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CLASS CERTIFICATION IN SECURITIES FRAUD ACTIONS: A VIEW FROM THE SECOND CIRCUIT

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INTRODUCTION

It has been said that "consensus holds that allegations of securities fraud are particularly suitable for class action treatment" under Federal Rule of Civil Procedure 23. Kermit Roosevelt III, *Defeating Class Certification in Sec. Fraud Actions,* 22 REV. LITIG. 405, 406 (2003), *accord, Biben v. Card,* 1986 WL 1199, at *12 (W.D. Mo. 1986) ("Securities fraud cases are uniquely suited to class action treatment.") (citation and quotations omitted). Nevertheless, there are various issues that arise at the class certification stage in federal securities fraud litigation that must be resolved through rigorous analysis before the matter may proceed on a class basis. This article presents a current overview of many of those issues, primarily from the perspective of courts within the Second Circuit.

I. THE SECOND CIRCUIT FRAMEWORK FOR ASSESSING THE REQUIREMENTS OF RULE 23

A. Rule 23 Requirements Generally

In determining whether class certification is appropriate under Rule 23, a district court must first ascertain whether the proposed class representative meets the preconditions of Rule 23(a) – numerosity, commonality, typicality, and adequacy – and whether the proposed class action is maintainable by satisfying one of the subsections of Rule 23(b). In the context of securities fraud class actions, the relevant subsection is 23(b)(3), which requires that "[t]he 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 fair[ly] and efficient[ly] adjudicat[ing] of the controversy." Fed.R.Civ.P. 23(b)(3) (2009). If the district court determines that the claim meets these requirements of 23(a) and 23(b), it may grant class certification.

B. Burden of Proof

The party moving for class certification bears the burden of demonstrating that each of the Rule 23 prerequisites is met. *See, e.g., Newman v. RCN Telecom Servs., Inc.,* 238 F.R.D. 57, 72 (S.D.N.Y. 2006) ("In order to pass muster, plaintiffs–who have the burden of proof at class certification–must make 'some showing' [that the class comports with Rule 23]. That showing may take the form of, for example, expert

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opinions, evidence (by document, affidavit, live testimony, or otherwise), or the uncontested allegations of the complaint.") (citations omitted). Moreover, the district court must find that the Rule 23 requirements are met by a "preponderance of the evidence." *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.,* 546 F.3d 196, 202 (2d Cir. 2008), *accord, In re Dynex Capital, Inc. Sec. Litig.*, No. 05 Civ. 1897(HB), 2011 WL 781215, at *1 (S.D.N.Y. March 7, 2011).

C. Standard of Determination

Rule 23 is given liberal rather than restrictive construction, and "courts are to adopt a standard of flexibility." *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. 298, 304 (S.D.N.Y. 2010) (granting motion for class certification); *see also, Gary Plastic Packaging Corp. v. Merrill Lynch,* 903 F.2d 176, 179 (2d Cir. 1990), *cert. denied,* 902 F.2d 176 (2d Cir. 1991) ("In light of the importance of the class action device in securities fraud suits, [Rule 23] these factors are to be construed liberally.") (citations omitted). That said, "[t]he class-action device was designed as an exception to the usual rule that litigation is conducted by and on behalf of the individual named parties only." *Gen. Tel. Co. of Sw. v. Falcon,* 457 U.S. 147, 155 (1982) (internal quotations omitted), *accord, In re Visa Check/Mastermoney* Antitrust Litig., 192 F.R.D. 68, 78 (E.D.N.Y. 2000), *aff'd,* 280 F.3d 124 (2d Cir. 2001). Therefore, [a]pproving a party to represent (and, upon final judgment, bind) absent class members ought not be taken lightly. Nor should subjecting defendants to the enhanced potential liability that comes with a certified class." *In re Countrywide Fin. Corp. Sec. Litig.,* 273 F.R.D. 586, 595 (C.D. Cal. 2009).

The Second Circuit has summarized its standard of determination for class certification as follows:

> (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; [and] (4) in making such determination, a district judge should not assess any aspect of the merits unrelated to a Rule 23 requirement.

In re Initial Pub. Offering (IPO) Sec. Litig., 471 F.3d 24, 41 (2d Cir. 2006). Thus, rather than accepting "some showing" by the plaintiffs that the claim satisfies the requirements of Rule 23, the district court must make a clear "ruling" or "determination" that each requirement is met before granting class certification even if there is an overlap with an issue on the merits. *Id.* at 40, *accord, Lapin v. Goldman Sachs & Co.,* 254 F.R.D. 168, 174 (S.D.N.Y. 2008). Notably, "the district judge *must* receive enough evidence, by affidavits, documents, or testimony, to be satisfied that each Rule 23 requirement has been met." *In re IPO Sec. Litig.,* 471 F.3d at 41 (emphasis added). In this regard, a district judge must assess all relevant evidence, including expert testimony, to make this determination, "just as the judge would resolve a dispute about any other threshold prerequisite for continuing a lawsuit." *Id., accord, In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. at 307; *Fogarazzo v. Lehman Bros., Inc.,* 263 F.R.D. 90, 98 (S.D.N.Y. 2009).[1]

Although expert testimony is not explicitly required to support a motion for class certification, Plaintiffs will likely have to produce an expert who can demonstrate that injury can be proven on a classwide basis with common proof. Indeed, plaintiffs and defendants routinely present expert testimony at the class certification phase, and failure to do so can have severe consequences. For example, the Eighth Circuit affirmed an order denying class certification for lack of expert evidence presented by plaintiff, holding, "a court may be required to resolve disputes concerning the factual setting of the case. This extends to the resolution of expert disputes concerning the import of evidence concerning the factual setting – such as

economic evidence as to business operations or market transactions." *Blades v. Monsanto Co.,* 400 F.3d 562, 575 (8th Cir. 2005). This inquiry should be limited to whether, "if [plaintiff's] basic allegations were true, common evidence could suffice, given the factual setting of the case, to show classwide injury." Id.[2]

II. RULE 23(A) REQUIREMENTS

To be certified, a putative class must initially meet all four prerequisites set forth in Rule 23(a), commonly referred to as numerosity, commonality, typicality, and adequacy. *In re Salomon Analyst Metromedia Litig. v. Citigroup Global Mkts., Inc.,* 544 F.3d 474, 478 (2d Cir. 2008).

A. Numerosity

First, the proposed class must be so numerous that the joinder of all members is impractical. Fed.R.Civ.P. 23(a)(1). However, joinder need not be impossible. "[J]oinder may merely be difficult or inconvenient, rendering use of a class action the most efficient method to resolve plaintiffs' claims." *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. at 304; *Fogarazzo,* 263 F.R.D. at 96.

In the context of securities fraud litigation, this requirement is fairly straightforward. "In securities fraud class actions relating to publicly owned and nationally listed corporations, the numerosity requirement may be satisfied by a showing that a large number of shares were outstanding and traded during the relevant period." *In re IMAX Sec. Litig.,* 272 F.R.D. 138, 146 (S.D.N.Y. 2010) (quoting *In re Vivendi Universal, S.A. Sec. Litig.,* 242 F.R.D. 76, 84 (S.D.N.Y. 2007)); *see also, Cheney v. Cyberguard Corp.,* 213 F.R.D. 484, 490 (S.D. Fla. 2003) ("[C]ourts generally assume that the numerosity prong has been met where a class action involves nationally traded securities.") (citation omitted). Moreover, "numerosity is presumed when a class consists of 40 members" or more. *Consol. Rail Corp. v. Town of Hyde Park,* 47 F.3d 473, 483 (2d Cir. 1995).

B. Commonality

Second, there must be questions of law and fact that are common to all class members. Fed.R.Civ.P. 23(a)(2). However, it is not necessary that all class members make identical claims and arguments. As long as "common questions ... predominate, differences among the questions raised by individual members will not defeat commonality." *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. at 304; Fogarazzo, 263 F.R.D. at 96. Commonality often merges with the Rule 23(a)(3) requirement of typicality, discussed below, because "'both serve as guideposts for determining whether . . . the named plaintiff's claim and the class claims are so interrelated that the interests of the class members will be fairly and adequately protected in their absence.'" *In re IMAX Sec. Litig.,* 272 F.R.D. at 146 (quoting *Gen. Tele. Co. of Sw.,* 457 U.S. at 158 n. 13).

Like numerosity, "[t]he commonality requirement has been applied permissively in securities fraud [class] litigation." In *re Initial Public Offering Sec. Litig.,* 227 F.R.D. 65, 87, (S.D.N.Y. 2004), *vacated on other grounds,* 471 F.3d 24 (2d Cir. 2006) (footnotes omitted). "In general, where putative class members have been injured by similar material misrepresentations and omissions, the commonality requirement is satisfied." *Id.* Furthermore, because a party seeking certification for a securities fraud class action must also satisfy the more demanding "predominance" requirement of 23(b)(3); the Supreme Court has stated that the commonality inquiry is essentially "subsumed under" this more stringent predominance inquiry. *Amchem Prod., Inc. v. Windsor,* 521 U.S. 591, 609 (1997). The Second Circuit has followed this holding. See, *e.g., Brown v. Kelly,* 609 F.3d 467, 486 (2d Cir. 2010) ("To the extent that the [defendants] contend that [plaintiff] failed to establish commonality and typicality under Rule 23(a) because individualized questions will arise, we address these arguments *infra* in the context of the predominance requirement of Rule 23(b)(3).") (citation omitted).

C. Typicality

The third requirement under Rule 23(a) is that the claims or defenses of the representative parties must be typical of the claims or defenses of the class. Fed.R.Civ.P. 23(a)(3). Thus "the party seeking certification must show that 'each class member's claim arises from the same course of events and each class member makes similar legal arguments to prove defendant's liability.'" *In re Flag Telecom Holdings, Ltd. Sec. Litig.,* 574 F.3d 29, 35 (2d Cir. 2009) (quoting Robidoux v. Celani, 987 F.2d 931, 936 (2d Cir. 1993)). This burden is "fairly easily met." *DeBoer v. Mellon Mortg. Co.,* 64 F.3d 1171, 1174 (8th Cir. 1995), *accord, Dupler v. Costco Wholesale Corp.,* 249 F.R.D. 29, 40 (E.D.N.Y. 2008).

Nonetheless, a lack of typicality may be found in cases where the named plaintiff "was not harmed by the [conduct] he alleges to have injured the class" or the named plaintiff's claim is subject to "specific factual defenses atypical of the class." *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. at 304-05; *Fogarazzo,* 263 F.R.D. at 96. Indeed, class certification is inappropriate where the unique defenses of a class representative might become "the focus of litigation" and thus threaten the interests of absent class members. *Gary Plastic Packaging Corp.,* 903 F.2d at 180, cert. denied, 903 F.2d 176 (2d Cir. 1991); *see also, Baffa v. Donaldson, Lufkin & Jenrette Sec. Corp.,* 222 F.3d 52, 60 (2d Cir. 2000).

In securities fraud class actions in particular, the possibility of unique defenses is often a problem for the proposed class because the circumstances surrounding the representatives' purchases of securities are often different from those of the other class members. If the timing or motivation behind these purchases is found to be substantially different from the rest of the class, the district court may find the representative claims atypical and deny certification.

