06-3225-cv

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

IN RE SALOMON ANALYST METROMEDIA LITIGATION

DOUGLAS MILLOWITZ, on behalf of himself and all others similarly situated,

Plaintiffs-Appellees,

—against—

CITIGROUP GLOBAL MARKETS, INC., f/k/a Salomon Smith Barney Inc., formerly known as Salomon Smith Barney Holdings Inc., CITIGROUP INC., CITICORP USA, INC. and JACK GRUBMAN,

Defendants-Appellants.

ON APPEAL PURSUANT TO FEDERAL RULE OF CIVIL PROCEDURE 23(f)
FROM AN ORDER GRANTING CERTIFICATION OF A CLASS ACTION BY THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF DEFENDANTS-APPELLANTS

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INTEREST OF THE *AMICUS CURIAE*

SIFMA is the trade association resulting from the November 1, 2006, merger of the Securities Industry Association and The Bond Market Association. It brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that expand and improve markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the United States and globally. It has offices in New York, Washington, D.C., and London.

Many of SIFMA's members employ analysts who provide investors with research and opinions on a wide variety of securities. SIFMA and its members thus have a profound institutional interest in the development of rational legal standards for adjudicating securities fraud claims against analysts and their employers. Given the increase in securities fraud class action litigation over the last decade and the rash of recent filings challenging the conduct of analysts, SIFMA and its members are especially interested in the standards for certifying as class actions claims based on analyst statements.

This case represents a potential watershed for the litigation of securities fraud claims against analysts and other third parties. In the nearly twenty years

since the Supreme Court approved the use of the fraud-on-the-market doctrine to create a presumption of reliance on misrepresentations by issuers, no appellate court has ever allowed use of the doctrine to facilitate certification of a class action by investors against individual third-party analysts, whose views represent but a small fraction of the total information available in the marketplace and pale in importance in comparison to the authoritative financial projections and results provided by issuers.

If this Court sanctions the application of the fraud-on-the-market presumption here, then analysts and their employers will be subject to claims not only by investors who claim to have acted in reliance on the analyst's opinions and reports, but potentially by anyone who has traded in any stock that the analyst has discussed publicly. Having been relieved of the obligation to prove individual reliance, this expanded pool of potential claimants will make massive class-action lawsuits against analysts an enduring fact of life for the securities industry, exposing analysts and their employers to huge increases in potential liability and changing forever the calculus about whether an analyst should cover a particular company and how the analyst's views should be disseminated.

Especially in the wake of Congressional action to rein in abusive securities fraud class actions, the decision whether to adopt a new legal rule that will produce an upsurge in class actions against non-issuers and multiply their exposure to

damages exponentially should include full consideration of its basis in the law and its practical implications. Without repeating the arguments made by defendants-appellants, with which SIFMA concurs, SIFMA respectfully submits this brief in order to elaborate upon the legal and policy concerns that counsel against that course of action.

INTRODUCTION

In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court—in a 4-2 decision—approved the use of a fraud-on-the-market theory in the context of alleged securities fraud by an issuer to create a presumption of reliance by plaintiffs "who traded a corporation's shares * * * after the issuance of a materially misleading statement ***by the corporation***." *Id.* at 226 (emphasis added). According to the district court in this case, "[n]othing in the language of *Basic* limits its holding to issuer statements alone." *In re Salomon Analyst Metromedia Litig.*, 236 F.R.D. 208, 220 (S.D.N.Y. 2006) (quoting *DeMarco v. Robertson Stephens Inc.* 228 F.R.D. 468, 474 (S.D.N.Y. 2005)). Purporting to rely on *Basic*, the district court certified a class action alleging misrepresentations by a third-party analyst on the theory that the plaintiffs—who do not claim that they were even aware of the analyst's alleged misrepresentations—nonetheless would be able to satisfy the reliance requirement simply by demonstrating at the merits stage that the analysts' statements affected the stock price.

