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SCA Filings and Volatility

In 2004 there were 211 Securities Class Action (SCA) filings (Stanford Law School / Cornerstone Research[1]), a number close to the annual average for what Cornerstone calls "classic" filings — filings not in response to unique non-traditional situations such as IPO laddering — from 1998 to 2004.

However, in 2005 the number declined to 178 and declined further in 2006 to 111, the lowest since 1996. The impact of Sarbanes-Oxley is often cited as one reason for this decline; others include a tougher approach by the enforcement agencies and the effect of reduced stock market volatility. This issue of CUG.COMments will look at the concept of "volatility:" what it is, how it can be measured and a possible correlation between volatility and the frequency of SCA filings.

What is Stock Market Volatility?

For stock markets, volatility typically means the market is seeing significant drops as well as increases. A market that edges constantly upward with occasional pauses and minor set-backs is not a volatile market. Only when the market starts to see-saw up and down does it become volatile.

Measuring Volatility

Volatility is often recognized informally: You know it when you see it. But if we are to attempt to track a general perception of volatility with the very specific SCA filing data, something more than anecdotal evidence is needed. A data-based approach to volatility can be found in the Chicago Board of Options Exchange (CBOE) index that tracks volatility, known as the VIX.

The VIX

The VIX is calculated not from actual stock market prices but from market expectations of the short term volatility of the Standard & Poor's 500 share index (S&P 500), as these expectations are revealed in the pricing of options to buy or sell securities linked to that index. [The mathematical conversion of options pricing to the VIX index is complex[2].]

Options to trade in securities come in two basic forms: "put" options and "call" options. Buying a "put" option gives the buyer the right — but not the obligation — to sell a security at a certain price before a certain date. Conversely, a "call" option gives the buyer the right to buy a security before a certain date. If the security does not perform as expected then the investor will probably allow the option to expire unexercised, and the investor will have forfeited the cost of the option.

The market professionals — market makers — who offer options for sale have to either deliver the security to the investor or buy the security from the investor upon exercise of the option. This means the market maker has to price the option based on his confidence in being able to fulfill his obligations as required under the contract without suffering a loss.

If the market for the underlying security is viewed as stable, the market maker can lower the price on the options he is selling (if he charges too high a price in a stable market he will have no buyers for his options). But when the market becomes volatile, the market maker is less certain about his stock price predictions and compensates by raising the price of the options.

The increased prices charged for S&P 500 options — which affect both "put" and "call" options as the market could jump or plummet — are reflected in an increase in the VIX index. So greater perceived volatility in the S&P 500 means higher option prices which means the VIX goes up.

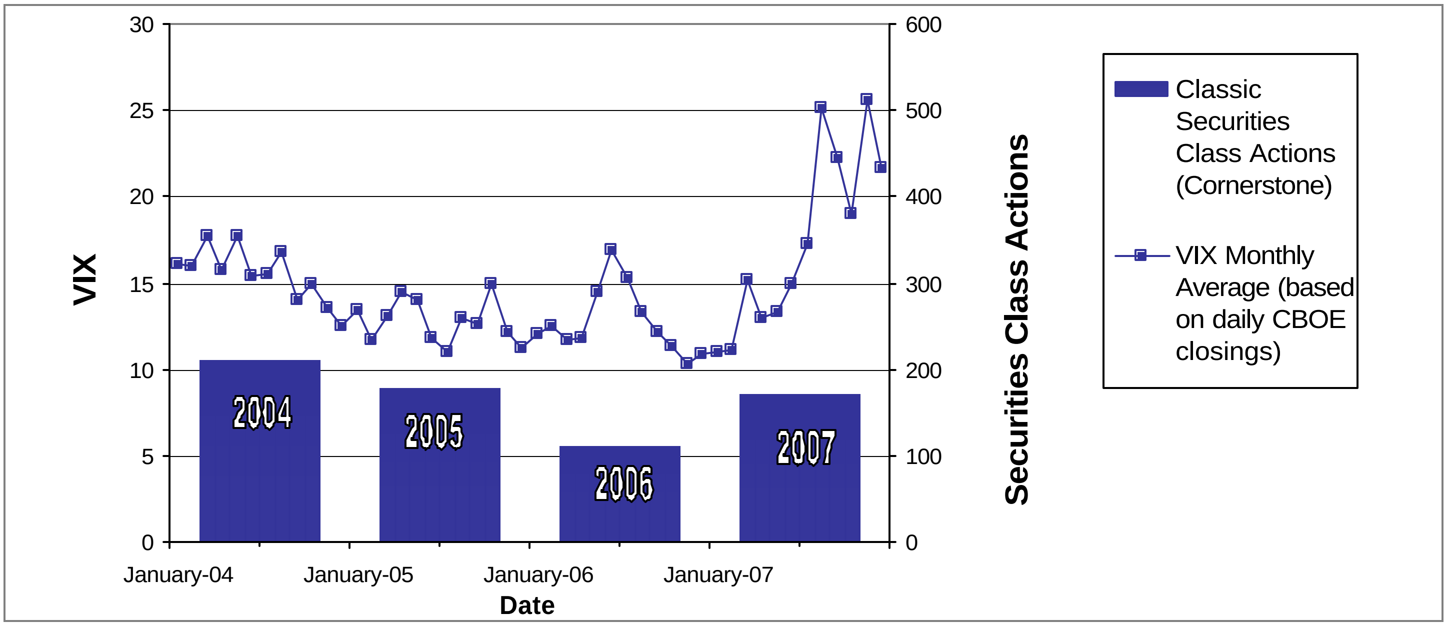
VIX and SCA Lawsuits

The chart below matches the VIX index[3] with SCA filings from 2004 to 2007. Although only four years of data are captured, there is a broad but clear correlation between the movement of the VIX and the number of SCA filings.

Summary

For all its complex calculations the VIX is predicated upon the measure of a single factor: options pricing for the S&P 500 index. SCA filings, however, are made in response to a myriad of much-debated factors. It is not axiomatic that SCA filing frequency will move in line with stock market volatility, but the corresponding three-year fall from 2004 to 2006 followed by the dramatic rise of both numbers in 2007 suggests there is at least a reasonable chance. A rising stock market will typically give the plaintiffs' bar less opportunities; but the market falls that are implicit in higher volatility will usually attract their attention.

The downward trend in SCA filings from 2004 through 2006 caused some commentators to declare that SCA lawsuits were disappearing; it appears that predictions about the demise of SCA lawsuits have been exaggerated. Regardless of other influences, as long as there is volatility in the stock market, it seems likely there will be Securities Class Action litigation. ❖



1. Stanford Law School / Cornerstone Research: http://securities.stanford.edu/
2. "The New CBOE Volatility Index — VIX": http://www.cboe.com/micro/vix/vixwhite.pdf
3. In 2003 the VIX upgraded its methodology; data from the new methodology is used.

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