehicles Can. Exp. Antitrust Litig.), 522 F.3d 6, 8 (1st Cir. 2008)).

Part II will discuss *Basic* in further detail, explain the basis of the fraud-on-the-market theory, and provide the elements of the presumption set out by the U.S. Supreme Court. Part III reviews the decisions in which federal courts have extended the presumption to research analysts and other secondary parties under the standard established by *Basic*. Part IV discusses why courts should not treat misstatements made by research analysts the same as those made by securities issuers. It argues that extending the *Basic* framework to determine whether reliance can be presumed in actions against analysts alleging fraud is improper and overly broad. Part V argues that plaintiffs should meet a heightened standard and that courts should perform deeper inquiry than what *Basic* required before applying the fraud-on-the-market presumption in class actions against analysts. The section explains what the higher standard should be and what issues a court should examine to determine if an alleged misstatement was incorporated into the market price of a stock. Finally, Part VI emphasizes the importance of involving the analysis and work of experts to determine whether application of the fraud-on-the-market presumption makes economic sense.

II. *BASIC INC. V. LEVINSON* AND THE FRAUD-ON-THE-MARKET THEORY

Investors may file a private class action for damages suffered as a result of an alleged misstatement or omission of material fact in connection with the purchase or sale of a security pursuant to section 10(b) of the Securities Exchange Act of 1934[40] and Securities Exchange Commission Rule 10b-5.[41] Courts recognize that class actions are appropriate in securities litigation because it may be the only practical means of enforcing the rights of investors, as the claims are often too small to warrant litigation.[42] Before a class action can proceed, a court must certify the class upon a finding that the plaintiffs have satisfied requirements pursuant to Rule 23.[43] Courts must "rigorously analyze" whether the plaintiffs have satisfied each element of Rule 23 by resolving relevant factual disputes even if they must make inquiries into the merits.[44] Rule 23 requires that "questions of law or fact common to the members of

40. 15 U.S.C. § 78j (2006 & Supp. IV 2010).

41. 17 C.F.R. § 240.10b-5 (2010).

42. *E.g.*, *In re* Bos. Scientific Corp. Sec. Litig., 604 F. Supp. 2d 275 (D. Mass. 2009).

43. Fed. R. Civ. P. 23.

44. *In re* Salomon Analyst Metromedia Litig., 236 F.R.D. 208, 211 (S.D.N.Y. 2006); Miles v. Merrill Lynch & Co. (*In re* Initial Pub. Offering Sec. Litig.), 471 F.3d 24, 34 (2d Cir. 2006).

> [W]e reach the following conclusions: (1) a district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met; (2) such determinations can be made only if the judge resolves factual disputes relevant to each Rule 23 requirement and finds that whatever underlying facts are relevant to a particular Rule 23 requirement have been established and is persuaded to rule, based on the relevant facts and the applicable legal standard, that the requirement is met; (3) the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement; (4) in making such determinations, a district judge should not assess any aspect of the merits unrelated to a Rule 23 requirement; and (5) a district judge has

the class predominate over any questions affecting only individual members."[45] Satisfying this rule becomes difficult when the investors must show that the question of whether plaintiffs in fact relied on the misstatement, a fundamental element in a securities fraud claim, can be satisfied as a class.[46] In *Basic Inc. v. Levinson*, the U.S. Supreme Court addressed this matter in a class action brought by investors against a public company and its directors for issuing misleading public statements.[47] The Supreme Court acknowledged that requiring evidence of reliance from each individual plaintiff on the misrepresentations would prevent the class action from proceeding because individual issues would prevail over common ones.[48] The Court also noted that in today's modern securities markets, where impersonal transactions are the norm, investors face undue difficulties in proving direct reliance.[49] The Court held that the investors' reliance on an issuer's misstatements may be presumed based

> ample discretion to circumscribe both the extent of discovery concerning Rule 23 requirements and the extent of a hearing to determine whether such requirements are met in order to assure that a class certification motion does not become a pretext for a partial trial of the merits.

Id. at 41.

45. Fed. R. Civ. P. 23. Rule 23(b)(3) is satisfied when:

> [T]he court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of the class action.

Id. See Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988) ("Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues would have overwhelmed the common ones.").

46. *See Basic*, 485 U.S. at 243 ("Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury.").

> The basic elements of a cause of action for securities fraud under § 10(b) and Rule 10b-5 are (1) material misstatement or omission, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance, "often referred to in cases involving public securities markets (fraud-on-the-market cases) as transaction causation," (5) economic loss, and (6) "loss causation, i.e., a causal connection between the material misrepresentation and the loss."

Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 478 n.1 (2d Cir. 2008) (quoting Dura Pharms., Inc. v. Broudo, 554 U.S. 336, 341 (2005)) (internal quotation marks omitted).

47. 485 U.S. at 228.

48. *Id.* at 242.

49. *Id.* at 243–44; *In re* Worldcom, Inc. Sec. Litig., 219 F.R.D. 267, 291 (S.D.N.Y. 2003).

upon the fraud-on-the-market theory.[50] The theory provides that, in an open and well-developed market, the stock price reflects all public information.[51] The Court reasoned that, when making a decision to trade, many investors do not personally review all available information on a publicly held company.[52] Instead, investors "rely on informed traders and market makers" who digest and incorporate the public information into the stock through their trades.[53] Thus, when investors rely on the price, they rely indirectly on the accuracy of the information disseminated into the market.[54] The market is the "unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price."[55] Public misrepresentations that affect the stock price will then "defraud [stock purchasers] even if [they] do not directly rely on the misstatements."[56]

To trigger the presumption, the Court required the plaintiffs to prove the defendant: "(1) publicly made (2) a material misrepresentation (3) about stock traded on an . . . [efficient] market."[57] The plaintiff had to demonstrate that he or she held the shares of the affected stock "between the time the misrepresentation was made and the truth was revealed."[58] Once a plaintiff establishes these elements, the defendant may rebut the presumption with "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price."[59]

In establishing the fraud-on-the-market presumption, the Supreme Court specifically dealt with the context of issuers and misrepresentations by corporate management.[60] Whether the presumption can be applied in actions alleging misrepresentation by non-issuers is unclear. In *Stoneridge Investment Partners, LLC v. Scientific-Atlantic, Inc.*, the U.S. Supreme Court held that the fraud-on-the-market presumption did not apply to a class action brought by investors against entities that transacted as suppliers and customers with the investors' company.[61] The investors alleged that these entities participated in agreements that allowed the issuer to

50. *Basic*, 485 U.S. at 250.

51. *Id.* at 241.

52. McLaughlin, *supra* note 27, § 5:26.

53. *Id.*

54. DeMarco v. Robertson Stephens Inc., 228 F.R.D. 468, 475 (S.D.N.Y. 2005).

55. *Basic*, 485 U.S. at 244 (quoting *In re* LTV Sec. Litig., 88 F.R.D. 134, 143 (N.D. Tex. 1980)) (internal quotation mark omitted).

56. *Id.* at 241–42.

57. Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 481 (2d Cir. 2008); *see also Basic*, 485 U.S. at 248.

58. *Basic*, 485 U.S. at 248 n.27.

59. *Id.* at 248.

60. *Id.* at 224.

61. 552 U.S. 148, 152–53 (2008).

mislead its auditors, misstate its financial statements, and inflate its stock price.[62] The Supreme Court held that the implied private right of action under section 10(b) and Rule 10b-5 did not extend to suppliers and customers, who owed no duty to disclose their fraudulent transactions with the investor's company.[63] The fraud-on-the-market presumption did not apply because "their deceptive acts were not communicated to the public."[64] Thus, reliance could not be established.[65] The Supreme Court has not addressed whether the presumption can be extended to misrepresentations made by other non-issuers, such as research analysts.[66]

In the last decade, investor claims against research analysts for their failure to disclose conflicts of interest with the investment banking firms that employed them have surged.[67] Federal courts are divided on whether the theory should apply to research analysts and other non-issuers, as well as on what evidence plaintiffs should be required to show prior to being afforded the presumption.[68]

III. EXTENSION OF THE PRESUMPTION UNDER THE *BASIC* FRAMEWORK TO RESEARCH ANALYSTS AND "ANYONE ELSE"

Recently, federal courts have held that the fraud-on-the-market theory applies in class actions alleging misrepresentation against analysts and other non-issuers.[69] Some of these courts, including the Second Circuit Court of Appeals, have taken the position that, to invoke the presumption in such actions, plaintiffs need merely to satisfy the elements set forth in *Basic*.[70] Despite the qualitative differences between statements made by issuers and non-issuers, courts have found that the standard created for actions against issuers is also appropriate in actions brought against non-

62. *Id.*

63. *Id.* at 159.

64. *Id.*

65. *Id.*

66. *See* Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 481 (2d Cir. 2008).

67. *See, e.g.*, *id.*; Ray v. Citigroup Global Mkts., Inc., 482 F.3d 991 (7th Cir. 2007); Hevesi v. Citigroup Inc., 366 F.3d 70, 73 (2d Cir. 2004); *In re* Credit Suisse First Bos. Corp. (Lantronix, Inc.) Analyst Sec. Litig., 250 F.R.D. 137, 137–38 (S.D.N.Y. 2008); *In re* Credit Suisse-AOL Sec. Litig., 253 F.R.D. 17, 20 (D. Mass. 2008); DeMarco v. Robertson Stephens Inc., 228 F.R.D. 468, 475 (S.D.N.Y. 2005); LaGrasta v. First Union Sec., Inc., No. 2:01-CV-251-FTM29DNF, 2005 WL 1875469, at *1 (M.D. Fla. Aug. 8, 2005); DeMarco v. Lehman Bros., 222 F.R.D. 243, 246–47 (S.D.N.Y. 2004); *see also* Miles v. Merrill Lynch & Co. (*In re* Initial Pub. Offering Sec. Litig.), 471 F.3d 24, 28 (2d Cir. 2006) (involving claims brought against the issuer, individual officers, and underwriters for, among other things, "analyst manipulation").

