# Commencing a Securities Class Action: Identifying Claims

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*A Practice Note examining strategies for plaintiff's counsel to identify claims and potential defendants under the federal securities laws. This Note provides an overview of available claims, with a focus on private actions asserting material misstatements or omissions in violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 and Sections 11 and 12(a)(2) of the Securities Act of 1933, and describes factors relevant to deciding whether a specific misstatement or omission is actionable. It also provides guidance on deciding whether to bring a claim as a class action and on defining the class and class period.*



  

The Securities Act of 1933, as amended (Securities Act) and the Securities Exchange Act of 1934, as amended (Exchange Act) govern most securities litigation. The Securities Act protects investors by requiring full and fair disclosure relating to offerings of securities registered with the SEC, including initial public offerings, follow on offerings, and secondary offerings. The Exchange Act regulates the securities marketplace by identifying and penalizing improper conduct, including sales on the open market, proxy solicitations, and tender offers. Private lawsuits asserting claims under these acts generally take the form of class actions.

Counsel considering whether to assert **class action** claims under the federal securities laws must:

- Understand the potential causes of action (see Potential Causes of Action).
- Make an appropriate and timely response to that trigger a cause of action (see Identifying Potential Claims).
- Consider which defendants face potential liability (see Identifying Potential Defendants).
- Decide whether to style the claim as an individual action instead (see Determining Whether an Individual Action Is Preferable to a Class Action).
- Determine the class period and the likelihood of lead plaintiff and counsel appointments if class action treatment is appropriate (see Considering the Likelihood of Lead Plaintiff and Lead Counsel Appointments in Class Actions).

This Note provides guidance to plaintiffs' counsel on how to identify potential claims under the federal securities laws in light of these considerations.

For an overview of the securities litigation and enforcement practice area, see Practice Note, Securities Litigation and Enforcement: Overview.

## Potential Causes of Action

Private plaintiffs, governmental agencies, and non-governmental regulators may bring lawsuits based on alleged violations of the federal securities laws. While the government may bring actions based on an alleged violation of any liability provision of the federal securities laws, which may also lead to criminal proceedings, private plaintiffs may recover only on certain provisions, including:

- Exchange Act Section 10(b), under its implementing regulation, SEC Rule 10b-5 (see Exchange Act Section 10(b)).
- Securities Act Sections 11 and 12(a)(2) (see Securities Act Sections 11 and 12(a)(2)).
- Control person liability provisions (see Control Person Liability Provisions).
- Other provisions of the federal securities laws (see Other Private Rights of Action).

Because the liability provisions of the federal securities laws frequently overlap, liability under one provision or act does not preclude liability under another claim. When considering whether to bring suit, counsel should identify and assess all the plaintiff's possible claims against the defendant.

  

Plaintiffs in securities class actions must comply with the **Private Securities Litigation Reform Act of 1995** (PSLRA), which provides, among other things, stringent pleading standards and contains numerous restrictions for the conduct of class actions (15 U.S.C. § 78u-4(b); *In re Kingate Mgmt. Ltd. Litig.*, 784 F.3d 128, 138 (2d Cir. 2015)).

## Exchange Act Section 10(b)

Nearly all federal securities class actions alleging fraud include a claim under Exchange Act Section 10(b) and Rule 10b-5 (17 C.F.R. § 240.10b-5).

Together, Section 10 of the Exchange Act and Rule 10b-5 provide an implied private right of action to recover damages based on material misstatements or omissions and use of manipulative or deceptive devices in connection with the sale or purchase of a security.

Notably, federal courts have exclusive jurisdiction over Exchange Act claims (15 U.S.C. § 78aa(a)).

### Misstatements or Omissions

To prevail on a Section 10(b) and Rule 10b-5 claim based on alleged misstatements or omissions, plaintiffs must plead and prove each of the following required elements:

- **A misrepresentation or omission of material fact.** A fact is material if there is a substantial likelihood that its disclosure would be viewed by a reasonable investor as having significantly altered the total mix of information available in the market about a particular security (*Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)).

- **A connection with the purchase or sale of a security.** The requisite connection exists when the misstatement or omission coincides with or touches the purchase or sale of a security (*Chadbourne & Parke LLP v. Troice*, 571 U.S. 377, 389-90 (2014); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85 (2006)).

- **Scienter.** Scienter refers to a mental state embracing intent to deceive, manipulate, or defraud and is an essential element of a securities fraud claim under Section 10(b) and Rule 10b-5. A plaintiff must raise an inference at least as strong as any to the contrary, that the defendants were aware, or recklessly disregarded, and that their statements were false and misleading when made. (*Tellabs, Inc. v. Makor Issues & Rights, Ltd*., 551 U.S. 308, 314, 319 (2007).)

