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A Lower Bar To Prove Market Efficiency In Securities Cases

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In securities fraud cases, plaintiffs often hire experts to conduct event studies to establish that a company's stock traded in an efficient market. Experts generally rely on, and courts tend to require, the scientific standard of a 95% confidence level to determine that a price change in the company's stock in response to firm-specific news is statistically significant and reliable evidence of market efficiency.[1]

However, a number of recent court decisions across the country have reaffirmed that such a high confidence level is not appropriate in all instances of measuring stock price reactions, and is inconsistent with the preponderance of the evidence standard in civil actions.[2]

Presumption of Reliance: Establishing Market Efficiency

Stemming from the fraud-on-the-market theory, plaintiffs in securities fraud actions are entitled to a rebuttable presumption of reliance:

> An investor who buys or sells stock at the [market price] does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed.[3]

This presumption — which requires a showing of market efficiency — is relied upon by plaintiffs during class certification to show that the issue of reliance is a common question to the class as a whole.[4] Although this presumption can be rebutted, it is defendants' burden to present direct "evidence that an alleged misrepresentation did not actually affect the market price of the stock."[5]

One way market efficiency is established is via event studies — "regression analyses that seek to show that the market price of the defendant's stock tends to respond to pertinent publicly reported events."[6]

A 95% confidence level is often used in these event studies, as is common in academia to show that a study's conclusions are reliable. While standard in academic and scientific studies, courts and legal scholars have long recognized, however, that a 95% confidence level need not be achieved to find market efficiency in civil litigation, which only requires a greater than 50% chance that the claim is true.[7]

Indeed, the U.S. Supreme Court confirmed that the preponderance standard applies in federal securities actions, holding, "If [investors] prove that it is more likely than not that they were defrauded, they should recover."[8] Similarly, the Supreme Court has "declined to define a precise evidentiary standard for market efficiency, but the Court's opinions consistently suggest that the burden is not an onerous one."[9]

In light of the modest evidentiary bar set in civil actions, a 95% confidence level "appears to be a

heavier burden than the normal probabilities, just better than a 50% chance, required of the moving party to establish its position by the civil liability's preponderance of the evidence rule."[10]

At a minimum, then, plaintiffs should only need to establish market efficiency by a preponderance of the evidence, as several courts have held.[11] It follows, confidence levels of 90%, 85% and even 70% should suffice.[12]

Recent Decisions Requiring Less Than 95% Confidence

A number of recent decisions have underscored the notion that 95% confidence is not required in all circumstances and that an absence of a stock price return at the 95% confidence level does not establish the market is inefficient.

In September 2019, in Di Donato v. Insys Therapeutics Inc., U.S. District Judge Neil Wake of the U.S. District Court for the District of Arizona certified a class of investors in a Section 10(b) fraud case, and rejected the defendants' attempt to rebut the presumption of reliance by pointing to instances where the market did not react to news at the 95% confidence level.[13]

Judge Wake explained, the "lack of statistically significant proof that a statement affected the stock price is not statistically significant proof of the opposite, i.e., that it did not actually affect the stock price."

Further, the plaintiffs' expert explained that, "it is not at all unusual for earnings announcements to be accompanied by movements that are not statistically significant (after all, requiring 95% confidence that a stock price movement was caused by information sets a high bar for evidence of cause and effect)."[14]

Other recent decisions by courts throughout the country have come to similar conclusions. For example, in Vizirgianakis v. Aeterna Zentaris Inc.[15] and Monroe County Employees' Retirement System v. Southern Company,[16] the U.S. Court of Appeals for the Third Circuit and the U.S. District Court for the Northern District of Georgia, respectively, have held that a "non-statistically significant price decline" is not "necessarily proof of [a lack of price impact]."[17]

Similarly, in accepting a 92.1% confidence level, the U.S. District Court for the Southern District of New York has held in Pirnik v. Fiat Chrysler Automobiles NV that while a level under 95% is "obviously less comfort than a result that is statistically significant at a confidence level of 95%, ... it does not prove the absence of price impact." Thus, if defendants do "not carry their burden of demonstrating the absence of price impact, [p]laintiffs are entitled to the presumption of reliance pursuant to the fraud-on-the-market theory."[18]

Likewise, in In re Petrobras Securities Litigation, the U.S. Court of Appeals for the Second Circuit recently explained that while showing a price reaction at a statistically significant level evidences an efficient market, "the converse is not true—the failure of the price to react so extremely as to be [detectable] does not establish that the market is inefficient."[19]

Moreover, in Bing Li v. Aeterna Zentaris Inc., the U.S. District Court of New Jersey held — and the Third Circuit affirmed — that an 84% confidence level was sufficient to establish market efficiency.[20]

Notwithstanding the defendants' argument that "the standard industry practice is to determine price impacts at the 95% confidence level," the court reasoned that (1) the "event study was not prepared to demonstrate price impact, but, rather, market efficiency"; (2) the "failure of an event study to find price movement does not prove lack of price impact with scientific certainty"; and (3) defendants "failed to present any competent evidence demonstrating a lack of price impact."[21]

Similarly, in Billhofer v. Flamel Technologies SA, the Southern District of New York held that despite the plaintiff's expert "showing no statistically significant correlation at the 95% confidence level," the plaintiff "established by the preponderance of the evidence that [the defendant's stock] traded in an efficient market."[22]

Finally, a less stringent confidence level is further supported by the very fact that plaintiffs need not

even conduct an event study to establish market efficiency, as there are other factors to consider. Requiring such a "strong showing" via a high confidence level, therefore, would "unreasonably [discount] the potential probative value of [other] evidence of market efficiency."[23]

That is, there could be absolutely no price movement, and courts could find market efficiency.[24] To be sure, requiring a plaintiff to "submit proof of market reactions—and to do so with an event study—ignores Supreme Court precedent as well as practical considerations. Event studies test for a degree of efficiency that may not be required."[25]

Thus, the "failure of an event study to show immediate impoundment does not necessarily indicate whether the market is efficient for purposes of the Basic presumption."[26]

Given these recent developments, it will not be surprising if courts continue to accept event studies with less than 95% confidence levels for purposes of establishing market efficiency.