That decision was error. As defendants-appellants argue in their brief, because plaintiffs made only the most minimal showing of a possible impact on the stock price, the factual predicate for the district court's grant of class certification entirely lacked the necessary evidentiary support. See *In re Initial Public Offering Sec. Litig.*, 471 F.3d 24, 41-42 (2d Cir. 2006). More fundamentally, this Court has properly deemed it to be "doubtful whether the *Basic* presumption can be extended, beyond its original context, to * * * analysts' reports." *Id.* at 43. The availability of the fraud-on-the-market presumption of reliance does not simply turn on questions of fact, as the district court seemed to believe. Instead, it is a legal rule that has important procedural implications and substantively alters the scope of the defendant's liability—expanding the class of potential claimants beyond those who actually relied upon the analysts' words to include all persons who traded in the relevant stock during the relevant time period.

The expansion of the *Basic* presumption of reliance to the reports and opinions of third-party analysts cannot be justified. As we explain below, the rationale for presuming that investors in a corporation's stock rely on material information disclosed by corporate insiders is inapplicable to reports and opinions of third-party analysts. The severe practical consequences of extending the fraud-on-the-market doctrine to such third-party opinions—which would subject analysts and their employers to liability in every 10b-5 case in which an analyst's report

was issued during the purported class period—also weigh heavily against expansion of this judicially-created evidentiary presumption,

ARGUMENT

There is no doubt that "reliance is an element of a Rule 10b-5 cause of action." *Basic,* 485 U.S. at 243; see also *id.* at 258 (White, J., concurring in part and dissenting in part) ("Congress * * * anticipated meaningful proof of 'reliance' before civil recovery can be had under the Securities Exchange Act"). Unless the fraud-on-the-market doctrine is applied, therefore, each plaintiff seeking to recover for an affirmative misrepresentation under Rule 10b-5 must, in order to establish transaction causation, assert that he was aware of the alleged misrepresentation and purchased or sold a security as a result—meaning that individual issues of reliance would almost certainly predominate over common issues. See, *e.g.*, *Emergent Capital Inv. Mgmt. LLC v. Stonepath Group, Inc.*, 343 F.2d 189, 197 (2d Cir. 2000) (issue is whether "but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction"). Securities fraud actions alleging traditional reliance are routinely filed against non-issuers. *See, e.g., AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 209 (2d Cir. 2000) (finding that plaintiff investor established transaction causation through the "ample evidence in the record" that it had relied upon independent auditor's representations).

The question here, therefore, is not whether research analysts are subject to private actions under the securities laws in appropriate cases—they clearly are—but whether the Court should create a presumption that will subject analysts and their employers to suit by large classes of investors, many of whom may not have been aware of the analyst's opinions. The answer is no.

I. THE RATIONALE FOR APPLYING THE FRAUD-ON-THE-MARKET DOCTRINE TO ISSUER MISSTATEMENTS DOES NOT APPLY TO ANALYST REPORTS

When *Basic* was decided, "[t]he paradigm of a fraud on the market litigation [was] a class action brought by purchasers of stock alleging that over a period of time the stock prices were artificially inflated due to material misstatements appearing in publicly available corporate documents." Barbara Black, *Fraud on the Market: A Criticism of Dispensing With Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 435-437 (1984) (cited in *Basic*, 485 U.S. at 247 n.26). *Basic* likewise involved a claim that corporate officers and directors had misled the corporation's shareholders—and artificially depressed the stock price—by making false representations about whether there was a plan for the issuer to be acquired. This fact was essential to the Court's decision. Indeed, the Court's explanation for its conclusion that "considerations of fairness, public policy, and probability" (485 U.S. at 245) supported a presumption of reliance makes sense only when the plaintiffs have "traded a corporation's shares on a

securities exchange after the issuance of a materially misleading statement ***by the corporation***." *Id.* at 226 (emphasis added).

First, the *Basic* Court reasoned that a presumption of reliance furthered "the congressional policy embodied in the 1934 Act" (*id.* at 245), which "implement[ed] a 'philosophy of full disclosure'" by public corporations. *Id.* at 229 (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-478 (1977)). As the Court explained, the basic premise of the 1934 Act's requirement of complete, accurate, and regular disclosures of financial information by corporations was that the market relies upon such information "as indices of real value." *Id.* at 246 (quoting H.R. Rep. No. 1383, 73rd Cong., 2d Sess., at 11 (1934)); see also *id.* at 235 n.12 ("'The importance of accurate and complete ***issuer disclosure*** to the integrity of the securities markets cannot be overemphasized'") (emphasis added); *id.* at 246 n.23 (rejecting the dissent's argument that the fraud-on-the-market presumption would reduce the incentive for investors "'to pay attention to' ***issuers' disclosures***") (emphasis added); 15 U.S.C. § 78m (providing for detailed disclosure by issuers in periodic reports).

