THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 48 No. 12 June 17, 2015

SEC EXAMINATIONS OF PRIVATE FUND ADVISERS

With new personnel, technology, and types of examinations, the SEC has expanded its examination program in an effort to encompass the influx of advisers to private funds, newly required to register by the Dodd-Frank Act. The author describes these developments, some examination focus areas, and current enforcement activity. In conclusion, he cites several recent cases to underline the importance of candor in keeping rectifiable violations from becoming enforcement matters.

By Marc E. Elovitz *

This article discusses some of the recent developments in the U.S. Securities & Exchange Commission's examinations of advisers to private investment funds. The SEC's examination program has developed significantly since the addition of several thousand new SEC-registered investment advisers pursuant to the Dodd-Frank Act.[1] Historically, the SEC examined less than 10 percent of its investment adviser registrants each year;[2] but that number increased by 20% in 2014.[3] The SEC's Office of Compliance Inspections and Examinations ("OCIE") has developed new types of examinations and implemented new technologies to select advisers for examination and to aid the SEC staff in conducting examinations. OCIE has also hired personnel from the private sector and has been able to conduct more probing reviews of many private fund managers. The increasingly robust nature of SEC examinations combined with a greater willingness by the OCIE staff to refer cases to the SEC's Division of Enforcement has created an increased enforcement risk

[1] Pub. L. No. 111-203, § 403, 124 Stat. 1571 (2010). Title IV of Dodd-Frank, among other things, amended the Investment Advisers Act of 1940 (the "Advisers Act") to eliminate the "private adviser exemption." *Id.*

[2] *See, e.g.*, *Budget Hearing – Securities and Exchange Commission: Hearing Before the H. Comm. On Appropriations*, 113th Cong. (2013) (prepared testimony of Mary Jo White, Chair, SEC).

[3] Letter from Mary Jo White, Chair, SEC, to Rep. Jeb Hensarling, Chairman, H.R. Comm. on Fin. Services (Dec. 16, 2014), at 2.

footnote continued from previous column…

SEC Chair Mary Jo White also recently requested an evaluation of the relative merits of permitting third-party audits or compliance reviews of investment advisers to address the chronically low percentage of registered investment advisers OCIE examines each year. *Id.* at 1-2.

∗ *MARC E. ELOVITZ is a partner and the Chair of the Investment Management Regulatory & Compliance Group in Schulte Roth & Zabel LLP's New York office. His e-mail address is marc.elovitz@srz.com. Christopher S. Avellaneda, an associate at Schulte Roth & Zabel, assisted with the preparation of this article.*

IN THIS ISSUE

● ***SEC EXAMINATIONS OF PRIVATE FUND ADVISERS***

● ***DAMAGES AND PREDOMINANCE IN SECURITIES CLASS ACTIONS AFTER* COMCAST, *Page 149***

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. Copyright © 2015 by RSCR Publications LLC. ISSN: 0884-2426. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by *The Review of Securities & Commodities Regulation* from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions, or for the results obtained from the use of such information.

for private fund managers undergoing an SEC examination.[4]

TYPES OF EXAMINATIONS

Dodd-Frank added approximately 1,500 new private fund adviser registrants to the SEC's jurisdiction.[5] To address this influx of registrants, OCIE created the "presence exam" initiative [6] with the goal of covering a significant percentage of these advisers within two years. In fall 2014 this target was reached, with almost 400 presence examinations completed, split almost equally between hedge fund and private equity advisers.[7] The presence exams tend to be much briefer and more focused than other examinations. Many have lasted one week or less, and have covered just a handful of issues. Of course, when these examinations uncovered potential legal violations they have lasted longer, sometimes morphing into the type of lengthy and comprehensive examinations that many registered advisers have faced historically.[8]

Some of the key issues in the presence examinations for private equity managers have been the appropriateness of certain fees charged to the funds and the allocation of expenses. OCIE Director Andrew Bowden reported a non-compliance rate of more than 50% among private equity managers based on these initial examinations.[9] Questions about broker-dealer registration have also come up during investment adviser examinations, particularly in the context of private equity managers receiving transaction-based fees in connection with deals involving portfolio companies.[10] For hedge fund managers, some key issues raised during presence examinations have been: (1) marketing[11] (e.g., performance reporting, backtesting, portability of performance, and cherry-picking); (2) custody rule compliance[12] (e.g., not identifying all accounts that need

[4] As of 2013, one in 10 SEC examinations led to referral to the SEC's Enforcement Division. Yin Wilczek, *Only One in 10 SEC Exams Referred for Enforcement Action, Official Says*, BLOOMBERG BNA (Mar. 15, 2013). Recent experience indicates a higher percentage. http://corplawrc.bna.com/clrc/5435/split_display.adp?fedfid=29971980&vname=carenotallissues&wsn=509382000&searchid=24225452&doctypeid=4&type=date&mode=doc&split=0&scm=5435&pg=0.

[5] DIV. INV. MGMT., SEC, DODD-FRANK ACT CHANGES TO INVESTMENT ADVISER REGISTRATION REQUIREMENTS 2 (JAN. 2013), *available at* http://www.sec.gov/divisions/investment/imissues/df-iaregistration.pdf.

[6] Form Letter from Andrew Bowden, Deputy Dir., OCIE (Oct. 9, 2012), *available at* http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

[7] *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System: Hearing Before the S. Comm. On Banking, Hous., and Urban Affairs*, 113th Cong. (2014) (testimony of Mary Jo White, Chair, SEC).

[8] While the number of examinations conducted as part of the presence examination initiative is impressive, the impact on the industry remains to be seen. Because of the brevity of these

footnote continued from previous column…

exams, the message sent to new registrants may not be clear. For example, the limited nature of these examinations may give registrants unrealistic assumptions about what future examinations will entail and a false sense of comfort in the robustness of their compliance programs.

[9] Andrew Bowden, Director, OCIE, Spreading Sunshine in Private Equity, address before the Private Equity International Private Fund Compliance Forum (Mar. 6, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541735361#.VKoUlYrF8eY.

[10] *See, e.g.*, Lincolnshire Management, Inc., Adv. Act Rel. No. IA-3927 (2014). In the *Lincolnshire* case, the SEC specifically noted the use of so-called 'accelerated monitoring fees,' whereby Lincolnshire Management, Inc. ("LMI") entered into consulting agreements with each portfolio company owned by a fund advised by LMI.

[11] *See, e.g.*, OCIE, EXAMINATION PRIORITIES FOR 2014 5 (Jan. 9, 2014), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf [hereinafter EXAM PRIORITIES 2014]; Modern Portfolio Mgmt, Inc., G. Thomas Damasco II, and Brian F. Ohm, Adv. Act Rel. No. IA-3702 (2013).

[12] *See, e.g.*, OCIE, SIGNIFICANT DEFICIENCIES INVOLVING ADVISER CUSTODY AND SAFETY OF CLIENT ASSETS (Mar. 4, 2013), *available at* http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf.

to be audited under the custody rule; delayed or incorrect reporting); and (3) valuation[13] (e.g., disclosures compared to actual practices; changes to valuation methodologies).

In addition to presence examinations, advisers to private funds continue to undergo more routine examinations. These are typically conducted on a "risk" basis, meaning that OCIE staff has analyzed data regarding the manager and funds, and has chosen the manager for examination based on perceived risks. With the aid of sophisticated new technologies, OCIE is able to more carefully and objectively prioritize advisers for examination.

As a time-saving measure, examination staff have conducted certain preliminary reviews via telephone and correspondence. Indeed, some advisers to private funds have been examined with no on-site review by OCIE staff or with just a brief on-site meeting following a series of calls and correspondence. More commonly, an initial telephone call with examination staff will be used to gather additional information for the staff to consider in prioritizing firms for examination.

Examinations for "cause" have continued to constitute a significant component of reviews of hedge and private equity fund managers. Whether such examinations are instigated by a potential whistleblower or by the SEC's independent investigative efforts, these examinations are particularly sensitive because the examination staff may come in with an expectation of finding wrongdoing.

