05-3349-cv

United States Court of Appeals
for the
Second Circuit

IN RE: INITIAL PUBLIC OFFERING SECURITIES LITIGATION

JOHN G. MILES, SASWATA BASU, MICHAEL HUFF, SEAN ROONEY, KRIKOR KASBARIAN, STATHIS PAPPAS, JAMES COLLINS, DIANE COLLINS, JOSEPH ZHEN, ZITTO INVESTMENTS, J. CHRIS ROWE, VASANTHAKUMAR GANGAIAH, FREDERICK HENDERSON,

(For Continuation of Caption See Inside Cover)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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– v. –

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ISSUES PRESENTED

1. Whether the District Court correctly chose to follow this Court's decisions in *Caridad v. Metro-North Commuter R.R.*, 191 F.3d 283 (2d Cir. 1999) ("*Caridad*") and *In re VisaCheck/Mastermoney Antitrust Litig.*, 280 F.3d 124 (2d Cir. 2001) ("*VisaCheck*") in determining the proper evidentiary standard for evaluating whether Plaintiffs satisfied the requirements of Rule 23.

2. Whether the 2003 amendments to Rule 23 heightened the standards for certifying class actions, given the Advisory Committee's explanation that the amendments "focus on the process by which class actions are litigated, rather than on changing the standards for certifying cases as class actions."

3. Whether the District Court properly presumed that material omissions in a Prospectus and Registration Statement artificially inflate stock prices under the fraud-on-the-market doctrine.

4. Whether the District Court properly presumed that investors who purchase stock at market price could rely upon that price as fairly representing available material information.

5. Whether the District Court properly refused to engage in a "battle of experts" at class certification in concluding that Plaintiffs would be able to prove, class-wide, that Defendants' manipulative conduct artificially inflated stock prices and caused Plaintiffs' losses.

6. Whether the District Court abused its discretion in carefully crafting a class definition, based on objective criteria, to weed out those class members who were most likely to be aware of the fraud.

STATEMENT OF FACTS

This is an appeal from an order certifying classes in six individual securities fraud actions, each alleging claims under the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §77 *et seq.*, and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. §§78j(b) and 78t(a), in connection with a distinct initial public offering ("IPO").[1] Each case alleges that Defendants-Appellants ("Underwriters") manipulated market prices of the offered securities by, among other things, inducing certain customers to commit to make purchase orders in the aftermarket as a condition of receiving IPO allocations. (A1132-35). These "tie-in agreements" are forbidden under the federal securities laws. *See* SEC Staff Legal Bulletin No. 10, 2000 No-Act. LEXIS 820 ("SLB 10").[2] Underwriters are also

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[1] The cases are: *In re Corvis Corp. IPO Sec. Litig.* ("Corvis"); *In re Engage Technologies, Inc. IPO Sec. Litig.* ("Engage"); *In re Firepond, Inc. IPO Sec. Litig.* ("Firepond"); *In re iXL Enterprises, Inc. IPO Sec. Litig.* ("iXL"); *In re Sycamore Networks, Inc. IPO Sec. Litig.* ("Sycamore"); and *In re VA Software Corp., f/k/a VA Linux Systems, Inc. IPO Sec. Litig.* ("VA Linux").

[2] Plaintiffs have agreed to settle with the issuing companies and their respective officers and directors for a guaranteed recovery of $1 billion. *In re IPO Sec. Litig.*, 226 F.R.D. 186 (S.D.N.Y. 2005). Underwriters have settled several government actions with similar claims. *E.g., SEC v. Goldman Sachs,* 05CV853 (S.D.N.Y. 2005); *SEC v. Morgan Stanley,* 05CV00166 (D.D.C. 2005); *SEC v. J.P. Morgan*

alleged to have demanded undisclosed compensation in exchange for allocations, and to have used affiliated analysts to hype the subject stocks.

The parties selected the six "focus" cases that are the subject of this appeal to facilitate the assessment of common issues relevant to 304 other class actions alleging similar claims. (SPA8-9). These actions are "coordinated" before Judge Scheindlin for "decision of pretrial motions, discovery and related matters other than trial," *In re IPO Sec. Litig.,* 241 F. Supp. 2d 281, 294 (S.D.N.Y. 2003), but each remains distinct.[3]

I. IPO UNDERWRITING PROCESS

The NASDAQ consists of registered broker-dealers known as "market makers" who register with the National Association of Securities Dealers ("NASD") to trade in particular securities. A market maker offers to sell securities at a particular price (the "ask") and offers to buy at a particular price (the "bid"). The spread between bid and ask is where the market maker earns a profit. Market makers continually reset price quotes based upon trading activity and information from other market makers. *See generally* U.S. Gen. Accounting Office, *Securities*

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cont'd.
Sec., 03CV02028 (D.D.C. 2003); *SEC v. Robertson Stephens,* 03CV0027 (D.D.C. 2003); *SEC v. CSFB*, 02CV00090 (D.D.C. 2002).

[3] A related case alleges that certain Underwriters violated antitrust laws by conspiring to institute these illegal practices. This Court recently reversed the district court's dismissal of that complaint. *Billing v. Credit Suisse First Boston Ltd.*, 426 F.3d 130 (2d Cir. 2005).

Market Operations: The Effects of SOES on the Nasdaq Market 1 (1998), *available at* http://www.gao.gov/archive/1998/gg98194.pdf ; *In re Certain Market Making Activities on Nasdaq*, Exchange Act Release No. 34-40900, 68 SEC Docket 2693 (Jan. 11, 1999).

Some market makers also underwrite IPOs. A company desiring to sell securities to the public (an "issuer") hires a "lead" or "managing" underwriter to effect the public distribution of its securities (an "offering").[4] The lead underwriter puts together a syndicate of other interested underwriters which collectively is responsible for selling the issuer's securities directly to interested investors. *See generally* 1 Louis Loss & Joel Seligman, *Securities Regulation* §2-A-2 (3d ed. 1998). These securities will eventually trade on an impersonal "aftermarket" such as the NASDAQ.

The "offer price" at which shares are initially sold to investors is set by the issuer and the underwriter and is based on a combination of perceived institutional demand for the shares and an assessment of the underlying fundamentals of the issuer's business. Prior to setting an offer price, the lead underwriter, selected syndicate members, and company officials meet with potential institutional investors to discuss the company and propose potential offer prices (a process

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[4] Entities must meet NASD requirements, among others, to serve as an underwriter. NASD Conduct Rule 2720(b)(15).

known as the "roadshow"). During the roadshow, the underwriting syndicate obtains non-binding indications of how many shares of the new security their institutional customers may be willing to buy at potential prices ("indications of interest"). *See* SEC Release No. 33-8565, 34-51500, 17 C.F.R. pts. 231, 241, 271 (2005) ("Release 34-51500"). The underwriters thus observe the supply and demand characteristics of the IPO. In unmanipulated IPOs, to induce initial investment, the offer price has historically been set about 7-15% below the price at which the underwriter expects the shares will trade in the aftermarket. *E.g.*, Aggarwal, Purnanandam & Wu, *Underwriter Manipulation in IPOs*, 1 (May 15, 2005)(unpublished), available at https://student-3k.tepper.cmu.edu/wfa/wfasecure/upload/352334_IPO_Mani_09.pdf.

Prior to the offering, the issuer and underwriter publicly file with the SEC a registration statement, including a prospectus, for the new issue (together, "Prospectus"), that discloses all material facts relating to the terms of the offering and the issuer's business, and is continually updated as the offering date nears. 15 U.S.C. §77h(a-b); 17 C.F.R. 229 *et seq*. Once the SEC approves the Prospectus, it issues an effectiveness order, which allows the underwriting syndicate to make final allocations of the issuer's securities into customer accounts at the offer price. Then, and only then, may they and other market makers receive orders to buy and sell these shares in the aftermarket. Underwriters have historically selected

allocants based upon their long-term interest in the company; that is, in a typical IPO, allocants are chosen in part with an eye to keeping stock prices stable and discouraging excessive speculation. *See* Release 34-51500.

Just before the stocks "open" for aftermarket trading, market makers – including the lead underwriter – exchange non-binding price quotes indicating the levels at which they are willing to purchase shares of the new issue and resell them. This "pre-open bid session" generally lasts fifteen minutes. The exchange of quotes, based on market makers' estimation of impending demand, operates like an auction, resulting in an "opening price," often at some level above the offering price. *See generally* Exchange Act Release No. 34-40968, 68 SEC Docket 2957 (Jan. 22, 1999). The lead underwriter usually has particularly good knowledge of impending demand, and is thus able to set appropriate quotes. In an unmanipulated IPO, other market makers also use their own order flow to estimate impending demand and bid accordingly.

II. PLAINTIFFS' CLAIMS

Plaintiffs allege that Underwriters sought to inflate aftermarket prices for certain IPOs by inducing certain customers to commit to place orders to buy shares in the aftermarket as a condition of receiving stock allocations. (A1132-35). Sometimes, customers were required to commit to place buy orders at predetermined escalating prices ("laddering") to make the shares appear to be in

great demand. (A1132-35). Underwriters also employed a cadre of analysts who ostensibly operated independently, but, in fact, were instructed to help maintain false inflationary pressure on stock prices through positive recommendations and reports that failed to disclose the scheme. (A1245-54). Underwriters also used the promise of favorable analyst coverage to attract issuers' business (A1245-54); because most NASDAQ stocks receive little or no coverage, the promise of any coverage – let alone favorable coverage – served as a potent lure. (A1245-48); Susanne Craig, *Left Out of Shrinking Research Pool, Companies Resort to Buying Coverage*, Wall St. J., Mar. 26, 2003, at C1.

Underwriters also required certain customers, as a condition to receiving IPO allocations, to pay back to Underwriters a portion of the profits they earned on their allocations through various mechanisms, including: (a) inflated brokerage commissions; (b) transactions in unrelated securities to generate commissions; and (c) purchasing other equity offerings underwritten by the Underwriters. (A1210-14). Often, the allocant was required to pay back a set percentage of the hypothetical profit that the allocant could have earned by selling its IPO shares on the first day of trading. (A1134). Thus, the higher the stock soared on the first day, the more money the Underwriter received.

Finally, Plaintiffs allege that these arrangements were not disclosed in the Prospectuses, in violation of the securities laws and SEC rules. (A1832).

Plaintiffs claim that these techniques artificially inflated aftermarket stock prices. (A1132-35). With firm tie-in arrangements in hand that constituted a material share of the demand for each stock before opening, the lead underwriter was able to manipulate the pre-open bid session, causing each stock to open at prices well above the offer price. (A1132-35). Laddered orders in the aftermarket continued the illusion of demand for the stock. (A1132-35). Captive analysts hyped the stock and omitted mention of these arrangements. (A1245-54). The result was that each stock experienced explosive first-day rises, only to later trade at much lower, and, ultimately, often worthless, levels.

III. DISTRICT COURT'S CLASS CERTIFICATION DECISION

As part of the cases' coordination, Plaintiffs filed one set of Master Allegations ("Complaint") containing allegations applicable across cases, as well as an individual complaint in each action. Following Underwriters' unsuccessful motions to dismiss, (A1774), the parties selected the focus cases.

In September 2003, Plaintiffs moved for class certification. The District Court accepted numerous rounds of briefing consisting of thousands of pages as well as multiple, competing expert reports, and heard a full-day of oral argument. After reviewing that record, the District Court requested additional submissions from Plaintiffs, including an amended definition of the proposed classes, a proposed Trial Plan and further expert submissions, (A4554; A4639), to which

Underwriters responded. This comprehensive record, coupled with the court's active supervision of the litigation for more than three years and its consideration of Underwriters' motions to dismiss (which included several volumes of additional exhibits and two days of oral argument), provided the basis for the District Court's 150-page opinion in support of its ultimate decision to certify some but not all of the claims.

The District Court held that in order to proceed as a class action, Plaintiffs must make "some showing" of their ability to prove their claims class-wide. (SPA69). Because much of the dispute between the parties focused on their disagreement as to whether the alleged scheme's inflationary effect, and the losses it caused, could be subject to common proof, the parties submitted multiple expert reports and rebuttals thereto. (SPA11). Plaintiffs relied upon the opinions of Professor Daniel Fischel, a noted law and economics scholar, who submitted three separate reports setting out methodologies to measure artificial inflation and losses caused by Underwriters' scheme. Underwriters' experts contended that aftermarket "laddered" trades were incapable of having a material impact on stock prices, but did not examine many aspects of the scheme examined by Professor Fischel, including the effects of tie-ins on the pre-opening bid session.

Following this Court's decision in *VisaCheck*, 280 F.3d at 132, the District Court concluded that "now is not the time to 'weigh conflicting evidence or engage

in 'statistical dueling' of experts.'" (SPA127-28). Instead, after an exhaustive examination of the various reports, the District Court found that Plaintiffs' evidence was not "fatally flawed," and that therefore Plaintiffs had made "some showing" that they could prove their claims class-wide. The District Court certified the classes, identifying seventeen common questions (SPA70-71). Recognizing that Underwriters' illicit scheme required that some IPO allocants knowingly participated, the District Court modified Plaintiffs' once-revised class definition to exclude allocants who, based on objective criteria, appeared to have done so. (SPA149-50).

This Court granted the Underwriters' Rule 23(f) petition seeking immediate review,[5] directing the parties to brief: (1) whether amendments to Rule 23 affect the Second Circuit's class certification standards; and (2) whether the fraud-on-the-market presumption applies to Plaintiffs' claims. These questions are addressed below in Parts II.D and III.A, respectively.

SUMMARY OF ARGUMENT

A district court must be persuaded, after "rigorous analysis," that Rule 23 has been satisfied. Underwriters cherry-pick the "some showing" language from the District Court's opinion, arguing that because "some" cannot comport with

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[5] Underwriters do not challenge the propriety of certification with respect to Plaintiffs' 1933 Act claims.

"rigorous," the District Court applied a lesser standard to Plaintiffs' submissions. Underwriters ignore the court's actual analysis, which involved careful scrutiny of the extensive record as a whole – a record further developed by all parties at the District Court's urging.

Neither Rule 23 nor this Court's precedents require that the elements of Rule 23 be established by a preponderance of evidence, as Underwriters claim. Following the Supreme Court's prohibition against conducting "a preliminary inquiry into the merits" at class certification, *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 178 (1974), this Court emphasizes that though district courts must carefully examine plaintiffs' submissions, they may not weigh the evidence or decide a battle of the experts. Accordingly, this Court requires Plaintiffs to make "some" threshold showing that Plaintiffs satisfy each of the elements of Rule 23. The 2003 amendments to Rule 23 do not supersede this Court's precedent, because, as the drafters made clear, they were specifically *not* intended to change the substantive standards.

