

**NEW YORK CITY BAR ASSOCIATION
COMMITTEE ON SECURITIES LITIGATION**

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*Report on the Possible Impact of Halliburton II
on Securities Class Action Litigation*

I. INTRODUCTION

The U.S. Supreme Court’s November 15, 2013 decision granting *certiorari* in *Halliburton Co. and David Lesar v. Erica P. John Fund* has captured the imagination of the securities bar and economists alike. At least one commentator went so far as to suggest that “[n]o dispute on the Supreme Court’s 2013-14 docket has attracted more intense interest in corporate litigation circles than *Halliburton* ... and with good reason.”¹ Petitioners invite the Supreme Court to overrule *Basic, Inc. v. Levinson*, a precedent that has served as a cornerstone of federal securities fraud class action world for the last 25 years. *Basic* makes it possible to certify a class action asserting claims under Section 10(b) of the Securities Exchange Act of 1934 – the federal securities fraud catchall provision – in cases involving affirmative misrepresentations without having to show that plaintiffs individually relied on the alleged misrepresentations. Overruling that decision could have a substantial effect on securities class action practice. Although the end of an era, overruling *Basic* might not necessarily bring an end to federal securities fraud class actions. There are a variety of different means by which investors might be able to prosecute Section 10(b) claims based on affirmative

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¹ Paul M. Barrett, *Behind the Briefs: A Secret History of the Supreme Court’s Halliburton Case*, Bloomberg Businessweek (Feb. 21, 2014), <http://www.businessweek.com/articles/2014-02-21/behind-the-briefs-a-secret-history-of-the-supreme-courts-halliburton-case>.

misrepresentations on an aggregate basis. And, in any event, reversal of *Basic* is far from a foregone conclusion.

The impetus for the current debate over whether that longstanding precedent should be abandoned is certain critics' dissatisfaction with the "fraud-on-the-market" presumption that is at the heart of the *Basic* Court's ruling and with the efficient capital markets hypothesis on which the presumption is premised. The Supreme Court has at its disposal potential alternative ways to address the concerns raised by critics of the presumption and its underpinnings. Overruling *Basic* is but one of them.

This report begins with the background necessary to understanding fully the issues before the Supreme Court in *Halliburton*, followed by a concise explanation of the history and key concepts most relevant to the current debate, including the efficient capital markets hypothesis, the fraud-on-the-market presumption, and the legal landscape in which the Supreme Court recently granted *certiorari*. The Supreme Court's decisions in *Basic, Inc. v. Levinson, Erica P. John Fund, Inc. v. Halliburton Co.* ("*Halliburton I*"), *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds* ("*Amgen*"), and *Halliburton Co. and David Lesar v. Erica P. John Fund* ("*Halliburton II*") are discussed in detail. The report then draws on the perspectives and experiences of the New York City Bar Association's Securities Litigation Committee, which is comprised of academics, in-house counsel, securities regulators, and plaintiff and defense securities litigators, to identify and analyze the potential implications of the Supreme Court's decision in *Halliburton II*.

II. BACKGROUND

Section 10(b) of the Securities Exchange Act of 1934 makes it:

unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ... [t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.²

In a typical Section 10(b) private action, the plaintiff must plead and prove that the defendant: (1) made a misstatement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of a security (5) upon which the plaintiff reasonably relied and (6) that the plaintiff's reliance proximately caused his or her injury (loss causation).³ Reliance by the plaintiff upon the defendant's deceptive acts is thus an essential element of the Section 10(b) private cause of action. The reliance requirement ensures that, for liability to arise, the "requisite causal connection between a defendant's misrepresentation and a plaintiff's injury" exists as a predicate for liability.⁴

² 15 U.S.C. § 78j. Pursuant to this section, the U.S. Securities and Exchange Commission ("SEC") promulgated Rule 10b-5, which makes it unlawful: (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. 17 CFR § 240.10b-5.

³ *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-342 (2005).

⁴ *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

In order for plaintiffs to bring a Section 10(b) claim on behalf of themselves and a class of similarly situated investors under Federal Rule of Civil Procedure 23(b)(3), questions common to the class must “predominate” over questions affecting individual class members. Under traditional fraud and class-certification principles, securities fraud plaintiffs were often stymied by Rule 23(b)(3)’s predominance requirement because, if proof of actual reliance were required, individual issues of each plaintiff’s knowledge of and reliance on particular misrepresentations would overwhelm the common ones. Wrestling with how to certify a class where the element of reliance was individual rather than common to a class, some courts initially dealt with the issue by permitting questions of individual reliance to be litigated separately, after other common liability issues had been tried, or by applying a “presumption” of reliance.⁵

In 1988, the majority in *Basic* approved a “rebuttable presumption” of classwide reliance available to plaintiffs who invoke the “fraud-on-the-market” theory.⁶ As the Supreme Court recognized in *Basic*, “[t]he fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business,” including any available material misstatements.⁷ Because investors who purchase or sell stock necessarily do so in reliance on

⁵ *Hurwitz v. R.B. Jones Corp.*, 76 F.R.D. 149, 169 (W.D. Mo. 1977). See *Green v. Wolf Corp.*, 406 F.2d 291, 301 (2d Cir. 1968) (rejecting the argument that a fraud case is unsuited for class treatment if there is a material variation in the representations made or in the kinds or degrees of reliance by the persons to whom they were addressed, as “[c]arried to its logical end, it would negate any attempted class action under Rule 10b-5, since . . . reliance is an issue lurking in every 10b-5 action” and holding that a trial court, “if it determines individual reliance is an essential element of the proof,” can “order separate trials on that particular issue, as on the question of damages, if necessary”); *Vernon J. Rockler & Co. v. Graphic Enters., Inc.*, 52 F.R.D. 335, 345-346 (D. Minn. 1971) (holding that a “rigid application of the requirements of Rule 23(a)(2) and (b)(3) has largely been rejected in favor of a policy which permits securities fraud claimants to proceed as a class in spite of foreseeable variation on the issue of reliance” and that “[o]nce the common elements have been adjudicated, the court may or at least could order separate trials on the issue of reliance”).

⁶ *Basic*, 485 U.S. at 242, 247. Many lower courts had already recognised such a presumption. See e.g. *Peil v. Speiser*, 806 F.2d 1154, 1160-1161 (CA3 1986); *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (ND Tex.1980).

⁷ *Id.* at 241 (quotation and citation omitted).

“the integrity of the market price,” they indirectly rely on misstatements reflected in the stock price.⁸ Under the fraud-on-the-market theory, “[m]isleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.”⁹ The fraud-on-the-market presumption thus made it possible for investors to obtain class certification without having to prove that each individual class member actually knew of the alleged misstatements when deciding to purchase or sell the security at issue.¹⁰ Following *Basic*, both the number of securities fraud class actions filed and the size of the amount paid in settlement increased dramatically.¹¹

To trigger the presumption at the certification stage, the plaintiff must show that: (i) the misrepresentations were public; (ii) the stock traded in an efficient market; and (iii) the plaintiff traded in the period between when the misrepresentations were made and when the truth was revealed.¹² It is not enough that plaintiffs simply allege that the requirements have been met; rather, plaintiffs bear the burden of proving all three prerequisites – including, in particular,

⁸ *Id.* at 247.

⁹ *Id.* at 241-242.

¹⁰ See, e.g., Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623, 663 (1992) (stating that “the rate at which securities fraud class action suits were filed nearly tripled between April 1988, just after *Basic* was decided, and June 1991”); Brief for Chamber of Commerce of the United States of America as *Amicus Curiae* in Support of Respondents at 4, *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (No. 09-1403), 2011 U.S. S. Ct. Briefs LEXIS 445, at *6 (*Basic* “significantly expanded the Rule 10b-5 implied right of action by creating a fraud-on-the-market presumption in order to permit securities fraud plaintiffs to meet class certification requirements under Fed. R. Civ. P. Rule 23”).

¹¹ Brief for Former SEC Commissioners and Officials and Law Professors as *Amici Curiae* in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Oct. 11, 2013), 2013 WL 5652547, at *3 (hereinafter “*Halliburton II* Former SEC Comm’r Br.”).

¹² *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1198 (2013).

market efficiency – often by a “preponderance of the evidence,” and district courts must weigh all competing evidence.¹³

According to the prevailing definition of market efficiency, an efficient market is one in which the market price reflects all material, publicly available information.¹⁴ Defendants need not demonstrate that the market is inefficient, only that “plaintiffs’ proffered proof of market efficiency falls short of the mark.”¹⁵ Because plaintiffs bear the burden of proof, defendants can avoid *Basic*’s presumption of reliance by challenging the efficiency of the market in which their stock trades. The certification of securities class actions has become the subject of statistics-driven expert analysis by market efficiency experts as well as analysis of specific factors which provide circumstantial evidence of efficiency.¹⁶ Specifically, courts typically look to “event studies” to aid them in determining whether the market is efficient. An event study, in this context, identifies a particular event (or type or series of events), and uses statistical methods to analyze whether that event (or series of events) affected the price of a security net of general market and industry factors. Such studies attempt to determine, typically to a statistically significant (*i.e.*, 95% confidence) level, whether an event affected the price of a security.¹⁷

¹³ Neither Rule 23 nor Supreme Court precedent specifies a particular burden of proof that the plaintiff must meet in showing that the requirements of Rule 23 are satisfied. At least four circuits have adopted a standard of proof for Rule 23 requirements, specifically the preponderance of the evidence standard. *See Messner v. Northshore Univ. HealthSystem*, 669 F.3d 802, 811 (7th Cir. 2012); *Novella v. Westchester Cnty.*, 661 F.3d 128, 148–49 (2d Cir. 2011); *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221 (5th Cir. 2009); *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 320 (3d Cir. 2008). This standard of proof appears to be the trend in federal courts. Newberg on Class Actions, § 7:21 (Dec. 2013).

¹⁴ Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383 (1970).

¹⁵ *IBEW Local 90 Pension Fund v. Deutsche Bank AG*, No. 11 Civ. 4209, 2013 WL 5815472, at *20 (S.D.N.Y. Oct. 29, 2013).

¹⁶ In analyzing market efficiency, courts use the following list of factors from a district court decision, *Cammer v. Bloom*, decided shortly after *Basic*: (1) the average weekly trading volume of the securities at issue; (2) the number of securities analysts reporting on or following the securities; (3) the extent to which market makers traded in the securities; (4) the extent to which the issuer was/is eligible to file an SEC Registration Form S-3; and (5) the demonstration of a cause and effect relationship between the unexpected, material disclosures and changes in the securities’ price. *Cammer v. Bloom*, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989). In addition, courts sometimes

Economists still believe that stock prices reflect material public information. However, in recent years, the foundation for *Basic*'s presumption of reliance has been questioned by some critics, who dispute the strength and pervasiveness of market efficiency.¹⁸ Although *Basic* accepted that the market “act[s] as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price,”¹⁹ some have observed significant deviations from market efficiency even in the case of widely-traded stocks.²⁰ “A stock might trade efficiently some of the time, for some information types, but then trade inefficiently at other times, for other information types.”²¹ “Information that is easy to understand and that is trumpeted in the business media. . . may be incorporated into market prices almost instantaneously,” but there are also counterexamples where that does not occur.²² The more difficult information is to understand, critics contend, the more likely it is that it will

apply three additional “*Krogman*” factors: (1) the company’s market capitalization; (2) the size of the bid-ask spread; and (3) the percentage of shares available to the public. *Krogman v. Sterritt*, 202 F.R.D. 467, 478 (N.D. Tex. 2001). No circuit courts have explicitly endorsed either set of factors.

¹⁷ See generally Brief of Testifying Economists as *Amici Curiae* in Support of Respondent, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Feb. 5, 2014).

¹⁸ See, e.g., Harrison Hong & Jeremy C. Stein, *Disagreement and the Stock Market*, 21 J. Econ. Perspectives 109 (2007); Malcolm Baker & Jeffrey Wurgler, *Investor Sentiment in the Stock Market*, 21 J. Econ. Perspectives 129 (2007). On the degree of doubt and disagreement about efficiency among finance and economics professors, see Ivo Welch, *Views of Financial Economists on the Equity Premium and on Professional Controversies*, 73 J. Bus. 501 (2000); James S. Doran et al., Market Efficiency and Its Importance to Individual Investors – Surveying the Experts (Aug. 10, 2007) (unpublished Ph.D. dissertation, Florida State University), <http://ssrn.com/abstract=1006237> (noting that not only are economists in disagreement about the degree of efficiency, they do not act as if the market is efficient in their own investment activities), cf. Brief of Securities Law Scholars as *Amicus Curiae* in Support of Respondent at 14, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Feb. 5, 2014) (hereinafter “*Halliburton II* Securities Law Scholars Br.”) (legal and finance scholars widely accept that the public capital markets demonstrate the required level of efficiency – that prices respond to and incorporate material information).

¹⁹ *Basic*, 485 U.S. at 244 (citation omitted).

²⁰ See David Hirshleifer & Siew Hong Teoh, *Limited Attention, Information Disclosure and Financial Reporting*, 36 J. Acct. & Econ. 337 (2003).

²¹ Geoffrey Rapp, *Rewiring the DNA of Securities Fraud Litigation: Amgen’s Missed Opportunity*, 44 Loy. U. Chi. L.J. 1475, 1484 (2013).

²² Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. Corp. L. 635, 656 (2003).

take longer “to be fully incorporated into prices,” if it is indeed ever “incorporated at all.”²³ Critics further note that financial economists still “do not know how to calculate the price that fully reflects the available information,” and thus there is no baseline against which to gauge market efficiency.²⁴ The issues surrounding this debate were given particular notoriety with the recent award of the Nobel prize in economics to three economists with famously differing views of market efficiency in connection with that very work.²⁵

Amidst these criticisms, the Supreme Court decided *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*.²⁶ The majority opinion, written by Justice Ginsburg, held that proof of materiality is not a prerequisite to class certification, reasoning that “because ‘[t]he question of materiality . . . is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor,’” materiality is a common question for purposes of Rule 23(b)(3), and thus there is no risk that a failure of proof on the common question of materiality would result in individual questions predominating.²⁷ The majority opinion recognized that materiality is a central issue for the fraud on the market presumption and “that the fraud-on-the-market theory cannot apply absent a *material* misrepresentation or omission” – because it is only material information that affects stock price and, therefore, it is only material information that is indirectly conveyed to investors through stock price – but the court concluded

²³ *Id.*

²⁴ Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. Corp. L. 517, 525 (2003) (citation omitted), *cf.* Richard Thaler, *Markets Can be Wrong and the Price is Not Always Right*, Fin. Times (Aug. 4, 2009), <http://www.ft.com/intl/cms/s/0/efc0e92e-8121-11de-92e7-00144feabdc0.html#axzz30PXyh6Dr> (explaining that market efficiency does not require that prices reflect fundamental values of stocks).

²⁵ Rich Miller, Joshua Zumbrun, & Niklas Magnusson, *Fama, Shiller, Hansen Win Nobel Prize for Asset-Price Work*, Bloomberg (Oct. 14, 2013), <http://www.bloomberg.com/news/2013-10-14/fama-hansen-shiller-share-nobel-economics-prize-academy-says.html>.

²⁶ *Amgen*, 133 S. Ct. at 1184.

²⁷ *Id.* at 1195.

that “proof of materiality is not required prior to class certification because such proof is not necessary to ensure satisfaction of Rule 23(b)(3)’s predominance requirement.”²⁸ Four justices – Scalia, Thomas, and Kennedy in their dissents and Alito in a concurrence – signaled a desire to revisit *Basic*’s original “fraud-on-the-market” presumption. Justice Alito wrote that he believed that reconsideration of *Basic*’s “fraud-on-the-market” theory was appropriate in light of recent evidence suggesting that the presumption rested on a “faulty economic premise.”²⁹ Justice Thomas, joined by Justices Kennedy and Scalia, likewise noted in a footnote that the “*Basic* decision itself is questionable” and that the concern Justice White articulated in *Basic* – that the Court “is ‘not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory’” – “remains valid today.”³⁰

Significantly, neither party in *Amgen* had actually asked the Court to reevaluate the “fraud-on-the-market” theory articulated in *Basic*. Instead, the issue was raised in an *amicus curiae* brief submitted by two law professors – Adam Pritchard of the University of Michigan and Todd Henderson of the University of Chicago. The professors had argued that rather “than being totally ‘efficient’ or ‘inefficient,’ securities markets enjoy varying degrees of efficiency, and therefore incorporate information at varying rates” and that “the Court should shift the focus of fraud on the market inquiries from a market’s overall efficiency to the question of whether the fraud at issue affected market price.”³¹ Those comments were more than sufficient to pique the interest of nearly half the Supreme Court.

²⁸ *Id.* at n.4.

²⁹ *Id.* at 1204.

³⁰ *Id.* at 1209 n.4 (Thomas, J., dissenting).

³¹ Brief of Law Professors as *Amici Curiae* in Support of Petitioners at 3-4, *Amgen, Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013) (No. 11-1085).

While *Amgen* called into question the 26-year-old *Basic* precedent, *Erica P. John Fund, Inc. v. Halliburton* brought the issue squarely before the Court. The first time that the case was before the Supreme Court, the Court held that plaintiffs need not prove loss causation to invoke the “fraud-on-the-market” presumption in Section 10(b) cases based on affirmative misrepresentations. Loss causation, like reliance, is an element of private claim under Section 10(b) and Rule 10b-5 and, because of the efficient capital markets hypothesis (upon which the “fraud-on-the-market” presumption is based and that is also relevant to the element of loss causation), loss causation is typically demonstrated by showing through event studies that the disclosure of the truth underlying an alleged misrepresentation caused the stock price to correct, *i.e.*, drop, as it was previously inflated by the misrepresentation. As discussed below, the Court held that such a subsequent drop need not be established at the class certification stage.