68. *See* cases cited *supra* note 67.

69. *See* cases cited *supra* note 67.

70. *See Millowitz*, 544 F.3d 474; *In re Credit Suisse-AOL*, 253 F.R.D. 17; *In re* Bos. Scientific Corp. Sec. Litig., 604 F. Supp. 2d 275 (D. Mass. 2009).

issuers.[71] These courts came to this conclusion without examining whether the market was efficient with regard to the particular type of information disseminated by a non-issuer or whether the information actually affected the market price.[72] The standard set by these courts disregards the necessary examination of the facts and circumstances to determine that the presumption can be properly applied. In doing so, courts have opened the door to improper application of the presumption and to certification of classes that cannot, and should not, meet the requirements of Rule 23.

In the 2008 decision *Millowitz v. Citigroup Global Markets, Inc.*, the Second Circuit became the first circuit to reach the issues of whether the fraud-on-the-market presumption could be extended to actions against research analysts and what evidentiary showing should be required to invoke the presumption.[73] The *Millowitz* court considered whether the district court properly applied the presumption in a class action by investors against security research analyst Jack Grubman, his employer, Salomon Smith Barney, Inc. (SSB), SSB's sister corporation Citicorp USA, Inc., and SSB's parent, Citigroup, Inc., for misrepresentation.[74] The plaintiffs, investors of Metromedia Fiber Network, Inc. ("Metromedia"), filed a class action in the U.S. District Court for the Southern District of New York against the defendants for allegedly violating section 10(b) and Rule 10b-5 in a scheme to defraud purchasers and sellers of Metromedia stock.[75] The plaintiffs contended that the defendants misstated or omitted material facts relating to a credit facility provided by Citicorp USA to increase its investment banking business with Metromedia and, accordingly, Grubman's personal compensation.[76] In December 2000, Metromedia and Citicorp USA signed a commitment letter for Citicorp USA to provide a $350 million facility to Metromedia.[77] Citicorp USA was to underwrite the facility, provide $75 million of the credit, and syndicate the remaining amount to other lenders.[78] SSB and Grubman published research reports in which they opined on the strength of Metromedia's stock.[79] To maintain independence, SSB's policies implemented a "Chinese Wall" to shield SSB equity investors from obtaining non-public information held by Citicorp USA investment bankers.[80] On January 9, 2001, Metromedia

71. *See* cases cited *supra* note 67.

72. *See* cases cited *supra* note 67.

73. 544 F.3d at 476; *cf. In re* Credit Suisse First Bos. Corp. (Lantronix, Inc.) Analyst Sec. Litig., 250 F.R.D. 137, 141 (S.D.N.Y. 2008) ("No Court of Appeals has ever held that the *Basic* presumption applies to research analyst statements.").

74. *Millowitz*, 544 F.3d at 476.

75. *Id.*; *In re* Salomon Analyst Level 3 Litigation, 350 F. Supp. 2d 477, 481 (S.D.N.Y. 2004).

76. *Millowitz*, 544 F.3d at 476.

77. *Id.* at 477.

78. *Id.*

79. *Id.*

80. *Id.* The complaint contained allegations that Grubman "breached the 'wall' on numerous occasions," which the district court found to be sufficient "notwithstanding the many dubious leaps of logic made

publicly announced the execution of the commitment letter with Citicorp USA.[81] Over the next several months, the proposed facility faced delays and problems.[82] Despite knowledge of these complications, between March 8 and July 25, 2001, Grubman issued reports stating that Metromedia "obtained a commitment for a fully underwritten credit facility for $350 million from Citicorp USA, Inc., which it expects will fully fund its current business plan."[83] Then, on June 28, Grubman expressed some doubt about the facility, indicating that the closing deadline was approaching and the deal was not yet complete.[84] A month later, Grubman downgraded his recommendation to "Neutral" because of continued delays in closing the facility and a lack of visibility.[85] Ultimately, the facility evolved into a significantly different package.[86]

In its decision on the plaintiffs' motion for class certification, the district court considered whether the plaintiffs could satisfy the predominance requirement and establish reliance through the fraud-on-the-market presumption.[87] It noted the controversy of the presumption's applicability to statements made by analysts.[88] Indicating that nothing in the *Basic* decision limited its holding to issuer statements, the district court decided that the presumption applied to the defendants' statements if plaintiffs made an adequate showing that the *Basic* elements were met.[89] The court determined that the plaintiffs satisfied their burden because Metromedia stock was actively traded on an open, developed, and generally efficient securities market and the defendant's misrepresentations were material and publicly made.[90] The court proceeded to apply the presumption against the defendants.[91] Contesting the application, the defendants argued that the plaintiffs were not entitled to the presumption because they failed to show that the misstatements regarding the credit facility "actually had an effect on the value of Metromedia shares."[92] Rejecting this argument, the court conducted no analysis of whether the alleged misrepresentation actually affected the

by plaintiffs." *Id.* (quoting *In re* Salomon Analyst Metromedia Litig., 373 F. Supp. 2d 235, 240 (S.D.N.Y. 2005)) (internal quotation mark omitted).

81. *In re Salomon Analyst*, 373 F. Supp. 2d at 240.

82. *Id.* at 239.

83. *Millowitz*, 544 F.3d at 477 (quoting *In re Salomon Analyst*, 373 F. Supp. 2d at 239) (quotation marks omitted).

84. *In re Salomon Analyst*, 373 F. Supp. 2d at 239.

85. *Id.*

86. *Id.*

87. *In re* Salomon Analyst Metromedia Litig., 236 F.R.D 208, 220 (S.D.N.Y. 2006).

88. *Id.*

89. *See id.*

90. *Id.* at 222.

91. *See id.*

92. *Id.* at 223.

market price of the security.[93] It declined to allow the defendants to present their rebuttal arguments prior to certification because doing so would require inquiry into the merits of the suit, which precedent from the Second Circuit Court of Appeals prohibited.[94] At conclusion of the hearing, the court certified the class.[95]

Subsequently, defendants appealed to the Second Circuit.[96] The Second Circuit addressed the issue of whether the plaintiffs were entitled to the presumption and whether a heightened standard should be adopted in claims against analysts for misrepresentation.[97] The court affirmed the lower court's application of the presumption, but vacated the order and remanded the request for certification to allow the defendants an opportunity to present a rebuttal.[98] The court held that the fraud-on-the-market presumption may be invoked by a class of investors in an action alleging misrepresentations made not only research analysts, but by "*anyone else*."[99] It reasoned that, in an efficient market, share prices reflect all public information, including any material misrepresentations made by "an issuer, an analyst, or anyone else."[100] The court concluded that mere fulfillment of the *Basic* elements was sufficient to justify application of the presumption and that a heightened test was unnecessary despite the qualitative differences between statements made by issuers and non-issuers.[101] Thus, the court stated that plaintiffs were not required to show that the alleged misstatement caused a change in the stock price; nor did plaintiffs need to prove that the alleged misstatement had any effect on the market.[102] The plaintiffs were not required to make any showing that an alleged misstatement, which could be made by *anyone*, was even the type of information that could be incorporated into the

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93. *See id.* The court recognized that some courts have held in cases against analysts that plaintiffs must make a prima facie showing that the alleged misstatements "materially and measurably impacted the market price of the security." *Id.* (quoting DeMarco v. Lehman Bros., 222 F.R.D. 243, 247 (S.D.N.Y. 2004)). The district court, however, declined to adopt this standard. *Id.*

94. *See id.*; *see also* Caridad v. Metro-North Commuter R.R., 191 F.3d 283, 293 (2d Cir. 1999) (determining that "district courts must not consider or resolve the merits of the claims of the purported class").

95. *In re Salomon Analyst*, 236 F.R.D. at 224.

96. Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 479–80 (2d Cir. 2008).

97. *Id.* at 476.

98. *Id.* at 484–86. The Court of Appeals found that the district court erred by declining to allow the defendants to present their rebuttal arguments prior to class certification. *Id.* It stated that *Caridad*, 191 F.3d at 293, and the "some showing" standard of proof it set forth, was overruled. *Millowitz*, 544 F.3d at 484. The court required a "definitive assessment" by district courts to determine that the predominance requirement was met. *Id.* (quoting Miles v. Merrill Lynch & Co. (*In re* Initial Pub. Offering Sec. Litig.), 471 F.3d 24, 41 (2d Cir. 2006)). Defendants' rebuttal arguments must be heard prior to class certification. *Id.* at 485.

99. *Millowitz*, 544 F.3d at 481 (emphasis added).

100. *Id.*

101. *See id.* at 481–84.

102. *See id.* at 482–83.

stock price.[103] The court did not explore the possibility that information disseminated by analysts and other non-issuers is not absorbed by the market. Instead, it established a standard that allows a plaintiff to invoke the presumption in an action against a non-issuer without a proper assessment of the facts and circumstances to determine whether the presumption should apply.