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[1] In re Moody's Corp. Sec. Litig., 274 F.R.D. 480, 493 n.11 (S.D.N.Y. 2011); In re Intuitive Surgical Sec. Litig., 2016 WL 7425926, at *15 (N.D. Cal. Dec. 22, 2016).

[2] Di Donato v. Insys Therapeutics, Inc., 2019 WL 4573443, at *13 (D. Az. Sept. 20, 2019); Pirnik v. Fiat Chrysler Automobiles, N.V., 327 F.R.D. 38, 46 (S.D.N.Y. 2018); Bing Li v. Aeterna Zentaris, Inc., 324 F.R.D.331,344–45 (D.N.J.2018), aff'd by Vizirgianakis, 775 F. App'x 51; Smilovits v. First Solar, Inc., 295 F.R.D. 423, 437 (D. Az. 2013); George v. China Automotive Sys., Inc., 2013 WL 3357170, at *7 (S.D.N.Y. July 3, 2013); Billhofer v. Flamel Techs., S.A., 281 F.R.D. 150, 162–63 (S.D.N.Y. 2012); United States v. Hatfield, 795 F. Supp. 2d 219, 234 (E.D.N.Y. 2011).

[3] Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).

[4] Erica P. John Fund, Inc. v. Halliburton Co. ("Halliburton I"), 563 U.S. 804, 810–11 (2011).

[5] Halliburton Co. v. Erica P. John Fund, Inc. ("Halliburton II"), 573 U.S. 258, 282–84 (2014).

[6] Id. at 280; see also Cammer v. Bloom, 711 F. Supp. 1264, 1285–87 (D.N.J. 1989).

[7] Hatfield, 795 F. Supp. 2d at 234 ("Court recognizes that the 95% confidence interval is the threshold typically used by academic economists in their work. But the Court strongly questions whether its use is appropriate ... where the [party's] burden is by a preponderance of the evidence."); see also Joni S. Jacobsen, Securities Class Action Litigation: The Recent Trend Toward Moderation, New Developments in Securities Litigation, 2015 WL 2407612, at *7 (April 2015).

[8] Herman & MacLean v. Huddleston, 459 U.S. 375, 390 (1983).

[9] In re Petrobras Sec., 862 F.3d 250, 278 (2d Cir. 2017) (citing Halliburton II, 573 U.S. at 272).

[10] Merritt B. Fox, Halliburton II: It All Depends on What Defendants Need to Show to Establish No Impact on Price, 70 BUS. LAW. 437, 459 (2015).

[11] First Solar, 295 F.R.D. at 437 ("Plaintiffs have shown by a preponderance of the evidence that [defendant's] stock traded on an efficient market."); c.f. China Automotive, 2013 WL 3357170, at *7 ("Class certification is only warranted if plaintiffs can establish by a preponderance of the evidence a class-wide presumption of reliance by virtue of the presence of an efficient market critical to the fraud-on-the-market theory.").

[12] One scholar has aptly pointed out that the level of confidence to use "depends on the consequences of being wrong." Jeff Sauro, Ph.D, How Confident Do You Need To Be In Your Research?, MEASURINGU (Jan. 5, 2015), https://measuringu.com/confidence-levels/. For instance, while a higher confidence level may be preferred in high risk situations such as pharmaceutical drug testing, a lower confidence level could be used in other, less scientifically rigorous settings. Id.

[13] 2019 WL 4573443, at *13.

[14] Id.

[15] 775 F. App'x 51 (3d Cir. 2019).

[16] 2019 WL 3956139 (N.D. Ga. Aug. 22, 2019).

[17] Southern Company, 2019 WL 3956139, at *21 (quoting Vizirgianakis, 775 F. App'x at 53) (citing collection of cases).

[18] 327 F.R.D. at 46; see also Bing, 324 F.R.D. at 344–-45.

[19] 862 F.3d at 279 n.30 (citing Alon Brav & J.B. Heaton, Event Studies in Securities Litigation: Low Power, Confounding Effects, and Bias, 93 Wash. U. L. Rev. 583 (2015)).

[20] 324 F.R.D. at 344-45; Vizirgianakis, 775 F. App'x at 53-54.

[21] Id. (internal citations omitted).

[22] 281 F.R.D. at 162–63.

[23] Petrobras, 862 F.3d at 278.

[24] Waggoner v. Barclays PLC, 875 F.3d 79, 97 (2d Cir. 2017), cert. denied, 138 S. Ct. 1702, 200 L .Ed. 2d 954 (2018); Carpenters Pension Tr. Fund of St. Louis v. Barclays PLC, 310 F.R.D. 69, 83 (S.D.N.Y. 2015); Southern Company, 2019 WL 3956139, at *11 n.8 (citing collection of cases nation-wide).

[25] Barclays, 310 F.R.D. at 84.

[26] Id. at 85.