1. Unique Defenses Arising from the Circumstances of Plaintiffs' Transactions in the Subject Securities

One example of this is where the representatives of the proposed class are shown to have relied upon an insider or broker or other investment professionals in making their purchases. In *Blank v. Jacobs,* the court denied plaintiffs' motion for class certification because the lead plaintiffs did not rely on statements of the company's auditors in purchasing shares and thus "did not rely on the price of the stock as a reflection of the value of that stock." No. 03-CV-2111 (JS)(MLO), 2009 WL 3233037, at *5 (E.D.N.Y. Sept. 30, 2009). Instead, the lead plaintiffs relied upon either information received from the company that was not otherwise available or their own assessment of the value of the shares. *Id.* Because the proposed lead plaintiffs would be subject to unique defenses that threatened to become the focus of the litigation, the court held that typicality had not been established by a preponderance of the evidence. *Id.* at *6.

In addition, a district court may determine that there is a lack of typicality given the timing of the proposed class representatives' purchases of the securities. If these lead plaintiffs were 'in-and-out' traders who purchased and sold all of their stock before the alleged fraud was first revealed, they may not be able to satisfy the loss causation element of their Section 10(b) claim. Thus, given that the in-and-out traders are subject to unique defenses, the court is likely to determine that their claims as proposed lead plaintiffs are atypical of the class by a preponderance of the evidence. *See, e.g., In re Flag Telecom Holdings, Ltd. Sec. Litig.,* 574 F.3d 29 (2d Cir. 2009) (finding that investors seeking class certification did not meet the typicality requirement of Rule 23(A)(3) because they did not show by a preponderance of the evidence that they were likely to establish loss causation).

Similarly, in *In re IMAX Sec. Litig.*, 272 F.R.D. at 147, the court held that the plaintiff seeking class representative status was subject to unique defenses because it could not establish loss causation and thus was atypical. The complaint sought damages based on a stock price drop following an alleged corrective disclosure regarding an SEC investigation into financial results. *Id.* The plaintiff purchased

stock prior to the close of the company's fourth quarter of 2005 and prior to the announcement of financial results in that quarter. *Id.* However, the August 9, 2006 disclosure at issue was not a corrective disclosure for alleged misstatements because it went "beyond the temporal (4Q 2005 and later) and topical . . . limitations" of the alleged misstatements. *Id.* at 148. Thus, the court explained: "While a disclosure of a government investigation may be sufficient to adequately plead loss causation, . . . a corrective disclosure for the purposes of loss causation should place investors on notice of the type of specific fraudulent accounting practices that Plaintiffs allege. Here, while the disclosure of the SEC investigation specifically addressed IMAX's MEA accounting policy that was applied in 4Q 2005, and disclosed in the Company's 2005 10–K, it did not address, or suggest an investigation into, IMAX's accounting practices in earlier periods." *Id.* at 149 (internal quotations omitted). As a result, the plaintiff could not establish loss causation and thus could not establish typicality for purposes of class certification.

Finally, some courts look to the circumstances of the purchase and sale to determine that the class members are in conflict and thus cannot satisfy typicality. For example, in *In re Seagate Tech. II Sec. Litig.,* 843 F. Supp. 1341 (N.D. Cal. 1994), the court found that there were potential class conflicts between a group of class members who sold a security on a particular day on which the price of the security fell and those who purchased the security on the same day. However, while *Seagate* has been widely cited, courts in the Second Circuit have nearly universally declined to follow its holding or reasoning. *See In re Am. Int'l. Grp., Inc. Sec. Litig.,* 265 F.R.D. 157, 164 (S.D.N.Y. 2010) (citing cases).

2. Unique Defenses Arising from Intra-Class Period Purchases Following "Corrective" Disclosures

While "there is no per se rule to this effect," courts have sometimes found that "a person that increases his holdings in a security after revelation of an alleged fraud involving that security is subject to a unique defense that precludes him from serving as a class representative." *Rocco v. Nam Tai Elec., Inc.,* 245 F.R.D. 131, 136 (S.D.N.Y. 2007) (rejecting as atypical a proposed class representative who had purchased defendant's stock after the public disclosure of some, but not all, of defendant's fraudulent statements and omissions); see also *Gary Plastic Packaging Corp.,* 903 F.2d at 179-80 (holding that there was no abuse of discretion by district court in finding plaintiff was an inappropriate class representative "since its claim is subject to several unique defenses including its continued purchases of CDs through Merrill despite having notice of, and having investigated, the alleged fraud.").

Courts in the Second Circuit, on the other hand, have been more lenient and do not necessarily find that a representative's purchase of shares after a corrective disclosure will create a unique defense that defeats typicality. *See, e.g., In re Monster Worldwide, Inc. Sec. Litig.,* 251 F.R.D. 132, 135 (S.D.N.Y. 2008) ("the fact that a putative class representative purchased additional shares in reliance on the integrity of the market after the disclosure of corrective information has no bearing on whether or not [the representative] relied on the integrity of the market") (quoting *In re Salomon Analyst Metromedia,* 236 F.R.D. 208, 216 (S.D.N.Y. 2006), rev'd on other grounds, 544 F.3d 474 (2d Cir. 2008)).[3]

D. Adequacy

The fourth requirement of Rule 23(a) is that the representative parties demonstrate that they will fairly and adequately protect the interests of the class. Fed.R.Civ.P. 23(a)(4). "Generally, adequacy of representation entails inquiry as to whether: 1) plaintiff's interests are antagonistic to the interest of other members of the class and 2) plaintiff's attorneys are qualified, experienced and able to conduct the litigation." *Baffa,* 222 F.3d at 60. This inquiry extends to both the class representative and the representation by counsel because they are intertwined in the question of whether there is fair and adequate representation of the class. *Id.* The Second Circuit has also held that "to judge the adequacy of representation," courts may look beyond the capacity of the representative plaintiff and "consider the honesty and trustworthiness of the named plaintiff." *Savino v. Computer Credit, Inc.,* 164 F.3d 81,

87 (2d Cir. 1998) (citations omitted); *see also, In re NYSE Specialists Sec. Litig.,* 240 F.R.D. 128, 144 (S.D.N.Y. 2007) ("The Second Circuit has allowed for the consideration of characteristics such as honesty, trustworthiness, and credibility in judging the adequacy of a class representative pursuant to Rule 23(a).") (citations omitted).

1. Knowledge and Capacity of the Class Representatives.

The Second Circuit has found that adequacy is not met "where the class representatives ha[ve] so little knowledge of and involvement in the class action that they would be unable or unwilling to protect the interests of the class against the possibly competing interests of the attorneys." *Maywalt v. Parker & Parsley Petroleum Co.,* 67 F.3d 1072, 1077-78 (2d Cir. 1995) (citations omitted); accord, In re WorldCom, Inc. Sec. Litig., 219 F.R.D. 267, 286 (S.D.N.Y. 2003). That said, the Supreme Court has expressly disapproved of attacking the adequacy of a class representative based on his or her ignorance. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 370-74 (1966). Therefore, the Second Circuit has held that even in the absence of extensive knowledge of the case, proof of the representative's ability and willingness to carry out the responsibilities of representing the class is sufficient to demonstrate adequacy. *Baffa,* 222 F.3d at 61-62.

For example, in *In re Sadia, S.A. Sec. Litig.,* defendants challenged the adequacy of the plaintiffs' corporate designee because he could not answer numerous questions during depositions and demonstrated an "alarming unfamiliarity with the suit." 269 F.R.D. at 310. The court determined that this was insufficient to challenge adequacy under Rule 23(a)(3). *Id.; see also Wagner v. Barrick Gold Corp.,* 251 F.R.D. 112, 118 (S.D.N.Y. 2008) ("[I]n complex actions such as securities actions, [a] plaintiff need not have expert knowledge of all aspects of the case to qualify as class representative."). Similarly, in *New Jersey Carpenters Health Fund v. Residential Capital, LLC,* the defendants failed to successfully challenge adequacy when they argued that the plaintiffs were not educated about the allegation, had not read the pleadings or other case documents, and had little control over the proposed class counsel who made unilateral decisions throughout the litigation. No. 08 CV 8781(HB), 2010 WL 1257528, at *3 (S.D.N.Y. Mar. 31, 2010). The court determined that the plaintiffs' general knowledge of the basic issues and the counsel's over-forty-years experience with securities and other class action litigation were sufficient to demonstrate adequacy of class representation. *Id.* at *4; *In re Monster Worldwide, Inc. Sec. Litig.,* 251 F.R.D. at 135 (finding that the proposed class representative was inadequate because plaintiff had simply lent its name to a suit that was "controlled entirely by the class attorney").

2. Antagonistic Interests Among Class Members.

To satisfy the adequacy requirement, "the class members must not have interests that are 'antagonistic' to one another." *In re Drexel Burnham Lambert Grp., Inc.,* 960 F.2d 285, 291 (2d Cir. 1992) (citations omitted). In practice, this inquiry into potential inter-class antagonism substantially overlaps with the typicality inquiry as outlined above. A case out of the Fifth Circuit is instructive on this point. In *In re Enron Corp. Sec. Litig.,* 206 F.R.D. 427, 455 (S.D. Tex. 2002), the proposed lead plaintiff had purchased Enron stock pursuant to its investment advisor's advice *after* the initial public disclosures regarding Enron's overstatement of its assets and partnership liabilities were issued. These purchases also occurred after the first lawsuits were filed and after the SEC announced it was investigating the company. *Id.* As a result, the court found the lead plaintiff to be inadequate under Rule 23(a)(3) because it had "issues and interests atypical of and antagonistic to those of the rest of the class." *Id.*

In addition to such conflicts, "[a] key element in the determination of whether a plaintiff's interests are antagonistic to those of other members of the class is the relationship between the class representative and class counsel." *In re IMAX Sec. Litig.,* 272 F.R.D. at 141 (citations omitted). In *IMAX,* the long-standing and close business relationship between the proposed lead plaintiff and the class counsel appeared problematic to the court given the financial stake each had in the other. *Id.* at 156. The court appealed to

the reasoning stated in *In re Discovery Zone Sec. Litig.,* 169 F.R.D. 104, 109 (N.D. Ill. 1996) "Even where the named plaintiff does not expect to share directly in the attorneys' fees, his business relationship with counsel may leave him more interested in maximizing the return to his counsel than in aggressively presenting the proposed class' action"(internal quotations omitted). Thus, the *IMAX* court determined the proposed lead plaintiff to be inadequate, particularly in light of the large pool of disinterested investors who could serve as class representative, and it ultimately denied class certification. 272 F.R.D. at 157.

3. Adequacy Under the Private Securities Litigation Reform Act.

The adequacy inquiry in securities fraud litigation must also conform to the heightened standards set forth in the 1995 Private Securities Litigation Reform Act (PSLRA), which governs all civil actions arising under the federal securities laws and brought on behalf of a class. The PSLRA provides that "[t]he most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class." 15 U.S.C. § 77z-1(a)(3)(B)(v) (1998). In short, the lead plaintiff procedures require all plaintiffs who file a putative securities class action to publish notice of the action which, inter alia, informs eligible and interested investors of their right to seek appointment as lead plaintiff in the action. This procedure specifically banned the pre-PSLRA practice of counsel selecting plaintiff. "Giving the Lead Plaintiff primary control for the selection of counsel was a critical part of Congress' effort to transfer control of securities class actions from lawyers to investors." *Schulman v. Lumenis, Ltd.,* No. 02 Civ. 1989 (DAB), 2003 WL 21415287, at *6 (S.D.N.Y. June 18, 2003) (quoting *Gluck v. CellStar Corp.,* 976 F. Supp. 542, 550 (N.D. Tex. 1997)). Courts, however, may decline to approve the lead plaintiff's suggested counsel to "protect the interests of the class." 15 U.S.C. § 77z-1(a)(3)(B)(iii)(II)(aa).