As of the date of this writing, no other circuit court has ruled on the applicability of the fraud-on-the-market presumption to analysts. However, a federal district court in Massachusetts has taken a similar position to that of the Second Circuit. In *In re Credit Suisse-AOL Securities Litigation*, the District Court of Massachusetts considered certification of a class of investors in an action against Credit Suisse First Boston, Inc., its subsidiary, and two of its employed research analysts.[104] The plaintiffs alleged the defendants issued a series of research reports in which they touted the stock of AOL Time Warner, Inc. (AOL) without revealing their knowledge of adverse information about the company.[105] The plaintiffs claimed that the defendants were motivated to issue false and misleading reports to win AOL's lucrative investment banking work.[106] The defendants argued that, "because analyst statements are qualitatively different from issuer statements," the application of the *Basic* framework should be conditioned on an additional showing that the analyst reports impacted AOL's market price.[107] Noting that the First Circuit Court of Appeals had not yet addressed the applicability of the presumption to analysts, the district court acknowledged the distinction between issuer and analyst statements in the *DeMarco v. Lehman Brothers, Inc.* decision:

> [T]here is a qualitative difference between a statement of fact emanating from an issuer and a statement of opinion emanating from a research analyst. A well-developed efficient market can reasonably be presumed to translate the former into an effect on the price, whereas no such presumption attaches to the latter. . . . As a result, no automatic impact on the price of a security can be presumed and instead must be proven and measured before the statement can be said to have "defrauded the market" in any material way that is not simply speculative.[108]

The court stated that proving that a particular statement was material and had an impact on a stock's market price may be more difficult for statements made by analysts than for those made by issuers.[109] Nonetheless, the court concluded that the

103. *See id.* at 480–84.

104. 253 F.R.D. 17, 19 (D. Mass. 2008). For a detailed recitation of the facts, see *In re* Credit Suisse-AOL Sec. Litig., 465 F. Supp. 2d 34 (D. Mass. 2006).

105. *In re Credit Suisse-AOL*, 253 F.R.D. at 19–20.

106. *Id.* at 20.

107. *Id.* at 28.

108. *Id.* (alteration in original) (quoting DeMarco v. Lehman Bros., 222 F.R.D. 243, 246–47 (S.D.N.Y. 2004)).

109. *Id.* at 29.

identity of the speaker should not alter the legal or analytical framework.[110] It reasoned that nothing in *Basic* required a showing of market impact even though *Basic* only addressed misstatements made by issuers.[111]

Furthermore, the court feared that it would inquire too far into the merits of the issues to determine whether a misstatement actually affected the stock price.[112] It argued that to require the plaintiff to show more than market efficiency at the certification stage "would conflate the issue of whether common issues will dominate the merits decision with the merits decision itself."[113] The court asserted that the defendants' arguments regarding market impact did not address the purposes of Rule 23 and that to engage those arguments would drag the court into an "unwieldy trial on the merits."[114] Ultimately, the court held that the defendants would be allowed to show the lack of a market impact in a rebuttal against the presumption, but that this right would not be afforded to them until trial.[115]

A more recent decision by the district court of Massachusetts reached the same conclusions as the *Credit Suisse* court.[116] This time the district court again accepted the argument that an analysis beyond a showing of market efficiency would unnecessarily drag the court too far into merit-based issues.[117] In *In re Boston Scientific Corp. Securities Litigation*, the court held that the issue of whether the fraud-on-the-market theory can be applied to a class action should not be determined until after certification.[118] It stated, "[a] plaintiff seeking class certification in the First Circuit need only 'present basic facts that the fraud-on-the-market presumption could be invoked,' while the theory's *actual* applicability should be resolved on summary judgment or trial."[119] Thus, the court presumed that the plaintiffs relied on the misstatement before determining whether the presumption's applicability was proper with the knowledge that it might be refuted at trial.[120] It expressly declined the Second Circuit's approach of providing defendants an opportunity to present a rebuttal at class certification.[121]

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110. *Id.*

111. *Id.*

112. *Id.* at 30.

113. *Id.* (quoting DeMarco v. Robertson Stephens Inc., 228 F.R.D. 468, 475 (S.D.N.Y. 2005)) (internal quotation marks omitted).

114. *Id.* (quoting Bowe v. PolyMedica Corp. (*In re* PolyMedica Corp. Sec. Litig.), 432 F.3d 1, 17 (1st Cir. 2005)) (internal quotation mark omitted).

115. *Id.* at 30 n.15.

116. *See In re* Bos. Scientific Sec. Litig., 604 F. Supp. 2d 275, 286–88 (D. Mass. 2009).

117. *See id.*

118. *See id.* at 287.

119. *Id.* at 286 (quoting Brown v. Am. Honda (*In re* New Motor Vehicles Can. Exp. Antitrust Litig.), 522 F.3d 6, 25 (1st Cir. 2008)).

120. *See id.*

121. *Id.* at 287.

Although the Second Circuit refused to hold plaintiffs to a heightened standard to invoke the presumption in actions against non-issuers, it provided defendants an opportunity to challenge the application before certification. Defendants could rebut plaintiffs' proof of the elements by "[a]ny showing *that severs the link* between the alleged misrepresentation and . . . the price."[122] But the District Court of Massachusetts has taken the position that defendants may not contest the presumption prior to certification.[123] Thus, the district court declined to hold plaintiffs to a heightened standard *and* denied defendants a right to rebuttal at certification.[124]

IV. THE BROAD APPLICATION OF THE *BASIC* FRAMEWORK: THE CONSEQUENCES OF TREATING APPLES AND ORANGES AS THE SAME

The issue of whether the fraud-on-the-market doctrine can be invoked in class actions against analysts for public misrepresentations and omissions is of particular significance because investors, as a class, cannot satisfy the reliance requirement if the doctrine is not applied.[125] If reliance cannot be presumed or proven, investors as a class cannot recover for legitimate losses suffered as a result of material misrepresentations and omissions transmitted by the defendants.[126] Thus, investors may have no redress for their investment losses resulting from faulty, misleading recommendations made by analysts solely to further their own self-interests.[127]

In the financial research industry, conflicts of interest between retail brokerages and research analysts are commonplace.[128] Research analysts play an important role in securities markets.[129] They acquire information about a security that is publicly available and generated from their own research.[130] They then analyze and transmit the information to provide coverage on a stock to the marketplace.[131] In addition, analysts provide recommendations and ratings on securities.[132] Conducting research

122. Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 484 (2d Cir. 2008) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988)).

123. *See In re Bos. Scientific*, 604 F. Supp. 2d 275, 286 (D. Mass. 2009); *In re* Credit Suisse-AOL Sec. Litig., 253 F.R.D. 17, 19 (D. Mass. 2008).

124. *In re Credit Suisse-AOL*, 253 F.R.D. at 30.

125. *See Basic*, 485 U.S. at 228–30 (1988).

126. *See id.* at 243 (stating that "[w]e agree that reliance is an element of a Rule 10b-5 cause of action").

127. An investor may pursue a direct claim in his or her individual capacity, however, individual losses are often too small to pursue the high litigation costs. *E.g.*, *In re* Bos. Scientific Corp. Sec. Litig., 604 F. Supp. 2d 275 (D. Mass. 2009).

128. *See* 3 Harold S. Bloomenthal & Samuel Wolff, Securities and Federal Corporate Law § 1:196 (2d ed. 2010); 5 Thomas Lee Hazen, Law of Securities Regulation § 14.16[6] (6th ed. 2009 & Supp. 2010).

129. *See* DeMarco v. Lehman Bros., 222 F.R.D. 243, 246 (S.D.N.Y. 2004).

130. Fisch, *supra* note 2, at 46.

131. *Id.*

132. *DeMarco*, 222 F.R.D. at 246.

and generating information is costly.[133] The problem that analysts face is that the information they produce can easily become a public good.[134] If analysts sold the information they produce, the value of the information can dissipate quickly because it is easily transferrable from investors who purchased the information to other investors who paid nothing.[135] Consequently, analysts are constrained to subsidize their research and depend on brokerage firms and investment banks.[136] Because these arrangements often involve some linkage between the analyst's compensation or funding and the subsidizer's success, conflicts of interest develop.[137] A conflict of interest, for example, will arise if an analyst works for a firm that has investment banking or other business relationships with issuers of the securities recommended by the analyst.[138] Such conflicts put pressure on analysts to publish favorable recommendations about a stock to generate business or commissions for the subsidizer despite contrary beliefs analysts may have about the merits of an investment in the stock.[139] A recommendation, made without a reasonable basis and for the purpose of enhancing personal investments, increasing compensation, or furthering any other self-interest without disclosure of such interest, is improper and impermissible.[140]

As a result of an analyst's misleading recommendation or statement, investors may suffer significant losses. Investors can recover their losses in an action for fraud if they can establish reliance.[141] If investors bring a class action against an analyst, reliance can be established only by presumption under the fraud-on-the-market doctrine.[142] The doctrine prescribes that reliance may be presumed on a publicly

133. *See* Fisch, *supra* note 2, at 48.

134. *Id.* at 47.

135. *Id.* at 48.

136. *Id.* at 48–49.

137. *Id.* at 55–66.

138. 14B Guy P. Lander, U.S. Securities Law for International Financial Transactions and Capital Markets § 13:263 (2d ed. 2009).

