EXPERT ANALYSIS OF MARKET EFFICIENCY IN SECURITIES CLASS ACTIONS[1]

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On August 15th, Judge Victor Marrero of the Southern District of New York issued his opinion certifying a class of buyers of the common stock of a company created by a Chinese reverse merger. *McIntire v. China MediaExpress Holdings, Inc.*, 2014 U.S. Dist. LEXIS 113446 (S.D.N.Y. Aug. 15, 2014). In doing so, he rejected defendants' *Daubert* motion challenging the qualifications and methodology of plaintiffs' expert witness on market efficiency, Cynthia Jones, and concluded that the market was efficient enough to support the *Basic*[2] presumption of reliance and to permit class certification.

The *McIntire* decision stands in stark contrast to two other recent decisions involving Chinese companies that accessed U.S. markets via reverse mergers, each of which found plaintiffs' experts unreliable and concluded that markets for the securities at issue were inefficient and could not support the *Basic* presumption of reliance. *George v. China Automotive Systems, Inc.*, 2013 U.S. Dist. LEXIS 93968 (S.D.N.Y. July 3, 2013) (Judge Forrest); *Brown v. China Integrated Energy, Inc.*, 2014 U.S. Dist. LEXIS 117764 (C.D. Cal. Aug. 4, 2014) (Judge O'Connell).

It is the thesis of this article that *McIntire* was wrongly decided, and that *George*, *Brown* and other recent cases yield more persuasive assessments of expert qualifications and the methodology necessary to establish market efficiency.

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[1] This article initially appeared in the September 2014 issue of the *Securities Reform Act Litigation Reporter*, Vol. 37, No. 6, as part of a round table on market efficiency.

[2] *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

A. Expert Qualifications

Judge Marrero rejected defendants' *Daubert* challenges to Ms. Jones' qualifications as an expert on market efficiency, initially by noting that courts in 19 other cases had accepted her as an expert "on a variety of matters pertaining to the economic analysis of issues relevant to securities law." *McIntire* at *23. But his opinion did not suggest that any of those courts found her to be an expert regarding market efficiency, a highly specialized area of economic analysis in securities cases.

By contrast, other courts have rejected proffered experts on market efficiency whose prior experience did not include analysis of market efficiency itself. *See, e.g., IBEW Local 90 Pension Fund, et al. v. Deutsche Bank AG*, 2013 U.S. Dist. LEXIS 155136 at *43-49 (S.D.N.Y. Oct. 29, 2013) (Judge Forrest) (finding plaintiffs' expert Michael Marek (Cynthia Jones's supervisor) unqualified where his reports were riddled with mistakes, lacked awareness of current research and used flawed methodology, and where his "expertise is being an expert in plaintiffs' securities cases" and "simply being an expert at being an expert is not enough"); *Brown* at *15-18 (finding plaintiff's expert Kenneth McGraw unqualified where, despite impressive academic credentials and experience as an expert witness, he had testified only once based on an event study he used to evaluate market efficiency (receiving help from Marek) and in this case gave unimpressive testimony based on work done largely by Jones); *George* at *26 n.8, 39 (plaintiff's expert had not previously provided opinions on market efficiency or analyzed it in the context of a Chinese reverse merger, was not particularly confident or articulate regarding his opinions, and could not explain or defend why his methodology made analytical sense given the definition of market efficiency).

Some courts have also pointed to an expert's flawed methodologies for assessing market

efficiency as evidence of lack of actual expertise, warranting a *Daubert*[3] challenge. Others have addressed flawed methodologies, not so much as showing a lack of expertise, but as failing to meet plaintiff's burden of proving the market efficiency essential to establishing a presumption of reliance that will allow a putative class to meet the predominance requirement of Rule 23(b)(3). Both types of cases are discussed below.

B. Methodology

Judge Marrero in *McIntire* accepted Ms. Jones's methodology for conducting an event study that "correlates the disclosures of unanticipated, material information about a security with corresponding fluctuations in price," citing *Teamsters Local 445 etc. v. Bombardier, Inc*., 546 F. 3d 196, 207 (2d Cir. 2008).[4] *McIntire* at *20.