Applying these standards, the District Court properly determined that Plaintiffs met their Rule 23 burdens. The District Court found that artificial inflation could be proved class-wide through two distinct methods: first, under *Basic v. Levinson*, 485 U.S. 224 (1988) and *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), Plaintiffs are entitled to a presumption that they relied on

material omissions in the Prospectuses and that the omissions artificially inflated stock prices. Second, Plaintiffs submitted expert evidence to prove that the tie-ins forced stock prices up to stratospheric levels on the first day of trading. The District Court correctly refused, at this stage, to credit the opinions of Underwriters' experts that the tie-ins were incapable of having such an effect, because Underwriters' experts failed to consider critical aspects of the scheme, and their findings are at odds with the longstanding views of Congress and the SEC.

The District Court also properly credited the opinion of Plaintiffs' expert that loss causation could be established class-wide. Plaintiffs' expert demonstrated that losses due to fraud could be evaluated using two well-accepted methods regularly employed in securities litigation. Plaintiffs' expert was not required, at this stage, to eliminate all alternative explanations for the price declines. Moreover, many "alternative" explanations proffered by Underwriters, such as issuers' business problems, are not "alternative" at all, but represent the method by which the truth about the underlying value of the companies became publicly known.

Finally, the District Court did not abuse its discretion in crafting the class definition. The District Court set several objective criteria to exclude investors who, due to their knowledge of the scheme, likely did not rely upon market price as a reflection of information about the security. Underwriters contend that the

definition allows persons to remain in the class who knew of the fraud. Courts agree that it is better to opt for an overinclusive definition than one that excludes genuinely injured persons. Underwriters still may challenge individually any remaining class members who they believe are not entitled to recover, but these challenges will not render the class unmanageable.

ARGUMENT

I. STANDARD OF REVIEW

"[T]he district court is often in the best position to assess the propriety of the class." *In re Sumitomo Copper Litig.*, 262 F.3d 134, 139 (2d Cir. 2001). A district court's class certification decision should be accorded substantial deference and overturned only if it constitutes an abuse of discretion. *VisaCheck*, 280 F.3d at 132. This is particularly true when the court *grants* a motion for certification. *Moore v. PaineWebber, Inc.*, 306 F.3d 1247, 1252 (2d Cir. 2002).

II. THE DISTRICT COURT APPLIED THE CORRECT EVIDENTIARY STANDARD FOR RULE 23

A. This Circuit's Evidentiary Standard Comports With the Goals of Rule 23 and Supreme Court Precedent

Rule 23 was designed to "promote judicial efficiency and to provide aggrieved persons a remedy when individual litigation is economically unrealistic, as well as to protect the interests of absentee class members." 5 James Wm. Moore et al., *Moore's Federal Practice* §23.03 (3d ed. 2005). The rule assists courts in ascertaining "whether the named plaintiff's claim and the class claims are

so interrelated that the interests of the class members will be fairly and adequately protected in their absence." *Gen. Tel. Co. of Southwest v. Falcon*, 457 U.S. 147, 158 (1982).

Accordingly, as the District Court recognized, Rule 23 is "aimed at answering two questions: *Can* the claims be managed as class actions, and *should* they be managed as class actions?" (SPA59). The merits should be considered only to the extent necessary to identify issues to be adduced at trial and to determine whether they are susceptible to class-wide proof. *See* Manual for Complex Litigation (Fourth) §21.14, at 255-56 (2004). Any greater consideration of the merits at the class certification stage "may result in substantial prejudice to a defendant, since of necessity [such consideration] is not accompanied by the traditional rules and procedures applicable to civil trials" and "may color the subsequent proceedings." *Eisen*, 417 U.S. at 178.

In *Falcon*, the Supreme Court further clarified the analysis when it found a district court had improperly presumed that plaintiffs satisfied Rule 23(a)(3)'s typicality requirement. The Court explained that a district court must engage in a "rigorous analysis" to ensure that each element of Rule 23 has been met, 457 U.S. at 161, and that "sometimes it may be necessary for the court to probe behind the pleadings." *Id.* at 160.

In *Caridad* and *VisaCheck*, this Court created a perfect balance between *Falcon*'s "rigorous analysis" and *Eisen*'s prohibition on merits inquiries. When it is necessary to look at the merits to make a Rule 23 determination, district courts are counseled to carefully scrutinize the evidence to determine whether plaintiffs have made at least "some" threshold showing that they will present class-wide proof of their claims, while respecting *Eisen*'s prohibition against weighing the evidence to resolve merits disputes. In this way, this Court properly focuses on whether the issues can, in fact, be tried class-wide, rather than on whether plaintiffs will ultimately prevail.

1. *Caridad*

Underwriters incorrectly claim that in *Caridad*, this Court "suggests" a "preponderance of the evidence standard." (Und. 4). To the contrary, *Caridad* specifically rejected any analysis that would include weighing the evidence. As the District Court correctly observed, "[i]f a district court is forbidden to weigh the evidence on class certification, *a fortiori*, plaintiffs need not establish the elements of Rule 23 by a preponderance of the evidence." (SPA68).

Caridad involved an appeal of a denial of class certification in an employment discrimination action. Plaintiffs challenged Metro-North Commuter Railroad's ("Metro-North's") company-wide policy of delegating authority to supervisors to make subjective discipline and promotion decisions. The issue was

whether plaintiffs satisfied the typicality and commonality requirements for certification by showing that delegation resulted in company-wide racial discrimination, rather than creating a localized problem confined to particular supervisors or departments.

Plaintiffs submitted an expert report, testimony of a sociologist, testimony of Metro-North's own officers, and anecdotal evidence showing that there was a statistically significant disparity between discipline and promotion rates for white and black employees. Metro-North submitted a dueling expert report, showing that when the different discrimination rates across positions were taken into account, there was little racial disparity. The district court examined the reports, found the defendants' expert more persuasive, and denied certification.

Consistent with *Eisen* and the purposes of Rule 23, this Court reversed, explaining that "statistical dueling" is not relevant to certification.[6] *Caridad*, 191 F.3d at 292. This Court reiterated that:

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[6] Although Judge Walker dissented, he did not disagree with the conclusion that consideration of the dueling expert reports was error. *See Robinson v. Metro-North Commuter R.R. Co.*, 267 F.3d 147, 156 n.2 (2d Cir. 2001). Most courts follow this Circuit's prohibition against engaging in a battle of the experts at class certification. *E.g., In re Relafen Antitrust Litig.*, 221 F.R.D. 260, 272 (D. Mass. 2004); *In re Linerboard Antitrust Litig.*, 203 F.R.D. 197, 217 n.13 (E.D. Pa. 2001), *aff'd*, 305 F.3d 145 (3d Cir. 2002); *In re Bromine Antitrust Litig.*, 203 F.R.D. 403, 408 (S.D. Ind. 2001); *In re Cardizem CD Antitrust Litig.,* 200 F.R.D. 297, 311 (E.D. Mich. 2001); *In re Commercial Tissue Prods.*, 183 F.R.D. 589, 596 (N.D.

> [i]n deciding a certification motion, district courts must not consider or resolve the merits of the claims of the purported class. Here the District Court credited Metro-North's expert evidence over that of the Class Plaintiffs. *Such a weighing of the evidence is not appropriate at this stage of the litigation.*

Id. at 293 (citation omitted) (emphasis added).

After refusing to engage in a battle of experts, the Court held that "[o]f course, class certification would not be warranted absent *some showing* that the challenged practice is causally related to a pattern of disparate treatment or has a disparate impact on African-American employees." *Id*. at 292 (emphasis added). In reviewing plaintiffs' submissions to determine whether the appropriate "showing" had been met, the Court found that the statistical report and anecdotal evidence were sufficient to show that plaintiffs could present class-wide proof of their claims. *Id*.

2. *VisaCheck*

In *VisaCheck*, this Court further explained the threshold showing plaintiffs must make to support class certification. The plaintiffs alleged that Visa and MasterCard conspired to monopolize the debit card market. Certification turned on whether common issues of injury predominated over individual ones. The plaintiffs' expert opined that the tie-in had injured all retailers. Defendants' expert

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Fla. 1998). Even *Unger v. Amedisys*, 401 F.3d 316, 323 n.6 (5th Cir. 2005), relied on by Underwriters, refused to engage in a "battle of the experts."

asserted the tie-in had very different effects – from possible injury to possible benefit – and therefore injury was not subject to class-wide determination.

The district court granted class certification, noting that under *Caridad*, "weighing" expert testimony was not appropriate at the class stage. *In re VisaCheck/Mastermoney Antitrust Litig.*, 192 F.R.D. 68, 84 (E.D.N.Y. 2000) (citing *Caridad*, 191 F.3d at 293). This Court affirmed, emphasizing that "'rigorous analysis'" is not "an occasion for examination of the merits of the case." *VisaCheck*, 280 F.3d at 135 (quoting *Caridad*, 191 F.3d at 291). Instead, "[a] district court must ensure that the basis of the expert opinion is not so flawed that it would be inadmissible as a matter of law." *Id.* The Court, quoting *Caridad*, reiterated that a district court "may not weigh conflicting expert evidence or engage in 'statistical dueling' of experts" on class certification. *Id.*

B. The District Court Correctly Applied *Caridad* and *VisaCheck*

The District Court engaged in the exact type of rigorous analysis employed in *Caridad* and *VisaCheck*. First, the court recognized that it was required to evaluate the evidence carefully to determine whether Plaintiffs had made "some" threshold showing – but not a preponderance showing – to satisfy each element for class certification. (SPA68-69). Although Judge Scheindlin refused to engage in a battle of the experts, she thoroughly reviewed Plaintiffs' evidence to ensure that Professor Fischel's reports were not "fatally flawed," carefully considering the

critiques offered by Underwriters' experts. (SPA120-27). Indeed, after initial reports were submitted, she specifically requested that Plaintiffs submit a supplemental report analyzing "the causal link" between the misconduct and its effect on stock prices. (A4555). The District Court also requested that Plaintiffs submit a trial plan to demonstrate that the issues could be tried on a common basis. (A4639-40). Only after reviewing these materials did the District Court find that Plaintiffs had made at least "some showing," by way of a methodology that was not "fatally flawed," that common issues of artificial inflation and loss causation predominated.

Underwriters criticize this Court's "fatally flawed" standard, claiming all Plaintiffs need to do is put forward any expert and they will be able to obtain class certification. This is simply not true. Although this Court refuses to engage in a battle of the experts, it does require a critical evaluation of Plaintiffs' evidence. In *VisaCheck,* this Court specifically praised the district court's careful consideration of defendants' experts' reports: "in an almost fifty page opinion, [the district court] thoroughly considered each of defendants' criticisms of [plaintiffs' expert's opinion] and [plaintiffs' expert's responses thereto] and concluded in each case that [plaintiffs' expert's] response sufficiently addressed the criticism" offered by

defendants' experts. 280 F.3d at 135. Indeed, in *Caridad,* this Court accepted the district court's rejection of plaintiffs' sociological opinion as meaningless.[7]

Underwriters argue that the District Court was required to exclude the report under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). (Und. 104).[8] *Daubert*, however, was designed to shield the fact finder from flawed evidence at *trial*. 509 U.S. at 582. For that reason, in *VisaCheck*, this Court specifically rejected application of *Daubert* at class certification because it involves a "distinct" inquiry usually reserved for later stages of litigation. 280 F.3d at 132 n.4; *see also VisaCheck*, 192 F.R.D. at 76 ("I am very far from the 'trier of fact' contemplated in Rule 702. Indeed, I am expressly forbidden from engaging in a 'preliminary inquiry into the merits' of the case."). The majority of courts agree. *E.g.*, *Nichols v. Smithkline Beecham Corp.*, 2003 U.S. Dist. LEXIS 2049, at *11-12 (E.D. Pa. 2003) (citing cases).[9]

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[7] In finding that plaintiffs' evidence was sufficient, this Court referred only to "the statistical report and anecdotal evidence," *Caridad*, 191 F.3d at 292, ignoring the sociological opinion that the district court had rejected. *Robinson v. Metro-North Commuter R.R.*, 175 F.R.D. 46, 48 (S.D.N.Y. 1997).

[8] *Ruggiero v. Warner-Lambert Co.*, 424 F.3d 249 (2d Cir. 2005), relied on by Underwriters, has nothing to do with the application of *Daubert* at class certification.

[9] *See also In re Microcrystalline Cellulose Antitrust Litig.*, 218 F.R.D. 79, 83 (E.D. Pa. 2003); *Vickers v. GMC*, 204 F.R.D. 476, 479 (D. Kan. 2001); *J.B.D.L. Corp. v. Wyeth-Ayerst Labs.*, 225 F.R.D. 208, 219 (S.D. Ohio 2003). Even *Blades v.*

Moreover, a *Daubert* inquiry requires that the expert reach final conclusions to be evaluated along with full methodology and evidence, *e.g.*, *Oddi v. Ford Motor Co.*, 234 F.3d 136, 146 (3d Cir. 2000), which takes more time than contemplated by Rule 23's "as soon as practicable requirement." *See VisaCheck,* 280 F.3d 124 n.4; *Midwestern Mach. v. Northwest Airlines*, 211 F.R.D. 562, 565-66 (D. Minn. 2001).

This Court's limited inquiry charts the more appropriate course among the policies of Rule 23 and the edicts of *Eisen* and *Falcon*. As demonstrated in *Caridad* and *Visa*, the standard is not as "toothless" as Underwriters and Amicus Chamber of Commerce claim. Rather, the court must carefully analyze the evidence and assure itself that Plaintiffs have made a meaningful showing that they have met Rule 23's requirements. *E.g.*, *Parker v. Time Warner Entm't Co.*, 331 F.3d 13, 22 (2d Cir. 2003) (vacating grant of class certification where district court had no evidence supporting its determination); *Moore*, 306 F.3d 1247 (2d Cir. 2002).

Notably, a similar approach was recently taken by the First Circuit in *In re PolyMedica Corporation Securities Litigation*, 2005 U.S. App. LEXIS 27173 (1st Cir. 2005). In addressing "the level of inquiry" that district courts may pursue at

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Monsanto Co., 400 F.3d 562, 569 (8th Cir. 2005), relied on by Underwriters, refused to apply *Daubert*.

class certification, the court explained that a district court must "critically" evaluate plaintiffs' evidence, *id.* at *49, but twice warned that the court must not engage in a mini-trial on the merits. *Id.*; *see also id*. at *55. The court concluded that the amount of evidence is "one of degree," and district courts have "broad discretion to draw [those] lines." *Id*. at *55. This Circuit requires nothing less than this "critical" evaluation of the evidence presented and assures no mini-trials on the merits by prohibiting a dueling of experts and a weighing of evidence.[10]

C. District Courts Within this Circuit Similarly Apply this Court's Precedents

Far from being anomalous, the District Court's analysis is in accord with the majority of courts in this Circuit. *E.g., In re Natural Gas Commodities Litig.*, 231 F.R.D. 171, 181 (S.D.N.Y. 2005) ("plaintiff is only required to make 'some showing' beyond the complaint in support of class certification"). Similarly, courts within this Circuit recognize that this Court does not apply the preponderance standard advocated by Underwriters. *See DeMarco v. Roberston Stephens*, 228 F.R.D. 468, 470 (S.D.N.Y. 2005).