139. Bloomenthal, *supra* note 7, § 9:2.

140. 5 Hazen, *supra* note 128, § 14.16[6]. An analyst who receives compensation or other benefit for making recommendations and fails to disclose the self-interest may be accountable pursuant to section 17(b) of the Securities Act of 1933, 15 U.S.C. § 77q(b) (2006 & Supp. IV 2010). 5 Hazen, *supra* note 128, § 14.17. Section 17(b) applies to any person making a recommendation who receives undisclosed consideration directly or indirectly by the person or entity disseminating the information. *Id.* Further, an analyst who purchases stock and subsequently issues a buy recommendation on that same stock to intentionally boost the stock price and gain a profit commits the fraudulent practice of scalping. *Id.* The U.S. Supreme Court has held that failure to disclose the intention to scalp to clients or anyone else who is likely to rely on the recommendation is a violation of the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2006 & Supp. IV 2010). 5 Hazen, *supra* note 128, § 14.17 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)). In addition, failure to disclose scalping may be a violation of Rule 10b-5 as a prohibited material misstatement or omission in connection with the purchase or sale of securities. *Id.*

141. Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 478, 478 n.1 (2d Cir. 2008).

142. *See supra* Part II. This statement assumes that the analyst owed no duty to the aggrieved investors.

made material misrepresentation about a stock that is incorporated into the price of the stock.[143] But although recommendations made by some analysts can affect market prices,[144] recommendations by other analysts—for example, those who may carry weak reputations or are known to have conflicts of interest—do not affect or have little effect on market prices.[145]

There is public recognition that analysts' reports tend to be inaccurately optimistic.[146] The market discounts information that emanates from analysts with conflicts of interest who are potentially biased.[147] Studies show there is a limited market response to favorable buy recommendations issued by analysts affiliated with investment banks and a lower response to opinions that upgrade than those that downgrade a stock.[148] Professors Anup Agrawal and Mark A. Chen conducted a study to examine whether investors are misled by optimistic stock recommendations issued by analysts with conflicts of interest.[149] They analyzed a sample of over 110,000 stock recommendations issued by over 4000 analysts between 1994 and 2003 and examined potential conflicts based on the revenues of analyst employers.[150] They found that the recommendations were positively related to the magnitude of conflicts analysts faced.[151] Evidence of stock price and trading volume reactions to recommendations by analysts suggested that the market recognizes conflicts of interest and discounts opinions.[152] They concluded that analysts with conflicts of interest are not able to systematically mislead investors with optimistic stock recommendations.[153]

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143. *See supra* Part II.

144. DeMarco v. Lehman Bros., 222 F.R.D. 243, 246 (S.D.N.Y. 2004).

145. Fisch, *supra* note 2, at 65–66.

146. 3 Bloomenthal & Wolff, *supra* note 128, § 13.31.

147. *See* Fisch, *supra* note 2, at 66.

148. *See id.*

149. Anup Agrawal & Mark A. Chen, *Do Analyst Conflicts Matter? Evidence from Stock Recommendations*, 51 J.L. & Econ. 503 (2008).

150. *Id.* at 504, 509.

151. *Id.* at 531.

152. *Id.* Professors Agrawal and Chen stated:

> Consistent with the view of the media and regulators, we find that optimism in stock recommendations is positively related to the importance of both [investment banking] and brokerage businesses to an analyst's employer. . . . [S]everal pieces of empirical evidence . . . suggest that investors are sophisticated enough to adjust for this bias. First, the short-term reactions of both stock prices and trading volumes to recommendation upgrades vary negatively with the magnitude of potential [investment banking] or brokerage conflicts faced by analysts. . . . These results suggest that investors ascribe lower credibility to an analyst's upgrade when the analyst is subject to greater pressures to issue an optimistic view.

Id.

153. *Id.*

In contrast, statements made by the issuer of the security are viewed differently by the market.[154] It is hard to conceive that information transmitted by issuers have the same effect on the market as those made by analysts and other parties. "The key distinction between the statements of issuers and those of analysts cited by defendants in these cases is that the former are 'uniquely authoritative' while the latter are 'expressions of opinion.'"[155] Statements made by issuers are "relatively fixed, certain, and uncontradicted."[156] Conversely, statements of opinion made by analysts are "far more subjective and far less certain."[157] Unlike issuers, analysts do not have a general duty to the market; nor are they required to abide by extensive SEC reporting rules.[158] Moreover, when a research report is injected into a pool of information that includes opinions from multiple analysts and varying sources, it is likely to dissipate and have little effect on the stock price.[159]

Basic established the presumption of reliance to deal with repeated *issuer* misstatements about a material fact.[160] In light of the special authority an issuer has on matters pertaining to its publicly traded stock, the Supreme Court concluded as a matter of "common sense and probability" that such misstatements affected the stock price.[161] The issue therefore is whether the *Basic* framework, if used in actions against analysts, should allow application of the presumption to all statements by analysts, or only to those analysts whose recommendations affected the market price.

Based on the foregoing research, however, the *Basic* framework is too broad when used in actions brought by investors against research analysts for misrepresentation. Extending the *Basic* framework to these actions would allow investors to presume reliance on analysts' statements even when their misstatements may be unlikely to affect the stock market price. A class could then be certified under the fraud-on-the-market theory even though the market may have disregarded the information and, as a result, investors may not have relied on the alleged misstatement. Only in a case in which the misleading recommendation affected the stock price would it be fair to presume reliance under the fraud-on-the-market doctrine.[162]

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154. *See, e.g.*, McLaughlin, *supra* note 27, § 5:26.

155. Sarah S. Gold & Richard L. Spinogatti, *Fraud-on-the-Market Use for Analysts' Claims is Battle*, N.Y. L.J., Apr. 9, 2008, at 3 (quoting Hevesi v. Citigroup Inc., 366 F.3d 70, 79 (2d Cir. 2004)).

156. DeMarco v. Lehman Bros., 222 F.R.D. 243, 246 (S.D.N.Y. 2004).

157. *Id.* at 247.

158. Karmel, *supra* note 32, at 27, 46.

159. McLaughlin, *supra* note 27, § 5:26; John C. Coffee Jr., *Causation and the Analyst*, N.Y. L.J., July 15, 2004, at 5 ("The context of analyst litigation is different than that of . . . issuer statements generally, because there is seldom any corrective disclosure by the analyst. Rather, the inflated price may erode slowly as other analysts release different opinions or the issuer releases new information."); *In re* Credit Suisse First Bos. Corp. Analyst Sec. Litig., 250 F.R.D. 137, 142 (S.D.N.Y. 2008) (stating, when characterizing defendants' argument, that "analyst statements are, at least in some respects, different from those of issuers").

160. Basic Inc. v. Levinson, 485 U.S. 224, 228–30 (1988).

161. *Id.* at 246.

162. *See DeMarco*, 222 F.R.D. at 247.

Extension of the presumption can lead to significant consequences because it exposes new classes of defendants to civil liabilities by private parties.[163] Even the Second Circuit recognized the broad impact of extending the fraud-on-the-market doctrine to analysts prior to its decision in *Millowitz*. In *Hevesi v. Citigroup, Inc.*, the court noted that the application of the fraud-on-the-market doctrine to research analysts presented a "novel" and "significant" issue because it would "extend the potentially coercive effect of securities class actions to a new group of corporate and individual defendants—namely, to research analysts and their employers. . . . [It is] an issue that is 'of fundamental importance to the development of the law of class actions.'"[164] Further, the court expressed in *Miles v. Merrill Lynch & Co.* that it was "doubtful whether the *Basic* presumption can be extended, beyond its original context, to tie-in trading, underwriter compensation, and analysts' reports."[165]

The Supreme Court has warned that expanding the presumption to expose new classes of defendants to liability in a private cause of action can lead to significant consequences.[166] As a result of the standard set by the Second Circuit and the District Court of Massachusetts, analysts face lengthy trials and loss of considerable resources when investors have not shown the alleged misstatement was significant enough to distort the market price. Once a class is certified, the defendant's possible exposure to liability is multiplied exponentially.[167] Even if the court provides opportunity for rebuttal before certification, defendants must hire experts, gather empirical evidence, and obtain legal representation. The pressure on defendants to settle is extreme.[168] In *Stoneridge Investment Partners, LLC v. Scientific-Atlantic, Inc.*, the Supreme Court cautioned "that extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies."[169] In securities class actions, plaintiffs typically seek massive damages.[170]

163. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159–64 (2008).

164. 366 F.3d 70, 80 (2d Cir. 2004) (quoting Sumitomo Copper Litig. v. Credit Lyonnaise Rouse, Ltd. (*In re* Credit Lyonnaise Rouse), 262 F.3d 134, 140 (2d Cir. 2001)). In *Hevesi,* the Court of Appeals never opined on what evidentiary standard the plaintiffs must satisfy to prompt the presumption because the parties settled the suit. Fogarazzao v. Lehman Bros., 232 F.R.D. 176, 184 n.66 (S.D.N.Y. 2005).

165. (*In re* Initial Public Offering Sec. Litig.), 471 F.3d 24, 42 (2d Cir. 2006).

166. *See Stoneridge*, 552 U.S. at 159–64.

167. Theodore J. Sawicki & Alex Reid, *The New Focus on Class Certification of Securities Class Actions*, *in* 27 Alston & Bird LLP, Securities Litigation: Forms and Analysis § 1:8 (2009).

168. *Id.*; *see In re* Credit Suisse-AOL Sec. Litig., 253 F.R.D. 17, 22 (D. Mass. 2008) (noting the danger of "plaintiffs to unfairly bully defendants into settling 'non-meritorious cases in an effort to avoid both risk of liability and litigation expense'" (quoting Brown v. Am. Honda (*In re* New Motor Vehicles Can. Exp. Antitrust Litig.), 522 F.3d 6, 8 (1st Cir. 2008))).

