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RESEARCH FROM OUR EXPERTS

Securities Litigation and the Efficient Market Debate

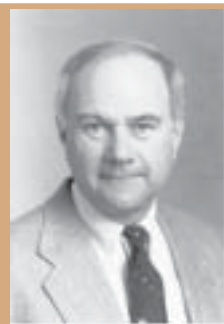
An efficient financial market is one in which all available information is reflected in the price of a security. Presumably, no piece of relevant, publicly available information has not been scrutinized by at least a few large investors who, by their purchase and sale decisions, set the actual security prices. In a perfectly efficient market, actual prices are always equal to the theoretically “correct” prices insofar as they are predicated upon extant public information.

Markets Are Not Perfectly Efficient

At this stage in the evolution of the science of financial economics, very few analysts still cling to the belief that markets are perfectly efficient. An illuminating argument against perfect efficiency arises from the observation that there are thousands of security analysts, all of whom get paid a salary. If markets were perfectly efficient, there would be no incentive or reward to invest in gathering information about securities, hence there would be no need for security analysts on the payroll. Accordingly, security prices, on average, must deviate often enough and by a wide enough mar-

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The opinions expressed in this article are those of the author and do not necessarily reflect those of The Michel/Shaked Group.



gin from their “correct” or true equilibrium values to allow for enough excess return to compensate for the expense of information gathering. Few, if any, financial economists would be prepared to argue that there is massive over-investment in security analysis, and this is an admission that there are opportunities to exploit public information profitably.

Though perfect efficiency is no longer widely believed, many still believe that security price changes generally behave in an efficient manner, even if the level of prices is often incorrect. That is, when new, previously non-public information is made known, the change in a security’s price reflects the economic content of the revelation.

Consider this example. A stock sells for \$50 per share. If markets are not perfectly efficient, the true value of the stock could be higher or lower. This seems to be the current consensus. Now suppose a new piece of information is revealed about the company. Let us say it is good news, and the stock price rises by \$5 per share. Many of those who question the proposition that \$50 is the correct level would still argue that the \$5 price change accurately reflects the true change in the value of the security. This change in value is related to both the change in the relevant company specific information set and to the change in general market conditions.

This sort of thinking continues to play a large role in Rule 10(b)(5) or disclosure litigation. In such litigation, a plaintiff’s typical contention is that a company either misrepresented its financial performance or failed to report to the market material facts which, if revealed, would have caused the stock price to change. Computation of damages in this sort of litigation quite frequently relies upon the validity of the form of market efficiency that relates to price changes. The standard method is the “event study”; this examines the reaction of the security after adjusting for both the risk and performance of the market as a whole during the period in question.

For example, Company X stock closes at \$40 per share on a particular day. The following day it is revealed that in the Company’s last financial statement, inventory

A Letter From Our Managing Directors

Dear Friend:

We are pleased to bring to you Professor Dennis Logue’s contribution to our series of research reports. In addition to serving as an Amos Tuck School professor and frequently appearing as an expert witness, he currently serves as the President of the Financial Management Association.

The topic of securities litigation continues to receive a significant amount of attention from both attorneys and corporate executives. Litigation has often arisen from disclosure of “soft” projection information and restatement of historical earnings. While the SEC is considering approaches to reduce the exposure of companies which disclose soft information, numerous disclosure related lawsuits are filed each year.

Interestingly, the measurement of damages from such disclosure violations has been an evolving science. Professor Logue’s cogent analysis of the state of the art of damage measurement illustrates the importance of efficient market research for damage calculations.

We hope that you will find Professor Logue’s opinion insightful and contributory to your practice.

Sincerely,



Allen Michel



Israel Shaked

was misstated and it actually was worth much less than reported. This is bad news and the stock drops \$2 per share or 5 percent. Part of the stock price change may be attributed to risk and to general market conditions and part to company specific factors. For simplicity, let us assume that the level of all broad based market indicators remained unchanged on the day in question, so the entire \$2 per share change can be linked to the company’s report. While there are commonly used methods for abstracting from market wide movements as well as for adjusting for the risk of the stock in question relative to the market, there are often tremendous disagreements regarding the actual application of such methods. We will not explore those complications here.