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[10] The First Circuit rejected the plaintiffs' proposal that a court "should not engage in a weighing of competing evidence at the class-certification stage, and should instead confine its review to the allegations raised in the plaintiff's complaint," *id.* at *11, a position those plaintiffs mistakenly attributed to *VisaCheck.* As discussed above, *VisaCheck* and *Caridad* require courts to look beyond the complaint's allegations when necessary for rigorous analysis.

In determining whether the requisite showing has been met, like Judge Scheindlin, when appropriate, district courts within this Circuit look at expert opinions, affidavits, and uncontested allegations to determine "'whether plaintiffs' . . . evidence is sufficient to demonstrate common questions of fact . . ., not whether the evidence will ultimately be persuasive.'" *Id.* at 470, 474 (quoting *VisaCheck*, 280 F.3d at 134-35); *see also Cortigiano v. Oceanview Manor Home for Adults*, 227 F.R.D. 194, 203-04 (E.D.N.Y. 2005); *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 296 (S.D.N.Y. 2003); *Warren v. Xerox Corp.*, 2004 U.S. Dist. LEXIS 5115, at *39-41 (E.D.N.Y. 2004); *Jones v. Ford Motor Credit Co.*, 2005 U.S. Dist. LEXIS 5381, at *32-33 (S.D.N.Y. 2005).

D. The 2003 Amendments Do Not Alter The Substantive Evidentiary Standards For Class Certification

Underwriters argue that even if *Caridad* and *VisaCheck* did create a "some showing" standard in this Circuit, that standard has been superseded by the 2003 amendments to Rule 23. (Und. 36). The Committee notes and materials, as well as subsequent case law, show that the amendments were specifically *not* intended to change the substantive standards for class certification.[11]

[11] No doubt aware that Judge Scheindlin was a member of the Advisory Committee at the time the 2003 amendments were being considered, Underwriters never raised this argument before her.

1. The 2003 Amendments Are Procedural

The Advisory Committee's proposals for changes to Rule 23 were intended to "focus on the process by which class actions are litigated, *rather than on changing the standards for certifying cases as class actions*." Memo from Judge Lee H. Rosenthal, Chair of Subcommittee on Class Actions, sent to Committee on Federal Rules of Civil Procedure, Feb. 27, 2001, at 3 (emphasis added). *See also* Civil Rules Advisory Committee Minutes, Oct. 16-17, 2000, at 5 ("The subcommittee has made a preliminary decision to focus its efforts on the process of class actions, not the standards for class certification. *Certification standards are already perceived to be exacting*.") (emphasis added).

Notably, when the Advisory Committee began its study of class actions in 1991, it worked on a series of proposals that specifically focused on the substantive standards for certification. *See* Preliminary Draft of Proposed Amendments (August 2001), *reprinted in* 201 F.R.D. 560, 589. These proposals were expressly *rejected*. Civil Rules Advisory Committee Minutes, Apr. 18-19, 1996, at 12-13. *See also* Rules of Practice and Procedure Committee Minutes, June 19-20, 1996, at 21 (discussing rejection of merits evaluation proposal: "After examination, though, the committee decided that the price of that inquiry was simply too great, for, among other things, it would require a minitrial.").

In ultimately recommending its proposal for the 2003 amendments, the Judicial Conference Committee explained that its focus was "*on class-action procedures rather than on substantive certification standards.*" Report of the Judicial Conference Committee on Rules of Practice and Procedure, Sept. 2002, at 8. *See also* Cover letter from Judge Scirica, Chair of Committee on Rules of Practice and Procedure, to Supreme Court, Nov. 18, 2002, at 3 (same). The amendments were simply put in place to deal with "the time for determining whether to certify a class, the contents of a certification order, and notice of certification." Report of the Civil Rules Advisory Committee, May 20, 2002, at 125.

2. Rule 23(c)(1)(A) Was Intended To Reflect Prevailing Practice

In 2003, Rule 23 (c)(1)(A) was amended to replace the phrase "as soon as practicable," with the phrase "at an early practicable time." The Committee Notes make clear that the change was only intended to allow the court time to obtain sufficient information to make the certification decision. Adv. Comm. Notes 2003.

When the Judicial Conference was studying Rule 23, a significant number of courts allowed discovery and dispositive motions in advance of certification. *See, e.g.*, Civil Rules Advisory Committee Minutes, Oct. 22-23, 2001, at 3. The amendment was intended to bring the rule in line with those practices. As explained in the introduction to the August 2001 draft:

> The proposed language is consistent with the reality that courts generally make certification decisions after the deliberation required for a sound decision…. The proposed language is also consistent with best practice; a court should decide a certification motion promptly, but only after obtaining the information necessary to make that decision on an informed basis....
>
> The current rule's emphasis on dispatch in making the certification decision has, in some circumstances, led courts to believe that they are overly constrained in the period before certification. A certain amount of discovery may be appropriate … to illuminate issues bearing on certification, including the nature of the issues; whether the evidence on the merits is common to the members of the proposed class; whether the issues are susceptible to class-wide proof; whether there are conflicts problems within classes; and what trial management problems the case will present. *As the Note discusses, this discovery does not concern the weight of the merits or the strength of the evidence*.

Preliminary Draft, 201 F.R.D. at 592-93. *See also* Judicial Conference Report, at 11; Cover Letter to Supreme Court, at 4.

Courts uniformly interpret this amendment to reflect prior prevailing practice. *E.g.*, *Weiss v. Regal Collections*, 385 F.3d 337, 348 n.17 (3d Cir. 2004); *In re Spring Ford Indus.*, 2004 Bankr. LEXIS 112, at *18 n.13 (E.D. Pa. 2004); *Arnold v. Ariz. Dep't of Pub. Safety*, 2005 U.S. Dist. LEXIS 24228, at *13-14 (D. Ariz. 2005); *Coburn v. DaimlerChrysler Servs. N. Am., L.L.C.*, 2005 U.S. Dist. LEXIS 6276, at *28 n.5 (N.D. Ill. 2005). Consequently, none of these decisions relies on the 2003 amendments to support a weightier evidentiary standard, *e.g.*, *In re Spring Ford*, 2004 Bankr. LEXIS 112, at *18 n.13, and Underwriters fail to cite a single case so holding. Whether or not they specifically mention the

amendments, courts continue to apply pre-amendment standards. *E.g.*, *In re Natural Gas*, 231 F.R.D. at 181-82; *Cortigiano*, 227 F.R.D. at 203.

Ultimately, Underwriters mistakenly attempt to turn a change that gives courts greater flexibility in *when* they should make class certification decisions into a seachange into *how* they should do so.[12] Nothing in the amendments to Rule 23 supports such an interpretation. *See, e.g.*, Memo from Judge Lee H. Rosenthal to Advisory Committee, April 23, 2002, at 1, 12 (describing revisions as "reflect[ing] a continuing belief that the change brings the Rule in line with prevailing, and good, practice" and concluding that "[t]he proposed amendments to Rule 23 do not attempt aggressive revision.").

E. Underwriters' Proposed Evidentiary Standard Contravenes *Eisen* and the History of the 2003 Amendments

Underwriters ask this Court to stray from its precedent and permit class certification only if it is more likely than not that Rule 23's requirements are met. Underwriters' standard is wholly inconsistent with Supreme Court precedent, the

[12] Underwriters also try to support their request for a weightier evidentiary standard by relying on the deletion of the provision permitting conditional certification. (Und. 37-38). The deletion of the conditional certification provision merely "reflected the common practice that treats this provision as an essentially redundant expression of the rule that a certification order can be altered or amended." Report of the Civil Rules Advisory Committee, May 20, 2002, at 126. Rule 23(c)(1)(A) makes clear that a court should take the time to complete a searching inquiry rather than grant certification on a tentative basis. Accordingly, this amendment no more supports an increased evidentiary standard than the amendment to Rule 23(c)(1)(A).

history of the 2003 amendments, and this Circuit's long history favoring the liberal application of Rule 23 in securities fraud suits. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 176, 179 (2d Cir. 1990); *see also Korn v. Franchard Corp.*, 456 F.2d 1206, 1209 (2d Cir. 1972); *Green v. Wolf Corp.*, 406 F.2d 291, 296 (2d Cir. 1968).

To begin, *Eisen* specifically "admonished that a 'more than likely to prevail' standard is inappropriate in a Rule 23 certification analysis." *Unger*, 401 F.3d at 326 (Dennis, J., concurring). This admonition informed the Judicial Committee's consideration of the 2003 amendments to Rule 23. As noted above, the Committee specifically rejected proposals that would have required consideration of the probable outcome on the merits. Even the proposals considered by the Committee did not include a preponderance of evidence standard. *See* Rules of Practice and Procedure Committee Minutes, Jan. 12-13, 1996, at 15 (discussing merits proposals and noting that "the committee's goal was to provide a *low threshold*") (emphasis added).

Moreover, a preponderance standard is not needed to avoid undue settlement pressures. The Federal Judicial study "show[ed] that ample protection is provided by motions to dismiss or for summary judgment." Civil Rules Advisory Committee Minutes, Apr. 18-19, 1996, at 13. Here, Plaintiffs' claims not only survived Underwriters' motions to dismiss, but after almost 2 years of arms-length

negotiations, Plaintiffs and the Issuers reached a landmark settlement guaranteeing $1 billion with the right to credits from future recoveries against Underwriters. Underwriters cannot possibly claim that a weightier standard was necessary to protect them from this "trivial" action.

Underwriters' arguments notwithstanding, the Fourth and Seventh Circuits have never endorsed a preponderance standard. (Und. 43). Rather, *Gariety v. Grant Thornton, LLP*, 368 F.3d 356 (4th Cir. 2004) and *Szabo v. Bridgeport Machines, Inc.*, 249 F.3d 672 (7th Cir. 2001) simply mentioned different types of inquiries, including a preliminary injunction hearing, as "models or analogs of how district courts can 'probe behind the pleadings in resolving class action certifications' without disobeying the Supreme Court's admonishment in *Eisen* against 'expanding the . . . certification analysis to include consideration of whether the proposed class is likely to prevail ultimately on the merits.'" *Unger*, 401 F.3d at 326 (Dennis, J., concurring)(citations omitted).[13] *See also In re Safety-Kleen Corp. Bondholders Litig.*, 2004 WL 3115870, at *2 (D.S.C. 2004) (finding

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[13] Notably, while the Advisory Committee was considering the 2003 amendments, "[t]he comparison to preliminary injunction proceedings was noted . . . but found *not helpful* because of the special factors that affect preliminary injunction decisions." Civil Rules Advisory Committee Minutes, April 18-19, 1996, at 9 (emphasis added).

that *Gariety* "[did] not address the standard of proof the court should use in making its findings in evaluating the propriety of class certification").[14]

In any event, even if these non-binding cases do support a preponderance standard, they conflict with *Eisen* and this Circuit's longstanding refusal to determine the merits at class certification. *E.g.*, *Bolanos v. Norwegian Cruise Lines Ltd.*, 212 F.R.D. 144, 147, 155 n.9 (S.D.N.Y. 2002) (*Szabo* "has not been adopted by the Second Circuit (or the district courts within the Second Circuit)," and conflicts with Second Circuit precedent).[15]

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[14] Most of the remaining cases relied on by Underwriters stand for the well-settled proposition that a court may look beyond the pleadings in deciding whether the Rule 23 requirements are met. *E.g.*, *Bell v. Ascendant Solutions, Inc.*, 422 F.3d 307, 314 (5th Cir. 2005) (district court did not err in going beyond pleadings in examining predominance); *Johnston v. HBO Film Mgmt.*, *Inc.*, 265 F.3d 178, 194 (3rd Cir. 2001) (same). As to the required standard of proof, the *Bell* court referred to a "preliminary showing,"—a standard more akin to "some showing" than Underwriters' preponderance of the evidence standard. 422 F.3d at 314. *Blades* says nothing about what evidentiary standard of proof a court should apply at class certification. Instead, the court warned, "[t]he closer any dispute at the class certification stage comes to the heart of the claim, the more cautious the court should be in ensuring that it must be resolved in order to determine the nature of the evidence the plaintiff would require." 400 F.3d at 567.

[15] Underwriters misleadingly claim that *West v. Prudential Securities*, 282 F.3d 935, 938 (7th Cir. 2002) was cited with approval by this Court in *Hevesi*, 366 F.3d 70 (2d Cir. 2004). (Und. 41). *Hevesi* cited *West* for the proposition that a district court's application of the fraud on the market doctrine to a *stockbroker's statement* to his customers "presented a novel and potentially important question of law." *Hevesi*, 366 F.3d at 77 (citation omitted). It did not cite *West* for its discussion of the proper evidentiary standard. To the contrary, this Court expressly reserved the question. *Id.* at 79.

III. ARTIFICIAL INFLATION, RELIANCE, AND LOSS CAUSATION

A. The District Court Properly Applied the *Basic* Fraud-on-the-Market Presumptions

Basic's fraud-on-the-market theory incorporates two distinct presumptions: *first*, that "[i]n an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock," and *second*, that "purchasers generally rely on the price of the stock as a reflection of its value." 485 U.S. at 244 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986)).

The District Court applied these presumptions exactly as written. (SPA101-03). *First*, it presumed that the misleading omissions contained in the Prospectuses inflated stock prices. (SPA100-01). *Second*, it presumed that purchasers relied upon market prices as an accurate reflection of available information. (SPA105 SPA105-09 & n.319). The District Court did *not* presume that Underwriters' manipulative conduct affected prices. Instead, it explicitly placed the burden on Plaintiffs to establish that such conduct caused artificial inflation. (SPA120). The District Court's order was thus indistinguishable from countless similar certifications.

B. Artificial Inflation Can Be Established Class-Wide

First, Plaintiffs allege that the Prospectuses failed to disclose that: (1) Underwriters illegally engaged in "tie-in" agreements designed to inflate stock

prices; and (2) Underwriters exacted compensation based upon potential allocant profits. (*E.g.*, A1564-68). These "omissions" claims are no different than the garden-variety Rule 10b-5 claims that are routinely certified.

Second, Plaintiffs allege "manipulation" claims which include: tie-in agreements; promises to new issuers that they would receive analyst coverage in exchange for selecting the Underwriter for the IPO (A1245-53); use of Underwriters' power as market makers (A1132-35); and biased analyst coverage that omitted mention of the scheme (A1245-53). These behaviors have been recognized as creating a serious threat to the integrity of the securities markets even prior to the 1933 Act. *See generally* 8 Loss & Seligman, *supra*, ch. 10 (3d ed. rev. 2004).