In February 2014, OCIE announced a special examination initiative for advisers "never before examined" despite having been registered for three or more years.[14] While private fund managers comprise some portion of the approximately 1,000 advisers in this category, this particular initiative is aimed primarily at advisers to clients other than private funds. OCIE has performed some of these examinations for "risk assessment" purposes and others as "focus reviews" of issues such as marketing, custody rule, compliance, and trade allocations.

Recent "sweep" examinations of private fund managers have studied cybersecurity and information security,[15] as well as the use of "liquid alternative"[16] strategies. The cybersecurity sweep was an information gathering exercise by OCIE, following the Commission's identification of information security as a threat to financial firms that must be addressed proactively.[17] Observations from the cybersecurity sweep are expected to be released to help educate firms about their risks and responsibilities. The liquid alternatives sweep was prompted by the increasing popularity of these registered fund products offering alternative strategies. The sweep looked at liquidity (which includes specific requirements under the Investment Company Act of 1940); leverage limits and controls (which alternative fund managers may not be experienced with); allocation of investments (which includes the potential conflict between allocating to a performance-fee paying account and an account with a management fee only); and governance (which is more prescriptive under the Company Act than under the Advisers Act).

Recidivism among registered investment advisers is a significant SEC concern. OCIE has formalized a longstanding practice of returning to advisers to review whether prior examination deficiencies have been corrected. These "Corrective Action Reviews"[18] have found that some firms do not satisfy requirements previously identified by the SEC staff. For example, a 2009 examination of Transamerica Financial Advisors revealed fee calculation issues that were still problematic when the exam staff came back in 2012.[19] Transamerica had taken significant steps to correct the miscalculations, including issuing a firm-wide compliance alert, modifying policies and procedures, and adding disclosures.[20] These remedial efforts were deemed insufficient by OCIE during the subsequent

[13] EXAM PRIORITIES 2014, *supra* note 11, at 5.

[14] Form Letter from Jane E. Jarcho, Nat. Assoc. Dir. IAIC Examinations, SEC (Feb. 20, 2014), *available at* http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf.

[15] OCIE CYBERSECURITY INITIATIVE (Apr. 15, 2015), *available at* http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf.

[16] Juliet Chung & Kirsten Grind, *SEC Launches Examination of Alternative Mutual Funds*, WALL ST. J. (Aug. 12, 2014), http://www.wsj.com/articles/sec-has-launched-examination-of-alternative-mutual-funds-1407874463.

[17] Cybersecurity Roundtable, Adv. Act Rel. No. IA-3799 (2014).

[18] OCIE, INFORMATION FOR ENTITIES SUBJECT TO EXAMINATION OR INSPECTION BY THE COMMISSION 4 (2014), *available at* http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.

[19] Transamerica Financial Advisors, Inc., Adv. Act Rel. No. IA-3808 (2014).

[20] *Id.* at 4.

examination.[21] These Corrective Action Reviews make it particularly important for registrants to address any open or disputed issues during an examination.

SEC examinations of private fund managers based outside of the U.S. are more likely to involve an on-site review than in the past. As of January 2013, there were approximately 314 private fund advisers registered with the SEC and based outside the U.S.[22] These examinations have typically been conducted by dedicated examination staff based in Washington, D.C., sometimes as "desk reviews" (via e-mail and phone) and occasionally sometimes on-site. Examination staff have more frequently been conducting on-site reviews in the U.K.[23] and Hong Kong. The amount of U.S. client and investor assets a non-U.S. manager advises may impact the likelihood of being examined.

NEW TECHNOLOGIES

Among the most significant hires the SEC has made in recent years are quantitative specialists who are developing sophisticated data analytic tools for the SEC, including for the examination staff. Within the Division of Economic and Risk Analysis, the Commission has created the Office of Risk Assessment, which systematically reviews data on registered investment advisers to prioritize advisers for examination.[24] The SEC's Quantitative Analytics Unit developed a new tool called MARS – Machine Analyzed Risk Scoring – to assist in this analysis.[25] Technologies such as this allow SEC examiners to tackle massive data sets and may add rigor to the selection of advisers for examination.

The SEC staff has also developed advanced technology for the purpose of reviewing advisers' investment activities. The NEAT – National Exam Analytics Tool – is a new system for identifying items that in previous years might have been the "needle in the haystack" an examiner very well might not uncover. OCIE examiners have the NEAT available to them prior to and during an examination. The tool allows analysis of trade data, including all of the securities traded by an investment adviser during the examination period.[26] Trading around news events can be identified by matching trade blotter entries with information pulled off of Bloomberg and other news sources. Allocations of favorable trades among certain client accounts can also be examined. For example, Chair White has stated that in a recent examination, the SEC staff used the NEAT to analyze, over a 36-hour period, 17 million transactions executed by an investment adviser.[27] This type of data can easily feed into SEC enforcement investigations. For example, the SEC's Aberrational Performance Inquiry has utilized this type of data, which has led to charges against several fund managers.[28]

EXAMINATION FOCUS AREAS

Many recent examinations of both private equity and hedge fund managers have focused on the allocation of expenses, both between manager and funds, and between funds. Common deficiencies related to expense allocations have been (1) failing to allocate "mixed-use" expenses to both the manager and the funds (e.g., expenses for travel involving meetings with prospective investors, as well as investment research meetings); (2) over-allocating expenses to one client where another client will not pay such expenses (e.g., a managed account client won't pay for "broken-deal" expenses and the fund client therefore pays the full amount); and (3) charging expenses to the fund that are not clearly disclosed to investors (e.g., certain consultant expenses). Examination staff have been aggressively drilling down on expense allocations even where the amounts are de minimis. In addition, many examiners have requested that the manager itself conduct a thorough review of all expenses charged to clients. In anticipation of such scrutiny, many managers have conducted those reviews

[21] For example, the SEC alleged that Transamerica's policies were not "reasonably designed" to comply with the Advisers Act because different compliance manual provisions regarding fee calculations were internally inconsistent. *Id.* at 5.

[22] DIV. INV. MGMT., *supra* note 5, at 2-3.

[23] Anita Raghavan, *Wielding Broader Powers, S.E.C. Examines Hedge Funds in London*, N.Y. TIMES, Sept. 18, 2013, at B6.

[24] Press Release, SEC Announces Creation of New Office within its Division of Economic and Risk Analysis (Sept. 11, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542914800#.VKtJHyvF91U.

[25] Peter Rawlings, *New Data Tools to ID Exam Targets*, COMPLIANCE INTELLIGENCE (May 2, 2014), http://www.complianceintel.com/Article/3337216/Default/Regs-Developing-Data-Tools-To-ID-Exam-Targets.html.

[26] Mary Jo White, Chair, SEC, The SEC in 2014, Address before the 41st Annual Securities Regulation Institute (Jan. 27, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540677500#.VKtLRSvF91V.

[27] *Id.*

[28] Press Release, SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting Suspicious Investment Returns (Dec. 1, 2011), *available at* http://www.sec.gov/news/press/2011/2011-252.htm.

prior to examination and made remediation to affected funds where appropriate.

Additional focus areas during examinations have been (1) valuations (especially changes to valuation processes); (2) the compliance program (including the competence of the CCO and the culture of compliance); (3) principal transactions and cross trades;[29] and (4) marketing (especially hypothetical returns, portability of trade record, and cherry-picking of profitable investments in marketing materials).

Insider trading continues to be a concern during examinations of private fund managers. Key risk areas include expert networks, relationships with other buy-side firms, information sharing with investors, and potential receipt of material non-public information ("MNPI") at broker-sponsored conferences. Particularly with respect to paid research consultants, the examination staff expects private fund managers to train their analysts, conduct screening of consultants, and perform surveillance of the consultations and any subsequent trading. Documentation with respect to these steps is expected as well. Implementing these controls is often challenging. For example, when analysts' calls with paid research consultants are monitored, what background and understanding does the person doing the monitoring have with respect to the subject matter of the consultation? How will they know if information conveyed by the paid consultant is material and non-public? A monitoring program that never results in any potential issues of concern may be viewed as ineffective. There are measures managers can take to address these complexities, but they require substantial time and analysis.

