

March 16, 2015

The Honorable Patti B. Saris, Chair  
United States Sentencing Commission  
One Columbus Circle, NE  
Suite 2-500, South Lobby  
Washington, DC 20002-8002  
Public\_Comment@ussc.gov

Re: Comments to Proposed Amendments to the Sentencing Guidelines, Fraud on the  
Market and Related Offenses

Dear Chief Judge Saris and Members of the United States Sentencing Commission:

The Commission seeks comment on, among other matters, the proper method of calculating loss in criminal securities fraud litigation. As an initial matter, allow me to express my support for the Commission's proposal to strike the method set forth in Application Note 3(F)(ix), U.S. Sentencing Guidelines Manual §2B1.1 (2014).

In cases involving aftermarket fraud, courts commonly adopt the fraud on the market hypothesis and rely on a variant of the out-of-pocket damage measure applied in civil actions to calculate the loss used for sentencing purposes.<sup>1</sup> Simply stated, the courts estimate the amount of stock price inflation (or deflation) caused by the fraud while it was "alive" in the market. They then multiply by an estimate of the number of shares that were traded when the

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<sup>1</sup> This letter addresses the challenges that arise in the calculation of loss in aftermarket frauds only. In direct frauds, *e.g.*, situations in which securities issuers engage in misrepresentations to sell securities at inflated prices, and thereby profit directly as a result of the fraud, the out-of-pocket damage measure can be entirely appropriate. For examples of loss calculations applied by courts in criminal sentencing situations involving aftermarket frauds, see, *e.g.*, *United States v. Brown*, 595 F.3d 498, 523-25 (3d Cir. 2010), *cert denied*, 131 S. Ct. 903 (2010); *United States v. Berger*, 587 F.3d 1038, 1045 (9th Cir. 2009); *United States v. Nacchio*, 573 F.3d 1062, 1078-79 (10th Cir. 2009); *United States v. Rutkoske*, 506 F.3d 170, 179 (2d Cir. 2007); *United States v. Olis*, 429 F.3d 540, 545-49 (5th Cir. 2005); *United States v. Snyder*, 291 F.3d 1291, 1296 (11th Cir. 2002); *United States v. Moskowitz*, 215 F.3d 265, 272 (2d Cir. 2000); *United States v. Bakhit*, 218 F. Supp. 2d 1232, 1236-1242 (C.D. Cal. 2002); *United States v. Grabske*, 260 F. Supp. 2d 866, 872-73 (N.D. Cal. 2002).

fraud was alive, applying an adjustment to eliminate double counting of shares that were purchased and sold while the fraud was alive in the market. The multiplicative product of these two estimates then serves as the estimate of the loss caused to public shareholders by the fraud.<sup>2</sup>

In some instances, the courts seek to adjust for changes in market price attributable to factors other than the fraud, thereby incorporating the loss causation logic articulated by the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005).<sup>3</sup> In other instances, courts have rejected that adjustment.<sup>4</sup>

Courts have also compared the affected issuer's total market capitalization during and after the fraud, with and without efforts to adjust for price influences unrelated to the fraud.<sup>5</sup> It bears emphasis that measures of loss that rely on changes in capitalization effectively assume that all of the issuer's outstanding shares transact while the fraud is alive. Market capitalization measures will therefore, all other factors being equal, generate larger estimates of loss than measures that analyze the actual number of shares transacted while the fraud was alive in the market.

Commentators have observed that the divergence in calculation methodologies gives rise to a split in the Circuits.<sup>6</sup> "The Second, Fifth, and Tenth Circuits have all recognized that 'a loss calculation involving publicly traded stock' that fails 'to distinguish between effects of the alleged misconduct and the effect of general market conditions is inherently flawed and thus unreasonable.' Each of these Circuits has therefore adopted the 'market adjusted method,' calculating the change in the value of the security while excluding changes in value

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<sup>2</sup> See, e.g., *United States v. Olis*, No. H-03-217, 2006 WL 2716048, at \*7-8 (S.D. Tex. Sept. 22, 2006) (expert multiplied estimated loss per share by the "number of damaged shares," which was less than the total number of shares outstanding).

<sup>3</sup> Scotland M. Duncan, *Recalculating "Loss" In Securities Fraud*, 3 HARV. BUS. L. REV. 257, 262-63 (2013) (citing *Rutkoske*, 506 F.3d at 179; *Olis*, 429 F.3d at 545-46; and *Nacchio*, 573 F.3d at 1078-79).

