CHICAGO BAR ASSOCIATION SECURITIES FRAUD PRESENTATION

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What is Loss Causation? The Statutory Basis

Securities Exchange Act of 1934 § 10(b), 15 USC § 78j(b)

"It shall be unlawful for any person, directly or indirectly … b. To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered … any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

SEC Rule 10b-5, 17 CFR § 240.10b-5

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Private Securities Litigation Reform Act ("PSLRA"), 15 USC § 78u-4(b)(4)

" In any private action arising under the [Securities Exchange Act of 1934] the plaintiff shall have the burden of proving that **the act or omission of the defendant alleged to violate [the Securities Exchange Act] caused the loss** for which the plaintiff seeks to recover damages. "

Proving Loss Causation

Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005)

Facts: Plaintiffs bought stock in Dura Pharmaceuticals, Inc. between April 15, 1997 and February 24, 1998. Plaintiffs alleged that Dura made false statements during this period regarding its profits and the pending FDA approval of a new asthmatic spray device. Subsequently, Dura disclosed that it would experience lower-than-expected earnings and that FDA would not approve the spray device. Dura's stock price dropped after these disclosures.

Issue: Plaintiffs argued that they adequately pled loss causation under the PSLRA by alleging that the price of the stock was artificially inflated on the date they purchased the stock. The Ninth Circuit held that this was sufficient to survive a motion to dismiss.

Outcome: SCOTUS reversed the Ninth Circuit.

Dura, cont..

SCOTUS Opinion:

- "To touch upon a loss is not to *cause* a loss, and it is the latter that the law requires."

- "***There is no loss attributable to a misrepresentation unless and until the truth is subsequently revealed and the price of the stock accordingly declines.***"

- The purpose of the Securities and Exchange Act "is not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."

- "When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."

Loss Causation After *Dura*

Two elements:

1. Plaintiff must show that the company made a material misrepresentation.
2. Plaintiff must show that they suffered a loss when that misrepresentation was revealed and the company's share price dropped *as a result* of that revelation (and not other market- or company-related factors).

Loss Causation in the Seventh Circuit

Two Primary Methods

- "Fraud on the Market" or "Corrective Disclosure"
  - "Plaintiffs must show the that Defendants' alleged misrepresentations artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception."
- "Materialization of the Risk"
  - "It was the very facts about which the defendant lied that caused [Plaintiffs'] injuries."

Ray v. Citigroup Global Markets, Inc., 482 F.3d 991 (7th Cir. 2007)

Fraud on the Market/ Corrective Disclosure

- Requires a new, specific disclosure that reveals the truth about a previously misrepresented fact.
  - Disagreements about what qualifies as a corrective disclosure, e.g., who may serve as the source, how specifically/completely it must refer to the misrepresentation, the form of communication.
- That disclosure – and not other negative news – must cause a "statistically significant" drop in stock price.
  - Statistical Significance: Confident that price movement was not simply due to random occurrences, but was instead caused by new information that was disclosed to the market. Determine thru a regression analysis.
  - Positive confounding news?
- In an efficient market, the drop in price must promptly follow the disclosure (exceptions?)

In re *Motorola Sec. Litig.* 505 F. Supp. 2d 501, 536 (N.D. Ill. 2007)

Materialization of the Risk

- Does *not* require a corrective disclosure that specifically identifies a prior false statement and calls it into question.

- Basic Example:
  - Company announces new lucrative contract.
  - Company lied. No actual K.
  - B/c no income from K, Company later violates debt covenant and bank forecloses.
  - No disclosure of truth (*i.e.*, no K), but the risk has "materialized."

- The Seventh Circuit recently questioned whether materialization of the risk is a distinct method of establishing loss causation, stating, "[materialization of the risk] is not a legal doctrine or anything special as a matter of fact."

  Schleicher v. Wendt, 618 F.3d 679 (7th Cir. 2010).

Loss Causation Methodology

1. Assume Plaintiffs prove allegations in the Complaint
2. Evaluate which disclosures are causally related to Plaintiffs' allegations.
3. Conduct event study to test for stock price movement related to the disclosure after controlling for market effects.
4. Evaluate whether further disaggregation of stock price response is necessary.