Given the policy of the 1934 Act that material information released by a corporation was crucial to establishing the value of its stock, it was reasonable for courts to adopt a presumption that the market takes account of this information in setting the stock price. Furthermore, because corporations have fiduciary duties to

their shareholders (see *Chiarella v. United States*, 445 U.S. 222, 228 (1980)), it is not unfair to allow a corporation's shareholders (or former shareholders) to sue the corporation for making misrepresentations that have distorted the market value of its stock.

That rationale is wholly inapplicable to analysts. The securities laws embody no philosophy of full disclosure for analysts. To the contrary, the law permits them to "ferrret out" information about corporations, use the information to "make judgments as to the market worth of a corporation's securities," and make their judgments available "in market letters or otherwise to clients of the firm" without incurring any duty to make the information available "to all of the corporation's stockholders or the public generally." *Dirks v. SEC*, 463 U.S. 646, 658-659 (1983). Moreover, third-party analysts have no fiduciary duty to shareholders generally, but incur such obligations only when they affirmatively induce investors "to repose trust and confidence" in them. *Id.* at 665; see also *id.* at 666 n.27 (pointing to the "'established doctrine that duty arises from a specific relationship between two parties'") (quoting *Chiarella*, 445 U.S. at 233). Accordingly, the securities laws do not embody a presumption that the market price of a security will be set in accordance with analysts' views.

Indeed, in contrast to the Act's policy that issuer disclosures would and ***should*** supply the basis for the market's determination of the "real value" of

securities, it is accepted wisdom that investors should ***not*** rely exclusively on analysts' views when making investment decisions. Both the SEC and the NASD expressly "caution investors never to rely solely on an analyst's recommendation when buying or selling a stock." SEC, *Investor Alert: "Analyzing Analyst Recommendations,* Apr. 20, 2005, *available at* www.sec.gov/investor/pubs/analysts.htm. See also *NASD Guide to Understanding Securities Analyst Recommendations*, *available at* www.nasd.com/InvestorInformation/InvestmentChoices/UnderstandingSecuritiesAnalystRecommendations/index.htm (advising investors that they "should never rely solely on an analyst recommendation when making an investment decision").

The NASD has explained that "because analysts are called upon to make so many judgments that are not black and white, any of [several] factors [e.g. investment banking relationships, compensation, brokerage commissions, buy-side pressures, and ownership interests] can put pressure on their objectivity—no matter how honest or competent they may be." *Id.* A judicial presumption that all investors do rely on the views of all individual analysts cannot be squared with these cautionary statements.

Indeed, given all the other factors that a rational investor must consider before buying or selling stock in reliance on an analyst's recommendation, the elimination of the need to prove individual reliance on an analyst report is contrary

to established law. This Court has ruled that in order to state a claim of securities fraud a plaintiff must show "reasonable" or "justifiable" reliance on the allegedly misleading statements. *Starr ex. rel. Estate of Sampson v. Georgeson Shareholder, Inc.*, 412 F.3d 103, 109 (2d Cir. 2005); *Harsco Corp. v. Segui*, 91 F.3d 337, 342 (2d Cir. 1996) ("The general rule is that ***reasonable*** reliance must be proved as an element of a securities fraud claim" (emphasis added) (citations omitted)). To determine whether an investor's reliance was in fact reasonable, "no single factor is dispositive, and all relevant factors must be considered and balanced." *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993).

Although this Court has never established a list of all relevant factors for determining whether reliance is reasonable, it has acknowledged that courts have been guided by the following: "(1) [t]he sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of longstanding business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations." *Id.* (citations omitted).

It is inherently reasonable for any investor to rely on a corporation's statements about its own financial status, and the element of reasonableness

therefore was no obstacle to the recognition of the fraud-on-the-market presumption in *Basic*. In contrast, the reasonableness of a particular investor's reliance on an analyst's report cannot be determined without an individualized inquiry regarding (among other things) the nature of the relationship between the investor and the analyst, the sophistication of the investor, the extent to which the investor is part of the analyst's intended audience, and the investor's access to other information that might cast doubt on the analyst's views. See *NASD Guide to Understanding Securities Analyst Recommendations*, *supra* ("[W]hatever a given analyst recommendation may say, always consider whether a particular investment is right for you in light of your own financial circumstances.").