The Jones study classified selected days in the class period into two buckets: "news" days on which "potentially material" information was released to the market and "non-news" days on which non-material news or no news at all was released. She used news articles alone to classify each day and concluded that statistically significant changes in the company's stock price were six times more likely to occur on "news" days than on "non-news" days (11 of 26, or 42%, of "news" days v. 12 of 212, or 7%, of "non-news" days). *McIntire* at *35-36.

Defendants countered that the Jones methodology for classifying days was subjective and was circular because some of the stories she selected were responding to, rather than causing, changes in stock price; that she failed to account for the directionality of stock price movement;

[3] *Daubert v. Merrell Dow Pharmaceuticals, Inc*., 509 U.S. 579 (1993).

[4] *Bombardier* is a striking example of flawed expert methodology precluding a finding of market efficiency. Noting that evidence of unexpected material events or releases causing an immediate response in the stock price is the essence of an efficient market and the foundation for the fraud-on-the-market theory, the court said a methodologically sound event study can provide *prima facie* evidence of such a causal relationship. 546 F.3d at 207-08. But because plaintiff's expert had tested only events that were immaterial to the security at issue, his study could not reflect market efficiency. *Id*. at 210.

and that a finding of market efficiency requires that the stock react at least half the time to potentially material news. *McIntire* at *24-28.

Judge Marrero responded to the last point by saying that the Jones test was "derived from a law review article co-authored by accomplished economists that has been endorsed by courts in the past," citing Ferrillo, Dunbar and Tabak, *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof From Plaintiffs in Fraud-on-the-Market Cases*, 78 St. John's L. Rev. 81, 120 (2004), and then citing only his own cursory examination of market efficiency in *In re Alstom SA Sec. Litig*., 253 F.R.D. 266, 280 (S.D.N.Y. 2008). *McIntire* at *28-29.

True enough, Judge Marrero had credited expert testimony in *Alstom* that the company was over six times more likely to have a statistically significant stock price movement on "news" days than on "non-news" days, but had cited neither the Ferrillo article nor any other support for such a test. More importantly, though, the Ferrillo article itself expressly cautions that comparing stock price reactions on "news" and "non-news" days is only "a threshold step, not a sufficient condition, to show that a stock traded in an efficient market." 78 St. John's L. Rev. at 122.[5]

When plaintiffs' expert in another case cited the Ferrillo article as support for such a comparison, the Court was quick to point out the article's acknowledgment that the comparison was insufficient to show market efficiency. *In re Federal Home Loan Mortg. Corp. (Freddie Mac) Sec*., 281 F.R.D. 174, 180 (S.D.N.Y. 2012) (Judge Cedarbaum) (denying class certification

[5] Judge Marrero's willingness to accept a skimpy methodology for assessing market efficiency may have derived from his view that "the Second Circuit has directed courts to adopt a liberal interpretation of Rule 23 . . . to maximize the benefits to the public provided by class actions." *McIntire* at *10-11. But the Second Circuit decision he cited for that view hails from the relative dark ages of securities class actions, some 46 years ago (*Green v. Wolf Corp*., 406 F.2d 291, 298 (2d Cir. 1968)) and ignores the Supreme Court's more recent jurisprudence mandating a "rigorous" analysis of the Rule 23 prerequisites, *e.g.*, *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2551 (2011), and subsequent cases applying the "rigorous analysis" standard to the finding of market efficiency necessary to support a presumption of reliance. *See, e.g.*, *George* at *2.

and crediting defense expert's opinion that an economist may conclude that a market is efficient if it reacts to news 80% to 90% of the time).[6]

In *Brown*, Judge O'Connell excluded both of plaintiff's market efficiency experts under *Daubert* and denied class certification in light of plaintiff's inability to establish the predicate for a presumption of reliance. As noted above, she found one proffered expert unqualified. Though she found the other expert qualified (the same Michael Marek found unqualified in *Deutsche Bank*),[7] she concluded that he should be excluded because his methodology was flawed in that his selection of events for an event study, consisting of "releases of unexpected information," was entirely subjective. *Brown* at *18-25. Marek could not explain what criteria he used in selecting particular days and not others, saying only that he selected releases of information that are "of the import necessary to change the price" of stock. *Brown* at *21-22. Assessing materiality of information by looking to the market's reaction is a subjective approach inconsistent with standard practice and compromised the reliability of Marek's methodology and conclusion. *Id*. at *24.