FROM EXAMINATION TO ENFORCEMENT

While there have long been examinations that led to enforcement investigations, there is evidence indicating that the rate of referrals to the Enforcement Division has increased.[30] This may be partly due to structural factors. The Enforcement Division's Asset Management Unit is working closely with OCIE staff to identify potential violations by asset management firms. In addition, several Enforcement Division attorneys have moved to OCIE, including the head of the investment adviser examination program in the New York Regional Office,[31] which covers a large segment of the private funds industry.

Increased hiring from the private sector, as well as the new technologies described above, may also have contributed to the uptick in enforcement activity. However, the training and increased sophistication of the examination staff should not be discounted. Now that examiners better understand the operations and investment practices of private funds, they are better positioned to identify control weaknesses and potential violations.

As noted above, one area of focus during SEC examinations has been investment advisers' utilization of performance marketing. Three recent enforcement actions regarding performance marketing all arose out of SEC examinations.

- *In the Matter of ZPR Investment Management, Inc.*;[32] SEC examination of adviser showed performance marketing to be misleading because adviser claimed compliance with the Global

[29] Several enforcement cases have arisen as a result of principal transactions uncovered during examinations. *See, e.g.*, Strategic Capital Group, LLC and N. Gary Price, Adv. Act Rel. No. IA-3924 (2014).

[30] There are several statistics that indicate an increase in the rate of OCIE referrals to the Division of Enforcement. OCIE's regional offices increased the number of cases referred to enforcement from 232 in FY 2006 to 272 in FY 2010, with a particularly large increase between FY 2008 (198 cases) and FY 2010. OFF. INSPECTOR GEN., SEC, REPORT NO. 493, OCIE

footnote continued from previous column…

REGIONAL OFFICES' REFERRALS TO ENFORCEMENT 2 (2011), *available at* http://www.sec.gov/oig/reportspubs/493.pdf.

Additionally, the SEC's Office of the Inspector General published a report in June 2001 stating that approximately five percent of investment adviser examinations result in a referral to the Enforcement Division, which can be contrasted with OCIE Director Andrew Bowden's recent statement that approximately 10 percent of investment adviser examinations result in a referral to enforcement. *Compare* OFF. INSPECTOR GEN., SEC AUDIT NO. 322, COMPLIANCE INSPECTION AND EXAMINATION REFERRALS TO ENFORCEMENT 2 (2001), *available at* http://www.sec.gov/about/oig/audit/322fin.pdf *with* Wilczek, *supra* note 4.

[31] Press Release, Ken C. Joseph Named Head of Investment Adviser/Investment Company Examination Program in SEC's New York Regional Office (July 3, 2012), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483018#.VKtheSvF91U.

[32] ZPR Investment Mgmt., Inc. and Max E. Zavanelli, Adv. Act Rel. No. IA-3574 (2013).

Investment Performance Standards when that was not the case.

- *In the Matter of GMB Capital Management LLC*;[33] SEC examination of fund manager showed that performance claims had no basis, and personnel created false documents during the course of the examination to try to support the performance claims.

- *In the Matter of F-Squared Investments, Inc.*;[34] SEC examination showed that back-tested returns were not properly identified as such. The firm settled, agreeing to disgorgement and penalties of $35 million. The former CEO of the firm was charged with fraud under Sections 206 and 207 of the Advisers Act for his role in the misleading performance marketing.[35]

Private fund managers should consider the importance of the manner in which their employees conduct themselves during SEC examinations. A sure-fire way to turn an examination into an enforcement matter is to lie to the examination staff or to produce fabricated documents. In addition to the *GMB Capital Management* case referenced above, in the *Judy K. Wolf* case, the SEC charged a compliance officer at Wells Fargo Advisors, LLC, a dually registered investment adviser and broker-dealer, with fabricating reports produced to OCIE staff in order to make it seem as though she had conducted a more thorough investigation of insider trading than was actually the case.[36] The Commission alleged that Wolf altered the reports after an investment adviser representative at Wells Fargo was charged by the SEC with insider trading in the securities that were the subject of the report in question.[37]

In another case, the SEC charged George B. Franz III, the CEO of Ruby Corporation, a registered investment adviser, with several violations of the Advisers Act, noting that he lied to examination staff when he told them he first learned of any potential misconduct by his son involving firm clients earlier that year and that he immediately fired his son, when neither was the case.[38] The SEC also charged Franz with providing fabricated documents to the enforcement staff to try to show that he spoke with clients impacted by his son's fraud and addressed the issue in writing to these clients, as well as with lying under oath during the Enforcement Division's investigation.[39]

Private fund managers should be prepared to have OCIE staff subject their policies, procedures, and practices in the areas mentioned above to scrutiny during SEC examinations. These are focus areas for SEC examiners, but each manager should also take a holistic approach to improving its compliance program overall. Due to the SEC staff's expanding resources and greater experience, it is difficult to predict which issues SEC examiners will focus on in coming years, which makes adequate preparation invaluable. During examinations, managers must be aware that mishandling the process and interactions with examiners, especially when such missteps give the impression of a lack of candor, can heighten the risk that otherwise rectifiable violations can turn into enforcement actions.

CONCLUSION

Post Dodd-Frank, the examination regime to which SEC-registered private fund managers are subject is undergoing a sea-change. With so many more advisers to examine, OCIE has taken a variety of new examination approaches, and leveraged new staffing and technologies to increase the effectiveness of its examination program. We can expect OCIE to use these resources to greater effect in future examinations. ■

[33] GMB Capital Mgmt. LLC (currently known as "Clearstream Investments LLC"), GMB Capital Partners LLC, Gabriel Bitran and Marco Bitran, Adv. Act Rel. No. IA-3399 (2012).

[34] F-Squared Inv., Inc., Adv. Act Rel. No. IA-3988 (2014).

[35] Complaint at 1-4, *SEC v. Howard B. Present*, No. 1:14-cv-14692 (D. Mass. Dec. 22, 2014).

[36] Judy K. Wolf, Adv. Act Rel. No. IA-3947 (2014), at 5-7.

[37] *Id.*

[38] George B. Franz III and Ruby Corp., Adv. Act Rel. No. IA-3826 (2014), at 10-11.

[39] *Id.* at 13-14.

DAMAGES AND PREDOMINANCE IN SECURITIES CLASS ACTIONS AFTER *COMCAST*

Despite the Supreme Court's decision in the Comcast *antitrust case rejecting a proffered plaintiff class, almost all courts in securities class actions have certified such classes in traditional cases invoking the fraud-on-the-market presumption of reliance. The authors discuss these cases and the key role played by "event studies" in estimating the inflation of the stock price — a measure common to all class members — by the abnormal price declines following disclosure of the relevant truth obscured by the fraud.*

By Matthew L. Mustokoff and Stacey M. Kaplan *

Two years ago, the U.S. Supreme Court decided *Comcast Corp. v. Behrend*, which denied class certification to a proffered plaintiff class in an antitrust case because the plaintiffs had failed to establish that "questions of law or fact common to class members predominate over any questions affecting only individual members."[1] *Comcast* held that, while damages "[c]alculations need not be exact, [] at the class-certification stage (as at trial), any model supporting a plaintiff's damages case must be consistent with its liability case . . ."[2] Courts across the country have struggled to interpret *Comcast*, resulting in a wide array of conflicting readings.[3] What is clear, however, is that *Comcast* has provided defendants with a new weapon at the class certification stage.

In the securities fraud class action arena, however, the decision's impact has been limited. This is largely because, to the extent *Comcast* requires that a plaintiff's theory of damages be tethered to its theory of liability, this test is easily satisfied in securities fraud cases, where "[t]he reliance element 'ensures that there is a proper connection between a defendant's misrepresentation and a plaintiff's injury.'"[4] In other words, because, as the Supreme Court has explained, "the price of stock traded in an efficient market reflects all public, material information — including material misstatements," purchasers of that stock are all damaged in the same manner, i.e., by the artificial inflation in the stock price caused by those misstatements and the precipitous price declines that occur when the fraud is revealed and the inflation comes out of the stock price.[5]

Guided by these principles, to calculate damages in securities cases economists and financial analysts use "event studies," which measure artificial inflation based upon the abnormal stock drops accompanying the

[1] 133 S. Ct. 1426 (2013).