III. IMPLICIT REQUIREMENTS OF RULE 23

In addition to the four enumerated requirements of Rule 23(a), courts in the Second Circuit and elsewhere have found that a class seeking certification must satisfy two other implicit requirements – standing and ascertainability.

A. Standing

Although not stated in Rule 23, the constitutional concept of "standing" requires the named plaintiffs to show that they have a personal interest in the outcome of the litigation. Thus, "any analysis of class certification must begin with the issue of standing. . . . Only after the court determines the issues for which the named plaintiffs have standing should it address the question of whether the named plaintiffs have representative capacity, as defined by Rule 23(a), to assert the rights of others." *Griffin v. Dugger,* 823 F.2d 1476, 1482 (11th Cir. 1987).

1. Standing Under Section 11 of the '33 Act: Where Lead Plaintiffs Are Aftermarket Purchasers.

All purchasers of registered securities have standing to sue under Section 11. Non-purchasers have no standing to sue. *Barnes v. Osofsky,* 373 F.2d 269, 271 (2d Cir. 1967). Thus, it has been long-established that to have standing to assert a Section 11 claim, "plaintiffs must be able to 'trace their shares to an allegedly misleading registration statement.'" In *re Global Crossing, Ltd. Sec. Litig.,* 313 F. Supp. 2d 189, 206 (S.D.N.Y. 2003) (quoting *DeMaria v. Andersen,* 318 F.3d 170, 176 (2d Cir. 2003)); *see also, In re IPO Sec. Litig.,* 227 F.R.D. 65, 117 (S.D.N.Y. 2004), vacated *on other grounds,* 471 F.3d 24, 41 (2d Cir. 2006) (stating that only "[a]ftermarket purchasers who can trace their shares to an allegedly misleading registration statement have standing to sue under §11 of the 1933 Act."). Furthermore, the ability to show standing under Section 11 impacts the typicality requirement under Rule 23(a)(3). As the In *re IPO* court explained, "class representatives are atypical with respect to plaintiffs' section 11 classes [when] they are subject to the unique defense that they cannot trace their shares to an allegedly defective

registration statement" 227 F.R.D. at 96; *see also, In re Quarterdeck Office Sys., Inc. Sec. Litig.,* No. CV 92-3970-DWW(GHKx), 1993 WL 623310, at *3 (C.D. Cal. Sept. 30, 1993) (finding that the "named plaintiffs' lack of standing provides adequate grounds for denying certification since it indicates that their claims are atypical"). Therefore, demonstrating traceability is an important requirement for lead plaintiffs seeking class certification under Section 11.

A Section 11 plaintiff bears the burden of proving that her securities are traceable. *See In re Global Crossing,* 313 F. Supp. 2d at 207. The plaintiff may successfully trace her shares "if she demonstrates that her stock was actually issued pursuant to a defective registration statement." *In re IPO Sec. Litig.,* 227 F.R.D. at 117 (quotations and alterations omitted). But the plaintiff's evidence must be fairly direct: "[t]racing may be established either through proof of a direct chain of title from the original offering to the ultimate owner (*e.g.,* if the owner was an allocant in the IPO, or took actual physical possession of share certificates directly from an allocant), or through proof that the owner bought her shares in a market containing only shares issued pursuant to the allegedly defective registration statement." *Id.* at 117-18. Thus, bare assertions or hypothetical tracing is insufficient. Courts apply this requirement strictly, "even where its application draws arbitrary distinctions between plaintiffs based on the remote genesis of their shares." *Id.* at 117.[4]

The requirement can be insurmountable for some plaintiffs. As some courts have noted, it is "virtually impossible to trace shares to a registration statement once additional unregistered shares have entered the market." *In re IPO Sec. Litig.,* 227 F.R.D. at 117-18. Yet plaintiffs are not entitled to a presumption of traceability, "[e]ven where the open market is predominantly or overwhelmingly composed of registered shares." *Id.* Moreover, the actual tracing of each plaintiff's stock has been found to be a necessarily individualized inquiry that could disqualify a class under the Rule 23(b) predominance requirement. *See id.* at 118 ("insofar as each class member must individually prove that her shares were issued pursuant to the relevant registration statement, the necessity of trying individual issues should disqualify the class").[5]

2. Standing Under Section 12 of the '33 Act.

Unlike Section 11 claims, standing to sue under Section 12 is limited to those "persons who have directly purchased the securities from the underwriting defendants in the subject public offering(s), and not in the secondary market." *Pub. Emps.' Ret. Sys. of Mississippi v. Merrill Lynch & Co.,* 714 F. Supp. 2d 475, 484 (S.D.N.Y. 2010) (citing *Gustafson v. Alloyd Co.,* 513 U.S. 561, 578 (1995)); *see also, Caiafa v. Sea Containers Ltd.,* 525 F. Supp. 2d 398, 407 (S.D.N.Y. 2007) ("[B]ecause the plaintiffs fail to allege that they purchased the securities in a public offering, as opposed to in the aftermarket, their Section 12(a)(2) claim [is] dismissed.") (internal quotations omitted). Therefore, if plaintiffs demonstrate that they purchased shares directly in the initial public offering, they have standing to sue under Section 12 and do not need to "trace" their purchases as they would for a Section 11 claim. *In re Am. Bank Note Holographics, Inc. Sec. Litig.,* 93 F. Supp. 2d 424, 436 (S.D.N.Y. 2000).

3. Standing Under Section 10(b) of the '34 Act.

While the language of Section 10(b) and Rule 10b-5 does not specifically provide for a private right of action, the Supreme Court has long recognized the implicit creation of such a right in light of Congress' intent to supplement Commission action of the Commission with private enforcement. *J. I. Case Co. v. Borak,* 377 U.S. 426, 432 (1964). However, the Second Circuit placed limits on this private right of action under Rule 10b-5 by limiting the class of plaintiffs who could make use of it. In *Birnbaum v. Newport Steel Corp.,* the court held that because Rule 10b-5 "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities," a plaintiff must be a purchaser or seller of securities to have standing. 193 F.2d 461, 464 (2d Cir. 1952). This "purchaser or seller" requirement was later confirmed by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores,*

421 U.S. 723, 754-55 (holding that individuals who failed to purchase a stock due to misrepresentation of its value did not have standing to sue because they were not purchasers or sellers of the security). The Second Circuit has thus continued to apply this restrictive "purchaser or seller" requirement for standing to sue under Rule 10b-5 that it set in *Birnbaum. See, e.g., Ontario Pub. Servs. Emps. Union Pension Trust Fund v. Nortel Networks Corp., 369 F.3d* 27, 34 (2d Cir. 2004); *In re NYSE Specialists Sec. Litig.,* 503 F.3d 89, 102 (2d Cir. 2007).

4. Standing Where Lead Plaintiff Did Not Purchase All Securities At Issue.

While federal courts do not require that each member of a class submit evidence of personal standing, "a class cannot be certified if it contains members who lack standing." *Denney v. Deutsche Bank* AG, 443 F.3d 253, 263-64 (2d Cir. 2006). However, while a lead plaintiff must have standing to sue on at least some of the claims at issue, "it would be premature to defeat class certification on the basis that some Plaintiff did not purchase every single security forming the basis of the claims." *In re Dynex Capital, Inc. Sec. Litig.,* No. 05 CIV. 1897(HB), 2009 WL 3380621, at *3 (S.D.N.Y. Oct. 19, 2009); *see also Hevesi v. Citigroup, Inc.,* 366 F.3d 70, 82 (2d Cir. 2004) ("[I]t is inevitable that, in some cases, the lead plaintiff will not have standing to sue on every claim.") (citation omitted).

Second Circuit case law is somewhat conflicting regarding whether a court may certify a class of purchasers of a security or fund that was not also purchased by the lead plaintiffs. This issue has been addressed as one of standing, not whether Rule 23 requirements have been met. *See In re Am. Int'l. Grp., Inc. Sec. Litig.,* 265 F.R.D. at 164. Thus, a class action plaintiff does not have standing to bring claims on behalf of purchasers of different securities where those claims are based on different factual allegations and legal theories. *Id.* (citing cases). For example, where purported class representatives bought only ordinary shares as opposed to debt, they were found to lack standing to bring claims on behalf of class members who purchased debt, despite allegations that the same general course of conduct allegedly engaged in by the defendants caused injury to all putative class members. *In re Parmalat Sec. Litig.,* No. 04 MD 1653(LAK), 2008 WL 3895539, at *3 (S.D.N.Y. Aug. 21, 2008).

Similarly, in *In re Am. Int'l Grp., Inc. Sec. Litig.,* because the lead plaintiffs' Section 10(b) and Rule 10b-5 claims related to AIG stock were based upon different legal theories and would require proof of different facts than their Section 11 claims related to AIG bonds, the lead plaintiffs did not have standing to bring the Section 11 bond claims of the proposed class by virtue of their Section 10(b) and Rule 10b-5 claims. 265 F.R.D. at 165.

B. Ascertainability

Courts in the Second Circuit have recognized additional implicit requirements under Rule 23(a) – that the proposed class be precise, objective, and presently ascertainable by the court. *Bakalar v. Vavra,* 237 F.R.D. 59, 64 (S.D.N.Y. 2006). Thus, "the requirement that there be a class will not be deemed satisfied unless the class description is sufficiently definite so that it is administratively feasible for the court to determine whether a particular individual is a member." *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. 298, 305 (S.D.N.Y. 2010); Fogarazzo 263 F.R.D. at 97. The class must be ascertainable "by reference to objective criteria," *In re Sadia,* 269 F.R.D. at 305, without requiring the court to engage "in numerous fact-intensive inquiries." *Bakalar,* 237 F.R.D. at 64; *Fears v. Wilhelmina Model Agency, Inc.,* 02 CIV. 4911 HB, 2003 WL 21659373, at *2 (S.D.N.Y. July 15, 2003).

IV. RULE 23(B) REQUIREMENTS

After showing that the proposed class satisfies the prerequisites of Rule 23(a), plaintiffs must further show that the class is "maintainable" under Rule 23(b). *In re Salomon Analyst Metromedia Litig. v. Citigroup Global Mkts.,* 544 F.3d 474, 478 (2d Cir. 2008). For securities fraud class actions, once the district court determines that the requirements of Rule 23(a) are satisfied, it "may then consider

granting class certification where it ‘finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.’” *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.,* 546 F.3d 196, 202 (2d Cir. 2008) (quoting Fed.R.Civ.P. 23(b)(3)). Therefore, the two principal inquiries when determining class certification under 23(b)(3) are superiority and predominance.

A. Superiority

When seeking class certification under Rule 23(b)(3), plaintiffs must demonstrate that a class action is superior to individual litigation or other available methods for fair and efficient adjudication of the controversy. F.R.Civ.P. 23(b)(3). This ensures that Rule 23(b)(3) “encompasses those cases in which a class action would achieve economies of time, effort, and expense, and promote uniformity of decision as to persons similarly situated, without sacrificing procedural fairness or bringing about other undesirable results.” *In re Nassau Cnty. Strip Search Cases,* 461 F.3d 219, 225 (2d Cir. 2006) (quoting Fed.R.Civ.P. 23(b)(3) adv. comm. n. to 1966 amend.). There are four non-exhaustive factors that are relevant to this inquiry: “(A) the interests 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; and (D) the difficulties likely to be encountered in management of a class action.” F.R.Civ.P. 23(b)(3)(A)-(D). Courts find the fourth factor, manageability, to be the most relevant. In the Second Circuit, for example, manageability concerns are often addressed by creating subclasses to divide the issues and keep arguments focused. *See, e.g., In re Cendant Corp. Litig.,* 264 F.3d 201, 244 n. 25 (3d Cir. 2001) (encouraging district courts to consider sub-classing and noting that it is “not inconsistent” with the PSLRA to create subclasses).

