

Exposure To Market Fraud Suits Is Not A Major Risk

By **Nessim Mezrahi** (February 21, 2019, 5:09 PM EST)

Crude measures of exposure to securities class actions that allege violations of Section 10(b) and 20(a) of the Securities Exchange Act of 1934 take the “change in target companies’ market capitalization over the class period.”[1] This measure of securities class action exposure to allegations of fraud-on-the-market exposure misses the mark.

A more accurate measure of such exposure accumulates the decline in market capitalization of the defendant corporation only during trading sessions that correspond with the timing of the alleged corrective disclosures. An even more accurate measure of exposure accumulates the decline in market capitalization of the defendant corporation only during trading sessions that correspond with statistically significant stock price impacts in response to information correcting alleged misstatements or omissions.



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The methodologies behind various legacy measures of exposure to Exchange Act claims have not been revised since the passing of the Private Securities Litigation Reform Act of 1995. There are two reasons why these legacy measures inaccurately estimate defendants’ exposure to Securities Exchange Act claims.

First, aggregate measures of exposure to alleged violations of the Securities Exchange Act should only account for declines in a defendant’s market capitalization when stock price impact is statistically significant in response to company-specific information that corrects an alleged misstatement or omission. Controlling for information that is unrelated to the alleged fraud, such as effects of the general market and industry-specific factors, is necessary to assess whether the corresponding market capitalization losses should be accumulated and accounted for as exposure to alleged violations of the Securities Exchange Act.

If the residual return of the defendant’s stock price is statistically significant in response to company-specific information that corrects alleged misstatements or omissions, then the corresponding decline(s) in market capitalization ought to be aggregated to estimate the corporation’s exposure. If the residual return of the defendant’s stock price is not statistically significant in response to the alleged corrective information, then the corresponding decline(s) in market capitalization should not be accounted for in the estimation of the corporation’s exposure.

Securities class actions that allege stock price declines that do not exhibit statistically significant price

reactions in response to alleged corrective disclosures have a much higher likelihood of early dismissal, based on the heightened pleading standards of loss causation in a post-Dura world.[2]

Second, legacy measures of exposure miss the mark because they account for the decline in a defendant's market capitalization during intervals that are unrelated to the specific allegations presented in the securities class action complaint. If the measures account for fluctuations in a corporation's market capitalization over the entire class period, or between the highest and lowest points, they grossly misrepresent defendant's exposure to Securities Exchange Act claims. These methodologies of quantifying exposure erroneously aggregate market capitalization losses during trading sessions that are unrelated to the timing of the alleged corrective disclosures.

Other legacy measures of exposure estimate market capitalization losses stemming solely from the alleged stock drop at the end of the class period. This measure certainly misses the mark, by not accounting for potential losses in a corporation's market capitalization attributable to alleged corrective disclosures other than the one occurring at the end of the alleged inflationary period.

Based on more accurate methodologies, defendants' aggregate exposure to claims alleging violations of the Securities Exchange Act account for less than half a percent of the aggregate market capitalization of U.S.-based corporations that traded on U.S. exchanges during the second half of 2018. Data and analyses indicate that exposure of defendant corporations to alleged violations of the federal securities laws under Section 10(b) and 20(a) of the Securities Exchange Act of 1934 was \$80.5 billion and \$91.6 billion during the third and fourth quarters of 2018, respectively.[3]

Defendant corporations' total exposure to Securities Exchange Act claims during the second half of 2018 was \$172.2 billion. These figures are based on securities class action filings that exclude non-U.S. based corporations that trade on U.S. exchanges via American depository shares.[4]

During the third quarter of 2018, the aggregate market capitalization of U.S.-based corporations that trade on U.S. exchanges was \$30.6 trillion.[5] In the same quarter, defendant corporations' exposure to alleged violations of the Securities Exchange Act was \$80.5 billion. \$80.5 billion is equal to 0.26 percent — or 26 basis points — of the aggregate market capitalization of all U.S.-based corporations that traded on U.S. exchanges during the third quarter. The data for the fourth quarter indicates that Securities Exchange Act class action litigation exposure is 28 basis points of the aggregate market capitalization of all U.S.-based corporations that traded on U.S. exchanges.

