No. 03-7948

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

JOHN KILGOUR LENTELL, BRETT RAYNES and JULIET RAYNES,

Plaintiffs-Appellants,

v.

MERRILL LYNCH & CO., INC. and HENRY M. BLODGET,

Defendants-Appellees.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF FOR *AMICI CURIAE* THE UNITED STATES CHAMBER OF COMMERCE AND BUSINESS ROUNDTABLE IN SUPPORT OF DEFENDANTS-APPELLEES AND URGING AFFIRMANCE OF THE DISTRICT COURT'S DECISION

Robin S. Conrad
Stephanie A. Martz
NATIONAL CHAMBER
LITIGATION CENTER
1615 H Street, N.W.
Washington, D.C. 20062
(202) 463-5337

David C. Frederick
Neil M. Gorsuch
Paul B. Matey
KELLOGG, HUBER, HANSEN
TODD & EVANS, P.L.L.C.
1615 M Street, N.W., Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for Amici Curiae United States Chamber of Commerce and Business Roundtable

June 3, 2004

CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, amici curiae the United States Chamber of Commerce and Business Roundtable state that there are no parent companies, subsidiaries, or affiliates of the amici that have issued shares to the public.

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INTEREST OF AMICI CURIAE

The United States Chamber of Commerce (the "Chamber") is the nation's largest business federation, representing more than three million businesses and organizations of every size, and in every region of the country. The Chamber regularly advocates the interests of its members in legal matters involving issues of national concern to the American business community.

The Business Roundtable is an association of chief executive officers of leading U.S. corporations with a combined workforce of more than 10 million employees in the United States. The Roundtable is committed to advocating public policies that ensure vigorous economic growth, a dynamic global economy, and the well-trained and productive U.S. workforce essential for future competitiveness.

The Chamber and Business Roundtable have a substantial interest in the issues presented in this appeal. Businesses represented by the amici curiae routinely face liability for alleged violations of the federal securities laws. In 2003 alone, companies named in federal securities class actions lost an estimated $540 billion in market capitalization during the class periods. See Cornerstone Research, Securities Class Action Case Filings 2003: A Year in Review 2, Exh. 1 (May 2004). These statistics confirm the Supreme

Court's long-standing conclusion that securities fraud actions present "a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975). Indeed, as Judge Friendly once remarked, securities fraud litigation carries the risk of "'large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.'" Id. (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968)).

The membership of the Chamber and Business Roundtable thus have a strong interest in ensuring that the requirements of the federal securities laws are applied in a fair and uniform manner to avoid unwarranted intrusions into the nation's commerce and industry.

STATEMENT OF THE CASE

A. The Internet Stock Bubble

This case involves the economic fallout caused by the collapse of the Internet stock bubble of the late 1990s. The rise and fall of the market for Internet stocks was hardly the first instance of speculation driving prices and demand to unprecedented heights. See generally Peter M. Garber, Famous First Bubbles: The Fundamentals of Early Manias (2001). Yet, when compared with earlier market declines, "the Internet bubble was all the more

remarkable because it occurred in the most liquid, sophisticated, and ostensibly diverse market in history." Leon Levy & Eugene Linden, The Mind of Wall Street 151 (2002).

The frenzied speculation in Internet companies began in 1995, and by the summer of 1996, an estimated 800,000 Americans had online trading accounts, with new subscribers joining daily. See John Cassidy, Dot.con: How America Lost Its Mind and Money in the Internet Era 127 (2002). Investor fever soon spread to all technology-based stocks, and, by 1999, "anybody who questioned" the ability of these industries to fulfill their promise "was ignored." Id. at 207. Wired magazine, the monthly authority on this emerging "digital economy," proclaimed the "coming age of 'ultra prosperity,'" predicting that by 2020 the average household income in the United States would top $150,000, middle-class families would staff personal chefs, and the Dow Jones Industrial Average would be heading towards 100,000. Id. at 256. All the world joined in the rush, and the resulting "magical rise of [these] profitless companies distorted the scales of traditional business." Roger Lowenstein, Origins of the Crash: The Great Bubble and Its Undoing 117 (2004).

While the inflation continued, skepticism about the ability of Internet stocks to retain their startling prices began to rise. As researchers have

noted, "many media accounts in the mid- to late 1990s . . . focused on what they consider[ed] the craziness of investors." Robert J. Shiller, Irrational Exuberance 113 (2001). Throughout the late 1990s, "a number of stories . . . ran in widely read newspapers and magazines . . . exposing the limits of Wall Street research . . . [b]ut while the market was going up, these stories barely created a ripple." Maggie Mahar, Bull!: A History of the Boom, 1982-1999, at 346 (2003). As a result, the Internet bubble "continued to inflate despite a drumbeat of warnings in the mainstream press that laid out in the plainest possible language the absurdity of the valuations that investors were lavishing on stocks." Levy & Linden, The Mind of Wall Street 151.

By 2003, of course, the widespread skepticism about the values of Internet companies had proven correct. When the collapse was over, an estimated 100 million individual investors had lost nearly five trillion dollars. See Mahar, Bull!: A History of the Boom, 1982-1999, at 333. As the now-humbled editors at Wired would conclude, "[t]he problem with a stock bubble is you never really know it is one until it pops." Joanna Glasner, Why the Bubble's in Trouble, Wired News (Apr. 11, 2000), available at http://www.wired.com/news/print/0,1294,35477,00.html.

Although the technologies behind the creation and crash of the Internet bubble were unique, the unexpected rise and fall of publicly traded stocks is a story as old as the federal securities laws. Though written especially for the securities industry, section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission are framed on the fundamental common law prohibition against fraud, including the basic requirement that plaintiffs allege and prove that the defendant's tort proximately caused the stated injury. By limiting liability to "foreseeable" risks or "direct" consequences, legal causation represents a doctrinal policy decision that a defendant's liability is not limitless. In securities fraud litigation, proximate causation — known as "loss causation" — serves the essential function of filtering out claims caused not by a specific wrongful act, but through the often chaotic churnings of the free capital marketplace.

The facts alleged in the two cases on appeal underscore the important function served by the loss causation requirement at the pleadings stage to weed out frivolous claims seeking to impose liability that is neither proximate nor foreseeable. Merrill Lynch has long offered its investment customers a variety of research materials for use in evaluating market options. As investments in Internet-based companies began to surge after

1995, Merrill Lynch, like all the major (and indeed minor) brokerage firms in the country, organized a research department to advise its clients on investments in Internet stocks. Merrill Lynch's Internet research group published reports on both general industry trends and specific company profiles using information supplied by the individual businesses.

These reports expressly stated that they were "circulated for general information only" and that these general recommendations were not intended to address "the specific financial objectives, financial situation, and the particular needs of any specific person." Each report further cautioned investors to "seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed," and "that statements regarding future prospects might not be realized." The authors of these reports then added their own subjective opinions on whether investors should purchase shares in the companies profiled.