What is Loss Causation?

- I understand loss causation (or proximate causation) to be a combination of the But-for Test and the Foreseeability test
  - But-For Causation
    - Would loss have occurred earlier (or at all) but-for the alleged violation?
  - Foreseeability Test
    - Were investor losses a foreseeable consequence of the alleged violation?

But-For Causation

- Why is this an economic question?
  - Trying to evaluate: did B (disclosure and loss) occur because of, or was delayed by, A (misrepresentation)
  - Is there a coherent economic link between misrepresentation and value – and thus artificial inflation in the market price?
    - Example 1: why would earnings misstatement be economically relevant to an investor?
    - Example 2: why would lack of proper disclosure of underwriting practices and loan loss reserve policies be economically relevant to an investor in a financial services company?
  - Does the disclosure reveal the relevant economic truth that was concealed?
    - Example 1: Restatement of financials
    - Example 2: Company announces poor earnings (or insolvency) due to increased loan losses.
- Economic analysis plays an important role in answering these types of questions

Foreseeability

- Why is this an economic question?
  - Trying to evaluate: was B (disclosure and loss) a foreseeable consequence of A (misrepresentation)
  - Is there a coherent economic link between misrepresentation and value – and thus artificial inflation in the market price?
    - Example 1: why would earnings misstatement be economically relevant to an investor?
    - Example 2: why would lack of proper disclosure of underwriting practices and loan loss reserve policies be economically relevant to an investor in a financial services company?

Event Study Methodology

- Estimate a "market model" to learn how the security's return tends to vary with market and industry returns.
  - *Estimation period*: typically a period prior to the allegation-relevant dates
  - *Specification*: choice of market and industry indices, maybe other factors
  - *Returns frequency*: typically daily, but intraday or multiday if indicated
- Use the regression model to predict returns on dates of interest ("predicted return").
  - Decide on event window over which to calculate abnormal returns
  - Calculate the "abnormal return" as the difference between the actual return and the predicted return and determine whether the abnormal return is statistically significant.
  - If the abnormal return is statistically significant and there is new company-specific news, then draw a causal link between the company-specific news and the abnormal stock price movement

Event Study Example

- On disclosure date:
  - Company A Return: -6%
  - Predicted return: -1% (because of market/industry movements)
- "Abnormal" Return = Actual Return (-6%) minus index return (-1%), or -5%
- Test for statistical significance:
  - -5% abnormal return
  - Standard deviation of abnormal returns: 2%
  - T-statistic = abnormal return (-5%) divided by standard deviation (2%), or -2.5
  - If abnormal returns are normally distributed, there is 95% chance t-statistic will fall between 1.96 and -1.96, unless there is only random fluctuation in the stock price.
  - Since t-stat (-2.5) falls outside that range, then we reject randomness as the cause and infer the new news caused the stock price movement.

Parse Abnormal Returns If The Event is Confounded

- If confounding and corrective news enter the market at different times during the same trading day, evaluate possibility of disentangling by time
  - Conduct overnight or intraday event studies
- If confounding and corrective news enter the market simultaneously, attempt to disentangle using analyst reports, fundamental valuation, or statistical methods. For example:
  - Decompose earnings surprise by source based on analysts' explicit breakdown or qualitative discussions
  - Price disclosures with a one-time impact dollar for dollar
  - Price elements of disclosure (e.g. delay in 10-K filing) using a cross-sectional event study

Carrying Inflation Back Through Time

- Event studies can tell us how the market valued untimely information on the date of disclosure, but they say nothing about the evolution of that valuation (i.e., inflation) over time.

- Constant dollar and constant percent are simple and oft-used models of how the market valued the fraudulent information pre-disclosure.

- Potential divergence between economic question and legal limitations on recovery.
  - Example of when constant dollar appropriate: one-time cash effect.
  - Example of when constant percentage appropriate: proportionate effect through time – e.g. misstatement of productive capacity.