The "standard practice" Judge O'Connell cited echoes the reasoning of numerous other cases that have rejected plaintiffs' proof of market efficiency. *See, e.g., In re Polymedica Corp. Sec. Litig*., 453 F. Supp. 2d 260, 270 (D. Mass 2006) (selecting only days with large price movements is subjective; "to approach usefulness, an analysis should statistically compare ***all*** news days with ***all*** non-news days") (emphasis added); *In re Countrywide Fin. Corp. Sec. Litig*.,

[6] Even this view is generous to plaintiffs. As virtually all courts recognize, *Basic* requires that, for a market to be deemed efficient, it must rapidly incorporate ***all*** unexpected material information into the stock price, not just some information some of the time. Comparisons of "news" and "non-news" days are regularly rejected where the release of new information is not strongly correlated with stock price movement. *See, e.g., Deutsche Bank* at *22, in which Marek's study found that statistically significant price movement followed only 25% of his selected "news" days.

[7] Judge O'Connell noted that the facts leading to Marek's disqualification in *Deutsche Bank* – compelling as they may be – were not in the record before her and that Marek's having testified on market efficiency in four prior cases satisfied plaintiff's burden of establishing his expertise. *Brown* at *14-15.

273 F.R.D. 586, 618 (C.D. Cal. 2009) (citing *Polymedica* and noting that "the events for study should be selected using criteria that are as objective as possible"); *Deutsche Bank* at *35-36 (Marek's selection of only certain earnings disclosure dates for study was too limited and subjective a data set and could not determine whether the market is consistently efficient in incorporating all information).

George is a third Chinese reverse merger case exploring the requirements a plaintiff must meet to prove market efficiency at the class certification stage and the methodology an expert must use to assess it. In *George*, Judge Forrest (who subsequently decided *Deutsche Bank*, discussed above) denied class certification upon concluding that, in addition to unique defenses rendering the named plaintiffs neither typical nor adequate (*George* at *19-20), plaintiffs had not proven market efficiency in light of the flaws in five separate analyses prepared by their expert Kenneth Kotz (*Id*. at *28).

The first analysis purported to test the speed of stock price reaction to new information, but "took the event out of 'event study'" by failing to examine whether the days with price movement were associated with any actual news (*Id*. at *29-31).

The second analysis, similar to that accepted in *McIntire*, purported to compare the proportion of statistically significant "news" and "non-news" days and concluded that the ratio was four to one; but on cross-examination Kotz conceded he could not opine on whether the ratio itself was statistically significant because, as in *McIntire*, he had studied only a portion of the "news" and "non-news" days (*Id*. at *31-32).

The third analysis tested whether price movements were associated with trading volume, using volume as a proxy for information; but again Kotz had to concede that the test did not assess whether any specific news was disclosed on the selected dates, thus failing to test the key

market efficiency question whether news is impounded into the stock price (*Id*. at *32-33).

The fourth analysis most closely approximated an event study. Kotz selected 16 predefined events – analyst rating changes and earnings guidance releases – that were expected to impact the stock price and found that seven had statistically significant price movement. But Kotz conceded that in one quarter the stock movement was actually directionally inconsistent, and his study made no determination whether an event was material, necessitating an assumption that the days without stock price movement must have reflected immaterial information. In any event, Judge Forrest found that movement on only seven of the 16 tested days – less than 50% – was an insufficient basis for pronouncing market efficiency (*Id*. at *33-37).

The fifth analysis identified the 10 days with the largest single-day price movement, then looked at whether there was any relevant news associated with those days. Kotz found that four of the 10 days had company-specific news, which he declared "consistent" with an efficient market. But Judge Forrest pointed out that plaintiffs' burden is not to show mere "consistency," but to prove an efficient market by a preponderance of the evidence. *George* at *38. Their failure to do so compelled denial of class certification (*Id*. at *39).