[2] *Id.*

[3] *See, e.g.*, Rubenstein, Newberg on Class Actions § 4:54 (West 5th ed. 2014) ("*Comcast* is a somewhat baffling opinion for several reasons …. Given that the *Comcast* decision addressed a question not truly briefed, allegedly did so under established legal norms, yet overruled two lower courts to reject certification, courts interpreting *Comcast* have struggled with what, if anything, the decision means for the predominance analysis."); *Jacob v. Duane Reade, Inc.*, 293 F.R.D. 578, 581-82 (S.D.N.Y. 2013) ("In the wake of *Comcast*…district and circuit courts alike have grappled with the scope, effect, and application of *Comcast's* holding, and, in particular, its interaction with non-antitrust class actions. Broadly, the class-certification decisions applying *Comcast* can be divided into three, distinct groups…."); Parkinson, *Comcast Corp. v. Behrend and Chaos on the Ground*, 81 U. Chi. L. Rev. 1213, 1213-14 (2014) ("To wit, interpreting precisely what *Comcast*

footnote continued from previous column…

stands for has proven a vexatious task — stumping nearly two hundred lower courts thus far.").

[4] *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407 (2014) ("*Halliburton II*") (quoting *Amgen Inc. v. Conn. Ret. Plans and Trust Funds*, 133 S. Ct. 1184, 1192 (2013)).

[5] *Halliburton II*, 134 S. Ct. at 2405.

* *MATTHEW L. MUSTOKOFF and STACEY M. KAPLAN are partners at Kessler Topaz Meltzer & Check, LLP and practice in the firm's Radnor, Pennsylvania and San Francisco, California offices. Mr. Mustokoff currently serves as Co-Chair of the American Bar Association Section of Litigation's Subcommittee on Securities Class Actions. Their e-mail addresses are mmustokoff@ktmc.com and skaplan@ktmc.com.*

disclosure of the fraud.[6] Event studies therefore enable a measure of damages that is directly linked to a plaintiff's theory of liability: the measure of the stock price decline when the artificial inflation caused by the fraud exits the stock price — like the air coming out of a balloon. And because the daily, even minute-to-minute, prices for securities traded in efficient markets are readily available, the measure of inflation in a particular security's price can be determined with reference to these historical prices and can be mechanically applied to every stock purchaser in the class to determine individual damages.

Thus, in securities fraud class actions, "the fraud-on-the-market doctrine" — which provides a rebuttable presumption of class-wide reliance for all purchasers of a security traded in an efficient market — "makes it rather easy for a lead plaintiff to establish that common questions predominate over individual ones."[7] To that end, district courts hearing securities class actions have almost uniformly held that the standard event study methodology satisfies *Comcast.*[8] By contrast, the few securities cases where certification has been denied on *Comcast* grounds have all involved unconventional damages methodologies.[9] Indeed, in the two years since *Comcast* was decided, no court has ultimately declined to certify a securities class invoking a standard event study methodology to measure traditional out-of-pocket (or "but for") damages.[10] This article explores the post-*Comcast* landscape for securities class actions.

I. *COMCAST* AND ITS APPELLATE PROGENY

Comcast was an antitrust case involving a proposed class of over "2 million current and former *Comcast* subscribers" spanning 16 counties.[11] The *Comcast* plaintiffs alleged that the defendants had engaged in antitrust violations that resulted in four disparate types of "antitrust injury" (or "antitrust impact")[12] to subscribers

[6] *See, e.g., In re Imperial Credit Indus. Sec. Litig*., 252 F. Supp. 2d 1005, 1014-15 (C.D. Cal. 2003), *aff'd sub nom. Mortensen v. Snavely*, 145 Fed. Appx. 218 (9th Cir. 2005) (noting the "importance and centrality of the event study methodology in determining damages in securities cases"); *FindWhat Investor Grp. v. FindWhat.com*, 658 F.3d 1282, 1312-13 (11th Cir. 2011) (same); *United States v. Schiff*, 602 F.3d 152, 173 n.29 (3d Cir. 2010) (event studies are the technique "most often used by experts to isolate the economic losses caused by the alleged fraud").

[7] *In re Groupon, Inc. Sec. Litig.*, 2014 U.S. Dist. LEXIS 137382, at *7-9 (N.D. Ill. 2014).

[8] *See, e.g.*, *In re Diamond Foods, Inc. Sec. Litig.*, 295 F.R.D. 240, 251-52 (N.D. Cal. 2013) (*Comcast* satisfied because "[t]he event study method is an accepted method for the evaluation of materiality damages to a class of stockholders in a defendant corporation."); *see also IBEW Local 98 Pension Fund v. Best Buy Co*., 2014 U.S. Dist. LEXIS 108409, at *22 (D. Minn. 2014) ("[p]laintiffs' expert…performed an event study using methodology for the quantification of damages to show that damages are capable of calculation on a class-wide basis."); *Wallace v. Intralinks*, 302 F.R.D. 310, 318 (S.D.N.Y. 2014) ("[p]laintiff's proposed determination of damages by event study appears to be a workable methodology of determining damages on a class-wide basis that conforms to its theory of liability, thus meeting the requirements of [*Comcast*]."); *In re St. Jude Med., Inc. Sec. Litig*., 2014 U.S. Dist. LEXIS 169354, at *7 (D. Minn. 2014) (*Comcast* satisfied where plaintiff's expert opined that "[a]n event study can be used to provide the jury with a flexible framework to calculate recoverable damages in

footnote continued from previous column…

this case based on the market adjusted price[] decline that occurred on [the corrective disclosure date].").

[9] *See, e.g.*, *In re BP p.l.c. Sec. Litig*., 2014 U.S. Dist. LEXIS 69900, at *82-89 (S.D. Tex. 2014) ("*BP II*") (certifying out-of-pocket subclass but refusing to certify subclass of plaintiffs who "eschew[ed]" the traditional "but for" method); *Sicav v. Jun Wang*, 2015 U.S. Dist. LEXIS 6815, at *5-8 (S.D.N.Y. 2015) (denying certification where plaintiffs proposed an "unusual theory of class-wide injury").

[10] "[O]rdinarily, the correct measure of damages . . . in § 10(b) cases involving fraud by a seller of securities" is the "'*out-of-pocket*' measure of damages." *Randall v. Loftsgaarden*, 478 U.S. 647, 661-62 (1986) (emphasis added). The out-of-pocket measure "allows a purchaser to recover the difference between the purchase price and the true value of the securities absent the alleged fraud as measured by the correction in the market price following curative disclosure, *i.e.*, the difference between what the plaintiff paid for the security and what the plaintiff would have paid but for the fraud." *In re Enron Corp. Sec. Derivative & "ERISA" Litig*., 529 F. Supp. 2d 644, 716-21 (S.D. Tex. 2006).

[11] 133 S. Ct. at 1429-30.