- **Reliance.** Plaintiffs must show that:

  - they made an investment decision in reliance on the allegedly fraudulent misrepresentation, qualify for an applicable presumption (generally based on the fraud-on-the-market theory which allows for the presumption of reliance in class claims), or are exempted from the reliance requirement because they assert claims based primarily on omissions; and

  - the plaintiff's reliance was reasonable, primarily depending on plaintiff's degree of sophistication and expertise in financial and securities matters.

  (*Amgen Inc. v. Conn. Ret. Plans and Tr. Funds*, 568 U.S. 455, 461, 467 (2013).)

  

- **Economic loss.** Most courts assessing a plaintiff's economic loss use the out-of-pocket measure of damages, sometimes called the price inflation metric, which limits recovery to the difference between the price paid and the true value of the security (see, for example, *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972); *Mathews v. Kidder, Peabody & Co.*, 260 F.3d 239, 250 (3d Cir. 2001)).

- **Loss causation.** This requirement requires a showing that the alleged misrepresentation actually caused a loss. The requisite causal connection between the alleged fraud and the plaintiff's later loss exists if the market reacted to the revelation of the alleged misrepresentation or the facts underlying it. (*Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343 (2005).)

### Manipulative or Deceptive Conduct

Most plaintiffs suing under Rule 10b-5 assert securities fraud claims based on misstatements or omissions in violation of Rule 10b-5(b) (15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5(b)). However, liability may also arise from other parts of Rule 10b-5 making manipulative and deceptive conduct actionable. Specifically:

- Rule 10b-5(a) prohibits the use of a fraudulent "device, scheme, or artifice."

- Rule 10b-5(c) prohibits engagement in an "act, practice, or course of business" that operates as fraud or deceit.

(17 C.F.R. § 240.10b-5(a), (c).)

Courts generally refer to claims under Rules 10b-5(a) and (c), which are generally invoked together, as scheme liability claims (see *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159-60 (2008); see also *Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 986 (8th Cir. 2012)).

Most Rule 10b-5(a) and (c) claims allege manipulative conduct, meaning that the defendant acted in ways designed to artificially affect the price of a security by simulating market activity that does not reflect genuine investor demand. Manipulative activity deceives investors into believing that natural interplay of supply and demand determines the prices at which they purchase and sell securities, when, in reality, manipulators have rigged those prices through transactions that send false pricing signals to the market. Conduct other than manipulation can also be deceptive and actionable under Rules 10b-5(a) and (c). (See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977); *Lorenzo v. SEC*, 139 S. Ct. 1094, 1099 (2019).)

## Securities Act Sections 11 and 12(a)(2)

Section 11 of the Securities Act provides remedies for investors who purchased securities in, or traceable to, an offering of securities registered with the SEC under a registration statement which contained false or misleading information (15 U.S.C. § 77k; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381–82 (1983)). Unlike Section 10(b), Section 11 claims are subject to a negligence standard (see *Herman*, 459 U.S. at 382). This means that the plaintiff generally does not need to show that:

- It relied on the relevant registration statement.

- The defendant's misconduct caused its losses.

  

- The defendant had scienter.

(*N.J. Carpenters Health Fund v. Royal Bank of Scot. Grp., PLC*, 709 F.3d 109, 120 (2d Cir. 2013).)

Section 11(e) of the Securities Act limits the damages available to a Section 11 plaintiff to the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and either:

- The value of the security when the suit was brought.
- The price of the security when disposed of in the market before suit.
- The price of the security when disposed of after suit but before judgment, if it is less than the difference between the purchase price and the value of the security when the suit was brought.

(15 U.S.C. § 77k(e).)

Securities Act Section 12(a)(2) allows securities purchasers to assert claims based on the offer or sale by a prospectus or oral communication that contains a material misstatement or omission (15 U.S.C. § 77***l***(a)(2)). Because a prospectus typically accompanies a registration statement, plaintiffs filing suit under Section 11 often also bring claims under Section 12(a)(2).

Section 12(a) provides for two alternative remedies, either:

- Rescission, meaning that the plaintiff promptly tenders shares in exchange for the original purchase price.
- Damages, if a plaintiff has sold the shares.

(15 U.S.C. § 77***l***(a); see also *In re Broderbund/Learning Co. Sec. Litig*, 294 F.3d 1201, 1205 (9th Cir. 2002); *Rensel v. Centra Tech, Inc.*, 2018 WL 4410110, at *4-5 (S.D. Fla. June 14, 2018).)