169. 552 U.S. at 163.

170. Sawicki & Reed, *supra* note 167 ("[M]any corporate executives are unwilling to bet the company that they are in the right in big stakes litigation, and a grant of class certification can propel the stakes of a case into the stratosphere." (quoting Blair v. Equifax Check Servs., Inc., 181 F.3d 832, 834 (7th Cir. 1999))).

Although the plaintiffs may have weak positions, the possibility of an adverse jury verdict may not be one a defendant is willing to risk.[171]

The lasting effects of the presumption are over-deterrence and increased litigation.[172] During the period after the *Basic* decision, securities fraud class-action lawsuits almost tripled.[173] In a study conducted on a sample of 330 securities fraud class-action lawsuits occurring from 1988 through 1991, ninety-six percent were resolved through settlement while the norm for most other civil cases was sixty to seventy percent.[174] Extension of the fraud-on-the-market doctrine to claims against any party, whether issuer or non-issuer, may result in litigation multiple times the current level. The effects are significantly larger class actions and potential damages under Rule 10b-5.[175] The presumption facilitates an extraordinary aggregation of claims, a process encouraged by attorneys who may stand to gain twenty-five to thirty-five percent of the recovery.[176] Every investor who purchased the stock during the time the alleged misrepresentation caused an inflation or deflation in the stock price and held the stock until after the truth was revealed has a cause of action.[177] Shareholder class actions can then act as an insurance policy against legitimate

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171. *Id.*

172. Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 529–30 (2006).

173. *Id.* at 529 (citing Vincent E. O'Brien, *The Class-Action Shakedown Racket*, WALL ST. J., Sep. 10, 1991, at A20).

> The class-action securities-fraud suit has become a feature of doing business for just about every size and type of company in the U.S. Since 1988, the number of these suits filed in federal courts has almost tripled. In the past three years, at least one out of every 14 companies on the Big Board has experienced a securities-fraud suit, most of them alleging concealment or failure to disclose information, and claiming significant monetary damages.

O'Brien, *supra*.

174. O'Brien, *supra* note 173. In all of the cases in the study, the "plaintiffs alleged material misrepresentations and omissions by management regarding the true health . . . of the defendant company." Only three cases were decided by a jury and five were dismissed or withdrawn. All of the others were settled out of court. *Id.*

175. A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta*: The Political Economy of Securities Class Action Reform*, 2007–08 CATO SUPREME CT. REV. 217, 221 (2008).

> [T]he combination of the potential for enormous judgments and the cost of litigating securities class actions means that even weak cases may produce a settlement if they are not dismissed at the complaint stage. The deterrent effect of class actions is thus diluted, because both wrongful and innocent conduct is punished. This possibility of extracting multimillion dollar settlements from strike suits has driven post-*Basic* efforts to rein in securities class actions.

Id. at 227.

176. Karmel, *supra* note 32, at 27; *see also* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d. 261, 266–67 (5th Cir. 2007).

177. *Cf. Oscar Private Equity Invs.*, 487 F.3d. at 261, 267.

losses.[178] As a result of over-deterrence, analysts and other reporters will be discouraged from revealing justifiable positive information in fear that they will be penalized for not disclosing minute negative facts.[179]

V. THE KEY TO PROPER APPLICATION: A HEIGHTENED STANDARD

Before reliance by a class of investors can be presumed in actions against research analysts and other non-issuers for a public misrepresentation or an omission of a material fact, a court must determine in each case whether applying the fraud-on-the-market presumption is appropriate. Applying the *Basic* framework is insufficient to make this determination. *Basic* established that, to trigger the presumption against an issuer, plaintiffs who traded the stock between the time the misrepresentation was made and the truth was revealed must meet a three-prong test, demonstrating that the defendants: (1) "publicly made (2) a material misrepresentation (3) about stock traded on an . . . efficient . . . market."[180] This standard is inadequate in actions against non-issuers because the market is less likely to incorporate misstatements transmitted by non-issuers than those made by issuers.[181] In other words, under the *Basic* framework, no consideration is given to whether the market is efficient to the particular type of information that was misrepresented or omitted, or to whether the information affected the market for the stock.

To avoid this inconsistency, courts should require class-action plaintiffs to make a higher evidentiary showing than that prescribed in *Basic* to invoke the presumption in cases against analysts and other non-issuers.[182] In addition to the *Basic* elements, plaintiffs should also be required to show that (1) the market is efficient with regards to the particular type of information misstated by the defendants, and (2) the misrepresentation caused a material distortion in the stock price. This section will outline why these elements should be applied and the proper analysis courts should undertake when applying them.

A. Rule 23 Requires a Factually Sensitive Inquiry at Class Certification

Courts must determine that the underlying theory of the presumption pertains to the particular facts and circumstances in each case at class certification. As discussed in Part III, some courts presume reliance without first determining whether

178. *See* Dunbar & Heller, *supra* note 172, at 531. If courts applied a heightened standard during class certification, they would signal the market that class-action lawsuits are not an insurance scheme against losses. *Id.*

179. Karmel, *supra* note 32, at 53; Dunbar & Heller, *supra* note 172, at 530.

180. Millowitz v. Citigoup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 481 (2d Cir. 2008); *see* Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988).

181. *See supra* Part III.

182. *See* Karmel, *supra* note 32, at 27 ("[S]tatements are made by an issuer in a document required to be filed with the SEC, but that such a presumption of reliance should not end the inquiry as to whether such reliance was reasonable."); DeMarco v. Lehman Bros., 309 F.R.D. 243, 245–46 (S.D.N.Y. 2004).

application of the presumption is appropriate.[183] At least part of the reason courts are disinclined to conduct such an analysis is a misapprehension that the inquiries into the merits of the case are not appropriate at class certification.[184] However, Congress intended courts to fully assess all factual and legal issues before certifying a class even if courts must rule on the merits.[185] When amending Rule 23 in 2003, the Advisory Committee noted that "'[a] court that is not satisfied that the requirements of Rule 23 have been met should refuse certification until they have been met,' an inquiry which may require 'controlled discovery into the merits, limited to those aspects relevant to making the certification decision on an informed basis.'"[186] Accordingly, the Supreme Court has stated that class certification requires a "rigorous analysis" and that it "involves considerations that are enmeshed in the factual and legal issues comprising the plaintiff's cause of action."[187]

Reliance is required to pursue a claim under Rule 10b-5 because it ensures the causal connection between the defendant's conduct and the plaintiff's injury.[188] As the notes to Rule 23(b)(3) indicate, courts must determine whether a case that has some commonality of law or fact may nonetheless be unsuited to be treated as a class action "if there was material variation . . . in the kinds or degrees of reliance by persons to whom they were addressed."[189] "[T]he substantive test for invoking the fraud-on-the-market presumption is critical to weeding out cases that are ill-suited for class certification."[190] Without a proper assessment of whether the presumption is appropriate, plaintiffs can gain an unfair advantage over defendants and use Rule 10b-5 to establish a scheme of investor's insurance.[191] Thus, a court must make a

183. *See supra* Part III.

184. *See* Caridad v. Metro-North Commuter R.R., 191 F.3d 283, 292 (2d Cir. 1999); Wal-Mart Stores, Inc. v. Visa U.S.A. Inc. (*In re* Visa Check MasterMoney Antitrust Litig.), 280 F.3d 124, 134–35 (2d Cir. 2001); Laurie B. Smilan, *A Basic Truth: Courts Increasingly Require the Rebuttable Fraud-on-the-Market Presumption of Reliance Be Fully Established Before Certification of Securities Class Actions*, *in* Practising Law Inst., Securities Litigation & Enforcement Institute 2008, at 413, 415 (2008).

185. Miles v. Merrill Lynch & Co. (*In re* Initial Pub. Offering Sec. Litig.), 471 F.3d 24, 38 (2d Cir. 2006).

186. Matthew L. Mustokoff, Oscar Private Equity Investments v. Allegiance Telecom, Inc.*: The Fifth Circuit Requires Proof of Loss Causation to Certify Class in Fraud-on-the-Market Case*, Sec. Reg. L.J., Fall 2007, at 3 (quoting Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d. 261, 267 (5th Cir. 2007)).

187. *Miles*, 471 F.3d at 33 (quoting Gen. Tel. Co. of the Sw. v. Falcon, 457 U.S. 147, 160 (1982)) (internal quotation mark omitted).

188. *See* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

189. Fed. R. Civ. P. 23 advisory committee's note.

190. Brian E. Pastuszenski & Inez H. Friedman-Boyce, *Back to Basic—Challenging the Application of the Efficient Market Hypothesis in Federal Securities Lawsuits* (ALI-ABA Course of Study, Apr. 28–29, 2005), WL SK080 ALI-ABA 907,933.

191. *See List*, 340 F.2d at 463; *see also* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d. 261, 265 n.22 (5th Cir. 2007) ("[A]pplying the fraud-on-the-market theory to such complex circumstances by rote would yield a victory of habit over reason."). The advisory committee and the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15

factually sensitive inquiry into the application of the presumption[192] and plaintiffs cannot maintain a class action unless it is determined that it can be invoked.[193]

B. Market Efficiency to the Particular Type of Information

This section discusses the first of two proposed elements that courts should require plaintiffs to satisfy in addition to the *Basic* test to invoke the presumption of reliance. First, plaintiffs must provide evidence that the market is efficient to the particular type of information that they allege the defendants misstated.