After issuing its decision, the Court remanded the case to the district court. On remand, Halliburton argued that plaintiffs were required to show the alleged misrepresentations had a ‘price effect’ on the company’s stock, because if there had been no price effect, then the “fraud-on-the-market” doctrine was inapplicable and there could be no class-wide basis for proving reliance. The district court rejected Halliburton’s evidence showing that the alleged misrepresentations did not have a price impact and certified a class. The United States Court of Appeals for the Fifth Circuit affirmed, observing that the absence of price impact may indicate that the allegedly fraudulent information was not incorporated into the market price, but nevertheless holding that, under the “proper analytical framework” set forth in *Amgen*, common questions still predominate because the measure of a misrepresentation’s impact on the stock price is an objective inquiry that “inherently applies to everyone in the class.”³²

³² *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 3:02-cv-1152-M, 2012 WL 565997 (N.D. Tex. Jan. 27, 2012) (hereinafter “*Halliburton II Dist. Ct.*”), *aff’d sub nom.*, *Erica P. John Fund, Inc. v.*

Halliburton subsequently petitioned to the Supreme Court for *certiorari*. In its petition, Halliburton asked the Court to consider both (i) whether the Court should overrule or substantially modify its 1988 ruling in *Basic*, which adopted the “fraud-on-the-market” presumption of reliance; and (ii) in the alternative, whether defendants may rebut the presumption of reliance at the class certification stage by introducing evidence that the alleged misrepresentations did not affect the price of the stock.³³ Halliburton argues that *Basic* should be overruled because, among other reasons, the efficient capital markets hypothesis upon which the “fraud-on-the-market” presumption is based has been “almost universally repudiated” by recent economic research.³⁴ Alternatively, Halliburton argues that, although it has conceded that securities fraud plaintiffs need not prove loss causation to win class certification, plaintiffs nevertheless must show “price impact” (*i.e.*, whether the alleged misrepresentations affected the market price in the first place).³⁵

The Court’s reconsideration of *Basic*’s “fraud-on-the-market” presumption is particularly significant in light of recent decisions imposing more stringent standards for Rule 23 class certification. In *Wal-Mart Stores, Inc. v. Dukes*,³⁶ for example, the Supreme Court overturned a grant of class certification to a class of 1.5 million women alleging discrimination over pay and promotion by their supervisors at Wal-Mart, in violation of Title VII. The plaintiffs alleged that Wal-Mart’s corporate culture permitted bias against female employees, affecting local

Halliburton Co., 718 F.3d 423, 433 (5th Cir. 2013) (hereinafter “*Halliburton II* Cir. Ct.”), *cert. granted*, 134 S. Ct. 636 (2013) (No. 13-317).

³³ Petition for Writ of *Certiorari*, *Halliburton Co. v. Erica P. John Fund, Inc.* No. 13-317 (U.S. Sept. 9, 2013) (hereinafter “*Halliburton II* Petition for Writ”).

³⁴ *Id.* at 12.

³⁵ *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2182-87 (2011) (hereinafter “*Halliburton I*”).

³⁶ 131 S. Ct. 2541, 2547 (2011).

supervisors' decision-making and subjecting women at the company to discriminatory practices.³⁷

Although an employment discrimination case, the Court's decision is nevertheless potentially relevant to securities fraud class actions. In a 5-4 opinion, the Court held with respect to the commonality requirement under Rule 23(a)(2) that the claims "must depend upon a common contention" that is "capable of classwide resolution – which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke."³⁸ Because of "dissimilarities" among the experiences of myriad class members employed at thousands of Wal-Mart stores nationwide, which related directly to the central allegation of gender discrimination, the majority held that the class lacked commonality as to the primary issue requiring classwide resolution.³⁹ In addition, Justice Scalia also wrote that Rule 23 is not a "mere pleading standard," but instead that a party seeking class certification must "affirmatively demonstrate his compliance with the Rule – that is, he must be prepared to prove that there are *in fact* . . . common questions of law or fact, etc."⁴⁰ The Court in *Wal-Mart* distinguished securities fraud actions, noting that to access the fraud-on-the-market presumption, plaintiffs must prove a merits question at the certification stage, namely, whether the stocks were traded on an efficient market,⁴¹ but defendants in securities class actions may argue that dissimilarities among class members similarly defeat commonality under *Wal-Mart*.

³⁷ *Id.* at 2548.

³⁸ *Id.* at 2545.

³⁹ *Id.* at 2556-2557.

⁴⁰ *Id.* at 2551 (emphasis added).

⁴¹ *Id.* at n.6.

Moreover, if this Court were to overturn *Basic* on the ground that the efficient markets theory is flawed, that result may call into question the underpinnings of numerous other settled securities law principles. As an initial matter, courts' treatment of the essential elements of materiality, loss causation and damages are largely premised on the notion that the market assimilates all or most material public information about a security and reflects that information in that security's market price. Indeed, materiality is often tested, in part, by reference to the effect that a misstatement has on the price of a given security. Somewhat similarly, the inflationary impact of a misstatement and size of a subsequent loss is generally considered to be evidenced by event studies measuring the movement in a security's price following the disclosure of the relevant truth versus an "index" of similar securities, which is, again, a concept premised on the notion that markets react to publicly available information such as disclosures revealing fraud. In addition, many SEC regulations rest squarely on the principle that issuers need to disclose information to the market, which will incorporate that information into the price as a matter of course. In pursuing criminal and civil violations of federal securities laws, the Department of Justice and the SEC also regularly rely on the assumption that information is generally incorporated into the market price of stocks, including through the use of "event studies."⁴²

III. THE FRAUD-ON-THE-MARKET PRESUMPTION

A. *Securities Class Actions Before Basic v. Levinson*

The potential for securities class actions to protect investor rights was recognized early on. For example, Professor Louis Loss wrote in the early 1960s that "the ultimate effectiveness of the federal remedies, when the defendants are not prone to settle, may depend in large

⁴² Brief for Respondent on Writ of *Certiorari* at 6-7, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Jan. 29, 2014) (hereinafter "*Halliburton II* Respondent's Br.>").

measure on the applicability of the class action device.”⁴³ Courts also recognized the need for securities class actions, as exemplified by the Second Circuit’s 1965 decision in *Escott v.*

Barchris Construction Corp.:

In our complex modern economic system where a single harmful act may result in damages to a great many people there is a particular need for the representative action as a device for vindicating claims which, taken individually, are too small to justify legal action but which are of significant size if taken as a group. In a situation where we depend on individual initiative, particularly the initiative of lawyers, for the assertion of rights, there must be a practical method for combining these small claims, and the representative action provides that method. The holders of one or two of the debentures involved in the present action could hardly afford to take the risk of an individual action.⁴⁴

Securities class actions became more effective tools of practice after major amendments to Federal Rule of Civil Procedure 23 were adopted in 1966. Before then, class actions seeking damages under the securities laws had to be brought as “spurious class actions” under former Rule 23(a)(3). A spurious class action was a form of permissive joinder and had limited effectiveness because judgments in such actions were only binding on the parties, not on absent class members who did not intervene as named plaintiffs.⁴⁵ Thus, spurious class actions often did not provide a meaningful class-wide remedy or prevent a multiplicity of suits based on the same alleged fraud. Although courts permitted absent class members to intervene as plaintiffs in securities class actions before the final judgment, many felt that such a cumbersome procedure did not adequately address “the unsatisfactory character” of pre-1966 class actions.⁴⁶

⁴³ Louis Loss, *Securities Regulation* 1819 (2d ed. 1961).

⁴⁴ 340 F.2d 731, 733 (2d Cir.1965).

⁴⁵ See *All Am. Airways, Inc. v. Elderd*, 209 F.2d 247 (2d Cir. 1954).

⁴⁶ *Escott*, 340 F.2d at 735 (Friendly, J., concurring).

The modern era of securities class actions was made possible by the fundamental rewriting of Rule 23 of the Federal Rules of Civil Procedure in 1966, which permitted class actions seeking money damages if they satisfied the now-familiar requirements of numerosity, commonality, adequacy, and typicality under Rule 23(a) and predominance and superiority under Rule 23(b)(3).

Before the Supreme Court adopted the fraud-on-the-market presumption in *Basic*, predominance was often the main hurdle to certification of securities class actions. Defendants typically argued that each class member's direct reliance on defendants' alleged misrepresentations was an individual question that overwhelmed any common questions, defeating the predominance requirement. Plaintiffs were often able to pass over this hurdle in one of three ways.

First, courts in the pre-*Basic* era often held that proof of class members' individual direct reliance, if required, could be presented in separate trials after the trial of common issues such as the falsity of defendants' public representations. For example, the Second Circuit rejected defendants' argument in a 1968 case "that each person injured must show that he personally relied on the misrepresentations in order to recover and thus any common issues of misrepresentations do not predominate over the individual questions of reliance," because the court saw "no sound reason why the trial court, if it determines individual reliance is an essential element of the proof, cannot order separate trials on that particular issue, as on the question of

damages, if necessary.”⁴⁷ Language in *Basic* and subsequent Supreme Court decisions, however, raises questions about the continued viability of this approach to class certification.⁴⁸

Second, the Supreme Court held in 1972 that class members’ reliance could be presumed in cases involving material omissions.⁴⁹ Thus, some class actions proceeded without evidence of direct reliance because they were primarily based on omissions.

Third, the fraud-on-the-market presumption found wide, although not universal, acceptance in the lower courts starting in the 1970s.⁵⁰

Thus, securities class actions were well established during the period from 1966 to 1988, and the foundations for their post-*Basic* development were strong.

B. Basic Inc. v. Levinson: *Factual Brief, Procedural Posture, and Decision*

Basic Incorporated (“Basic”) was a publicly-traded company primarily engaged in the business of manufacturing chemical refractories for the steel industry. Beginning in 1976, Combustion Engineering, Inc. (“Combustion”) had meetings and telephone conversations with Basic concerning the possibility of a merger. Over the course of the next two years, Basic made three public statements denying it was engaged in merger negotiations. In December 1978, Basic asked the New York Stock Exchange to suspend trading in its shares and issued a release

⁴⁷ See *Green*, 406 F.2d at 301; *Eisenberg v. Gagnon*, 766 F.2d 770, 786 (3d Cir. 1985) (“The presence of individual questions as to the reliance of each investor does not mean that the common questions of law and fact do not predominate over questions affecting individual members Rather than eliminate securities class actions, it would be more efficient to order separate trials, if necessary, limited to the issue of reliance.”).

⁴⁸ See, e.g., *Amgen*, 133 S. Ct. at 1199 (citing *Basic*, 485 U.S. at 242).

⁴⁹ See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972).

⁵⁰ See *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 & n.9 (8th Cir. 1986); *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984); *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1332-33 (10th Cir. 1983); *Panzirer v. Wolf*, 663 F.2d 365, 367-68 (2d Cir. 1981), *vacated on other grounds sub nom. Price Waterhouse v. Panzirer*, 459 U.S. 1027 (1982); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979); *Blackie v. Barrack*, 524 F.2d 891, 908 (9th Cir. 1975). *But see Zimmerman v. Bell*, 800 F.2d 386, 390 (4th Cir. 1986) (holding that class members’ reliance on misrepresentations was an individual question defeating predominance).

stating that it had been “approached” by another company concerning a merger. The next day, Basic’s board endorsed Combustion’s per share offer for its common stock and subsequently announced its approval of Combustion’s tender offer for all outstanding shares.⁵¹

Former Basic shareholders who sold their stock after Basic’s first alleged misstatement and before the suspension of trading filed a class action against Basic asserting Section 10(b) claims based on allegations that they were injured by selling Basic shares at artificially depressed prices in a market affected by Basic’s misleading statements about the status of merger negotiations.

The district court adopted a class-wide presumption of reliance that enabled the court to conclude that common questions of fact or law predominated over particular questions pertaining to individual plaintiffs and certified a class. The United States Court of Appeals for the Sixth Circuit affirmed the class certification. The Sixth Circuit joined a number of other Circuits in accepting the “fraud-on-the-market theory” to create a rebuttable presumption that plaintiffs’ relied on Basic’s material misrepresentations, noting that without the presumption it would be impractical to certify a class under Rule 23.

The Supreme Court granted *certiorari* to determine (a) whether the information at issue was material and (b) whether the Sixth Circuit erred in adopting and applying the fraud-on-the-market presumption.⁵² Justices William Rehnquist, Antonin Scalia, and Anthony Kennedy recused themselves.⁵³ Justices Harry Blackmun, William Brennan, Thurgood Marshall, and John

⁵¹ *Basic*, 485 U.S. at 247.

⁵² Brief For Petitioners on Writ of *Certiorari* at i, *Basic Inc., et al. v. Levinson et al.*, 485 U.S. 224 (1988) (No. 86-279), 1987 U.S. S. Ct. Briefs, LEXIS 1150 at **1.

⁵³ *Basic*, 485 U.S. at 224.

Paul Stevens filed the majority opinion. Justices Bryon White and Sandra Day O'Connor dissented.

After explaining that it had previously dispensed with a requirement of positive proof of reliance in the federal securities class action context, including with respect to Section 10(b) class claims based on material omissions,⁵⁴ the Court recognized that the “modern securities markets ... differ from the face-to-face transactions contemplated by early fraud cases, and [that the Court’s] understanding of [Section 10(b)’s] reliance requirement must encompass these differences.”⁵⁵ The Court held that “where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed.”⁵⁶ The Court explained that “the market is interposed between seller and buyer ..., transmits information to the investor in the processed form of a market price,...[and] [t]hus ... is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction.”⁵⁷ In other words, “[t]he market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.”⁵⁸ It further held that the presumption is rebuttable: “Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or [the plaintiff’s] decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.”⁵⁹

⁵⁴ *Affiliated Ute*, 406 U.S. at 128.

⁵⁵ *Basic*, 485 U.S. at 243-44.

⁵⁶ *Id.* at 247.

⁵⁷ *Id.* at 244 (quotations and citations omitted).

⁵⁸ *Id.* (quotations and citations omitted).

⁵⁹ *Id.* at 248.

The Court made clear that “[b]y accepting this rebuttable presumption, [it did] not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.”⁶⁰

The dissent expressed concern that the Court’s endorsement would have “many adverse, unintended effects as it is applied and interpreted in the years to come.”⁶¹ The theory, they said, did not deserve the “sweeping confidence usually reserved for more mature legal doctrines.”⁶² Justices White and O’Connor were also skeptical that the judiciary would be able to embrace “novel constructions of a statute based on contemporary microeconomic theory,”⁶³ and urged Congress to lead any effort to make the securities laws into something approaching “an investor insurance scheme.”⁶⁴

C. *Acceptance and Application of the Fraud-on-the-Market Presumption*

1. Tests To Establish That There Is An Efficient Market

To invoke the fraud-on-the-market presumption, a plaintiff must prove that the security at issue traded in an efficient market.⁶⁵ There is no single test used to determine if a market for a security is efficient. Courts typically examine several factors, the most widely-cited of which are set forth in *Cammer v. Bloom*.⁶⁶ There, the court considered:

⁶⁰ *Id.* at 247 n. 24, n. 28.

⁶¹ *Id.* at 251.

⁶² *Id.* at 250-251.

⁶³ *Id.* at 253.

⁶⁴ *Id.* at 256-257.

⁶⁵ *Halliburton I*, 131 S. Ct. at 2185 (quotations omitted). A plaintiff must also prove that: 1) that the alleged misrepresentations were publically known; and 2) that the “relevant transaction took place between the time the misrepresentations were made and the time the truth was revealed.”

⁶⁶ 711 F. Supp. at 1286-87.

- 1) Average weekly trading volume, because market interest implies investors are trading on new information about the company;
- 2) The number of securities analysts that followed the company, because that number demonstrates investment professionals are analyzing new information about the company;
- 3) The number of market makers, because they will trade in response to new information about the company;
- 4) Whether the company had sufficient stock outstanding to file an S-3 shelf registration statement; and
- 5) Whether the price of the stock generally responded to corporate events and financial releases, because a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price implies the existence of market efficiency.⁶⁷

Each of these factors could support the inference that “disclosed company information (or misinformation) would be reflected in the company’s stock price.”⁶⁸ No single one, though, is intended to serve as a determinative factor for assessing if a security’s market is efficient.⁶⁹

Some courts have supplemented this list. For example, many courts have followed *Krogman v. Sterritt*,⁷⁰ which considered three additional factors: (1) market capitalization; (2) bid-ask spread; and (3) the percentage of shares held by the investing public as opposed to insiders (*i.e.*, the “float”).⁷¹ These courts reason that the market for widely held, cheap-to-trade securities will likely be efficient.⁷² Other courts have also looked at other factors, such as the amount of stock held by institutional investors, or the exchange on which the stocks were traded.⁷³

⁶⁷ *Id.*

⁶⁸ *Id.* at 1286.

⁶⁹ *Id.* at 1287.

⁷⁰ 202 F.R.D. 467 (N.D. Tex. 2001).

⁷¹ *Id.* at 478.

⁷² *Id.*

⁷³ See *O’Neil v. Appel*, 165 F.R.D. 479, 503 (W.D. Mich. 1996) (“[P]ricing inefficiencies are much more likely to be found in small companies, especially when their stock is not widely held by institutional investors.”). And, perhaps not surprisingly, courts have held that – while not dispositive – there is a rebuttable presumption of efficiency for a

2. Elements Subject to Challenge

Though some of these factors have achieved widespread acceptance in the courts and in academia, some have also been criticized by some as both unsound in theory and unwise in practice. Critics say that many of these factors represent only weak proxies for measuring the efficiency of a market. One study found that of eight factors⁷⁴ typically used by courts, only two – trading volume and number of analysts covering a stock – “systemically differentiate[d] between efficiently and inefficiently priced stocks.”⁷⁵ In addition, some of the factors – such as trading volume and firm size – are highly correlated; analyzing one after analyzing the other adds no independent value.⁷⁶

Moreover, critics argue that courts have struggled to apply these factors in a consistent fashion – frequently reaching different results on similar facts.⁷⁷ Critics argue that while *Cammer* and its progeny recite factors that can measure efficiency, they do not provide a framework for weighing the factors against each other. Without economic or statistical expertise, some judges may overlook the significance of certain evidence within the context of a

security traded on a national exchange. *See Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 2006 WL 2161887, at *8 & n.114 (S.D.N.Y. Aug. 1, 2006) (collecting cases).