Unlike Exchange Act claims, claims arising under the Securities Act may be brought in state or federal court, assuming compliance with all other provisions of the federal securities laws (*Cyan, Inc. v. Beaver Cty. Emps Ret. Fund*, 138 S. Ct. 1061 (2018)).

## Control Person Liability Provisions

Section 15 of the Securities Act and Section 20(a) of the Exchange Act impose liability on any person directly or indirectly controlling any person liable under those acts, to the same extent as the controlled person (15 U.S.C. §§ 77***o*** and 78t(a)). These sections have been interpreted as parallel statutes. Because they provide for secondary liability, the plaintiff must establish a primary violation before the defendant is liable under either statute.

To establish control person liability, a plaintiff must prove:

- A primary violation, meaning that the controlled person (not the controlling person) violated the federal securities laws.

- That the defendant had actual direct or indirect control over the primary violator.
- In certain courts requiring this element for Exchange Act Section 20 claims, culpable participation, meaning that the controlling person culpably participated, in some meaningful sense, in the controlled person's fraud.

Although the Securities Act and the Exchange Act leave the term "control" undefined, SEC Rule 405 defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise" (17 C.F.R. § 230.405). Courts often use this definition as guidance, recognizing that in private lawsuits involving Section 15 and Section 20, the determination of whether control exists depends on the facts of each case (see, for example, *Laperriere v. Vesta Ins. Grp., Inc.*, 526 F.3d 715, 723 (11th Cir. 2008)).

## Other Private Rights of Action

Liability may also arise under other provisions, such as:

- Securities Act Section 12(a)(1) for the sale or offer of an unregistered security in violation of Securities Act Section 5.
- Exchange Act Section 9(f), providing an express civil remedy against participants in stock price manipulation.
- Exchange Act Section 14, including:
  - Sections 14(a) and Rule 14a-9, providing implied private rights for violations involving proxy solicitations; and
  - Section 14(e), providing implied private rights for violations involving tender offers.
- Exchange Act Section 16(b), expressly requiring the disgorgement of any short-swing profits realized for certain company insiders.
- Exchange Act Section 18(a), providing an express civil remedy for false or misleading statements in Exchange Act filings.
- Exchange Act Section 20A, providing an express private remedy based on insider trading.
- Exchange Act Section 29(b), expressly voiding contracts that violate Exchange Act provision or rules.

(15 U.S.C. §§ 77e, 77***l***(a)(1), 78i(f), 78p(b), 78r(a), 78t(a), 78t-1, and 78cc(b).)

For more on potential causes of actions under the federal securities laws, including, for each, a summary of which parties can sue and be sued, the elements of a claim, the most common defenses, the statute of limitations, and any available remedies and damage, see Practice Note, Securities Act and Securities Exchange Act Liability Provisions: Overview and Private Actions Under US Securities Laws Chart.

## No Ancillary Claims

  

Plaintiffs alleging class claims under the federal securities laws are forbidden from bringing additional state or common law claims. Specifically, under the Securities Litigation Uniform Standards Act (SLUSA), plaintiffs may not bring state or common law class claims alleging material misstatements and omissions in connection with the purchase or sale of a security on a national exchange. (15 U.S.C. §§ 77p(b) and 78bb(f); *Cyan,* 138 S. Ct. at 1072-73.)

# Identifying Potential Claims

For the most part, cognizable securities class action claims under the federal securities laws are premised on the negative price movement of a publicly traded security, such as stocks and bonds. The broad statutory definition of a security in Section 3(a)(10) of the Exchange Act, however, is flexible and captures a diverse array of investments (15 U.S.C. § 78c(a)(10)).

## Triggering Event

To begin the analysis into potential Securities Act claims, the security in question must have fallen below its offering price. Otherwise, Section 11 claims are precluded due to a lack of statutory damages.

Similarly, to identify potential Exchange Act Section 10(b) claims, a sharp movement in the price of a security must cause investors financial harm. This generally happens when a disclosure causes a sudden decline in the price of a company's stock causing harm to those investors who held shares over the drop.

Section 10(b) claims are not inherently limited to instances where a security has declined in value, however. For example, Section 10(b) claims may be brought on behalf of a class of investors who sold their securities during a period in which a company fraudulently released or withheld information to artificially deflate the price of said security, where the stock price rises in response to the corrective disclosure.

## Analyzing the Triggering Event

Once a triggering event has been identified, counsel must determine the reasons for the adverse market reaction. Typically, those reactions are caused by the disclosure of negative information which has, or potentially will, impact a company's financial results.