B. Predominance

The predominance requirement “tests whether proposed classes are sufficiently cohesive to warrant adjudication by representation,” and is “far more demanding” than the commonality requirement under Rule 23(a). *Moore v. PaineWebber, Inc.,* 306 F.3d 1247, 1252 (2d Cir. 2002) (quoting *Amchem Prods., Inc. v. Windsor,* 521 U.S. 591, 623-24 (1997)). The predominance requirement is met “if the plaintiff can establish that the issues in the class action that are subject to generalized proof, and thus are applicable to the class as a whole, ... predominate over those issues that are subject only to individualized proof.” *Cordes & Co. Fin. Serv., Inc. v. A.G. Edwards & Sons, Inc.,* 502 F.3d 91, 108-09 (2d Cir. 2007). (Internal quotations omitted). The predominance requirement is defeated where common questions of knowledge do not predominate over individual questions. For example, in *IPO,* “[t]he claim that lack of knowledge [was] common to the class [was] thoroughly undermined by the plaintiffs own allegations as to [] widespread [] knowledge of the alleged scheme.” *In re IPO Sec. Litig.,* 471 F.3d 24, 43 (2d Cir. 2006).

Whether securities fraud class actions can satisfy the predominance requirement for certification often involves a complex inquiry into the substance of the claims themselves. As the Supreme Court recently noted, “[c]onsidering whether ‘questions of law or fact common to class members predominate’ begins, of course, with the elements of the underlying cause of action.” *Erica P. John Fund, Inc. v. Halliburton Co.,* 131 S.Ct. 2179, 2181 (2011). Therefore, before analyzing the predominance inquiry in securities fraud litigation in depth, it is necessary first to outline the elements of the substantive claims at issue.

1. Liability Under the Securities Act of 1933.

Section 11 of the Securities Act imposes liability on issuers and other signatories of a registration statement that, upon becoming effective, “contain [s] an untrue statement of a material fact or omit[s]

to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). "So long as a plaintiff establishes one of the three bases for liability under these provisions -- (1) a material misrepresentation; (2) a material omission in contravention of an affirmative legal disclosure obligation; or (3) a material omission of information that is necessary to prevent existing disclosures from being misleading," the issuer's liability is absolute. *Litwin v. Blackstone Grp., L.P.,* 634 F.3d 706, 715-716 (2d Cir. 2011) (quoting *In re Initial Pub. Offering ("IPO") Sec. Litig.,* 483 F.3d 70, 73 n. 1 (2d Cir. 2007)). Thus, a prima facie case under Section 11 is straightforward, requiring only a showing of a material misrepresentation or omission from a defendant's registration statement. *Herman & MacLean v. Huddleston,* 459 U.S. 375, 381-82 (1983). However, it is important to note that strict liability only extends to statutorily enumerated parties: (1) signatories of the registration statement; (2) directors or partners of the issuer at the time of filing; (3) persons consenting to be named as about to become a director or partner; (4) accountants or other experts consenting to be named as preparing or certifying part of the registration statement; and (5) underwriters of the security at issue. *See* 15 U.S.C. § 77k(a) (1998); Herman, 459 U.S. at 381-82 (noting the limits of Section 11 liability).

Section 12(a)(2) of the Act imposes liability under similar circumstances on issuers or sellers of securities by means of a prospectus. *See* 15 U.S.C. § 77l(a)(2) (1974). Specifically, Section 12(a)(2) allows purchasers in an offering to seek damages from "statutory sellers" if the offering was carried out by a prospectus or oral communication that is materially false or misleading. *Id.*

Control person claims under Section 15 of the Securities Act are often included along with claims for liability under Sections 11 and 12. To establish Section 15 liability, a plaintiff must show a "primary violation" and "control of the primary violator." *ECA & Local 134 IBEW Joint Pension Trust v. JP Morgan Chase Co.,* 553 F.3d 187, 206-07 (2d Cir. 2009); *see also, In re Morgan Stanley Info. Fund Sec. Litig.,* 592 F.3d 347, 358 (2d Cir. 2010).

2. Liability Under the Securities Exchange Act of 1934.

To bring a securities fraud claim under Section 10(b) of the Securities Exchange Act and Rule 10b-5, a plaintiff must show: (1) a material misrepresentation (or omission); (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta,* 552 U.S. 148, 157 (2008); *Dura Pharms., Inc. v. Broudo,* 544 U.S. 336, 341-42 (2005); *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 172 (2d. Cir. 2005), cert. denied, 546 U.S. 935 (2005). However, the Supreme Court has stated that because Rule 10b-5 provides for an *implied* private right of action, liability under this provision must be construed narrowly. *Cent. Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.,* 511 U. S. 164, 180 (1994) (holding that Rule 10b–5's private right of action does not include suits against aiders and abettors). The Court recently reaffirmed this narrow scope of 10b-5 liability in *Janus Capital Grp., Inc. v. First Deriv. Traders,* 131 S. Ct. 2296, 2303 (2011), where it held that "the maker of a statement is the entity with authority over the content of the statement" and thus only the maker, not the alleged source of the false statement, is liable under Rule 10b-5.

Control persons can also be held liable for securities fraud under Section 20(a) of the Exchange Act. See, e.g., *S.E.C. v. First Jersey Sec., Inc.,* 101 F.3d 1450, 1472 (2d Cir. 1996) ("a plaintiff must show a primary violation by the controlled person and control of the primary violator by the targeted defendant, and show that the controlling person was in some meaningful sense [a] culpable participant [] in the fraud perpetrated by [the] controlled person []") (internal quotations omitted).

Under Section 101(b) of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4(b), a complaint alleging fraud under the '34 Act which is brought as a class action must "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading, and" if an allegation regarding the statement is made on information and belief, the complaint

shall state with particularity all facts on which that belief is formed" and "state with particularity facts giving rise to a strong inference that the defendant acted with" scienter. The Second Circuit has recognized that the PSLRA "establishes a more stringent rule for inferences involving scienter because [it] requires particular allegations giving rise to a strong inference of scienter." *ECA, Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.,* 553 F.3d 187, 196 (2d Cir. 2009) (quotations and citation omitted).

V. DEMONSTRATING PREDOMINANCE IN SECURITIES FRAUD CLASS ACTIONS

Having outlined the substantive elements of the relevant securities fraud claims, it is then possible to examine the unique issues that arise for class representatives seeking to show predominance in the putative class' claims as required by Rule 23(b)(3).

A. Transaction Causation: Presumptions of Reliance.

A Section 10(b) claim presents a unique problem to parties seeking class certification under Rule 23(b)(3). Because reliance is an element of a Section 10(b) claim, parties cannot establish reliance *individually* by members of the class because it would defeat the predominance requirement for class certification that common questions of fact and law predominate over those affecting only individual members. *In re IPO Sec. Litig.,* 471 F.3d 24, 42 (2d Cir. 2006). Securities fraud plaintiffs generally seek to rely on two presumptions to demonstrate reliance or transaction causation: the fraud-on-the-market presumption and the *Affiliated Ute* presumption. Plaintiffs may also try to appeal to the fraud-created-the-market presumption to establish reliance, but will likely not have success outside of the Fifth and Tenth Circuits. As discussed in more detail in Section VI, below, these presumptions are rebuttable, and the court must provide the defendant the opportunity to rebut. *Basic v. Levinson,* 485 U.S. 224, 245 (1988). If the defendant succeeds, the plaintiff cannot establish "reliance on a class-wide basis, and each plaintiff will have to prove reliance individually." *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.,* No. 05 Civ. 1898(SAS), 2006 WL 2161887, at *12 (S.D.N.Y. Aug. 1, 2006), aff'd., 546 F.3d 196 (2d Cir. 2008).

1. Fraud-on-the-Market Presumption.

The Supreme Court established the fraud-on-the-market presumption in *Basic Inc. v. Levinson,* 485 U.S. 224, 245-47 (1988), where it held that the class members were all purchasers of securities who presumptively relied on a price in an efficient market. Under this principle, courts presume that "(1) misrepresentations by an issuer affect the price of securities traded in the open market, and (2) investors rely on market price of securities as an accurate measure of their value." *In re IPO,* 471 F.3d at 42 (quoting *Hevesi,* 366 F.3d at 77. Therefore, an investor generally "may avail herself of the presumption that she 'relied on the integrity of the price set by the market' if the market is efficient." *Fogarazzo,* 263 F.R.D. at 99. But she must "show that the alleged misrepresentation was material and publicly transmitted into a well-developed market" to successfully invoke the presumption. *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. at 307. Defendants can rebut the presumption by demonstrating that the market price was not affected by the misrepresentations, possibly by showing that market makers knew the truth or that the concealed information "credibly entered the market and dissipated the effects of the misstatements." *Fogarazzo,* 263 F.R.D. at 99. In other words, defendants can present rebuttal evidence that the plaintiff did not actually rely upon the market price or that such reliance was not reasonable.

In *Fogarazzo v. Lehman Bros., Inc.,* the fraud-on-the-market presumption was successfully invoked. The plaintiffs presented an expert to support their contention that analyst reports contained material statements, which affected the price of securities. *Id.* at 102. The plaintiffs' expert noted that numerous empirical studies in the past two decades confirmed the "broadly accepted principle" that analyst reports issued by reputable brokerage firms "tend to cause substantial impacts on stock transaction prices."

Id. at 102-03. The expert also conducted an analysis of the market reaction to the analyst reports that were the subject of this action. "By utilizing a three-day cumulative abnormal return methodology, [the expert] concluded that significant price responses surrounded the release of the analyst reports at issue, indicating that the market relied on the recommendations of these analysts." *Id.* at 103. As such, the Court found the plaintiff was entitled to the fraud-on-the-market presumption. *Id.*

In contrast, the court in *In re IPO Sec. Litig.,* held that the plaintiffs failed to put forth sufficient evidence of market efficiency to avail themselves of the presumption. 471 F.3d at 42. In their claim against underwriters for alleged misrepresentation and market manipulation, they asserted through their own allegations that the alleged fraud was in connection with an IPO. *Id.* As the court explained, because a "primary market for newly issued [securities] is not efficient or developed under any definition of these terms," the plaintiffs essentially admitted to purchasing from an inefficient market. *Id.* (citation omitted.) Therefore, the proposed class could not establish collective reliance to show predominance under Rule 23(b)(3).

2. Fraud-Created-the-Market Presumption

In addition to the fraud-on-the-market theory, plaintiffs in securities fraud class actions sometimes attempt to establish reliance under a fraud-created-the-market presumption. "Fraud-created-the-market is based on the theory that investors rely not on the integrity of the market price, but on the integrity of the market itself." *Alter v. DBLKM, Inc.,* 840 F. Supp. 799, 805 (D. Colo. 1993) (citation omitted.) The Fifth Circuit, for example, has held that even if a plaintiff cannot establish that she relied on the offering itself, she is still entitled to 10b-5 relief if she can plead and prove the following elements to establish reliance: "that (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) [the plaintiff] reasonably relied on the Bonds' availability on the market as an indication of their apparent genuineness, and (3) as a result of the scheme to defraud [the plaintiff] suffered a loss." The Tenth Circuit affirmed this fraud-created-the-market theory in *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth.,* 717 F.2d 1330, 1332 (10th Cir. 1983) (citation omitted), and added a fourth requirement that the plaintiff prove that the securities were "unlawfully issued." *Id.* at 1330.

