03-9350

In the United States Court of Appeals for the Second Circuit

IN RE WORLDCOM, INC. SECURITIES LITIGATION

ALAN G. HEVESI, COMPTROLLER OF THE STATE OF NEW YORK, ET AL.,

Plaintiffs-Appellees

v.

CITIGROUP INC., CITIGROUP GLOBAL MARKETS INC. F/K/A SALOMON SMITH BARNEY INC., and JACK GRUBMAN,

Defendants-Appellants.

(*For Full Caption See Inside Cover*)

BRIEF OF THE SECURITIES INDUSTRY ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF APPELLANTS

On Appeal from an Order Granting Certification of a Class Action, United States District Court for the Southern District of New York, Judge Denise L. Cote, Master File No. 02 Civ. 3288 (DLC)

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ALAN G. HEVESI, COMPTROLLER OF THE STATE OF NEW YORK, AS ADMINISTRATIVE HEAD OF THE NEW YORK STATE AND LOCAL RETIREMENT SYSTEMS AND AS TRUSTEE OF THE STATE OF NEW YORK, COMMON RETIREMENT FUND, THE FRESNO COUNTY EMPLOYEES RETIREMENT ASSOCIATION, THE COUNTY OF FRESNO, and HGK ASSET MANAGEMENT, INC., ON BEHALF OF PURCHASERS AND ACQUIRERS OF ALL WORLDCOM, INC. PUBLICLY TRADED SECURITIES DURING THE PERIOD BEGINNING APRIL 29, 1999 THROUGH AND INCLUDING JUNE 25, 2002,

Plaintiffs-Appellees,

- against -

CITIGROUP INC., CITIGROUP GLOBAL MARKETS INC. F/K/A SALOMON SMITH BARNEY INC., and JACK GRUBMAN,

Defendants-Appellants,

- and -

ABN AMRO, INC., BANC OF AMERICA SECURITIES LLC, BLAYLOCK & PARTNERS, L.P., BNP PARIBAS SECURITIES CORP., CABOTO SIM S.P.A. (F/K/A CABOTO HOLDING SIM S.P.A.), CHASE SECURITIES INC. (N/K/A J.P. MORGAN SECURITIES INC.), CREDIT SUISSE FIRST BOSTON LLC (F/K/A CREDIT SUISSE FIRST BOSTON CORPORATION), DEUTSCHE BANC ALEX BROWN, INC. (N/K/A DEUTSCHE BANK SECURITIES, INC.), FLEET SECURITIES, INC., GOLDMAN SACHS & CO., J.P. MORGAN CHASE & CO., LEHMAN BROTHERS INC., MIZUHO INTERNATIONAL PLC, TOKYO-MITSUBISHI INTERNATIONAL PLC, UBS WARBURG LLC, UTENDAHL CAPITAL PARTNERS, L.P., WESTLB AG (F/K/A WEST-DEUTSCHE LANDESBANK GIROZENTRALE), ARTHUR ANDERSEN LLP, BERNARD EBBERS, SCOTT SULLIVAN, DAVID MYERS, BUFORD YATES, JR., JAMES C. ALLEN, JUDITH AREEN, CARL J. AYCOCK, MAX E. BOBBITT, FRANCESCO GALESI, CLIFFORD ALEXANDER, STILES A. KELLETT, JR., GORDON S. MACKLIN, JOHN A. PORTER, BERT C. ROBERTS, JR., JOHN W. SIDGMORE, LAWRENCE C. TUCKER,

Defendants.

RULE 26.1 CORPORATE DISCLOSURE STATEMENT

Amicus Curiae Securities Industry Association is a non-profit corporation. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

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INTEREST OF THE AMICUS CURIAE

The Securities Industry Association ("SIA"), which was established in 1972, represents the shared interests of some 600 securities firms. SIA member firms, which include mutual fund companies, broker-dealers, and investment banks (among them the Citigroup appellants), are active in all United States and foreign markets and in all phases of corporate and public finance. The securities industry, of which SIA's members comprise a large portion, is enormously important to the Nation's economy, employing some 780,000 persons and generating $209 billion in domestic revenue in 2003. See http://www.sia.com/about_sia.

Many SIA members employ analysts who provide investors with a broad range of research and opinion on securities. Accordingly, the standards applied to determine when securities fraud claims relating to analyst opinions may be certified as class actions are of substantial interest to SIA and its members. SIA submits this brief in support of appellants because the district court's erroneous certification of a 38-month-long class of hundreds of thousands of WorldCom investors—for claims that seek to shift responsibility for plaintiffs' investment losses from WorldCom's $11 billion overstatement of earnings to a single equity analyst's allegedly misleading opinions—seriously distorts the fraud-on-the-market presumption of reliance set forth in *Basic* v. *Levinson* and expands the class action device far beyond what Rule 23 authorizes. SIA has often before filed amicus briefs in cases concerning civil liability under the federal securities laws including, recently, briefs in *Dura Pharmaceuticals* v. *Broudo*, U.S. Sup. Ct. No. 03-932 (certiorari petition pending), and *Howsam* v. *Dean Witter Reynolds*, 537 U.S. 79 (2002).