⁷⁴ The study considered: (1) trading volume; (2) the number of market makers; (3) size; (4) bid-ask spread percentage; (5) standard deviations of returns; (6) price; (7) number of analyst following; and (8) institutional holdings. Brad M. Barber, et al., *The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiency*, 19 J. Corp. L. 285, 298-301 (1994).

⁷⁵ *Id.* at 285-86. The effect the Internet has had on the structure of securities markets may call the use of even those factors into question. *See* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 Emory L. J. 843, 930 (2005) (“[L]arge trading volume does not - if significantly including day trading and other online retail brokerage transactions – signal that the *mechanism* for efficient market pricing is actively working on the stock price.”).

⁷⁶ Brad M. Barber, et al., *The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiency*, at 293 (1994).

⁷⁷ Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in Cammer v. Bloom and Its Progeny*, 10 U. Miami Bus. L. Rev. 303, 305 (2002).

specific case,⁷⁸ or rely too heavily on biased experts.⁷⁹ Thus, even setting aside the merits of the fraud-on-the-market presumption itself, its application has come under criticism by some.

3. Burden Of Proof At Various Stages of Litigation

The burden of proof regarding the presumption of reliance varies depending on when the presumption is invoked during the litigation.

Motion to Dismiss: The fraud-on-the-market presumption can be invoked to defeat a motion to dismiss (and the truth-on-the-market defense to support one). Where that happens, courts must “assume the truth of well-pleaded allegations,”⁸⁰ but may still take judicial notice of certain public statements and market prices and movements outside the four corners of the Complaint.

Class Certification: As discussed, among other requirements, Fed. R. Civ. P. 23 requires that a plaintiff seeking class certification prove that “questions of law or fact common to class members predominate over any questions affecting only individual members.” Rule 23 sets forth more “than a mere pleading standard” and a party “seeking class certification must affirmatively demonstrate his compliance with the Rule.”⁸¹ And, as noted above,⁸² the fraud-on-the-market theory “facilitates class certification by recognizing a rebuttable presumption of classwide

⁷⁸ *Id.* at 317-19; *see, e.g., Unger v. Amedisys Inc.*, 401 F.3d 316, 325 (5th Cir. 2005) (criticizing district court for failing to weigh “the fact that no analyst was reporting on [the] stock at the time in question” against the “rather scant utility of, for example, the number of market makers” (citation omitted)).

⁷⁹ Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in Cammer v. Bloom and Its Progeny*, at 319-21.

⁸⁰ *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 78 n.6 (2d Cir. 2004) (collecting cases where fraud-on-the-market doctrine was used to defeat motion to dismiss in complaints brought against research analysts).

⁸¹ *Wal-Mart*, 131. S. Ct. at 2551.

⁸² *See supra*, n.13.

reliance on public, material misrepresentations when shares are traded in an efficient market.”⁸³

A plaintiff still must prove the predicates to the theory to take advantage of the presumption.

Summary Judgment/Trial: Even after a class is established, plaintiffs continue to have the burden of proving reliance at trial. Defendants have greater ability to rebut the presumption once a case proceeds to the merits, and the court will consider all competing evidence to determine whether the plaintiff has met its burden of proving the prerequisites to invoking the fraud-on-the-market theory by a preponderance of the evidence, including materiality.⁸⁴

4. Price Impact Evidence

That the alleged misrepresentation is reflected in the price of the security is central to the fraud-on-the-market presumption. The *Halliburton II* Court may address – if it does not jettison the fraud-on-the-market presumption altogether – whether plaintiffs must establish that an alleged misrepresentation affected a security’s price to avail themselves of the presumption or whether defendants can rebut the fraud-on-the-market presumption at the class certification stage by showing the alleged misrepresentation did not affect a security’s price.⁸⁵ Proponents of this “price-impact” theory argue that “[i]t makes scant sense to presume that plaintiffs relied on alleged misrepresentations by purchasing at a distorted market price without asking whether the

⁸³ *Amgen*, 133 S. Ct. at 1193. The parties in *Halliburton II* dispute whether the fraud-on-the-market presumption is consistent with the Court’s class-action precedent.

⁸⁴ Bromberg & Lowenfels on Securities Fraud § 7:495 (2d ed.). The parties in *Halliburton II* dispute the appropriate standard for determining whether a defendant has sufficiently rebutted the presumption of reliance. Petitioners, relying on Fed. R. Evidence 301, argue that they face only a burden of production in rebutting the presumption. Brief for Petitioners on Writ of *Certiorari* at 55, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Dec. 30, 2013) (hereinafter “*Halliburton II* Petitioners’ Br.”). Respondents, relying on *Affiliated Ute*, 406 U.S. 128 (1972) argue that defendants face a burden of persuasion in rebutting the presumption. *Halliburton II* Respondent’s Br. at 56..

⁸⁵ Courts could use event studies to answer this question. Event studies attempt to isolate and quantify the impact a misrepresentation had on a security’s price. See *United States v. Gushlak*, 728 F.3d 184, 201 (2d Cir. 2013) (Event studies identify the “relevant dates on which disclosure of fraud is thought to have reached the market, and then quantifying the extent to which the market reacted in a way that can only have been a response to the relevant event.”)

misrepresentation actually distorted that price in the first place.”⁸⁶ Allowing price-impact evidence at the certification stage, they argue, would promote sound policies and put the fraud-on-the-market theory on stronger theoretical ground.

As an initial matter, supporters argue that an inquiry into price impact better reflects how markets operate. Efficiency is not a binary question, they say – it is a matter of degree. Different markets will process different information at different speeds. Even “efficient” markets may not immediately incorporate all information.⁸⁷ An event study would demonstrate whether a misrepresentation was reflected in the price of a particular security.

Under this argument, event studies would allow courts to determine whether the plaintiffs’ invocation of the fraud-on-the-market doctrine squares with the “fundamental premise” of *Basic*: “that an investor presumptively relies on a misrepresentation so long as it was reflected in the market price at the time of his transaction.”⁸⁸ According to the arguments’ proponents, permitting (or requiring) such evidence at the class certification stage would prevent courts from erroneously granting certification where a seemingly “efficient” market did not actually incorporate a piece of information.

Moreover, plaintiffs could benefit if they could invoke the fraud-on-the-market presumption (on the basis of price impact) even when they could not otherwise prove the existence of an efficient market. The fraud-on-the-market theory could thereby exist independently of the efficient capital market hypothesis – “[p]erfect market efficiency may be a

⁸⁶ *Halliburton II* Petitioners’ Br. at 38.

⁸⁷ See, e.g., Donald C. Langevoort, *Basic at Twenty: Rethinking the Fraud on the Market*, 2009 Wis. L. Rev. 151, 170 (noting that even in presumably efficient market “[o]ne of the most common types of material disclosures – an earnings surprise – actually takes a while to be fully impounded, even for large-cap stocks, and even varies depending on whether it is good news or bad”).

⁸⁸ *Halliburton I*, 131 S. Ct. at 2186.

sufficient reason why an investor relying on market-price integrity would be harmed by fraud, but is not a necessary one because fraud can and does distort prevailing prices even in inefficient markets.”⁸⁹ If plaintiffs need prove price impact, instead of market efficiency, they could potentially apply the fraud-on-the-market theory to securities – such as mortgage-backed bonds and collateralized debt obligations – that courts have sometimes held do not trade on efficient markets.⁹⁰

Others, however, have argued that it is inappropriate to consider evidence of price impact at the class-certification stage.⁹¹ The absence of price impact, they contend, would not cause individual questions to predominate over common ones – the reason for denying class certification. Rather, “it would end the case for one and for all,”⁹² because a plaintiff class limited to investors who were concededly unaware of the alleged misrepresentation (and therefore relying on the fraud-on-the-market presumption) could not prove reliance at trial, they say. Following the Court’s decisions in *Halliburton I* and *Amgen* then (both of which are discussed in greater detail below), they say, questions about price impact should be left for the merits stage.

Opponents of price impact also raise practical concerns. They assert that whether price impact can be established is not determinative of whether information is “reflected” in the security’s price and that evaluating price impact would “be inefficient and premature because

⁸⁹ Brief of Law Professors as *Amici Curiae* in Support of Petitioners at 7, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Jan. 6, 2014) (hereinafter “*Halliburton II* Law Professors Br.”) (quotations and citation omitted).

⁹⁰ *Id.* at 10 (collecting cases).

⁹¹ Other than to the extent courts look at how a security generally responds to information when determining when a market is efficient.

⁹² *Amgen*, 133 S. Ct. at 1196.

merits discovery is often required.”⁹³ “Requiring plaintiffs to prove price impact at certification would either compel them to address an intensely factual question prior to the completion of discovery or cause the court to postpone the certification decision until completion of discovery.”⁹⁴

Finally, opponents say, there is simply no need to consider price impact at the class-certification stage. The frequency and cost of class-action securities settlements are overstated, they argue. And defendants can move for summary judgment under Fed. R. Civ. P. 56(a) – without prejudice to other issues – even before a class is certified. “This well-established procedure allows defendants to mount an early, fact-based challenge to any meritless cases that advance beyond the pleading stage, and confines merits issues not tied to Rule 23 to the summary judgment and trial stages where they belong, under the proper standard of proof.”⁹⁵ (Defendants point out, though, that any decision on the merits before class certification would bind only the named plaintiffs.)

The call to shift the focus of fraud-on-the-market inquiries from a market’s overall efficiency to the question of whether the alleged fraud distorted market price ultimately may be heeded. At oral argument, Justice Kennedy indicated support for what he deemed the “midway position,” suggesting that requiring an event study focused on analyzing price impact at the class certification stage might be a “substantial answer” to the “challenge [made] to the economic premises of the *Basic* decision.”⁹⁶

⁹³ *Halliburton II* Respondent’s Br. at 54.

⁹⁴ Brief of *Amicus Curiae* Civil Procedure Scholars Supporting Respondent at 19-20, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Feb 5, 2014) (hereinafter “*Halliburton II* Civil Procedure Scholars Br.”).

⁹⁵ *Halliburton II* Respondent’s Br. at 49-50.

⁹⁶ Transcript of Oral Argument at 17: 9-17, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Mar. 5, 2014).

D. *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds: Factual Brief, Procedural Posture, and Decision*

On February 27, 2013, the U.S. Supreme Court held in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds* that a class action plaintiff need not demonstrate the materiality of alleged misrepresentations at the class certification stage of a securities fraud class action seeking to employ the fraud-on-the-market doctrine. The Court also determined that, in such circumstances, district courts are not required to consider rebuttal evidence offered by defendants on the issue of materiality when deciding the predominance issue in connection with class certification. As noted, the *Amgen* decision is also important because four Justices – including Justice Alito in concurrence and Justices Kennedy, Scalia, and Thomas in dissent – indicated a willingness to reconsider the validity of *Basic*'s fraud-on-the-market presumption of reliance generally.

1. *Amgen in the District Court*

In 2007, Connecticut Retirement Plans and Trust Funds (“Connecticut Retirement”) brought a securities fraud action against biotechnology company Amgen Inc. and several of its officers (collectively, “Amgen”) under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.⁹⁷ Connecticut Retirement alleged that Amgen made a series of material misrepresentations and omissions regarding two of its pharmaceutical products that artificially inflated the value of the company’s stock.⁹⁸ Specifically, Amgen was accused of downplaying the significance of an FDA meeting regarding the safety of the

⁹⁷ See *Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, No. CV07-2536PSG, 2009 WL 2633743, at *1 (C.D. Cal. Aug. 12, 2009) (hereinafter “*Amgen Dist. Ct.*”), *aff’d*, *Conn. Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170 (9th Cir. 2011) (hereinafter “*Amgen Cir. Ct.*”), *aff’d*, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013).

⁹⁸ *Amgen Dist. Ct.* at *1.

company's products; concealing material information regarding a clinical trial from investors; repeatedly touting the safety of its products despite serious concerns; and misrepresenting its marketing practices.⁹⁹ According to Connecticut Retirement, a series of partial corrective disclosures later revealed the truth underlying Amgen's alleged misstatements and omissions, leading to a decline in the company's stock price and harming investors.¹⁰⁰ On the basis of these allegations, Connecticut Retirement moved under Rule 23(b)(3) to certify a class of purchasers of Amgen's publicly traded securities between the time of the alleged misstatements and corrective disclosures.

On August 12, 2009, Judge Gutierrez of the U.S. District Court for the Central District of California granted Connecticut Retirement's motion for class certification. After determining that the four prerequisites for certification under Rule 23(a) – numerosity, commonality, typicality, and adequacy – were satisfied, the district court analyzed whether Connecticut Retirement's motion satisfied Rule 23(b)(3)'s requirement of predominance – i.e., “that the questions of law or fact common to class members predominate over any questions affecting only individual members.”¹⁰¹ If the members of the putative class had to demonstrate that they *individually* relied on the alleged misstatements and omissions, then class certification should be denied because common questions would not predominate as required by Rule 23(b). To avoid this result, the *Amgen* plaintiffs argued that reliance – an essential element of a securities claim under Section 10(b) – could be presumed on a class-wide basis under *Basic*'s fraud-on-the-market theory.

⁹⁹ *Id.* at *1-2.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at *8.

Based in part upon footnote 27 of Supreme Court’s *Basic* opinion, Amgen argued before the district court that, in order to trigger the presumption of reliance at the class certification stage, plaintiffs must allege *and prove* the ultimate “elements” of the *Basic* theory.¹⁰² These elements include “(1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.”¹⁰³ In addition, Amgen asserted that plaintiffs should also be required to prove that the defendant’s alleged misrepresentation “materially affected the market price of the security” (i.e. loss causation) before certification.¹⁰⁴ The district court disagreed, and instead adopted Connecticut Retirement’s argument “that to trigger the presumption of reliance” at the class certification stage, plaintiffs “need only establish that an efficient market exists” for the securities at issue.¹⁰⁵ In the district court’s view, the remaining “elements” from the *Basic* footnote do not implicate the requirements of Rule 23, but concern only the merits of the case.¹⁰⁶ Similarly, the inquiry into loss causation was “properly taken up

¹⁰² Footnote 27 in the *Basic* opinion, which describes the court of appeal’s decision below, states that: “The Court of Appeals held that in order to invoke the presumption, a plaintiff must allege and prove: (1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed [. . .] Given today’s decision regarding the definition of materiality as to preliminary merger discussions, elements (2) and (4) may collapse into one.” 485 U.S. at 248 n.27.

¹⁰³ *Id.*

¹⁰⁴ *Amgen* Dist. Ct. at *8-9. “Loss causation” is “a direct causal link between the misstatement and the claimant’s economic loss.” *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 413 (5th Cir. 2001).

¹⁰⁵ *Amgen* Dist. Ct. at *11-12.

¹⁰⁶ *Id.* at *11.

at a later stage in th[e] proceeding” after class certification.¹⁰⁷ Because Amgen had admitted in its answer to the complaint that the market for its securities was “efficient,” the court held that Connecticut Retirement “established that it purchased its securities on an efficient market” and therefore was “entitled to a presumption of reliance” under *Basic*.¹⁰⁸

Finally, the district court rejected Amgen’s attempts to rebut the presumption of reliance at the class certification stage by use of a truth-on-the-market defense. The district court reasoned that offering evidence to rebut the presumption of reliance, which is essentially the assertion of a defense of non-reliance, is “not a basis for denial of class certification” and is only allowed at a post-certification stage.¹⁰⁹ After determining pursuant to Rule 23(b)(3) that a class action would be “superior to other available methods for fairly and efficiently adjudicating the controversy,” the district court certified a class of Amgen shareholders.

2. Amgen in the Court of Appeals

In a decision following Amgen’s Rule 23(f) appeal, the Ninth Circuit unanimously affirmed the district court’s class certification order. The Ninth Circuit held that to invoke the fraud-on-the-market presumption in aid of class certification, plaintiffs must show only that the security in question traded in an efficient market and that the alleged misrepresentations were public.¹¹⁰ In the Ninth Circuit’s view, “materiality, like all other elements of a 10b–5 claim, is a merits issue that abides the trial or motion for summary judgment.”¹¹¹ Therefore, at the class certification stage, plaintiffs need only plausibly *allege*, and not *prove*, that the defendant’s

¹⁰⁷ *Id.* at *12.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at *13-14 (citation omitted).

¹¹⁰ *Amgen Cir. Ct.* at 1172.

¹¹¹ *Id.*

purported misrepresentations were material. Similarly, “rebuttal of the fraud-on-the-market presumption, at least by showing that the alleged misrepresentations were not material, is a matter for trial or summary judgment, not a matter to be taken up in a class certification motion.”¹¹²

Amgen argued that the district court’s certification order represented an abuse of discretion because Connecticut Retirement had not proven the materiality of the company’s alleged misrepresentations. If the misrepresentations were in fact immaterial, the company argued, its stock price would not have been affected in an efficient market, and no purchaser could claim to have been misled by an artificially inflated market price.¹¹³ As a result, each member of the purported class would be required to prove reliance individually, rendering class certification inappropriate because individual questions of reliance would predominate. The Ninth Circuit rejected this argument, stressing that because materiality is an essential element of the merits of a securities fraud claim, “plaintiffs cannot both fail to prove materiality yet still have a viable claim for which they would need to prove reliance individually.”¹¹⁴ If the misrepresentations turned out to be immaterial, the plaintiffs’ claims would all fail on the merits on a class-wide basis. On the other hand, the elements of the fraud-on-the-market presumption that plaintiffs *are* required to demonstrate prior to class certification – namely, “whether the securities market was efficient and whether the defendant’s purported falsehoods were public” – do not go to the merits of a securities fraud claim. “Thus, if the plaintiffs failed to prove those elements, they could not use the fraud-on-the-market presumption, but their claims would not be

¹¹² *Id.*

¹¹³ *Id.* at 1175.