B. Plaintiffs' Effort To Blame Merrill Lynch for Their Speculation

By 2001, the now-famous "irrational exuberance" that fueled investments in Internet-based companies diminished, and the Internet stock price bubble had burst.[1] Around the same time, New York's Attorney

[1] Experts now agree that the collapse of the "Internet bubble" could not be identified until after the steep decline in stock values began. See, e.g., Paul

General began a year-long investigation of the sales practices at Merrill Lynch. As part of this investigation, the Attorney General's office made public an affidavit by Eric R. Dinallo, chief of New York's Investment Protection Bureau, stating that Merrill Lynch analysts often worked closely with the firm's investment banking division.

Based almost exclusively on the Dinallo affidavit, dozens of class action suits were filed against Merrill Lynch alleging that the analysts' reports were materially misleading and seeking to place the blame for investors' losses not on the general deterioration of the market, but on Merrill Lynch. The two cases at issue in this appeal center on recommendations concerning two Internet companies, 24/7 Real Media, Inc. ("24/7") and Interliant, Inc. ("Interliant"). Plaintiffs are investors who purchased shares in 24/7 between May 12, 1999 and November 9, 2000, and who purchased shares in Interliant between August 4, 1999 and February 20, 2001. During the putative class period, shares in 24/7 traded between a high

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A. Ferrillo et al., The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases, 78 St. John's L. Rev. 81, 116 & n.150 (2004) (quoting analyst Stanley Druckenmiller's statement that "we thought it was the eighth inning, and it was the ninth," as an explanation for holding technology stocks despite his belief that shares were overvalued); see also Levy & Linden, The Mind of Wall Street 159 ("If time had stopped in March 2000, pundits would have had ample ammunition to argue that a new golden age had arrived.").

of $65.25 per share and a low of $2.75. Shares in Interliant reached a high of $55.50 during the putative class period before falling to a low of $3-1/8.

These bookends, however, do not tell the whole story. During the class periods, prices in both 24/7 and Interliant fluctuated wildly and without regard to the recommendations of Merrill Lynch analysts. For example, between September 21, 1999 and August 31, 2000, Merrill Lynch rated 24/7 as a "buy." During this same time, share prices climbed from $32.87 (September 21, 1999) to $48.50 (October 11, 1999) before falling to $35.81 (October 18, 1999), then rising to $63.43 (December 10, 1999), falling to $42.18 (January 12, 2000), rising again to $64.62 (January 26, 2000), falling to $17.87 (April 27, 2000), and recovering to $23.12 (May 17, 2000). Similarly, Merrill Lynch rated Interliant as a "buy" between May 8, 2000 and March 8, 2001. Nonetheless, share prices fell from $22.25 (May 8, 2000) to $15.25 (May 25, 2000) before recovering to $24.37 (July 7, 2000), then declining to $4.25 (October 18, 2000) but rising to $10.68 (November 8, 2000). Moreover, the projections issued by Merrill Lynch analysts during these periods were hardly unique or out-of-line with the industry; rather,

Merrill's ratings mirrored those issued by virtually every other brokerage firm.[2]

Finally, as found by the district court, Plaintiffs are not clients or customers of Merrill Lynch. Plaintiffs do not allege that any class member relied on, read, or even saw a copy of any of these analyst reports. Despite all of this, Plaintiffs claim that Merrill Lynch's predictions about 24/7 and Interliant (somehow) caused their losses.

SUMMARY OF ARGUMENT

The district court's correct conclusion that Plaintiffs' allegations are insufficient to satisfy the requirement of loss causation as a matter of law is supported by important goals of economic efficiency codified by Congress in the Private Securities Litigation Reform Act of 1995 (the "PSLRA").

The district court properly recognized that, under the PSLRA, the adequacy of allegations demonstrating loss causation is a legal determination that does not turn on discoverable facts. By adding a loss causation pleading requirement to federal law, Congress sought to weed out unmeritorious

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[2] Numerous news sources and commentary document the nearly uniform agreement among analysts regarding the potential returns in Internet stocks. See, e.g., Shiller, Irrational Exuberance 19-21; see also David Wessel, Greenspan Gives No Hint of Rate Boost, Wall St. J., July 23, 1997, at A2; Dean Foust, Alan Greenspan's Brave New World, Bus. Week, July 14, 1997, at 44; Nelson D. Schwartz, The Tech Boom Will Keep on Rocking, Fortune, Feb. 15, 1999, at 64; The Net Imperative, Economist, June 26, 1999.

securities fraud claims at the earliest possible stage. Allowing complaints lacking a sufficient allegation of loss causation to progress into discovery or, more ominously, class certification, upsets the careful balance between just recovery and over-deterrence codified in the PSLRA. To fulfill Congress's intent, courts must therefore assume a gatekeeping function that involves a preliminary assessment of whether the plaintiff's allegations state a valid causal nexus, and whether that nexus reasonably explains the plaintiff's claimed loss. This test, analogous to the requirements for admitting scientific evidence under Federal Rule of Evidence 702 and the holding of Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1993), provides a manageable and familiar framework for district courts to analyze securities fraud claims.

Before Daubert, courts struggled with instances of "phantom" injuries: cases involving actual harms producing actual suffering, but for which no single cause could be reliably identified. Phantom injuries, though undoubtedly real in a literal sense, become unwieldy in a legal sense when no means exists to trace the injury to a specific action. Phantom harms thus present a new variant on the old problem of proximate causation and the need to place limitations on liability.

Requiring plaintiffs to plead facts showing loss causation enables judges to separate investor losses stemming from actual fraud from those caused by mere market downturns. As this Court implicitly recognized in Emergent Capital Investment Management, LLC v. Stonepath Group, Inc., 343 F.3d 189 (2d Cir. 2003),[3] allowing the theory of "fraud-on-the-market" to satisfy the plaintiff's entire burden on causation risks overcompensating investors for stock losses unrelated to any specific action by a defendant. Where, as here, an alternative cause like the marketwide drop in Internet securities results in comparable losses across similarly situated investors, plaintiffs must logically allege some facts that tend to show that their particular losses were caused by the defendants' alleged wrongdoings. Only by requiring a specific causal nexus can courts achieve optimal deterrence against fraud without transforming the federal securities laws into a system of national investor insurance. For these reasons, the Solicitor General recently filed an amicus curiae brief urging the Supreme Court to review the Ninth Circuit's contrary holding in Broudo v. Dura Pharmaceuticals, Inc., 339 F.3d 933 (9th Cir. 2003). See Brief for the United States as Amicus

[3] Emergent accords with the majority of circuit court decisions that require plaintiffs to allege facts showing a causal link between the alleged misrepresentation and their claimed losses. See Semerenko v. Cedant Corp., 223 F.3d 165 (3d Cir. 2000); Robbins v. Koger Props., Inc., 116 F.3d 1441 (11th Cir. 1997); Bastian v. Petren Res. Corp., 892 F.2d 680 (7th Cir. 1990).

Curiae at 12, Dura Pharms., Inc. v. Broudo, No. 03-932 (U.S. filed May 28, 2004) (concluding that cases allowing fraud-on-the-market to satisfy loss causation are "difficult to reconcile with the well-established principle that transaction causation and loss causation are distinct elements of a Rule 10b-5 cause of action").