<sup>4</sup> See, e.g., *Berger*, 587 F.3d at 1043.

<sup>5</sup> See, e.g., Duncan, *supra* note 3, at 261 nn. 25 & 26 (citing *Bakhit*, 218 F. Supp. 2d at 1241 as an example of a case in which the court relied on unadjusted changes in market capitalization, and *Moskowitz*, 215 F.3d at 272 as an example of a situation in which a court applied a market adjusted method).

<sup>6</sup> See, e.g., Alan R. Friedman & Theodore S. Hertzberg, *Possible Circuit Split in Calculating Loss Under Sentencing Guidelines*, N.Y.L.J., Jan. 15, 2010, at 3.

caused by external market forces.”<sup>7</sup> In contrast, the Ninth Circuit has expressly rejected the application of Dura’s loss causation logic in the context of criminal sentencing.<sup>8</sup>

Further, when applying the market adjustment method contemplated by the Second, Fifth and Tenth Circuits, courts should also be sensitive to the possibility that the corrective disclosure announcing the fraud to the market can occur simultaneously with earnings announcements or with the disclosure of other forms of material information that can influence stock price for reasons entirely unrelated to the fraud. Additional analysis is required to disentangle the price effects of the fraud from the price effects of simultaneously disclosed, non-fraudulent confounding information.<sup>9</sup>

But putting aside for the moment the technical measurement challenges posed by all current methodologies used in aftermarket sentencing litigation, the very notion that any of these measures can serve as a rational estimate of the loss caused by an aftermarket fraud is profoundly flawed, and has been broadly criticized by many scholars for many decades. The critical flaw with the application of the out-of-pocket damage measure in the context of aftermarket trading is that it overlooks the fact that for every innocent purchaser (seller) of a security who suffered a loss by buying (selling) at an artificially inflated (deflated) price, there exists an innocent seller (purchaser) of the very same security who earns a profit by selling (buying) at precisely the same artificially inflated (deflated) price.<sup>10</sup>

The academic literature describes this as the “circularity” problem: for every dollar of “loss” suffered by an innocent seller or purchaser, there must be an equal and offsetting dollar of gain captured by an equally innocent purchaser or seller. In this context, the out-of-pocket measure estimates a wealth transfer among investors, and does not describe “damages” or “costs” as typically conceptualized in the law.

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<sup>7</sup> Duncan, *supra* note 3, at 262- 263 (quoting Brief of Charles F. Dolan, et al. as Amici Curiae in Support of Petitioners at 9, *Rigas v. United States of America*, 131 S. Ct. 140 (2010) (No. 09-1456), 2010 WL 2665558, and citing *Rutkoske*, 506 F.3d at 179; *Olis*, 429 F.3d at 545-46; and *Nacchio*, 573 F.3d at 1078-79).

<sup>8</sup> See, e.g., *Berger*, 587 F.3d at 1043.

<sup>9</sup> For an example of a court analyzing the impact of confounding information on the price effect of a fraud, see *Olis*, 2006 WL 2716048, at \*8-9. For a discussion of the methodological issues that can arise when a corrective disclosure occurs simultaneously with the disclosure of material non-fraudulent information, see, e.g., Declaration of Joseph A. Grundfest, *Olis*, 2006 WL 2716048 (No. H-03-217).

<sup>10</sup> For ease of exposition, this analysis assumes that the violator, and the company whose shares are at issue, are not trading in the market while the fraud is alive. Trading by the violator, or by the company, does not alter the logic of the analysis but requires that the profits earned in those transactions be separately addressed.

The academic literature in support of this critique is substantial. Judge Frank Easterbrook of the United States Court of Appeals for the Seventh Circuit and Professor Daniel R. Fischel of the University of Chicago have called this phenomenon “the problem of matched gains and losses.”<sup>11</sup> They explain: “Damages computed on the basis of the loss of the investors who purchased [while the fraud was ‘alive’ in the market] would greatly exceed the optimal sanction.... An investor with a diversified portfolio will be the hidden gainer in a transaction like the example in this section as often as he will be a loser. Every losing buyer during [the period the fraud is ‘alive’] is matched with a gaining seller. Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time.... This is not to say that the optimal damages in aftermarket cases are zero just because most gains and losses net out... [Instead,] the optimal award is surely a good deal smaller than the gross transfer of wealth.”<sup>12</sup>