[12] "Antitrust injury" is the "type [of injury that] the antitrust laws were intended to prevent and that flows from that which makes defendants' acts unlawful." Parkinson, 81 U. Chi. L. Rev. at 1243 (quoting *Brunswick Corp. v Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477 (1977)). "The fact of individual injury, in other words, is a liability issue, not simply a damages issue." 1 McLaughlin on Class Actions: Law and Practice § 5:36 at 1416 (West 10th ed. 2013). *See also* Berger and Bernstein, *An Analytical Framework for Antitrust Standing*, 86 Yale L J 809, 811 (1977) (antitrust injury is "like the proximate cause requirement in the law of torts").

in those 16 counties.[13] Of the four theories of liability, the district court accepted only one as capable of class-wide resolution. The plaintiffs' proposed damages methodology, however, "assumed the validity of all four theories of antitrust impact initially advanced" and "calculated damages resulting from 'the alleged anticompetitive conduct as a whole'" rather than "attribut[ing] damages to any one particular theory of anticompetitive impact."[14]

The district court certified the class, reasoning that striking the three theories of antitrust injury did "not impeach [plaintiffs' expert's] damages model" and the Third Circuit affirmed.[15] The Supreme Court, in a 5-4 decision, reversed. Writing for the five-Justice majority, Justice Scalia explained that because the plaintiffs' damages methodology measured damages resulting from all four types of antitrust impact, rather than being tethered to the one type of impact remaining in the case, it "identifie[d] damages that are not the result of the wrong."[16] Further, because the different franchise areas were each damaged in differing combinations and degrees by the four types of impact, the "permutations involving four theories of liability and 2 million subscribers located in 16 counties are nearly endless," and calculating damages would "require labyrinthine individual calculations."[17] As a result, the Court concluded that "[w]ithout presenting another methodology, respondents cannot show [Federal] Rule [of Civil Procedure] 23(b)(3) predominance: Questions of individual damage calculations will inevitably overwhelm questions common to the class."[18]

The *Comcast* majority, however, made clear that its decision did not create a new predominance requirement but, rather, "turn[ed] on the straightforward application of class-certification principles."[19] This led Justices Ginsburg and Breyer to clarify, in their dissenting opinion, that *Comcast* "breaks no new ground on the standard for certifying a class action" and "[i]n the mine run of cases, it remains the 'black letter rule' that a class may obtain certification under Rule 23(b)(3) when liability questions common to the class predominate over damages questions unique to class members."[20]

By and large, the circuit courts — perhaps recognizing the unique factual posture of *Comcast* and, specifically, the fact that the court had dismissed three of the plaintiffs' four theories of liability — have been reluctant to bring about a full-scale change in class certification jurisprudence since the decision was handed down. For example, the Sixth Circuit has made clear that *Comcast* does not disturb the "well-nigh universal" rule that "individual damages calculations do not preclude class certification under Rule 23(b)(3)."[21] The Ninth Circuit has also reiterated that "'the presence of individualized damages cannot, by itself, defeat class certification under Rule 23(b)(3).'"[22] And earlier this year, the Second Circuit held that *Comcast* does not require that a plaintiff present a class-wide damages model that accounts for every class member's individual injury to establish predominance.[23] Rather, "[a]ll that is required at class certification is that the plaintiffs must

[13] *Comcast*, 133 S. Ct. at 1434-35.

[14] *Id*. at 1434.

[15] *Id.* at 1439.

[16] *Id.* at 1434.

[17] *Id.* at 1434-35.

[18] *Id.* at 1433.

[19] *Id.*

[20] *Id.* at 1436-37.

[21] *In re Whirlpool Corp. Front-Loading Washer Prod. Liab. Litig.*, 722 F.3d 838, 861 (6th Cir. 2013). *See also id.* at 860-61 (after *Comcast* "it remains the 'black letter rule' that a class may obtain certification under Rule 23(b)(3) when liability questions common to the class predominate over damages questions").

[22] *Jimenez v. Allstate Ins. Co.*, 765 F.3d 1161, 1168 (9th Cir. 2014) (quoting *Leyva v. Medline Industries Inc*., 716 F.3d 510, 514 (9th Cir. 2013) ("'[T]he amount of damages is invariably an individual question and does not defeat class action treatment.")).

[23] *Roach v. T.L. Cannon Corp.*, 2015 U.S. App. LEXIS 2054, at *14 (2d Cir. 2015) ("*Comcast* . . . did *not* hold that a class cannot be certified under Rule 23(b)(3) simply because damages cannot be measured on a class-wide basis. *Comcast*'s holding was narrower[:]…a model for determining class-wide damages relied upon to certify a class under Rule 23(b)(3) must actually measure damages that result from the class's asserted theory of injury; but the Court did not hold that proponents of class certification must rely upon a class-wide damages model to demonstrate predominance…."). *See also In re Deepwater Horizon*, 739 F.3d 790, 815 (5th Cir. 2014) (rejecting argument that *Comcast* "precludes certification under Rule 23(b)(3) in any case where the class members' damages are not susceptible to a formula for class-wide measurement" as a "misreading of *Comcast*," "which has already been rejected by three other circuits"); *In re Urethane Antitrust Litig.*, 768 F.3d 1245, 1257-58 (10th Cir. 2014) ("*Comcast* did not rest on the ability to measure damages on a class-wide basis.").

be able to show that their damages stemmed from the defendant's actions that created the legal liability."[24]

II. SECURITIES CLASS ACTIONS POST-*COMCAST*

To the extent these recent appellate decisions have construed *Comcast* to require a nexus between class members' damages and the conduct giving rise to defendants' liability, such a requirement is readily met in a traditional securities class action invoking the fraud-on-the-market presumption of reliance.[25]

As the Supreme Court explained recently in *Halliburton II*, the fraud-on-the-market presumption which undergirds the modern securities class action system is based on the premise that "the price of stock traded in an efficient market reflects all public, material information — including material misstatements."[26] In the words of Judge Easterbrook of the Seventh Circuit, "[w]hen someone makes a false (or true) statement that adds to the supply of available information, that news passes to each investor through the price of the stock. And since all stock trades at the same price at any one time, every investor effectively possesses the same supply of information. *The price both transmits the information and causes the loss*."[27] Thus, in the typical securities case, there is one theory of liability (public misrepresentations) that causes one uniform injury (artificial inflation) to one variable (stock price).[28] And when the relevant truth concealed by the misrepresentations is disclosed, the stock price falls, removing the artificial inflation.

For many years, courts have recognized event studies as "the most prevalent, accepted method to establish loss causation and damages" in securities class actions.[29] An event study is "a statistical regression analysis that examines the effect of an event [, such as the disclosure of a corporate fraud,] on a dependent variable, such as a corporation's stock price."[30] More specifically, the regression analysis identifies dates on which there is an abnormal stock price decline for the subject company when compared to the overall market. Then, more qualitative loss causation analysis, including review of market analyst reports and other sources, is performed to determine the actual cause of the decline — i.e., whether the decline was caused by disclosure of the fraud or other, non-fraud-related, company-specific factors.

Of course, plaintiffs need not prove loss causation at the class certification stage — that inquiry is saved for summary judgment or trial.[31] Nor does *Comcast* "articulate any requirement that a damage calculation be

[24] *Sykes v. Mel S. Harris & Assocs., LLC*, 2015 U.S. App. LEXIS 2057, at *40 (2d Cir. 2015). *See also In re Nexium Antitrust Litig.*, No. 14-1 1521, 2015 WL 265548, at *8, *10 (1st Cir. 2015) ("*Comcast* 'simply' requires that a damages calculation reflect the associated theory of liability"); *Deepwater Horizon*, 739 F.3d at 817 ("The principal holding of *Comcast* was that a 'model purporting to serve as evidence of damages . . . must measure only those damages attributable to th[e] theory' of liability on which the class action is premised."); *Butler v. Sears, Roebuck & Co.*, 727 F.3d 796, 799 (7th Cir. 2013) (construing *Comcast* as holding only "that a damages suit cannot be certified to proceed as a class action unless the damages sought are the result of the class-wide *injury* that the suit alleges") (emphasis in original); *Leyva*, 716 F.3d at 514 (under *Comcast*, "the plaintiffs must be able to show that their damages stemmed from the defendant's actions that created the legal liability").

[25] *Leyva*, 716 F.3d at 514.

[26] 134 S. Ct. at 2405.

[27] *Schleicher v. Wendt*, 618 F.3d 679, 682 (7th Cir. 2010) (Easterbrook, J.) (emphasis added).

[28] *See, e.g.*, *McIntire v. China MediaExpress Holdings, Inc.*, 2014 U.S. Dist. LEXIS 113446, at *42 (S.D.N.Y. 2014) (certifying

footnote continued from previous column…

class over *Comcast* argument, explaining that, "Plaintiffs' theory of liability is that [defendant's] misrepresentations caused losses of the same kind: the artificial inflation of [the] share price").

