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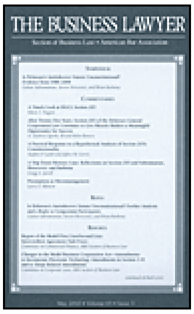

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The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission

*By Mark L. Mitchell and Jeffry M. Netter**

INTRODUCTION

Litigants, including the Securities and Exchange Commission (SEC), increasingly have applied modern financial economics in securities fraud cases. One of the most important applications of financial economics for securities law comes from the efficient markets hypothesis. This Article presents an overview of areas where securities fraud law has adopted some of the reasonings and applications of the efficient markets hypothesis and provides examples of the use of financial economics in SEC enforcement actions. Specifically, this Article discusses how techniques developed by financial economists can be used to establish the materiality of information allegedly used in securities fraud, and to compute profits (or losses avoided) resulting from fraudulent actions. It then shows how the methodology was applied in recent SEC enforcement cases.

A leading expert on the efficient markets hypothesis, Professor Eugene F. Fama of the University of Chicago's Graduate School of Business, recently reviewed the empirical evidence on the efficient markets hypothesis and defined market efficiency with the simple statement that security prices fully reflect all available information.[1] Fama noted that, while no market is perfectly efficient, the idea that prices quickly adjust to the release of new information is a useful tool to analyze many situations, especially when information and transactions costs are low, as in the United States stock market.

An event study, a technique developed and refined by financial economists, can be very useful in securities fraud cases. An event study relates changes in stock prices to the release of new information. Researchers

Abstract

This Article illustrates how financial economics has been and can be applied in securities fraud litigation. Specifically, Mark L. Mitchell andjeffry M. Netter describe an empirical technique (event study) developed by academic financial economists, relate this event study methodology to the relevant areas of securities...

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