1. Artificial Inflation from the Prospectuses' Material Omissions Can be Determined Class-Wide

It is blackletter law that plaintiffs receive a rebuttable presumption that in an efficient market, stock prices reflect available public information and are distorted by material false statements and omissions. *See Basic*, 485 U.S. at 246-47. Thus, the presumption of artificial inflation was perfectly appropriate for Plaintiffs' omissions claims.

a. The Omissions Were Material

The mere fact that a prestigious firm like CSFB or Goldman chooses to underwrite an offering and take on associated risks sends a strong signal to

investors. *E.g.*, Alon Brav & Paul Gompers, *The Role of Lockups in Initial Public Offerings*, 16 Rev. Fin. Stud. 9, 26 (2003) (new issuers have less need to "signal" their reliability to the market when they have high-quality underwriters); Frank Easterbrook & Daniel Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 675 (1984) (underwriter syndicates signal issue's worth with "reputational capital"). Had investors understood that Underwriters sought profits based on the success of their ability to rig prices in the aftermarket, they would have doubted the diligence and quality of the underwriting, suspecting – correctly – that Underwriters had ceased selecting new issues based on the companies' legitimate future potential, and instead were choosing vehicles to produce quick, astronomical profits. Indeed, one article introduced by Underwriters suggests just that. (A3046).

Additionally, had the facts been disclosed, investors would have interpreted the trading activity and initial rises in the issuers' stock price differently. As Underwriters concede (Und. 12-13), underwriters are expected to ensure the long-term stability of the issuer by seeking allocants interested in legitimate investment opportunities rather than speculative profits from "flipping" shares. In these cases, however, undisclosed compensation undermined that incentive because Underwriters profited based on allocants' ability to "flip" shares at high prices.

Investors, unaware of these conflicting incentives, would have incorrectly expected a greater number of long-term investors and more stable share prices.[16]

Underwriters claimed that these facts were not material, and Professor Fischel averred that they were. (A4279). But "[t]he determination of materiality is a mixed question of law and fact that generally should be presented to a jury," *Press v. Chem. Inv. Servs.*, 166 F.3d 529, 538 (2d Cir. 1999), and, in its ruling on the motion to dismiss, the District Court concluded that Plaintiffs had properly pled the existence of material omissions. (A1832).[17] Whether or not Plaintiffs are able to establish materiality at trial, the issue operates *class-wide*, as in any other 10b-5 action.

b. The District Court Properly Presumed that Material Omissions in Prospectuses Inflate Stock Prices

Underwriters make no distinction between the *market manipulation* claims and the *omissions* claims, and, as a result, do not confront the omissions claims directly, except to fault Plaintiffs for failing to produce a "study" proving that the existence of undisclosed compensation would cause investors to devalue the stock.

[16] Rule 101 of Regulation M prohibits an underwriter from bidding for shares in the IPO to prevent this precise conflict of interest.

[17] In denying Underwriters' motion to dismiss, the District Court held that the Prospectus was defective for failure to include material information. (A1852-56). That conclusion is not subject to this Court's review at this time. *See VisaCheck*, 280 F.3d at 132 n.4.

(Und. 74). Underwriters do not explain why such omissions, if material, should be treated any differently from any other material omission from a public SEC filing. Plaintiffs typically are not required to produce studies "proving" the inflationary effects of material omissions; rather, it is a defendant's burden to *disprove* those effects. *See Basic*, 485 U.S. at 248-49; *Black v. Finantra Capital*, 418 F.3d 203, 209 (2d Cir. 2005); *Ganino v. Citizens Utils.*, 228 F.3d 154, 167 (2d Cir. 2000). If Underwriters wish to challenge the materiality of such omissions in the first place, they may move for summary judgment. *Cf. Castellano v. Young & Rubicam*, 257 F.3d 171 (2d Cir. 2001) (reviewing grant of summary judgment on materiality). But Underwriters have offered no support for their novel argument that the materiality of omitted facts should be tested at *class certification*. *Cf. Caridad*, 191 F.3d at 291 ("motion for class certification is not an occasion for examination of the merits of the case").[18]

Underwriters criticize the District Court for adopting a presumption of impact for "non-issuer conduct." (Und. 78). The District Court's conclusions with respect to the *manipulations* claims are discussed below, but as to the *omissions*,

[18] Obviously, the question of how investors would have reacted to the true facts is a bit like angels-on-pinheads here, because had the facts been disclosed, the SEC would have immediately halted the issue.

Plaintiffs know of no case where any court has expressed doubt about the propriety of presuming market impact from a materially defective prospectus.

This Court *has* questioned the propriety of presuming that statements of third-party *analysts* distort market price, because there may be a "distinction between, on the one hand, the uniquely authoritative statements of issuers and, on the other hand, expressions of opinion by analysts." *Hevesi*, 366 F.3d at 79. Analyst assessments may be rendered side-by-side with the publicly-available facts underlying their opinions. *See Lentell v. Merrill Lynch*, 396 F.3d 161, 176 (2d Cir. 2005).[19] A single analyst may be one voice among similar voices. *See DeMarco v. Lehman Bros*., 222 F.R.D. 243 (S.D.N.Y. 2004). These characteristics have led courts to question whether an automatic presumption of impact is advisable in every case.

[19] In 2000, the SEC adopted Regulation FD, which forbids issuers from selectively sharing information with favored analysts. *See* 17 C.F.R. §243.100.

But whatever the merits of such arguments, they have no application here.[20] The District Court explicitly stated that it would *not* presume that the analyst reports inflated stock prices, (SPA105 n.319); instead, the analysts were treated as one part of the manipulative conduct, discussed below. And the *omissions* appeared in a registration statement– an offering's foundational document, for which the underwriter is legally responsible, 15 U.S.C. §77k. Registration statements are tightly regulated by the SEC, and the 1933 Act provides special penalties for false statements contained therein. For this reason, courts routinely presume that registration information is incorporated into stock prices. *E.g.*, *Shaw v. Digital Equip.*, 82 F.3d 1194 (1st Cir. 1996); *Kaplan v. Rose*, 49 F.3d 1363 (9th Cir. 1994); *In re CINAR Corp. Sec. Litig.*, 186 F. Supp. 2d 279 (E.D.N.Y. 2002). Certainly, no court should parse a registration statement to determine which pieces are attributable to the issuer and which to underwriters.

[20] Though the Court need not address it, whether a single analyst may be "presumed" to impact stock price is simply a question of materiality. Materiality, like all fact-based inquiries, depends on circumstances; opinions expressed by Jack Grubman may be more material than opinions expressed by lesser-known figures. This is why *Basic* did not limit its holding to issuers, but instead held that the "price of a company's stock is determined by the available material information regarding the company and its business." *Basic*, 485 U.S. at 241. *See generally* Brief of the SEC as Amicus Curiae, *In re Worldcom Sec. Litig.*, No. 03-9350 (2d Cir. Apr. 2004), *available at* http://www.sec.gov/litigation/briefs/ wchevesi_amicus.htm.

Moreover, courts commonly presume artificial inflation from false statements of "insiders" even if they are not the issuer, because insiders have special knowledge, and their views carry weight. *Cf. Va. Bankshares v. Sandberg*, 501 U.S. 1083, 1091 (1991) ("[S]hareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources…."). The conduct of auditors, lawyers, banks, and NYSE "specialists" are routinely presumed to impact stock prices. *E.g.*, *Knapp v. Ernst & Whinney*, 90 F.3d 1431 (9th Cir. 1996); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002); *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005); *In re NYSE Specialists Sec. Litig.*, 2005 U.S. Dist. LEXIS 32597 (S.D.N.Y. 2005).

Documents endorsed by the underwriter are especially significant. Unlike some analysts, the underwriter has reviewed confidential corporate information and undertaken a unique assessment of market demand. *See* U.S. SEC, Special Study of the Securities Markets, HR Doc. No. 88-95, at 493 (1st Sess. 1963) ("Special Study") (underwriters "play[] a particularly important role" for new securities and primarily determine "which issues are suitable for public ownership"). Even if *analyst* opinions should not be presumed to influence market price, underwriters are more akin to issuers. Therefore, the District Court properly

held that Plaintiffs were entitled to a presumption of artificial inflation for their omissions claims.

c. *Affiliated Ute*

Even apart from the *Basic* presumption of artificial inflation, when a fraud action is premised on omissions, a presumption of reliance is appropriate because it is difficult for a plaintiff to put forth affirmative evidence that he relied upon the *absence* of information. *See Affiliated Ute*, 406 U.S. at 153; *Black*, 418 F.3d at 209; *DuPont v. Brady*, 828 F.2d 75 (2d Cir. 1987).

Underwriters contend that *Affiliated Ute* does not apply because concealment of manipulation should not "count" as an omission. (Und. 86-87). The Supreme Court would disagree, because *Affiliated Ute*, too, involved market makers whose omissions concealed their manipulation and control over the price of securities. 406 U.S. at 153. But even if Underwriters are correct, the omissions *also* concealed the Underwriters' conflicting incentives. These undisclosed facts were material independent of the manipulations.

True, courts grappling with "mixed" cases (involving both misstatements and omissions) observe that it would be impractical to expect the jury to presume reliance on omissions, while requiring affirmative proof of reliance on false statements. *Joseph v. Wiles*, 223 F.3d 1155, 1162 (10th Cir. 2000). As a result, they attempt to determine whether the case's "core" involves misrepresentations.

See Starr v. Georgeson S'holder, 412 F.3d 103, 109 n.5 (2d Cir. 2005); *Hoxworth v. Blinder, Robinson & Co.*, 903 F.2d 186, 202 (3d Cir. 1990); *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93 (2d Cir. 1981). However difficult that line may be to draw in particular instances, the line is simple here. *E.g.*, *Newton v. Merrill Lynch, Pierce, Fenner & Smith*, 259 F.3d 154, 176 (3d Cir. 2001) ("When defendants fail to disclose material information about a uniform practice involving the purchase or sale of securities, plaintiffs may be entitled to a presumption of reliance which defendants may rebut."); *Hoxworth*, 903 F.2d at 202 (failure to disclose illegal price markup is a "pure" omission).[21]

Underwriters cite Justice Blackmun's concurrence in *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977) to argue market manipulation cases do not merit the *Affiliated Ute* presumption. (Und. 88). However, Justice Blackmun explicitly said that the market manipulation claims *in that case* did not include allegations of false statements or omissions, and it was for that reason alone that *Affiliated Ute* did not apply. *See Piper*, 430 U.S. at 53 n.2 (Blackmun, J., concurring). *Gurary v. Winehouse*, 190 F.3d 37 (2d Cir. 1999), also cited by Underwriters, is equally

[21] Underwriters point out that the District Court, in denying the motion to dismiss, highlighted "affirmative" false statements in the Prospectuses. (Und. 89). These statements almost exclusively alleged that Underwriters failed to disclose noncompliance with the securities laws and NASD rules, (A1832), prompting the District Court to write "Finally, the materiality of the alleged omissions here (i.e., the total nondisclosure of the alleged scheme) has not been disputed." (SPA104).

irrelevant; that investor had been told of the manipulation, and the court's discussion of the necessity for "proof" of reliance simply was not undertaken in the context of the burden-shifting regimes of *Affiliated Ute* (or *Basic*). *See id.* at 45.

Moreover, when in doubt as to who should bear the burden of proving reliance, courts look to *Affiliated Ute*'s underlying rationale: When no positive false statements exist, "reliance as a practical matter is impossible to prove." *Wilson*, 648 F.3d at 93; *Titan Group v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975); *Newton*, 259 F.3d at 177. That rationale applies here: it would be unduly burdensome for Plaintiffs to offer affirmative proof that they relied upon Underwriters' *failure* to disclose that they were soliciting illegal aftermarket purchase orders.

2. Plaintiffs Can Prove Artificial Inflation from Market Manipulation Class-Wide

a. The District Court Did Not Presume that Underwriters' Manipulations Inflated Stock Prices

The District Court held that "[i]n a market manipulation case, plaintiffs can satisfy their burden by presenting a *means to determine that the scheme caused an increase* in price that dissipated throughout the class period." (SPA119) (emphasis added). Later, the court stated during oral argument that it expected Plaintiffs to prove that the scheme had an inflationary effect on prices (A4516-17, A4523), and directed Plaintiffs to "submit a supplemental report from Dr. Fischel in which he

analyzes the causal link between the alleged tie-in agreements and their effect on stock price…." (A4555). Thus, the District Court did not extend *Basic*'s presumption of artificial inflation to the manipulation scheme.

Properly, the District Court did allow Plaintiffs the presumption that investors *rely* upon market price as a reflection of available information. (SPA105-09). Though Underwriters contend that presumption is inappropriate *in this case* (because of publicity, etc.), they do not argue that there is anything unique about market manipulation claims that, in the abstract, renders them immune from this presumption.[22] *Cf. Scone Invs., L.P. v. Am. Third Mkt. Corp.*, 1998 U.S. Dist. LEXIS 5903, at *16 (S.D.N.Y. 2004) ("The fraud on the market theory is especially applicable in the market manipulation context."); *In re Sumitomo Copper Litig.*, 995 F. Supp. 451, 458 (S.D.N.Y. 1998) ("[T]here is no

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[22] In fact, the District Court demanded more of Plaintiffs than the law requires, because a presumption of artificial inflation would have been appropriate. False statements, if material, will be presumed to distort stock prices. *Basic*, 485 U.S. at 246-47. A similar presumption is appropriate for market manipulation – namely, intentionally manipulative conduct, if accomplished on a material scale, should be presumed to affect stock prices. The SEC characterizes the types of manipulations alleged here as a prohibited transaction that "undermine[s] the integrity of the market as an independent pricing mechanism for the offered security." SLB 10. Given the scale of the misconduct alleged, it was "material" and Plaintiffs are entitled to a presumption that Underwriters' manipulative scheme inflated share prices.

reason to abandon the presumption of reliance in a case involving market price manipulation" in RICO action.).

b. The Inflationary Effect of Targeted Trading Has Been Long Documented

Well before the 1933 Act, it was understood that trading patterns and stock prices reflected available public information, and that false statements would be reflected in market prices. *See* Adolf A. Berle, *Liability for Stock Market Manipulation*, 31 Colum. L. Rev. 264, 268-70 (1931). This quality of securities markets renders them vulnerable to fraud through manipulative trades that create a false impression of demand. As Professor Berle wrote in 1931:

> [T]he highest type of representation which can be made to the market is the representation contained in the published report of a sale…. This constitutes an open representation to the market of an appraisal at which one party has been willing to sell and another party willing to buy; and it promptly becomes an element in every subsequent appraisal, at least for a period of time. Accordingly, the so-called "washed" sale is presumably actionable as a false representation at common law….

Id. at 270-71. Even before the passage of the federal securities laws, states like New York forbade manipulative trading. *E.g.*, *People v. Rice*, 221 A.D. 443 (N.Y. 1st Dep't 1927).

Although common law recognized "wash" sales and "matched" orders – which did not involve true changes of beneficial ownership – as fraudulent, such doctrines did not extend to manipulative trading that included actual stock sales, and they rarely provided civil remedies to defrauded investors. State statutes did

little better. In part because existing remedies for market manipulation were inadequate, Congress adopted the 1934 Act. *See* Note, *Regulation of Stock Market Manipulation,* 56 Yale L.J. 509, 516-517 (1947).

Congress understood most investors would not read lengthy disclosure documents; instead, Congress expected that the documents would be read by sophisticated professionals, and that those professionals, as well as trading information, would signal securities' value to investors. *See* William Douglas & George Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171-72, 176 (1933). Thus, in the 1934 Act's legislative history, Congress recognized the dangers posed by precisely the kinds of activity alleged here:

> But the most subtle manipulating device employed in the security markets is not simply the crude form of a wash sale or a matched order. It is the conscious marking up of prices to make investors believe there is a constantly increasing demand for stocks at higher prices….

