Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Fed. Courts Are Best Regulator Of Securities Class Actions

By **Nessim Mezrahi** (June 19, 2020, 6:03 PM EDT)

Nessim Mezrahi

In their working legal paper, law professors Jill E. Fisch and Jonah B. Gelbach posit: "Federal judges are poorly positioned to weigh the policy considerations reflected by the tradeoff between confidence level and power" in single-firm event studies that are used and relied upon to evaluate market efficiency, price impact, and loss causation in securities class actions that allege violations of federal securities laws under Section 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by the U.S. Securities and Exchange Commission.[1]

The Fisch and Gelbach working paper states that the evaluation of the statistical threshold "for determining whether an event study is admissible or probative is a legal, not a scientific question."[2]

Moreover, the law professors' working paper indicates that the judiciary cannot weigh policy considerations related to the deterrence of fraud on the market and as a result "it becomes clear that although courts are wrong to accept blindly the 95% confidence level, the judiciary also is not the best-situated branch of government to determine whether or how to modify that standard."[3]

According to the working paper, Fisch and Gelbach propose that the SEC "is well — and deliberately — positioned to regulate the private securities litigation landscape" and better suited than the federal judiciary to undertake the fact-intensive exercise of determining the statistical threshold that should be applied in single-firm event study analyses that are routinely relied on to evaluate class certification and loss causation.[4]

The proposal presented in the Fisch and Gelbach working paper is inapplicable and untimely for two reasons.

First, their working paper acknowledges that the judiciary in the U.S. Court of Appeals for the Second Circuit has already addressed the applicability of the 95% confidence standard and the power tradeoff in multivariate linear regression analyses that support single-firm event studies in the context of securities class action litigation.[5]

In re: Chicago Bridge & Iron Co. NV Securities Litigation, former U.S. District Judge Shira A. Scheindlin reviewed extensive expert testimony by leading financial economists regarding the adequacy of the 95% confidence standard and the application of the Holm-Bonferroni adjustment to address the "multiple comparisons" issue.[6]

In the current landscape, federal court judges are not blindly accepting any statistical threshold in single-firm event studies that are contested in motions for class certification, as suggested in the Fisch and Gelbach working paper.

The Chicago Bridge & Iron Co. NV Securities Litigation demonstrates the effectiveness of expert testimony to evaluate the applicability and fit of single-firm event studies to analyze price impact and market efficiency — particularly, the fifth Cammer factor. After extensive expert testimony, the judge in the Chicago Bridge & Iron Co. NV Securities Litigation, concluded:

> The case law establishes that 5% is the standard — though not exclusive — decision rule employed by courts in this context. ... For this purpose it is helpful for experts to report the precise p-value, rather than merely stating that the return is significant at the 5% level or the 10% level. I therefore conclude that Dr. Finnerty's report of p-values for all of the dates analyzed and his opinion as to whether those between .05 and .10 (5-10% statistical significance) support a finding of market efficiency or price impact may be considered in deciding the issues presented by this motion.[7]

The Fisch and Gelbach working paper does not address the multiple-comparisons problem nor does it source relevant scientific research published by mathematicians and statisticians that evaluate certain statistical methods that control for type I and type II errors that may be present in multivariate linear regression analyses.[8]

For example, according to the defendant's expert in the Chicago Bridge & Iron Co. NV Securities Litigation, Lucy Allen of NERA Economic Consulting, her report on price impact addressed the multiple-comparisons problem and proposed the use of the Holm-Bonferroni adjustment to correct for it:

> A standard and commonly accepted method to correct for the multiple comparisons problem is the Holm-Bonferroni adjustment. The Holm-Bonferroni adjustment is based on the number of tests performed so that the overall statistical significance takes into account the number of tests performed and adjusts the statistical threshold of individual tests accordingly.[9]

Judge Scheindlin sourced the research of financial economist David Tabak of NERA to further understand and address the multiple-comparisons issue and concluded:[10]

> [A] price impact analysis does not present the type of problem that the Holm-Bonferroni adjustment corrects. Particularly in light of the few dates at issue here and the precedential rarity of applying multiple comparison adjustments in 10b-5 cases, I decline to require the use of the Holm-Bonferroni adjustment in weighing competitive expert analyses.[11]

Second, the Fisch and Gelbach working paper states: "Most judges are lawyers, and although modern legal training has been influenced by law and economics, 'a standard legal education does not include rigorous training in statistics or the evaluation of scientific evidence.'"[12]

This is precisely the reason that the federal judiciary relies on expert testimony by established financial economists experienced in securities class action litigation to address econometric issues that are specific to the allegations in the claim at issue.