A presumption that investors indirectly rely on any analyst report that may have affected the market price when they enter into stock transactions simply ignores these factors. It would effectively "[a]llow[] plaintiff[s] to circumvent the reliance requirement" altogether, thus "disregard[ing] the careful limits on 10b-5 recovery mandated by * * * earlier cases." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994).

As a second ground for its decision, the *Basic* Court opined that it 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. Indeed, it is entirely reasonable to

create a presumption that an ***insider's*** financial pronouncements are indirectly transmitted to all persons who trade in reliance on the stock price. Because insiders uniquely possess internal financial information, it 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. See *Hevesi v. Citigroup, Inc.*, 366 F.3d 70, 77 (2d Cir. 2004) (the fraud-on-the-market presumption assumes that in an efficient market "the market price of securities" is "an accurate measure of their intrinsic value" based on publicly available information); *Seaboard World Airlines, Inc. v. Tiger Int'l, Inc.*, 600 F.2d 355, 361-362 (2d Cir. 1979) (prices in an efficient market reflect "financial factors that determine 'value'"); see also *West v. Prudential Sec., Inc.*, 282 F.3d 935, 938 (7th Cir. 2002). The securities laws reflect this understanding and therefore seek 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.

In contrast, it comports with neither common sense nor probability to adopt a presumption that statements by third parties have the same direct and durable effect on a security's market price. To the contrary, given the "tangle of factors" that affect the market price of a security (*Dura Pharm., Inc. v. Brouda*, 544 U.S. 336, 343 (2005)), common sense compels the conclusion that the views of

individual analysts have ***not*** "been transmitted through market price" to all investors. *Basic*, 485 U.S. at 248.

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. Elec. 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 research analysts to form their view of a stock's worth.

These institutional investors typically 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, CalPERs, the nation's largest public pension fund, employs a 180-person investment staff and a dozen professional money management firms to handle its portfolio. http://www.calpers.ca.gov /index.jsp?bc=/investments/home-xml. With such extensive resources, these major market participants are most unlikely to be swayed by the predictions of a "sell-side" analyst like Jack Grubman.

Indeed, institutional investors have long 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 & Co.*, 273 F. Supp. 2d 351, 382-389 (S.D.N.Y. 2003); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 266-267 (S.D.N.Y. 2003).

For these reasons, it is well established 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. See also 2 Harold Bloomenthal, SECURITIES LAW HANDBOOK 1397 (2002) (there can be no reliance under "the efficient market theory" when the available information enables the market "to recognize that the representations are optimistic"); accord *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 175 (2d Cir. 2005) (contemporaneous disclosure of analyst conflict of interest sufficient to cast doubt on loss causation allegations).

Moreover, unlike an issuer's statements regarding its own finances—which are uniquely authoritative, an analyst's "opinion" is but one view among a cacophony of third-party commentary regarding the value of a security. The SEC recently reported that "[i]ssuers with market capitalization in excess of $700 million that conducted offerings in 1997-2003 typically have had an average of 10 analysts following them prior to the offering." *Well-Known Seasoned Issuers;*

Other Categories of Issuers, 69 Fed. Reg. 67,396, 67,397 (Nov. 17, 2004). As Professor Coffee has written, moreover, "analyst reports typically diverge substantially in their prediction of future earnings and have never been found to be very accurate." John C. Coffee, Jr., *Security Analyst Litigation*, N.Y.L.J., Sept. 20, 2001, at 5. Given that "multiple analysts cover the same security" and that they often disagree, it is "logically more difficult to presume that investors relied on a particular report in the absence of actual proof of reliance." *Ibid.*

Furthermore, these competing analyst reports are far from investors' only source of information. Investors are bombarded daily with a changing mix of news, opinions, and speculation from a wide variety of sources. They include not only the mainstream media—which have increasingly focused their coverage on the stock market and investment choices—but also countless internet sites and chat rooms devoted to the same subjects. See Robert J. Schiller, IRRATIONAL EXUBERANCE 28-29 (2000); Maryann A. Waryjas & Louis M. Thompson, *A New Millenium Dawns for Corporate Disclosures*, 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"). Investors' views about a company's worth also are influenced by more general news about the industry sector or the activities of its competitors.