Two Approaches to Damage Calculations

In disclosure litigation, two approaches to damage calculations are common. One approach simply takes the \$2 per share price drop and multiplies that by the number of shares outstanding. A second approach focuses on “damaged shares.” Essentially, this approach attempts to identify how many shares were bought after the erroneous report was issued and held until the disclosure. Under this more economically sensible approach, there is recognition that those who own the stock prior to the issuance of the erroneous report would have experienced a drop in value no matter whether the information was reported when it ought to have been revealed or when it actually was revealed. No matter how the number of damaged shares is computed, both approaches would likely agree that the per share damage is \$2. Both implicitly agree that markets are efficient with respect to the way in which new information is incorporated into market prices.

Market Overreaction: The Effect on Damages

Unfortunately, recent academic evidence suggests that even this limited view of market efficiency can be challenged. There is a growing body of literature showing that stock prices may overreact to the release of economically meaningful information. Much of the support for such contentions is based upon the phenomenon of price reversals, that is a sharp upward or downward price change followed by a smaller move in the opposite direction.

This leads to a very interesting issue. In computing damages, should the entire price change on the day of the announcement (and perhaps the day before in order to allow for news leaks) be used, or should the analyst consider a wider announcement window, say the day before, the day of, and three to five days after the announcement to accommodate the stock price’s possible overreaction? Further, should the idea of damaged shares be adjusted

so that those that were sold immediately are allowed the \$2 per share damage, but those that were retained receive less, reflecting the correction to the initial reaction?

There are several reasons for ignoring the possible correction to the initial price change. First, the reversal could simply be a random price change. Second, the reversal could occur because of additional information unrelated to the disclosure. Third, if the company created a situation that disrupted the trading market so that trading on the company’s stock could not take place efficiently, then it should reimburse investors for the entire initial price change regardless of the later correction.

However, there are reasons why the correction to the overreaction should be considered in

computing damages. First, the company should not have to reimburse investors who did not sell for the temporary price pressures created by those who did. Second, in some cases it could be argued that investors ought to have known that the trading market lacks liquidity and resiliency. Accordingly, even selling shareholders ought to be compensated only for the true economic difference between the price received and the

"... Stock prices may overreact to the release of economically meaningful information."

final price. These shareholders should not be compensated for losses caused by their own impatience. Theoretically, those shares bought at prices that were too high and held through the announcement/distillation period would be entitled only to the difference between the price paid and the price after the correction for overreaction; only the shares bought at too high a price and sold at the time of the announcement would be allowed the full damage amount.

The attorneys or experts postulating this argument should be prepared for the other side’s counterarguments. Specifically, they should be prepared for the argument that the company’s own original failure to disclose led to the impairment in the market; therefore it ought to be held accountable.

Additional Complications to the Damage Calculations

To make things even more confusing, note that there is also some evidence of lagged adjustments of stock prices to certain kinds of news, unexpected large or small earnings announcements for instance. Instead of overreaction, followed by correction, there is a delayed reaction. Essentially, the broad issues raised above still exist, except their treatment will be different.

the possibility of overreaction by reviewing much more data following the event day. It also is likely to consider whether there was historical evidence cautioning the investor that this security's liquidity evaporates in the face of major announcements and heavy trading. This can be accomplished by evaluating the company's stock price changes at the time of other major disclosures.

Recent empirical evidence is casting doubt on some of our most cherished beliefs. It suggests that stock prices do not react instantly and unbiasedly to new information. Sometimes they overreact, then correct; sometimes, they react too slowly. Oversimplistic approaches to damage calculations must be enhanced significantly by more data, more analyses, greater judgment, and tremendous familiarity with the current research finding in financial economics.

Conclusion

All these considerations point to the need for more complete analyses of stock price behavior around disclosure announcements than is currently done in disclosure cases. The analysis may well account for



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