In addition to *McIntire* and *Brown*, a third August 2014 decision also addresses market efficiency, albeit without a discussion of expert analysis. In *Local 703, et al., v. Regions Financial Corp*., 2014 U.S. App. LEXIS 15106 (11th Cir. Aug. 6, 2014), the court placed an exceedingly light burden on plaintiffs, saying that a market "is generally efficient when 'millions of shares change hands daily and a critical mass' of investors and/or analysts 'study the available information and influence the stock price through trades and recommendations.'" *Regions* at *11, citing the court's earlier opinion in *FindWhat Investor Group v. FindWhat.com*, 658 F.3d

1282, 1310 (11th Cir. 2011),[8] which in turn took the internally quoted remarks from *Basic*, 485 U.S. at 243, 248. But the *Regions* court's purported reliance on *FindWhat*, which said nothing about "millions of shares" daily or a "critical mass of investors and/or analysts" sufficing to show market efficiency, was entirely misleading; both *FindWhat* and the quotes it took from *Basic* were explaining only that high volume and a critical mass of market makers (not investors and/or analysts) can rapidly digest all available information. The *Regions* transformation of that language into supposed proof of an efficient market that displaces the need to look at the *Cammer* and *Krogman* factors typically used to assess market efficiency, or anything else, is pure judicial alchemy.[9]

Defendants in *Regions* also urged that the district court had erred by refusing to hold a *Daubert* hearing. But the panel said the court below had relied on expert testimony only in deciding materiality issues that were no longer relevant in light of the intervening holding in *Amgen, Inc. v. Connecticut Retirement Plans, etc*., 133 S. Ct. 1184 (2013) that plaintiffs need not prove materiality at the class certification stage. *Regions* at *22-23 n.7.

On the other hand, the court agreed with defendants that they should be given an opportunity to rebut the presumption of reliance by showing an absence of price impact in accordance with the intervening holding in *Halliburton Co. v. Erica P. John Fund, Inc*., 134 S.

[8] *FindWhat* involved review of a loss causation determination made on summary judgment, not a market efficiency determination made at class certification. Nonetheless, the court noted the corollary of the efficient market hypothesis that information already known to the market will not cause a change in stock price, thus echoing the familiar teaching of *TSC Industries, Inc. v. Northway, Inc*., 426 U.S. 438, 449 (1976) (applied to 10b-5 cases in *Basic*, 485 U.S. at 231-32) that for information to be material, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." The Supreme Court's view that information is material only if it alters the total mix already in the market, *i.e*., is new and unexpected, calls into question *FindWhat's* ultimate conclusion that a 10b-5 claim can be based on information that merely confirms prior disclosures. 658 F.3d at 1314.

[9] *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989); *Krogman v. Sterritt*, 202 F.R.D. 467 (N.D. Tex. 2001). Although acknowledging that many circuit courts have described a cause-and-effect relationship between alleged misstatements and immediate effect on stock price as the most important of the *Cammer* factors, the *Regions* court relieved plaintiff of making any such showing. *Regions* at *15.

Ct. 2398 (2014) ("*Halliburton II*"). *Regions* at *23-25.

Regions serves to highlight some of the turmoil that attends the recent Supreme Court decisions regarding class certification in securities cases. *Basic* posited that an efficient market "reflects all publicly available information, and, hence, any material misrepresentations." 485 U.S. at 246. That language has been regularly endorsed by the Court ever since.[10]

But there is inherent tension among decisions requiring an efficient market to rapidly incorporate all new material public information and to be proven at the class certification stage (*Basic*), yet materiality – a linchpin of the efficient market hypothesis – need not be proved at the class certification stage (*Amgen*), but defendants can rebut the presumption of reliance at the class certification stage by showing an absence of price impact (*Halliburton II*), which necessarily establishes either that the market was inefficient (otherwise the new information would impact the price) or that the statement was immaterial (in which case an efficient market would ignore it).

While further exploration of these conundrums is beyond the scope of this article, it will be undertaken in an article slated for an upcoming issue of the *Securities Reform Act Litigation Reporter*.

[10] *See, e.g., Erica P. John Fund, Inc. v. Halliburton Co*., 131 S. Ct. 2179, 2185 (2011) ("*Halliburton I*"); *Amgen*, 133 S. Ct. at 1192; *Halliburton II*, 134 S. Ct. at 2408.