Thus, a single analyst report inevitably becomes irrelevant as new commentary—based on more up-to-date information—is issued by any of the many participants in this robust information marketplace. A particular commentator's opinions and forecasts soon become stale, with the issuance of statements by other third parties and the passage of time rapidly eliminating any evanescent price effect one report might possibly 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).

In short, analysts compete with a multitude of equally non-authoritative voices—including other analysts, journalists, bloggers, and others—each offering their own views regarding the value of a corporation's stock; and the limited impact that a single analyst's opinions may have given the total mix of information available to investors is ephemeral by nature. Analyst reports therefore plainly lack the special status of an issuer's own authoritative disclosures in providing the building blocks of stock valuation. This common-sense conclusion is supported by empirical data, which shows that "share price responses to earnings announcements—statements of fact made by issuers—and to management forecasts—statements of opinion made by issuers—are both more material and more pervasive than are share price responses to analysts' forecasts." *See* Qi Chen, Jennifer Francis, and Katherine Schipper, *The Applicability of the Fraud on the*

Market Presumption to Analysts' Forecasts, Duke Univ. Fuqua Sch. of Business Faculty Working Paper 4 (Draft, Nov. 2005), *available at* http://faculty.fuqua.duke.edu/~qc2/bio/Research/ FOTM.pdf.

Finally, adopting a presumption that all investors rely on the statements of all analysts—even if the investor has never heard of the analyst much less acted on his or her recommendation—would be patently unfair. The Supreme Court has pointed out that private securities fraud actions were never intended "to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." *Dura*, 544 U.S. at 345 (citing *Basic*, 485 U.S. at 252). Certifying a class action against an analyst based on the fiction that the plaintiffs have relied on his or her statements "would bring about harm of the very sort the statutes seek to avoid." *Id.* at 347 (citing H.R. Conf. Rep. No. 104-364, at 31 (1995). "It would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than reasonably founded hope that the [discovery] process will reveal relevant evidence.'" *Ibid.* (quoting *Blue Chip Stamps v. Manor Drug Stores, Inc.*, 421 U.S. 723, 741 (1975)).

Thus, the result of recognizing a presumption of reliance in this context would be "to transform a private securities action into a partial downside insurance

policy. *Dura*, 544 U.S. at 347-348 (citations omitted). As we next discuss, moreover, subjecting analysts to massive securities fraud class actions based on the presumption of reliance will have substantial deleterious effects. These inevitable harms negate any argument that the expansion of the fraud-on-the-market doctrine to analysts will further the purposes of the securities laws.

II. THE EXTENSION OF THE *BASIC* PRESUMPTION TO ANALYST REPORTS WOULD HAVE SERIOUS NEGATIVE CONSEQUENCES FOR THE AVAILABILITY OF ANALYST REPORTS AND THE COMPETITIVENESS OF THE U.S. CAPITAL MARKETS

As this Court recently observed, "[a]pplication of the fraud-on-the-market doctrine to opinions expressed by research analysts would extend the potentially coercive effect of securities class actions to a new group of corporate and individual defendants—namely, to research analysts and their employers." *Hevesi*, 366 F.3d at 80. There is little risk of overstating the deterrent effect of these behemoth class actions: indeed, the damages asserted in a single case can easily dwarf the defendant companies' combined assets. 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"). Accordingly, creating a presumption of reliance that facilitates the certification of securities fraud class actions against analysts and their employers will have a chilling effect that is unnecessary to prevent fraud, but will inhibit useful conduct.

"Litigation 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*, 421 U.S. at 739. 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). Today, securities class actions represent "the 800-pound gorilla that dominates and overshadows other forms of class actions." John C. Coffee, Jr., *Reforming the Securities Class Action*, 106 COLUM. L. REV. 1534, 1539 (2006) (citing data of Administrative Office of the U.S. Courts showing that securities class actions over recent years averaged from 47% to 48% of all class actions pending in federal court). Such class actions "necessarily consume significant judicial resources" and "are essentially subsidized by the U.S. taxpayer." *Id.* at 1540.

Class actions seeking significant damages are largely trial-proof. If they survive dismissal and a large 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 v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 192 (3d Cir. 2001).