H.R. Rep. No. 73-1383, pt. 2, at 10 (1934).[23] Those tactics frequently combined fraudulent trading with purportedly "independent" media coverage to encourage investor interest. *See* S. Rep. No. 73-792, pt. 1, at 8 (1934) (market operators "employ a publicity agent to tout a stock in which they were momentarily

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[23] Congress enacted specific prohibitions on manipulative trading in Section 9 of the 1934 Act, 15 U.S.C. §78i. That provision may not apply to NASDAQ. *See Fezzani v. Bear, Stearns & Co.*, 384 F. Supp. 2d 618, 641 (S.D.N.Y. 2004). Nonetheless, manipulative trading violates Section 10(b) and Rule 10b-5, as well as Section 9. *E.g.*, *Schaefer v. First Nat'l Bank*, 509 F.2d 1287 (7th Cir. 1975).

interested: [A] financial writer on a great New York newspaper was discovered to have been a regular participant in the profits of a free-lance trader…. Still other cases were observed where persons were employed to broadcast over the radio, ostensibly as economists tendering gratuitous advice….”); 8 Loss & Seligman, *supra*, at 3986.9-3986.10 (describing the use of purportedly independent analysts to fuel illicit “pools”).

Since the passage of the 1934 Act, numerous courts, including this one, have recognized that intentionally manipulative trading can inflate stock prices. *E.g.*, *Billing*, 426 F.3d at 142; *United States v. Russo*, 110 F.3d 948 (2d Cir. 1997); *Rosenberg v. Hano*, 121 F.2d 818 (3d Cir. 1941); *Coplin v. United States*, 88 F.2d 652 (9th Cir. 1937).

The SEC has identified specific schemes that accompany – and fuel – periodic “hot-issue” IPO markets. (A1789-97). At the end of a historic “hot-issue” market from 1959 to 1961, the SEC issued a release explaining that solicitation of aftermarket purchases violated then-Rule 10b-6 (now codified as Regulation M). *See* Exchange Act Release No. 6536 (April 24, 1961). In 1963, the SEC found that illicit tie-ins had contributed to extraordinary rises in first day trading prices of new issues. *See* Special Study, at 520-22. A 1984 SEC report, following another “hot issue” market, concluded that tie-in arrangements “stimulate[] demand for a hot issue in the aftermarket, thereby facilitating the

process by which stock prices rise to a premium." Report of the Securities and Exchange Commission Concerning the Hot Issues Markets, at 37-38 (August 1984), at 37-38. The SEC described one typical case:

> During the underwriting period, the broker-dealer [] required a substantial number of its customers to place aftermarket purchase orders for the company's stock at substantial premiums above the one dollar per share offering price as a *quid pro quo* for obtaining shares in the underwriting. As a consequence of its activity, the broker-dealer was able to drive the price to over $4 per share only a few hours after commencement of aftermarket trading.

Id. at 39.

During the "hot-issue" market that forms the context for these actions, the SEC issued a staff bulletin describing tie-ins as a "particularly egregious" prohibited transaction that "undermine[s] the integrity of the market as an independent pricing mechanism" because "traders in the aftermarket will not know that the aftermarket demand, which may appear to validate the offering price, has been stimulated by the distribution participants." SLB 10. In 2002, then-SEC Chair Harvey Pitt requested that the NASD and the NYSE review IPO abuses, singling out tie-ins as a practice that "distort[ed] the market for these securities." NYSE/NASD IPO Advisory Committee Report and Recommendations, at A-2 (May 2003), *available at* http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_010373.pdf. The resulting report confirmed that "laddering" practices had that effect, *id.* at 6, a conclusion adopted by the SEC in Release 34-

51500. The SEC found that tie-in arrangements and "laddering" practices "tend to: (1) create offering demand; (2) cause artificial aftermarket price escalation; and (3) erode market integrity" and that investors "would not know that the aftermarket demand had been stimulated by the underwriters' unlawful conduct." *Id.* at 8.

Despite the recognition by courts, Congress, and the SEC that stock prices can be manipulated through trading and that tie-ins create an artificial appearance of demand, Underwriters contend that as a matter of law and fact, manipulative trades are *literally incapable* of inflating a stock's market price for more than a few seconds at a time. (Und. 70-72, 92-94). To support their revolutionary argument, Underwriters offer the single, distinguishable case of *West*, 282 F.3d 935.

In *West*, a lone stockbroker privately counseled a handful of clients that a particular corporation would soon be acquired, causing them to purchase the corporation's stock. The district court certified a class of *all* purchasers of the stock on the theory that the single brokers' lies inflated its market price for a seven-month period. On appeal, the Seventh Circuit concluded that although the fraud-on-the-market theory allows for a presumption that publicly-announced material information will affect a company's stock price, "[n]o similar mechanism explains how prices would respond to non-public information." *Id.* at 938. Without even a theoretical basis for how the broker's misbehavior could have affected market prices, the Seventh Circuit held that although *public* statements

will be presumed to affect prices, *nonpublic* statements will not be so presumed, and rejected as inadequate plaintiffs' expert evidence to that effect. *See id.* at 939-40.

Unlike *West*, Plaintiffs' theory of inflation is one that has been ratified by historical experience. Additionally, *West* involved a few false statements to a few customers; these cases involve numerous tie-in agreements deliberately arranged by the lead underwriters who had market power over the issues, control over the IPO process, and a cadre of analysts to keep the scheme under wraps.

Indeed, Underwriters' argument that tie-ins are incapable of producing sustained stock price inflation is absurd in this case. Plaintiffs will prove through direct evidence, including emails and testimony, that Underwriters devoted considerable time and energy to inducing and enforcing tie-in agreements for the explicit purpose of inflating stock prices. (A1210-13). That they continued this conduct for years strongly suggests that their efforts were successful – any other scenario posits that Underwriters did not notice that their relentless efforts were making absolutely no difference whatsoever.[24]

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[24] Complaints filed by the SEC contain additional allegations demonstrating that the *Underwriters themselves* believed that aftermarket laddering affected stock prices. *E.g., SEC v. Morgan Stanley*, No. 05CV00166, ¶57 (D.D.C. filed Jan. 25, 2005), *available at* http://www.sec.gov/litigation/complaints/comp 19050.pdf ("Morgan Stanley obtained aftermarket interest from customers at increasing prices that were well above the IPO price range to attempt to induce aftermarket orders

c. Plaintiffs Presented a Method for Determining Artificial Inflation Class-Wide

The District Court carefully analyzed submissions of both parties and held that Plaintiffs provided "a method of proving that the alleged scheme inflated stock prices as early as the beginning of trading, and that the inflation dissipated throughout the class period." (SPA120). In challenging these conclusions, Underwriters invite this Court to substitute its judgment for the District Court's.

3. Pre-Opening Bidding

The District Court concluded that Professor Fischel "empirically demonstrates the effect of tie-in agreements on demand and price through an analysis of the pre-open bid sessions." (SPA120). Professor Fischel discovered patterns suggesting Underwriters used their tie-in arrangements to set inflated opening prices. (SPA120-22). Institutions with alleged tie-in agreements accounted for much of the demand for the new issues; the lead underwriters set the first bids substantially above the offer price (suggesting they were relying on their knowledge of impending demand); and the lead underwriter's bids set floors that guided the other bidders throughout the session. (SPA120-22; CA816; A4284).

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cont'd.

and purchases at prices higher than the IPO price. A syndicate manager explained to an IPO company's management 'that aftermarket interest from IPO customers was a factor that could cause the stock to trade up in the aftermarket.'"). This Court may judicially notice publicly filed documents. *See Kavowras v. N.Y. Times*, 328 F.3d 50, 57 (2d Cir. 2003).

As a result, the issuers' stocks opened at prices substantially (if not shockingly) higher than the offer price (*e.g.*, CA840).

These initial, widely publicized "pops" influenced the stocks' performance in the aftermarket; they signaled that market makers and their customers had great confidence in and demand for the new issue. Because market makers are a critical mechanism for ensuring that stock prices reflect material information, *see Basic*, 485 U.S. at 258, the initial price jump served as an important source of information that infected subsequent trading; indeed, Underwriters do not contest that high opening bid prices influenced the stocks' market performance.

Instead, Underwriters dispute that they exercised control over the pre-opening bidding, at least for Sycamore and iXL. (Und. 72-73).[25] But they cannot dispute that this is a *class-wide* issue. The bidding session generally lasts about fifteen minutes before trading, complete records exist, and a discrete number of market makers participate in each session. If Underwriters used tie-in arrangements to signal price levels to other market makers, this may be proved – or disproved – class-wide. Because the question whether the pre-open bid sessions were manipulated is common to all classmembers, no further inquiry is needed.

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[25] Presumably, they do not challenge the District Court's findings for the remaining bid sessions.

See Blades, 400 F.3d at 566; *VisaCheck*, 280 F.3d at 134-35; *Tardiff v. Knox County*, 365 F.3d 1, 5 (1st Cir. 2004).

Even if this Court were tempted to engage Underwriters' merits-based argument, Plaintiffs have put forward evidence of manipulation. In each case, the lead underwriter setting a price floor that other market makers followed. Even when the underwriter's bid was not the "best" bid, Professor Fischel found that the high bids increased shortly after the underwriter increased its own bid. (SPA122; A4284). In Sycamore, for example, Morgan Stanley (with the issuer) set an offering price of $38 per share, but then *started* bidding with $150 per share. Despite that extraordinary leap, other market makers immediately topped the $150 price, and after bidding leveled out, Morgan Stanley increased its own bid, causing a noticeable increase in bids by other market makers (CA816, CA838). The stock ultimately opened at $270. Similarly, with iXL, Professor Fischel documented how increases in Merrill Lynch's bid were followed by increases in the highest bid (CA816).[26]

These facts alone establish that the opening prices were manipulated upward as a result of tie-ins, and Underwriters do not dispute that opening prices

[26] Though Underwriters do not challenge Professor Fischel's analysis for VA Linux, that case is particularly striking. CSFB doubled its offer price with the first bid, then led other market makers in a substantial price increase after bidding leveled out. (CA840).

influenced aftermarket trading. At later litigation phases, Plaintiffs may produce additional evidence, such as communications between market makers, further proving the scheme's existence.[27] But stand or fall, Plaintiffs' proof extends class-wide.

4. Aftermarket Tie-Ins

Plaintiffs also demonstrated the inflationary effects of laddered orders in the aftermarket. (SPA122-23). Professor Fischel explained that large trades have prolonged, quantifiable effects on stock prices. (SPA123). He also found that allocants purchased heavily in the immediate aftermarket, and that the size of their purchases correlated with the size of their allocations. (SPA123). He further noted that in the aftermarket, underwriters could use their knowledge of impending orders and dual roles as market makers to hold stock prices above the level at which they ordinarily would lie, even for orders that ultimately never executed (A4279 n.6). After acknowledging, and rejecting, Underwriters' contrary analysis (SPA123 n.365), the District Court concluded that Professor Fischel had "established a mechanism for proving that the alleged scheme caused artificial inflation." (SPA123-24).

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[27] Underwriters contend that a "scientific model" would be needed to determine the degree to which the pre-opening bid session involved "signaling" and inflated bids. (Und. 100-01). This is nonsense. Plaintiffs have never argued that "signaling" must be proved solely by examining each bid; Plaintiffs can call industry participants to the stand and ask them about the conduct of the sessions.

Other than vague charges that Professor Fischel "assumed" that tie-in agreements have an inflationary impact, (Und. 72), Underwriters only specifically dispute his iXL analysis, arguing that iXL allocants made up only a small percentage of trades after the IPO. (Und. 73). However, the Underwriters did not produce crucial data about the number of allocant orders fueling the trading after the pre-open bid session, as the District Court observed. (CA814; SPA120 n.354). Moreover, Underwriters' analysis ignores Professor Fischel's point that laddered trades send a signal to other market participants, (A4279), and ignores that the lead underwriter-as-market maker can inflate aftermarket prices with unexecuted orders (A4279 n.6). More relevantly, the question whether iXL allocants engaged in sufficient trading to influence iXL's share price is one that operates *class-wide.*

Underwriters also point out that Sycamore's price declined from its opening on the first day of trading. This is because (as Underwriters' own experts concede) the inflated opening price of Sycamore came in *above* the prices at which allocants had agreed to make aftermarket purchases. (A3860). If anything, that Sycamore stock *fell* absent follow-up laddering supports Plaintiffs' allegations that tie-in trading contributed to the artificial inflation.

Underwriters insist that Plaintiffs have identified "no" tie-in trades. (Und. 71). The District Court found to the contrary (SPA123 n.364), but the issue is whether Plaintiffs will be able to establish the existence of tie-in trades *class-wide*.

Plaintiffs have alleged that explicit records of tie-in trades were kept by Underwriters. (A1212). Professor Fischel cited direct evidence of tie-ins in his report. (CA813). The factfinder will believe, or not, that these trades were executed pursuant to prior arrangements, but either way, the question is common to all class members. Certainly, Professor Fischel was correct to assume that Plaintiffs would later prove that these were tie-ins, for his reports were offered to prove the *effect* of tie-ins – not their *existence*. *See Thomas & Thomas Rodmakers v. Newport Adhesives & Composites*, 209 F.R.D. 159 (C.D. Cal 2002) (expert may assume existence of facts that will be proved at trial).

5. Analyst Reports

The District Court refused to presume that analyst reports had any effect. (SPA105 n.319). This is because the analysts were just one piece of the overall scheme to manipulate prices. Underwriters promised analyst coverage to attract new IPOs. (A1245-48). The mere *existence* of coverage, regardless of its content, fueled “buzz.” Finally, Underwriters’ cadre of “captive” analysts helped sustain artificially inflated prices for prolonged periods by keeping information *out* of the market – namely, information about the scheme. As Plaintiffs explained in their trial plan, in this way, analysts helped to *sustain* artificial inflation. (A4651).

Given these various roles, the District Court properly considered analysts to be one piece of Underwriters' overall manipulation.[28]

C. Reliance Can Be Established Class-Wide

1. Efficiency

In *PolyMedica*, the First Circuit explained that "an efficient market is one in which the market price of the stock fully reflects all publicly available information." 2005 U.S. App. LEXIS 27173, at *37. An efficient market is necessary for fraud-on-the-market claims for two reasons: first, investors may justifiably rely on prices set by an efficient market; and second, efficiency allows the court to presume that any particular false statement was, in fact, reflected in stock prices. By contrast, in an inefficient market, there can be no assurance that a particular false statement had any effect. *Id.* at *19-20.

At trial, a plaintiff need only establish the "basic facts" necessary to support a finding of efficiency, at which point defendants may rebut. *See id.* at *48. At class certification, however, the quantum of evidence necessary is "one of degree."

