Portfolio Media. Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Fraud-On-The-Market Presumption: Rebuttable

Law360, New York (December 01, 2008) -- Given the current volatility in the financial markets, many are left scratching their heads about whether or not to buy particular securities and what information to rely on in doing so.

While some are motivated to buy securities based on price-to-earnings ratios, others trade because of their own prognostications about the future of the regulatory environment or impact of certain political events.

Still other investors use strategies that rely on statistical analyses that have little if anything to do with information about a particular security (other than past price movements) or on non-market information obtained through discussions with management, competitors, customers or suppliers of a potential investment.

In securities litigation, each of the investors described above are treated the same and are afforded a presumption that they relied on the integrity of the market in purchasing securities.

The "fraud-on-the-market" theory of reliance, adopted by the Supreme Court in a plurality opinion in Basic Inc. v. Levinson, 485 US 224 (1988), presumes that investors who bought or sold a security did so in reliance on the integrity of the market price of that security.

That presumption, however, is rebuttable through "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff or his decision to trade at a fair market price ..." Id. at 248.

Different investors use different trading strategies, rely on different information and have different levels of sophistication.

Therefore, in securities litigation, discovery aimed at uncovering the investor plaintiff's sophistication, including investment philosophy and other investment holdings, may be relevant to rebutting the fraud-on-the-market presumption of reliance by showing that the decision to purchase was based on something other than the integrity of the market for a particular security.

There is renewed discussion among academics about whether some sophisticated investors' trading strategies should allow them to benefit from the fraud-on-the-market presumption of reliance.

This past summer, the U.S. Chamber Institute for Legal Reform released a study on securities class action litigation that stated: "[w]hile the [fraud-on-the-market] theory may plausibly be defended when it comes to small investors who rely on market pricing and generally may not as a practical matter be able to show actual reliance on any alleged misstatements, it makes no sense when it comes to the large institutional investors who disproportionately benefit from the existing system.

Those large investors are sophisticated enough to make trading decisions based on their own market evaluations and, when necessary, to prove actual reliance on any alleged misstatements that may in fact have influenced their evaluations." See Securities Class Action Litigation: the problem, its impact, and the path to reform (U.S. Chamber Institute for Legal Reform), July 2008, at 21-22.

Moreover, a working paper by three economists released on Nov. 12, 2008, notes, among other things, that litigants and judges often make "no distinction between investors who rely on market efficiency and those that make the market more efficient by seeking to exploit whatever inefficiencies may exist." See Erenburg, Smith & Smith, The Paradox of "Fraud-on-the-Market Theory": Who Relies on the Efficiency of Market Prices? at 6 (Robert Day School of Economics and Finance Working Paper No. 2008-2), available at ssrn.com/abstract=1138018.

This working paper also acknowledges that "professional investment managers often have clearly articulated trading strategies and other records that can shed light on the motivations for their decisions to trade." Id. at 37.

Such documents, which bear on investor sophistication and reliance, can become the subject of discovery in securities litigation as relevant both to class certification and the merits of the case.

While several courts have recognized that discovery of these trading strategies and records may provide evidence that rebuts the fraud-on-the-market presumption, see e.g., Shiring v. Tier Tech. Inc., 244 F.R.D. 307 (E.D. Va. 2007) and In re Acceptance Ins. Cos. Sec. Litig., 2002 U.S. Dist. LEXIS 27681 (D. Neb. Aug. 2, 2002), there is little discussion about the proof required to "sever the link" of presumed reliance.

Discovery of trading notes and investment strategy documents may show that an investor uses strategies that do not rely on the integrity of the market, including direct contacts with management, suppliers or customers.

This discovery may also uncover the use of momentum-based trading strategies, statistical formulas tied to volatility and not to information about a stock, trades based on certain types of hedging strategies, or purchases or liquidations of securities because of liquidity requirements.

Indeed, it is well-recognized that many hedge funds employ strategies that "attempt to find trades that are almost arbitrage opportunities — pricing mistakes in the market that can produce low risk profits." See R. Stulz, Hedge Funds: Past, Present, and Future, (February 2007).

These types of investment strategies, as well as the countless others that exist, should be examined to determine their "link" to the integrity of the market.

Investors that employ trading strategies which do not rely on the integrity of the market, but on other factors, often will highlight such strategies in marketing materials to attempt to differentiate themselves from their competitors.

In addition to information regarding investment holdings and trading information, marketing materials may also prove relevant to rebutting the fraud-on-the-market presumption.

Accordingly, details regarding an investor's sophistication, including investment philosophy and investment holdings, are potentially significant pieces of discovery that can assist in rebutting the fraud-on-the-market presumption and show that the decision to purchase a security was based on something other than the integrity of the market for that security.

--By David L. Comerford and Jeffery A. Dailey, Akin Gump Strauss Hauer & Feld LLP

David Comerford is a partner with Akin Gump in the firm's Philadelphia office. Jeffery Dailey is counsel with the firm in the Philadelphia office.

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