INTRODUCTION

Millions of investors suffered losses with the bursting of the technology market "bubble" in 2000 and recent revelations of financial fraud by some issuers of securities, including WorldCom. The same events that precipitated these investor losses in many cases bankrupted or slashed the value of the issuers of the securities. Deprived of any practical hope of recovering all their losses from issuers, plaintiffs in search of deeper pockets have turned their sights on the securities industry, in particular on firms that served as underwriters for issuers' stock and bond offerings and that employed analysts to research and offer opinion on securities. Plaintiffs have ratcheted up the threat these damages suits pose to the securities industry by seeking certification of extraordinarily lengthy class periods and of classes that encompass not just customers of defendant securities firms but any person or entity, anywhere in the world, that purchased securities of the issuer in question.

Such suits, once certified, effectively make securities firms into insurers against catastrophic market declines and wholesale financial fraud by company insiders. And class certification vastly increases the likelihood that plaintiffs can extract a settlement. Few firms, plaintiffs calculate—no matter how weak the claim of fraud against them or how strong their factual and legal defenses—would be prepared to risk a jury trial with such huge sums at stake. The "hydraulic pressure" to settle that comes from certification of a securities fraud class action in the normal course is exponentially increased in this latest round of suits because of the large amount of the market losses for which plaintiffs seek to hold securities firms responsible. *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001).

Class certification here, however, is clearly improper. While "certain" securities fraud cases are suitable for class certification (*Amchem Prods.* v. *Windsor*, 521 U.S. 591, 625 (1997)), those that require the jury to resolve individual questions of fact to determine liability are not. *E.g.*, *Newton, supra*; *Zimmerman* v. *Bell*, 800 F.2d 386 (4th Cir. 1986); *West* v. *Prudential Sec.*, 282 F.3d 935 (7th Cir. 2002); *Grandon* v. *Merrill Lynch*, 2003 WL 22118979 (S.D.N.Y. 2003); see also *Moore* v. *PaineWebber*, 306 F.3d 1247, 1253 (2d Cir. 2002). Plaintiffs' claims that they were injured by a single equity analyst's allegedly misleading and conflicted reports cannot be resolved without the jury engaging in time- and investor-specific inquiries into each class member's reliance on those reports. Those inquiries would predominate over questions common to all class members, require endless mini-trials to determine key elements of liability, and make class-wide adjudication hopelessly unmanageable.

The typical securities fraud case involves misrepresentation of insider information concerning a company's financial condition or business operations, disclosure of which produces an abrupt change in the price of securities. In those circumstances—given the uniquely authoritative nature of a company's statements about its own business and finances—it is reasonable to presume if the market for the securities is efficient that those who traded during the period of the misrepresentation did so in reliance on a market price that impounded incorrect financial information put forth by the issuer. This case is dramatically different. Plaintiffs challenge one analyst's *opinions* concerning WorldCom. Those opinions lack the unique status and lasting price impact of insider statements that make presuming reliance a matter of "common sense and probability." *Basic Inc.* v. *Levinson*, 485 U.S. 224, 246 (1988).

To the contrary, it is well understood that a misrepresentation by an "outsider" like a research analyst cannot cause "a long-term rise in price" in an "efficient market" because "[p]rofessional investors" draw "more astute inferences and the price effect disappears." *West*, 282 F.3d at 940. Institutional and other professional investors, whose judgments are key to determining the price of securities, do not rely exclusively or to any significant extent on the opinions of broker-dealers' analysts but instead conduct or purchase independent research.

Moreover, a research analyst's opinions enter a marketplace full of competing opinion and information and are soon drowned out as new data and commentary appear. Hundreds of different analyst reports concerning WorldCom were issued during the putative class period, by dozens of different analysts, at the same time that traditional and online media reported on the company virtually every day and WorldCom constantly announced news about its business. In the efficient market that plaintiffs allege existed in WorldCom securities, presuming class-period-long price inflation from analyst opinions cast into this maelstrom of data and predictions is unjustified.

That is all the more true during the telecom market "bubble" encompassed by the 38-month class period, when stock price reaction to events was unpredictable and impossible to trace over any significant period of time. *E.g.*, Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets*, 97 NW. U.L. REV. 135, 177-178 (2002) ("noise and the presence of other information" make calculation of the price effect of events "imprecise," "unusable," and "increasingly doubtful" as the time period under consideration lengthens). With the predicates for the *Basic* presumption lacking, investors would individually have to prove that they relied on the allegedly false elements of an analyst report at the time they made each purchase, which precludes "proceeding with a class action." *Basic*, 485 U.S. at 242.

Even putting aside this fatal defect, no class should have been certified. If reliance were presumed defendants would have the right to engage in discovery and introduce evidence to rebut reliance as to every member of the class. *Amchem*, 521 U.S. at 613; *Baffa* v. *Donaldson, Lufkin & Jenrette*, 222 F.3d 52, 59-60 (2d Cir. 2000). The extraordinary bubble market was full of momentum traders and short sellers who bought and sold WorldCom stock to take advantage of price movements, however caused, "without relying on the integrity of the market." *Basic*, 485 U.S. at 249. In addition, knowledge of analysts' alleged conflicts of interest was widespread (*Merrill Lynch Research Litig.*, 273 F. Supp. 2d 351, 382-389 (S.D.N.Y. 2003)), and there were "material variations" in the communications investors received from defendants and others. *Moore*, 306 F.3d at 1251-1256. Plaintiffs' claims, unlike the typical securities fraud case, could be adjudicated only through individualized mini-trials to determine if each investor relied, as to each transaction, on defendants' alleged misrepresentations.