Data and analyses indicate that Securities Exchange Act class action litigation exposure does not exceed 1 percent of the market capitalization of all U.S.-based corporations that traded on U.S. exchanges during the second half of 2018. This ratio is, in fact, well below 1 percent even after segmenting the universe of defendant companies by market capitalization size.[6]

Exposure of large cap corporations amounted to \$71.5 and \$82 billion during the third and fourth quarters of 2018, respectively. During the third and fourth quarters of 2018, defendants' exposure was 25 and 27 basis points of the aggregate market capitalization of all large cap corporations that traded on U.S. exchanges.[7]

The Securities Exchange Act class action litigation exposure of mid cap corporations amounted to \$6.6 and \$8.3 billion during the third and fourth quarters of 2018, respectively. During the third and fourth quarters of 2018, defendants' exposure was 42 and 53 basis points of the aggregate market capitalization of all mid cap corporations that traded on U.S. exchanges.[8]

The Securities Exchange Act class action litigation exposure of small cap corporations was \$2.4 billion during the third quarter and it decreased by 43.57 percent, to \$1.4 billion, during the fourth quarter of 2018. During the third and fourth quarters of 2018, defendants' exposure was 33 and 18 basis points of the aggregate market capitalization of all small cap corporations that traded on U.S. exchanges.[9] Securities class action litigation against small cap corporations decreased significantly during the fourth quarter of 2018.

Exposure of public corporations to alleged violations of the federal securities laws under Section 10(b) and 20(a) of the Securities Exchange Act of 1934 is approximately one quarter of a percentage point of the aggregate market capitalization of U.S.-based corporations. Excluding the overall effects of merger and acquisition filings, these figures are not indicative of a "securities litigation contagion." [10]

The dollar amount of defendants' aggregate exposure, in relation to the aggregate market capitalization of the corporations that enjoy the benefits of trading on U.S. exchanges, highlights the investigative specificity applied by investors' counsel that seek to attain monetary recovery from allegations of fraud-on-the-market perpetuated by directors and officers.

Securities class action industry practitioners should not rely solely on the litigation rate — the ratio of "unique number of companies on the NYSE or NASDAQ subject to federal securities fraud class actions in a given year divided by the unique number of companies listed on the NYSE or NASDAQ" — to make industry-wide conclusions regarding the efficacy of the courts to successfully screen for meritless private securities fraud actions.[11]

Unbiased industry-wide conclusions related to alleged violations of the federal securities laws under Section 10(b) and 20(a) of the Securities Exchange Act of 1934 should also take into consideration the percentage of defendants' Securities Exchange Act class action litigation exposure to the aggregate market capitalization of all U.S.-based corporations.

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[1] Andrew J. Pincus, "A Rising Threat; The New Class Action Racket That Harms Investors and the Economy," U.S. Chamber Institute for Legal Reform, Oct. 18, 2018.

[2] *Dura Pharmaceuticals Inc. v. Broudo*, No. 03-932, 2005 WL 885109 (April 19, 2005).

[3] SAR Securities Exchange Act Class Action Litigation Exposure Report — Q3 & Q4 2018, available at <http://bit.ly/SAR-Exposure-Report-Q3-Q4-18>.

[4] According to the enumeration methodology of SAR, this accounts for 32 cases filed in Q3 and 39 cases filed in Q4 of 2018.

[5] Bloomberg Finance LP.

[6] Segmentation of all U.S.-based corporations was done according to the market capitalization ranges of the constituent members of the S&P 500 Index, the S&P MidCap 400 Index and the S&P SmallCap 600 Index.

[7] The aggregate market capitalization of U.S.-based large cap corporations, according to the market capitalization range of the S&P 500 Index during Q3 and Q4 of 2018, was \$28.3 and \$30.3 trillion, respectively.

[8] The aggregate market capitalization of U.S.-based mid cap corporations, according to the market capitalization range of the S&P MidCap 400 Index during Q3 and Q4 of 2018, was approximately \$1.6 trillion for each of the two three-month periods.

[9] The aggregate market capitalization of U.S.-based small cap corporations, according to the market capitalization range of the S&P SmallCap 600 Index during Q3 and Q4 of 2018 was \$729.7 and \$745.5 billion, respectively.

[10] <https://www.instituteforlegalreform.com/events/securities-litigation-contagion>.

[11] Cornerstone Research Securities Class Action Filings — 2018 Year in Review.