[29] *WM High Yield Fund v. O'Hanlon*, 2013 U.S. Dist. LEXIS 90323, at *43 n.20 (E.D. Pa. 2013). *See also United States v. Schiff*, 602 F.3d 152, 173 n.29 (3d Cir. 2010) (observing that event studies are the technique "most often used by experts to isolate the economic losses caused by the alleged fraud") (quoting *In re Apollo Grp. Inc. Sec. Litig.*, 509 F. Supp. 2d 837, 844 (D. Ariz. 2007)); *FindWhat*, 658 F.3d at 1313 ("event studies are a 'common method' of establishing loss causation"); *In re Novatel Wireless Sec. Litig*., 2013 U.S. Dist. LEXIS 154599, at *16 (S.D. Cal. 2013) ("Federal courts have required event studies to establish loss causation and damages."); *Credit Suisse*, 853 F. Supp. 2d at 186 (event studies "often play[] a 'pivotal' role in proving loss causation and damages in a securities fraud case") (citing *In re Williams Sec. Litig*., 496 F. Supp. 2d 1195, 1272 (N.D. Okla. 2007)).

[30] *FindWhat*, 658 F.3d at 1313.

[31] *Erica P. John Fund, Inc. v. Halliburton Co.* 131 S. Ct. 2179, 2183 (2011) ("*Halliburton I*") ("The question presented in this case is whether securities fraud plaintiffs must also prove loss causation in order to obtain class certification. We hold that they need not.").

performed" for class treatment.[32] But to meet the predominance test of Federal Rule of Civil Procedure 23(b), securities fraud plaintiffs have invoked, and the courts have accepted, the event study methodology as the principal means of estimating damages and a tried method for showing that investors in the same efficiently traded security are harmed by price inflation in a common (i.e., class-wide) manner. These courts have reasoned that, because damages are derived directly from the stock price decline caused by the revelation of the fraud, there is a clear link between the liability theory and the damages methodology, and the event study enables the damages expert to estimate the price inflation associated with the corrective events.

As discussed below, district courts have applied these principles to almost unanimously certify securities fraud classes following *Comcast*. In those few instances where certification has been denied, unusual fact patterns gave rise to unconventional damages theories which were found to have not aligned with the underlying theory of liability.

A. Groupon

The claims in *In re Groupon, Inc. Securities Litigation* arose from Groupon's 2011 initial public offering.[33] Plaintiffs alleged violations of both the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), and moved to certify classes of investors alleging claims under each act. Defendants opposed, arguing that individualized damages issues predominated under *Comcast*. In granting plaintiffs' motion, Judge Norgle of the Northern District of Illinois explained that "[i]n a securities fraud class action, the fraud-on-the-market doctrine makes it rather easy for a lead plaintiff to establish that common questions predominate over individual ones." Thus, "[e]vidence from a plaintiff's expert verifying that the company's stock's price 'changed rapidly . . . in response to new information' will suffice to certify the class because 'certification is largely independent of the merits' of the case."[34] As a result, the court found *Comcast* "inapposite in a securities fraud class action such as this" and did not accept the defendants' damages arguments as a basis to deny class treatment.[35]

Groupon is in accord with Supreme Court precedent holding that, in a securities action, the critical element for purposes of the predominance inquiry is reliance — not damages.[36] In particular, as the Supreme Court explained four years ago in *Halliburton I*, "[w]hether common questions of law or fact predominate in a securities fraud action often turns on the element of reliance."[37] Then in *Halliburton II*, its first post-*Comcast* securities decision, the Supreme Court reaffirmed that "[i]n securities class action cases, the crucial requirement for class certification will usually be the predominance requirement of Rule 23(b)(3)."[38] As the Court explained, "[t]he *Basic* [fraud-on-the-market]

---

[32] *In re: Cathode Ray Tube (CRT) Antitrust Litig.*, 2013 U.S. Dist. LEXIS 137945, at *137-38 (N.D. Cal. 2013). *See also In re Scotts EZ Seed Litig.*, 304 F.R.D. 397 (S.D.N.Y. 2015) ("nothing in *Comcast* requires an expert to perform his [damages calculation] at the class certification stage"); *Brown v. Hain Celestial Grp.*, 2014 U.S. Dist. LEXIS 162038, at *57-58 (N.D. Cal. 2014) ("The point for Rule 23 purposes is to determine whether there is an acceptable class-wide [damages] approach, not to actually calculate under that approach before liability is established."); *Werdebaugh v. Blue Diamond Growers*, 2014 WL 2191901, at *25 ("Because *Comcast* did not articulate any requirement that a damage calculation be performed at the class certification stage, that [plaintiffs' expert] has yet to actually run the regressions and provide results is not fatal.").

[33] 2014 U.S. Dist. LEXIS 137382 (N.D. Ill. Sept. 23, 2014).

[34] *Id.* at *7-9, citing *Wendt*, 618 F.3d 679.

[35] *Id. See also In re Heckmann Sec. Litig.*, 2013 WL 2456104, at *14 (D. Del. June 6, 2013) ("[P]laintiff correctly points out that while *Comcast* addresses class action certification, it was not in regard to a securities fraud litigation, which have generally been certified for class status.").

[36] In antitrust actions, by contrast, predominance often turns on the "antitrust impact" element at issue in *Comcast*. *See* Parkinson, 81 U. Chi. L. Rev. at 1248 ("an existing body of case law predating *Comcast* holds that, in antitrust class actions, antitrust injury is more than simply a factor in the Rule 23(b)(3) predominance inquiry.") (citing *In re Ins. Brokerage Antitrust Litig.*, 579 F.3d 241, 268 (3d Cir. 2009) ("for purposes of class certification pursuant to Rule 23(b)(3), 'the task for plaintiffs . . . is to demonstrate that the element of antitrust impact is capable of proof at trial through evidence that is common to the class rather than individual to its members.'"); *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 311 (3d Cir. 2008) ("In antitrust cases, impact often is critically important for the purpose of evaluating Rule 23(b)(3)'s predominance requirement because it is an element of the claim that may call for individual, as opposed to common, proof."); *Blades v Monsanto Co.*, 400 F.3d 562, 569 (8th Cir. 2005); *Bell Atlantic Corp. v. AT&T Corp.*, 339 F.3d 294, 303–04 (5th Cir 2003)).

[37] *Halliburton I*, 131 S. Ct. at 2184.

[38] *Halliburton II*, 134 S. Ct. at 2412.

presumption does not relieve plaintiffs of the burden of proving — before class certification — that this requirement is met. *Basic* instead establishes that a plaintiff satisfies that burden by proving the prerequisites for invoking the [fraud-on-the-market] presumption . . . ."[39] Even Justice Thomas's concurring opinion (in which Justice Scalia, who penned *Comcast*, joined) suggested that "Plaintiffs who invoke the presumption of reliance are deemed to have shown predominance as a matter of law…."[40]

B. Diamond Foods

In *In re Diamond Foods Securities Litigation*, plaintiffs moved for certification of a class of investors alleging violations of Section 10(b).[41] To meet their *Comcast* burden, plaintiffs asserted that "[d]amages in this matter will be calculated using an event study analysis similar to the event study analysis presented" to establish market efficiency, which "shows that damages are calculable to the class using standard event study methodology."[42] Defendants opposed, arguing that a "conclusory statement" that "damages 'will be calculated using an event study analysis'" was "a far cry from the evidentiary showing that *Comcast* requires."[43]

In granting plaintiffs' motion, Judge Alsup of the Northern District of California first explained that the court "need not decide whether, as defendant claims, *Comcast* requires that class certification be denied absent affirmative evidence that 'damages are susceptible of measurement across the entire class.'"[44] Rather, the court noted, "in a recent decision affirming class certification in a securities fraud action alleging violations of Section 10(b) and Rule 10b-5 of the Exchange Act, the Supreme Court emphasized that Rule 23(b)(3) 'does not require a plaintiff seeking class certification to prove that each element of her claim is susceptible to class-wide proof. What the rule does require is that common questions predominate over any questions affecting only individual class members.'"[45]

Ultimately, however, the court found that the plaintiff's event study satisfied *Comcast*, explaining that "[t]he event study method is an accepted method for the evaluation of materiality damages to a class of stockholders in a defendant corporation."[46] The court also relied on the Ninth Circuit's previous determination, in a Section 10(b) case, that "the amount of price inflation during the [class] period can be charted and the process of computing individual damages will be virtually a mechanical task."[47] At the end of the day, it found that "[w]hether plaintiff will ultimately prevail in proving damages is not necessary to determine at this stage."[48] The court thus concluded that "plaintiff has sufficiently shown that damages are capable of measurement on a class-wide basis such that individual damage calculations do not threaten to overwhelm questions common to the class."[49]