The Chamber and Business Roundtable have a strong interest in combating the meritless securities fraud litigation that remains a burden on both the judicial system and the national economy. Despite the clear goals of the PSLRA, the number of new securities suits has remained almost constant since the early 1990s. Although courts routinely question the merits of many of these claims, businesses represented by the amici curiae face relentless pressure to settle these suits rather than operate under the shadow of lingering uncertainties. In addition, frivolous securities actions threaten to chill the free flow of advice to investors, reducing the efficiency of the capital markets and stunting the growth of American business.

The loss causation requirement of the PSLRA avoids these potential harms and should therefore be rigorously enforced — as Congress intended — at the pleading stage of litigation. Reaffirming the loss causation pleading requirement already adopted by this Circuit will protect purchasers from harms outside the normal risks of stock ownership without inefficiently

deterring sales of shares in publicly held businesses through "phantom" securities fraud claims.

ARGUMENT

LOSS CAUSATION IS CRITICAL TO A REASONABLE BALANCE BETWEEN DETERRING WRONGDOING AND DETERRING MARKET FUNCTIONS

A. Loss Causation Is an Independent Element of a Securities Fraud Claim That Balances the Liberal Pleading Standards for Transaction Causation Under the Fraud-on-the-Market Theory

In 1995, Congress passed the PSLRA, 15 U.S.C. § 78u-4, and expressly adopted the then-prevailing view in the circuit courts that loss causation is a separate and unique element of any securities fraud claim. The PSLRA requires all plaintiffs bringing a claim for securities fraud to prove "that the act or omission of the defendant alleged . . . caused the loss for which the plaintiff seeks to recover damages." Id. § 78u-4(b)(4). The loss causation requirement of the PSLRA is one part of a comprehensive system of regulation passed by Congress to remedy abuses in securities litigation, including an increasing number of frivolous lawsuits. See S. Rep. No. 104-98, at 6, 10 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685, 689.

As explained by the Senate Banking Committee, the loss causation requirement in the PSLRA imposes a "strong pleading requirement" on the filing of any securities fraud action. Id. at 15, reprinted in 1995

U.S.C.C.A.N. at 694. The Senate Banking Committee specifically noted that the bill "requires the plaintiff to show that the misstatement . . . alleged in the complaint caused the loss incurred by the plaintiff." Id. Likewise, the House Report concluded that the law "requires the plaintiff to plead and then to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff." H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740. These reports confirm that Congress added the loss causation requirement specifically to increase the plaintiff's pleading burden to deter unmeritorious securities fraud claims. See Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 597 (2001) (noting the "stricter pleading requirements" imposed in the PSLRA).

The loss causation standard adopted by Congress in the PSLRA, moreover, draws on the rich jurisprudential history of the doctrine of causation in the law of torts. As every first-year law student learns, explanations for the causation requirement in tort are variously couched in terms of a defendant's "duty" to the plaintiff, or whether the particular harm suffered by the plaintiff was a "foreseeable" result of the defendant's conduct. See, e.g., Palsgraf v. Long Island R.R., 248 N.Y. 339, 162 N.E. 99 (1928). All expressions of this test recognize, however, that while "the consequences of an act go forward to eternity, . . . legal responsibility must

be limited to those causes which are so closely connected with the result" that liability is justifiable. W. Page Keeton et al., Prosser and Keeton on Torts § 41, at 264 (5th ed. 1984).

This policy decision is at the heart of the loss causation requirement in the PSLRA. The requirement of loss causation emerged in three phases as courts interpreted the causal showing needed to sustain a claim of securities fraud under Rule 10b-5. In List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), this Court first held that plaintiffs must show that the defendant's "'misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.'" Id. at 462 (quoting Restatement of Torts § 546 (1938)) (alteration in original). Four years later, in Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), this Court held that reliance on an alleged misrepresentation was sufficient to satisfy the plaintiff's entire burden on causation, concluding that any eventual loss on the stock purchase was "a reasonably foreseeable result of the misleading statement." Id. at 1291 (internal quotation marks omitted).

Allowing reliance to generally satisfy causation, however, dangerously appeared to some to collapse the distinction between the common law concepts of actual and proximate causation. Accordingly, a second phase of interpretation began in Schlick v. Penn-Dixie Cement Corp.,

507 F.2d 374 (2d Cir. 1974), where this Court distinguished between "loss causation" and "transaction causation." Schlick defined transaction causation as the connection between the defendant's alleged fraud and the plaintiff's decision to participate in the transaction. See id. at 380. Loss causation, in contrast, refers to the causal connection between the alleged fraud and the plaintiff's claimed injury. See id.

After Schlick, courts gradually refined the distinction between transaction and loss causation in response to the development of new, relaxed standards of pleading and proof under the fraud-on-the-market theory. The fraud-on-the-market theory allowed plaintiffs to establish transaction causation based solely on proof that the defendant made a material misrepresentation in an "open and developed securities market." Basic Inc. v. Levinson, 485 U.S. 224, 241-42 (1988) (internal quotation marks omitted). The fraud-on-the-market theory thus allowed purchaser plaintiffs to demonstrate causation even in situations where "the purchasers do not directly rely on the misstatements." Id. Given this new standard, courts properly grew concerned that defendants would be liable for misrepresentations without any allegation or evidence tending to show that the misrepresentations caused the plaintiff's loss. See, e.g., Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 718 (2d Cir. 1970) (Meskill, J., dissenting)

(noting that "causation must be proved else defendants could be held liable to all the world") (internal quotation marks omitted).

In the third and final phase, circuit courts returned to the standards of common law fraud that had long informed securities claims and concluded that recovery under Rule 10b-5 should be permissible "only if the misrepresentation touches upon the reasons for the investment's decline in value." E.g., Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. Unit A Mar. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983). This insistence sharpened in the years after the Supreme Court's decision in Basic, as courts explicitly linked loss causation to proximate cause. See, e.g., Robbins, 116 F.3d at 1447; see also Bastian, 892 F.2d at 683 (pre-Basic decision noting that "what securities lawyers call 'loss causation' is the standard common law fraud rule . . . merely borrowed for use in federal securities fraud cases").

The adequacy of the allegations demonstrating loss causation is thus a pure question of law, ensuring that remedies for securities fraud are premised on the basic economics of legal sanctions. As leading securities law scholars have explained, "[t]he economics of sanctions starts from the proposition that the objective of a legal rule is to deter certain undesirable behavior without simultaneously deterring (too much) beneficial behavior."

Frank H. Easterbrook & Daniel R. Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611, 612 (1985). This model of optimal deterrence embodies a classic moral judgment that retributive sanctions must stem from a causal relationship. See Guido Calabresi, Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr., 43 U. Chi. L. Rev. 69, 79 (1975). From this precept flows the "common law's universal requirement" that a claim sounding in tort must include a sufficient allegation that the defendant's conduct caused the plaintiff's injury or, stated simply, "[n]o hurt, no tort." Bastian, 892 F.2d at 683-84. Causation is thus an essential element of any cause of action in tort, requiring the plaintiff to plead "some reasonable connection between the act or omission of the defendant and the damage which the plaintiff has suffered." Keeton et al., Prosser and Keeton on Torts § 41, at 263.