In short, the class litigation plaintiffs propose would be far more fragmentary and burdensome that the "Frankenstein monster posing as a class action" in *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 156, 169 (1974), which this Court held would be "hopelessly unmanageable." 479 F.2d 1005, 1010-1011 (2d Cir. 1973). It could not be litigated without shortcuts to proof of liability and curtailment of defenses that would impose injustice on defendants and absent class members that this Court has roundly condemned. See *Malcolm* v. *National Gypsum Co.*, 995 F.2d 346, 350 (2d Cir. 1993) ("The systemic urge to aggregate litigation must not be allowed to trump our dedication to individual justice, and we must take care that each individual plaintiff's—and defendant's—case not be lost in the shadow of a towering mass litigation"). Certification of a class here would also predictably deter firms from providing analysis, chilling speech that assists investors and promotes market efficiency. See *Dirks* v. *SEC*, 463 U.S. 646, 658 & nn.17, 18 (1983). It would be far inferior to individual litigation and arbitration as a way of resolving plaintiffs' claims.

Without repeating the arguments made by appellants, with which SIA concurs, this brief elaborates the legal and policy concerns that counsel against the erosion of Rule 23 certification standards effected by the District Court below.

ARGUMENT

The past five years have seen the peak and subsequent decline of an unprecedented market bubble in internet, telecom, and other technology stocks, during which investors who held securities through the bursting of the bubble suffered substantial losses. In the same period investors have been hurt by a series of massive financial frauds by company insiders including, at WorldCom, "the largest accounting fraud in U.S. history." Shawn Young, *MCI Restatement Drops $74.4 Billion*, WALL ST. J., Mar. 15, 2004, at B2. Securities fraud lawsuits have proliferated with investor losses. Thirty-one per cent more securities class actions were filed in 2002 than in 2001, and 85 per cent of those class actions involved Section 10(b) fraud claims. Cornerstone Research, *Securities Class Action Case Filings—2002: A Year in Review* 2, 17 (2003) (available at http://securities.stanford.edu/clearinghouse_research/2002_YIR/2002_yir.pdf).

This proliferation is in part due to the unbounded growth of the securities class actions now being filed. With securities issuers bankrupt or financially depleted, plaintiffs have sought out defendants perceived to have deeper pockets, such as underwriters of public offerings and broker-dealers. Claims against securities analysts and their employers, like this one, are among the most far-reaching of all these suits. Though WorldCom insiders reported $11 billion in earnings that the company did not make, and have been criminally indicted or convicted for conduct related to that fraud, plaintiffs seek to place the legal blame for their investment losses on a single equity analyst employed by a single securities firm, on the ground that the analyst did not adequately disclose his ties to the firm's investment banking business for WorldCom. The purported class is not limited to the customers of the Citigroup defendants but encompasses anyone anywhere in the world who bought WorldCom stock or bonds over a more than three year period when the stock price plunged.

"[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739 (1975). That danger is multiplied many times over when the litigation is a class action. See *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 345 (1979) (courts must "be especially alert" to prevent "class-action harassment" when considering "the certification and management of potentially cumbersome" class actions). And it is particularly acute when the class action seeks to impose responsibility for huge market losses on participants like third-party equity research analysts. See Andy Kessler, *We're All Analysts Now*, WALL ST. J., July 30, 2001, at A18 ("Paying back the $500 billion loss of market cap in Cisco alone would wipe out Wall Street's capital, as virtually every firm recommended that stock").

Class actions seeking billions of dollars in damages are largely trial-proof. If they survive dismissal and a large and lengthy class is certified the risks to a defendant of a jury trial are so enormous that even weak cases are usually settled. See THOMAS WILLGING ET AL., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 184 table 40 (Federal Judicial Center 1996). However meritless a company and its advisors judge the claim, defendants typically cannot "stake their companies on the outcome of a single jury trial." *In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995). This phenomenon of "blackmail settlements" "induced by a small probability of an immense judgment" is universally acknowledged to occur and to be a serious problem with the class action device. HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973); *Rhone-Poulenc*, 51 F.3d at 1298; see, *e.g.*, Fed. R. Civ. P. 23(f), 1998 Committee Note ("An order granting certification * * * may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability"); *Parker* v. *Time Warner Entm't Co.*, 331 F.3d 13, 22 (2d Cir. 2003); *Newton*, 259 F.3d at 192.

It is thus of critical importance to the fairness of our legal system and the health of our economy that the class action device be used appropriately and rejected where it does not fit—and never more so than in cases like this one that combine gigantic damages claims with novel and highly aggressive theories about who should be held liable for securities fraud. "[R]igorous analysis" and "careful attention to the requirements of [Rule] 23 [are] indispensable" to ensure that certification serves its goal of streamlining the adjudication of cases where issues are truly "applicable in the same manner to each member of the class" and does not instead become a cudgel to force settlement of weak claims brought against non-traditional defendants when the defrauder is effectively judgment proof. *General Tel. Co.* v. *Falcon*, 457 U.S. 147, 155, 157, 161 (1982); *East Texas Motor Freight Sys.* v. *Rodriguez*, 431 U.S. 395, 405 (1977).

The "sprawling" and "enormously diverse" class proposed by plaintiffs does not satisfy Rule 23's "demanding" requirements, because "significant questions * * * of liability and defenses of liability [affect] individuals in different ways" that cannot properly be glossed over using a presumption of reliance or other shortcuts. *Amchem*, 521 U.S. at 622-625 & n.17; *Ortiz* v. *Fibreboard Corp.*, 527 U.S. 815, 831 n.12, 844 n.20 (1999). Class adjudication here would dissolve into an endless series of mini-trials that would make the case hopelessly unmanageable and far inferior to alternatives by which aggrieved investors could obtain compensation.