Counsel should not limit their investigations to the reasons offered by the company itself, however. Instead, counsel should undertake a fulsome review of all relevant market commentary surrounding the triggering event, including reports by analysts closely following the company in question.

Counsel should also conduct a preliminary damages analysis to estimate class-wide damages. Firms typically employ an in-house data analytics team to conduct this analysis and may also retain outside financial experts to engage in additional analysis.

Counsel must then analyze prior statements from the company and its executives to determine whether the events which caused the financial harm were previously withheld from investors or contradict prior statements. Actionable statements are predominantly found in:

- A company's regulatory filings.

- Transcripts of investor calls.
- Press releases.

If the issues and risks were previously and adequately disclosed to investors in full before the triggering event, the analysis ends here, and counsel should not pursue the claim.

### Company-Specific Event-Based Disclosure

A cause of action has a higher likelihood of success if counsel can identify a disclosure relating to a company-specific event. These disclosures may include, for example:

- A company's restatement of its previous financial results to remedy a past error due to internal control weaknesses. This error may include non-conformity with generally accepted accounting principles (GAAP).
- The loss of an asset integral to a company's financial results, such as a major customer or key product.
- The disclosure of a governmental investigation or action, such as a disclosure that certain business practices are under SEC investigation.
- A failure to secure regulatory approval, such as Food and Drug Administration (FDA) approval for a new drug, or Federal Trade Commission (FTC) approval of a merger.
- Adverse issues related to a recently completed corporate transaction or business initiative, such as a merger or acquisition. This may entail a company disclosure about material integration issues following the closing of a major acquisition.
- Disclosures concerning a calamitous event or occurrence which relates back to the company, such as a major fire or oil spill.

Counsel should understand, however, that event-based disclosures generally provide an advantage to plaintiffs if they are specific to the company at issue. Events causing declines in the market as a whole are not indicative of company-specific wrongdoing.

### Guidance-Based Disclosure

Disclosures related only to a company's financial guidance are not as strong as an event-based disclosure. These disclosures may involve disappointing financial forecasts or a failure to meet previously issued guidance or analyst estimates. While securities class actions premised on negative guidance may have merit when not linked to an adverse event such as those outlined above, it will likely be harder to overcome a motion to dismiss, particularly regarding Section 10(b) claims where scienter must be proved.

### "Plus" Factors

  

While identifying potential securities class action claims is more art than science, certain contemporaneous factors may assist counsel in determining if the claim is strong, such as:

- Analyst surprise and reductions in the guidance, estimates, and projections that a company disseminated to indicate future performance serving as a strong barometer in determining whether the market's negative reaction to a company's disclosure was warranted (see, for example, *City of Pontiac Gen. Emps. Ret. Sys. v. Lockheed Martin Corp.*, 875 F. Supp. 2d 359, 368 (S.D.N.Y. 2012) (reasoning that the reactions of securities analysts supported an inference of materiality at the motion to dismiss stage)).

- Close temporal proximity between management statements and either later contradictory statements or incongruous results (see, for example, *In re SunEdison, Inc. Sec. Litig.*, 300 F. Supp. 3d 444, 480 (S.D.N.Y. 2018)).

- Suspiciously timed and unusual stock sales by company insiders during the relevant period at artificially inflated prices (see *Pugh v. Tribune Co.*, 521 F.3d 686, 695 (7th Cir. 2008); see also *Rothman v. Gregor*, 220 F.3d 81, 94 (2d Cir. 2000) (finding that the court could properly infer a motive and opportunity to defraud from insider trading activity);*Xiaojiao Lu v. Align Tech., Inc.*, 417 F. Supp. 3d 1266, 1280-81 (N.D. Cal. 2019)).

- First-hand accounts by former employees indicating that company executives were aware of, or at least recklessly disregarded, the falsity of their statements (see, for example, *New Orleans Emps. Ret. Sys. v. Celestica, Inc.*, 455 F. App'x 10, 13-14 (2d Cir. 2011)).

- Abrupt resignations or other departures of senior corporate executives (see, for example, *In re Scottish Re Grp. Sec. Litig.*, 524 F. Supp. 2d 370, 394 (S.D.N.Y. 2007)).

## Timeliness

In addition to identifying and analyzing a triggering event, counsel must also consider whether the potential claim would be timely if brought.

A claim under Exchange Act Section 10(b) and SEC Rule 10b-5 fraud claims must satisfy:

- A statute of limitations, which requires plaintiffs to file a complaint within two years after the fraud is discovered, subject to a discovery rule under which the claim begins to run on discovery, or when a "reasonably diligent plaintiff would have discovered" the fraud (*Merck & Co. v. Reynolds*, 559 U.S. 633, 637 (2010)).

