TAKING A MORE SOPHISTICATED APPROACH TO MARKET EFFICIENCY: HOW SECURITIES ANALYST REPORTS CAN BE USED TO ESTABLISH LOSS CAUSATION IN A FEDERAL SECURITIES FRAUD ACTION

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By Bernard S. Sharfman[1]

Private plaintiffs in a federal securities fraud suit must establish "'loss causation,' i.e., a causal connection between the material misrepresentation and the loss,"[2] in order to pursue their claims. Establishing loss causation is not an easy proposition. In *Dura Pharmaceuticals v. Broudo*, the U.S. Supreme Court made clear that "an inflated purchase price will not by itself constitute or proximately cause the relevant economic loss" needed to demonstrate loss causation.[3] This decision has raised the hurdle for plaintiffs trying to establish loss causation. However, *Dura* did not impede plaintiffs from establishing loss causation by showing that a securities price decline occurred because of a "corrective disclosure."[4] Such a disclosure "reveals the fraud, or at least some aspect of the fraud, to the market."[5]

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[1] Mr. Sharfman is a graduate of the Georgetown University Law Center (2000). The opinions expressed in this article are solely the author's and are not to be taken as representative of the opinions of any former, current, or future employer. This article is dedicated to Mr. Sharfman's wife, Susan Thea David, and his daughter, Amy David Sharfman, for without their love and encouragement this article would never have been completed. Mr. Sharfman would like to thank Professors Michael D. Klausner and Erik Gerding for their helpful comments and insights.

[2] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005).

[3] *Id.* at 346-47.

[4] Order at 3, *In re Apollo Group, Inc. Securities Litigation*, CV 04-2147-PHX-JAT (filed August 4, 2008).

[5] *Id.*

In the newly evolving case law of what constitutes a corrective disclosure, a recent U.S. District Court for the District of Arizona decision in *In re Apollo Group, Inc. Securities Litigation*[6] has brought to the fore the issue of whether or not corrective disclosures must come only in the form of "hard facts," such as the public disclosure of prospective accounting restatements or the failure of the FDA to approve a drug for public use, or if they can also come in the form of "soft facts," i.e., a public disclosure of how a securities analyst has changed her opinion or valuation of a security based on the incorporation of hard facts into her analysis or valuation model(s). Such a change in an analyst's opinion will typically be communicated to the market by the public release of a written research report. In this essay, it is argued that corrective disclosures must also include the later in order to be consistent with a correct understanding of how the mechanisms of an efficient financial market operate. If not, many investors who have been the victim of securities fraud will go uncompensated.

A Troubling Opinion

In *Apollo*, the Court overturned a jury finding that two analyst reports authored by the same securities analyst were corrective disclosures.[7] Even though the Court did not completely rule out securities analysis as the basis for a corrective disclosure, since doing so would encourage public companies to provide "opaque, piecemeal disclosures,"[8] the Court held that a the public disclosure of a security analyst's findings will rise to the level of a corrective disclosure in securities litigation in only rare circumstances:

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[6] *Id.*

[7] *Id.*

[8] *Id.* at 4.

> *[T]he typical securities fraud will be fully revealed through the disclosure of facts, without the need for any subsequent analysis.* As the *Merck* court stated, "An efficient market for good news is an efficient market for bad news." 432 F.3d at 271. *The situations in which the pertinent facts are obfuscated in such a way, or are of such complexity, as to require someone to connect the dots for a bewildered market represent a* ***very rare type*** *of securities-fraud case*, and would not be the rule. The Court's position simply recognizes that an efficient market is not necessarily an omniscient one.[9]

Mechanical Efficiency

According to the U.S. Supreme Court in *Basic, Inc. v. Levinson*, the market "transmits information to the investor in the processed form of a market price" and thus "performs a substantial part of the valuation process performed by the investor in a face-to-face transaction."[10] By contrast, the holding in *Apollo* says something different because it denies the existence of a pricing mechanism. It essentially says that an efficient market does not need the help of securities analysts to figure out how the disclosure of hard facts will affect the price of a security, whether or not we are talking about the disclosure of securities fraud. Somehow, the market will automatically do this for investors. But how can it happen without the involvement of securities analysts? Someone must provide the market with analysis that allows securities prices to move as close as possible to their fundamental values at any particular point in time. This is the key function of an efficient market and is of key importance to investors.

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[9] *Id.* at 4.