C. Best Buy

IBEW Local 98 Pension Fund v. Best Buy Company also involved claims brought under Section 10(b).[50] Defendants challenged plaintiffs' motion for class certification, arguing that plaintiffs had failed to satisfy *Comcast* because "a plaintiff in a securities case has an affirmative duty to proffer a damages model that tracks his liability theory, and cannot simply say he will conduct an 'event study.'"[51] Defendants further averred

---

[39] *Halliburton II*, 134 S. Ct. at 2412. In holding that predominance was satisfied in securities cases by meeting the elements set forth in *Basic*, the Supreme Court rejected Halliburton's argument that *Basic* could not be reconciled with *Comcast. Id*. As Justice Roberts noted, *Basic* does not eliminate the predominance requirement but, rather, "establishes that a plaintiff satisfies that burden by proving the prerequisites for invoking the presumption – namely, publicity, materiality, market efficiency, and market timing." *Id.*

[40] *Id.* at 2423-24.

[41] 295 F.R.D. 240 (N.D. Cal. 2013).

[42] *See* Declaration of Dr. Jay Hartzell in Support of Motion for Class Certification, ¶¶23-24, *Diamond Foods* 295 F.R.D. 240 (Case No. 11-cv-05386-WHA), Dkt. No. 202-1.

[43] Defendant Diamond Foods, Inc.'s Sur-Reply in Opposition to Class Certification at 3, *Diamond Foods* 295 F.R.D. 240 (Case No. 11-cv-05386-WHA), Dkt. No. 225.

[44] *Id.* at 251.

[45] *Id.* (quoting *Amgen*, 133 S. Ct. at 1196).

[46] *Id.* at 251-52 (citing *In re Credit Indus., Inc. Sec. Litig.*, 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003); *In re Apollo Grp. Inc. Sec. Litig.*, 509 F. Supp. 2d 837, 844 (D. Ariz. 2007); *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993)).

[47] *Id.* at 251-52 (citing *Blackie v. Barrack*, 524 F.2d 891, 905 (9th Cir. 1975)).

[48] *Id.* at 252.

[49] *Id.*

[50] 2014 U.S. Dist. LEXIS 108409, at *3 (D. Minn. 2014).

[51] Defendants' Memorandum in Opposition to Lead Plaintiff's Motion for Class Certification and Appointment of Lead Plaintiff Marion Haynes as Class Representative at 13-14, *Best*

that certain of the alleged misstatements had been dismissed at the pleading stage, and the proposed event study methodology was flawed because it made "no effort to isolate the impact on the share price (and the resultant alleged damages) flowing from the… actionable statements in this case."[52] Finally, defendants argued that certain class members, who bought early on the first day of the class period (and, thus, prior to any misstatements) had suffered no damages.[53]

Judge Frank of the District of Minnesota found *Comcast* satisfied, explaining that "[p]laintiffs' expert … performed an event study using methodology for the quantification of damages to show that damages are capable of calculation on a class-wide basis."[54] Like *Diamond Foods*, the court rejected defendants' other attacks on the model, reasoning that "[w]hether Plaintiffs will ultimately prevail in proving damages is not an issue presently before the Court."[55] Nor was the court concerned with the potential gap in damages on the first day of the class period, finding that it would not "make the calculation of damages difficult or improper."[56] In so concluding, the court adopted the reasoning of Judge Easterbrook in *Wendt*[57] that questions relating to the "[t]iming of each person's transactions" "can be resolved mechanically. A computer can sort them out using a database of time and quantity information."[58] The *Best Buy* court thus held "that Plaintiffs have sufficiently demonstrated that damages are capable of measurement on a class-wide basis such that individual issues of damages calculations will not overwhelm the predominate questions common to the class."[59]

D. Intralinks

In *Wallace v. Intralinks,*[60] plaintiff moved to certify a class of investors bringing claims pursuant to the Exchange Act and a subclass of investors bringing claims pursuant to the Securities Act. To satisfy *Comcast*, plaintiff proposed an event study methodology similar to the event study that it had provided to establish market efficiency.[61] Citing heavily to *Diamond Foods*, plaintiff argued that the event study, which measured inflation based upon corrective disclosure stock drops, was sufficiently tethered to its liability theory because "each [corrective] disclosure…directly relates to Lead Plaintiff's claims…."[62] Defendants countered that the relevant truth had been disclosed prior to the class period-ending corrective disclosure, and that plaintiffs had failed to demonstrate predominance for class members who had purchased Intralinks stock after the truth was revealed.[63]

Judge Griesa of the Southern District of New York disagreed, finding that "[d]efendants' arguments [] belong more properly to the discussion of damages, not class certification."[64] The court noted that "[p]resumably, if plaintiff prevails, class members who purchased or sold at different times during the class period will be entitled to significantly different recoveries" but "[i]ndividualized calculations of damages do not generally defeat the predominance requirement."[65] Moreover, the court reasoned that damages do "not demand excessive individual inquiry" because "[p]laintiff's proposed determination of damages by event study appears to be a workable methodology of determining damages on a class-wide basis that conforms to its theory of liability, thus meeting the requirements of [*Comcast*]."[66] As a result, the court found Rule 23(b)(3) satisfied.

footnote continued from previous page…

Buy, 2014 U.S. Dist. LEXIS 108409 (Case No. 11–429 (DWF/FLN)), Dkt. No. 156.

[52] *Id.* at 18-19.

[53] *Id.* at 28-29.

[54] *Best Buy*, 2014 U.S. Dist. LEXIS 108409, at *22.

[55] *Id.* at *24.

[56] *Id.* at *23.

[57] 618 F.3d at 681.

[58] *Best Buy*, 2014 U.S. Dist. LEXIS 108409, at *23 (quoting *Wendt*, 618 F.3d at 681).

[59] *Best Buy*, 2014 U.S. Dist. LEXIS 108409, at *24.

[60] 302 F.R.D. 310 (S.D.N.Y. 2014).

[61] Memorandum of Law in Support of Lead Plaintiff's Motion for Class Certification at 21-22, *Intralinks*, 302 F.R.D. 310 (Civil Action No. 11-CV-8861), Dkt. No. 71.

[62] *Id.* at 22.

[63] *Intralinks*, 302 F.R.D. at 318.

[64] *Id.*

[65] *Id*.

[66] *Id.*

E. BP p.l.c.

In *In re BP p.l.c. Securities Litigation*, or "*BP I*," plaintiffs alleged "multiple frauds" and "competing theories" of liability based on "misrepresentations both before and after the Deepwater Horizon explosion" in the Gulf of Mexico.[67] Judge Ellison of the Southern District of Texas initially denied class certification, holding that plaintiffs' proposed event study did "not assuage the Court that the class-wide damages methodology proposed will track Plaintiffs' theories of liability."[68] In particular, the court required "a more complete explanation" of how the event study would "incorporate" and "respond to" "the various theories of liability."[69] Thereafter, plaintiffs again moved for certification, this time proposing distinct damages methodologies for two subclasses — Pre- and Post-Explosion.[70]

The Post-Explosion subclass alleged that defendants concealed the full magnitude of the Deepwater Horizon oil spill for weeks after it occurred.[71] Plaintiffs proposed a standard "out-of-pocket" damages model, utilizing an event study to calculate inflation based on stock drops following the disclosures revealing the true, previously concealed magnitude of the oil spill.[72] The *BP* court held that this model satisfied *Comcast*, reasoning that "the 'out-of-pocket' measure of damages employed in most securities fraud cases is particularly consonant with the 'fraud-on-the-market' theory."[73] Moreover, the court explained, "case law reflects a longstanding and widespread practice of measuring the stock price impact of a given misstatement by implication from the stock price decline caused by the misstatement's disclosure."[74] The court "reiterate[d] its understanding that Plaintiffs' task at the class certification stage is to present a legally viable, internally consistent, and truly class-wide approach to calculating damages" and explained that "[w]hether Plaintiffs have properly executed under the approach is a question for a different day."[75] As a result, Judge Ellison concluded that the "damages methodology proposed for the Post-Explosion Subclass meets the requirements for Rule 23(b)(3) predominance."[76]