Congress endorsed — and codified — just that causation requirement in the PSLRA. By remedying only losses that are traceable to the defendant's action, the PSLRA avoids imposing dead losses on the marketplace, such as the misallocation of resources to prosecute or defend a lawsuit based on factors unrelated to the investment decision.

B. Efficient Enforcement of the Federal Securities Laws Requires Courts To Screen Complaints and Determine Whether the Claimed Losses Are Causally Connected to the Alleged Fraud

Assigning a gatekeeping responsibility to the federal courts is hardly novel. The same concerns that spurred the passage of the PSLRA — including an abundance of frivolous suits, questionable claims of injury, and speculative theories of causation — prompted the adoption of Federal Rule of Evidence 702 and the Supreme Court's holding in Daubert.

Daubert and Rule 702 both address the need to ensure that the nexus between a plaintiff's injury and the alleged cause of that injury is supported by reliable evidence. Prior to Daubert, courts viewed relevancy under a loose standard that tolerated almost any correlation between cause and injury. Without a rigorous examination of the causal nexus underlying the allegations, claims of questionable merit inefficiently proceeded to trial. As a result, courts were unable to exclude "marginal or unreliable" theories of causation. See Kenneth R. Foster et al., Phantom Risk: Scientific Inference and the Law 433 (1993).

Daubert and Rule 702 provided courts with the tools to screen out scientifically questionable claims in two ways. First, Daubert allows courts to determine whether a claim is based on a proper temporal logic, where the

alleged harmful act precedes the alleged injury. Second, Daubert provides courts with the flexibility to exclude other factors beyond the alleged harmful act that could have caused the plaintiff's injury. Together, these guideposts "invite[] courts to take a hard look" at the causal basis underlying a plaintiff's alleged injury and thus to "act with dispatch" in quickly rejecting speculative and unproven claims. Christopher B. Mueller & Laird C. Kirkpatrick, Evidence § 7.17, at 740 (2d ed. 1999); see also Amorgianos v. National R.R. Passenger Corp., 303 F.3d 256, 267 (2d Cir. 2002) ("The flexible Daubert inquiry gives the district court the discretion needed to ensure that the courtroom door remains closed to junk science while admitting reliable expert testimony that will assist the trier of fact.").

Loss causation under the PSLRA achieves this same goal in the securities fraud context. By subjecting securities claims to a loss causation requirement, courts can test for some reliable indication that the alleged loss was not caused by fluctuations in the marketplace due to causes other than a defendant's putative fraud. As noted by scholars, speculative investments are a natural and even beneficial part of any open market: "[I]n stock trading, as elsewhere, speculation serves the salutary purpose of enabling the rapid adjustment of prices to current values." Richard A. Posner, Economic Analysis of the Law 458 (6th ed. 2003). Naturally, however, the significant

potential benefits of speculation carry a correspondingly high degree of risk. Given this trade-off, Rule 10b-5 should ensure that market participants are held liable only for the injuries they cause, and not as "insurers against national economic calamities." Bastian, 892 F.2d at 685.[4]

In this manner, the loss causation gatekeeping function protects against "phantom losses" — securities fraud claims based on "cause-and-effect relationships whose very existence is unproven and perhaps unprovable." Foster et al., Phantom Risk 1. The loss causation requirement of the PSLRA recognizes that, although investors have suffered real and

[4] This basic premise explains the district court's characterization of Plaintiffs in this action as "speculators." Although Plaintiffs suggest that this label is somehow derogatory, speculators are, in fact, held in high esteem. "The speculator is the eager searcher for undervalued and overvalued securities," and the information discovered through this search "diffuses rapidly throughout the market." Posner, Economic Analysis of the Law 458. In particular, speculators may be attracted to what economists refer to as "rational bubbles," where a stock's price incorporates all publicly available information without "represent[ing] the true value of the underlying company." Ferrillo et al., Efficient Capital Markets, 78 St. John's L. Rev. at 114. Risk-neutral investors might reasonably conclude that an overvalued stock will continue to appreciate during the life of the bubble. See id. at 115. These investors realize that "[e]ventually the bubble will burst, of course, but it is always a fair investment until that point." Id.; see also Brief for the United States as Amicus Curiae at 11, Dura Pharms., Inc. v. Broudo, No. 03-932 (U.S. filed May 28, 2004) (explaining that an investor "will be able to recoup part or all of his overpayment 'by reselling the security at the inflated price'") (quoting Semerenko, 223 F.3d at 185). Accordingly, the district court's opinion merely — and quite rightly — recognized that "having knowingly gambled in the high-yield market," Plaintiffs "cannot now be heard to complain too loudly" about their losses. Miller v. New Am. High Income Fund, 755 F. Supp. 1099, 1109 (D. Mass. 1991).

identifiable losses, the cause of those injuries is sometimes unproven and unprovable with any degree of reliability. See Miller, 755 F. Supp. at 1109 (concluding that, although plaintiffs "cannot be blamed for seeking redress for the wrongs they have suffered," no causal nexus to the alleged fraud supported their claims). Loss causation is thus a safeguard against "infinite liability for all wrongful acts" no matter how attenuated or unrelated to the investor's claim of loss. Keeton et al., Prosser and Keeton on Torts § 41, at 264.

C. Fraud-on-the-Market Theories Cannot Satisfy Loss Causation Without Risk of Limitless Liability for Harms Caused by the Natural Rise and Fall of Capital Markets

In recent years, some courts have returned to the "pure reliance" test of the 1960s by allowing the fraud-on-the-market theory to satisfy the entire causation requirement. In these cases (as here), the plaintiffs restate the fraud-on-the-market theory as a claim of "price inflation" or "price disparity" and argue that a misrepresentation about a stock disseminated on the market caused an artificial inflation in the stock's price. See Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 831 (8th Cir. 2003) (holding that causation is presumed where the alleged fraud inflated the stock price throughout the market); Broudo, 339 F.3d at 938 ("[I]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the

price on the date of purchase was inflated because of the misrepresentation.") (internal quotation marks omitted); DeMarco v. Lehman Bros. Inc., 309 F. Supp. 2d 631, 636 (S.D.N.Y. 2004). These decisions are wrong on three levels.

First, allowing fraud-on-the-market to satisfy loss causation is inconsistent with the plain language of the PSLRA. Second, it is inconsistent with Congress's intent to enhance the pleading requirements in securities fraud cases to weed out frivolous suits. Cases like ConAgra and Broudo do not honor this intent; indeed (as illustrated below), they permit the opposite result.

Third, a separate and independent loss causation pleading requirement is necessary under sound economic reasoning. Allowing the fraud-on-the-market theory to satisfy both transaction and loss causation collapses two separate considerations: whether the defendant's conduct caused the plaintiff to enter into the investment and whether the defendant's conduct is sufficiently related to the plaintiff's damages to impose liability for the claimed loss. Imposing sanctions on this basis poses the danger of over-deterrence, overcompensation, and thus an inefficient use of the federal courts and laws.