I. RELIANCE CANNOT BE PRESUMED IN THIS CASE BUT MUST BE PROVED INDIVIDUALLY FOR EACH CLAIMANT, PRECLUDING CLASS CERTIFICATION.

The district court ruled that plaintiffs are entitled to a presumption of reliance under both *Basic* v. *Levinson* and *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). That was error. Courts should "presume reliance only when it is logical to do so." *Ockerman* v. *May Zima & Co.*, 27 F.3d 1151, 1159 (6th Cir. 1994); see 2 JOHN W. STRONG, MCCORMICK ON EVIDENCE § 343, at 438 (5th ed. 1999) ("[T]he most important consideration in the creation of presumptions is probability"). There is no logical reason to presume reliance here, where the predicate facts necessary to sensibly apply either presumption are missing.

Because plaintiffs challenge not issuer misstatements about hard financial data but third-party opinions issued in the midst of an extraordinary market "bubble," *Basic*'s fraud-on-the-market presumption of reliance does not apply. Nor is there any "silence" that would impede plaintiffs' proof—the challenged analyst reports are all readily available—so *Affiliated Ute*'s presumption of reliance on omissions is also inapplicable.

A. The *Basic* Presumption Cannot Reasonably Be Applied To Research Analyst Reports.

Basic addressed the question whether plaintiffs "who traded a corporation's shares on a securities exchange *after the issuance of a materially misleading statement* *by the corporation* [could] invoke a rebuttable presumption that, in trading, [they] relied on the integrity of the price set by the market." The Court held that they could, accepting the premise of the fraud-on-the-market theory that in an open and well-developed market the price of a stock is determined by public, material information—specifically corporate misrepresentations—and that an "investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." 485 U.S. at 226, 246-247 (emphasis added). Reliance on the market price could thus indirectly establish reliance on the alleged misrepresentation.

In *Basic*, as in most fraud cases brought under the securities laws, corporate insiders were alleged to have duped the public—officers and directors of the company were accused of falsely denying participation in merger negotiations. It fully accords with "common sense and probability" to presume that a "materially misleading statement *by the corporation" issuing the security* will artificially deflate or inflate the market price. *Basic*, 485 U.S. at 226, 246 (emphasis added). Insiders are uniquely possessed of internal financial information. It therefore follows that false corporate financial announcements will produce a durable effect on stock price that will not dissipate until the truth comes out, at which point the market adjusts to the new information. The securities laws reflect this understanding and aim to maintain the integrity of the market by strictly regulating the timing and type of disclosures issuers must make, thereby minimizing the risk associated with insider control over vital corporate information. See*, e.g., id.* at 235 n.12 ("'The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized'"); 15 U.S.C. § 78m (providing for detailed disclosure by issuers in periodic reports).

An analyst report, by contrast—even one by a well-known analyst like Jack Grubman—has no such special status. Unlike the immediate and persistent effect of fundamental financial data disseminated by the issuer, analyst reports vie with, and are quickly overwhelmed by, a continuous barrage of other information about the particular stock, the relevant business sector, the market, and the broader economy.

An analyst's "opinion" is but one view among a multitude of outsider commentary. Most obviously, it competes with reports by *other analysts*. There were 35 analysts covering WorldCom who, during the proposed class period, issued nearly 500 research reports about the company. Comment Decl. ¶ 14. The sheer number, variety, and accumulation of competing analyst reports make it highly *unlikely* that the price effect of a single report could be anything but ephemeral.

That "multiple analysts cover the same security" is a "unique fact about litigation against a securities analyst" which renders the fraud-on-the-market presumption inapt. Any "irresponsibly glowing report" will inevitably be countered by "highly critical" ones. John Coffee, *Security Analyst Litigation*, N.Y.L.J., Sept. 20, 2001, at 5. Even where, as with WorldCom, the bulk of the reports are optimistic (though with varying reasoning and target prices), Comment Decl. ¶ 14 & Ex. 8, "[a]t the least, the market is aware of opposing viewpoints" and no one report can reasonably be singled out as having a meaningful long-term impact on stock price. Coffee, *supra*. Moreover, an analyst report by nature becomes increasingly irrelevant with the passage of time. Opinions and forecasts soon become stale, time rapidly eliminating any price effect the report may once have had. See *In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1270 (S.D.N.Y. 1996) (statement's materiality fades with age; "stale" information is immaterial as a matter of law).

Of course, these competing analyst reports are far from investors' only source of information. Investors are bombarded daily with a changing mix of news, opinion, and speculation from a myriad of different sources. During the putative class period WorldCom made 125 SEC filings and frequently updated the public on developments within the company, such as its financial performance and projections, industry conditions, merger strategy, and spin-off possibilities. Over the proposed class period there were some 200 days on which WorldCom made SEC filings or the press published news stories discussing WorldCom. Comment Decl. ¶ 10 & Ex. 8. That does not account for more general news about the telecom sector or WorldCom's competitors, which also bears upon an investor's evaluation of WorldCom's worth. *Id.* Ex. 8 (listing select "peer" news).