Although the Supreme Court required that plaintiffs prove the efficiency of the market in which the *Basic* stock was bought and sold, the Court has never clearly defined the concept of an efficient market.[194] The Court did provide a hint: a market is efficient if it is "open and developed" so that the stock price reflects all publicly available information.[195] Since *Basic*, courts have developed and used a number of factors to determine whether a stock is traded in an efficient market: (1) the average weekly trading volume expressed as a percentage of total outstanding shares; (2) the number of securities analysts following and reporting on the stock; (3) the extent to which market makers and arbitrageurs trade in the stock; (4) the company's eligibility to file SEC Registration Form S-3; (5) the existence of empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price; (6) the company's capitalization; (7) the bid-ask spread for stock sales; and (8) float, the stock's trading volume without insider-owned stock.[196] These measures may be indicative of how closely investors heed the performance or news updates of a company to make trading decisions. But evidence offered to satisfy these factors will not substantiate whether investors give the slightest consideration to analyst research reports and other information that is not communicated by the issuer when they invest.[197] The essence of the fraud-on-

U.S.C.) "recognize that a district court's certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it." *Oscar Private Equity*, 487 F.3d at 267.

192. *See In re* Credit Suisse First Bos. Corp. (Lantronix, Inc.) Analyst Sec. Litig., 250 F.R.D. 137, 143 (S.D.N.Y. 2008).

193. *See Miles*, 471 F.3d at 43; *see also* Smilan, *supra* note 184, at 415.

194. *See Basic*, 485 U.S. 224.

195. *Id.* at 241.

196. *See* Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc., No. 05 Civ. 1898(SAS), 2006 WL 2161887, at *6–7 (S.D.N.Y. Aug. 1, 2006). Factors one through five ("Cammer factors") were established in *Cammer v. Bloom*, 711 F. Supp. 1264, 1286 (D.N.J. 1989). *See* Pastuszenski & Friedman-Boyce, *supra* note 190, at 924.

197. Some have even argued that these factors are "only indirect indicia of market efficiency," and that, "even in cases where each of the Cammer factors is [sic] present, . . . an efficient market may not exist. . . . [T]he Cammer factors measure conditions exhibited in a market for a particular stock that may be consistent with, but do not prove, market efficiency." Pastuszenski & Friedman-Boyce, *supra* note 190, at 925. The number of security analysts following a stock may be an indication that information about a security will more likely be widely dispersed into the public. However, it is not an indication of whether investors will rely on information originally released by analysts. *Id.*

the-market theory is that the way in which the market processes information justifies the investors' reliance.[198] If information is not considered by the investing public, then it is not reflected in the stock price.[199] Thus, even though plaintiffs can present sufficient evidence to meet the above factors, the market may be inefficient with regards to the particular type of information alleged to be misleading.[200] One circuit court recognized that a market may have "information-type inefficiencies":

> [I]t might be that even though the market for the defendant's shares has been demonstrated efficient by the usual indicia, the market is actually inefficient with respect to the particular type of information conveyed by the material misrepresentation. . . . "[T]he market price of a security will not be uniformly efficient as to all types of information."[201]

Consequently, evidence of market efficiency that is limited to the factors listed above may give little to no assurance that the market incorporates the misrepresentation of a non-issuer into the stock price.[202]

The financial arrangements between research analysts and investment banks, brokerage firms, and financial institutions often result in conflicts of interest where analysts are motivated to write optimistic opinions that will generate commissions for their employers.[203] In fact, studies show that nearly all analyst recommendations advise investors to buy.[204] As a result, the public approaches information emanated by analysts with the expectation that the reports will be biased and optimistic.[205] Investors respond to these conflicts by discounting the information, placing it into proper perspective in other ways, or disregarding it when making investment decisions.[206] Thus, these analyst reports do not typically affect the market price.[207]

198. Bowe v. PolyMedica Corp. (*In re* PolyMedica Corp. Sec. Litig.), 432 F.3d 1, 16 (1st Cir. 2005).

199. *See id.* at 8.

200. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d. 261, 269 (5th Cir. 2007).

201. *Id.* (citation omitted) (quoting Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 Stan. L. Rev. 1059, 1083 (1990)).

202. *See Bowe*, 432 F.3d at 18–19 ("If the district court had used the definition of market efficiency that we adopt today, other factors cited by PolyMedica may have also been relevant to the efficiency analysis and may have supported a contrary finding. The district court's error, therefore, was not in analyzing the factors that it did, but in applying an erroneous definition of market efficiency that prevented it from analyzing other arguably relevant evidence.").

203. Fisch, *supra* note 2, at 45–66.

204. *Id.* at 60 (noting that the "SEC reported survey results from 2000 showing that less than 1 percent of all analyst recommendations were sell recommendations").

205. 3 Bloomenthal & Wolff, *supra* note 128, § 13:31 ("There is widespread recognition among the courts that analysts and other securities professionals, if not a large segments [sic] of the public, understand that projections and other forward-looking statements are likely to err on the side of optimism.").

206. *Id.*; Fisch, *supra* note 2, at 66 ("[T]he market appears to respond to investment banking and other conflicts by discounting information that carries the greatest risk of bias. For example, studies have shown a limited market response to buy recommendations issued by investment bank-affiliated analysts, a more significant response to recommendation revisions, and a greater response to downgrades than to upgrades.")

207. John C. Coffee Jr., *Security Analyst Litigation*, N.Y. L.J., Sept. 20, 2001, at 5.

To the extent the market accounts for the optimism of these reports, there has been no reliance on the information under the efficient market theory.[208]

Before applying the presumption in a securities fraud class action against analysts, courts should determine whether the market is efficient with regards to information disseminated by research analysts regarding the security. Specifically, courts should "address and weigh the factors for and against market efficiency."[209] First, courts should examine how the information is disseminated into the public and how investors obtain the information. Professors Ronald Gilson and Reinier Kraakman recognize that the market responds differently to particular kinds of information.[210] They maintain that market efficiency depends upon the availability of the information to traders.[211] Because the different ways information is distributed make information available to varying numbers of investors, Gilson and Kraakman assert that information should be categorized into particular "sets" of information rather than as information in general.[212] "An efficient market response to one information set does not necessarily mean that the market will respond efficiently to a different information set."[213] They assert that the availability of information is a function of how it is disseminated to the market, how many traders are aware of the information, and the cost to traders to obtain the information.[214] The expense of obtaining, verifying, and analyzing information varies from investor to investor.[215] Thus, even though a piece of information is technically placed into the public domain, it may only be absorbed only by a small number of investors.[216]

Studies have shown that many types of information relevant to the economic health of companies appear to be incorporated into the stock price far more slowly and incompletely than suggested by the conventional view of market efficiency.[217] Professor Lynn Stout analogizes the flow of information to the flow of liquid into a vessel.[218] "How full the vessel gets, and how quickly, depends on both the diameter of the channel through which the fluid flows (how widely the information is

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208. *Id.*

209. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 267 (5th Cir. 2007) (quoting Unger v. Amedisys, Inc., 401 F.3d 316, 325 (5th Cir. 2005)) (internal quotation mark omitted).

210. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 555 (1983) (describing "'weak,' 'semi-strong,' and 'strong' forms as a device for classifying empirical tests of price behavior").

211. *Id.* at 554.

212. *Id.* at 558–59.

213. *Id.* at 559.

214. *Id.* at 558.

215. *Id.* at 594–96.

216. Lynn A. Stout, *Revisiting the Mechanisms of Market Efficiency: An Introduction to the New Finance*, 28 J. Corp. L. 635, 652 (2003).

217. *Id.* at 653.

218. *Id.* at 656.

disseminated) and the viscosity of the liquid (how complex, technical, or difficult to understand the information may be)."[219] Information that is easily grasped and distributed into the public may be reflected in the market price quickly.[220] For example, press releases about mergers or stock splits and other issuer information that is easily retrieved from the various channels of information a corporation might regularly use will be reflected in the stock price instantaneously.[221] On the other hand, information that is public but difficult to obtain, hard to understand, or requires expertise to act upon "may take weeks or months to be fully incorporated into prices. . . . [Or it] may never be fully incorporated at all."[222]

By examining how analyst statements are distributed into the public and how the information is obtained by investors, the court can better understand how the market for the particular security responds to the information. If, for example, the class of plaintiffs can demonstrate that information originally released by research analysts is typically widely distributed, the market for the security would more likely be efficient. A showing that the misstatement's particular subject matter is easily understood by investors would also militate toward market efficiency.

Plaintiffs can also provide historical evidence that the stock price reacted consistently after each time information was released by research analysts. A consistent pattern of a particular effect on the price is strong evidence of an efficient market. An examination of stock-price activity subsequent to the release of an analyst's statement may also indicate how long after the release the information incorporation occurred. A study conducted by Professors Saeyoung Chang and David Suk illustrates the feasibility and utility of this analysis.[223] They examined stock price reactions to an article series in the *Wall Street Journal* that reported insider trades of public companies.[224] To examine the efficiency of the market, changes in particular stock prices were measured for a period of time after inside trades were reported.[225] They found significant abnormal stock performance accompanied by a significant increase in trade volume on publication dates.[226] The study revealed that the information was incorporated into the stock price and thus the market was efficient with regards to the information.[227]

Historical price changes to statements that are similar to the alleged misstatement provide stronger evidence of market efficiency than price changes resulting from less

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.*

223. *See id.* at 654 (discussing the Chang-Suk study).