- A statute of repose, which requires the plaintiff to file the complaint no later than five years after the fraud occurred regardless of when it was or could have been discovered.

(28 U.S.C. § 1658(b).)

Securities Act claims, too, must satisfy:

  

- A statute of limitations, which requires plaintiffs to file a complaint within one year after plaintiffs discovered or, with reasonable diligence, could have discovered, the violation (15 U.S.C. § 77m; *Merck & Co*, 559 U.S. at 653; *Yi Xiang v. Inovalon Holdings, Inc.*, 268 F. Supp. 3d 515, 521 & n.1 (S.D.N.Y. 2017)).

- A statute of repose, which requires plaintiffs to file the complaint no later than three years after the issuer conducted the securities offering in question (*Cal. Pub. Emps.' Ret. Sys. v. ANZ Sec., Inc. (CalPERS)*, 137 S. Ct. 2042, 2047 (2017)).

(15 U.S.C. § 77m.)

## Identifying Potential Defendants

Most often, the named defendants in securities class action include the company itself as the issuer of securities, corporate officers such as the chief executive officer (CEO) and chief financial officer (CFO), and other employees (see, for example, *In re Bernard L. Madoff Inv. Sec. LLC*, 779 F.3d 74 (2d Cir. 2015); *Fezzani v. Bear, Stearns & Co.*, 777 F.3d 566 (2d Cir. 2015)).

Generally, plaintiffs should name as defendants the persons who made statements during the relevant period under Section 10(b) of the Exchange Act. A person or entity "makes" a statement when they have "ultimate authority over the statement, including its content and whether and how to communicate it" (Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011)).

Other appropriate defendants may include:

- **Underwriters, Directors, and Experts.** Section 11 explicitly allows any person or entity that signs a registration statement issued in connection with a public offering to be named as a defendant, such as:

  - underwriters (investment banks who assist in the offering) (see, for example, *Nat'l Credit Union Admin. Bd. v. Barclays Capital Inc.*, 785 F.3d 387 (10th Cir. 2015));

  - the directors who typically sign the registration statement (see *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82, 386 n.22 (1983)); and

  - any experts on whom the issuer relied in putting together a registration statement, such as the accountants and auditors (see, for example, *N.M. State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089 (9th Cir. 2011)).

  (15 U.S.C. § 77k.)

- **Control Persons.** Both the Securities Act and the Exchange Act allow for control persons to be named as defendants (15 U.S.C. §§ 77***o*** and 78t.)

In addition, the Supreme Court recently held that Rules 10b-5(a) and (c) applied to the intentional dissemination of false or misleading statements even if the disseminator did not "make" the statements and consequently falls outside Rule 10b-5(b) under its previous ruling in *Janus (Lorenzo*, 139 S. Ct. at 1100-01).

In *Janus* and other earlier rulings, the Supreme Court narrowed the scope of potential liability under Section 10(b) for secondary defendants and participants in securities transactions (see *Janus*, 564 U.S. at 142; see also *Stoneridge*, 552 U.S. at 155; *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994)).

Under *Lorenzo*, however, courts can hold even bit participants liable as primary violators under Rule 10b-5 so long as the plaintiff can plead and prove all the requirements for primary liability. If the plaintiff alleges that the defendant was a co-participant in a manipulative scheme and profited by that scheme, the court may impose liability on that defendant as a primary violator. (*Lorenzo*, 139 S. Ct. at 1104; see also *In re Longfin Corp. Sec. Class Action Litig.*, 2019 WL 3409684, at *3 (S.D.N.Y. July 29, 2019).)

Courts applying *Lorenzo* going forward may find that scheme liability under Rules 10b-5(a) and (c) reaches defendants not liable for Rule 10b-5(b) securities fraud (see, for example, *Malouf v. SEC*, 933 F.3d 1248, 1261-02 (10th Cir. 2019) (holding that a CEO's failure to correct an investment advisors' misstatements regarding his conflict of interest supported scheme liability under Rule 10b-5(a) and (c)); see also *Set Capital LLC v. Credit Suisse Grp. AG*, 2019 WL 3940641, at *14 n.6 (S.D.N.Y. Aug. 16, 2019)); *SEC v. SeeThruEquity, LLC*, 2019 WL 1998027, at *5 (S.D.N.Y. Apr. 26, 2019)). This may also enable private plaintiffs to pursue claims against other secondary players such as attorneys and business partners.

## Determining Whether an Individual Action Is Preferable to a Class Action

After identifying a claim under the federal securities laws, counsel must determine whether an individual action is preferable to bringing a class action.