The proposition made by Fisch and Gelbach, that the SEC is better suited than the federal judiciary to evaluate the applicable statistical threshold on every securities class action where market efficiency, price impact and loss causation are contested, will severely inhibit an effective and efficient delivery of justice.

Given the current state of affairs in Washington, D.C., investors in the U.S. public markets are better served if the SEC deploys its resources in support of executing the directives of legislation S. 945 — the Holding Foreign Companies Accountable Act.[13]

If approved by Congress and the president, the bill will amend Section 104 of the Sarbanes-Oxley Act of 2002 and require certain non-U.S. issuers to disclose to the commission their audit reports, including specific foreign ownership information, to evaluate their standing on U.S. national exchanges.

This is good for investors in our public equity markets and better for their protection than redirecting the commission's limited resources to duplicate specialized expert work that is already being performed by skilled financial economists in academia and the private sector.

Aside from the flurry of COVID-19-related enforcement actions, according to the SEC's Feb. 14 press release, the commission is focused "to improve the [National Market System] market data infrastructure by reducing the current disparity in content and latency between NMS market data and the proprietary data products that some of the individual exchanges sell directly to market participants."[14]

According to the SEC's press release on Sept. 9, 2019, the commission is also committed to execute on its mission to advance the implementation of the consolidated audit trail.[15]

The lack of data and price discovery uniformity born from various market data sources will inhibit the SECs ability to objectively oversee all public equity trades on U.S. exchanges and effectively evaluate price impact of all public disclosures, as proposed in the Fisch and Gelbach working paper:

> The SEC could collect data on corrective disclosures that do not result in litigation to evaluate the price impact associated with such disclosures and to determine whether litigation under existing empirical standards would be viable.[16]

The determination of what information may be considered corrective in publicly disseminated disclosures by directors and officers of U.S.-listed corporations is an arduous and time intensive legal undertaking that should not be placed on the shoulders of the SEC. According to Judge Scheindlin, in the Chicago Bridge & Iron Co. NV Securities Litigation:

> While there is no Second Circuit precedent directly reaching this issue, several district courts post-Arkansas Teachers have conducted the "correctiveness" analysis at the class certification stage. However, a review of those cases demonstrates that the analysis has been carefully limited to a few inquiries, including: (i) whether the information in the alleged corrective disclosure is new — if it is not new then it cannot be corrective; (ii) whether the information in the alleged corrective disclosure relates to the same subject matter or is wholly unrelated; and (iii) whether the information in the alleged corrective disclosure is merely analyst speculation or opinion which cannot be deemed corrective. Any further examination of the alleged corrective disclosure risks crossing the line into an analysis of loss causation.[17]

The SEC may have "the legal power and the institutional competence to develop litigation standards," Fisch and Gelbach state, but the commission does not have the resources to make hundreds of definitive legal conclusions related to the correctiveness of all disclosures made by directors and officers of U.S.-listed corporations.[18]

As a result, the commission may be reluctant to dictate affirmatively on the appropriate statistical threshold that should be applied on single-firm event studies that are relied upon in securities class actions.

The federal judiciary is the most experienced branch of government to make sound determinations of correctiveness in public disclosures that may be alleged to be rectifying materially misleading statements or omissions by directors and officers of U.S.-listed corporations.

Expert testimony rendered by qualified financial economists with class action litigation experience is an effective mechanism to evaluate the appropriate statistical threshold that should be applied in single-firm event study analyses that are contested in motions for class certification.

Just because "[f]ederal courts do not see cases that lawyers do not file [and they] do not see investor losses that are not pursued through litigation," as stated by Fisch and Gelbach, does not mean that the SEC should be tasked to regulate the private securities class action arena to better serve investors.[19]

The proposal is inapplicable, untimely and will severely undermine the legal defenses that have been afforded to directors and officers of U.S.-listed corporations through established case precedents in the U.S. federal court system.