This three-year time frame coincides not only with an increased focus by the mainstream media on the stock market and investment choices, but also with the appearance of countless internet sites and chat rooms devoted to the same subjects. See ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 28-29 (2000); Maryann A. Waryjas & Louis M. Thompson, *A New Millennium Dawns for Corporate Disclosure,* INSIGHTS, Feb. 2000, at 2 ("today's investors * * * are flocking to Motley Fool, Silicon Investor, Yahoo and other Internet sources for information, including chat rooms and corporate Web sites").

The enormous quantity of information that entered the marketplace in these ways and that was distributed far and wide at the speed of the Internet makes it farfetched to suppose that any one analyst could move WorldCom stock in a measurable and sustained fashion. An efficient market digests all of this information, including fundamental economic facts disclosed by the issuer, causing particular analyst opinions quickly to recede into irrelevance.

In addition, the mechanisms by which security prices are determined clearly distinguish insider misstatements from those of third parties and make applying the fraud-on-the-market presumption of reliance to the latter wholly inappropriate. In an efficient market prices are set by the judgments of investors concerning the value of a stock, and in particular the judgments of institutional investors, as reflected in their trading. *Basic*, 485 U.S. at 248; *Mills* v. *Electric Auto-Lite Co.*, 552 F.2d 1239, 1247-

1248 (7th Cir. 1977); *In re Compaq Sec. Litig.*, 848 F. Supp. 1307, 1313 (S.D. Tex. 1993). While these investors are as dependent as anyone else on the honesty of the company in stating its true revenue, expenditures, and earnings, they are not at all dependent on broker-dealers' analysts to form their view of a stock's worth.

Instead of relying on reports of "sell-side" analysts like Grubman, these institutional investors often employ their own "buy-side" analysts to research stocks. They also obtain information directly from issuing companies and subscribe to independent research services. See, *e.g.*, David Futrelle, *The Perils of Analyst Research on the Web*, MONEY, Jan. 2000, at 107 ("hedge funds, mutual funds, pensions and endowments have their own buy-side research teams * * * to act as truth serum against the endlessly optimistic sell-siders"); Carolyn Sargent, *The 2000 All-America Research Team*, INSTITUTIONAL INVESTOR, Oct. 2000, at 83 (institutions often meet with company executives without sell-side analysts present); Pablo Galarza, *The Outsiders*, MONEY, Feb. 1999, at 152 (three-quarters of institutions purchase research and advice from "independent researchers" with "no motivation for bias" who are "selling objectivity and originality"). For example, Fidelity, the country's largest mutual fund family, maintains a 500-person staff of portfolio managers, analysts, and traders, which it describes as providing "unparalleled, company-by-company research." http://personal.fidelity.com/myfidelity/Inside Fidelity. And CalPERs, the nation's largest public pension fund, employs a 100-person investment staff and a dozen professional money management firms to handle its portfolio. http://www.calpers.ca.gov/invest/invest.htm. With such extensive resources, these major market participants would not be swayed by the predictions of any "sell-side" analyst.

Indeed, institutional investors have always recognized the inherent limits of reports issued by multiservice financial firms, given that "sell" recommendations are rare and analysts may cover companies that are also investment banking clients. See, *e.g.*, Amitabh Dugar et al., *Analysts' Research Reports: Caveat Emptor*, J. INVESTING, Winter 1996, at 13, 17 (concluding that "the market reaction to [analysts'] favorably biased reports is insignificant, an indication that at least the institutional investors," who "say they are aware of such conflicts of interest," "are not fooled by the optimism"); Neil Barsky, *The Market Game*, WALL ST. J., May 8, 2002, at A18 ("No institutional money manager worth his salt pays any attention to analyst ratings"); see also *In re Merrill Lynch Research Sec. Litig.*, 273 F. Supp. 2d 351, 382-389 (S.D.N.Y. 2003); *id.*, 272 F. Supp. 2d 243, 266-267 (S.D.N.Y. 2003).

Accordingly, it is well understood that a misstatement by an analyst cannot cause "a long-term rise in price" because "[p]rofessional investors" draw "more astute inferences and the price effect disappears." *West*, 282 F.3d at 940 (reversing class certification where facts were unsuited to fraud-on-the-market presumption). Because "'market makers'" do not rely on the opinions of sell-side analysts, "the market price [could] not have been affected by their misrepresentations," and "the basis for finding that the fraud had been transmitted through market price [has] gone." *Basic*, 485 U.S. at 248.

The evanescent effect of analyst reports in an efficient market and their lack of influence on market makers are enough to make the fraud-on-the-market presumption inapplicable in a Section 10(b) case against securities analysts. And application of the presumption makes even less sense in a class period that spans an unprecedented market bubble in WorldCom's telecom sector. In that environment most investors knew they were buying into a speculative bubble. They "did not believe that prices were representative of the true valuations, [but] did believe that the bubble was likely to persist." These "momentum" investors "were willing to hold long positions in an overpriced stock because they were forecasting that other investors would be more optimistic than they were at some point in the future." FREDRICK C. DUNBAR & DANA HELLER, FRAUD ON THE MARKET MEETS BEHAVIORAL FINANCE 51-53 (2003) (available at http://www.law.columbia.edu/center_program/law_economics/wkshops/fall2003?exclusive=filemgr.download&file_id=87315&rtcontentdisposition=filename%3DDunbar,%20Fred%20C.%20-%20Fall%2003.pdf).

Given this disconnect between investors' perception of "true" value and market price, "[w]henever the market can be shown to have the elements of a bubble"—as telecom stocks indisputably did during the class period—"the *presumption* of reliance under *Basic* is no longer valid." *Id.* at 54. The "average investor" is not "substantially rel[ying]" on the integrity of "market price," so the empirical support for the presumption disappears, and its use is "unfounded." L. Brett Lockwood, *The Fraud-on-the-Market Theory*, 38 EMORY L.J. 1269, 1298 (1989).