### Distinguishing Characteristics of a Class Action

A class action is a procedural mechanism by which a large group of similarly situated plaintiffs may try to prosecute a lawsuit based on common claims as a class, instead of as individuals. The class action device is meant to simplify litigation involving large numbers of individuals with similar claims and encourage uniform resolution for the claims. Rule 23 of the Federal Rules of Civil Procedure (FRCP) identifies the circumstances in which class treatment is appropriate in the federal courts. It also aims to ensure that absent class members, who may not be actively participating in the class action, are adequately represented and protected.

Most class actions consist of one or more named class representatives (including one or more lead plaintiffs appointed under the PSLRA) and additional absent, unnamed class members. The class representatives take an active role in pursuing the class action on behalf of the entire class. While absent class members do not actively participate in the litigation, they do generally become bound by the outcome of the litigation unless they opt out.

For the most part, a class action is preferable for any claim involving a publicly traded security. A class action provides relief for plaintiffs whose limited losses (and potentially limited resources) make bringing an individual claim unfeasible. Additionally, as investors in a publicly traded security are often in the tens of thousands, a class action provides for the uniform resolution of claims that may be disparately decided if they were heard in different courts. Further, securities class actions, which are typically led by sophisticated institutional investors who have the experience and resources to adequately protect the interests of absent class members, ensure that the litigation has appropriate leadership. Finally, securities class actions may rely on the fraud-on-the-market presumption of reliance, which obviates the need to plead individual reliance on the defendants' class period misstatements. (*Basic*, 485 U.S. at 241.)

For more on the lifecycle of a typical securities class action, see US Securities Class Action Flowchart.

### Individual Actions

  

Determining whether to pursue an individual, or "opt out" action, is usually a plaintiff-specific question. For many institutional investors, appropriate individual securities cases arise only in select circumstances, generally involving securities with large market capitalizations or in which the institutional investor otherwise has large exposure.

The principal consideration governing whether to opt out of a securities class action or pursue other forms of individual litigation is the size of the client's potential damages weighed against the estimated class action recovery, with due consideration given to the strength of the claims on the merits. For example, the plaintiff, or group of plaintiffs, must have suffered a large enough loss to make an individual action economical. Additionally, an individual action may be preferable if the prospective plaintiff's investment was unique in nature, and therefore better litigated outside of a class claim.

Any relevant statutes of limitations are tolled for an individual claim during the pendency of a securities class action, allowing additional time for investors to determine whether to pursue an individual action instead of joining the class action. This tolling, however, does not apply to the relevant statutes of repose listed above, or to subsequent class actions filed after the expiration of the statute of limitations (*China Agritech, Inc. v. Resh*, 138 S. Ct. 1800 (2018); *CalPERS*, 137 S. Ct. at 2051).

## Considering the Likelihood of Lead Plaintiff and Lead Counsel Appointments in Class Actions

When counsel style a case as a class action, the PSLRA's lead plaintiff appointment procedure requires a sequential review process for the court to appoint the most adequate plaintiff under the statute.

When advising clients on whether to seek leadership of a putative securities class action, counsel should not only be mindful of the procedural mechanisms of the PSLRA, but also engage in a careful, client-specific review to determine the likelihood that the court would appoint that client as lead plaintiff. In a securities class action, the lead plaintiff selects lead counsel, subject to the court's approval.

Courts must generally name the lead plaintiff and lead counsel within 30 days of the end of the application period (15 U.S.C. § 78u-4(a)(3)(A)(i), (B)(i); see also US Securities Class Action Flowchart).

### Lead Plaintiff Selection Process

The PSLRA aims to encourage large institutional investors such as pension funds to serve as lead plaintiffs in securities class actions. In enacting the PSLRA, Congress reasoned that that sophisticated institutions have the experience and resources necessary to ensure that the interests of absent class members are adequately protected. (See H.R. Conf. Rep. No. 104-369, at 34 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 733.) Based on this legislative intent, many courts have demonstrated a clear preference for institutional investors to be appointed as lead plaintiff (see, for example, *Reitan v. China Mobile Games & Entm't Grp., Ltd.*, 68 F. Supp. 3d 390, 396 (S.D.N.Y. 2014)).

The presumptively most adequate plaintiff under the PSLRA is the lead plaintiff movant who:

- Timely filed a motion for appointment as lead plaintiff.
- Has claimed the largest financial interest in the outcome of the litigation, usually based on approximate losses suffered as calculated on a last-in, first-out (LIFO) accounting bases.

 

- Has made a preliminary showing that it satisfies the adequacy and typicality requirements of Rule 23 of the Federal Rules of Civil Procedure.