Collapsing the causal requirement, moreover, ignores the special function served by the fraud-on-the-market theory. Fraud-on-the-market recognizes that investors seldom base their investment decisions on a single piece of information, making a showing of actual reliance in the common law sense difficult, if not impossible, to prove. To address this problem (and to avoid under-deterring fraudulent conduct), the theory assumes that "most publicly available information is reflected in market price" and creates a rebuttable presumption of investor reliance on any material misrepresentation. Basic, 485 U.S. at 247.

Fraud-on-the-market does not, however, answer whether the defendant's conduct affected the stock price. See Miller, 755 F. Supp. at 1108 (holding that plaintiffs do not demonstrate loss causation "by saying they would not have bought [the] stock had they known the truth" and requiring an allegation that "they would not have suffered the loss absent the misrepresentations"). If this causal question is ignored, dissatisfied investors could invoke the fraud-on-the-market theory following any drop in a stock's price merely by citing some alleged misrepresentation, and without ever demonstrating a causal connection between the two events. Employing loss causation in this manner would eliminate the ability to screen for intervening events that caused the harms alleged by an investor. This screening

function, which is critical in any tort action, is essential in the securities markets given the natural rise and fall of stock values that form the basis for all investments.[5]

As Judge Posner explained, "[n]o social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation." Bastian, 892 F.2d at 685. Allowing fraud-on-the-market to subsume the entire causation requirement under the PSLRA would transform the federal securities laws into "a system of investor insurance that reimburses investors for any decline in the value of their investments." Robbins, 116 F.3d at 1447. The facts of certain recent decisions in other circuits illustrate the illogical results of ignoring the loss causation

[5] Recognizing this dilemma, Plaintiffs assert that this Court should overlook the intervening collapse of the Internet bubble by creatively arguing that Merrill Lynch is also responsible for the overall market inflation of Internet stocks. This argument is correct only "[i]n a philosophical sense" in that "the causes of an event go back to the dawn of human events, and beyond." Keeton et al., Prosser and Keeton on Torts § 41, at 264. Here, however, Plaintiffs do not (nor could they plausibly) allege that Merrill Lynch analysts created and sustained the Internet bubble on their own, or even that the analysts were responsible for some identifiable percentage of the bubble.

requirement in the PSLRA and the dangers of permitting meritless claims to proceed past the pleadings stage.

In Broudo, the plaintiffs alleged that the defendants fraudulently concealed the status of FDA approvals for a new product. The plaintiffs based their claims on a February 24, 1998 forecast of expected revenue (that did not mention the status of FDA testing) and the immediate decline of the stock following the forecast. See 339 F.3d at 936. Nearly nine months later, the company announced that FDA approval would be denied. See id. The district court dismissed the action based on the plaintiffs' failure to plead "any allegations that the FDA's non-approval . . . had any relationship to the February price drop." Id. at 937 (internal quotation marks omitted). The Ninth Circuit reversed without addressing this inconsistency, noting only that "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." Id. at 938 (internal quotation marks omitted). The Solicitor General has specifically concluded that this holding "is incorrect" and that "not requiring any allegation of a subsequent loss of value attributable to the fraud[] would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation" alleged. Brief

for the United States as Amicus Curiae at 10-11, Dura Pharms., Inc. v. Broudo, No. 03-932 (U.S. filed May 28, 2004).

In ConAgra, the plaintiffs alleged that the company had fraudulently permitted a subsidiary to book revenues for future sales. The plaintiffs alleged that this fraud came to light when ConAgra issued two press statements disclosing the accounting irregularity and restating the company's income for a three-year period. See 335 F.3d at 827. The restated earnings, however, resulted in a net gain for the period in question. See id. (reducing gross income by $111 million for the years 1998 through 2000, and increasing income for 2001 by $127 million). Moreover, although ConAgra stock dropped from $20.61 to $20.07 on the day after the second press statement, "the stock price quickly recovered and began to trend higher." Id. Despite these facts, the Eighth Circuit reversed the district court's dismissal, finding loss causation satisfied by the fraud-on-the-market presumption. See id. at 831.

The facts of the present case similarly demonstrate the necessity of using loss causation as a screening mechanism. First, Plaintiffs did not even read Merrill Lynch's reports and thus could not have made purchase decisions based on the analysts' recommendations. Second, while the prices of both 24/7 and Interliant stock fluctuated wildly during the putative class

periods, there is absolutely no correlation between prices and Merrill Lynch's recommendations. Third, Merrill Lynch's recommendations were no different than the other analysts who are not alleged to have caused any "harm." To hold the PSLRA's loss causation pleading standard satisfied under these circumstances truly would render Congress's enactment — not to mention its stated purposes — a dead letter.

As the district court recognized, moreover, allowing this suit to proceed to class certification (and beyond) threatens to deprive the securities market of the research and analysis necessary for private and institutional investments. If Plaintiffs are able to hold Merrill Lynch liable without connecting their investment losses to the analyst reports, then all analysts can be held liable to all investors for any loss in a stock that has been discussed in a research report. To avoid this consequence, banks, brokers, and investment firms will simply cease publishing research reports and thus significantly reduce the amount of information available in the market. See Posner, Economic Analysis of the Law 458 (noting that "[i]nformation that may mislead some members of the audience may be valuable to others").

Screening for sufficient allegations of loss causation is also a necessary response to the proliferation of meritless securities fraud actions that have persisted since the early 1990s. Despite the reforms included in

the PSLRA, the number of new class actions arising from allegations of securities fraud has remained almost constant over the last decade. See Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003 (May 2004) ("Post-Reform Study"), available at http://securities.cornerstone .com/pdfs/2003_Settlements.pdf. Under pressure to resolve the uncertainties created by these suits, corporations routinely opt to settle for sums that total hundreds of millions of dollars. See Ontario Pub. Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp., --- F.3d ---, No. 03-7608, 2004 WL 1110496, at *4 (2d Cir. May 19, 2004) (noting that the danger of "abusive litigation" in securities fraud actions could force companies to "settle cases that were not meritorious in order to manage their risk levels"). Studies estimate that in 2003 alone, 96 securities class actions were settled for a total value of $2 billion. See Post-Reform Study at 1-2, figs. 1 & 2.

Each of these settlements is accompanied by a request for attorneys' fees ranging anywhere from 19 percent to 45 percent of the settlement fund. See National Association of Consumer Advocates, Standards and Guidelines for Litigating and Settling Consumer Class Actions § 7.C (Oct. 8, 1997), reprinted at 176 F.R.D. 375, 397 (1997); see also In re SmithKline Beckman Corp. Sec. Litig., 751 F. Supp. 525, 533 (E.D. Pa. 1990) (collecting cases).

Rather than benefiting investors, these cases primarily benefit plaintiffs' attorneys.[6] One recent securities fraud case was described by a Florida court as "the class litigation equivalent of the 'Squeegee boys' who used to frequent major urban intersections and who would run up to a stopped car, splash soapy water on its perfectly clean windshield and expect payment for the uninvited service of wiping it off." Fruchter v. Florida Progress Corp., No. 99-6167CI-20, 2002 WL 1558220, at *10 (Fla. Cir. Ct. Mar. 20, 2002).