B. Plaintiffs' Complaints About Analyst Reports Do Not Fall Within The Category Of "Omissions" For Which *Affiliated Ute* Relaxes The Requirement of Reliance.

In *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), the Supreme Court found direct proof of reliance unnecessary under Section 10(b) where the transaction involved face-to-face dealings and an affirmative duty to disclose combined with *total* nondisclosure of material facts. Defendants were two bank employees acting in a fiduciary capacity as transfer agents for sellers of tribal corporation shares. The employees failed to disclose, in one-on-one interactions, that they themselves had purchased shares and were fostering a secondary market in which the stock could be sold at a much higher price. *Id.* at 152-153. Holding that the plaintiff sellers had a "right to know" each of these facts, the Court ruled that "*[u]nder the[se] circumstances*," involving "primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery." *Id.* at 153 (emphasis added).

The Citigroup defendants' issuance of allegedly misleading analyst reports is too far removed from the "circumstances" of *Affiliated Ute* for its presumption to provide an alternate means of establishing class-wide reliance. Plaintiffs in *Affiliated Ute* were told nothing. Here, by contrast, hundreds of thousands of participants were on notice of defendants' banking relationship with WorldCom from SEC filings and Grubman's reports themselves. The *Affiliated Ute* plaintiffs had but one source of information—the employees who breached their trust by convincing plaintiffs to sell the tribal shares at low prices after secretly creating demand in a secondary market. Grubman's reports, in contrast, were only a fraction of the hundreds of analyst reports and countless other sources dispensing opinion and recommendations about an openly traded stock—as to which any reasonable investor understands there are no guarantees. See *Freeman* v. *Laventhol & Horwath*, 915 F.2d 193, 198 (6th Cir. 1990) (securities acts were not intended "to establish a scheme of investors' insurance"). Because the importance of the undisclosed information was so profound and unique in *Affiliated Ute*, the plaintiffs there could legitimately be presumed to have equated defendants' "stand[ing] mute" with the absence of those facts. *Affiliated Ute*, 406 U.S. at 153. That simply is not the case in the circumstances here.

The evidentiary difficulties the *Affiliated Ute* presumption was designed to offset also are not present here. The cases unanimously hold that the presumption operates only in cases of "omissions." *E.g., Wilson* v. *Comtech Telecomms. Corp.*, 648 F.2d 88, 93 (2d Cir. 1981); *Titan Group, Inc.* v. *Faggen*, 513 F.2d 234, 239 (2d Cir. 1975); *Cox* v. *Collins*, 7 F.3d 394, 395 (4th Cir. 1993); *Joseph* v. *Wiles*, 223 F.3d 1155, 1162 (10th Cir. 2000). If both misstatements and omissions are alleged, the claim must "analytically [be] characterize[d]" as "primarily" either one of affirmative misrepresentation or one of nondisclosure. *Finkel* v. *Docutel/Olivetti Corp.*, 817 F.2d 356, 359 (5th Cir. 1987); accord *Johnston* v. *HBO Film Mgmt., Inc.*, 265 F.3d 178, 192-193 (3d Cir. 2001); *Joseph*, 223 F.3d at 1162; *Binder* v. *Gillespie*, 184 F.3d 1059, 1063 (9th Cir. 1999). This ensures that the presumption is used only to compensate for insurmountable evidentiary hurdles. As this Court has observed, the "rationale for a presumption" in "cases like *Affliated Ute*, in which no positive statements exist" is that "reliance as a practical matter is impossible to prove." *Wilson*, 648 F.2d at 93; accord *Titan*, 513 F.2d at 239 ("in instances of total non-disclosure, * * * it is of course impossible to demonstrate reliance").

"Positive statements" are, however, the focus of the putative class claims here. Plaintiffs attack the recommendations and optimistic forecasts about WorldCom contained in Grubman's research reports as misrepresenting his true opinion. Their "principal grievance"—the purported falsity of "certain things upon which [they] relied" in purchasing WorldCom stock—is more than sufficient to require direct proof of reliance. *Estate of Detwiler* v. *Offenbecher*, 728 F. Supp. 103, 145 n.16 (S.D.N.Y. 1989) (defendants' misstatements to the board about benefits of selling company meant case could not be conceptualized as one of "omissions"). The analyst reports were not only published but, by plaintiffs' own account, widely disseminated. See *Wilson*, 648 F.2d at 93 (no problem of proof where claim depended on "informal statements" and financial projections); *Joseph*, 223 F.3d at 1162 (*Ute* did not apply to complaint about circulation of "false information about the company"); *Johnston*, 265 F.3d at 193 (no presumption of reliance where "primary claim" was that defendants had misrepresented actor's participation in project).[1]

Although Grubman's reports communicated the investment banking relationship between his employer and WorldCom, the district court thought that defendants inadequately disclosed the alleged *quid pro quo* relationship between the two—Grubman's "relentlessly positive" reports "exchange[d] for WorldCom's lucrative business" (219 F.R.D. at 277)—as an "omission" deserving of the *Affiliated Ute* presumption. The district court was wrong.