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[28] In *Lentell*, this Court held that "where the sole basis" for a securities fraud claim is "misrepresentations or omissions," the claim must be brought as a false statement claim under Rule 10b-5(b), rather than a manipulation claim under 10b-5(a) and (c). 396 F.3d at 177. Here, analysts are one piece of a larger manipulation scheme. As above, Congress recognized that market manipulators frequently employ "independent" analysts, and the Supreme Court in *Affiliated Ute* held that defendant market makers' material omissions were part of a "device, scheme, or artifice" to defraud under 10b-5(a) and (c). 406 U.S. at 152-53.

Id. District courts may choose, in their discretion, to rely on the "more accessible and manageable evidence" available at early stages of proceedings, and save for trial more difficult evidence. *Id.* A district court must "exercis[e] its broad discretion, [] understanding the correct definition of efficiency and the factors relevant to that determination, [and] evaluate the plaintiff's evidence of efficiency critically without allowing the defendant to turn the class-certification proceeding into an unwieldy trial on the merits." *Id.* at *49.

Employing these standards, the First Circuit vacated a district court's certification order because the district court adopted an erroneous definition of market efficiency, and, relying on the erroneous definition, refused to allow defendants to submit evidence. *Id.* at *50-53.

Under *PolyMedica*, Judge Scheindlin's decision was proper. *First*, she expressly adopted "the correct definition of efficiency," even *rejecting* the incorrect definition employed by the *PolyMedica* district court. (SPA106 n.321 & 107 n.323). *Second*, she identified the same "factors relevant" to the determination of efficiency approved by the First Circuit in *PolyMedica* and *In re XCelera.com Sec. Litig.*, 2005 U.S. App. LEXIS 27174 (1st Cir. 2005) (SPA106-10 (citing the factored-test derived from *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989))). Judge Scheindlin imposed no artificial restrictions on the evidence Underwriters were permitted to introduce. Relying on high trading volume, publicity and

analyst coverage, and presence on the NASDAQ, she determined that "[u]nder any conceivable test for market efficiency," Plaintiffs had met their Rule 23 burden. (SPA108). She also observed that in today's electronic environment, "efficiency" is likely achieved mere moments after opening. (A1850). Underwriters' *own experts* emphasized that stock prices reacted to new information to offer alternative explanations for their underperformance. (A2261). These are exactly the factors that were properly relied upon by the district court in *Xcelera.com*., 2005 U.S. App. LEXIS 27174, at *23. And, as in *Xcelera.com*, *id.* at *33-36, these stocks indisputably had multiple market makers (although, as co-conspirators, the market makers were not performing their normal functions).

Contrary to Underwriters' contention, the *Cammer* test does not require that all factors be present. *See id.* at *41. Additionally, underwriters have cited no case in which any court has held *at class certification* that a market with the characteristics identified by Judge Scheindlin was "inefficient."[29]

Underwriters, observing that an IPO's first 25 days are a "quiet" period, fault the District Court for failing to reach a "finding" as to the exact moment that the market for each issue became efficient. First, the "quiet period" only applies to

[29] Nor does it matter, in light of the overwhelming evidence of efficiency, whether the issuers were eligible to file S-3 registration statements. *Xcelera.com*, 2005 U.S. App. LEXIS 27174, at *36 n.15.

Underwriters' *affiliated* analysts, and not analysts unaffiliated with the offering. 17 C.F.R. §230.174(d). Other analysts – such as those affiliated with underwriter/market makers who had not participated in that offering – are not restricted. Even without analyst coverage, *media* coverage continued. (A3862).

Underwriters concentrate their efficiency objections on the earliest parts of the class periods, ignoring that the periods extend for months or years, and Sycamore and iXL each had secondary offerings. (A1655, A1697). Underwriters have cited no case involving aftermarket trading where certification was denied due to an overlong class period.[30] Several of Underwriters' citations stand for the proposition that the fraud-on-the-market doctrine does not extend to securities obtained *at an offering price*, and thus have no application to aftermarket purchasers.[31] *E.g.*, *Berwecky v. Bear, Stearns & Co.*, 197 F.R.D. 65, 68 n.5 (S.D.N.Y. 2000); *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990). Others, such as *Unger*, recognize that some markets may be so small or thinly traded that efficiency is called into doubt, but observe that "[i]n many cases,

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[30] This Court has approved certification of a longer period when there was doubt as to whether the earliest portion was properly included in the class. *See Sirota v. Solitron Devices*, 673 F.2d 566, 572 (2d Cir. 1982).

[31] Persons who obtain stock in an offering may still benefit from the rule of *Affiliated Ute*. *See Castellano*, 257 F.3d at 186.

where heavily-traded or well known stocks are the target of suits, market efficiency will not even be an issue. 401 F.3d at 322.

Underwriters fault the District Court for merely "reciting factors" pertaining to market efficiency without making "findings." (Und. 83). But in *Bell* and *Unger*, there were no proper findings as to the *existence* of the factors. *See Unger*, 401 F.3d at 324; *Bell*, 422 F.3d at 314-15. Here, the District Court did "find" that factors such as heavy trading and high publicity existed.

Further, Underwriters err in seeking a perfect "moment" of efficiency, divorced from any assessment of what efficiency represents. "Efficiency" permits a presumption that material statements and omissions have affected stock prices *and* a presumption that investors rely upon stock prices to reflect available information. *PolyMedica*, 2005 U.S. App. LEXIS 27173, at *19-20. For Plaintiffs' manipulation claims, the District Court employed the latter presumption, but not the former. Therefore, for manipulation claims, the only relevance of the efficiency inquiry is whether the investors justifiably relied upon stock prices.

Here, from the moment the stocks opened, their markets were characterized by heavy trading, NASDAQ listing, purportedly high-quality underwriting, multiple market makers, and media coverage – exactly the factors upon which

investors *should* rely.[32] *Cf. Basic*, 485 U.S. at 246-47 ("[I]t is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?"). Moreover, given the highly regulated and thorough vetting process typically involved in taking companies public, investors were justified in relying on the opening price for what it was: a representation of market makers' assessment of legitimate demand. If nothing else, the high degree of regulation of an IPO entitled investors to believe that this opening price was something other than a rigged production staged to fool average investors. *Cf. Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975) (market purchaser supposes that "market price is validly set"); *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1479 (N.D. Cal. 1992) ("plaintiffs should only be required to prove that, absent the alleged fraud, the market price would be unbiased…").

Any other rule would *impede* companies' ability to bring new stocks public. Plainly, average investors *do* rely on market makers' determinations of a stock's worth when purchasing new issues; if these investors are left without the protection of the securities laws *for the first 25 days after an offering*, as Underwriters suggest, they will be hesitant to purchase any new security; or, at minimum, will

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[32] Investors cannot be expected to employ the *Cammer* factors to determine whether it is "safe" to trade. And here, hallmarks of efficiency – such as the presence of multiple market makers – contributed to the fraud because of market makers' collusion.

not do so without first reading a lengthy prospectus and conducting their own investigation. This would undermine the goals of the 1934 Act by impairing market liquidity and raise transaction costs. *Cf. Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33, 40 (1st Cir. 1985) (1934 Act intended to "restor[e] investor's confidence in financial markets" and "reduc[e] transaction costs associated with a caveat-investor rule"); Berle, *supra*, at 266 (function of markets is to supply liquidity).

Additionally, even if the markets were not perfectly efficient in the early moments of trading, the twin presumptions of *Basic* are appropriate with respect to the Prospectus. It is appropriate to presume that information in such documents are immediately incorporated into stock prices, for registration statements are filed long before the stock opens. Indeed, Congress expected that for new stocks, early prices would reflect only the Prospectus's contents, and that gradually (absent any manipulation) stocks would reflect newer information. Douglas & Bates, *supra*, at 176.[33] Thus, investors would have been justified in expecting that even if early market prices did not reflect *all* available information, they at least reflected the offering's fundamental document.

[33] As Douglas & Bates explain, the 1933 Act recognizes this principle with a time-limitation for §11 claims (which are not at issue in this appeal), but allows recovery after the time limit upon proof of reliance, even if the plaintiff did not read the registration statement. 15 U.S.C. §77k(a).

Underwriters offer the surprising suggestion that no securities class actions for time periods between 1997 and 2000 may lie because of the existence of a "bubble" market. (Und. 83-85). The District Court hardly abused its discretion in declining to so hold. Further, an efficient market requires that *information* be absorbed rapidly; it does not require that information be absorbed *accurately*. *See Xcelera.com*, 2005 U.S. App. LEXIS 27174, at *13-19.[34] And because Plaintiffs allege that the "irrational exuberance" – to the extent it manifested in explosively high prices for new issues – *was itself* the product of Underwriters' own market manipulation scheme, Underwriters run afoul of the "chutzpah doctrine." *United States v. Reese*, 993 F.2d 254, 257 (D.C. Cir. 1993).

2. Knowledge of the Truth

a. Truth-on-the-Market

Underwriters contend that news of the scheme was so widespread as to permeate stocks' prices and offset the fraud's inflationary effect. (Und. 65-67). *Basic* itself suggested this theory as a rebuttal to the presumption that false statements affect stock prices:

[34] Relying on *Zlotnick v. TIE Commc'ns.*, 836 F.2d 818 (3d Cir. 1988), Underwriters argue that "day-traders" and short-sellers do not rely on market price. This argument, which would make certification of securities class actions impossible, has been routinely rejected. (SPA112). These traders rely on market prices to reflect available *information*, and market assessment of the value of that information, even if they do not personally share that valuation. (A3159).

> [i]f petitioners could show that the "market makers" were privy to the truth …, and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone.

485 U.S. at 248 (emphasis added). This defense is known as the "truth-on-the-market" corollary to the fraud-on-the-market doctrine. *See Ganino*, 228 F.3d at 167; *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1115 (9th Cir. 1989).

A "truth-on-the-market" defense does not depend on the actual knowledge of investors; instead, it argues that the stock price was never artificially inflated in the first place. Therefore, "truth-on-the-market" operates *class-wide*. Even if Underwriters are correct that market participants were aware of the fraud and priced stocks accordingly, this would not present individual questions any more than fraud-on-the-market presents individual questions. The ultimate inquiry still would be whether stock prices were inflated.

Similar issues arise in cases where defendants argue that a fraud became "known" to the market – thus deflating the stock price – prior to the class period end date chosen by the plaintiffs. *E.g.*, *Sirota*, 673 F.2d at 572. Courts extend the class period if there are genuine questions raised as to whether truthful information has eliminated inflation. *See In re Oxford Health Plans, Inc. Sec. Litig.*, 191 F.R.D. 369, 378 (S.D.N.Y. 2000); *Nathan Gordon Trust v. Northgate Exploration*, 148 F.R.D. 105, 108 (S.D.N.Y. 1993). These courts do not suggest that the

question raises *individual* issues, and Underwriters have cited no case holding that a "truth-on-the-market" argument defeats certification.

Although *Basic* emphasized that "truth-on-the-market" may be successful when market makers are aware of the fraud – and certainly, Plaintiffs have alleged that market makers were so aware – the Court was envisioning that independent market makers use their knowledge of the truth to correct for fraudulent information. *See Basic*, 485 U.S. at 248. Here, Plaintiffs allege the opposite. Thus, market makers' awareness would not have resulted in a correction of issuers' stock prices.

Even if this Court were to address the merits of Underwriters' "truth-on-the-market" defense, Underwriters cannot defeat class certification. Because "the laws of economics have not yet achieved the status of the law of gravity," it remains a factual question whether the market has "fully correct[ed] for prior misleading information once a necessary [corrective] disclosure has been made." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 270-71 (2d Cir. 1993); *Ganino*, 228 F.3d at 167. If Underwriters believe they have enough evidence to demonstrate that widespread knowledge of fraudulent practices sufficiently offset the inflationary effects of the fraud, they may seek summary judgment.

b. Actual Knowledge

Though Underwriters have not identified a single investor (other than allocants alleged in the Complaint[35]) who claims to have heard about the scheme, they insist that the scheme was such common knowledge that questions are raised whether individual class members *actually knew* of the fraud and thus did not "rely" upon market prices. (Und. 65-67). The District Court did not abuse its discretion in rejecting this argument.

Open market purchasers are entitled to a presumption that they relied upon market price. *See Basic*, 485 U.S. at 245-46; *In re Ames Dep't Stores*, 991 F.2d 953, 967 (2d Cir. 1993). This presumption even applies outside the class action context. *See Black*, 418 F.3d 203.

Underwriters contend that even if reliance is presumed, their right to *rebut* creates individualized questions that overwhelm common questions. The District Court properly concluded that there are significant *class-wide* issues whether the publicity cited by Underwriters was sufficient to inform investors of the scheme. (SPA115-17). Though the District Court acknowledged that, *if* particular news reports were sufficient to place investors on notice, individual questions might arise as to whether any investor had actually seen them, the District Court

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[35] The propriety of including some allocants in the classes is discussed below at Part IV.

ultimately concluded that such issues were not so significant as to predominate. (SPA117). Though Underwriters contend that this holding constituted an abuse of discretion, they have not cited a single fraud-on-the-market case holding that individual questions of class members' "actual" reliance on market price predominated over common questions. This argument was specifically rejected in *Blackie*, 524 F.2d at 906, and this Circuit has held that individualized defenses do not automatically defeat certification. *See VisaCheck*, 280 F.3d at 138; *accord Waste Mgmt. Holdings v. Mowbray*, 208 F.3d 288, 296 (1st Cir. 2000); *Thiessen v. GE Capital Corp.*, 267 F.3d 1095, 1107 (10th Cir. 2001).

Even outside the fraud-on-the-market context, defendants' right to rebut a demonstration of reliance will not defeat class certification. *See Green*, 406 F.2d 291; *Eisenberg v. Gagnon*, 766 F.2d 770, 787 (3d Cir. 1985); *Kennedy v. Tallant*, 710 F.2d 711, 717-18 (11th Cir. 1983); *Klay v. Humana*, 382 F.3d 1241 (11th Cir. 2004). And in *Newton* – which was not a fraud-on-the-market action, but which did involve "impersonal" trades on the NASDAQ – the court explained that "[w]hile it seems apparent that some class members likely knew of defendants' practice, this knowledge does not necessarily invalidate the presumption [of reliance]." 259 F.3d at 176.

The closest that Underwriters are able to come to finding precedential support for their novel argument is *Zimmerman v. Bell*, 800 F.2d 386 (4th Cir.

1986), where extensive media disclosure of the alleged fraud was held to preclude certification. *Zimmerman* was pre-*Basic* and was not a fraud-on-the-market case. Instead, it involved reliance on a false proxy statement, rather than "indirect" reliance on market price, making specific knowledge of corporate facts more relevant. Moreover, as the District Court observed (SPA116 n.342), the fraud in *Zimmerman* had been *explicitly* disclosed, which is not the situation here (discussed further below). *See Zimmerman*, 800 F.2d at 390. Plus, in *Zimmerman*, the district court documented additional deficiencies in the proposed class, and these cumulative burdens led to the district court's determination that individual issues predominated. *See id*. In light of this multiplicity of problems, the Fourth Circuit merely held that the district court had not abused its discretion in *refusing* to certify. *See id*. Nothing in *Zimmerman* supports the proposition that certification in the face of media coverage constitutes an abuse of discretion.[36]

Courts also frequently reject the conceptually similar argument that a fraudulent scheme was well-known enough so as to raise potential statute of limitations defenses against individual class members. *See In re Linerboard*

[36] Nor can Underwriters find solace in the language of *Basic*. As explained above, the portion of the opinion quoted in Underwriters' brief merely discussed the "truth on the market" scenario. Separately, the *Basic* Court acknowledged that defendants in securities actions would be free to try to prove that any individual class member might have been aware of the fraud, *see Basic*, 485 U.S. at 249, but nowhere did it suggest that class certification might be defeated by that possibility.