However, the fraud-created-the-market presumption has failed to gain traction in other circuits. In the Second Circuit in particular, courts have recognized that "[i]t is not established that the theory that fraud created the market is viable in this circuit." *Washington Nat. Ins. Co. of New York v. Morgan Stanley & Co. Inc.,* No. 90 Civ. 3342 (TPG), 1999 WL 461796, at *9 (S.D.N.Y. July 2, 1999) (expressing doubt about the theory and declining to apply it in the alternative because the bonds were not unlawfully issued); *see also, In re Towers Fin. Corp. Noteholders Litig.,* No. 93CIV 0810(WK)(AJP), 1995 WL 571888, at *23 (S.D.N.Y. Sept. 20, 1995) (discussing doubtful viability of theory in Second Circuit and declining to adopt theory under facts of case because "[n]otes were newly issued to a non-developed market"). Therefore, plaintiffs in the Second Circuit are only likely to have success establishing reliance on the integrity of the market *price* and not on the integrity of the market itself.

3. Affiliated Ute Presumption.

"[A] presumption of reliance may apply in cases in which plaintiffs have alleged that defendants failed to disclose information." *Fogarazzo,* 263 F.R.D. at 100. Specifically, "where a plaintiff's fraud claims are based on omissions, transaction causation may be satisfied so long as the plaintiff shows that defendants had an obligation to disclose the information and the information withheld is material." *Id.* Facts are material if "a reasonable investor might have considered them important in the making of [a] decision." *Id.* "This presumption is nevertheless not conclusive. 'Once the plaintiff establishes the materiality of the omission ... the burden shifts to the defendant to establish ... that the plaintiff did not rely on the omission in making the investment decision.'" *Id.* (quoting *duPont v. Brady,* 828 F.2d 75, 76 (2d

Cir. 1987)).

In *Fogarazzo,* plaintiffs alleged that defendants failed to disclose a *quid pro quo* arrangement it had with investment bankers and research analysts, which made the analyst reports misleading. 263 F.R.D. at 106. Plaintiffs were able to rely on the *Affiliated Ute* presumption because the court determined that "a reasonable investor would likely rely less on an analyst report if that investor knew it was tainted by conflicts of interest as a result of research analysts' quid pro quo arrangements with investment bankers." *Id.* In other words, the omission must be material before a court will presume collective reliance on that omission for purposes of class certification. *Id.; see also Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.,* No. 05 Civ. 1898 (SAS), 2006 WL 2161887, at *5 (S.D.N.Y. Aug. 1, 2006), *aff'd,* 546 F.3d 196 (2d Cir. 2008) (holding that the plaintiffs could not rely on the *Affiliated Ute* presumption because positive statements, not omissions, were central to the alleged fraud).

B. Whether the Alleged Misrepresentations Were Material.

For both the fraud-on-the-market and *Affiliated Ute* presumptions, the materiality of misrepresentation or misleading omission is key. Any 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, will be sufficient to rebut the presumption of reliance. *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. 298, 307 (S.D.N.Y. 2010). "One way to 'sever the link' is to demonstrate that the alleged misrepresentations were immaterial because they did not lead to a distortion in price." Id.

"Demonstrating materiality under the fraud on the market and *Affiliated Ute* presumptions presents essentially the same inquiry." *In re Sadia, S.A. Sec. Litig,* 269 F.R.D. at 308. "'[T]o fulfill the materiality requirement there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.'" *In re Salomon Analyst,* 544 F.3d at 482 (quoting Basic, 485 U.S. at 231-32.) (quotations omitted.) "In contrast, a fact is immaterial [w]here a reasonable investor could not have been swayed by the misrepresentation. Immaterial statements include vague, soft, puffing statements or obvious hyperbole." *In re K-Tel Int'l., Inc. Sec. Litig.,* 300 F.3d 881, 897 (8th Cir. 2002). "Materiality is determined in light of the circumstances existing at the time the alleged misstatement occurred." *Ganino v. Citizens Util. Co.,* 228 F.3d 154, 165 (2d Cir. 2000) (citations omitted). "An omitted fact may be immaterial if the information is trivial or is so basic that any investor could be expected to know it." *Id. (citations and quotations omitted).*[6] Materiality is an "inherently fact-specific finding." Basic, 485 U.S. at 236; *accord, Matrix Initiatives Inc. v. Siracusano,* 131 S. Ct. 1309, 1321 (2011) (Basic is a "'fact-specific' inquiry . . . [that] require[s] consideration of the source, content and context" of the [adverse event] reports.) Id. At 1312.

In *In re Sadia, S.A. Sec. Litig.,* the defendant did not dispute that the market was efficient or that the alleged misrepresentations were publicly made. 269 F.R.D. 298, 310-11 (S.D.N.Y. 2010). The only question was whether the misrepresentations regarding the defendants' hedging contracts were material. To establish materiality, the plaintiffs proffered: (1) an expert report analyzing the alleged wrongful disclosure and the daily movements in the price of the defendants' American Depositary Receipts during the class period on various indices (S & P 500 Index and the Bloomberg Food Index) to determine which portion of the price drop could be attributed to the wrongdoing as opposed to the financial impact, i.e., the actual dollar loss on the American Depositary Receipts; and (2) testimony from each class representative that the primary allegation of fraud was based on the defendants failure to disclose the amount of risk that the defendant undertook as part of its currency hedging practices and that doing so violated its internal hedging policies. *Id.* at 310-15. The court concluded that the class representatives' testimony along with the expert's opinion indicated that the alleged wrongdoing and the financial impact of such wrongdoing were material and that "a reasonable investor would view [the defendant's] undisclosed level of risk as

having significantly altered the total mix of information made available to the public." *Id.* at 312-13.

In *Litwin v. Blackstone Grp., L.P.,* the Second Circuit found that the district court erred in dismissing plaintiffs' complaint under Sections 11 and 15 for failure to establish that Blackstone had omitted material information related to its investments that it was required to disclose. 634 F.3d at 706, 719 (2d Cir. 2011). Blackstone argued that the relevant information was public knowledge and therefore could not be material because it was already part of the "total mix" of information available to investors. *Id.* at 717. The Court noted, however, that while true that the "total mix" of information might include information already in the public domain and facts reasonably available to potential investors, "case law does not support the sweeping proposition that an issuer of securities is never required to disclose publicly available information." *Id.* at 718. Instead, the court found that "[i]n this case, the key information that plaintiffs assert should have been disclosed is whether, and to what extent, the particular known trend, event or uncertainty might have been reasonably expected to materially affect Blackstone's investments. And this potential future impact was not certainly not public knowledge." *Id.* at 718-719. (emphasis in original).

C. Whether the Alleged Misrepresentations Were Publicly Transmitted Into an Efficient Market

In addition to the above materiality inquiry, the "threshold facts" underlying market efficiency must be shown at the class certification stage for the Basic presumption to apply. *Basic v. Levinson,* 485 U.S. 224, 248 nn. 27, 28 (1988). "Market efficiency refers to 'the flow of information in the relevant market' and its effect on the price of the security. An efficient market absorbs misrepresentations into the price of the security; an inefficient market does not." *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.,* No. 05 Civ. 1898(SAS), 2006 WL 2161887, at *6 (S.D.N.Y. Aug. 1, 2006), aff'd, 546 F.3d 196 (2d Cir. 2008). "[A]n efficient market is one in which market price fully reflects all publicly available information." *Id.*

The Second Circuit has held that there are two core requirements of an efficient market: "'[l]arge numbers of rational and intelligent investors,' and '[i]mportant current information' that is 'almost freely available to all participants.'" *In re Initial Pub. Offering Sec. Litig.,* 260 F.R.D. 81, 94 (S.D.N.Y. 2009) (quoting Paolo Cioppa, *The Efficient Capital Mkt. Hypothesis Revisited: Implications of the Economic Model for the United States Regulator,* 5 Global Jurist Advances 1, 5-6 (2005)). That said, the Second Circuit has not adopted a formal test for market efficiency. Rather it looks to several different factors as measures of these core requirements. *In re* IPO, 260 F.R.D. at 94. These include the five factors enumerated in *Cammer v. Bloom,* 711 F. Supp. 1264 (D.N.J. 1989): (1) whether the security has a large weekly trading volume of certificates; (2) whether a significant number of securities analysts followed and reported on the company's stock during the applicable period; (3) whether the stock had numerous market makers; (4) whether the company was entitled to file an S-3 Registration Statement in connection with public offerings; and (5) whether the security experienced an historical showing of immediate price response to unexpected corporate events or financial releases. *See, Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.,* 546 F.3d 196, 199 (2d Cir. 2008) ("[w]e conclude . . . that the district court properly used the *Cammer* factors as an 'analytical tool'" in determining market efficiency). These non-exclusive factors are not a fixed checklist. The inquiry may also include additional factors such as: (6) the company's market capitalization; (7) the bid-ask spread; (8) the float, or issue amount outstanding excluding insider-owned securities; and (9) the percentage of institutional ownership. See, e.g., *Unger v. Amedisys Inc.,* 401 F.3d 316, 323 (5th Cir. 2005).

"Even though the factors developed for assessing the market efficiency for stocks 'are admittedly not well-suited for the analysis of debt securities [,]' courts generally apply the same factors to the efficiency question for bonds." *In re Healthsouth Corp. Sec. Litig.,* 261 F.R.D. 616, 633 (N.D. Ala. 2009) (quoting *In re DVI Inc. Sec. Litig.,* 249 F.R.D. 196, 214 (E.D. Pa. 2008).) See also *In re Am. Int'l. Grp., Inc. Sec.*

Litig., 265 F.R.D. at 175-76 ("[I]n cases involving bonds rather than common stock, the Second Circuit has found that a district court may nevertheless 'properly use ... the *Cammer* factors as an analytical tool.'") (citation omitted).

"Evidence that unexpected corporate events or financial releases cause an immediate response in the price of a security has been considered the most important *Cammer* factor ... and the essence of an efficient market .... Without the demonstration of such a causal relationship, it is difficult to presume that the market will integrate the release of material information about a security into its price. An event study that correlates the disclosures of unanticipated, material information about a security with corresponding fluctuations in price has been considered prima facie evidence of the existence of such a causal relationship." Teamsters Local 445, 546 F.3d at 207-08. (quotations and citations omitted.)

In *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.,* the court held that the plaintiff could not rely on the fraud-on-the-market presumption because it did not satisfy a number of the market efficiency factors. 546 F.3d at 207-08. Specifically, the court noted that "[a]lthough the Certificates had a high average weekly trading volume and Bombardier filed an SEC Registration Form S-3, the infrequent trades, the absence of analysts following the Certificates, the absence of market makers for the Certificates, and especially the lack of a causal relationship between unexpected news and an immediate response in the price of the Certificates, all tend to establish the inefficiency of the Certificate market." *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.,* No. 05 CIV. 1898(SAS), 2006 WL 2161887, at *12 (S.D.N.Y. Aug. 1, 2006), aff'd, 546 F.3d 196 (2d Cir. 2008).

1. Trading Volume.

"A high average trading volume suggests market efficiency, because it implies that there is 'significant investor interest in the company' and 'a likelihood that many investors are executing trades on the basis of newly available or disseminated corporate information.'" *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.,* 05 CIV. 1898 (SAS), 2006 WL 2161887, at *6 (S.D.N.Y. Aug. 1, 2006), aff'd, 546 F.3d 196 (2d Cir. 2008).