What this claimed "omission" amounts to is an allegation that defendants' alleged "fraudulent scheme" was concealed. But the "mere fact of * * * concealment [cannot] transform [an] alleged malfeasance" like the dissemination of unduly optimistic analyst reports "into an omission rather than an affirmative act," otherwise "the *Affiliated Ute* presumption [would] swallow the reliance requirement almost

1/ Some Circuits apply the *Affiliated Ute* presumption even more restrictively—only when a plaintiff alleges pure nondisclosure or there is a face-to-face transaction. *E.g.*, *Cox*, 7 F.3d at 395-396 (presumption is not warranted if "plaintiff alleges both nondisclosure and positive misrepresentation"); *Rowe* v. *Maremont Corp.*, 850 F.2d 1226, 1233 n.4 (7th Cir. 1988) ("face-to-face transactions"); *In re Nationsmart Corp. Sec. Litig.*, 130 F.3d 309, 321 (8th Cir. 1997) (same). Those limitations—neither of which is satisfied here—best comport with the evidentiary rationale that this Court recognizes lies behind the *Affiliated Ute* presumption. *Wilson*, 648 F.2d at 92; *Titan*, 513 F.2d at 238-239.

completely." *Joseph*, 223 F.3d at 1163 (contention that defendants covered up "the existence of the unlawful scheme" could not give rise to *Ute* presumption); see also *Johnston*, 265 F.3d at 193 (no omission existed "simply because the defendants failed to disclose that the allegedly misleading fact was untrue"). In this instance, it would also allow allegations of undisclosed *motive* to substitute for omitted material *facts*—even though federal securities laws impose no such duty of "self-accusation." *Koppel* v. *4987 Corp.*, 167 F.3d 125, 133-134 (2d Cir. 1999) (dismissing claimed failure to disclose "potential conflicts of interest" since defendant had no obligation to pejoratively characterize its motivations); see also *Data Probe Acquisition Corp.* v. *Datatab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983) ("The disclosure required * * * is not a rite of confession * * *. What is required is the disclosure of material objective factual matters").

* * * * *

Without the benefit of *presumed* reliance under either *Basic*'s fraud-on-the-market theory or *Affiliated Ute*, each purchaser of WorldCom securities would have to individually prove that he or she was actually aware of and reasonably relied on the allegedly misleading elements of a Grubman analyst report at the time of each transaction. This need to prove "individualized reliance" means that "individual issues * * * overwhel[m] the common ones" and the class should not have been certified. *Basic*, 485 U.S. at 242; see *Johnston*, 265 F.3d at 194 (no predominance absent *Ute* presumption); *Zimmerman*, 800 F.2d at 390 (when reliance varies "from shareholder to shareholder" the need for "individual inquiry" means that that case "lack[s] the common characteristics required for class treatment").

II. REGARDLESS OF WHETHER RELIANCE MAY BE PRESUMED, INDIVIDUAL ISSUES WOULD PREDOMINATE IN A CLASS ACTION, WHICH WOULD BE UNMANAGEABLE AND INFERIOR TO ALTERNATIVE METHODS OF RESOLVING PLAINTIFFS' CLAIMS.

Even where reliance is presumed, defendants have the right to present a full defense. *Baffa* v. *Donaldson, Lufkin & Jenrette*, 222 F.3d 52, 59-60 (2d Cir. 2000); *Gary Plastic Corp.* v. *Merrill Lynch*, 903 F.2d 176, 180 (2d Cir. 1990); see *Nelson* v. *Adams USA, Inc.*, 529 U.S. 460, 466 (2000) ("opportunity to respond" to claims is "fundamental to due process"); *Ortiz*, 527 U.S. at 845 ("rules of procedure" like Rule 23 are not to abridge "any substantive right"). Defendants may rebut the presumption of reliance by "[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." *Basic*, 485 U.S. at 248.

At trial, therefore, the Citigroup defendants will have the right to show, on a trade-by-trade basis, that individual WorldCom investors did not "rel[y] on the integrity of the market" to reflect the stock's "true" value. *Basic*, 485 U.S. at 249; see *DuPont* v. *Brady*, 828 F.2d 75, 78 (2d Cir. 1987). It is characteristic of a "bubble" that a large proportion of trading in telecom stocks like WorldCom was attributable to momentum traders and others who were not primarily concerned about the integrity of the stock's price. *E.g.*, DON DEVITTO, IRRATIONAL MARKETS AND THE ILLUSION OF PROSPERITY 107-108 (2001) ("momentum" investors "identify stocks with the greatest upward momentum and buy them"; the "value or worth of a company is not a consideration"). In addition, short interest in WorldCom was considerable, with many purchases of the stock made, regardless of the integrity of its market price, to cover short trades. Determining who engaged in momentum trading and who was covering a short trade, and for which transactions, would require individual and subjective inquiries incompatible with class adjudication.

Plaintiffs cannot establish the fact-of-injury and loss causation elements of Section 10(b) liability on a class-wide basis either. No formula or economic methodology exists that could reliably trace out over 38 months the effects of a single equity analyst's opinions on WorldCom stock and bond prices. See Langevoort, *supra*, 97 NW. U.L. REV. at 177-178. To meet their burden to prove loss causation and injury as to each class member, plaintiffs would have to segregate out the effect of the lawful aspects of those reports (see *Merrill Research Litig.*, 273 F. Supp. 2d at 363-364, 368), the effect of hundreds of reports by dozens of other analysts, the widespread publicity given to analyst conflicts (see *id*. at 382-389), company announcements and news, price volatility during the telecom bubble, intervening events like the bursting of that bubble and WorldCom's $11 billion earnings misstatements (see *Emergent Capital* v.