[10] 485 U.S. 224 (1988).

Even though in error, the *Apollo* court's holding makes sense if it is understood to reflect a simple form of market efficiency that can be referred to as a "mechanical" or "semi-efficient."[11] This understanding of efficiency only requires that the market price of a security reflect all publicly available information that come in the form of hard facts. It is not concerned with the market pricing the security as accurately as possible.[12] In a world of mechanical efficiency, (1) prices respond quickly to new hard facts; and (2) the price change is "unbiased," that is, there is no systematic undershooting or overshooting that would allow a savvy market participant to earn excess returns.[13] Given this understanding of market efficiency, it is not surprising that the Court found little value in a securities analyst "connecting the dots" for investors.

However, while mechanical efficiency provides a sufficient understanding of market processes for a court to determine whether or not a rebuttable presumption of reliance under the fraud-on-the-market-theory (FOTM) can be established,[14] it is not sufficient for purposes of evaluating corrective disclosures. As already stated, a corrective disclosure "reveals the fraud, or

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[11] William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness*, 54 EMORY L.J. 843, 850 (Spring 2005).

[12] *Id.*

[13] *Id.* at 851.

[14] The FOTM was established by the U.S. Supreme Court in *Basic, Inc. v. Levinson*. 485 U.S. 224 (1988). "To facilitate class actions in securities fraud cases, courts have adopted the FOTM as a presumption of reliance. Since the market incorporates information into prices, it will reflect the misstatement in the securities price, and thus reliance on market prices is a substitute for reliance on the misstatement." Zohar Goshen and Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 766 (2006). Mechanical efficiency is sufficient for evaluating whether or not this has occurred.

at least some aspect of the fraud, to the market."[15] If so, a key ***aspect*** of the fraud must be how it will ultimately affect the price of the security, i.e., in terms of how the marketplace tries to estimate a security's fundamental value. This is something that can only be done by those market participants, such as securities analysts, who actually *study* the hard facts of the initial corrective disclosure and then adjust their valuations accordingly.[16] Moreover, the process of study takes time and therefore, the information it generates, the resulting changes in valuations, is not immediately available to the market. In *Apollo*, the Flynn reports came out five days after the hard facts of the fraud were revealed.[17] It was only then, and not when the hard facts were disclosed, did the stock price of Apollo fall significantly.[18]

Why a court would not consider the disclosure of an analyst's study as a corrective disclosure is because its understanding of market efficiency as being synonymous with mechanical efficiency limits its understanding of what really occurs in the marketplace. A major flaw in the use of mechanical efficiency is that it does not consider the necessity of studying the hard facts in order to understand what they mean to the value of a security or the time lag that study requires in creating *informed* changes in valuation. One result is that it can lead to the mistaken belief that markets instantaneously move a stock price to a level which best approximates its fundamental value as soon as new hard facts about a company are disclosed. Such markets would be considered almost perfectly efficient, which is not at all what mechanical

[15] Order, *supra* note 3, at 3.

[16] Goshen and Parchomovsky, *supra* note 13, at 721 (This pricing function "requires analyzing the information to determine its value.").

[17] Order, *supra* note 3, at 2.

[18] *Id.*

efficiency means or what reality provides. Mechanical efficiency only says that publicly available information is quickly reflected into the price of the stock. Given that a time lag occurs before a security price can in reality approximate its fundamental value, then a more accurate model of market efficiency is necessary for evaluating corrective disclosures.

Information and Value Efficiency

What is required for properly evaluating corrective disclosures is a theory of market efficiency that not only incorporates prices that respond quickly to new hard facts and price changes that are unbiased, but also a process for how security prices move to their fundamental values. Such a theory of market efficiency can be referred to as "value efficiency."[19] This theory requires a more expansive definition of information and how it is created than mechanical efficiency.

According to Professors Ronald J. Gilson and Reinier H. Kraakman, "in the broadest sense, information is data that has the capacity to alter one's beliefs about the world or, in our more limited context, one's beliefs about the appropriate price of an asset."[20] Such information about a company comes in two forms, hard or soft. Hard information is what has been referred to as hard facts.[21] This is the type of information that the *Apollo* court would view as potentially being a corrective disclosure. Soft information, on the other hand, would be the forecasts and

[19] *Id.*

[20] Ronald J. Gilson and Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 561 (1984).