¹¹⁴ *Id.*

dead on arrival.”¹¹⁵ Rather, “they could seek to prove reliance individually” without the use of a class action procedure.¹¹⁶ In the case at hand, however, the defendants both conceded that the company’s stock traded in an efficient market and did not contest that the alleged misrepresentations were publicly made.¹¹⁷ Therefore, plaintiffs were entitled to the fraud-on-the-market presumption and class certification was proper, provided that they “allege[d] materiality with sufficient plausibility to withstand a 12(b)(6) motion.”¹¹⁸

Finally, the Ninth Circuit agreed with the district court that Amgen’s attempted truth-on-the-market defense, which “is a method of refuting an alleged misrepresentation’s *materiality*,” was not appropriate at the class certification stage.¹¹⁹ Because plaintiffs need not prove materiality at that stage of the proceeding, the district court was correct in refusing to consider evidence on that point.

The Ninth Circuit’s ruling further deepened a split of authority amongst the Courts of Appeals. Previously, the Second Circuit held that plaintiffs were required to prove – and defendants were permitted to rebut – materiality at the class certification stage,¹²⁰ while the Third Circuit allowed defendants to present rebuttal evidence on this issue without requiring plaintiffs

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 1174.

¹¹⁸ *Id.* at 1177. Like the district court, the Ninth Circuit also dismissed arguments that materiality must be demonstrated prior to certification that were based on *Basic*’s footnote 27. Adopting the reasoning of the Seventh Circuit, the court explained that “All note 27 [in *Basic*] does . . . is state that the court of appeals deemed materiality essential; the Justices did not adopt it as a precondition to class certification.” *Id.* at 1176 (quoting *Schleicher*, 618 F.3d at 687).

¹¹⁹ *Id.* at 1177.

¹²⁰ See *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 484-86 & n.9 (2d Cir. 2008).

to make an affirmative showing.¹²¹ The Seventh Circuit, on the other hand, had agreed with the Ninth Circuit, finding that materiality is not relevant during class certification.¹²²

3. *Amgen* Before the Supreme Court

The U.S. Supreme Court granted *certiorari* in *Amgen* on June 11, 2012. The questions presented on appeal were: 1) Whether, in a misrepresentation case under SEC Rule 10b-5, the district court must require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory; and 2) Whether, in such a case, the district court must allow the defendant to present evidence rebutting the applicability of the fraud-on-the-market theory before certifying a plaintiff class based on that theory.

In its merits briefs, *Amgen* argued that “[t]he *Basic* Court’s repeated references to materiality in discussing the presumption, and the clear link between materiality and an effect on stock price, confirm that materiality is an essential predicate to the presumption of class-wide reliance.”¹²³ Thus, *Amgen* contended that like other “key predicates” to the *Basic* presumption and fraud-on-the-market theory – such as market efficiency and the public nature of the alleged misrepresentations – materiality must be proved at class certification. Otherwise, plaintiffs would not be able to take advantage of the presumption of reliance, which is necessary to satisfy Rule 23’s requirement that classwide issues predominate.

Amgen relied upon recent Supreme Court decisions to stress that Rule 23 requires a close scrutiny of proposed classes, in recognition of the “stark and immediate consequences” of a class

¹²¹ See *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631-32, 637-38 (3d Cir. 2011).

¹²² See *Schleicher*, 618 F.3d at 687.

¹²³ Brief for Petitioners on Writ of *Certiorari* at 8, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013) (No. 11-1085) (hereinafter “*Amgen* Petitioner’s Br.”).

certification order.¹²⁴ Similarly, Amgen argued that if materiality is not determined prior to class certification, the *in terrorem* settlement pressure that certification brings “will usually mean that defendants are forced to settle without any testing of the materiality of the alleged misstatements – that is, without any showing that class certification was warranted in the first place.”¹²⁵ In addition, Amgen cited certain modern economic research that calls into question the efficient-market hypothesis underlying *Basic*’s fraud-on-the-market theory.¹²⁶ This research demonstrates that market efficiency alone does not predict whether information will be incorporated into market price. Rather, market efficiency is a complex inquiry, and proof of materiality “provide[d] much of [the] necessary context.”¹²⁷ Amgen argued that “it would be improvident for courts to expand the *Basic* presumption by allowing class certification under the fraud-on-the-market theory based on a finding of general market efficiency alone.”¹²⁸

In its opposition, Connecticut Retirement began by asserting that proof of materiality is simply not required under Rule 23’s predominance requirement “because the immateriality of the defendant’s misstatements would not demonstrate a dissimilarity among the class members leading to predominance of individual questions. Rather, the immateriality of the misstatements would affect all class members alike.”¹²⁹ As a result, as long as the market is demonstrated to be efficient and the fraud-on-the-market presumption applies, materiality, which is measured by an objective reasonable investor standard, remains “a common question capable of only one answer

¹²⁴ *Id.* at 9, 21.

¹²⁵ *Id.* at 26.

¹²⁶ *Id.* at 31.

¹²⁷ *Id.* at 30-31.

¹²⁸ *Id.* at 34.

¹²⁹ Brief for Respondents on Writ of *Certiorari* at 18, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013) (No. 11-1085) (hereinafter “*Amgen Respondent’s Br.*”).

for the entire class.”¹³⁰ Connecticut Retirement thus argued that materiality was like the other securities-fraud elements of falsity and scienter, which affect all investors in equal fashion and present “paradigmatic common question[s] that need not be decided at class certification.”¹³¹ Such common elements are relevant only at the summary judgment or trial stage because they concern “the dispute . . . not over whether the members of the proposed class are relevantly the same or relevantly different but, instead, over whether they are the same in such a way as to indicate that *all* class members should lose on the merits.”¹³² Connecticut Retirement also criticized Amgen’s position as requiring plaintiffs to demonstrate (and courts to resolve) the fact-intensive and nuanced materiality issue at an early stage in the proceedings without the benefits of a fully developed factual record and merits discovery. Moreover, Amgen’s complaints about the assumptions of the efficient market hypothesis underlying the fraud-on-the-market theory were not at issue in the case; as Amgen had conceded the issue of market efficiency in the courts below.¹³³

In a 6-3 decision authored by Justice Ginsburg, the Court affirmed the lower courts’ rulings regarding class certification and held that Rule 23(b)(3) does not require plaintiffs to prove materiality in order to establish predominance at the class certification stage. Although acknowledging that “the fraud-on-the-market theory cannot apply absent a *material* misrepresentation or omission” “[b]ecause immaterial information, by definition, does not affect market price,” Justice Ginsburg’s opinion stressed that “the pivotal inquiry” in this case was not,

¹³⁰ *Id.* at 19.

¹³¹ *Id.* at 25-26.

¹³² *Id.* at 30 (internal quotations and citations omitted).

¹³³ Amicus briefs filed by economic experts in support of Connecticut Retirement defended the continued validity of the EMH. *See e.g.* Brief of Financial Economists as *Amici Curiae* in Support of Respondent, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013) (No. 11-1085).

as Amgen maintained, whether “materiality is an essential predicate of the fraud-on-the-market theory; indisputably it is.”¹³⁴ Rather, the “the pivotal inquiry is whether proof of materiality is needed to ensure that the *questions* of law or fact common to the class” predominate for Rule 23 purposes.¹³⁵ The majority answered this question in the negative based on two interrelated factors.

First, the Court stressed that materiality is based on an objective reasonable investor standard and can be demonstrated by use of evidence common to the class. As a result, the Court held that materiality is a “common questio[n] for purposes of Rule 23(b)(3).”¹³⁶ Second, no matter the result of the materiality inquiry, the Court stated “there is no risk whatever that a failure of proof on the common question of materiality will result in individual questions predominating.”¹³⁷ If the lead plaintiff were unable to sufficiently demonstrate materiality – a required element of a Section 10(b) claim – at summary judgment or trial, the result would be an “end [to] the case for one and for all; no claim would remain in which individual reliance issues could potentially predominate.”¹³⁸ The Court’s determination that materiality is a common question is consistent with its recent statement in *Wal-Mart Stores, Inc. v. Dukes* that a common question is one that “is capable of classwide resolution” because it “will resolve an issue that is central to the validity of each one of the claims in one stroke.”¹³⁹

¹³⁴ *Amgen*, 133 S. Ct. at 1195.

¹³⁵ *Id.*

¹³⁶ *Id.* at 1196 (citation omitted).

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Wal-Mart*, 131 S. Ct. at 2551.

In dissent, Justice Thomas, joined by Justice Kennedy and in part by Justice Scalia, argued that the majority’s decision in fact allowed securities class actions to be certified without proof that common questions of reliance predominate and “all but eliminat[ed] materiality as one of the predicates of the fraud-on-the-market theory.” According to the dissent, the *Basic* regime operates as follows: In order to certify a securities class action, plaintiffs must demonstrate that reliance is a common question; to demonstrate that reliance is a common question, plaintiffs can invoke *Basic*’s fraud-on-the-market presumption; and, to invoke the presumption, plaintiffs must demonstrate its necessary predicates, which include the materiality of the alleged misstatement. In Justice Thomas’s view, the majority’s argument was based on the flawed assumption that “[p]laintiffs will either (1) establish materiality at the merits stage, in which case class certification was proper because reliance turned out to be a common question, or (2) fail to establish materiality, in which case the claim would fail on the merits, notwithstanding the fact that the class should not have been certified in the first place, because reliance was never a common question.”¹⁴⁰ By identifying the “pivotal inquiry” as “whether proof of materiality is needed” at class certification instead of whether “*reliance* is susceptible to classwide proof,” the majority “effectively equate[d] § 10(b) materiality with fraud-on-the-market materiality and elide[d] reliance as a § 10(b) element.”¹⁴¹

Justice Ginsburg’s opinion disputed the dissent’s characterization, and stressed that the Court’s decision was compelled by the text of Rule 23(b), which requires plaintiffs to demonstrate that common questions predominate, not whether “the predominating question[s] will be answered in their favor.”¹⁴² In other words, Rule 23 “does *not* require a plaintiff seeking

¹⁴⁰ *Amgen*, 133 S. Ct. 1184, at 1206-07.

¹⁴¹ *Id.* at 1212.

¹⁴² *Id.* at 1196 (majority opinion).

class certification to prove that each ‘elemen[t] of [her] claim [is] susceptible to classwide proof.’ . . . What the rule does require is that common questions ‘*predominate* over any questions affecting only individual [class] members.’”¹⁴³ The majority stressed that at no point in Justice Thomas’s dissent did he explain how in cases involving the *Basic* presumption, plaintiffs’ failure to prove materiality would “result in individual questions predominating over common ones. Absent proof of materiality, the claim of the Rule 10b–5 class will fail in its entirety; there will be no remaining individual questions to adjudicate.”¹⁴⁴

The Court also rejected Amgen’s argument that materiality was akin to the other predicates of the fraud-on-the-market presumption – such as market efficiency and publicity – that must be proved at certification. Unlike materiality, “market efficiency and publicity are not indispensable elements of a Rule 10b–5 claim,” and, while a plaintiff’s failure to demonstrate those elements will preclude his use of the fraud-on-the-market presumption, he still can attempt to establish reliance through the traditional method of individual proof.¹⁴⁵ “Materiality thus differs from the market-efficiency and publicity predicates in this critical respect: While the failure of common, classwide proof on the issues of market efficiency and publicity leaves open the prospect of individualized proof of reliance, the failure of common proof on the issue of materiality ends the case for the class and for all individuals alleged to compose the class.”¹⁴⁶ Furthermore, regarding Amgen’s policy arguments regarding the settlement pressure of class actions, the Court observed that Congress has refused to undo *Basic*’s fraud-on-the-market

¹⁴³ *Id.* (quoting Thomas dissent at 1210 and Rule 23(b)(3)).

¹⁴⁴ *Id.* (quotations omitted).

¹⁴⁵ *Id.* at 1199.

¹⁴⁶ *Id.*

presumption or require securities-fraud plaintiffs to prove all elements of their claims prior to certification through litigation like the PSLRA.

In his separate dissent, Justice Scalia argued that the majority’s decision mistakenly assumed that the *Basic* rule “govern[s] only the question of substantive liability – what must be shown in order to prevail.”¹⁴⁷ In Justice Scalia’s view, however, “*Basic* established a presumption *that the misrepresentation was relied upon*, not a mere presumption that the plaintiffs relied on the market price. And it established that presumption not just for the question of substantive liability but also for the question of certification.”¹⁴⁸ It would be improper under this reading of *Basic* to presume that a “plaintiff relied on the market price, *unless* the alleged misrepresentation would likely have affected the market price – that is, unless it was material.”¹⁴⁹ Thus, Justice Scalia argued that *Basic* requires proof of all prerequisites of the fraud-on-the-market theory prior to certification. The majority disagreed with Justice Scalia’s reading of *Basic*, pointing out that the *Basic* Court held that the district court certification order below “was appropriate when made” even though the district court had not required proof of materiality at that stage.¹⁵⁰

Finally, the *Amgen* Court agreed that the district court did not err by disregarding the rebuttal evidence offered by the Company on materiality. As a result of the Court’s initial holding, proof of (im)materiality was not relevant to Rule 23(b)(3)’s predominance requirement

¹⁴⁷ *Id.* at 1205 (Scalia, J., dissenting).

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 1202-03 (majority opinion).

and thus evidence on this point was properly considered only at the summary judgment or trial stage.¹⁵¹

Of particular relevance to *Halliburton* was the signal sent by Justices Alito, Kennedy, Scalia and Thomas regarding the continued viability of *Basic*'s fraud-on-the-market presumption. Justice Alito, who was part of the *Amgen* majority, wrote separately to indicate that he “join[ed] the opinion of the Court with the understanding that the petitioners did not ask us to revisit *Basic*'s fraud-on-the-market presumption.”¹⁵² Justice Alito referred to the recent literature cited by Justice Thomas that indicates that *Basic*'s theory relies on a faulty premise – namely, that market efficiency is a binary, yes or no question.¹⁵³ “In light of this development,” Justice Alito suggested, “reconsideration of the *Basic* presumption may be appropriate.”¹⁵⁴ Enter *Halliburton II*.

E. *Halliburton II*

When the Supreme Court granted *certiorari* on November 15, 2013 in *Halliburton Co. and David Lesar v. Erica P. John Fund*, it was not the first time the case had been before the Court. As the defendants did in *Amgen*, *Halliburton* had previously argued before the Court about the prerequisites that a plaintiff needed to show to avail itself of the *Basic* presumption of reliance.

1. *Halliburton I* at the District Court

¹⁵¹ *Id.* at 1203-04 (majority opinion).

¹⁵² *Id.* at 1204 (Alito, J., concurring).

¹⁵³ *See id.* at 1208 n.4 (Thomas, J., dissenting) (citing Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. 151, 167). The portion of Justice Thomas's dissent citing this literature was joined by both Justices Kennedy and Scalia.

¹⁵⁴ *Id.* at 1204 (Alito, J., concurring); *see also id.* at 1208 n.4 (Thomas, J., dissenting) (noting that the *Amgen* Court was not “asked to revisit *Basic*'s fraud-on-the-market presumption”).

In 2002, investors in Halliburton Company brought a securities-fraud class action against the company and its CEO, David Lesar. The plaintiffs alleged that the company made material misrepresentations that inflated the company’s stock price regarding three issues: “(1) the expense of asbestos litigation; (2) changes to the accounting methodology used by Halliburton and their effect on earnings; and (3) the benefits of Halliburton’s merger with Dresser Industries.”¹⁵⁵ When the plaintiffs originally moved for class certification in 2008, the parties agreed, and the district court independently found, that the numerosity, commonality, typicality, and adequacy requirements of Rule 23(a) and the superiority requirement of Rule 23(b) were met. “The sole issue in dispute [was] the application of the requirement” in the Fifth Circuit “that, in a securities fraud class action, loss causation must be proven at the class certification stage.”¹⁵⁶

¹⁵⁵ *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 3:02-CV-1152-M, 2008 WL 4791492, at *1 (N.D. Tex. Nov. 4, 2008) (hereinafter “*Halliburton I Dist. Ct.*”), *aff’d*, *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010) (hereinafter “*Halliburton I Cir. Ct.*”), *vacated sub nom, Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011).

¹⁵⁶ *Halliburton I Dist. Ct.* at *1.

In 2007, the Fifth Circuit had clarified (and heightened) the requirements for plaintiffs to take advantage of the *Basic* presumption of classwide reliance. Plaintiffs were required to demonstrate at certification that: “the defendant made public material misrepresentations,”¹⁵⁷ “the defendant’s shares were traded in an efficient market,”¹⁵⁸ “the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed,”¹⁵⁹ and, by a preponderance of the evidence, that the defendant’s “misstatement *actually moved* the market.”¹⁶⁰ The Fifth Circuit had held that this would include proof of loss causation because proof of a decline in price after disclosure of the truth underlying an alleged misrepresentation would implicitly prove prior inflation at the time the misrepresentation was made.

To meet their loss causation burden, the *Halliburton* plaintiffs argued that a series of eight corrective disclosures, which were accompanied by drops in Halliburton’s stock price, provided evidence of the material effects of Halliburton’s alleged misrepresentations on the market. Plaintiffs presented expert testimony “assert[ing] that each of these eight disclosures resulted in a company-specific decline in the stock price that cannot be attributed to general market trends or other external factors.”¹⁶¹ There was no dispute that the market for Halliburton’s stock was efficient.

In its initial decision, the district court denied certification after finding that the plaintiffs failed to establish loss causation with respect to any of the three categories of alleged misrepresentations. Regarding the expenses for asbestos litigation, the court found that the

¹⁵⁷ *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 661 (5th Cir. 2004).

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Oscar Private Equity Inv. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 265 (5th Cir. 2007).