Stonepath Group, 343 F.3d 189, 198-199 (2d Cir. 2003)), and a host of other factors. These confounding events make it impossible for plaintiffs to prove—and illegitimate for a court to presume—that defendants' alleged misrepresentations caused price inflation across the entire class period, as defendants' critique of Mr. Torchio's report shows. And defendants would have the right at trial to contest evidence of injury and loss causation on a time- and transaction-specific basis, requiring countless mini-trials to resolve.

These individualized issues—and others like statute of limitation, materiality, scienter, and damages—would make this case truly a "Frankenstein monster posing as a class action" (*Eisen*, 417 U.S. at 169), one so "inordinately time consuming and difficult" as to "transgress upon the required standards of fairness and efficiency." *In re LifeUSA Inc.*, 242 F.3d 136, 148 (3d Cir. 2001). Individual, time-specific liability questions would require "Herculean" investigation of "the circumstances surrounding each trade" and "present insurmountable manageability problems" that take this case far beyond the scope of Rule 23. *Newton*, 259 F.3d at 187, 192.

With all these problems, a class action is far from the superior means to resolve WorldCom investors' claims. The drafters of Rule 23(b)(3) "had dominantly in mind vindication of the rights of groups of people who individually would be without effective strength to bring their opponents into court at all." *Amchem*, 521 U.S. at 617. Many members of the putative class here are large institutional investors and substantial individual traders with the resources to bring their own securities fraud suits. Dozens of such suits have already been filed. The "justification of class certification is absent" where some plaintiffs have the capacity to prosecute individual actions. *Windham* v. *American Brands, Inc.*, 565 F.2d 59, 69 (4th Cir. 1977).

NASD arbitration is available to smaller investors who were customers of the Citigroup defendants or other defendants with whom they had arbitration agreements. NASD Code of Arb. Proc. § 10101 (available at http://www.nasdadr.com/arb_code/arb_code.asp). Arbitration has been strongly endorsed by the Supreme Court as a means to resolve securities fraud disputes. See *Shearson/American Express, Inc.* v. *McMahon*, 482 U.S. 220, 232 (1987) (describing the "suitability of arbitration" for resolving securities law claims); *Howsam* v. *Dean Witter Reynolds, Inc.*, 537 U.S. 79, 85 (2002). It saves time and expense, it increases the share of recovery that an investor gets to keep, and experienced arbitrators are well positioned to consider the specific facts and circumstances of each investor's case. NASD rules provide for an efficient arbitration procedure with legal representation and substantial discovery rights. NASD Code of Arb. Proc. §§ 10316, 10321-10322. Claims less than $25,000 are channeled into a "simplified arbitration" procedure for even less costly and time-consuming resolution. *Id.* § 10302. These alternatives are superior to the sprawling and unmanageable class action plaintiffs propose. See *Rowe* v. *Morgan Stanley Dean Witter*, 191 F.R.D. 398, 416-419 (D.N.J. 1999) (dismissing class allegations in securities fraud cases in favor of arbitration). In fact, many hundreds of arbitrations arising out of WorldCom's fraudulent financial reporting have already been filed. See Susanne Craig, *David Stings Brokerage Goliaths: Wall Street's Big Houses Find Small Investors Get Payback with a Blizzard of Arbitrations*, WALL ST. J., Mar. 17, 2004, at C1, C5.

In light of the availability of these alternative judicial and arbitral forums for WorldCom investors' claims, no beneficial purpose would be served by stretching the bounds of Rule 23 so far as to encompass this case. To the contrary, certifying securities fraud class actions directed against research analysts' reports and recommendations would "have serious ramifications on reporting by analysts of investment views." *Dirks* v. *SEC*, 463 U.S. 646, 658 n.18 (1983). "[M]arket efficiency" is enhanced by analysts' "initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." *Id.* at 658 n.17. But the threat of easy certification of weak claims, based on a "presumption" that analysts' reports have a measurable long-term impact on market price, would "have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." *Id*. at 658.

Research coverage available to small investors has already been severely curtailed as a result of economic pressures. See Ann Davis, *Increasingly, Stock Research Serves the Pros, Not "Little Guy,"* WALL ST. J., Mar. 5, 2004, at A1 ("The

10 largest research departments on Wall Street are following nearly 20% fewer stocks"; "hundreds of midsize companies have lost analyst coverage entirely, and coverage of large companies has fallen off"). The risk of coerced settlement or a huge verdict that class certification brings—and of liability not just to the analyst's broker-dealer firm's own customers but to a class of every purchaser of a stock anywhere in the world, regardless whether they read the report or relied on other sources entirely in making an investment decision—would accelerate that unfortunate trend, deterring a valuable form of commercial speech. See *Dirks*, 463 U.S. at 658; *Lowe* v. *SEC*, 472 U.S. 181, 210 n.58 (1985) (First Amendment protects "the expression of an opinion about a marketable security").

CONCLUSION

For the foregoing reasons and those set forth in the brief of appellants, the district court's order granting certification of a class should be reversed.

Respectfully submitted.

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CERTIFICATE OF COMPLIANCE

I, Timothy S. Bishop, counsel for amicus curiae Securities Industry Association and a member of the Bar of this Court, certify that this brief contains 6969 words and complies with the type volume limitations of Federal Rules of Appellate Procedure 29(d) and 32(a)(7)(B).

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CERTIFICATE OF SERVICE

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