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Searching for an Efficient Market with Cross-Listed Securities: Denial of Class Certification in Deutsche Bank *Illustrates Increased Scrutiny of the Fraud on the Market Doctrine*

BY THE SECURITIES LITIGATION & ENFORCEMENT PRACTICE

On October 29, 2013, the Southern District of New York denied class certification in a securities fraud action brought against Deutsche Bank AG in *IBEW Local 90 Pension Fund v. Deutsche Bank AG* ("*Deutsche Bank*").[1] Significantly, the Court found that the shareholder plaintiffs failed to meet their burden of establishing market efficiency for the securities in question, and thus were not entitled to the presumption of reliance permitted under the so-called "fraud on the market" doctrine. In the wake of the U.S. Supreme Court's March 2013 decision in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds* ("*Amgen*"),[2] the *Deutsche Bank* order provides an insightful roadmap for defendants looking to challenge class certification in putative securities fraud class actions, particularly where the securities in question are cross-listed on multiple exchanges.

By way of background, a critical element of a claim under Section 10(b) of the Securities Exchange Act of 1934[3] and SEC Rule 10b-5[4] is reliance on a material misrepresentation in connection with the purchase or sale of a security. To address this element, the "fraud on the market" doctrine allows plaintiffs to invoke a rebuttable presumption of reliance on public, material misrepresentations regarding securities traded in an efficient market.[5] Without such a presumption, in order to establish their claims, individual shareholders who purchased the security in question would be required to prove that they each personally read (or heard) and relied on the alleged misrepresentations. This would effectively preclude the shareholders from proceeding with a class action, because the individual issues related to reliance would predominate over the issues common to the class.[6]

The foundation of the "fraud on the market" doctrine is a theory of economics known as the "efficient market hypothesis." According to this theory, the price of a security trading in an efficient market will rationally impound all material public information about that security. The reasoning behind the "fraud on the market" doctrine is that, if this is true, then shareholders who purchase securities in reliance on the integrity of the market price may be deemed to have indirectly relied on whatever misinformation may be incorporated into that price.

The Supreme Court recently examined an aspect of the "fraud on the market" doctrine in *Amgen*, finding that plaintiffs need not prove "materiality" at the class certification stage in order to obtain the benefit of the "fraud on the market" presumption of reliance. However, the Court did identify market efficiency as a necessary predicate that must be established in order to invoke the doctrine.[7]

The recent decision in *Deutsche Bank* illustrates the increased scrutiny that district courts are giving to the "efficient market" issue at class certification in securities cases. In particular, the case provides insight in the context of securities, like Deutsche Bank's global registered shares (GRSs), that are traded simultaneously on multiple exchanges around the globe. The case also provides general instruction on the evidentiary standards plaintiffs must meet to satisfy their burden of proof at the class certification stage, especially in relation to use of expert witnesses on the issue of market efficiency. Finally, the decision is notable because it found that the named plaintiffs could not serve as class representatives since, as so-called "in and out" traders, they both bought and sold shares before the conclusion of the proposed class period.

A. Analyzing the Efficient Market Requirement with Cross-Listed Securities

At a certain level, *Deutsche Bank* presents a fairly standard securities case involving a financial institution. The plaintiffs alleged that the defendants misled Deutsche Bank investors regarding the bank's risk management practices and exposure to losses in relation to mortgage-backed securities and collateralized debt obligations, and that this conduct violated the federal securities laws.[8] In moving to certify the case as a class action under Rule 23(b)(3) of the Federal Rule of Civil Procedure, the plaintiffs sought to invoke the "fraud-on-the-market" presumption of reliance.[9]

Citing *Amgen*, the court observed that a key predicate to the "fraud-on-the-market" presumption of reliance is the efficiency of the market on which the defendant's shares traded. The court noted that the burden of proof on this issue lies with the plaintiffs, explaining: "To defeat the presumption of reliance, defendants do not . . . have to show an inefficient market. Instead, they must demonstrate that plaintiffs' proof of market efficiency falls short of the mark."[10]