Nessim Mezrahi is co-founder and CEO of SAR LLC, a securities class action data analytics software company.

[1] "Power and Statistical Significance in Securities Fraud Litigation," ECGI Working Paper Series in Law No. 511/2020, Johah B. Gelbach and Jill Fisch, April 2020, Pg. 4.
See, https://corpgov.law.harvard.edu/2020/05/12/power-and-statistical-significance-in-securities-fraud-litigation/.

[2] Id., Pg. 40.

[3] Id., Pg. 43.

[4] Id., Pg. 45.

[5] Id., Pg. 10.

[6] "Ms. Allen cites the Reference Guide on Statistics for the proposition that the 5% level "'is the most common in social science' and that is typically used by courts." In his Reply Report, Dr. Finnerty argues that this claim regarding the 5% level in social science is not specific to finance and economics." In re Chicago Bridge & Iron Company NV Securities Litigation. See, Special Master Report and Recommendation Regarding Class Certification and Appointment of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin, Special Master, dated Oct. 16, 2019, Pg. 34.

[7] In re Chicago Bridge & Iron Company NV Securities Litigation. See, Special Master Report and Recommendation Regarding Class Certification and Appointment of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin, Special Master, dated Oct. 16, 2019, Pg. 34-36.

[8] Academic journals that reference the "multiple comparisons" problem and not referenced in the Fisch and Gelbach working paper include: Freedman, David A., and David H. Kaye, "Reference Guide on Statistics," Reference Manual on Scientific Evidence (Washington D.C.: Federal Judicial Center, 3rd ed., 2011); Fisher, Franklin M., "Multiple Regression in Legal Proceedings," Columbia Law Review, 80: 1980. Rice, John A., Mathematical Statistics and Data Analysis (Belmont, CA: Cengage Learning, 3rd ed., 2007); Mikel Aickin & Helen Gensler, "Adjusting for Multiple Testing When Reporting Research Results: The Bonferroni vs Holm Methods," American Journal of Public Health, 86(5): (1996). Austin, Peter C., et al,. "Testing Multiple Statistical Hypotheses Resulted in Spurious Associations: A study of Astrological Signs and Health," Journal of Clinical Epidemiology 59: 2006.

[9] In re Chicago Bridge & Iron Company NV Securities Litigation. See, Expert Report of Lucy P. Allen, dated April 9, 2019, Pg. 28-29.

[10] Id., See, Special Master Report and Recommendation Regarding Class Certification and Appointment of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin, Special Master, dated Oct. 16, 2019, Pg. 40, citing David Tabak, "Multiple Comparisons and the Known or Potential Error Rate," Journal of Forensic Economics, 19. 231, 232 (2006).

[11] Id., See, Special Master Report and Recommendation Regarding Class Certification and Appointment of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin, Special Master, dated Oct. 16, 2019, Pg. 44-45.

[12] "Power and Statistical Significance in Securities Fraud Litigation," ECGI Working Paper Series in Law No. 511/2020, Johah B. Gelbach and Jill Fisch, April 2020, Pg. 43.

[13] S.945 – Holding Foreign Companies Accountable Act, 116th Congress (2019-2020), 2nd Session.

[14] "SEC Proposes to Modernize Key Market Infrastructure Responsible for Collecting, Consolidating, and Disseminating Securities Market Data," Washington, D.C., February 14, 2020. https://www.sec.gov/news/press-release/2020-34.

[15] "SEC Proposes Transparency and Financial Accountability Amendments to the CAT NMS Plan," Washington, D.C., September 9, 2019. https://www.sec.gov/news/press-release/2019-173.

[16] "Power and Statistical Significance in Securities Fraud Litigation," ECGI Working Paper Series in Law No. 511/2020, Johah B. Gelbach and Jill Fisch, April 2020, Pg. 47.

[17] In re Chicago Bridge & Iron Company NV Securities Litigation. See, Special Master Report and Recommendation Regarding Class Certification and Appointment of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin, Special Master, dated Oct. 16, 2019, Pg. 57-58.

[18] "Power and Statistical Significance in Securities Fraud Litigation," ECGI Working Paper Series in Law No. 511/2020, Johah B. Gelbach and Jill Fisch, April 2020, Pg. 1.

[19] Id., Pg. 44.