Finally, if Plaintiffs successfully pin their losing investments on Merrill Lynch, no apparent barrier will remain to prevent future litigants from even bolder attempts to expand liability to anyone even remotely connected to an investment decision. For example, media programs with

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[6] In re PeopleSoft Securities Litigation illustrates the phenomenon. See Order Certifying Settlement Class, Approving Class Settlement, and Awarding Fees and Expenses, In re PeopleSoft, Inc. Sec. Litig., No. C 99-00472 WHA, at 9-10 (N.D. Cal. Aug. 24, 2001). Immediately following a decline in the common stock of PeopleSoft, Inc., 19 complaints were filed alleging that top company executives had made materially false and misleading statements to inflate the stock price. At the outset of the action, counsel represented that the case was worth hundreds of millions of dollars in damages. Yet, one year later, the plaintiffs sought approval for a settlement of $15 million. In reviewing the proposed settlement, the district court concluded that counsel had engaged in "minimal" discovery, "on the borderline of acceptability" given the purported scope of the case. Id. Although the district court concluded that "a substantial part of the allegations that led the court to sustain the complaint in the first place are untrue, were never true, and had, at most, razor-thin support," plaintiffs' counsel pocketed $2.5 million in fees and expenses. Id.

"talking heads" touting various Internet stocks became a popular feature on cable television during the class periods in this case. See, e.g., CNN, CNNfn on TV, at http://money.cnn.com/ontv/; FOXNews.com, FNC Shows, at http://www.foxnews.com/business/. Similarly, Internet sites such as "The Motley Fool" regularly praised investments in the Internet sector. Without loss causation to limit the scope of liability, dissatisfied investors could bring claims against these news and entertainment sources simply by finding some statement recommending an Internet stock made to a wide public audience. See Bastian, 892 F.2d at 685.

Allowing Plaintiffs' putative class suit to proceed without a sufficient allegation of loss causation will reduce the circulation of information within the securities market and thus chill investment advice and reporting. Such a result is contrary to Congress's statute, its express purpose, and the fundamental law of tort causation. It is also inconsistent with the basic premise of an open capital market. See Posner, Economic Analysis of the Law 457 (explaining that competitive capital markets exist to "generate information about the products sold"). The district court's decision prevents these harms and ensures that securities investors continue to benefit from the free flow of information that allows for profitable investments.

CONCLUSION

For the foregoing reasons, the Court should affirm the judgment of the district court dismissing these actions.

Respectfully submitted,

Robin S. Conrad
Stephanie A. Martz
National Chamber Litigation Center
1615 H Street, N.W.
Washington, D.C. 20062
(202) 463-5337

David C. Frederick
Neil M. Gorsuch
Paul B. Matey
Kellogg, Huber, Hansen, Todd & Evans, P.L.L.C.
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for Amici Curiae United States Chamber of Commerce and Business Roundtable

June 3, 2004

CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C), the undersigned counsel for amici curiae the United States Chamber of Commerce and Business Roundtable, hereby certifies that the foregoing Brief has been prepared in a proportionally spaced typeface using Microsoft Word 2000 in 14 point Times New Roman font and contains 6,922 words as determined by the word count feature of Microsoft Word 2000, and therefore complies with the requirements of Federal Rules of Appellate Procedure 29(d) and 32(a)(7)(B)(i).

Paul B. Matey

SPECIAL APPENDIX

SPECIAL APPENDIX

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15 USCS § 78u-4

TITLE 15. COMMERCE AND TRADE
CHAPTER 2B. SECURITIES EXCHANGES

§ 78u-4. Private securities litigation

(a) Private class actions.

(1) In general. The provisions of this subsection shall apply in each private action arising under this title [15 USCS §§ 78a et seq.] that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure.

(2) Certification filed with complaint.

(A) In general. Each plaintiff seeking to serve as a representative party on behalf of a class shall provide a sworn certification, which shall be personally signed by such plaintiff and filed with the complaint, that--

(i) states that the plaintiff has reviewed the complaint and authorized its filing;

(ii) states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action arising under this title [15 USCS §§ 78a et seq.];

(iii) states that the plaintiff is willing to serve as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary;

(iv) sets forth all of the transactions of the plaintiff in the security that is the subject of the complaint during the class period specified in the complaint;

(v) identifies any other action under this title [15 USCS §§ 78a et seq.], filed during the 3-year period preceding the date on which the certification is signed by the plaintiff, in which the plaintiff has sought to serve as a representative party on behalf of a class; and

(vi) states that the plaintiff will not accept any payment for serving as a representative party on behalf of a class beyond the plaintiff's pro rata share of any recovery, except as ordered or approved by the court in accordance with paragraph (4).

(B) Nonwaiver of attorney-client privilege. The certification filed pursuant to subparagraph (A) shall not be construed to be a waiver of the attorney-client privilege.

(3) Appointment of lead plaintiff.

(A) Early notice to class members.

(i) In general. Not later than 20 days after the date on which the complaint is filed, the plaintiff or plaintiffs shall cause to be published, in a widely circulated national business-oriented publication or wire service, a notice advising members of the purported plaintiff class--

(I) of the pendency of the action, the claims asserted therein, and the purported class period; and

(II) that, not later than 60 days after the date on which the notice is

published, any member of the purported class may move the court to serve as lead plaintiff of the purported class.

(ii) Multiple actions. If more than one action on behalf of a class asserting substantially the same claim or claims arising under this title [15 USCS §§ 78a et seq.] is filed, only the plaintiff or plaintiffs in the first filed action shall be required to cause notice to be published in accordance with clause (i).

(iii) Additional notices may be required under Federal Rules. Notice required under clause (i) shall be in addition to any notice required pursuant to the Federal Rules of Civil Procedure.

(B) Appointment of lead plaintiff.

(i) In general. Not later than 90 days after the date on which a notice is published under subparagraph (A)(i), the court shall consider any motion made by a purported class member in response to the notice, including any motion by a class member who is not individually named as a plaintiff in the complaint or complaints, and shall appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members (hereafter in this paragraph referred to as the "most adequate plaintiff") in accordance with this subparagraph.

(ii) Consolidated actions. If more than one action on behalf of a class asserting substantially the same claim or claims arising under this title [15 USCS §§ 78a et seq.] has been filed, and any party has sought to consolidate those actions for pretrial purposes or for trial, the court shall not make the determination required by clause (i) until after the decision on the motion to consolidate is rendered. As soon as practicable after such decision is rendered, the court shall appoint the most adequate plaintiff as lead plaintiff for the consolidated actions in accordance with this paragraph.

(iii) Rebuttable presumption.

(I) In general. Subject to subclause (II), for purposes of clause (i), the court shall adopt a presumption that the most adequate plaintiff in any private action arising under this title [15 USCS §§ 78a et seq.] is the person or group of persons that--

(aa) has either filed the complaint or made a motion in response to a notice under subparagraph (A)(i);

(bb) in the determination of the court, has the largest financial interest in the relief sought by the class; and

(cc) otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.