In analyzing whether the market for Deutsche Bank's securities was efficient, the court first looked to the so-called *Cammer* factors, a set of indicators that many courts have used to help address the question of market efficiency.[11] Of these, the parties and the court focused on the question of whether the evidence demonstrated "a cause and effect relationship between the unexpected, material disclosures and changes in the securities' price."[12]

In support of their motion for class certification, the plaintiffs proffered an expert report premised on an "event study" that examined the price movement of Deutsche Bank's shares on the New York Stock Exchange ("NYSE") for twelve days during the proposed class period. These were days associated with Deutsche Bank's public disclosure of its quarterly earnings information. According to the plaintiffs' expert, this study was intended to show that "[w]hen important, unexpected news about [Deutsche Bank] was released to the market, the price of its GRSs moved in a directionally appropriate way by a statistically meaningful amount."[13]

Ultimately, however, after considering expert reports submitted by the defense, and conducting a live evidentiary hearing at which all of the experts were subject to examination by the parties and the court, the court determined that the plaintiffs failed to meet their burden with respect to market efficiency, and therefore denied class certification.

1. Finding the Locus of Price Formation

A critical focus of attention in *Deutsche Bank* was on the fact that the bank's GRSs did not trade solely on the NYSE. To the contrary, the defense pointed out that the vast majority of the GRSs traded outside the U.S., primarily in Germany on the Frankfurt Stock Exchange.[14] Moreover, U.S. trading volume, trade frequency, and average trade size paled in comparison to those same metrics on the German market.[15] Nevertheless, as noted above, the plaintiffs' expert examined only the movement of prices on the NYSE, and did not study at all the efficiency of the German market.

As explained by the defense experts, for issuers with cross-listed shares, the efficiency of the market for those shares cannot be determined simply by looking to the trading occurring on U.S. exchanges. Rather, a threshold inquiry is necessary to determine "the true locus of price formation," that is, to define the market where the price of the security responds to new information about the issuer. Then the inquiry may turn to whether that market is operating in a manner consistent with the efficient market hypothesis. In the *Deutsche Bank* case, for example, the evidence presented by the defense showed that information about the bank tended to be disclosed first in Germany, at times when the U.S. markets were closed. This meant that the information was being impounded into the price of the GRSs even before the open of the NYSE. Then, once the NYSE opened, the price on that exchange tended to track the price set in Frankfurt. Because the efficient market hypothesis relates to how information is impounded into the price, simply examining movements of the price on the NYSE could not reveal much about this critical issue. Thus, the court found, "an analysis of market efficiency that ignores the main market which is impounding (or not) material information [in this case, the German market] . . . is fatally flawed."[16]

2. Looking Beyond the Cammer *Factors for Market Efficiency*

Another important aspect of the *Deutsche Bank* case is the rigor with which the court examined the plaintiffs' evidentiary proffer on the efficient market issue. After reviewing the parties' written submissions and conducting an evidentiary hearing at which both sides' experts testified, the court carefully compared the competing submissions and found the plaintiffs' submission was so lacking that the court granted the defendants' *Daubert* motion to preclude the plaintiffs' expert altogether.[17]

Even apart from the German market issue, the court found fault with the plaintiffs' event study analysis. For example, the court concluded that the event study had "an inadequate foundation" where the analysis was limited to a mere 12 trading days out of 515, when the lengthy class period covered the fallout of the global financial crisis and there was an enormous amount of information regarding Deutsche Bank being released into the market.[18]

Notably, the court also put great emphasis on an issue that is not specifically called out among the *Cammer* factors, illustrating the willingness of courts to look beyond those limited items to other factors identified by qualified experts as bearing on the issue of market efficiency. In *Deutsche Bank*, this related to the unavailability of short-selling during extended portions of the class period. The court noted that both sides' experts agreed that "arbitrage is one of the principal hallmarks of an efficient market," and that "short sellers are important to the efficiency of a market."[19] Under the circumstances, the court faulted plaintiffs' analysis for failing to account for three bans on "short selling" that were instituted in both Germany and the U.S. during the class period.[20] The court reasoned that because a ban on short selling could have a negative impact on market efficiency, at a bare minimum, the issue should have been covered in plaintiffs' analysis.[21]