Rule 10b-5 Damage Per Share: The Basic Metric and Applicable Caps

- Damage per share is:
  - out-of-pocket loss (= inflation drop over the holding period)
    - Purchase with $2 inflation, sell at $1 inflation, damages equal $1
    - Purchase with $3 inflation, hold to end, damages equal $3
    - Purchase with $3 inflation, sell at $3 inflation, no damages
  - Capped by Private Securities Litigation Reform Act ("PSLRA"), which limits damages to purchase price less average post-disclosure price to the earlier of sale or 90 days.

Constant dollar inflation example

Day	Price	Value of Disclosure	Inflation	Implied True Value	News
Monday	$10		$6	$4	
Tuesday	$9		$6	$3	
Wednesday	$6	$3	$3	$3	Corrective Disclosure
Thrusday	$5		$3	$2	
Friday	$2	$3	$0	$2	Corrective Disclosure

SEC'S APPROACH TO CORPORATE PENALTIES

Fundamental Principle

- Corporate penalties are an essential part of an aggressive and comprehensive program to enforce the federal securities laws

Statement on Penalties

- Statutory authority
  - 1990 Securities Enforcement Remedies and Penny Stock Reform Act ("Remedies Act")
  - Before the Remedies Act, the Commission's penalty authority was essentially limited to the ability to seek penalties in district court for insider trading violations

Fair Funds

- Section 308 of Sarbanes-Oxley Act of 2002
  - Penalty moneys no longer always go to the Treasury
  - Penalty moneys can be used to compensate victims for the losses they experienced from the wrongdoing

SEC Statement on Penalties

- Jan 4, 2006
- "… a key question for the Commission is whether the issuer's violation has provided an improper benefit to shareholders, or conversely whether the violation has resulted in harm to shareholders."

“Circularity” problem

- Because of the fraud, some shareholders were harmed.
  - Specifically, they purchased stock at an inflated price and did not sell at an inflated price
- If the company pays a penalty to the SEC, the aggregate value of common stock will drop by the amount of the penalty
  - Value of the company’s debt, if any, is likely not affected
- Therefore, there is a risk that the penalty “will ultimately be paid by shareholders who were themselves victimized by the violations.” (S. Rep. No. 337, 101st Cong., 2d Sess. at 17 (1990)

Circularity issue is highlighted in the Bank of America – Rakoff Decision

- Sept 14, 2009
- In effect, Judge Rakoff found, the settlement would force the victims of the alleged misstatements–Bank of America shareholders–to pay an additional $33 million.
- "It does not comport with the most elementary notions of justice and morality, in that it proposes that the shareholders who were the victims of the bank's alleged misconduct now pay the penalty for that misconduct," the judge wrote.
- (Source: WSJ, 9/14/09)

Circularity issue raised again – Citi failed to disclose subprime holdings

- 8/17/2010 – Judge Huvelle does not approve SEC $75 million settlement with Citigroup, questioning "why current Citigroup shareholders should pay those harmed by the loss."
- 9/24/2010 – Judge Huvelle approves the settlement, asking "that the $75 million []be used to compensate shareholders who had suffered losses because of Citigroup's misstatements"

Fair funds and the circularity problem

- 2/22/2010 – Judge Rakoff approves Bank of America settlement

What the proposal does, in effect, is to transfer $150 million from all shareholders to those current Bank shareholders who were victimized by the non-disclosures. Since the S.E.C. in its letter dated February 16, 2010 estimates that this latter group is roughly around 50 percent of all current Bank shareholders, the effect is to transfer $75 million from Merrill "legacy" shareholders to Bank "legacy" shareholders. Put another way, it serves to renegotiate the price that Bank shareholders would have paid to Merrill shareholders for purchasing Merrill shares if the disclosures had been made.

Deterrence Is a Focal Point

- Egregious misconduct
- Scope and duration of the misconduct
- Involvement of Senior Management
- Contribution of Internal Controls Failures
- Recidivism
- Self-reporting, cooperation and remediation (after the misconduct)