In *Teamsters Local 445 Freight Div. Pension Fund,* the court rejected the plaintiffs' attempt to compare a Certificate market to the market for Fixed Income Pricing System high-yield corporate bonds, because the plaintiff did not provide support for its position that a market for one type of security was found efficient merely by analogy to a market for another type of security. 2006 WL 2161887, at *12, aff'd, 546 F.3d 196 (2d Cir. 2008). In order for a market to be found efficient, that market must *independently* satisfy at least some of the factors. *Id.*

In re Dynex Capital, Inc. Sec. Litig., No. 05 CIV. 1897(HB), 2011 WL 781215, at *4 (S.D.N.Y. March 7, 2011) ("There is a substantial presumption of market efficiency where 1% of the average outstanding balance is traded, i.e. a 1% weekly turnover rate.") The *Dynex* court recently observed that "[t]he Second Circuit has not fully addressed this issue, but has suggested that the *Cammer* factors be adjusted in the context of bond markets. ... A turnover rate below the 1% threshold established in *Cammer* for the stock market does not, without more, defeat a finding of an efficient bond market." *Id.*

When it comes to debt securities, courts have held that "the test should not be whether bonds can be traded as efficiently as stocks listed on a national exchange. Instead, the focus should be on 'whether market makers in the over-the-counter-market, specifically the market for [the particular security], provided a sufficiently fluid and informed trading environment so that when material information about [the issuer] was disseminated, investors had available to them an opportunity to trade at informed, and therefore appropriate, bid and asked prices.'" In *re Healthsouth Corp. Sec. Litig.,* 261 F.R.D. 616, 633 (N.D. Ala. 2009) (quoting *Cammer v. Bloom,* 711 F.Supp. 1264, 1282-83 (D.N.J. 1989)). *See also, In re Enron Corp. Sec. Litig.,* 529 F.Supp.2d 644, 768 (S.D.Tex. 2006) ("[T]he issue is not whether the market for equity is

more efficient than the market for debt securities, but ... whether the price reflect[s] all publicly available information [] to trigger the fraud-on-the-market presumption of reliance.") To qualify for the fraud-on-the market presumption of reliance, bondholder plaintiffs must demonstrate that the market for the bonds was not only well-developed but open. In *re Healthsouth Corp. Sec. Litig.,* 261 F.R.D. 616, 641-642 (N.D. Ala. 2009) (Finding that primary market for Rule 144A unregistered bonds "in no way operated as an open market" as required to invoke the Basic presumption.).

2. Existence of Relevant Analyst Reports.

"If a large number of financial analysts report on the stock, one can infer that financial statements are 'closely reviewed by investment professionals, who would in turn make buy/sell recommendations to client investors.' Although sporadic commentary by news reporters 'cannot substitute for serious attention by professional securities analysts,' it is not necessary for 'big name' Wall Street companies' to follow the security." *Teamsters Local 445 Freight Div. Pension Fund,* 2006 WL 2161887, at *6. The lack of analyst coverage indicated that the market was inefficient. Id. at 10.

"[T]he mere fact that a rating agency rates a bond is not indicative of it trading in an efficient market." In re *Am. Int'l. Grp. Inc. Sec. Litig.,* 265 F.R.D. at 177. Courts have found that the existence of just two analysts "does not heavily favor a finding of efficiency," and instead look for "at least six (6) securities analysts issued reports on the stock during the class period." *Cheney v. Cyberguard Corp.,* 213 F.R.D. 484, 499 (S.D. Fla. 2003) (citation omitted).

3. Existence of Market Makers and Arbitrageurs.

"A market-maker is 'one who helps establish a market for securities by reporting bid-and-asked quotations' (the price a buyer will pay for a security and the price a seller will sell a security), and who 'stands ready to buy or sell at these publicly quoted prices.' Arbitrageurs are 'professional investors who exploit price differences in different markets by buying and selling identical securities in those markets.' Market-makers and arbitrageurs contribute to market efficiency by 'reacting swiftly to company news and reported financial results by buying or selling stock and driving it to a changed price level.' " Teamsters L*ocal 445 Freight Div. Pension Fund,* 2006 WL 2161887, at *7. Because the plaintiffs have failed to show that there were market markers, i.e., "[a] firm that maintains a firm bid and offer price in a given security by standing ready to buy or sell at publicly-quoted prices," the court concluded that the certificates were not traded in an efficient market. Id. at 10.

"One way that efficient markets absorb information is through arbitrageurs, whose actions stabilize the market so as to eliminate arbitrage opportunities. The capacity of arbitrageurs to 'seek out new information and evaluate its effects on the price of securities' distinguishes them from ordinary investors, who 'lack the time, resources, or expertise to evaluate all the information concerning a security,' and are thus 'unable to act in time to take advantage of opportunities for arbitrage profits.' In an efficient market, an ordinary investor 'who becomes aware of publicly available information cannot make money by trading on it,' because the market will have already incorporated the information through the actions of the arbitrageurs." *Teamsters Local 445 Freight Div. Pension Fund,* 2006 WL 2161887, at *7.

4. Evidence Regarding Share/Note Price Movements.

"Evidence that unexpected corporate events or financial releases cause an immediate response in the price of a security has been considered the most important *Cammer* factor, and the essence of an efficient market and the foundation for the fraud on the market theory." *Teamsters Local 445 Freight Div. Pension Fund,* 546 F.3d at 207-08 (internal quotation marks and citations omitted). "[T]he 'cause-and-effect relationship between company disclosures and an immediate response in the price of the stock,' is 'the essence of an efficient market and the foundation for the fraud on the market theory.' 'An efficient

capital market is one in which the price of the [security] at a given time is the best estimate of what the price will be in the future.' Hence, in an efficient market, a security's price remains stable in the absence of news, and changes rapidly as the market receives new and unexpected information. Because many variables have the potential to and, in fact, do affect the price of a security, 'expert testimony may be helpful because of the utility of statistical event analysis' to isolate the true effect of corporate financial disclosures." *Teamsters Local 445 Freight Div. Pension Fund,* 2006 WL 2161887, at *7. The court rejected the plaintiffs expert because his study focused solely on the disclosure of information immaterial to the certificates. Id. at *11. "[T]he absence of proof that unanticipated, material information caused changes in the Certificates' price-as well as the infrequency of [the] trades in the Certificates 'all tend to establish the inefficiency of the Certificate market' and prevent [the plaintiffs] from relying on the fraud-on-the-market presumption." Teamsters Local 445 Freight Div. Pension Fund, 546 F.3d at 210.

VI. REBUTTING THE PRESUMPTION OF RELIANCE

"*In re IPO* now requires a district court to make a 'definitive assessment' that the Rule 23(b)(3) predominance requirement has been met. This assessment cannot be made without determining whether defendants can successfully rebut the fraud-on-the-market presumption. The *Basic* Court explained that a successful rebuttal defeats certification by defeating the Rule 23(b)(3) predominance requirement. Hence, the court must permit defendants to present their rebuttal arguments 'before certifying a class'." In *re Salomon,* 544 F.3d at 485 (internal citations omitted). See also *Erica P. John Fund, Inc. v. Halliburton,* 131 S.Ct. 2179, 2185 (2011) ("The [Basic] Court also made clear that the presumption was just that, and could be rebutted by appropriate evidence.") (citation omitted). Some examples of how the presumption might be rebutted follow.

A. Evidence of Market Makers "Privy to the Truth" and of Other Divergent Sources of Information.

One way to rebut the presumption is to show that the "truth [was] on the market"-- i.e., that the market knew the truth and therefore the market price did not change in reliance on the misrepresentations. *Provenz v. Miller,* 102 F.3d 1478, 1492-93 & n. 4 (9th Cir. 1996); In *re Apple Computer Sec. Litig.,* 886 F.2d 1109, 1114-15 (9th Cir. 1989) (explaining Basic and concluding "that in a fraud on the market case, the defendant's failure to disclose material information may be excused where that information has been made credibly available to the market by other sources.").

B. Plaintiff's Prior Knowledge of the Alleged Misstatements.

Defendants could also rebut the presumption by showing that a plaintiff actually knew of the concealed information but "nevertheless" still transacted to his detriment because of other forces. *Basic,* 485 U.S. at 249.

If a plaintiff relied upon material, non-public information when making her investment decisions, she could not use the fraud on the market presumption and her claims would not be typical and she would not be an adequate class representative. *Schleicher v. Wendt,* No. 1:02-cv-1332-DFH-TAB, 2009 WL 761157, at *2 (S.D. Ind. Mar. 20, 2009).

In *New Jersey Carpenters Health Fund v. Residential Capital, LLC,* the investors brought putative class action against issuers, underwriters, and rating agencies, alleging the offering documents for mortgage-backed securities they purchased were materially misleading. The defendants asserted that different putative class members had different levels of knowledge regarding the underwriting guidelines and practices based on their respective levels of sophistication and time of purchase. 272 F.R.D. 160, 168 (S.D.N.Y. 2011) (denying a motion for class certification). "Where a defendant shows that broad knowledge of the alleged wrongful conduct existed 'throughout the community of market participants

. . . this widespread knowledge [] would precipitate individual inquiries as to the knowledge of each member of the class,' and defeat the predominance of common issues under Rule 23(b)(3)." *Id.* at 168. To support its argument that different levels of sophistication indicate different levels of knowledge, defendants provided evidence imputing knowledge to its investment advisor, whom regularly met with mortgage originators, including the largest originator of loans comprising the securities at issue in this litigation in order to "understand what their underwriting guidelines were, and also get a sense for how their businesses were doing, [and] understand what their procedures were in servicing loans and [try to learn] about any changes to the underwriting guidelines." *Id.* When the investment advisor purchased the 2007-7 certificates, it knew that loans could be originated with exceptions to underwriting guidelines, and it knew that such loans posed increased the risk of delinquencies and heightened losses. *Id.* at 170. In addition, many putative class members are sophisticated investors with significant experience in asset-backed securities markets. The court noted that certain investors had knowledge regarding the systematic disregard of underwriting guidelines in another lawsuit brought by Intervener-Plaintiff, and expertise in mortgage backed securities, were extensively involved in the structuring of the 2006-4 and 2007-7 offerings at issue. The defendants also argued that different times of purchase indicate different levels of knowledge. Notably, "[d]ifferences in purchase dates may work against a finding of commonality or predominance. *Id.* at 169. *See, In re IMAX Sec. Litig.,* 272 F.R.D. 138, 158-159 (S.D.N.Y. 2010) (class certification was denied because the proposed lead plaintiff was subject to unique defenses). In this situation, different levels of knowledge can be imputed to investors who purchased at different times because throughout the relevant period more and more information became publicly available, including reports of government actions or investigations, analysts reports, news items and raw data. *New Jersey Carpenters Health Fund.,* 272 F.R.D. at 169-170. As a result, the court concluded that individualized issues presented by the putative class members in both cases predominated. *Id.* at 171.

C. Evidence of an Absence of Price Impact.

"Parties to a securities class action who seek to demonstrate that a change in the price of a stock is or is not attributable to misrepresentations or omissions by the defendant frequently resort to the use of statistical 'event studies,' performed by experts in the field of financial economics." In re *Am. Int'l Grp. Inc. Sec. Litig.,* 265 F.R.D. 157, 182 (S.D.N.Y. 2010).

In *In re Sadia, S.A. Sec. Litig.,* to rebut the presumption of reliance, the defendants argued that there was no price impact because the "investors would not consider the undisclosed risk – [the defendants] violation of its internal currency hedging policies material unless there was an actual substantial loss." The defendants argued that the wrongdoing resulted in an undisclosed benefit to the company, but was unable to show that because its actions would have resulted in a profit, the price of the securities would not have declined upon disclosing that the defendant had take on substantial more risk than disclosed and had violated its internal hedging policies. The court concluded that any risk taking is material to investors and thus the defendants did not rebut the presumption. 269 F.R.D. 298, 314 (S.D.N.Y. 2010).