B. *"In-and-Out" Traders are Inappropriate Class Representatives*

In addition to the efficient market issue, the court also denied class certification in *Deutsche Bank* because the proposed class representatives would be subject to unique defenses. The court observed that the proposed class representatives purchased and sold Deutsche Bank GRSs during the class period (*i.e.*, made "in-and-out" trades). Consistent with the Supreme Court's "loss causation" holding in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), a shareholder who purchases shares during the class period and then sells those shares before the alleged "truth is revealed" will be unable to demonstrate that the alleged misrepresentations or omissions caused any loss suffered on the sale of those shares. As such, the shareholder would not be able to state a claim with respect to those transactions.

As the court recognized in *Deutsche Bank*, even those in-and-out traders who hold some of their shares through the end of the class period may be subject to unique defenses. In particular, in-and-out traders may profit from their sales during the class period while the securities are trading at an allegedly inflated price. Thus, those traders may be subject to a showing of "negative loss causation."[22] Likewise, the court observed that an in-and-out trading pattern may raise serious questions about why the traders made their investment decision and whether the alleged fraud was relevant to the purchases and sales. "These individualized questions as to the named plaintiffs threaten to predominate over common questions," and led the court to conclude that "these named plaintiffs cannot meet the 'predominance' factor Rule 23(b)(3)."[23]

C. *Conclusion*

Deutsche Bank provides an illustration of the high level of scrutiny on class certification in federal securities cases, with an example of how plaintiffs' failure to proffer sufficient evidence of market efficiency will preclude application of the "fraud on the market" presumption of reliance. Given the Supreme Court's recent opinion in *Amgen*, the order in *Deutsche Bank* provides parties in these cases insight into how to approach the issue of market efficiency at the class certification stage, particularly where the issuer has cross-listed shares.

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1 *IBEW Local 90 Pension Fund v. Deutsche Bank AG*, No. 86, 1:11-cv-04209-KBF (S.D.N.Y. Oct. 29, 2013).

2 *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013).

3 15 U.S.C. § 78j (2006 & Supp. 2010).

4 17 C.F.R. § 240.10b-5 (2012).

5 *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

[6] The Supreme Court in *Amgen* noted that "[a]bsent the fraud-on-the-market theory, the requirement that Rule 10b-5 plaintiffs establish reliance would ordinarily preclude certification of a class action seeking money damages because individual reliance issues would overwhelm questions common to the class." *Amgen*, 133 S. Ct. at 1193.

[7] *Id.* at 1197. Several justices expressed an interest in revisiting the fraud on the market doctrine altogether, suggesting that the Court might consider abandoning the "fraud on the market" presumption in a future case.

[8] *Id.* at 1.

[9] *Id.* at 44.

[10] *Id.* at 46.

[11] *See Cammer v. Bloom*, 711 F. Supp. 1264, 1286-87 (D. N.J. 1989) (setting forth factors to consider as indicia of market efficiency).

[12] *Id.* at 46.

[13] *Id.* at 6 (citation omitted).

[14] *Id.* at 16-17.

[15] *Id.* at 17.

[16] *Id.* at 47-48.

[17] *Id.* at 27. A *Daubert* analysis is derived from the Supreme Court's opinion in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), and provides the standards by which the admissibility of expert testimony is to be judged.

[18] *Id.* at 24 & 47. The defense criticized plaintiffs' event study for focusing on a small dataset (2% of all trading days during the Class Period) and for not considering that the information disclosed on the "event days" (formal earnings reports) was likely already anticipated by markets before actual disclosure. *Id.*The defense also argued that plaintiffs' own facts suggested the market was actually *inefficient*, noting the market moved in the "inappropriate" direction relative to the news that was disclosed. *Id.* at 25.

[19] *Id.* at 11.

[20] *Id.* at 47.

[21] *Id.* at 24, 47.

[22] *Id.* at 49-50.

[23] *Id.* at 50.