(15 U.S.C. § 78u-4(a)(3)(B)(iii)(I).)

Other movants for lead plaintiff appointment may rebut this presumption only by proof that the presumptively most adequate plaintiff either:

- Will not fairly and adequately protect the interests of the class.
- Is subject to unique defenses that render that plaintiff incapable of adequately representing the class.

(15 U.S.C. § 78u-4(a)(3)(B)(iii)(II); see also *R.I. Laborers' Pension Fund v. FedEx Corp.*, 2019 WL 5287997, at *1 (S.D.N.Y. Oct. 18, 2019).)

When a movant rebuts the presumption, courts must then analyze the movant with the second largest financial interest, and so forth, until a movant has satisfied the statutory criteria (see, for example, *In re Cavanaugh*, 306 F.3d 726, 729–30 (9th Cir. 2002)).

## Analyzing Whether the Client Has Standing to Sue

Both constitutional and statutory standing are threshold inquiries in analyzing an investor's ability to serve as a plaintiff. In class action lawsuits, courts generally focus on the standing of the named plaintiffs.

To have constitutional standing, a plaintiff must have suffered "injury in fact." In the context of securities claims, the prospective plaintiff either must have:

- Been the beneficial holder of the security in question.
- Received a valid assignment of claims from the actual beneficial holder.

Therefore, absent transfer of legal title to the claims, investment managers may not bring suit on behalf of their clients who have suffered investment losses (*W.R. Huff Asset Mgmt. Co. v. Deloitte & Touche LLP*, 549 F.3d 100, 106–09 (2d Cir. 2008)).

In addition, to have statutory standing, a plaintiff must satisfy the elements of each specific securities claim they seek to bring.

### Exchange Act Section 10(b) and Rule 10b-5 Standing

Courts have limited the private civil right of action under Section 10(b) and Rule 10b-5 to actual purchasers and sellers. Specifically, *Blue Chip Stamps v. Manor Drug Stores* held that only plaintiffs that are themselves purchasers or sellers of a security have standing to sue for securities fraud, a requirement also referred to as the "purchaser-seller rule" (421 U.S. 723, 749 (1975) (endorsing the standing rule created by *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952)).

In addition, the loss causation requirement means that the plaintiffs suffer no injury under the statute, and therefore lack standing, if they simply allege financial loss during the period of alleged fraud. Specifically, a plaintiff must be able to prove a causal connection between the alleged fraud and their financial loss. For example, in a typical securities case revolving around a decline in the price of a company's stock, a prospective plaintiff must have sold its shares at a loss following the revelation of truth which caused said decline.

### Securities Act Standing

Plaintiffs asserting Section 11 claims show that they either:

- Purchased the securities at the time of the initial public offering.
- Made aftermarket purchases and can trace their shares to the allegedly misleading registration statement.

(15 U.S.C. § 77k(a); *In re Ariad Pharm., Inc. Sec. Litig.*, 842 F.3d 744, 755-56 (1st Cir. 2016); *DeMaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003).)

The class of eligible plaintiffs is narrower for claims under Section 12(a)(2) because this provision requires a plaintiff to have purchased the subject security in the offering itself and not in the aftermarket (*Gustafson v. Alloyd Co.*, 513 U.S. 561, 577-78 (1995)). Only actual purchasers of the securities have Section 12 standing, even if the alleged misconduct involves an offer, and that standing extends only to claims against the plaintiff's statutory seller, meaning a defendant who either:

- Actually passed title to the buyer.
- Successfully solicited the purchase of the security "motivated in part by a desire to serve his own financial interests or those of the securities owner."

(*Pinter v. Dahl*, 486 U.S. 622, 647 (1988).)

## Consider the Likelihood of Lead Counsel Selection

Counsel bringing claims under the federal securities laws tend to do so on behalf of private and public institutional investors in class actions, individual actions, and derivative cases in state and federal courts. In class actions, the lead plaintiff selects the lead counsel, subject to court approval.

Developing and maintaining client relationships is typically done on a per-client basis specifically tailored to said client's needs. For example, existing or potential clients may request that counsel provide analysis regarding their exposure to certain market events and provide a recommendation about whether or not they have a potential claim.

Securities litigation firms also frequently employ dedicated personnel to evaluate market movement to identify potential claims. Plaintiffs' firms focusing on complex securities litigation typically have monitoring and case evaluation practice groups composed of attorneys who work with financial analysts, as well as in-house private investigators to identify and evaluate potential claims and pending litigation. That team may monitor and evaluate market news and other information that might result in a material loss or other negative impact to their clients' investment portfolios. This includes scrutinizing and determining the impact of:

- All class action notices filed under the PSLRA.