Professors Stephen J. Choi of NYU and Adam C. Pritchard of the University of Michigan explain that the type of fraud that arises in this proceeding “differs from what we typically consider fraud in that there is no net wealth transfer away from the investors, at least in the aggregate. Instead, the wealth transfers caused by fraud on the market overwhelmingly occur between equally innocent investors. For every shareholder who *bought* at a fraudulently inflated price, another shareholder has *sold*: The buyer’s individual loss is offset by the seller’s gain. Assuming all traders are ignorant of the fraud, over time they will come out winners as often as losers from fraudulently distorted prices.”<sup>13</sup>

Professors James Cox of Duke, Robert Hillman of the University of California at Davis, and Donald Langevoort of Georgetown observe that “in a case involving false publicity unaccompanied by insider trading, for example, the net economic loss to marketplace traders is something close to zero, since for every disadvantaged buyer there was probably a non-defendant seller who benefited by exactly the same amount.... Over time, the fortuitous gains and losses from marketplace misinformation of investors with diversified portfolios will largely cancel each other out.”<sup>14</sup>

Professor Richard A. Booth of Maryland explains: “[Aftermarket] [s]ecurities fraud is a zero-sum event. For every buyer-loser there is a seller-winner. Buyers and sellers *in the*

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<sup>11</sup> FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339-341 (1991).

<sup>12</sup> *Id.*

<sup>13</sup> STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 348 (2005).

<sup>14</sup> JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 727-28 (5th ed. 2006).

*aggregate* neither gain nor lose. A diversified investor is equally likely to be on the winning side of a given trade as on the losing side. A diversified investor who owns 200 or so different stocks with a modest turnover of about 60 percent per year (as through a typical mutual fund) is likely to see gains and losses that are roughly equal over the course of a few years. Thus, a diversified investor is already effectively protected against securities fraud in most cases.”<sup>15</sup>

Professor John Coffee of Columbia observes that “[o]ften shareholders will belong to both the plaintiff class that sues and the residual shareholder class that bears the cost of the litigation.... Thus, they are effectively making wealth transfers to themselves, in effect shifting money from one pocket to another, minus the high transaction costs of securities litigation.”<sup>16</sup>

My colleague, Professor Janet Cooper Alexander, explains that “[t]he aggregate amount by which class members overpaid does not represent the true social cost of the violation .... For every buyer who pays too much, and thereby acquires a cause of action to recover the excess, there is a seller – just as innocent of the fraud – who reaps a windfall in an equal amount. We make no effort to recover these windfalls and restore them to the purchasers.”<sup>17</sup>

A recent study sought empirically to measure the extent to which such diversification in fact occurs among large institutional investors. It observed that “diversified investors -- such as large institutional investors -- who ‘lose’ on one transaction (*i.e.*, from buying a security at what is alleged to be an artificially inflated price) are eligible to recover damages under the law while they are, at the same time, permitted to keep gains from separate ‘winning’ transactions (*i.e.*, from selling a security at what is alleged to be an artificially inflated price).”<sup>18</sup> This study found that “diversified investors [often] break even from their investments in common stocks impacted by fraud allegations even prior to considering any

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<sup>15</sup> Richard A. Booth, *Who Should Recover What for Securities Fraud?* 6 (University of Maryland School of Law Legal Studies Research Paper No. 2005-32, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=683197](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=683197).

<sup>16</sup> John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1558-59 (2006).

<sup>17</sup> Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1495-96 (1996).

<sup>18</sup> Anjan V. Thakor, U.S. Chamber Institute for Legal Reform, *The Economic Reality of Securities Class Action Litigation* (Oct. 26, 2005), available at <http://www.nytimes.com/packages/pdf/business/27suit.pdf>.

The Honorable Patti B. Saris, Chair  
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Page 6

recoveries through litigation” and that “large institutional investors are, in fact, often *overcompensated* as a result of litigation.”<sup>19</sup>

I hope that these observations prove useful to the Commission in its continued deliberations.

With best regards,

A handwritten signature in black ink, appearing to read "Joseph A. Grundfest". The signature is written in a cursive style with a long horizontal stroke at the end.

Joseph A. Grundfest

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<sup>19</sup> *Id.* at 1.