In *Fogarazzo v. Lehman Bros., Inc.,* the plaintiffs presented an expert to support their contention that analyst reports contained material statements, which affected the price of securities. 263 F.R.D. 90, 104 (S.D.N.Y. 2009). To rebut the presumption of reliance, a defense expert conducted an analysis of the stock price on the fifteen days that analyst reports were issued. The expert concluded that the "stock's movements were abnormally volatile compared to other stocks. He noted that so long as the stock moved within the bounds of +/-13.79% on a given day, the stock could be considered to have "moved within the bounds of 'normal' volatility for the stock." *Id.* Second, he found that thirteen reports were associated with statistically insignificant company stock price movements. *Id.* Lastly, although the remaining two reports caused statistically significant stock price movements, the expert noted that one report was a negative report that led to an increase in price, while the other negative report was released to the public after the stock price had already declined. *Id.* As a result, the expert "concluded that none of

the fifteen analyst reports contained material information" that affected the stock price. *Id.* Additionally, the defendant's expert argued that the plaintiffs' expert methodology was flawed because he used a three-day window method (the day before the event, the day of the event, and the day after the event) to analyze the stock movements. *Id.* By adding extra days the expert unnecessarily added "extraneous stock price movements" and failed to show that any price movements on those days were statistically significant, which is required in order to conclude that the movements in the stock price were in reaction to the alleged analysts reports. *Id.* In response, plaintiffs' expert indicated that his method was proper and in fact, it is "recommended by one of the most respected financial methodology textbooks. *Id.* at 105. The plaintiffs' expert also noted that his three-day study did not include extraneous stock prices because it "was often wise to include the day after the event day in the window where a continuation of price impact may be expected." *Id.* at 104. The Court concluded that defendants failed to rebut the presumption because it was persuaded by the plaintiffs' experts challenges to the defense experts opinions. *Id.* at 106.

In *In re Am. Int'l. Grp. Inc. Sec. Litig.,* ("[T]o the extent a Defendant can show that there was no price decrease in AIG stock on the date a misrepresentation was disclosed, the Court views this showing as strong evidence that there was no price change on the date of the misrepresentation, thus rebutting the fraud-on-the-market presumption.") 265 F.R.D. at 182.

VII. DISPROVING LOSS CAUSATION IN SECTION 10(B) ACTIONS

To succeed on the merits, plaintiffs in a Section 10(b) action must ultimately prove that a misrepresentation "proximately caused the plaintiff[s'] economic loss." *Dura Pharm. Inc. v. Broudo,* 544 U.S. 336, 346 (2005). The *Dura* Court held that the "loss" element could not be proven by merely showing that a misrepresentation caused the price of a security to be inflated at the time of purchase; rather, it must be shown that the misrepresentation actually caused a later economic loss. *Id.* at 342-43. "This requirement is commonly referred to as 'loss causation.'" *Halliburton,* 131 S. Ct. at 2183.

"To demonstrate loss causation, a plaintiff must show 'that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security.' A plaintiff must show that it was the fraud, as opposed to 'the tangle of [other] factors affecting [the] price' of the security that caused the loss." *In re Sadia, S.A. Sec. Litig.,* 269 F.R.D. at 309. Additionally, "[t]he Second Circuit has made clear that a claim of loss causation is unsustainable for those who sold their shares prior to the corrective disclosure in the absence of allegations that some information had already leaked into the market." *Id.* at 317-318. The pertinent inquiry for loss causation purposes focuses on the most plausible understanding of a given disclosure at the time it was made. *In re IMAX Sec. Litig.,* 272 F.R.D. 138, 147 (S.D.N.Y. 2010); *see also, Lentell v. Merrill Lynch & Co., Inc.,* 396 F.3d 161, 173 (2d Cir. 2005) (to show loss causation, plaintiff must allege that "the misstatement or omission concealed something from the market that, *when disclosed,* negatively affected the value of the security.") (emphasis added).

A. Plaintiffs Need Not Prove Price Impact at the Class Certification Stage, But Defendants May Rebut and Show Otherwise.

In *Erica P. John Fund, Inc. v. Halliburton Co.,* 131 S. Ct. 2179 (2011), the Supreme Court unanimously resolved the question of whether securities fraud plaintiffs are required to prove loss causation before a class can be certified under Rule 23. Prior to the decision in *Halliburton,* "there appear[ed] to be a clear trend in the federal courts," especially in the Fifth Circuit, "toward requiring substantial proof of loss causation," particularly in Section 10(b) cases in which plaintiffs seek to establish reliance through fraud-on-the-market presumption. *See Bruce G. Vanyo and William M. Regan, Recent Dev. in Loss Causation,* 1832 PLI/Corp 341, 343 (July 2010). The Fifth Circuit view was that plaintiffs in securities fraud actions must satisfy not only the requirements set forth in *Basic* to trigger a rebuttable presumption of fraud on

the market, but must also establish loss causation at the class certification stage by a preponderance of admissible evidence. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.,* 597 F.3d 330, 334 (5th Cir. 2010), *cert. granted, Erica P. John Fund, Inc. v. Halliburton Co.,* 131 S. Ct. 856 (2011), vacated & remanded, 131 S. Ct. 2179 (2011) ("In order to obtain class certification on its claims, Plaintiff was required to prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses.") However, the *Halliburton* Court made clear that because "[l]oss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock," it was error to have required a plaintiff "to show loss causation as a condition of obtaining class certification." 131 S. Ct. at 2186. Importantly, the Supreme Court did not address, and instead left to the Court of Appeals, "any other question about *Basic,* its presumption, or how and when it may be rebutted." *Id.* at 2187.

Of course, the Second Circuit had earlier rejected the Fifth Circuit view. While acknowledging that loss causation is an element of securities fraud that would ultimately have to be proven under Section 10(b) and Rule 10b-5, the Second Circuit has held that at the class certification stage, "plaintiffs do not bear the burden of showing an impact on price" or loss causation in order to establish the rebuttable presumption of reliance. *In re Salomon Analyst Metromedia Litig.,* 544 F.3d 474, 483 (2d. Cir. 2008). Thus, in the Second Circuit, loss causation need not be proven by a preponderance of the evidence in order to trigger the fraud on the market presumption at the class certification stage.") See *In re IMAX Sec. Litig.,* 272 F.R.D. at 158 ("[W]e agree with the other courts in this district that have considered this issue and held that loss causation need not be proven by a preponderance of the evidence in order to trigger the fraud on the market presumption at the class certification stage."); *Lapin,* 254 F.R.D. at 186 ("Other courts have agreed that loss causation need not be proven at the class certification stage."), *accord, Schleicher v. Wendt,* 618 F. 3d 679, 687 (7th Cir. 2010) (Not requiring investors to prove loss causation at class certification stage).

Indeed, in *In re Flag Telecom Holdings Ltd. Sec. Litig.,* the Second Circuit expressly declined to address whether it would follow the Fifth Circuit's approach requiring plaintiffs seeking to establish reliance through fraud-on-the market must affirmatively prove loss causation at the class certification stage. 574 F.3d 29, 39 (2d. Cir. 2009). However, In *re Salomon* also states that "*In re IPO* now requires a district court to make a 'definitive assessment' that the Rule 23(b)(3) predominance requirement has been met. This assessment cannot be made without determining whether defendants can successfully rebut the fraud-on-the-market presumption. The *Basic* Court explained that a successful rebuttal defeats certification by defeating the Rule 23(b)(3) predominance requirement ... Hence, the court must permit defendants to present their rebuttal arguments before certifying a class." 544 F.3d at 485 (internal citations omitted).

B. Evidence of Confounding Events.

In *Fogarazzo,* the defendants argued that because the plaintiffs' expert failed to account for "confounding events such as market or industry factors," his methodology did not accurately measure the impact of the alleged analyst reports. 263 F.R.D. 90, 107 (S.D.N.Y. 2009). Plaintiffs' expert responded by noting that it was unnecessary for him to consider some of the news items during the relevant period because they were not "economically significant." Id. Defendant then proposed five techniques that would have controlled for confounding events such as market or industry factors. For, instance, one technique was to categorize groups of events, i.e., a group that included confounding events and analyst reports and one group that only included confounding events, then compare the price effects. Another technique called for the elimination of all analyst reports that were published on days on which confounding events also occurred, which would still leave a sufficient sample of reports for event study analysis. *Id.* at 108. Despite the defendants' objections to plaintiffs' expert, the court concluded that the plaintiff proved by a preponderance of the evidence that loss causation can be proven on a class-wide basis because

"employment of a methodology and demonstration that the analyst reports did indeed cause plaintiffs' loss is unnecessary at the class classification stage." *Id.* at 108.

C. "In-and-Out" Investors Who Purchased and Sold Before the First "Corrective" Disclosure.

Relying on *Dura Pharm., Inc. v. Broudo,* 544 U.S. 336, 342 (2005), defendants have argued that a plaintiff fails the typicality requirement because it sold shares before the alleged corrective disclosures and is thus an "in and out trader" that suffered no harm. In *Dura,* the Supreme Court held that investors cannot establish loss causation solely by pointing to an inflated share price-investors must prove that the alleged misrepresentations caused their loss. *Dura,* 544 U.S. at 342 ("if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss."); *see also, Roth v. Aon Corp.,* 238 F.R.D. 603, 609 (N.D. Ill. 2006) ("an inflated purchase price will not itself constitute or proximately cause the relevant economic loss." (citing *Dura Pharm., Inc. v. Broudo,* 544 U.S. 336, 342 (2005)).

In *In re Flag Telecom Holdings, Ltd., Sec. Litig.,* the Second Circuit declined to include in-and-out traders in a class action on a motion for class certification. 574 F.3d 29, 37-41 (2d Cir. 2009). In *Flag,* defendants argued that the lower court abused its discretion by including as members of the certified class investors who sold their stock before the alleged corrective disclosure because those investors cannot prove loss causation and are subject to unique defenses. *Id.* at 37. The plaintiffs who sold before the corrective disclosures would have to prove "that the loss they suffered was both foreseeable and caused by the 'materialization of the concealed risk.'" *Id.* at 40. Plaintiff argued that the truth regarding the company's financial condition began to leak into the market prior to the corrective disclosure and supported its position with an event study prepared by their expert. *Id.* However, the court agreed with the defendants and noted that the plaintiffs did not show by a preponderance of the evidence that it could even conceivably be able to prove loss causation because it failed to demonstrate that any of the information that "leaked" into the market prior to the corrective disclosure revealed the truth and failed to connect the decline in the price of the stock to any corrective disclosure. *Id.* at 40-41. Ultimately, the court excluded these traders from the class. *Id.* at 41.

Courts in other circuits are in conflict over whether in-and-out traders are appropriately included. *See, e.g, McGuire v. Dendreon Corp.,* 267 F.R.D. 690, 698-699 (W.D. Wash. 2010) (citing cases). For example, holding that the Ninth Circuit requires a different level of proof for loss causation at the class certification stage, the *McGuire* court found that in-and-out traders are appropriately included in the class at the class certification stage. "The Second Circuit's reasoning places too great of a burden on the plaintiffs at the class certification stage by forcing them to prove by a 'preponderance of the evidence' that they suffered a loss before discovery has even taken place." *Id.* at 699. In *Silversman v. Motorola, Inc.,* the Northern District of Illinois held that, "[f]or purposes of determining class certification, the Court adopts the approach of … a number of other cases that have included "in-and-out" traders in the proposed class yet limited class membership to those who suffered damage as a result of their purchase of [defendant's] stock during the Class Period," noting that "Defendants are free to renew this argument at the summary judgment stage, after both parties have had a full and fair opportunity to complete discovery." 259 F.R.D. 163, 171 (N.D. Ill. 2009).