  

- Other pending court proceedings, such as antitrust actions or bankruptcy proceedings.
- All corporate transactions, such as mergers, executive compensation agreements, and stock option grants.

In some instances, as a result of this review, counsel may proactively advise certain clients regarding recent adverse market events, which may significantly improve the likelihood of securing lead counsel selection if that client decides to start an action and seek leadership of a class.

## Identifying the Class Period and Class Definition

The class period refers to the period of time in which the alleged misconduct occurred. In cases asserting claims based on misstatements and omissions under the federal securities laws, the class period refers to the period of time in which the false and misleading statements were made, and ends with the revelation of the truth that negatively impacted a security's value. In other words, the usual class period:

- Begins on the first instance of the alleged fraud or, at the latest, the date the plaintiff executed the first trade in the security at issue, if the trade was after the fraud began.
- Concludes on the date when the defendant made statements correcting the relevant misstatement or omission (usually accompanied by a price drop).

(See, for example, *Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods. N.V.*, 2007 WL 2814653, at *15 (D.N.J. Sept. 24, 2007).)

Classes consist of those investors who engaged in the relevant transactions in that security during the class period and who suffered an economic loss as a result.

## Monitoring Potential Claims and Pending Litigation

In some instances, counsel may find it preferable to delay bringing suit and instead monitor potential claims, particularly where the market has not fully digested the adverse information, or if future disclosures are expected.

Counsel may choose to delay when, for example:

- A company discloses a regulatory investigation which may harm the company in the future, but the market has not yet reacted. Private lawsuits may follow enforcement actions brought by regulators and prosecutors including:
  - the SEC, for Exchange Act and Securities Act violations (see Practice Note, Roadmap of the SEC's Investigation and Enforcement Process);
  - the Department of Justice, including through criminal proceedings brought by the US Attorney's Office (Practice Note, Federal Securities Regulators: Overview: Department of Justice (DOJ));

    - the Commodities Futures Trading Commission (CFTC), for violations of the Commodity Exchange Act (CEA) (see Practice Note, Roadmap of the CFTC's Investigation and Enforcement Process); and

    - state attorneys generals and other regulators.

  (See, for example, *Kaplan v. S.A.C. Capital Advisors, L.P.*, 40 F. Supp. 3d 332, 337 (S.D.N.Y. 2014); *In re J.P. Jeanneret Assoc., Inc.*, 769 F. Supp. 2d 340, 353 (S.D.N.Y. 2011); *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 321 (S.D.N.Y. 2003).)

- Pending litigation against the company, such as a derivative or antitrust action, may eventually give rise to a finding of wrongdoing which bolsters potential securities claims.

In these cases, it is frequently advantageous to continue to investigate the company until the potential claim has ripened to the point that starting litigation is warranted.

## Example of Identification of a Securities Class Action Claim

On March 1, 2020, Pharma Corp. disclosed in its full year 2019 financial results that the FDA had rejected its application for New Drug due to troubling mortality rates during clinical testing. Because Pharma Corp. had previously announced the development of New Drug as its flagship product, the disappointing announcement caused a fifty percent decline in the price of Pharma Corp. stock after a year of substantial highs. As this disclosure is event-based, in that it is related to regulatory approval of a key product, it warrants investigation.

Within the three months leading up to the March 1, 2020, disclosure, Pharma Corp. successfully closed on a secondary stock offering. Additionally, Pharma Corp.'s Chief Executive Officer sold off one million of his personally held shares for a sizeable profit. These factors strengthen potential claims under Section 10(b). Further, the secondary offering now introduces the possibility of Securities Act claims in addition to Section 10(b) claims.

In reviewing Pharma Corp.'s SEC filings and earnings calls, counsel learn that New Drug clinical trials began on January 1, 2019. Further, during Pharma Corp's full-year 2018 earnings call on March 1, 2019, Pharma Corp.'s CEO and CFO both stated that the New Drug Trials were "going well," that patient mortality rates "were well within FDA requirements," and that "FDA approval was guaranteed." This narrative continued all the way until the March 1, 2020 disclosure and was included in the registration statement issued in connection with Pharma Corp.'s secondary offering.

Together, these facts give rise to a strong potential Section 10(b) claim against Pharma Corp., as well as its CEO and CFO, on behalf of a class of all persons or entities that purchased or otherwise acquired Pharma Corp. stock on or between March 1, 2019 and February 28, 2020. Additionally, claims under Sections 11 and 12(a)(2) may be brought on behalf of all persons or entities who purchased shares on the secondary offering against all those who signed the associated registration statement.