Antitrust Litig., 305 F.3d 145 (3d Cir. 2002); *In re NASDAQ Market-Makers Antitrust Litig.*, 169 F.R.D. 493 (S.D.N.Y. 1996); *Mowbray*, 208 F.3d at 296-97. These courts hold that in most cases, common questions regarding concealment of the fraud will predominate over individualized issues of knowledge.

Finally, even if, theoretically, there might arise a case where the fraud was so widespread as to raise issues of reliance on stock price for each class member, the cases here are poor choices to so hold. The class representatives all denied being aware of the fraud. Though Underwriters have cited several articles published during the class periods, none mentioned the six cases at issue.[37] (SPA115 n.339). One article observed that there would be no way for an investor to tell an unrigged IPO from a rigged one. (A2181). The articles also contained Underwriters' categorical *denial* of the fraud. (SPA115 n.339; A3047-48; A3070).[38] Several articles attributed extraordinary stock prices to investor demand rather than to fraud. (A3057; A3146).

[37] Underwriters' statute of limitations argument is nearly identical to their reliance argument, and the District Court rejected it on the same grounds (SPA115-116 n.342). Inquiry notice cannot be triggered by media reports that either pre-date an offering, or that do not mention the specific company at issue. *Lentell*, 396 F.3d at 171. It would be ironic indeed if the same argument rejected in the context of inquiry notice were to succeed when dubbed one of "reliance."

[38] Given Underwriters' public denials of wrongdoing, and their failure to identify even one news report alleging fraud in connection with the focus cases, it cannot

Nor are these cases analogous to situations involving oral frauds. In those scenarios, there could be no class-wide proof that each class member received the same false communication in the first place. *E.g.*, *Moore*, 306 F.3d 1247; *Johnston*, 265 F.3d 178; *Sprague v. GMC*, 133 F.3d 388 (6th Cir. 1998). And although Underwriters are correct that in *Broussard v. Meineke Discount Muffler Shops*, 155 F.3d 331 (4th Cir. 1998), individualized issues were held to predominate in part because class members may have had access to truthful information, in that case: (1) the affirmative burden of proving lack of access to truthful information was put on the plaintiffs; (2) the court documented an overwhelming number of additional problems with the class; and (3) defendants themselves had disclosed the truth to class members, with whom they had an ongoing contractual relationship.[39] *See id.* at 341-42.

By contrast, in these cases, the fraudulent acts are uniform class-wide, and reliance is presumed. Underwriters have not offered any evidence that *any* investor – other than some allocants, discussed separately below in Part IV, *infra* –

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cont'd.
be said that class members did not "justifiably" rely on market price. *See Starr*, 412 F.3d at 109-10; *Brown v. E.F. Hutton Group*, 991 F.2d 1020 (2d Cir. 1993).

[39] Underwriters incorrectly cite *Brown* as holding that individual issues predominated when alternative sources of information were available. (Und. 53). In fact, *Brown* was decided on *summary judgment* because the plaintiffs could not recover due to their own recklessness in failing to discover the truth. *Brown* thus underscores the propriety of addressing such arguments on a class-wide basis.

was informed of the fraud through "oral" communications or any other means. Underwriters have cited no case where the entirely speculative possibility that some class members may have been orally informed of the truth defeated certification.[40]

D. Loss Causation Can Be Established Class-Wide

The District Court concluded that loss causation could be established class-wide, and Underwriters identify no evidence that the District Court failed to consider. For that reason, Underwriters' challenge should be rejected.

Loss causation requires that the plaintiff demonstrate that injuries were proximately caused by the fraud. *See Dura Pharm. v. Broudo*, 125 S. Ct. 1627, 1633 (2005). This occurs when "the risk that caused the loss was within the zone of risk concealed" by the fraud. *Lentell*, 396 F.3d at 173. Plaintiffs only must establish that some portion of their economic loss was caused by the fraud, *see Emergent Capital Inv. Mgmt. v. Stonepath Group*, 343 F.3d 189 (2d Cir. 2003);

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[40] Even if many people were informed of the scheme, the court would have options for structuring trial rather than denying certification. *See Robinson*, 267 F.3d at 167 (encouraging district courts to "'take full advantage'" of flexibilities accorded under the federal rules to partially certify class actions to achieve "judicial efficiencies").

precise damages calculations usually are reserved for later phases of litigation, *VisaCheck*, 280 F.3d at 139.[41]

Plaintiffs allege a scheme designed to exploit investors' reliance on informational "proxies" by forcing the stocks to mimic the behavior of a strong, promising issue. The District Court explained:

> Once the manipulation ceases … the information available to the market is the same as before, and the stock price gradually returns to its true value. For example, suppose that a bank manipulates the market for a stock by engaging in 'wash sales'… Once the wash sales cease, ordinary trading resumes. The spectre of wash sales may continue to affect the stock price for some time as investors recall the recent increased activity and observe the higher price; over time, however, the security will fall back to its true investment value.

In re IPO Sec. Litig., 297 F. Supp. 2d 668, 674 (S.D.N.Y. 2003). Disclosure of the "truth" does not come from a specific revelation but from the cessation of manipulative activity, which allows the true facts about the issuer to exert their natural pull on price. Thus, the "risk" concealed by the fraud is that the market price and demand are unusually poor predictors of the company's underlying potential.[42]

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[41] Certification of a securities action is proper even when the degree to which the stock was artificially inflated varies throughout the period. *See In re Honeywell Int'l Inc. Sec. Litig.*, 211 F.R.D. 255, 262 (D.N.J. 2002).

[42] Similarly, the omissions made it appear as though the companies were stronger than they were. Investors did not know that Underwriters had ceased choosing new companies based on business prospects, and did not know of Underwriters conflicting incentives when making allocations.

The District Court found Professor Fischel's hypothesis plausible: if stock prices were inflated, their subsequent price declines would, over time, be relatively sharp and steep as they corrected for false information. Thus, Professor Fischel proposed to measure the stocks' performance in the aftermarket to show that "in the long run, the focus stocks consistently declined further in price than comparable market benchmarks, which presumably reflected the same market-wide variables." (SPA126). Professor Fischel "proposes that the rate of dissipation can be shown using either the Comparable Index Approach or the 'Event Study Approach,' both of which compare the observed fluctuations in a security's price to the expected returns if that stock had not been manipulated." (SPA124 n.366). He demonstrated that the six focus cases underperformed the benchmarks even after the class period closed (SPA126-27), and the District Court concluded that "[a]s a result, Fischel has established a method by which a finder of fact could conclude both that stock prices were artificially inflated and that the inflation dissipated throughout the class period, continuing even after December 6, 2000." (SPA127). These are well-accepted methodolgies based on the approach that Professor Fischel originated in his oft-cited article, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. L. 1 (1982) (cited in *Basic*, 485 U.S. at 247).[43]

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[43] Professor Fischel has frequently served as a defense expert in securities fraud

Professor Fischel's hypothesis captures Congress's understanding when it enacted the 1934 Act. Congress recognized that once market manipulation ceases, stock prices "correct" to their natural levels. Prior to the Act's passage, Congress investigated so-called "market pools," which used various techniques to create artificial impressions of demand. After the manipulative activity ceased, prices fell. *See* Note, *Manipulation of the Stock Markets Under the Securities Laws*, 99 U. Pa. L. Rev. 651, 660-62 (1951). These price drops were exactly the sort of losses for which investors were expected to recover.

Certainly, it should make no difference that some of the price drops here occurred over time, rather than in one fell swoop.[44] The speed of the drop may contribute to a *factual* inference that it was caused by the cessation of manipulative activity, but there is no legal requirement that stocks "crash" to satisfy the element of loss causation. Losses may accumulate as the market gradually comes to understand the truth about an issuer. For example, in a case of accounting fraud, the company's true financial condition may gradually "leak" to the market and drag down the stock price. *See Dura*, 125 S. Ct. at 1631; *Parmalat*, 375 F. Supp. 2d at 307 ("That the true extent [of] the fraud was not revealed to the public until

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cont'd.
cases.

[44] Of course, some cases involve stocks with a clear crash pattern. (A2111; A2117).

… after the close of the Class Period - is immaterial where, as here, the risk allegedly concealed by defendants materialized during that time and arguably caused the decline in shareholder and bondholder value."); *Danis v. USN Commc'ns, Inc.*, 73 F. Supp. 2d 923, 943 (N.D. Ill. 1999); *In re TyCom Ltd. Sec. Litig.*, 2005 U.S. Dist. LEXIS 19154, at *42 (D.N.H. 2005).

Basic, too, endorsed the notion that false statements cannot exert their influence forever; stocks eventually will correct to their true levels: "We note there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. *Proof of that sort is a matter for trial*, throughout which the District Court retains the authority to amend the certification order as may be appropriate." 485 U.S. at 249 n.29 (emphasis added); *see also* Berle, *supra*, at 269 (inflationary effect of a single false statement likely to dissipate over time). Thus, the question of how long the inflation lasted is common to all classmembers and is for a jury to determine.

Significantly, the theory that the impact of fraud eventually will dissipate, causing a price decline, was endorsed by Underwriters' *own* experts. As discussed below, Underwriters' experts insisted that any upward pull from a laddered trade eventually would dissipate and the stock would correct to its true level. (Und. 93-

94). The only disagreement on this point was the *magnitude* and *duration* of such an effect.

Underwriters, relying on an article by Professor Fischel, contend that an efficient market cannot stay "fooled" for long, and thus stock prices should revert to their natural levels very quickly.[45] (Und. 93). But Professor Fischel's article (like Underwriters' experts) did not purport to examine a scheme of this nature, including the cooperation of esteemed market makers, several large traders, and directed by the lead underwriter.[46] Additionally, Plaintiffs have alleged that Underwriters used captive analysts to interfere with the normal market forces that would ordinarily restore stocks to their true values. Because analysts and other professionals are the method by which raw economic data is translated into market price, *see In re Res. Am. Sec. Litig.*, 202 F.R.D. 177, 190 (E.D. Pa. 2001), analysts here prevented truthful information from bringing stock prices down.

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[45] Contradicting their argument, one of Underwriters' experts admitted that some information will exert influence over price for prolonged periods, though he disagreed that trading activity was among this type. He did not consider whether an inflated opening price fell into this category. (A3730 n.10)

[46] Professor Fischel's article also hypothesized that laddered trades rarely would have sufficient impact to permit the trader to recoup expenses and make a profit, a fact which Underwriters' experts seized upon (*e.g.*, A3834). As Professor Fischel explained, in this case, cooperating allocants earned profits not from the laddered trades alone, but from the enormous difference between offer and opening prices. (A4283).

Underwriters contend that Professor Fischel's evidence of long-term underperformance of the six focus cases represents "correlation" rather than "causation." This is sophistry. Any observation of real-world phenomena involves the use of correlation to infer causation with a particular degree of certainty, as this Court recognized in *Akerman v. Oryx Communication*, 810 F.2d 336, 342 n.2 (2d Cir. 1987). An examination of the behavior of a securities market, for example, will use correlation and predictive hypotheses, because it is impossible (not to mention illegal) to use manipulative trading to "prove" causation. One basic college textbook explains that "causation" is established by three factors: the "cause" must precede the "effect"; the variables must be correlated; and the two variables cannot be "explained away" as being due to a third influence on both. *See* Earl Babbie, *The Practice of Social Research* 69-70 (7th ed. 1995). This is exactly what Professor Fischel's evidence shows. Of course, the relative *strength* of the evidence will depend on how well a particular theory predicts observed behavior, but the *nature* of the evidence remains correlative. As further discovery is conducted, more extensive expert analyses will produce reports with further details and more refined market comparisons. But there is nothing inherently wrong with using correlation to demonstrate causation even at trial. *Cf. Stroheim & Romann, Inc. v. Allianz Ins. Co*., 2003 U.S. Dist. LEXIS 14305, at *9-10

(S.D.N.Y. 2003) (expert opinion demonstrating that effects were "consistent with" a hypothesis satisfies *Daubert*).

Underwriters fault Professor Fischel for failing to rule out all alternative explanations for the particularly steep declines of the stocks of the focus cases. But Plaintiffs are not required to *prove* loss causation at this time –they merely must provide a *method* for doing so. *See Nichols*, 2003 U.S. Dist. LEXIS 2049; *In re Sumitomo Copper Litig.*, 182 F.R.D. 85, 91 (S.D.N.Y. 1998). This is why courts do not require preliminary expert reports at class certification to rule out alternative explanations. Even at *trial* the expert "need not eliminate all other possible causes of the injury. … 'The fact that several possible causes might remain 'uneliminated' . . . only goes to the accuracy of the conclusion, not to the soundness of the methodology.'" *Jahn v. Equine Servs., PSC*, 233 F.3d 382, 390 (6th Cir. 2000) (citing *Ambrosini v. Labarraque*, 101 F.3d 129, 140 (D.C. Cir. 1996)); *see Thomas*, 209 F.R.D. 159; *In re Mercedes-Benz Antitrust Litig.*, 213 F.R.D. 180 (D.N.J. 2003); *see also Caridad*, 191 F.3d at 292 (reserving for fact-finder defendant's critique that expert "failed to take into account the fact that various Metro-North positions have materially different rates of discipline and promotion"); *Emergent*, 343 F.3d at 197 (whether loss was "caused by an intervening event, like a general fall in the price of Internet stocks" is a "matter of proof at trial").

Moreover, Professor Fischel explained that Underwriters misunderstand the loss causation inquiry. "Confounding" factors identified by Underwriters – such as poor *business* performances of the companies – are not confounding factors at all. (CA821 n.7). The fraud made the companies appear more valuable than they were by acting directly on "proxies" that investors typically rely upon to assess value – stock prices, trading patterns, underwriter endorsement. Gradual revelations that the companies were *not* as valuable represented the process by which truthful information displaced fraudulent information. In other words, these represent incremental disclosures of the fraud. *Cf. In re Daou Sys.*, 411 F.3d 1006, 1026 (9th Cir. 2005) (loss causation existed when "the price of Daou's stock fell precipitously after defendants began to reveal figures showing the company's true financial condition"); *Emergent*, 343 F.3d at 198 (loss causation exists if defendants "concealed [facts that] reflected [an] executive's inability to manage debt and maintain adequate liquidity," and plaintiffs' investment "became worthless because of the company's liquidity crisis"). Indeed, even if the companies suffered due to a general market downturn, but suffered *more* than they would have had they been as strong as their (manipulated) stock prices made them seem, investors would be entitled to recover for that portion of their losses

attributable to the fraud. *See* Restatement (Second) of Torts §548A cmt.b (cited with approval in *Dura*, 125 S. Ct. at 1632).[47]

Finally, Underwriters offer an alternative factual analysis, contending that each alleged tie-in trade was associated with only a few moments' price movement before they reverted to earlier levels. Thus, inflation lasted no more than minutes, and loss causation for each class member depends on a complicated analysis of the market at the time of his purchase and sale. Underwriters' alternative theory "challenge[s] manageability and predominance …; and ... provide[s] a method that assumes an almost instantaneous rate of dissipation that, if adopted, would exclude most class members from recovery." (SPA128 n.375). With this characterization of the effects of the tie-ins in hand, Underwriters rely on such cases as *Newton*, 259 F.3d 154, for the unremarkable proposition that when the fact of injury can only be determined case-by-case, class certification is inappropriate. (Und. 96-97).