224. Saeyoung Chang & David Y. Suk, *Stock Prices and the Secondary Dissemination of Information: The Wall Street Journal's "Insider Trading Spotlight" Column*, 33 FIN. REV. 115, 116 (1998).

225. *Id.* at 117.

226. *Id.*

227. *See id.* at 122.

related statements.[228] For example, a pattern of price movement to statements previously made by the same analyst is more compelling evidence than a pattern of price changes to statements made by other research analysts. Likewise, information within the same subject matter as the misstatement can provide a stronger indication of market efficiency over unrelated statements.

In sum, courts should determine, as an element in their analysis of whether the fraud-on-the-market presumption should apply, the efficiency of the market for the stock with regards to the particular type of information allegedly misstated by an analyst. Understanding how the information is distributed to the public, obtained by investors, and incorporated into the stock price historically will better equip a court to determine if there was reliance on the misstatement. The analysis will also provide insight on whether price changes that occurred subsequent to the misstatement's release were actually caused by the misstatement.

C. Price Movement

In addition to the *Basic* elements and a finding of the market's efficiency to the particular type of information allegedly misstated, reliance should be presumed only where the analyst report actually moved the market.[229] "Reliance is an indispensable element of any fraud claim because it provides the causal connection between a defendant's misrepresentation and a plaintiff's injury."[230] Under the fraud-on-the-market theory, investors are presumed to rely on the integrity of the *market price*, and not merely on the integrity of the *market*.[231] It can be assumed that a misstatement made by an issuer of securities affected the stock market price because the issuer owes a duty to public investors and is obligated to abide by extensive SEC reporting rules.[232] The strong credibility and wide dissemination of issuer statements increase the likelihood that a misstatement will be incorporated into the price. Moreover, issuers should be held to stringent standards because they represent that their SEC filings and other disclosures to the public are truthful.[233] But where a defendant is a secondary party who, unlike an issuer, owes no general duty to investors, there is no assurance that the price was affected by his misleading communication.[234] Plaintiffs

228. *See* Carol R. Goforth, *The Efficient Capital Market Hypothesis—An Inadequate Justification for the Fraud-on-the-Market Presumption*, 27 Wake Forest L. Rev. 895, 930 (1992).

229. Coffee, *supra* note 207, at 5; *see also* Coffee, *supra* note 159, at 5; Karmel, *supra* note 32, at 47–48.

230. Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 663 (5th Cir. 2004) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988)).

231. *See* Freeman v. Laventhol & Horwath, 915 F.2d 193, 199 (6th Cir. 1990).

232. Karmel, *supra* note 32, at 49.

233. *Id.* at 31.

234. *See id.* at 49.

must allege and prove that the fraud affected the market price to establish a causal connection.[235]

Professor Roberta Karmel asserts that plaintiffs accusing a research analyst of a fraudulent misstatement must provide evidence of an impact on the stock price:

> Where there is no evidence that a research report directly affected the price of a security, not only is there a failure of proof of causation, but it would seem anomalous to employ the fraud-on-the-market doctrine to establish reliance. If research reports do not affect securities prices, the viability of the ECMH would seem to be undermined, and the viability of the fraud-on-the-market presumption would seem to be weakened.[236]

A showing that the alleged misstatement affected the stock price assures that the presumption can be properly applied to establish reliance.

Evidence that the price experienced a material change as a result of the misstatement substantiates that there was a substantial likelihood the information was important to investors.[237] Economists Frederick Dunbar and Dana Heller noted that the stock price directly reflects the change in investors' decisions to trade at a given price.[238] If certain information causes investors to buy or sell stock at a particular price, then the supply-and-demand equilibrium will be disturbed.[239] The price will rise or fall until demand equals supply.[240] Thus, material information causes a material rise or fall in the market price of the stock.[241] If the impact of the misrepresentation on the price was insignificant, then investors did not consider the misstatement important.[242]

Accordingly, several circuit courts have recognized the significance of market price analysis and required plaintiffs to prove the alleged misrepresentation materially moved the market to trigger the fraud-on-the-market presumption.[243] The Third

235. DeMarco v. Lehman Bros., 309 F.R.D. 243, 247 (S.D.N.Y. 2004). "[T]he plaintiff must adduce admissible evidence that . . . makes a prima facie showing that analyst's statements alleged to be false or fraudulent materially and measurably impacted the market price of the security to which the statements relate." *Id.*

236. Karmel, *supra* note 32, at 46–47.

237. *See In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997).

238. Dunbar & Heller, *supra* note 172, at 468.

239. *Id.*

240. *Id.*

241. *Id.*

242. *Id.*

243. *See, e.g.*, Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d. 261, 265 (5th Cir. 2007); Ray v. Citigroup Global Mkts., Inc., 482 F.3d 991, 995 (7th Cir. 2007) ("Under [the fraud-on-the-market theory], plaintiffs must show both that the defendants' alleged misrepresentation artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception."); Bowe v. PolyMedica Corp. (*In re* PolyMedica Corp. Sec. Litig.), 432 F.3d 1, 18 (1st Cir. 2005) (stating that the district court properly included the factor of information effect on stock market prices in its analysis of market efficiency); *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997).

Circuit mandates evidence of an adverse impact on the stock price for a plaintiff to meet the materiality element of the misstatement. In *In re Burlington Coat Factory Securities Litigation*, the court held that, because the market for the stock was efficient and the misstatement had no effect on the stock price, the information was immaterial as a matter of the law.[244] Information is material if it would be important to a reasonable investor in making a decision to invest in the stock.[245] The court reasoned that "[i]n the context of an 'efficient' market, the concept of materiality translates into information that alters the price of the firm's stock."[246] In an efficient market, information that is important to investors is incorporated into the stock price.[247] In contrast, information that is regarded as unimportant will have no effect, or a negligible effect, on the price.[248]

In support of this position, the Fifth Circuit stated that, even if a misstatement was objectively material to an investor, there must be a showing that the culpable information was priced.[249] Recognizing "the *in terrorem* power of certification," the Fifth Circuit requires plaintiffs to prove that the alleged misstatement actually moved the market to invoke the presumption of reliance.[250] The court provided two reasons why it cannot be assumed that every objectively material misrepresentation will move a stock.[251] First, the market may be inefficient to the particular type of information and information-type inefficient, as described in Part V.B.[252] Second, a misrepresentation may fail to move the market because the market was strong-form efficient with respect to that type of information.[253] In other words, the misstatement was reflected by the stock price long before the corrective disclosure because of insider trading and other market forces.[254]

Before its decision in *Millowitz*, even the Second Circuit noted the importance of evidence of price movement in determining whether the fraud-on-the-market presumption should apply. In *Hevesi*, investors of WorldCom alleged the defendant analysts' research reports were "relentlessly positive, but materially false" and written to support their investment banking business with the company.[255] The Second

244. 114 F.3d at 1425.

245. *Id.* at 1425–26.

246. *Id.* at 1425.

247. *Id.*

248. *Id.*

249. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 265 (5th Cir. 2007).

250. *Id.* at 265, 267.

251. *Id.* at 269.

252. *Id.*

253. *Id.* Strong form efficiency is a form of the Efficient Capital Market Hypothesis that holds that current security prices fully reflect all currently existing information, including information that is not public. Jeffrey J. Haas et al., Corporate Finance and Governance 262 (2006).

254. *Oscar*, 487 F.3d at 269.

255. Hevesi v. Citigroup Inc., 366 F.3d 70, 74 (2d Cir. 2004).

Circuit cited Professor John C. Coffee Jr.'s argument that "[o]nly in a case where the publication of the [analyst] report clearly moved the market in a measurable fashion would the 'fraud-on-the-market' doctrine seem fairly applicable."[256]

The decision in *In re Credit Suisse First Boston Corp. (Lantronix, Inc.) Analyst Securities Litigation* is an example of how the analysis on price movement can be conducted to determine whether application of the fraud-on-the-market presumption is appropriate.[257] There, investors alleged the analyst issued research reports to support a promise to the company in exchange for underwriting business.[258] The analyst failed to fully disclose the fact that the initial public offering had "fallen flat."[259] Instead, he recommended the stock despite knowledge of internal memoranda that warned the positive rating was unwarranted.[260] The defendants argued the reliance presumption should not be extended to analyst reports without proof of some link between the alleged misstatement and the security price.[261] They noted they were not aware of any decision certifying a class action where the court did not consider any expert evidence of market movement.[262] The court agreed with the defendants and determined that, because analyst statements differ from those of issuers, investors must show the alleged misstatements affected the market to trigger the presumption.[263]

The district court examined the evidence of price impact immediately after the alleged misleading research reports were issued, during the middle of the class period, and toward the end of the class period.[264] The court considered public documents, external general expertise by well-known professionals, and extensive expert testimony and reports from the plaintiffs and defendants.[265] The evidence focused on the movement of the price and accounted for other public information about the stock in the market.[266] The court found that there were no statistically significant abnormal returns following the issuance of the research reports.[267] It also

256. *Id.* at 79 n.7 (quoting Coffee, *supra* note 207, at 5) (alteration in original) (internal quotation marks omitted). As noted in footnote 166, *supra*, the Second Circuit Court of Appeals in *Hevesi* never opined on what evidentiary standard the plaintiffs must satisfy to invoke the presumption because the parties settled the suit.