¹⁶¹ *Halliburton I* Dist. Ct. at *1.

plaintiffs failed to “actually link” the asbestos-related disclosures to any actionable misrepresentations in order to demonstrate loss causation.¹⁶² Plaintiffs’ “‘fraud in the aggregate’ argument” – i.e., that “each of the . . . disclosures corrected some of the inflation caused by the aggregate of Halliburton’s prior statements” – was insufficient under the Fifth Circuit’s loss causation standard, which required plaintiffs to “identify specific statements that were revealed to be fraudulent by [the] corrective disclosures.”¹⁶³ Regarding the changes to accounting methodology, plaintiffs “fail[ed] to identify specific misrepresentations ‘that [were] capable of moving the market;’” identified only “confirmatory positive statements [that] do not actually affect the market;”¹⁶⁴ and could not demonstrate that any alleged corrective disclosure either directly or indirectly revealed a fraudulent statement.¹⁶⁵ Finally, with respect to the various alleged corrective disclosures regarding the benefits of Halliburton’s merger with Dresser Industries, the court found that the disclosures “reveal[ed] nothing *fraudulent* about the statements” concerning the merger – the release of negative information or an earnings adjustment, without ties to an actionable misstatement, was simply insufficient to demonstrate a fraudulent scheme or establish loss causation.¹⁶⁶

Because the plaintiffs failed to demonstrate loss causation with respect to any of the alleged misrepresentations, the district court held that they did not meet the “extremely high burden on plaintiffs seeking class certification in a securities fraud case” in the Fifth Circuit.¹⁶⁷

¹⁶² *Id.* at *4.

¹⁶³ *Id.* at *4-5.

¹⁶⁴ Confirmatory information is “information [that] has already been digested by the market and will not cause a change in stock price.” *Greenberg*, 364 F.3d at 666.

¹⁶⁵ *Halliburton I* Dist. Ct. at *13-16 (citation omitted).

¹⁶⁶ *Id.* at *17-19.

¹⁶⁷ *Id.* at *20.

Thus, despite the fact that all other requirements of Rule 23 had been met, the court denied certification.¹⁶⁸

2. *Halliburton I* at the Circuit Court

The Fifth Circuit unanimously affirmed the district court's denial of certification on February 12, 2010, holding that the plaintiffs failed to meet the Circuit's requirements for demonstrating loss causation to trigger the fraud-on-the-market presumption at the certification stage. In the Fifth Circuit's view, the district court correctly applied circuit precedent requiring plaintiffs "to establish a causal link between the alleged falsehoods and [their] losses," which can be demonstrated "either by an increase in stock price immediately following the release of positive information, or by showing negative movement in the stock price after release of the alleged 'truth' of the earlier falsehood."¹⁶⁹ The Fifth Circuit agreed with the district court that the plaintiffs failed to identify specific, actionable misrepresentations and link them to corrective disclosures that actually affected the company's stock price. Although the plaintiffs argued that the Fifth Circuit's requirement that they demonstrate loss causation prior to certification ran afoul of Supreme Court and sister circuit precedent, the court stressed that it was bound by prior panel decisions establishing that requirement.

3. *Halliburton I* at the Supreme Court

The Supreme Court granted *certiorari* in *Halliburton I* on January 7, 2011, to resolve the conflict amongst the courts of appeals and address the Fifth Circuit's requirement that putative securities class action plaintiffs demonstrate loss causation to obtain certification.¹⁷⁰ Writing for

¹⁶⁸ *Id.*

¹⁶⁹ *Halliburton I* Cir. Ct. at 335.

¹⁷⁰ See generally *In re Salomon*, 544 F.3d at 483 (investors not required to prove loss causation at class certification stage); *Schleicher* 618 F.3d at 687 (same); *In re DVI*, 639 F.3d at 636-37 (same).

a unanimous court, Chief Justice Roberts held that plaintiffs *do not* need to establish loss causation to obtain class certification under Rule 23(b)(3).

The Court’s *Halliburton I* opinion acknowledges that plaintiffs are required to demonstrate certain prerequisites to invoke *Basic*’s presumption of reliance – “for example [. . .] that the alleged misrepresentations were publicly known . . . , that the stock traded in an efficient market, and that the relevant transaction took place ‘between the time the misrepresentations were made and the time the truth was revealed.’”¹⁷¹ However, the Court reasoned that requiring plaintiffs to demonstrate loss causation – i.e. that a company’s stock price declined *because of* the correction of a prior misrepresentation, and not for other unrelated circumstances – was “not justified by *Basic* or its logic.”¹⁷² Reliance, which is also referred to as “transaction causation,” concerns “the investor’s decision to engage in the transaction” and the extent to which “‘information is reflected in [the] market price’ of the stock at the time of the relevant transaction.”¹⁷³ On the other hand, loss causation concerns whether a plaintiff can demonstrate “a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss.”¹⁷⁴ As a result, loss causation is a separate and distinct issue from reliance, and “has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory.”¹⁷⁵ For example, if it were established that a decline in value of a stock that was inflated because of a misrepresentation was actually “the result of other intervening causes, such as ‘changed economic circumstances, changed investor expectations,

¹⁷¹ *Halliburton I*, 131 S. Ct. at 2185 (citation omitted).

¹⁷² *Id.* at 2185-2186.

¹⁷³ *Id.* at 2186 (citation omitted).

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

new industry-specific or firm-specific facts, conditions, or other events,” a plaintiff would not be able to prove loss causation.¹⁷⁶ “This is true,” however, “even if the investor purchased the stock at a distorted price, and thereby presumptively relied on the misrepresentation reflected in that price. . . . The fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on the misrepresentation in the first place.”¹⁷⁷

As a result, the Court held that because loss causation was not relevant to reliance – the element upon which the predominance issue “often turns” – securities plaintiffs need not prove loss causation at class certification under Rule 23(b)(3). The question remained, if loss causation was not necessary to prove reliance, what was necessary to prove reliance?

4. *Halliburton II* at the District Court

On remand, the district court found that the fraud-on-the-market presumption of reliance applied, and thus common questions predominated over questions affecting individuals. In light of this holding, and its initial conclusion that all other elements of Rule 23 were satisfied, the district court certified a class consisting of “all persons and entities who purchased or otherwise acquired Halliburton Company’s common stock between June 3, 1999, through and including December 7, 2001.”¹⁷⁸

5. *Halliburton II* at the Circuit Court

Halliburton appealed to the Fifth Circuit, arguing that the district court abused its discretion in certifying the class without first determining whether Halliburton’s alleged misrepresentations actually affected the company’s stock price – i.e. whether the

¹⁷⁶ *Id.* (citation omitted).

¹⁷⁷ *Id.*

¹⁷⁸ *Halliburton II* Dist. Ct. at *3.

misrepresentations caused a “price impact.”¹⁷⁹ The district court refused to hear evidence on this issue, finding price impact irrelevant to Rule 23(b)(3)’s predominance inquiry.

While *Halliburton II* was pending before the Fifth Circuit, the Supreme Court decided *Amgen*, establishing that materiality, “an objective standard” that “can be proved through evidence common to the class,” need not be demonstrated at certification by plaintiffs seeking to employ the *Basic* presumption.¹⁸⁰ In a unanimous opinion that relied heavily on *Amgen*, the Fifth Circuit in *Halliburton II* affirmed the district court’s certification order, holding that defendants are not permitted to prevent certification under Rule 23(b)(3) by attempting to show that their alleged misrepresentations did not have an impact on stock price.¹⁸¹

Halliburton argued that its evidence regarding price impact was “not intended to rebut materiality, market efficiency, or statement publicity,” but rather “to generally rebut the fraud-on-the-market presumption of reliance without necessarily attacking one of the presumption’s individual elements.”¹⁸² The Fifth Circuit did agree that evidence showing that the alleged misrepresentations did not have an effect on stock price would sever the link between the defendants’ fraud and the plaintiffs’ purchase and, therefore, rebut the presumption of reliance.¹⁸³ Whether such evidence was relevant at the class certification stage, however, was a separate inquiry based on the requirements of Rule 23(b)(3).

¹⁷⁹ *Halliburton II* Cir. Ct. at 427; see also *id.* at 428 (“The pivotal question in this case is whether a defendant should be permitted to show the absence of price impact at the class certification stage of the proceedings to establish that common issues among class members do not predominate and that class certification is inappropriate.”).

¹⁸⁰ *Amgen*, 133 S. Ct. at 1191, 1195.

¹⁸¹ *Halliburton II* Cir. Ct. at 435.

¹⁸² *Id.* at 432-33.

¹⁸³ *Id.* at 433.

The Fifth Circuit reiterated based on *Amgen* that “the focus of the 23(b)(3) class certification inquiry – predominance – is not whether the plaintiffs will fail or succeed, but whether they will fail or succeed *together*.”¹⁸⁴ “Thus, only those issues which bear directly on the pivotal inquiry of common question predominance and the propriety of class resolution should be addressed at class certification.”¹⁸⁵ To determine whether price impact was a predominance issue, the Fifth Circuit applied a 2-step approach derived from *Amgen*. First, the court asked “whether price impact evidence is common to the class” and involves “an objective inquiry.”¹⁸⁶ The answer to this question was clearly yes, since price impact is “simply a measure of the effect of a misrepresentation on a security’s price” that is determined for the entire class, usually by an expert’s evaluation of the stock price.¹⁸⁷ This counseled against the consideration of price impact evidence at the class action stage under *Amgen*. Second, the court asked “whether there is any risk that a later failure of proof on the common question of price impact will result in individual questions predominating.”¹⁸⁸ On this point, Halliburton argued that, unlike with materiality, if the company successfully rebutted the reliance presumption based on evidence of no price impact, plaintiffs could still pursue individual fraud claims because price impact is not a required element of a 10b-5 claim. The Fifth Circuit disagreed, stressing that if Halliburton demonstrated no price impact – i.e. by showing “both that the stock price did not increase when the misrepresentation was announced, and that the price did not decrease when the

¹⁸⁴ *Id.* at 431; *see also id.* at 433 (“As the *Amgen* court made clear, the ‘pivotal inquiry’ when determining whether to consider a matter at class certification is whether resolution of the matter ‘is needed to ensure that the questions of law or fact common to the class will ‘predominate over any questions affecting only individual members’ as the litigation progresses.’”) (quoting *Amgen*, 133 S. Ct. at 1195).

¹⁸⁵ *Id.* at 431.

¹⁸⁶ *Id.* at 433.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

truth was revealed” – the plaintiffs would not be able to demonstrate *loss causation*, which requires a showing of negative price impact and is a necessary element of a securities fraud claim.¹⁸⁹ As with materiality, then, the demonstrated absence of price impact would “end the case for one and for all” and there would be “no risk whatever that a failure of proof on the common question” of price impact “will result in individual questions predominating.¹⁹⁰ Thus, based on *Amgen*, the Fifth Circuit concluded that “price impact evidence does not bear on the question of common question predominance, and is . . . appropriately considered only on the merits after the class has been certified.”¹⁹¹

F. *Does the Fraud-on-the-Market Theory Conflict or Comport with the U.S. Supreme Court’s Rule 23 Jurisprudence?*

The parties in *Halliburton II* also dispute whether *Basic*’s fraud-on-the-market presumption comports with the Court’s recent class-action jurisprudence, specifically *Wal-Mart Stores, Inc. v. Dukes*,¹⁹² and *Comcast Corp. v. Behrend*.¹⁹³ In petitioners’ view, the *Basic* presumption is “fundamentally at odds” with Rule 23 – opening “an escape hatch” from Rule 23’s rigorous requirements “for 10b-5 plaintiffs alone.”¹⁹⁴ Respondents, however, argue the presumption is entirely consistent with Rule 23 and related Supreme Court cases. Their positions are summarized below.

¹⁸⁹ *Id.* at 434.

¹⁹⁰ *Amgen*, 133 S. Ct. at 1196.

¹⁹¹ *Halliburton II* Cir. Ct. at 435.

¹⁹² 131 S. Ct. at 2541.

¹⁹³ 133 S. Ct. 1426 (2013).

¹⁹⁴ *Halliburton II* Petitioners’ Br. at 25.

1. Petitioners' Argument

The petitioners argue that the fraud-on-the-market presumption “flouts” Rule 23’s requirement that a court “find” that common questions predominate over individual ones.¹⁹⁵ The Court, they say, has “insisted with increasing rigor that plaintiffs show compliance with Rule 23.”¹⁹⁶ *Basic*’s presumption allows plaintiffs to sidestep this burden in a manner not permitted in any other context.¹⁹⁷

Petitioners use *Wal-Mart* and *Comcast* as examples. As petitioners would have it, the Court rejected certification in *Wal-Mart*, because – despite statistical and other evidence showing discrepancies in pay and promotions between women and men¹⁹⁸ – plaintiffs failed to prove “the bare existence of common issues, given the diversity of outcomes among class members.”¹⁹⁹ And the Court held certification was improper in *Comcast*, petitioners say, because the bases and amount of damages would have varied “widely” among the class members – “[m]erely identifying a method that can be applied class-wide, while ignoring how arbitrary the measurements may be, cannot satisfy Rule 23 without reduc[ing] Rule 23(b)(3)’s predominance requirement to a nullity.”²⁰⁰ *Basic* (particularly absent evidence of price impact) conflicts with these decisions because it provides a method to ignore the “actual facts” that show individual issues of reliance predominate – indeed, the presumption was created, they say, precisely to

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.* at 26.

¹⁹⁸ In *Wal-Mart*, the class plaintiffs consisted of current and former female *Wal-Mart* employees alleging discrimination under Title VII.

¹⁹⁹ *Halliburton II* Petitioners’ Br. at 26.

²⁰⁰ *Id.* at 26-27 (quotations omitted).

avoid this problem. But “[n]othing justifies insisting that all plaintiffs *except securities plaintiffs* must actually demonstrate predominance, rather than assume it,” petitioners conclude.²⁰¹

2. Respondent’s Argument

In respondent’s view, *Basic* is consistent with the Court’s class-action decisions. Rather than assume commonality, *Basic* requires the plaintiff to “*demonstrate commonality by satisfying the prerequisites of market efficiency, timing, and publicity.*”²⁰² Only after the plaintiff meets this high burden can a class be certified.

Moreover, respondent says, the Court approvingly cited *Basic* in *Wal-Mart*,²⁰³ and *Comcast* is easily distinguishable. As respondent sees it, the Court disapproved of certification in *Comcast* because “the plaintiffs’ proof of the existence of common damages relied on theories of antitrust liability that the district court had already rejected.”²⁰⁴ The *Basic* presumption, however, does not rely on any invalid theories of liability. Accordingly, it would not violate the Court’s mandates regarding Rule 23.

G. *Stare Decisis and Basic v. Levinson*

Petitioners argue that *Basic* was not only wrongly decided, but is also entitled to less deference than certain other types of Supreme Court decisions, and should be overruled.²⁰⁵

First, petitioners contend that the Court exceeded the bounds of Section 10(b) in holding that the presumption was appropriate. According to petitioners, when demarcating the contours of the private right of action implied under Section 10(b) and Rule 10b-5, the Court has looked to

²⁰¹ *Id.* at 27.

²⁰² *Halliburton II* Respondent’s Br. at 42 (emphasis added).

²⁰³ *See Wal-Mart*, 131 S. Ct. at 2552 n.6.

²⁰⁴ *Halliburton II* Respondent’s Br. at 42.

²⁰⁵ *Halliburton II* Petitioners’ Br. at 14.

express causes of action provided under the Securities Exchange Act of 1934 as the primary model, identifying and borrowing from “the express provision most analogous to the private 10b-5 right of action.”²⁰⁶ Petitioners contend that Section 18(a) of the Exchange Act is the closest textual analog to Section 10(b) because it is the only provision in the Securities Exchange Act that authorizes damages for misrepresentations made by a defendant who did not buy from or sell to the plaintiff when those statements affect aftermarket trading. They point out that Congress rejected a preliminary version of Section 18(a) that contained language closely akin to the fraud-on-the-market presumption in favor of the final version which contained a requirement that plaintiff plead and prove actual reliance.²⁰⁷ And they argue that, because *Basic* adopted the fraud-on-the-market presumption for Section 10(b)’s *implied* action that Congress specifically considered and rejected in Section 18(a)’s analogous *express* action, *Basic* exceeded the Court’s proper judicial role, was wrongly decided, and should be overruled.

Second, petitioners argue that *Basic*’s presumption is largely a procedural and evidentiary construct implicating Rule of Civil Procedure 23 and Rule of Evidence 301, and that decisions involving such rules are subject to lessened precedential weight.²⁰⁸ Petitioners contend that, even if a substantive doctrine, *Basic* does not merit *stare decisis* because: (i) as explained in greater detail below, the decision offers no reliable methodology and cannot generate consistent, predictable, justifiable results; (ii) it is not a case from “antiquity”; (iii) *Basic*’s presumption does

²⁰⁶ *Id.* (quotations omitted).

²⁰⁷ Section 18(a) states in relevant part that “[a]ny person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.” 15 U.S.C. §78r(a).

²⁰⁸ *Halliburton II* Petitioners’ Br. at 29-30.

not “serve as a guide to lawful behavior,” but merely facilitates establishing the reliance element in litigation; and (iv) as discussed in Part III.F, *Basic* was not “well reasoned” because, among other things, its presumption “flows from serious misjudgments about the nature of securities markets, and it impinges on other important jurisprudence.”²⁰⁹

Petitioners further argue that the Court has the authority and responsibility to correct the purported legal errors in *Basic*. According to petitioners, because the private right implied under Section 10(b) is a judicially created cause of action, the Court has the “principal responsibility” for articulating and policing its scope, particularly in the case of *Basic* where the Court ignored the requirement that it remain faithful to statutory analogs like Section 18(a) which, as discussed above, requires plaintiffs to plead and prove actual reliance.²¹⁰ Moreover, Congress’s silence on the fraud-on-the-market presumption at most reflects its failure to express an opinion, not implicit approval of the doctrine, and should not serve as a basis for the Court to shift to Congress the burden of correcting the error the Court made when it decided *Basic*.²¹¹

Respondents argue that *Basic* correctly decided that Section 10(b) does not require actual reliance. According to respondents, the Court in *Basic* grounded its decision in the federal securities laws, which Congress enacted in the midst of the Great Depression based on the premise that “securities markets are affected by information, notwithstanding the dramatic, and still-fresh evidence that the market also could be infected by speculation and bubbles.”²¹² Respondents point to legislative history that they claim shows that Congress endorsed the core principles underlying the fraud-on-the-market presumption, including the principle that

²⁰⁹ *Id.* at 31-32 (quotations omitted).