The Pre-Explosion subclass, on the other hand, involved alleged misstatements regarding BP's safety measures to prevent oil spills issued prior to the Deepwater Horizon explosion.[77] Plaintiffs claimed that the Pre-Explosion "fraud was revealed when the Deepwater Horizon exploded and BP was subsequently unable to contain the oil spill."[78] The Pre-Explosion subclass thus involved a distinctive fact-pattern because the defendants' alleged misstatements concealed the risk of an event (the massive oil spill) that had not yet occurred at the time they were made.[79] Judge Ellison found this anomaly significant. In that regard, the court distinguished plaintiffs' principal authority, *In re Vivendi Universal, S.A. Securities Litigation*, where, Judge Ellison explained, "[a] nearly 100 percent risk was present" *at the time the misrepresentations were made*. As the court continued, "[b]ecause the risk was virtually certain to materialize in [*Vivendi*]" — as opposed to the oil spill in *BP* — the Court finds it uninstructive for present purposes."[80]

The unique fact pattern of the Pre-Explosion claims presented plaintiffs with a conundrum. In a securities case, "inflation" typically refers to the difference between the purchase price and the "but-for price" — the price an investor would have paid but for the fraud. The *BP* court explained, however, that because the oil spill had not occurred at the time of the alleged misstatements, even if defendants had disclosed the truth (*i.e.*, that BP was failing to adhere to its stated safety measures), the most investors could have understood from that information was that BP was at *risk* of suffering an oil spill. Thus, the court reasoned, because, theoretically, BP's stock price would not have dropped

---

[67] 2013 U.S. Dist. LEXIS 173303, at *27, 29 (S.D. Tex. 2013) ("*BP I*").

[68] *Id.* at *74-75.

[69] *Id.* at *75.

[70] *BP II*, 2014 U.S. Dist. LEXIS 69900.

[71] *Id.* at *60-61.

[72] *Id.* at *90-92.

[73] *Id.* at *88 n.14.

[74] *Id.* at *76-78 (citing *Blackie*, 524 F.2d at 909 n.25).

[75] *Id.* at *94-95.

[76] *Id.* at *96.

[77] *Id.* at *55-56.

[78] *Id.*

[79] *Id.* at *78-79 ("[h]ere, not even Plaintiffs argue that the risk of a deepwater well blow-out and oil spill was 100 percent").

[80] *Id.* at *79 n. 9 (citing *In re Vivendi Universal, S.A. Sec. Litig.*, 634 F. Supp. 2d 352 (S.D.N.Y. 2009)). *Vivendi* rejected an argument that there was a disconnect between a corrective disclosure revealing a liquidity crisis, and a misstatement that concealed the *risk* of a liquidity crisis. 634 F. Supp. 2d at 370-71. The court reasoned that at the time of the misstatements, "all the pieces were there" and "the probability [of the liquidity crisis] was basically a hundred percent." *Id.*

as significantly on that hypothetical news as it did when the actual spill occurred and the true magnitude of the spill became known, it was inappropriate to measure inflation utilizing the entirety of the stock price declines that occurred upon the news of the spill.[81] In employing such a measure, the Pre-Explosion subclass had "eschew[ed]" the traditional "but for" method of determining damages, instead seeking (much higher) consequential damages.[82] Specifically, the Pre-Explosion plaintiffs argued (unsuccessfully) that investors should recover the full stock drop following the oil spill because, had they known of the greater risk of an oil spill occurring, they would not have purchased BP stock at all, and thus would not have suffered those damages.[83]

The court ultimately rejected plaintiffs' consequential damages model, reasoning that it was "antithetical to the 'fraud-on-the-market' theory which enables the class-wide resolution of [plaintiffs'] claims…."[84] The court explained that the fraud-on-the-market theory "presumes that in an impersonal well-developed market for securities, investors rely upon the 'integrity of the market price.'"[85] But if "investors are not relying upon the integrity of the market price — if they are, as Plaintiffs suggest, determining their own risk thresholds specific to the company at issue — then Plaintiffs' proposed measurement of damages cannot be deployed without an individualized inquiry into each investor's subjective motivations."[86] Because the proposed consequential damages theory "injects individualized inquiries into what is supposed to be a class-wide model of recovery" the court held that "[c]lass-wide treatment would be patently inappropriate…."[87]

Because of its unique facts and damages model, the *BP* court's Pre-Explosion subclass holding remains an outlier among post-*Comcast* decisions in securities cases.[88] In the vast majority of securities cases, the plaintiff alleges that the defendant knew or recklessly disregarded facts that were in existence or had already occurred at the time of the public misrepresentations — an allegation that could not be sustained in the case of an unforeseen oil spill that occurred years after the alleged fraudulent statements were issued. For these reasons, the holding has limited applicability. Indeed, in the year since it was decided, not a single court has applied it to deny a class certification bid.

III. CONCLUSION

When *Comcast* was issued, courts and practitioners alike grappled with its impact. Two years later, it is clear that the decision has provided defendants with a powerful new argument to oppose certification in certain types of class actions. In the securities class action domain, however, the district courts have not viewed *Comcast* as a major obstacle to class certification. Rather, because all investors in a fraud-on-the-market case are injured in a common manner — by the artificial inflation in a company's stock price caused by a defendant's false statements — the courts have by and large held that common questions of damages predominate over individualized ones. In particular, these courts have found that the traditional event study methodology, which seeks to estimate inflation based upon the abnormal stock price declines following disclosure of the fraud, is sufficiently tethered to a securities fraud plaintiff's liability theory to satisfy *Comcast*. Moreover, given the recent opinions by appellate courts in non-securities cases interpreting *Comcast*'s holding narrowly, this trend appears likely to continue. ■

---

[81] *BP II*, 2014 U.S. Dist. LEXIS 69900, at *59-60, 82-83.

[82] *Id.* at *82-85.

[83] *Id.* at *86.

[84] *Id.* at *86-89.

[85] *Id.*

[86] *Id.*

[87] *Id.*

[88] In the other securities actions in which class certification has been denied on *Comcast* grounds, the plaintiffs likewise proposed unconventional damage models. For example, in *Jun Wang*, 2015 U.S. Dist. LEXIS 6815,plaintiffs were forced abandon their traditional damages methodology because "there did not appear to have been any" "legally cognizable 'corrective disclosure.'" *Id.* at *3-4. As a result, plaintiffs proposed an "unusual theory of class-wide injury" that "face[d] daunting precedent." *Id.* at *5-8. Similarly, *Fort Worth Emps. Ret. Fund v. J.P. Morgan Chase & Co.*, 301 F.R.D. 116 (S.D.N.Y. 2014), did not involve stock trading in an efficient market, but rather "complex asset-backed securities" that "trade[] in an illiquid market and therefore ha[d] no 'actual market price.'" *Id.* at 141-42.

The Review of Securities & Commodities Regulation

General Editor
Michael O. Finkelstein

Associate Editor
Sarah Strauss Himmelfarb

Board Members

Jay Baris
Morrison & Foerster LLP
New York, NY

James N. Benedict
Milbank, Tweed, Hadley & McCloy LLP
New York, NY

John C. Coffee, Jr.
Columbia Law School
New York, NY

Roberta S. Karmel
Brooklyn Law School
Brooklyn, NY

Amy Jane Longo
O'Melveny & Myers LLP
Los Angeles, CA

Rita M. Molesworth
Willkie Farr & Gallagher LLP
New York, NY

Richard M. Phillips
K&L Gates LLP
San Francisco, CA

A. Robert Pietrzak
Sidley Austin LLP
New York, NY

Irving M. Pollack
Pollack & Storch LLP
Washington, DC

Norman S. Poser
Brooklyn Law School
Brooklyn, NY

Edmund R. Schroeder
Scarsdale, NY