(II) Rebuttal evidence. The presumption described in subclause (I) may be rebutted only upon proof by a member of the purported plaintiff class that the presumptively most adequate plaintiff--

(aa) will not fairly and adequately protect the interests of the class; or

(bb) is subject to unique defenses that render such plaintiff incapable of adequately representing the class.

(iv) Discovery. For purposes of this subparagraph, discovery relating to whether a member or members of the purported plaintiff class is the most adequate plaintiff may be conducted by a plaintiff only if the plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class.

(v) Selection of lead counsel. The most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class.

(vi) Restrictions on professional plaintiffs. Except as the court may otherwise permit, consistent with the purposes of this section, a person may be a lead plaintiff, or an officer, director, or fiduciary of a lead plaintiff, in no more than 5 securities

class actions brought as plaintiff class actions pursuant to the Federal Rules of Civil Procedure during any 3-year period.

(4) Recovery by plaintiffs. The share of any final judgment or of any settlement that is awarded to a representative party serving on behalf of a class shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class. Nothing in this paragraph shall be construed to limit the award of reasonable costs and expenses (including lost wages) directly relating to the representation of the class to any representative party serving on behalf of a class.

(5) Restrictions on settlements under seal. The terms and provisions of any settlement agreement of a class action shall not be filed under seal, except that on motion of any party to the settlement, the court may order filing under seal for those portions of a settlement agreement as to which good cause is shown for such filing under seal. For purposes of this paragraph, good cause shall exist only if publication of a term or provision of a settlement agreement would cause direct and substantial harm to any party.

(6) Restrictions on payment of attorneys' fees and expenses. Total attorneys' fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class.

(7) Disclosure of settlement terms to class members. Any proposed or final settlement agreement that is published or otherwise disseminated to the class shall include each of the following statements, along with a cover page summarizing the information contained in such statements:

(A) Statement of plaintiff recovery. The amount of the settlement proposed to be distributed to the parties to the action, determined in the aggregate and on an average per share basis.

(B) Statement of potential outcome of case.

(i) Agreement on amount of damages. If the settling parties agree on the average amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title [15 USCS §§ 78a et seq.], a statement concerning the average amount of such potential damages per share.

(ii) Disagreement on amount of damages. If the parties do not agree on the average amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title [15 USCS §§ 78a et seq.], a statement from each settling party concerning the issue or issues on which the parties disagree.

(iii) Inadmissibility for certain purposes. A statement made in accordance with clause (i) or (ii) concerning the amount of damages shall not be admissible in any Federal or State judicial action or administrative proceeding, other than an action or proceeding arising out of such statement.

(C) Statement of attorneys' fees or costs sought. If any of the settling parties or their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought (including the amount of such fees and costs determined on an average per share basis), and a brief explanation supporting the fees and costs sought. Such information shall be clearly summarized on the cover page of any notice to a party of any proposed or final settlement agreement.

(D) Identification of lawyers' representatives. The name, telephone number, and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to the

class.

(E) Reasons for settlement. A brief statement explaining the reasons why the parties are proposing the settlement.

(F) Other information. Such other information as may be required by the court.

(8) Security for payment of costs in class actions. In any private action arising under this title [15 USCS §§ 78a et seq.] that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the court may require an undertaking from the attorneys for the plaintiff class, the plaintiff class, or both, or from the attorneys for the defendant, the defendant, or both, in such proportions and at such times as the court determines are just and equitable, for the payment of fees and expenses that may be awarded under this subsection.

(9) Attorney conflict of interest. If a plaintiff class is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall make a determination of whether such ownership or other interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the plaintiff class.

(b) Requirements for securities fraud actions.

(1) Misleading statements and omissions. In any private action arising under this title [15 USCS §§ 78a et seq.] in which the plaintiff alleges that the defendant--

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind. In any private action arising under this title [15 USCS §§ 78a et seq.] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title [15 USCS §§ 78a et seq.], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) Motion to dismiss; stay of discovery.

(A) Dismissal for failure to meet pleading requirements. In any private action arising under this title [15 USCS §§ 78a et seq.], the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

(B) Stay of discovery. In any private action arising under this title [15 USCS §§ 78a et seq.], all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

(C) Preservation of evidence.

(i) In general. During the pendency of any stay of discovery pursuant to this paragraph, unless otherwise ordered by the court, any party to the action with actual notice of the allegations contained in the complaint shall treat all documents, data compilations (including electronically recorded or stored data), and tangible objects that are in the custody or control of such person and that are relevant to the allegations, as if they were the subject of a continuing request for production of documents from an opposing party under the Federal Rules of Civil Procedure.

(ii) Sanction for willful violation. A party aggrieved by the willful failure of an opposing party to comply with clause (i) may apply to the court for an order

awarding appropriate sanctions.

(D) Circumvention of stay of discovery. Upon a proper showing, a court may stay discovery proceedings in any private action in a State court, as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this paragraph.

(4) Loss causation. In any private action arising under this title [15 USCS §§ 78a et seq.], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title [15 USCS §§ 78a et seq.] caused the loss for which the plaintiff seeks to recover damages.

(c) Sanctions for abusive litigation.

(1) Mandatory review by court. In any private action arising under this title [15 USCS §§ 78a et seq.], upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.

(2) Mandatory sanctions. If the court makes a finding under paragraph (1) that a party or attorney violated any requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion, the court shall impose sanctions on such party or attorney in accordance with Rule 11 of the Federal Rules of Civil Procedure. Prior to making a finding that any party or attorney has violated Rule 11 of the Federal Rules of Civil Procedure, the court shall give such party or attorney notice and an opportunity to respond.

(3) Presumption in favor of attorneys' fees and costs.

(A) In general. Subject to subparagraphs (B) and (C), for purposes of paragraph (2), the court shall adopt a presumption that the appropriate sanction--

(i) for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation; and

(ii) for substantial failure of any complaint to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action.

(B) Rebuttal evidence. The presumption described in subparagraph (A) may be rebutted only upon proof by the party or attorney against whom sanctions are to be imposed that--

(i) the award of attorneys' fees and other expenses will impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed; or

(ii) the violation of Rule 11(b) of the Federal Rules of Civil Procedure was de minimis.

(C) Sanctions. If the party or attorney against whom sanctions are to be imposed meets its burden under subparagraph (B), the court shall award the sanctions that the court deems appropriate pursuant to Rule 11 of the Federal Rules of Civil Procedure.

(d) Defendant's right to written interrogatories. In any private action arising under this title [15 USCS §§ 78a et seq.] in which the plaintiff may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred.

(e) Limitation on damages.

(1) In general. Except as provided in paragraph (2), in any private action arising under this title [15 USCS §§ 78a et seq.] in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception. In any private action arising under this title [15 USCS §§ 78a et seq.] in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

(3) Definition. For purposes of this subsection, the "mean trading price" of a security shall be an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period referred to in paragraph (1).

(f) Proportionate liability.

(1) Applicability. Nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws.

(2) Liability for damages.

(A) Joint and several liability. Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.

(B) Proportionate liability.

(i) In general. Except as provided in subparagraph (A), a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person, as determined under paragraph (3).

(ii) Recovery by and costs of covered person. In any case in which a contractual relationship permits, a covered person that prevails in any private action may recover the attorney's fees and costs of that covered person in connection with the action.