²¹⁰ *Id.* at 32-33.

²¹¹ *Id.* at 32-35.

²¹² *Halliburton II* Respondent’s Br. at 19-20.

information is rapidly incorporated into a publicly-traded security's price, and that there was widespread acceptance of the fraud-on-the-market-doctrine at the time Congress enacted the Securities Act of 1933 and Securities Exchange Act of 1934, including by then-Professor William O. Douglas, who was deeply involved in drafting the securities laws and later served as SEC Chairman, and Adolph Berle, Jr., who was a Columbia Law Professor and member of President Franklin Roosevelt's "brain trust."²¹³

Respondents further argue that petitioners' reliance on Section 18(a) is misguided. Among other things, the Court's favorable comparisons between Sections 10(b) and 18 have also always included the cause of action in Section 9, which prohibits certain practices manipulating securities prices and does not contain an actual reliance requirement.²¹⁴ Respondents contend that Section 9 is more analogous to Section 10(b) because Section 18 does not address price manipulation and is narrowly limited to misleading statements in documents publicly filed with the SEC while, by contrast, Sections 9 and 10 are codified side-by-side and each explicitly addresses "manipulation" as well as false statements. Sections 9 and 10 thus both require a showing of scienter, while Section 18(a) does not.²¹⁵ Respondents point out that, in the statute of limitations context, the Court addressed a circumstance in which differences between Sections 9

²¹³ *Id.* at 20-21.

²¹⁴ 15 U.S.C. § 78i provides, in relevant part: "It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange (1) For the purpose of creating a false or misleading appearance of active trading in any security other than a government security, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties."

²¹⁵ *Id.* at 30-31.

and 18 required it to choose between the two in construing Section 10(b) and chose Section 9. Respondents argue there is no reason why Section 9 would be relevant for the purposes of the statute of limitations, but not for the purposes of reliance.²¹⁶

Additionally, according to respondents, principles of *stare decisis* apply with full force to the decision, particularly in light of the fact that it is a twenty-five-year-old precedent that the Court has cited favorably five times within the last ten years (including in *Halliburton I*).²¹⁷ Respondents further contend that *stare decisis* applies with special force to *Basic* because, when enacting the PSLRA, Congress specifically considered and rejected proposals to undo *Basic*, and instead adopted restrictions on private securities fraud actions that assumed the presumption's vitality.²¹⁸ Moreover, when Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") to modify the securities laws to deal with private securities plaintiffs' attempts to circumvent the PSLRA, Congress again implemented another round of major reforms without altering the fraud-on-the-market presumption.²¹⁹ Respondents further contend that, contrary to petitioners' claims, the Court has not accepted primary responsibility for defining the substantive standards of conduct and liability under Section 10(b), which is demonstrated by the fact that Congress has been so heavily involved in amending the federal laws governing private securities class actions through, for example, the PSLRA and SLUSA.²²⁰ Certain of the Amici note that

²¹⁶ *Id.* at 31-32.

²¹⁷ *Id.* at 11-12.

²¹⁸ *Id.* at 12-17.

²¹⁹ *Id.* at 17. Likewise, the SEC has relied on *Basic* in drafting its disclosure requirements, on the assumption that shareholders need not directly review required disclosures in order to seek a remedy for the harms caused by false disclosures through their effect on market prices. See Brief of Legal Scholars as *Amici Curiae* with Respect to *Stare Decisis* in Support of Respondent at 18, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-1307 (U.S. Feb. 5, 2014) (hereinafter "*Halliburton II* Legal Scholars Br.").

²²⁰ *Halliburton II* Respondent's Br. at 18-19.

the complex empirical claims *Basic* raises about the operation of the securities markets are more appropriately the province of Congress, the fact-finding capabilities of which far outstrip those of the courts.²²¹

Finally, in response to petitioners' claim that *Basic* concerns a procedural and evidentiary rule, respondents point out that in *Amgen*, the Court recently recognized that the presumption is a substantive doctrine of federal securities law, and argue that presumptions, which are oft intended to fulfill congressional policy, are entitled to no less precedential weight than other forms of statutory construction.²²²

H. *Ongoing Validity of the Efficient Market Hypothesis*

In their briefs and in oral argument, petitioners and respondents set forth opposing views concerning the validity of the efficient market hypothesis and its importance to the underlying rationale of *Basic*.

The semi-strong version of the efficient market hypothesis (SSEMH) holds that prices will adjust immediately to each piece of newly available material public information.²²³ Its adherents include economists and Nobel laureates Eugene Fama and Milton Friedman. Proponents contend that the theory is supported empirically by numerous studies that show that issuers' share prices move very quickly after the public announcement of events such as the last quarter's earnings or the plan for a new issue of stock, and thereafter follow a random walk,²²⁴ as well as by studies showing that generally mutual funds cannot consistently generate returns (adjusted for risk) better than the market average, even funds that are actively managed by

²²¹ *Halliburton II* Legal Scholars Br.

²²² *Halliburton II* Respondent's Br. at 18.

²²³ Brealey, Myers & Allen, *Principles of Corporate Finance* 324-325 (11th ed. 2014).

²²⁴ *Id.* at 325-328.

financial professionals always looking for stocks whose prices do not reflect all available information.²²⁵ The apparent inability of these professionally managed funds to do better than a buy-and-hold strategy suggests that such mispricings are limited in number and short in duration. Both these sets of empirical results are consistent with the theory that well-funded, sophisticated, rational investors, through a process known as “arbitrage,” quickly correct any impact on price by other investors who act irrationally or without good information.

Other economists, such as Nobel laureate Robert Shiller, have conducted a different kind of empirical study – one extending over many years – and find that share prices over the longer run can sometimes be predicted by such factors as the dividend-to-price ratio. This finding implies that an investor could, in certain circumstances, earn better returns than the market average if she purchased shares in periods when the ratio was high and sold when the ratio was low. These results suggest that an issuer’s share price is not always “fundamentally efficient” in the sense that it represents the best available prediction of the future cash flow that will be available to the holder of the share.²²⁶ The results are also consistent with behavioral theories of stock pricing, embraced by Shiller and other economists, such as Andrei Shleifer, Lawrence Summers, and Daniel Kahneman, that irrational investors, buying and selling on the basis of fads, fashions and psychological biases, have sufficiently great impact on share prices that their impact often cannot be fully counteracted by the arbitrage of the sophisticated, rational investors in the market. The results of Shiller’s work, however, do not undermine the findings of Fama and

²²⁵ *Id.*

²²⁶ See, e.g., Robert J. Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?*, 71 *Am. Econ. Rev.* 421 (1981). Efficient market adherents tend to explain these findings instead as the result of discount rates that vary from one period to another depending on how risk averse investors tend to be.

others that share prices generally react to new material public information.²²⁷ As Shiller recently wrote in The New York Times in explaining the extent of his disagreement with Fama, “[o]f course, prices reflect available information.”²²⁸ Also, there has always been awareness, even before 1988, that the relative speed and completeness of this reaction depends on a number of factors including the nature of the information, how it becomes public, and the issuer involved.²²⁹ Thus, respondents and other proponents of *Basic* argue that the overwhelming majority of economists still believe that the securities markets are informationally efficient, rapidly reflecting all publicly available information – the SSEMH.²³⁰ The disagreement, they assert, is only about whether markets *perfectly* process information and how quickly they do so; about whether prices reflect the fundamental value of the underlying stock; about the size and significance of “bubbles” and other pricing anomalies and the extent to which non-informational factors affect prices; and about whether it is possible to “beat the market” by pursuing various investment strategies designed to exploit pricing anomalies. These disagreements existed when *Basic* was decided in 1988, respondents assert, and still exist today.

But, respondents argue, *Basic*’s fraud-on-the-market presumption requires only that market prices respond relatively promptly to material information, not that the SSEMH – which goes further, asserting that the market *immediately and completely* digests *all* public information

²²⁷ In the report issued by the Committee deciding to award the 2013 Nobel Prize in Economics to Eugene Fama and Robert Shiller (along with Lars Peter Hansen), the Committee stated “Even though there is no broad consensus regarding the interpretation of some results, the research initiated by Fama, Shiller and Hansen has produced a body of robust empirical findings, which have practical implications: 1. In the short term, predictability in stock returns is very limited, which is consistent with stock prices quickly reflecting new public information about future cash flows...” Scientific Background on the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2013: Understanding Asset Prices.

²²⁸ Robert J. Shiller, *Sharing Nobel Honors, and Agreeing to Disagree*, N.Y. Times (Oct. 26, 2013), http://www.nytimes.com/2013/10/27/business/sharing-nobel-honors-and-agreeing-to-disagree.html?_r=0

²²⁹ See, e.g., the classic and often cited law review article, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984).

²³⁰ *Halliburton II* Respondent’s Br. at 32-39.

– be true.²³¹ *Basic* itself stated that “[b]y accepting this rebuttable presumption, we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.”²³²

Some proponents of *Basic* also argue that, in fact, technological changes since 1988 have actually made markets even more informationally efficient. Investors today rely on a variety of sources for investment information, including the internet, the financial media, and social media. Most retail investors and institutions outsource their investment research to professional advisors or managers and rely on those advisors’ and managers’ recommendations. Those intermediaries review publicly available information about industries and companies, and through their analysis, recommendations, and trading decisions, they have the effect of incorporating the information that they review into market prices. Through advances in machine-learning, some sophisticated institutions now use trading algorithms that trade automatically and instantaneously based on publicly disclosed information. Thus, market professionals cause the incorporation of information into stock prices, and investors’ reliance on that process supports the *Basic* presumption.

Critics of the theory argue the opposite. They contend that the lack of consensus as to “perfection” and speed of information efficiency, combined with the muddying effects of irrational behavior and momentum or “herd behavior” trading, undermines practical effects of efficiency. Indeed, they further contend that even if the SSEMH enjoyed support at the time that

²³¹ As the Department of Justice argues in its amicus brief, even the most vocal critics of the efficient markets hypothesis do not dispute that markets generally process information into the stock’s price – any challenge to this understanding would call the integrity of the entire market into question. See Brief for the United States as *Amicus Curiae* Supporting Respondent at 25, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-1307 (U.S. Feb. 5, 2014) (hereinafter “*Halliburton II* United States Br.”).

²³² *Basic*, 485 U.S. at 249 n. 28.

Basic was decided, a new “consensus” has formed since that the theory does not work in practice.²³³

According to petitioners, *Basic* simplistically presumed that investors generally purchase in reliance on the integrity of the market price. The reality, however, is that some investors employ strategies that attempt to locate undervalued stocks in an effort to ‘beat the market,’ (and are thus betting that the securities markets are in fact inefficient), while others rely on the integrity of the market (and thus bet on market efficiency).²³⁴ Petitioners in *Halliburton* maintain that the commonality of reliance generated by the *Basic* presumption is therefore merely a fiction.²³⁵

Pointing to academic papers documenting pricing anomalies even with respect to the most actively traded common stocks and securities exchanges, petitioners argue that new empirical evidence shows that markets are not fundamentally efficient. These studies demonstrate that, even in well-developed markets, public information is often not incorporated immediately or rationally into market prices. Among other things, petitioners cite examples where stock prices moved in response to new stories regarding old news.²³⁶

According to petitioners, *Basic* relies on a limited and outdated version of rationality that ignores the reality that many market participants trade based on motivation, impulse or events other than material information about the company, which contradicts conventional definitions of

²³³ It should be noted that this contention is strongly contested by a number of economists. *See e.g. Halliburton II Securities Law Scholars Br.* at 14.

²³⁴ Brief for Chamber of Commerce of the United States of America, *et al.* as *Amici Curiae* Supporting Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-1307 (U.S. Jan. 6, 2014) (hereinafter “*Halliburton II* Chamber of Commerce Br.”).

²³⁵ *Halliburton II* Petitioners’ Br. at 15-16.

²³⁶ *Id.* 17-18. *Cf. Halliburton II* Financial Economists Br. at 8 (experts argue that pricing anomalies can be explained by reference to hidden factors consistent with investor rationality).

rationality and inevitably limits the efficiency of the market.²³⁷ For example, some sophisticated investors may execute trading strategies designed to exploit the herd mentality of other less sophisticated investors. Even more significantly, sophisticated investors increasingly rely on computerized trading programs that use complex algorithms that execute trades based on predetermined metrics not, according to petitioners, the rational assimilation of material information in public disclosures, and can sometimes compound market irrationality by generating price fluctuations unrelated to material information about particular securities.²³⁸

I. *Is Basic Grounded in Important Practical and Policy-based Considerations or Does It Impermissibly and Negatively Shift Burdens?*

Proponents of the fraud-on-the-market presumption argue that it is also grounded in important practical and policy-based considerations, including a key underlying premise of the federal securities laws – that information affects price and, therefore, the disclosure of information that underlies most SEC regulation is necessary and practical. Opponents contend that the presumption simply removes the plaintiffs’ burden of proof on critical issues and allows tenuous claims to be brought that nonetheless have outsize settlement value.

Yet Halliburton concedes that it “never attacked” the premise “that market prices generally respond to new, material information.”²³⁹ Indeed, as the Court noted in *Basic*, Congress enacted the Exchange Act “to facilitate an investor’s reliance on the integrity of [the securities] markets,” and “expressly relied on the premise the securities markets are affected by

²³⁷ *Id.* at 19-21. Petitioners argue that state courts have uniformly refused to adopt the fraud-on-the-market presumption because, among other things, the efficient market theory is exceedingly speculative. *Halliburton II* Petitioners’ Br. at 24-25. Respondents point out that federal securities laws are distinct from state common law and that, in any event, petitioners’ claim is incorrect, citing decisions from Oregon, Colorado and Mississippi in which state courts applied *Basic* to state law causes of actions. *Halliburton II* Respondent’s Br. at 46.

²³⁸ *Halliburton II* Petitioners’ Br. at 20.

²³⁹ Reply for Petitioners On Writ of *Certiorari* at 13, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-1307 (U.S. Feb. 21, 2014) (hereinafter “*Halliburton II* Reply Br.”).

information.”²⁴⁰ Underlying the disclosure regime of both the Securities Act and the Exchange Act “is a legislative philosophy” that the markets need a foundation of accurate disclosure on which all investors are entitled to rely.²⁴¹ It is precisely because information must be given to the market as a whole that selective disclosure is also prohibited.²⁴²

As then-Professor (and later SEC Chairman and eventually Supreme Court Justice) William O. Douglas wrote in 1934:

[E]ven though an investor has neither the time, money, nor intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price. Through them investors who seek advice will be able to obtain it.²⁴³

Furthermore, even investors who do learn of a company’s statements sometimes learn information indirectly – through newspaper accounts or stockbrokers or others, and the information may not be relayed with all the lawyer-crafted nuance typically contained in a company’s SEC filings. Absent a presumption that the stock price reflects a company’s disclosures, proving reliance would require a series of mini-trials as to which investors actually learned what the company said, how they learned it, how close the second-hand source’s recitation was to what the company actually said, and how that information factored into each investor’s investment decision. As a practical matter, that might prevent class certification

²⁴⁰ *Basic*, 485 U.S. at 246. See also *Halliburton II* United States Br. at 14-16 (reviewing legislative history).

²⁴¹ *Basic*, 485 U.S. at 230 (quoting legislative history).

²⁴² See, e.g., Regulation FD, 17 CFR § 243.100.

²⁴³ William O. Douglas, *Protecting the Investor*, 23 Yale Rev. 522, 524 (1934).

because the reliance issue would not be susceptible of “common answers.”²⁴⁴ The effect would be to deny redress to many (and some would argue most) investors.

What is more, the private right of action under Section 10(b) not only allows defrauded investors to recover their losses but provides an important check (and perhaps deterrent) against corporate fraud because of the increased likelihood that the fraud will be caught and the perpetrators held to account.²⁴⁵

Opponents of the *Basic* presumption contend that there is no good reason to allow fraud claims by investors who were not defrauded, and investors who were unaware of the allegedly misleading statements were not defrauded. For example, according to opponents, an investor who just played “follow the leader” and bought what everyone else was buying without reading any company disclosures may suffer losses, but not because of fraud; he did not rely on anything the company said and should not be presumed to have been defrauded. The fraud-on-the-market presumption eliminates a plaintiff’s burden of proof both for class certification and on the ultimate merits, and there is no basis to create such a judicially-crafted exemption to both Rule 23 and Section 10(b).

While the proponents of fraud-on-the-market note that defendants are welcome to rebut the presumption if in a particular instance there were no correlation between information and price, defendants contend that such “rebuttal” just turns the burden of proof on its head. Worse still, if, as the Government urges, defendants are to be *precluded* from even trying to rebut the

²⁴⁴ See *Wal-Mart*, 131 S. Ct. at 2551; *Amgen*, 133 S. Ct. at 1196.

²⁴⁵ *Halliburton II* Respondent’s Br. at 25 (citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007)); *Halliburton II* United States Br. at 13 (same).

presumption at the class certification stage because the issues are intertwined with merits issues,²⁴⁶ the presumption will have placed not just a thumb but a foot on the scales of justice.