257. 250 F.R.D. 137, 141 (S.D.N.Y. 2008).

258. *Id.* at 138.

259. *Id.* at 139 (quoting Complaint for Petitioner at 30, *In re* Credit Suisse First Bos. Corp. (Lantronix, Inc.) Analyst Sec. Litig., 250 F.R.D. 137 (S.D.N.Y. 2008) (No. 03 Civ. 2467 (LAP)).

260. *Id.* at 138.

261. *Id.* at 141.

262. *Id.* at 142.

263. *Id.*

264. *Id.* at 143–49.

265. *Id.* at 142, 144, 145.

266. *See id.*

267. *Id.* at 143.

noted that it was the intervening information about the stock released into the market during the two-year class period that caused the stock to drop.[268] Therefore, the plaintiffs failed to meet their burden to invoke the reliance presumption and to demonstrate that each element of Rule 23 was satisfied.[269]

To summarize, placing the burden on the plaintiff to prove the misrepresentation impacted the market ensures the presumption is properly and fairly applied in class actions against non-issuers.[270] Disclosures made by publicly held companies are likely to be widely disseminated and highly regarded. Investors know that the information comes from a source with the best access to information about a stock, that the issuer owes a duty to investors, and that the issuer must fulfill SEC reporting and disclosure requirements. It is unlikely that information transmitted into the public by analysts and other parties will be absorbed by the market in the same way. Evidence that the alleged misstatement caused an impact on the stock price closes this gap. Without it, there is no assurance that the misstatement was incorporated into the market price and was causally connected to the loss investors allege they suffered.

D. The Burden on Plaintiffs and Other Avenues of Redress

The burden on plaintiffs to meet the proposed heightened standard is not a heavy one. Plaintiffs would need little discovery from defendants because it largely involves an empirical judgment and requires proof drawn from public data and public filings.[271] Moreover, plaintiffs must provide extensive expert analysis of the effect of the information in proceedings to establish damages later at trial.[272] Class-action plaintiffs anticipate these demands and are prepared to meet them before they proceed to file a claim.

Studies by experts have become an indispensible element of securities fraud claims. Expert testimony is common in the support and opposition of class certification.[273] A heightened standard that demands greater reliance on expert studies and empirical evidence assures that judges do not rubber-stamp class certifications. The decision on whether the presumption should apply would more likely be based upon a factual analysis and the opinions of experts who are better equipped to understand financial markets.[274]

268. *See id.* at 145.

269. *Id.* at 149.

270. *See id.*

271. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d. 261, 269 (5th Cir. 2007). *See generally* Michael J. Kaufman, Expert Witnesses: Securities Cases § 2:16 (2010) (explaining that event studies are necessary to determine whether there was market efficiency and material price movement).

272. *See, e.g.*, *Oscar*, 487 F.3d at 271.

273. Fener v. Operating Eng'rs Constr. Indus. & Misc. Pension Fund, 579 F.3d 401, 405–06, 408–09 (5th Cir. 2009) (discussing competing expert testimony in an appeal to a decision denying class certification in a securities litigation); McLaughlin, *supra* note 27, § 3:13.

274. This approach at least partially addresses Justice White's concerns expressed in his dissent in *Basic Inc. v. Levinson*, 485 U.S. 224, 250 (1988) (White, J., concurring in part and dissenting in part). Justice

Where class-action plaintiffs are unable to make a sufficient showing to invoke the presumption, they are not entitled to damages because there is no reliance on the misrepresentation. This, however, does not mean that analysts and other non-issuers should not be held responsible for culpable or reckless behavior. There are other mechanisms to hold them accountable and to deter others from engaging in fraudulent acts.[275] Plaintiffs are free to engage in a direct civil action against an analyst where they can show they actually relied on the alleged misleading analyst report. Additionally, the SEC plays a large role in deterring fraud and punishing culpable actors.[276] Research analysts can face charges for misrepresentations made with scienter without any showing of reliance.[277] Analysts may face sanctions for failing to comply with regulatory standards requiring disclosure of any potential conflicts of interest.[278] There are also disciplinary proceedings that can be filed against analysts associated with broker-dealers and SEC enforcement actions against investment banks as aiders and abettors.[279] Increased dependence on government action to punish wrongdoing by research analysts and other parties when reliance is difficult to prove may solve the problems resulting from a high level of civil liability.[280]

VI. CONCLUSION

The fraud-on-the-market presumption was created as a device to promote considerations of fairness, public policy, probability, and judicial economy. [281] To ensure that the presumption continues to be used for these purposes, courts must tread carefully in determining whether it is appropriate to extend the presumption to circumstances different from those under which it was created. The *Basic* framework was created so that a class of investors seeking to recover losses resulting from public misrepresentations made by the issuer of their stock could satisfy the requirements pursuant to Rule 23 and proceed in a class action. Issuers must satisfy SEC reporting

White warned against the confusion, contradiction, and the adverse, unintended effects that would result from application of the fraud-on-the-market theory. *Id.* at 251, 252. He argued that "with no staff economists, no experts schooled in the 'efficient-capital-market-hypothesis,' [and] no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory." *Id.* at 253. He asserted that courts are "ill suited" and "even less equipped" to control the application of the fraud-on-the-market theory. *Id.* at 263.

275. *See* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlantic, Inc., 552 U.S. 148, 166 (2008).

276. *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457, 462–63 (2d Cir. 1965) (discussing reliance on disclosure and nondisclosure from an insider and proceedings available to the SEC for insider misconduct).

277. *See, e.g.*, SEC v. Johnson, No. 03 Civ. 177, 2006 WL 238998 (S.D.N.Y. Jan. 31, 2006).

278. 5 Hazen, *supra* note 128, § 14.16.

279. Karmel, *supra* note 32, at 53.

280. Recent reports show that U.S. capital markets have become less competitive than those overseas, in part due to litigation levels. *Id.* at 27. In these circumstances, the national economic interest may outweigh the economic interest of a subset of investors who were in the best position to prevent the losses they claimed they incurred. *Id.*

281. *Id.*; Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988); *see* Millowitz v. Citigroup Global Mkts., Inc. (*In re* Salomon Analyst Metromedia Litig.), 544 F.3d 474, 483 (2d Cir. 2008).

and disclosure requirements and abide by their general duty to their shareholders to be truthful in their representations. Information published by research analysts and other secondary parties, who are not under these obligations, is qualitatively and inherently different from statements made by issuers. Recommendations and other statements of opinion made by analysts are subjective, uncertain, and likely to dissipate into the abyss of information, which includes opinions offered by many other analysts. Moreover, the market has little or no response to recommendations made by analysts who have conflicts of interest because investors discount the information by the risk of bias. Thus, if the *Basic* framework were extended to actions against analysts, investors could invoke the presumption of reliance even though the alleged misleading recommendation has little or no effect on the market. Presuming reliance on a misstatement that had no influence on the market price would be inconsistent with the fraud-on-the-market theory because the information was not incorporated into the stock price or the information was not actually material to investors.

A standard that is higher than the test established in *Basic* is necessary to ensure that application of the presumption is consistent with the fraud-on-the-market theory. Courts should require plaintiffs to present sufficient evidence that an alleged misstatement made by an analyst or other non-issuer defendant was incorporated into the stock price before properly applying the presumption. Evidence that (1) the market was efficient to the particular type of information alleged to be misrepresented, and (2) the misstatement had an impact on the stock price, in addition to meeting the *Basic* elements, would assure that the fraud-on-the-market presumption can be properly applied to claims against non-issuers.

The first additional prong assures that the market for the stock absorbed and incorporated the particular type of information that is alleged to have been misleading. It calls for an examination of how the misstatement and other similar information are disseminated into the public and how investors obtain the information. The second additional requirement provides assurance that reliance is presumed only when the alleged misstatement actually moved the market price. Only when the misleading information influenced the price is there assurance that the misstatement caused the loss investors alleged they suffered. To meet the proposed heightened standard, the burden on the plaintiffs is not heavy because it largely involves empirical evidence that plaintiffs would already need to establish damages at the trial.

Failure to adopt a heightened standard and properly apply the reliance presumption has significant consequences because it affects the determination of who can seek a remedy.[282] The failure to adopt a standard higher than the *Basic* test gives investors greater leverage to recover from analysts and other non-issuers. Every investor who acquired stock during the period the alleged misleading recommendation or misstatement was made until the truth was publicly exposed has a cause of action. To defendants, the issuance of class certification may mean facing expensive litigation

282. Stoneridge Inv. Partners, LLC v. Scientific-Atlantic, Inc., 552 U.S. 148, 165 (2008).

costs and a significantly higher risk of large-scale liability.[283] Class certification can place substantial pressure on defendants to settle plaintiffs' claims that have little likelihood of success and pay for plaintiffs' losses that were not caused by the defendants' alleged misstatement.[284] The effects of the broad expansion of *Basic* are increased litigation, over-deterrence, and reluctance by analysts to reveal justifiable positive information. In the end, those effects mean that the fraud-on-the-market presumption will no longer be a useful device to promote considerations of fairness, public policy, probability, and judicial economy, as it was originally intended.[285]

283. Sawicki & Reed, *supra* note 167, § 1:8 (citing Fed. R. Civ. P. 23(f) advisory committee's note). "An order granting certification, on the other hand, may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability." Fed. R. Civ. P. 23(f) advisory committee's note.

284. *Id.*

285. Basic Inc. v. Levinson, 485 U.S. 224, 217 (1988).