(3) Determination of responsibility.

(A) In general. In any private action, the court shall instruct the jury to answer special interrogatories, or if there is no jury, shall make findings, with respect to each covered person and each of the other persons claimed by any of the parties to have caused or contributed to the loss incurred by the plaintiff, including persons who have entered into settlements with the plaintiff or plaintiffs, concerning--

(i) whether such person violated the securities laws;

(ii) the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff; and

(iii) whether such person knowingly committed a violation of the securities laws.

(B) Contents of special interrogatories or findings. The responses to interrogatories, or findings, as appropriate, under subparagraph (A) shall specify the total amount of damages that the plaintiff is entitled to recover and the percentage of responsibility of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs.

(C) Factors for consideration. In determining the percentage of responsibility under this paragraph, the trier of fact shall consider--

(i) the nature of the conduct of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs; and

(ii) the nature and extent of the causal relationship between the conduct of each such person and the damages incurred by the plaintiff or plaintiffs.

(4) Uncollectible share.

(A) In general. Notwithstanding paragraph (2)(B), [if,] upon motion made not later than 6 months after a final judgment is entered in any private action, the court determines that all or part of the share of the judgment of the covered person is not collectible against that covered person, and is also not collectible against a covered person described in paragraph (2)(A), each covered person described in paragraph (2)(B) shall be liable for the uncollectible share as follows:

(i) Percentage of net worth. Each covered person shall be jointly and severally liable for the uncollectible share if the plaintiff establishes that--

(I) the plaintiff is an individual whose recoverable damages under the final judgment are equal to more than 10 percent of the net worth of the plaintiff; and

(II) the net worth of the plaintiff is equal to less than $ 200,000.

(ii) Other plaintiffs. With respect to any plaintiff not described in subclauses (I) and (II) of clause (i), each covered person shall be liable for the uncollectible share in proportion to the percentage of responsibility of that covered person, except that the total liability of a covered person under this clause may not exceed 50 percent of the proportionate share of that covered person, as determined under paragraph (3)(B).

(iii) Net worth. For purposes of this subparagraph, net worth shall be determined as of the date immediately preceding the date of the purchase or sale (as applicable) by the plaintiff of the security that is the subject of the action, and shall be equal to the fair market value of assets, minus liabilities, including the net value of the investments of the plaintiff in real and personal property (including personal residences).

(B) Overall limit. In no case shall the total payments required pursuant to subparagraph (A) exceed the amount of the uncollectible share.

(C) Covered persons subject to contribution. A covered person against whom judgment is not collectible shall be subject to contribution and to any continuing liability to the plaintiff on the judgment.

(5) Right of contribution. To the extent that a covered person is required to make an additional payment pursuant to paragraph (4), that covered person may recover contribution--

(A) from the covered person originally liable to make the payment;

(B) from any covered person liable jointly and severally pursuant to paragraph (2)(A);

(C) from any covered person held proportionately liable pursuant to this paragraph who is liable to make the same payment and has paid less than his or her proportionate share of that payment; or

(D) from any other person responsible for the conduct giving rise to the payment that would have been liable to make the same payment.

(6) Nondisclosure to jury. The standard for allocation of damages under paragraphs (2) and (3) and the procedure for reallocation of uncollectible shares

under paragraph (4) shall not be disclosed to members of the jury.

(7) Settlement discharge.

(A) In general. A covered person who settles any private action at any time before final verdict or judgment shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling covered person arising out of the action. The order shall bar all future claims for contribution arising out of the action--

(i) by any person against the settling covered person; and

(ii) by the settling covered person against any person, other than a person whose liability has been extinguished by the settlement of the settling covered person.

(B) Reduction. If a covered person enters into a settlement with the plaintiff prior to final verdict or judgment, the verdict or judgment shall be reduced by the greater of--

(i) an amount that corresponds to the percentage of responsibility of that covered person; or

(ii) the amount paid to the plaintiff by that covered person.

(8) Contribution. A covered person who becomes jointly and severally liable for damages in any private action may recover contribution from any other person who, if joined in the original action, would have been liable for the same damages. A claim for contribution shall be determined based on the percentage of responsibility of the claimant and of each person against whom a claim for contribution is made.

(9) Statute of limitations for contribution. In any private action determining liability, an action for contribution shall be brought not later than 6 months after the entry of a final, nonappealable judgment in the action, except that an action for contribution brought by a covered person who was required to make an additional payment pursuant to paragraph (4) may be brought not later than 6 months after the date on which such payment was made.

(10) Definitions. For purposes of this subsection--

(A) a covered person "knowingly commits a violation of the securities laws"--

(i) with respect to an action that is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading, if--

(I) that covered person makes an untrue statement of a material fact, with actual knowledge that the representation is false, or omits to state a fact necessary in order to make the statement made not misleading, with actual knowledge that, as a result of the omission, one of the material representations of the covered person is false; and

(II) persons are likely to reasonably rely on that misrepresentation or omission; and

(ii) with respect to an action that is based on any conduct that is not described in clause (i), if that covered person engages in that conduct with actual knowledge of the facts and circumstances that make the conduct of that covered person a violation of the securities laws;

(B) reckless conduct by a covered person shall not be construed to constitute a knowing commission of a violation of the securities laws by that covered person;

(C) the term "covered person" means--

(i) a defendant in any private action arising under this title; or

(ii) a defendant in any private action arising under section 11 of the Securities Act of 1933 [15 USCS §§ 77j], who is an outside director of the issuer of the securities that are the subject of the action; and

(D) the term "outside director" shall have the meaning given such term by rule

or regulation of the Commission.

(g) [Redesignated]

USCS Fed Rules Evid R 702

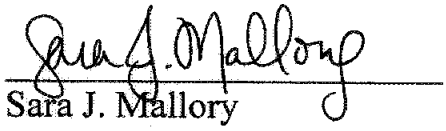
FEDERAL RULES OF EVIDENCE
ARTICLE VII. OPINIONS AND EXPERT TESTIMONY

Rule 702. Testimony by Experts

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

CERTIFICATE OF SERVICE

I hereby certify that, on this 3rd day of June 2004, I caused (1) the original and nine copies of the foregoing brief to be sent to the Clerk of the Court by overnight delivery; and (2) two copies of the foregoing brief to be sent to the parties listed below by overnight delivery.



Sara J. Mallory

Herbert E. Milstein
COHEN, MILSTEIN,
HAUSFELD
& TOLL, P.L.L.C.
1100 New York Avenue, N.W.
West Tower, Suite 500
Washington, D.C. 20005

Douglas G. Thompson
FINKELSTEIN, THOMPSON
& LOUGHRAN
1050 30th Street, N.W.
Washington, D.C. 20007

Jay B. Kasner
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
Four Times Square
New York, New York 10036

Marc B. Dorfman
FOLEY & LARDNER
3000 K Street, N.W.
Washington, D.C. 20007

Eliot Spitzer, Esq.
ATTORNEY GENERAL OF THE
STATE OF NEW YORK
120 Broadway, 25th Floor
New York, New York 10271