The "hydraulic pressure on defendants to settle" (*ibid.*) that comes from certification of a securities fraud class action is virtually impossible to resist, because settlement costs in securities class actions are at an all-time high. John. C. Coffee, Jr., "Nobody Asked Me, But . . .," N.Y.L.J., Jan. 18, 2007, at 5; see also *ibid.* (citing data showing that "seven of the ten largest securities class actions settlements occurred in 2005-2006; five cases settled for over $1 billion in 2005 and 2006, and a sixth * * * settled just under $1 billion at $960 million"). In 2005, corporations paid a record $9.6 billion in such settlements, as compared with $2.9 billion in 2004. Paul Davies, *Class-Action Pay Settlements Soar*, WALL ST. J.,

Feb. 7, 2006, at C3 (noting that the overall figure is still the largest ever after excluding Worldcom and Enron). *See* Cornerstone Research, *Post-Reform Act Securities Settlements – 2005 Review and Analysis* (2006) *available at* http://securities.stanford.edu/Settlements/REVIEW_19952005/Settlements_Through_12_2005.pdf.

Given that a single case—even a substantively weak one—can generate staggering costs once it is certified as a class action, the recognition of a presumption that facilitates class actions against analysts will surely lead analysts and their employers to attempt to avoid that possibility by limiting their research and restricting access to it. See Julie A. Heisel, *Panzirer v. Wolf: An Extension of the Fraud-On-The-Market Theory of Liability Under SEC Rule 10b-5*, 32 CATH. U. L. REV. 695, 727 (1985) (should "[a]nalysts voicing opinions to the press and reporters * * * become subject to extensive discovery as well as exposure to rule 10b-5 liability for allegedly unsubstantiated statements * * * [t]he net result may be an unwillingness on the part of analysts to disseminate information to the public through the media"). That would be unfortunate, because "the role of market analysts * * * is necessary to the preservation of a healthy market." *Dirks*, 463 U.S. at 658.

In fact, 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 firm's own customers but to a class of every purchaser of a stock anywhere in the world, regardless of whether they read the report or relied on other sources entirely in making an investment decision—would accelerate that trend.

A recent report commissioned by New York City Mayor Michael Bloomberg and U.S. Senator Charles E. Schumer warned that the global competitiveness of U.S. financial services is at risk because of concerns about the cost, fairness and predictability of the U.S. legal environment. Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership*, at 73-78, *available at* www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf. When market participants begin to "question their understanding of the scope of existing law," they "adopt costly risk-adverse behavior and * * * bear the associated opportunity costs." *Id.* at 78.

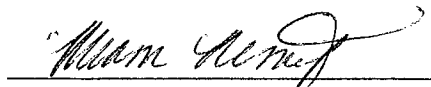
Another recent report by the independent, bipartisan Committee on Capital Markets Regulation found that "the United States is losing its competitive position

as compared to stock markets and financial centers abroad" as a result of several factors, including "the growth of * * * liability risks compared to other developed and respected market centers." *Interim Report of the Committee on Capital Markets Regulation*, at ix-x (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. The report identified the "considerable uncertainty [that] exists about many of the elements of Rule 10b-5 liability," including the element of reliance, specifically recommending clarification of "the fraud-on-the-market theory by defining more sharply the circumstances under which a plaintiff is excused from proving reliance on the defendant's alleged material misstatement or omission." *Id.* at 80-81. If the fraud-on-the-market doctrine is extended for the first time from corporate insiders to third-party analysts, concerns about the fairness of the U.S. legal system will surely increase, damaging the efficiency and competitiveness of an important sector of the national economy.

CONCLUSION

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

Respectfully submitted.



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CERTIFICATE OF COMPLIANCE WITH RULE 32(A)

1. This brief complies with the type-volume limitation of Fed.R.App.P. 32(a)(7)(B) because it contains 5480 words, excluding the parts of the brief exempted by Fed.R.App.P. 32(a)(7)(B)(iii).

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CERTIFICATE OF SERVICE

I hereby certify that pursuant to Fed.R.App.P. 31(b), I caused to be served on this 30th day of January, 2007, by United Parcel Service Overnight Mail, postage prepaid, two copies of the Brief for the Securities Industry and Financial Markets Association as *Amicus Curiae* in Support of Defendants-Appellants on each of the following:

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