[21] *Id.*

predictions about a company's value and prospects such as developed by securities analysts.[22] This is the type of information that the *Apollo* court incorrectly dismissed when evaluating alleged corrective disclosures. The two types of information are linked through the process by which an analyst will study the newly disclosed hard facts and incorporate them into her security valuation.[23] Such study and the resulting modifications in security valuation create new (soft) information for investors to trade on, helping the market properly price the security.[24]

Value efficiency is essentially mechanical efficiency plus an explanation of how markets move securities prices toward their fundamental values. According to Professors Zohar Goshen and Gideon Parchomovsky:

> Pricing *information* consists of two distinct activities: analyzing information and trading. Analyzing information requires analyzing both firm-specific and general market information. Firm-specific information cannot be accurately priced in isolation because one cannot evaluate the future prospects of a corporation without knowledge about the estimated course of the local and global economies. Trading, the act by which information is transmitted to the market, can take one of two forms: direct trading, or *indirect trading through recommendations and advice to others who trade*.[25]

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[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] Goshen and Parchomovsky, *supra* note 13, at 721.

Security analysts comprise a critical group of market participants called "information traders."[26] These traders "are willing and able to devote resources to gathering and analyzing information as a basis for their investment decisions."[27] Information traders include sophisticated professional investors such as institutional investors, money mangers and other market professionals; and analysts such as sell-side, buy-side and independent analysts.[28] Sell-side analysts, like Flynn in *Apollo*, who do not trade for their own account, are still considered information traders (indirect traders) because they provide valuations and recommendations to their clients who will then utilize this information for their own trading purposes.[29] Information traders look for differences between value and price based on the information they possess and "then trade to capture the value of their informational advantage."[30] Information traders move security prices toward their fundamental values and are in essence "the agents who render markets efficient."[31]

The role of the information traders in creating value efficient financial markets, including sell-side security analysts like Flynn, cannot be overstated. According to Professor Jill Fisch, "Passive diversified investing may be a rational strategy for a particular investor, but this

[26] *Id*. at 723. According to Goshen and Parchomovsky, the market players consist of five groups: insiders, information traders, liquidity traders, noise traders and market makers. *Id.* at 722.

[27] *Id*. at 723.

[28] *Id*.

[29] *Id*.

[30] *Id*. at 726.

[31] *Id*. at 719.

strategy is devastating for the market as a whole."[32] This should be clear if we think of a financial market where there are only liquidity traders, i.e., those "who buy and hold a portfolio of stocks based on consumption/saving considerations independently of general market or firm-specific information." [33] Such a market would be characterized by general price shifts affecting all indexed stocks as the liquidity needs of these investors shift over time.[34] However, it would be hopeless to suggest that such a market will price securities close to their fundamental values as liquidity traders buy and sell securities regardless of new information, making their trades random relative to new information entering the market.[35] Thus, without market participants such as security analysts, there would be no mechanism in place to allow a market to efficiently price securities.

If the *Apollo* court had understood market efficiency in terms of value efficiency instead of mechanical efficiency, then its perspective on corrective disclosures and the information provided by security analysts in connecting the dots for the marketplace would have been decidedly different. Value efficiency leads to the presumption that hard facts can only provide a partial corrective disclosure and that a full corrective disclosure must wait until information traders can fully incorporate the hard facts into their pricing models. How long the wait will be is dependent on the "relative efficiency" of the marketplace. That is, the speed by which new information is reflected in the price of the security. In this case, it is the speed by which security

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[32] Jill E. Fisch, *Confronting the Circularity Problem In Private Securities Litigation*, WISC. L. REV. 333, 346 (2009).

[33] Goshen and Parchomovsky, *supra* note 13, at 714.

[34] *Id.* at 715.

[35] *Id.* at 726 and 729.

analysts revise their opinions and valuations of a security based on the disclosure of the hard facts related to a material misrepresentation or omission and then have these revisions publicly disclosed to the marketplace.

Conclusion

The mistake the *Apollo* court made was applying an inadequate definition of market efficiency to the evaluation of corrective disclosures. Clearly, mechanical efficiency has the advantage of providing a simple understanding of how market efficiency works. It is also appropriate for establishing a rebuttable presumption of reliance under the FOTM. However, for evaluating corrective disclosures, a more sophisticated understanding of market efficiency, value efficiency, is required. When value efficiency is applied, it is clear that security analyst reports, when they are used to disclose how securities fraud affects the value of the security, must be considered corrective disclosures.