Underwriters' argument proceeds from the false legal premise that each tie-in trade represents an incidence of "misconduct" that must, individually, be traced to artificial inflation and loss. (Und. 92). In fact, the securities laws forbade

[47] Recent scholarship has validated Professor Fischel's approach. Researchers have found that tie-in agreements resulted in first-day returns seven times higher than IPOs without tie-in agreements, and long-run underperformance for up to three years after the IPO, "[e]ven after controlling for hot market conditions and issuer characteristics…." Aggarwal et al, *supra*, Abstract.

Underwriters' inducement of aftermarket orders, whether or not those orders were even executed. *See* SLB 10. The impact of that conduct must be assessed.

Further, as Professor Fischel explained, Underwriters' experts carefully selected the wrong unit of measurement. Patterns in stock prices must be examined on a macro level, not trade-by-trade. (A4280).[48] Additionally, Underwriters' experts failed to consider: the effects of the pre-opening bid session (CA815 n.4) (except, in iXL and Sycamore, to admit that the bids substantially influenced later market price (*e.g.*, A3778)); that laddering created the appearance of demand and induced other investors to buy (A4279);[49] and that the lead underwriter, in its role as market maker, was able to set prices in anticipation of tie-in trading demand in the aftermarket, even if orders were not executed. (A4279 n.6).[50]

Thus, although Underwriters will have an opportunity to present their "trade by trade" analysis for a jury determination, the District Court concluded that "[t]he

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48 Underwriters are thus incorrect when they claim that Professor Fischel never disputed that a trade-by-trade analysis was necessary. (Und. 94).

49 The capacity of manipulative conduct to tempt other traders into the market was precisely the harm identified by Congress when it passed the 1934 Act. *See* H.R. Rep. No. 73-1383, pt. 2, at 11 (1934 Act bans "the deliberate introduction of a mob psychology into the speculative markets by the fanfare of organized manipulation….").

50 One of Underwriters' experts detected a prolonged impact from a laddered trade, but – without any basis – rejected the evidence as "illogical." (A2986 n.14).

class certification decision is not the appropriate place to choose the winning theory of loss causation." (SPA127-28 n.375). The District Court did not abuse its discretion in rejecting Underwriters' views, whose experts are at odds with the accumulated experience of Congress and the SEC, not to mention Underwriters' own behavior suggesting that Underwriters themselves believed that tie-in trades had inflationary effects.[51] *Cf. West*, 282 F.3d at 939 (expert examined skeptically when there existed no theoretical mechanism to explain the effect he purported to observe).

Finally, Underwriters claim that there is no "sensible" end date for the class periods. Professor Fischel explained, and the District Court accepted, that his analysis found artificial inflation remained in the stock even past the December 6, 2000 class period end dates. (SPA126-27). Plaintiffs do not dispute that this date was chosen for legal and practical reasons, rather than to reflect the point at which all inflation had been removed from each stock. Plaintiffs were under no duty to

[51] Underwriters also attack Professor Fischel's report for failing to devise a "formula" to measure loss causation, (Und. 99), but the argument proceeds from the premise that each individual tie-in trade must be considered in a vacuum. In fact, the District Court concluded that Professor Fischel had proposed two workable methodologies (SPA124 n.366), and the choice between plausible methodologies need not be made at the certification stage. *See In re NASDAQ*, 169 F.R.D. 493; *DeLoach v. Philip Morris Cos.*, 206 F.R.D. 551, 559 (M.D.N.C. 2002) (distinguishing *Windham v. Am. Brands*, 565 F.2d 59 (4th Cir. 1977), as a case in which "there was no evidence that workable formulas existed").

extend the class periods *further*; their only obligation is to show that certification is appropriate for investors who purchased *during* the period.

IV. THE DISTRICT COURT DEFINED AN ASCERTAINABLE CLASS FOR WHICH COMMON ISSUES PREDOMINATE

Cognizant that some allocants necessarily would possess knowledge of the scheme, the District Court crafted the class definition to exclude allocants who, based on objective criteria, displayed hallmarks of knowing participation: those who bought in the aftermarket of the subject IPO, paid undisclosed compensation, and profited from transactions in the IPO. Such an allocant is excluded from classes for any later offerings. (SPA83-94).

Underwriters argue that "individual mini-trials would be required to identify the investors with knowledge of the alleged fraudulent scheme." (Und. 49). To the extent Underwriters are referring to investors who *did not* receive allocations – and who, Underwriters speculate, may have *heard* of these arrangements – their arguments are addressed *supra* Part III.C.2.b. To the extent Underwriters refer to allocants, these issues are not significant enough to invalidate the District Court's decision.[52]

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[52] To the extent Underwriters' arguments raise issues of manageability, these are matters that are "peculiarly within [the trial court's] discretion" and are not appropriate grounds for reversing a certification order. *VisaCheck*, 280 F.3d at 141. Plaintiffs know of no case in which this Court has overturned a district court's class certification decision on manageability grounds.

A. Ascertainability

Classes only must be ascertainable before judgment. *Gary Plastic Packaging*, 903 F.2d at 180. Here, the class definition factors are objectively determinable, and the documentary evidence necessary to apply the definition is retained by broker-dealers. *See* 15 U.S.C. §78q; 17 C.F.R. 240.17a-1 *et seq*. Investors who appear to have knowingly participated are excluded, just as corporate insiders are typically excluded from other securities class actions. In addition, because an allocant who meets the exclusion criteria is excluded from all classes for later IPOs, determining class membership becomes *simpler* chronologically. Though Underwriters contend that allocants' *knowledge* must be determined, nothing in the class *definition* requires so ephemeral an inquiry.

B. Predominance

Rule 23(b)(3)'s requirement that common questions predominate over individual questions "tests whether proposed classes are sufficiently cohesive to warrant adjudication by representation.'" *Amchem Prods. v. Windsor*, 521 U.S. 591, 623 (1997). "[W]hen one or more of the central issues in the action are common to the class and can be said to predominate, the action may be considered proper under Rule 23(b)(3) even though other important matters will have to be tried separately." 7AA Wright, Miller & Kane, Federal Practice & Procedure §1778 at 123 (3d ed. 2005). "[T]hat a defense 'may arise and may affect different

class members differently does not compel a finding that individual issues predominate over common ones.'" *VisaCheck*, 280 F.3d at 138 (citation omitted).

The Underwriters contend that individualized issues predominate because of the need to determine the knowledge of each allocant. They begin with the false premise that in a fraud-on-the-market case, a plaintiff must prove that "he or she [traded] in ignorance of the fact that the price was affected by the alleged manipulation" or prove that "[truthful] information was not otherwise available." (Und. 51). To the contrary, reliance is *presumed* class-wide. *Basic*, 485 U.S. at 249; *Black*, 418 F.3d at 209. Thus, the only question is whether Underwriters' right of *rebuttal* causes individual issues to predominate.[53]

The District Court recognized that some allocants who remained in the class would potentially be susceptible to the Underwriters' rebuttal of the presumption of reliance, but in its discretion, concluded that Rule 23 is served best with a slightly overinclusive definition. (SPA96). *See Fridrich v. Bradford*, 542 F.2d 307, 326 n.11 (6th Cir. 1976)("to accomplish the deterrent and compensatory

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[53] Underwriters ignore that this is a coordination of 310 separate class actions. When Underwriters complain of "thousands" of potential persons with knowledge, identified in the interrogatory responses, they are not referring to one class action, or even the six focus cases, they are aggregating 310 separate cases. The District Court properly refused to allow the administrative coordination of the cases to prejudice the classes.

purposes of 10b-5, it is better to be overinclusive in the definition of the plaintiff class than underinclusive"); *Blackie*, 524 F.2d at 906 (same).

Because the District Court's definition excludes those investors most likely to know of the scheme, remaining are those investors who may have been forced into tie-in agreements or paid undisclosed compensation, but who do not meet the requirements for exclusion. Underwriters argue that the inclusion of these individuals was error because these persons were unlikely to have traded in ignorance of the market manipulation.[54] But many allocants may have been the Underwriters' "unwitting tools, each performing certain acts that only when aggregated constituted a cohesive scheme to defraud investors." (SPA93). Indeed, Underwriters themselves argue that any single laddered trade is unlikely to have an effect on market price (Und. 92-93); without knowledge of the full scheme, an allocant making a single laddered trade would be unlikely to know of the total distortions in market price.

Contrary to Underwriters' claims, Plaintiffs do not allege that "thousands of institutional investors, plus market makers and market watchers" knew about the scheme, or that information about the alleged scheme was communicated to *every*

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[54] The District Court's definition excludes allocants who paid *any* form of undisclosed compensation, not merely those who paid excessive commissions. (SPA98). Thus, the universe of allocants excluded is broader than the Underwriters suggest.

allocant. (Und. 49-50, 86). Rather, Plaintiffs allege that *certain* institutional investors stated that receipt of allocations was conditioned on payment of undisclosed compensation and commitments to order in the aftermarket. (SPA88).

Nor did Plaintiffs' discovery responses provide the identity of allocants with knowledge of the entire scheme. The interrogatories to which Plaintiffs responded asked only for the identity of allocants who were induced to engage in tie-in agreements or pay undisclosed compensation. Nowhere have Plaintiffs asserted that the allocants knew that it was part of a scheme, or the extent or purpose of the activity. The District Court correctly concluded that the complaints "do not say that it was common knowledge that the price of the stock was artificially inflated…." (SPA89).[55]

Underwriters insist that even if some of the allocants who remain in the class did, in fact, trade in ignorance, individualized trials will be necessary to identify those who *did not* rely. Even if Underwriters are correct, this will not defeat predominance. The allocants who remain are readily identifiable by Underwriters' own records, the number of allocants per issue is not more than a few hundred

[55] Underwriters assert that any allocant who learned of the scheme in connection with the 600 additional offerings that are the subject of the antitrust action should be excluded from the classes. (Und. 50). The District Court properly rejected this argument on the ground that Underwriters oppose discovery related to these offerings.

(compared to the literally *tens or hundreds of thousands* of other traders), many will not have been forced into tie-in arrangements or forced to pay undisclosed compensation (and Underwriters' own records will provide that data),[56] many will be excluded by the class definition, and many others will overlap across IPOs. It is absurd to imagine that the existence of such a tiny fraction of persons for whom individualized inquiry may be necessary could undermine predominance for classes of these sizes. Certainly, the District Court's judgment on this point cannot be viewed as an abuse of discretion given this Court's clear pronouncement that individual defenses do not automatically defeat predominance. *See VisaCheck*, 280 F.3d at 138.

Neither does the District Court's definition "exceed the limits of judicial inventiveness." (Und. 54). District judges have broad discretion over class definitions. *Boucher v. Syracuse Univ.*, 164 F.3d 113, 118 (2d Cir. 1999). "Inventiveness" has only rendered certifications invalid where judges entirely disregarded current law. *See Amchem*, 521 U.S. at 621; *Kern v. Siemens Corp.*,

[56] Institutional allocants, who were the most likely to have paid undisclosed compensation or enter tie-in agreements, are a much smaller number than total allocants. In the Underwriters' example, for the *Engage* IPO, only 540 of roughly 2400 allocants are institutions. Plaintiffs do not allege that retail allocants knew of the tie-in agreements or undisclosed compensation.

393 F.3d 120, 124-28 (2d Cir. 2004) (district court creates unauthorized "opt-in" class). Judge Scheindlin's order does not disregard Rule 23.

Finally, Underwriters wrongly assert that Judge Scheindlin violated the Rules Enabling Act, 28 U.S.C. §2072, because of a single footnote where she observed that "[o]ne of the interesting side effects of the class action form is that, in some cases, it effectively transfers the burden of proving individual facts from plaintiffs to defendants. . . ." (SPA96 n.300). This statement is true, in that class action defendants must choose whether to raise individual defenses. *See Basic*, 485 U.S. at 249. But these choices are a function of the *substantive law* governing proof in a securities action, not the class action procedure. Even if the actions had been brought individually, the *burdens* would remain the same – Plaintiffs still would be presumed to rely on market price and Underwriters would be required to rebut that presumption. *See Black*, 418 F.3d at 209; *Blackie*, 524 F.2d at 908 (fraud-on-the-market presumption does not implicate Rules Enabling Act).

V. CLASS ADJUDICATION IS SUPERIOR

Superiority exists where "a class action would achieve economies of time, effort, and expense, and promote … uniformity of decision as to persons similarly situated." Fed. R. Civ. P. 23 Adv. Comm. Notes, 28 U.S.C. App. at 697.

The prohibitive costs associated with securities fraud actions render individual lawsuits impossible for all "but the very largest individual investors."

(SPA146). Moreover, "class actions are generally appropriate when plaintiffs seek redress for violations of the securities laws." *In re Deutsche Telekom AG Sec. Litig.*, 229 F. Supp. 2d 277, 282 (S.D.N.Y. 2002). Here, the "very heart" of Plaintiffs' claims involves the conduct of several large financial institutions and traders– allegations that "would necessarily have to be re-proven by every plaintiff" if a class was not certified. *Klay*, 382 F.3d at 1257. Thus, any difficulties posed by class certification are trivial compared to the difficulties inherent in individual actions.

Underwriters suggest that Plaintiffs can seek redress from the SEC Fair Fund Act, but cite no case holding that Fair Fund Act compensation makes a class action inferior. *Cf. In re Baldwin-United Corp. Litig.*, 122 F.R.D. 424, 429 (S.D.N.Y. 1986) (potential for arbitration does not render class action inferior due to "[t]he fairness and completeness of class litigation"). In fact, the SEC has not created a disbursement fund related to any of its enforcement actions against the Underwriters. *See* http://www.sec.gov/divisions/enforce/claims.htm (visited Dec. 17, 2005). In any event, because Underwriters raise this argument for the first time on appeal, it should not be considered. *See Leyda v. AlliedSignal, Inc.*, 322 F.3d 199, 207 (2d Cir. 2003).

CONCLUSION

The District Court's decision should be affirmed. In the alternative, this Court should remand to allow the District Court to revisit the issue of class certification based upon any standards set by this Court.

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