The opponents of *Basic* note further that the Court's jurisprudence has effectively removed all barriers to class certification in a Section 10(b) action – *Amgen* holds that materiality is not an issue for class certification and *Halliburton I* says loss causation is not a threshold issue, either. Falsity and scienter are obviously common issues, so if reliance is also to be presumed through the fraud-on-the-market doctrine, the Court effectively will have removed all Rule 23 burdens from a putative plaintiff class. The virtual certainty that a class will be certified – with its concomitant *in terrorem* threat of enormous class-wide damages – puts enormous pressure on defendants to settle such a case regardless of its merit. A claim that has only a 10% chance of success but relates to a stock price drop that caused a sizable loss of market capitalization could still have a multi-million dollar settlement value even though the plaintiffs will not have had to meet any burden of proving materiality, reliance or loss causation. Far from acting as a deterrent to corporate fraud, such cases amount to a game of “gotcha” in which corporations get held up for expensive settlements at the slightest hint of bad news.²⁴⁷

Ironically, petitioners contend, far from imposing liability on wrongdoers, the bulk of the costs of such payments are borne by current investors. For holders in the class who bought but did not sell, the benefit of the settlement is illusory – they are paying themselves. For others, it represents a simple value transfer from current investors to prior investors, though the current investors obtained no unwarranted benefit that justifies transferring the loss to them.²⁴⁸

²⁴⁶ *Halliburton II* United States Br. at 29-34.

²⁴⁷ See Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market?: Reflections on Amgen and the Second Coming of Halliburton*, Georgetown Public Law and Legal Theory Research Paper No. 13-058, at 2 (Nov. 16, 2013), <http://scholarship.law.georgetown.edu/facpub/1226>.

²⁴⁸ *Halliburton II* Petitioners' Br. at 41-43 (collecting authorities).

While respondents portray a world without *Basic* as one in which corporate fraud runs rampant, opponents of the fraud-on-the-market presumption argue that there is nothing inherently wrong with a result that permits suit only by those market participants who actually paid attention to and relied upon a company's misstatements. That such litigants may tend to be professional investors who actually review corporate disclosures is not contrary to legislative intent, petitioners contend. Indeed, the PSLRA's requirement that the "most adequate plaintiff" – the shareholder with the largest financial stake – should lead the class speaks to Congress's desire to have just such plaintiffs involved.²⁴⁹

1. Does *Basic* Effectively Force Parties to Settle Without Regard to the Merits?

Petitioners contend that *Basic* has given rise to a system of settlements that correspond to the threat of certification, not merit. When a court grants a plaintiff's motion for class certification, the case is more likely to move down the path to resolution by way of settlement, not testing of the plaintiff's case by trial.²⁵⁰ Indeed, certain members of the Supreme Court have long recognized that settlement pressures in the securities class action context are particularly great, not only because the size of a potential verdict is often staggering, but also because the mere pendency of a securities class action may be massively disruptive to a company's business operations. Petitioners further argue that *Basic* has added to the overall costs imposed on public companies. Citing statistics showing that a publicly-traded corporation's odds of being sued for securities fraud are about 10% in any given five-year period, petitioners argue that contrary to expectations, *Basic* has actually contributed to a rise in the filing of federal securities fraud class

²⁴⁹ Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2105 (1995).

²⁵⁰ *Halliburton II* Respondent's Br. at 40-41.

actions. According to petitioners, the costs are significant; from 1996 to 2012 alone, securities class settlements amounted to \$73 billion.

Respondents reject the claim that the pressures to settle are great and the costs unreasonably high.²⁵¹ Specifically, respondents assert that the vast majority of all securities class actions – 85% – are resolved before class certification, with the rate of dismissals on the rise since 2000. Respondents also contend that the fact that defendants file motions for summary judgment in nearly 10% of all cases filed disproves petitioners’ argument that a defendant who loses a motion to dismiss is incentivized to settle without regard for the merits.

Respondents also dispute the petitioners’ claim that there have been \$73 billion in securities class action settlements since 1995 and, in particular, the implication that publicly-traded companies are paying billions to settle meritless cases.²⁵² They point out that most cases only settle after they survive a motion to dismiss, and that the ten largest cases (which, they state, were unquestionably meritorious) alone count for nearly \$30 billion in settlements of the \$73 billion cited by petitioners. Moreover, the \$73 billion figure is arguably misleading, respondents contend because it includes settlements in Sections 11 and 12 cases (which have no reliance requirement) and cases involving secondary actors who would likely no longer be liable following several of the Supreme Court’s recent decisions limiting the scope of liability in Section 10(b) cases.

2. Does *Basic* Help or Harm Investors?

Petitioners further assert that *Basic* has not had its intended effect of compensating defrauded investors. Rather, given that the costs of such actions (*i.e.*, litigation expenses, settlements, and awards) fall primarily on the defendant corporation, the effect is to “merely shift

²⁵¹ *Id.* at 43-45.

²⁵² *Id.* at 44-45.

money from one shareholder pocket to another at enormous expense.”²⁵³ This system, petitioners maintain, has negative consequences for both diversified individual investors and smaller undiversified investors. Having bought stock at different times, large, diversified investors (who make up the bulk of almost any class) are typically plaintiffs *and* defendants at the same time. Given the likelihood that they retained more shares than they sold during the class period, most large, diversified investors stand to lose more as holders than they gain as purchasers.²⁵⁴ Class action settlements are even more disadvantageous for smaller, undiversified investors who are more likely to be “buy and hold” investors, purchasing their stock before the start of the class and holding through the date of settlement. These investors thus bear the costs of the litigation and receive none of the benefits.²⁵⁵

According to petitioners, the only clear winners from the process are the attorneys. Petitioners claim that courts typically award plaintiffs’ attorney fees amounting to between 23% and 32% of the settlement amount, and that defense fees (which are generally paid regardless of outcome) rival that amount overall.²⁵⁶ Petitioners further argue that, even in the absence of these enumerated structural impediments, securities class actions still poorly compensate investors, who, they claim, typically stand to recover only between 1.8% and 2.8% of their purported losses.²⁵⁷

In response, respondents contend that petitioners’ figures for attorneys fees are misleading, because they include the period prior to the enactment of the PSLRA, which sought

²⁵³ *Halliburton II* Petitioners’ Br. at 41-43.

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.* at 43.

²⁵⁷ *Id.*

to restrain attorney fees via a number of mechanisms.²⁵⁸ They point to studies of securities class action settlements post-PSLRA which found that attorneys received between 11% and 20% of the final settlement, a figure solidly below the usual 33% taken by contingency-fee attorneys.²⁵⁹ Respondents also argue that Halliburton’s depiction of securities class actions as merely redistributing money from one set of investors to another is false because, among other things, settlements are typically funded by external sources such as insurance companies and accounting firms, and those insurers alone pay an estimated 50% of all settlement amounts.²⁶⁰

3. Do Federal Securities Class Action Deter Fraud?

Petitioners argue that any deterrent effect provided by securities class action litigation is “significantly muted” because the corporation’s culpable executives, directors, and other agents do not suffer any financial consequences as a result of being sued. Rather, the corporation and insurance company typically fund the settlement and incur attorneys’ fees and costs.²⁶¹ In fact, petitioners claim that research shows that the “[c]ulpable individuals pay less than one-half of 1% of class-action settlements, while insurers pay about 68%, and companies pay 31%.”²⁶² Moreover, even where plaintiffs are owed payment from an individual, “it is extremely rare for executives or directors to personally pay *anything* from their own assets” because typically they are indemnified.²⁶³

²⁵⁸ *Halliburton II* Respondent’s Br. at 45.

²⁵⁹ Brief of *Amici Curiae* States of Oregon, et al. Supporting Respondent at 19, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-1307 (U.S. Feb. 5, 2014) (hereinafter “*Halliburton II* States of Oregon, et al. Br.”).

²⁶⁰ *Halliburton II* Respondent’s Br. at 45.

²⁶¹ *Halliburton II* Petitioners’ Br. at 44; *see also Halliburton II* Chamber of Commerce Br. at 3 (discussing securities fraud insurance).

²⁶² *Halliburton II* Petitioners’ Br. at 44 (citing John Coffee, *Re-forming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1550 (2006)).

²⁶³ *Id.* (citing *id.* at 1567-1568).

Recognizing that overruling *Basic* would lead to a substantial drop in the number of federal securities class action lawsuits, petitioners insist that public enforcement provides superior deterrence.²⁶⁴ They explain that, since *Basic* was decided, the SEC’s budget has increased five-fold, and disgorgement and penalties have increased significantly (reaching \$10 billion between 2002-2007 and \$2.1 billion in 2009 alone).²⁶⁵ Petitioners also point out that the SEC has the advantage of being able to prosecute securities fraud unconstrained by the requirements of private litigation such as proving reliance, damages and loss causation, and also has access to a variety of remedies, including injunctive relief and the ability to bar individuals from being officers or directors of publicly traded companies.²⁶⁶

Indeed, according to petitioners, in 2014, the SEC appears more focused than ever on enforcing all of the nation’s securities laws. When appointed SEC Chairwoman in 2013, Mary Jo White, a former federal prosecutor, chose two former federal prosecutors to lead the SEC’s Division of Enforcement. She and her team have transformed the Division’s priorities and thinking, in part based on the assumption that the “Broken Windows” theory can be applied to the securities markets.²⁶⁷ The Broken Windows theory states that maintaining and monitoring environments in a well-ordered condition is a sign that disorder will not be tolerated and it may stop further disorder and crime from happening. Now, the SEC no longer uses its Enforcement resources to address a few types of securities violations (i.e., those violations that contributed to

²⁶⁴ *Id.* at 45-46.

²⁶⁵ *Id.* at 47.

²⁶⁶ *Id.* at 46.

²⁶⁷ Mary Jo White, Chair, *Remarks at the Securities Enforcement Forum*, U.S. Securities & Exchange Commission (Oct. 9, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100> (footnotes and citations omitted).

the financial crisis), but instead distributes them so that the Division can be combating a wide variety of securities violations, large and small.

Respondents and other proponents of *Basic* and the fraud-on-the-market presumption staunchly maintain that private securities class actions play a critical role in enforcing the federal securities laws.²⁶⁸

Indeed, they assert, the SEC has always recognized the important role played by private securities actions in enforcing the federal securities laws. In fact, in *Basic*, the Solicitor General representing the SEC (under the Administration of President George H.W. Bush) filed an amicus curiae brief urging the Court to adopt the fraud-on-the-market presumption and warning that, without it, private securities actions would face insuperable hurdles:

The courts have viewed the fraud on the market theory, and the accompanying presumption of reliance, as a means of furthering the statutory goal of ensuring honest securities markets. To the extent that private securities fraud actions may be prosecuted more efficiently by adoption of the fraud on the market theory and its presumption of reliance, the enforcement of the securities laws, and the underlying goal of honest markets, are furthered.²⁶⁹

The brief also emphasized that the presumption “promote[s] important policies under the federal securities laws,” including the “integrity” of the securities markets and “investor confidence” in them.²⁷⁰

Respondents also reiterate that the Supreme Court has similarly recognized that private securities-fraud actions are “a necessary supplement” to SEC enforcement actions.²⁷¹ For

²⁶⁸ *Halliburton II* Respondent’s Br. at 24-26. See also Brief Amici Curiae of the Council of Institutional Investors et al. in Support of Respondent at 5-11, *Halliburton Co. v. Erica P. John Fund, Inc.*, No.13-317 (U.S. Feb. 5, 2014) (hereinafter “*Halliburton II* Council of Institutional Investors Br.”).

²⁶⁹ Brief of SEC as Amicus Curiae at 25-26, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (No. 86-279) (citations omitted).

²⁷⁰ *Id.* at 24.

example, in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*,²⁷² the Supreme Court reaffirmed that “private litigation under § 10(b) continues to play a vital role in protecting the integrity of our securities markets,” and that “[t]he SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws.”²⁷³

Congress, they assert, has likewise recognized the important role of institutional investors, including state and local governments, in the enforcement of the securities laws and that “private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses – a matter crucial to the integrity of domestic capital markets.”²⁷⁴ (Though, as Justice Alito pointed out in the *Halliburton II* argument, the PSLRA expressly rejected the argument that Congress had accepted even that there was a private right of action under Rule 10b-5.²⁷⁵)

Moreover, respondents argue that, contrary to petitioners’ claims, public enforcement is not a viable replacement for private litigation. The SEC does not have the resources to police the financial markets by itself. This is particularly true today due to the drastic expansion of the

²⁷¹ See e.g., *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964); *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986).

²⁷² *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 778 n.10 (2008) (quoting S. Rep., at 8, U.S. Code Cong. & Admin. News 1995, pp. 679, 687).

²⁷³ *Id.* at 778. Similarly, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (9-0), the Supreme Court held that “private securities litigation is an indispensable tool with which defrauded investors can recover their losses—a matter crucial to the integrity of domestic capital markets.” *Dabit*, 547 U.S. at 81.

²⁷⁴ *Tellabs*, 551 U.S. at 320 n.4 (2007) (internal quotation marks omitted). See also H.R. Conf. Rep. No. 104-369, at 31; S. Rep. No. 10498, at 8 (“[P]rivate rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC’s own enforcement program.” (quoting SEC Chairman Arthur Levitt)).

²⁷⁵ Transcript of Oral Argument at 26:10-15, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Mar. 5, 2014).

SEC's responsibilities and the growth of trading technologies and strategies.²⁷⁶ For example, implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111203, 124 Stat. 1376) ("Dodd-Frank"), "thrust [the SEC] into the driver's seat for issuing 100 new rules, creating five new offices, producing more than 20 studies and reports, overseeing the over-the-counter derivatives market and hedge fund advisers, registering municipal advisors and security-based swap market participants, and creating a new whistleblower program, among other new duties."²⁷⁷ The Jumpstart Our Business Startups Act of 2012, which directs the SEC to write rules and issue studies on capital formation, disclosure, and registration requirements, similarly added significant responsibility to the SEC.²⁷⁸ On behalf of respondents, various US states and the Council of Institutional Investors have submitted *amici* briefs that include facts and commentary concerning the SEC's budget, responsibilities, and effectiveness in recent history. As pointed out therein, a number of the industries that the SEC has responsibility for overseeing have also grown substantially in the past few years. For example, the number of investment advisors has recently risen by 40%, while the amount of assets managed by investment advisors has more than doubled to over \$50 trillion.²⁷⁹ In addition, the field has grown markedly more complex with the evolution of novel trading strategies, high-frequency and algorithm-based trading, and "complex 'families' of financial services companies with integrated operations."²⁸⁰

²⁷⁶ FY14 CFTC, SEC Budget Hearing, Subcomm. on Fin. Servs. and Gen. Gov., Sen. Approps. Comm., 113th Cong. 7 (2013) (statement of Mary Jo White, Chair, SEC).

²⁷⁷ *Id.* (statement of Sen. Mark Udall).

²⁷⁸ *Id.* (statement of Sen. Mark Udall).

²⁷⁹ *Halliburton II* States of Oregon, et al. Br. at 11 (citing FY14 CFTC, SEC Budget Hearing, 113th Cong. 6-7 (2013) (statement of Mary Jo White, Chair, SEC)).

²⁸⁰ *Id.* (citing FY14 CFTC, SEC Budget Hearing, 113th Cong. 7 (2013) (statement of Mary Jo White, Chair, SEC)).

As a result of this rapid expansion, the SEC was able to examine only 8% of investment advisors in FY 2012 and “over 40 percent of advisors have never been examined.”²⁸¹

Whereas, petitioners focus on recent aggressive moves by the SEC, respondents point to studies suggesting weakness. A GAO report issued in 2009 reflected that between 2004 and 2008, the number of investigative attorneys at the SEC dropped 11.5%, from 566 to 501.²⁸² Similarly, between 2005 and 2008, total staffing for the Enforcement Division declined.²⁸³ From 2002 to 2008, the number of investigations and enforcement actions remained level,²⁸⁴ even as the financial crisis brewed.

As the report reflected, the SEC acknowledged issues at the time. Further, “[i]n interviews and small group meetings, enforcement management and investigative attorneys agreed that resource challenges have affected their ability to bring enforcement actions.”²⁸⁵ Indeed, the SEC’s latest budgetary request acknowledges that its “current level of resources is not sufficient to keep pace with the growing size and complexity of the securities markets and of the agency’s broad responsibilities.”²⁸⁶ SEC budget authority rose from \$913 million in 2005 to \$1.3 billion in 2013, an increase of only 4.75% annually.²⁸⁷

²⁸¹ *Id.* at 6. Similarly, swap-based markets are evolving considerably, and the SEC has also been tasked with overseeing “new categories of registered entities” such as “security-based swap execution facilities, security-based swap data repositories, security-based swap dealers, and major security-based swap participants.” FY14 CFTC, SEC Budget Hearing, 113th Cong. 9 (2013) (statement of Mary Jo White, Chair, SEC).

²⁸² *Halliburton II* States of Oregon, et al. Br. at 11 (citing U.S. Gov’t Accountability Office, GAO-09-358, Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement 4 (2009) (“GAO Report”).

²⁸³ *Halliburton II* States of Oregon, et al. Br. at 10 (citing GAO Report at 17).

²⁸⁴ *Id.* (citing GAO Report at 21-22).

²⁸⁵ GAO Report at 23.

²⁸⁶ *Halliburton II* Council of Institutional Investors Br. at 7 (citing SEC, FY 2014 Congressional Budget Justification 4 (Apr. 10, 2013)).

²⁸⁷ *Id.* (citing SEC, Freedom of Information Act (“FOIA”) Document: Budget History (May 7, 2013)).