D. Lead Plaintiffs Who Continued to Purchase Stock After Corrective Disclosures.

Some courts have held that a putative lead plaintiff who continued to purchase stock after the truth was revealed is an inadequate class representative because that conduct is sufficient to rebut the fraud-on-the-market presumption. For instance, in *In re Cardinal Health, Inc. Sec. Litig.,* 226 F.R.D. 298 (S.D. Ohio 2005), investors in Cardinal Health, inc., a healthcare conglomerate, filed a class action lawsuit alleging that the company had engaged in a variety of improper revenue recognition practices. The court held that one of the movants for lead plaintiff was not a suitable candidate because it had

made significant purchases of the company's stock immediately after investigations into the company's accounting practices were announced. Therefore, the court reasoned, the movant was "susceptible to claims that [it] did not rely on the Defendants' alleged misrepresentations when purchasing Cardinal stock." *Id.* at 310.

Similarly, in *In re Safeguard Scientifics,* 216 F.R.D. 577 (E.D. Pa. 2003), investors in Safeguard Scientifics filed a class action alleging that Safeguard provided an improper, secret loan to its CEO in violation of Section 10(b) of the Exchange Act. The defendants opposed class certification on the ground that the lead plaintiff "increased his holdings in Safeguard stock even after public disclosure of the alleged fraud." *Id.* at 582. The court agreed, finding that the plaintiff's post-revelation purchases were strong evidence that he "would have made–and in fact did–purchase stock regardless of the fraudulent omission." *Id.* Therefore, the court held that "Defendants have presented compelling reason to rebut the reliance presumption" and denied class certification. *Id.* 582.

However, other courts have rejected this analysis. *In re Electronic Data Sys. Corp. Sec. Litig.,* 226 F.R.D. 559 (E.D. Tex. 2005), a pension fund brought a class action against Electronic Data Systems based on allegations that EDS concealed problems that it was having in fulfilling a large contract to create an intranet for the United States Navy. The court found that the fact that the fund continued to purchase EDS stock after the problems were disclosed did not undermine its suitability as a class representative. It reasoned that the fund continued to purchase the stock because it "felt EDS stock had hit a bottom and was thus a good buy at that point in time," not because it was not relying on the integrity of the market price. *Id.* at 565. "[A]lthough the securities were priced higher before the September 18th disclosures by EDS, both the high and low prices were assumed accurate since the stocks were traded on an efficient market" and the fund could still "plausibly believe that EDS stock remained a good bargain going forward since the lower price reflects new, and presumably accurate, information." *Id.* at 566.

The court in *In re Frontier Ins. Grp., Inc. Sec. Litig.,* 172 F.R.D. 31 (E.D.N.Y. 1997) reached a similar conclusion. Investors in Frontier Insurance Group, an insurance holding company, brought a class action alleging that Frontier had concealed problems with high risk medical malpractice policies that it had been underwriting. One of the lead plaintiffs continued to purchase Frontier stock after the problems became public "because her husband 'felt that all the information had come out at that point and that he would try to recoup some of the money.'" *Id.* at 42. The court found that "[t]he fact that [the lead plaintiff] attempted to recoup her losses by continuing to purchase Frontier stock after the disclosure of the alleged misrepresentations had no bearing on whether or not she relied on the integrity of the market during the class period." It therefore granted the plaintiffs' motion for class certification. *Id.* (citations omitted).

In *Polin v. Conductron Corp.,* 552 F.2d 797 (8th Cir. 1977), r*ehearing en banc denied,* the Eighth Circuit Court of Appeals affirmed the District Court for the Eastern District of Missouri's denial of plaintiff's motion to certify that an action brought under Sections 10(b) and 14(a) of the Securities Exchange Act could proceed as a class action. "[I]t was clear on the record, that plaintiff had, throughout the years, while charging various malfeasances and misfeasances against the defendants, continuously purchased [defendant corporation] stock himself, despite the gravity of the charges made, thereby raising the most serious questions as to whether or not he was a proper "representative" of the allegedly injured class." *Id.* at 802.

E. Day Traders.

Some defendants have argued that day traders should not be entitled to the fraud on the market presumption because they rely on market volatility and small, technical movements in stock prices rather than on market integrity in determining what stocks to purchase, making them vulnerable to unique defenses not shared by the class. But this argument has been largely unsuccessful. For example, in *In re CMS Energy Sec. Litig.,* 236 F.R.D. 338, 343 (E.D. Mich. 2006), the court rejected the defendants'

argument that "day traders should be excluded from the Class because they do not trade in reliance on the market's integrity." Rather, it found that "a plaintiff who bought and sold in short order is similar enough to one who bought for the long term to be included in the class," and therefore that "day traders are adequate class members and representatives." *Id*. For similar holdings, see also *Taubenfeld v. Career Educ. Corp.,* No. 03C8884, 2004 WL 554810, at *4 (N.D. Ill. Mar. 19, 2004) ("seeing no proof that [the day trader movant] is subject to unique defenses making him incapable of adequately representing the class, the challenge to his typicality is rejected."); *Crossen v. CV Therapeutics,* No. C 03-03709 SI, 2005 WL 1910928, at *5 (N.D. Cal. Aug. 10, 2005) (finding that the "relevant question" was not whether the lead plaintiff was a day trader, but what information he used when deciding to buy or sell).

The Second Circuit has followed this majority position and has also rejected day-trader defenses against certification in securities fraud class actions. Most recently, in *In re Imax Sec. Litig.,* the court rejected the contention that traders with sophisticated investment strategies, including short-sellers and arbitragers, are subject to unique defenses that would make them automatically atypical and bar class certification. No. 06 CIV. 6128 (NRB), 2011 WL 1487090, *7 (S.D.N.Y. Apr. 15, 2011). *See also, In re Flag Telecom Holdings, Ltd. Sec. Litig.,* 245 F.R.D. 147, 164 (S.D.N.Y. 2007), *aff'd in relevant part,* 574 F.3d 29 (2d Cir. 2009) ("[I]t is well-established that an investor's sophistication does not preclude him from relying on the integrity of the market and asserting the fraud-on-the-market presumption."); *In re Initial Pub. Offering Sec. Litig.,* 227 F.R.D. 65, 109 (S.D.N.Y.2004) Vacated on other grounds, 471 F.3d 24 (2d Cir. 2006) (stating, in the context of Rule 23(b)'s predominance analysis, that "[i]t can be stated without fear of gainsay that the shareholders of every large, publicly traded corporation includes [sic] institutional investors, short-sellers, arbitragers, etc. The fact that these traders have divergent motivations in purchasing shares should not defeat the fraud-on-the-market presumption absent convincing proof that price played no part whatsoever in their decision making.").

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1. Of course, district courts have "ample discretion" to limit discovery and "the extent of a hearing" on Rule 23 issues "in order to assure that a class certification motion does not become a pretext for a partial trial of the merits." In *re IPO,* 471 F.3d at 41; *accord In re Sadia,* 269 F.R.D. at 307-08.

2. Courts in other circuits have gone so far as to require "a full *Daubert* analysis before certifying the class if the situation warrants." *Am. Honda Motor Co. v. Allen,* 600 F.3d 813, 816 (7th Cir. 2010), accord, *Sher v. Raytheon Co.,* No. 09-15798, 2011 WL 814379, at *1 (11th Cir. Mar. 9, 2011) (finding that the district court erred by not sufficiently evaluating and weighing conflicting expert testimony on class certification). While there is a trend of using *Daubert* motions to defeat class certification, courts have utilized different approaches to evaluate class certification experts. The Supreme Court has not yet addressed whether expert testimony must pass muster under *Daubert* at the class certification stage.

3. "Of course, *unusual* post-disclosure trading patterns present typicality problems." *In re Countrywide Fin. Corp. Sec. Litig.,* 273 F.R.D. at 603 (emphasis in original).

4. Courts in other circuits apply this standard strictly as well. *See, e.g., In re Fleet Boston Fin. Corp. Sec. Litig.,* 253 F.R.D. 315, 348 (D.N.J. 2008) (requiring "actual, i.e., fact-based rather than statistical tracing"); *Krim v. PCOrder.com, Inc.,* 210 F.R.D. 581, 586 (W.D. Tex. 2002) ("Lead Plaintiffs must demonstrate *all* stock for which they claim damages was actually issued pursuant to a defective statement, not just that it might have been, probably was, or most likely was, issued pursuant to a defective statement."), *aff'd.,* 402 F.3d 489 (5th Cir. 2001).

5. Not all courts have viewed tracing difficulties among aftermarket purchases to be so problematic in the class certification stage. *See, e.g., Freeland v. Iridium World Commc'ns, Ltd.,* 233 F.R.D. 40, 46 (D.D.C. 2006) ("It would be inappropriate to foreclose such Plaintiffs' resort to the class action format simply because some of their cases may be difficult to prove."); *In re LILCO Sec. Litig.,* 111 F.R.D. 663, 671 (E.D.N.Y. 1986) (holding that because it was readily apparent that all class members were purchasers of the relevant stock, "tracing will not pose insurmountable obstacles warranting denial of class status.").

6. The test for materiality in the context of claims brought pursuant to Section 10(b) of the Securities Exchange Act of 1934 is the same as when claims are brought pursuant to Sections 11 and 12(a)(2) of the Securities Act. *Litwin v. Blackstone* Grp., L.P., 634 F.3d 706, 716 (2d Cir. 2011).

7. "Empirical evidence suggesting a causal connection between new information and price movement ... is 'the essence of an efficient market and the foundation for the fraud on the market theory.' It is therefore the 'most important' Cammer factor. ... Event studies are by far the most common test for a causal connection. An event study attempts to determine whether new information correlates with a price movement -- including the price movement's direction and, perhaps, magnitude. Causation

may be inferred from this correlation. Naturally, the inference that the new information has caused the price movement is stronger under some circumstances. For example, the inference will be stronger: (1) the more statistically significant the correlation; (2) the more objectively defined the event is; (3) the better the study controls for nonfraud factors; and (4) the larger and more representative the sample." *In re Countrywide Fin. Corp. Sec. Litig.,* 273 F.R.D. 586, 614 (C.D. Cal. 2009) (internal citations omitted).

8. In a Section 11 case, plaintiffs do not have the burden of proving causation, although defendants "may assert, as an affirmative defense, that a lower share value did not result from any nondisclosure or false statement." *In re Adams Golf Inc. Sec. Litig.,* 381 F.3d 267, 277 (3d Cir. 2004). Similarly, plaintiffs do not need to establish reliance on an issuer's statements, unless they purchased the stock more than "twelve months ... after the effective date of the registration statement." 15 U.S.C. § 77k(a)(5)(1998). Moreover, "any decline in value is presumed to be caused by the misrepresentation in the registration statement." *McMahan & Co. v. Wherehouse Entm't, Inc.,* 65 F.3d 1044, 1048 (2d Cir. 1995). Thus, the elements of a Section 11 claim "stand in stark contrast" to those of a Section 10(b) claim, which requires "a showing of reasonable reliance and scienter." In re: *Adams Golf, Inc. Sec. Litig.,* 381 F.3d 267, 273 n. 5 (3d Cir. 2004).

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