Respondents point out that the SEC’s expanded responsibilities and insufficient resources have resulted in a significant decline in SEC securities-fraud enforcement activity over the last ten years. For example, enforcement actions categorized by the SEC as “Financial Fraud/Issuer Disclosure” have fallen dramatically: Whereas the SEC averaged 175 such actions annually between 2004 and 2008, it brought just 73 in 2013 and averaged only 92 over the last three years.²⁸⁸ Over the same period, the proportion of the SEC’s docket dedicated to securities-fraud enforcement has fallen roughly by half, from 28% in 2004 to just 13% in 2013.²⁸⁹

Against these facts, respondents and their supporters assert, studies have shown that securities class actions are effective deterrents because “private lawsuits promote public and global confidence in our capital markets and help . . . to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs,”²⁹⁰ and cite studies demonstrating that the “greater institutional commitment of the United States to enforcement” of its securities laws, by both public and private actors, succeeds in repelling issuers prone to fraud while simultaneously lowering the cost of capital for honest issuers.²⁹¹

Some studies have also shown that securities class actions recover more compensation for plaintiffs than any other type of class action.²⁹² For example, they cite a study by Brian Fitzpatrick, which showed securities class actions recover more value for investors than any

²⁸⁸ *Id.* at 8 (citing SEC, Year-by-Year Enforcement Statistics (Dec. 17, 2013)). These data include FCPA enforcement which is not necessarily linked to financial-fraud.

²⁸⁹ *Id.* (citing Cornerstone Research, Securities Class Action Filings: 2012 Year in Review 23 (2013)).

²⁹⁰ *Id.* at 10 (citing H.R. Conf. Rep. No. 104-369, at 31).

²⁹¹ *Id.* (citing John Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 245-246 (2007)).

²⁹² *Halliburton II* States of Oregon, et al. Br. at 16, (citing Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. Empirical Legal Stud. 811, 825-30 (2010)).

other type of action.²⁹³ In 2006 and 2007, securities class action settlements constituted 73% and 76% of the amount of monetary value recovered in all class actions.²⁹⁴ The closest comparator in both years constituted 7% of the total.²⁹⁵ Even setting aside blockbuster securities settlements and focusing on average and median values, securities class action settlements are in the top tier alongside commercial and antitrust class action settlements.²⁹⁶ The study found that “securities settlements were quite distinctive from the settlements in other areas in their singular focus on cash relief: every single securities settlement provided cash to the class,” as opposed to in-kind or “coupon” relief.²⁹⁷

Respondents also point out that, even where it brings cases, SEC enforcement does not mean injured investors will recover at all, let alone what they may obtain through private litigation.²⁹⁸ For example:

- In *Enron*, the SEC recovered \$440 million while private lawsuits recovered approximately \$7.3 billion from private suits.²⁹⁹

²⁹³ *Id.* (citing *id.*).

²⁹⁴ Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, at 825 (table 4). Even though securities class action settlements totaled \$16 billion and \$8 billion for 2006 and 2007 respectively (*id.*), securities class action settlements recover on average only 3% of investor losses (Cornerstone Research, *Securities Class Action Settlements-2012 Review and Analysis* 8 (fig. 7) (2013)). As enormous as the amount of these settlements are, they pale in comparison to the losses they are attempting to compensate.

²⁹⁵ *Halliburton II States of Oregon, et al. Br.* at 16 (citing Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, at 825 (table 4)).

²⁹⁶ *Id.* (citing *id.* at 827-29 & table 6 (explaining that the commercial and antitrust averages are distorted by huge outlier settlements)).

²⁹⁷ *Id.* at 17 (citing Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, at 825).

²⁹⁸ The GAO Report found that the SEC was hobbled by internal policies that discouraged penalties and forced the SEC to play a losing hand at settlement talks. See GAO Report at 43-44.

²⁹⁹ *Halliburton II States of Oregon, et al. Br.* at 13. Compare SEC, *Enron*, U.S. Securities & Exchange Commission, <http://www.sec.gov/divisions/enforce/claims/enron.htm> (last modified May 14, 2007), with Kristen Hays, *Enron Settlement: \$7.2 Billion to Shareholders*, *Houston Chronicle* (Sept. 9, 2008), <http://www.chron.com/business/enron/article/Enron-settlement-7-2-billion-to-shareholders-1643123.php>.

- In *Worldcom*, the SEC recovered \$750 million – at the time the largest in the agency’s history – while private lawsuits recovered more than \$6.1 billion.³⁰⁰ Notably, the private settlement with WorldCom included \$24.75 million from individual directors while the SEC fine was paid only by the company.³⁰¹
- In *Cendant*, the SEC did not recover anything, while private lawsuits recovered \$3.2 billion.³⁰²

Indeed, without private securities class action, investors would often be denied any relief at all.³⁰³

IV. WHAT WOULD HAPPEN IF THE SUPREME COURT ELIMINATED THE FRAUD-ON-THE-MARKET PRESUMPTION?

Although, in this section, we consider how the securities class action landscape might look if the Court were to overrule *Basic* and eliminate the fraud-on-the-market presumption, the Court does not appear to be leaning in that direction. At oral argument, multiple justices made statements or asked questions relating to a “middle ground” position, which arguably suggests that there may be a possible willingness to modify *Basic*, rather than overrule it. Justice Kennedy, for example, suggested that if, in a securities class action litigation, a price impact

³⁰⁰ *Halliburton II* States of Oregon, et al. Br. at 16. *Compare \$750 Million MCI/WorldCom Settlement is Largest in SEC History*, Accounting Web (Jul. 7, 2003), <http://www.accountingweb.com/topic/750-million-mciworldcom-settlement-largest-sec-history>, with *Settlements*, Worldcom Sec. Litig., <http://www.worldcomlitigation.com/html/citisettlement.html> (last visited Jan. 5, 2014).

³⁰¹ *Halliburton II* States of Oregon, et al. Br. at 16. See Accounting Web, *supra* note 300; Worldcom Sec. Litig., *supra* note 300.

³⁰² *Halliburton II* States of Oregon, et al. Br. at 16. See *In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001).

³⁰³ *Halliburton II* Council of Institutional Investors Br. at 10 (citing Samuel Issacharoff, *Settled Expectations in a World of Unsettled Law: Choice of Law After the Class Action Fairness Act*, 106 Colum. L. Rev. 1839, 1861 (2006). “It is well understood that aggregation is the key to the viability of many claims routinely brought as class actions, particularly what are termed the negative value claims, in which the transaction costs of prosecuting individual actions make enforcement impossible absent aggregation.”).

study is ultimately required at the merits stage, then it might make sense to simply require it at the class certification stage instead.³⁰⁴

A. *Would Securities Class Actions Survive?*

Petitioners argue that overturning *Basic* would have little to no impact on private securities litigation. Sophisticated investors would still be able to demonstrate that they reviewed documents containing the alleged misrepresentations or omissions, and could therefore demonstrate actual reliance in individual actions. Institutional investors are already opting out of securities class actions in “increasing numbers” to pursue individual claims and settlements.³⁰⁵

Respondents contend that overruling *Basic* would likely leave entire classes of investors without a viable recourse against securities fraud. The hardest-hit class would be smaller, less sophisticated investors, who lack the resources to review financial statements and SEC disclosures in detail and would thus be unable to demonstrate actual reliance.³⁰⁶ Other proponents of the fraud-on-the-market presumption have expressed concerns that overruling *Basic* and leaving investors without a means of presuming reliance in cases alleging material misrepresentations would leave an entire class of investors without recourse against securities fraud, namely large, institutional investors who employ passive investment strategies. Such strategies include indexing which attempts to provide investment results that correspond to the total return performance of a specified stock or bond market benchmark or sector. Across the market as a whole, institutional investors use indexing strategies to manage \$900 billion in fixed-

³⁰⁴ Transcript of Oral Argument at 18:14-22, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Mar. 5, 2014).

³⁰⁵ *Halliburton II* Petitioners’ Br. at 48.

³⁰⁶ *Halliburton II* Respondent’s Br. at 24.

income assets and more than \$3.3 trillion in domestic equities.³⁰⁷ These investors, it is argued, would be unable to prove actual, direct reliance on fraudulent misstatements in the absence of the fraud-on-the-market presumption, as they would be unable to show that they actually reviewed the documents containing the alleged misrepresentations.³⁰⁸

Below we examine the possible ways in which investors might try to obtain class-wide relief even if the Court were to eliminate the fraud-on-the-market presumption.

1. Federal Securities Fraud Class Actions Based on Omission Claims

Long before the Supreme Court decided *Basic*, it held that “positive proof of reliance” is not required in cases involving primarily a failure to disclose a material fact that the defendant had a duty to disclose.³⁰⁹ The Court has since described the *Affiliated Ute* rule as a rebuttable presumption that arises “if there is an omission of a material fact by one with a duty to disclose.”³¹⁰ The *Affiliated Ute* presumption would presumably remain intact even if the Court were to repudiate the fraud-on-the-market presumption of reliance for Section 10(b) claims based on affirmative misrepresentations.³¹¹ The critical difference is that unlike the fraud-on-the-market presumption, the *Affiliated Ute* presumption does not depend on the acceptance of the efficient market hypothesis. To presume reliance under *Affiliated Ute*, a plaintiff need only show that the alleged omission was material.

³⁰⁷ *Halliburton II* Council of Institutional Investors Br. at 17.

³⁰⁸ *Id.* at 14.

³⁰⁹ *Affiliated Ute Citizens of the State of Utah v. U.S.*, 406 U.S. 128, 153-154 (1972).

³¹⁰ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008).

³¹¹ Certain of the *Halliburton II* amici have argued that the Court should harmonize its 10(b) jurisprudence, by permitting the presumption of reliance to be rebutted at class certification, as it is for the *Affiliated Ute* presumption. *See, e.g.*, Brief of the Washington Legal Foundation as *Amicus Curiae* in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, No.13-317 (U.S. Jan. 6, 2014) (hereinafter “*Halliburton II* Washington Legal Found. Br.”).

Were the Court to eliminate the fraud-on-the-market presumption, plaintiffs would likely respond by attempting to re-characterize and refashion affirmative misrepresentation claims as omission claims. Indeed, some plaintiffs already pursue that strategy in an effort to avoid a battle over market efficiency at the class certification stage. As a general matter, courts typically rebuff such tactics, holding that the *Affiliated Ute* presumption applies only to claims based on “pure” omissions. While there is already a burgeoning body of case law addressing this issue, the number of cases addressing alleged misrepresentations recast as omissions would only grow should the Court overrule *Basic*.

2. Federal Class Actions Asserting Securities Act Claims

Eliminating the presumption of reliance also would not appear to affect an investor’s ability to pursue class actions for violations of Sections 11 and 12 of the Securities Act. Like Section 10(b) of the Exchange Act, those sections provide a purchaser of securities a cause of action when a defendant makes material misstatements or omits material facts from certain securities filings or oral communications. But unlike under Section 10(b), a plaintiff need not plead or prove reliance to state a claim or prevail under Sections 11 and 12.³¹² Consequently, federal courts might see a rise in Securities Act class actions if the Supreme Court eliminated the fraud-on-the-market presumption. Of course, Sections 11 and 12 are more limited than Section 10(b), as they apply only to misrepresentations or omissions in registration statements (Section 11) or prospectuses and oral communications (Section 12).³¹³ Critics of *Basic* argue

³¹² One exception is where a plaintiff purchases a security after the issuer has made generally available to its security holders an earnings statement covering a period of at least 12 months beginning after the effective date of the registration statement. In that event, the plaintiff must plead actual reliance on any purported material misstatement in the registration statement, or reliance on the registration statement without knowledge of the omission. *See* 15 U.S.C. §77k(a); *DeMaria v. Andersen*, 318 F.3d 170, 176 (2d Cir. 2003) (“a purchaser who acquires the security more than twelve months after the issuance of the original registration statement must prove reliance on the registration statement in order to recover”).

³¹³ Investors also might attempt to bring class actions for violations of: (i) Section 9(a) of the Exchange Act, which prohibits certain practices that manipulate securities prices by creating an artificial price that gives investors false

that this means that claims brought under Sections 11 and 12 do not suffer from the purported circular payment problem that affects secondary trading claims brought under Section 10(b), as any recovery obtained under Sections 11 and 12 would be a refund of money received for the plaintiff's shares, thereby reducing the defendant's proceeds from the offering to what they would have been absent the false statement.³¹⁴

3. State Law Class Actions

If foreclosed from presuming reliance under the fraud-on-the-market doctrine, plaintiffs may try to find creative ways to bring state law class action claims, either in state or federal court. At least a few state courts have acknowledged the applicability of the fraud-on-the-market presumption to state law claims.³¹⁵ But the fraud-on-the-market presumption is in tension with the common law requirement of privity, which prevails in many states that have not adopted the presumption.³¹⁶ In any event, SLUSA may significantly limit plaintiffs' ability to file state law class actions based on alleged misrepresentations and omissions made in connection with the purchase or sale of certain securities.

information about the stock; and (ii) Section 14(a) (and the Rules promulgated thereunder) of the Exchange Act, which prohibits the solicitation of proxies that contain any materially false or misleading statement. Like Sections 11 and 12 of the Securities Act, Sections 9(a) and 14(a) of the Exchange Act do not require a plaintiff to plead or prove reliance.

³¹⁴ *Halliburton II* Chamber of Commerce Br. at 30.

³¹⁵ See, e.g., *State v. Marsh & McLennan Cos.*, 292 P.3d 525, 536 (Or. 2012) (allowing reliance to "be established through the use of the fraud-on-the-market doctrine"); *Farmers Ins. Exch. v. Benzing*, 206 P.3d 812, 821-22 (Colo. 2009) (recognizing the fraud-on-the-market theory, but not applying it because the class members alleged direct reliance on the defendant's material omissions in face-to-face transactions, not reliance on the market price of the securities); *Allyn v. Wortman*, 725 So.2d 94, 101 (Miss. 1998) ("this Court henceforth recognizes the validity of the fraud-on-the-market theory").

³¹⁶ Brief *Amici Curiae* of AARP, et al., in Support of Respondent, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-1307 (U.S. Feb. 5, 2014).

SLUSA “make[s] Federal court the exclusive venue for securities fraud class action litigation.”³¹⁷ In addition, SLUSA makes the antifraud provisions of the federal securities laws the only body of law that may provide a remedy, if any remedy is afforded at all, for damages caused by such alleged misconduct.³¹⁸ Thus, SLUSA provides for the removal, preclusion, and dismissal of “covered class actions” alleging under state law misrepresentations or omissions of a material fact “in connection” with transactions in “covered securities.”³¹⁹ As relevant here, SLUSA defines “covered securities” to include securities traded on a national exchange.³²⁰

B. *Absent Securities Class Actions, How Are Securities Fraud Claims to be Litigated?*

Many plaintiffs have argued that, if the Supreme Court were to use *Halliburton II* to invalidate the fraud-on-the-market doctrine, it is likely plaintiffs asserting Section 10(b) claims for affirmative misrepresentations would no longer be able to obtain class certification because individual questions of reliance would predominate over class-wide questions, making class certification inappropriate under Rule 23. However, even if *Basic* were overruled and the fraud-on-the-market doctrine rejected, plaintiffs may be able to prosecute certain securities fraud claims.

1. Individual Reliance Claims

³¹⁷ See *Dabit*, 547 U.S. at 87 n.12 (quoting H.R. Rep. No. 105-640, at 10 (1998)).

³¹⁸ See *id.* at 74.

³¹⁹ 15 U.S.C. § 78bb(f).

³²⁰ 15 U.S.C. § 78bb(f)(5)(E). Earlier this year, the Supreme Court decided *Chadbourne & Parke LLP v. Troice*, holding that SLUSA does not preclude state-law class actions unless the alleged misrepresentation is “material to the decision by one or more individuals (other than the fraudster) to purchase or sell a covered security.” Applying that test, the Court found that SLUSA did not bar the *Troice* plaintiffs’ state-law class claims alleging a scheme whereby defendants induced plaintiffs to purchase uncovered securities based on misrepresentations that those securities were backed by covered securities. The Court thus permitted a class of private plaintiffs to prosecute state-law class claims based on allegations of securities fraud against secondary actors in state court, including the kind of aiding and abetting claims prohibited under federal law.

The largest plaintiffs' firms with large institutional investors might still find it worthwhile to file large individual and non-class collective actions in certain situations. Smaller plaintiffs' firms probably could potentially also file individual and non-class collective actions. The damages in both types of cases would be significantly smaller, but the litigation burdens would be similar.³²¹

Because non-class securities actions based on actual reliance would involve the litigation of the same core issues, they would be no less expensive to defend. In some instances, non-class litigations would be more expensive, because they would involve multiple damages analyses and vastly more complex case management. Settlement logistics would also become more complex, as defendants would be forced to negotiate with multiple plaintiffs and firms.³²²

2. Consolidation and Joinder

If the Supreme Court were to overrule *Basic*, the courts might experience a proliferation of individual investors bringing securities fraud actions. Instead of entertaining multiple individual actions by different large position holders (and other potential plaintiffs) against the same defendant for the same alleged misrepresentations or omissions, the courts might try to promote judicial economy by consolidating similar and related actions. Where civil actions involving one or more common questions of fact are pending in different districts, the judicial panel on multidistrict litigation may order such actions to be transferred to a single district for coordinated or consolidated pretrial proceedings.³²³ Similarly, instead of filing separate actions against the same defendant, large position holders could join together to pursue one action

³²¹ Douglas W. Greene, *Is the Demise of the Fraud-on-the-Market Doctrine Near? Be Careful What You Wish For*, D&O Discourse (Feb. 16, 2014), <http://www.dandodiscourse.com/2013/11/17/is-the-demise-of-the-fraud-on-the-market-doctrine-near-be-careful-what-you-wish-for/>.

³²² *Id.*

³²³ 28 U.S.C. § 1407.

against the defendant.³²⁴ Still, absent *Basic*, each plaintiff would be required to show actual reliance, which could erode judicial economy and render discovery unwieldy and expensive.

To promote the effectiveness of consolidation or joinder, courts could try to minimize the individual reliance issue by first addressing issues common to all the plaintiffs and thus not require individualized proof, such as falsity and loss causation. A court would dismiss the action if the plaintiffs, collectively, could not meet their burden of proof for those elements. In actions in which the plaintiffs could meet their burden of proof for those elements, the court then would address issues that require individualized proof, such as reliance.

To determine if each plaintiff actually relied on the alleged material misrepresentations, courts could hold mini-trials. Indeed, before *Basic*, some courts addressed individual questions of reliance in this manner.³²⁵ Even after *Basic*, some courts have required mini-trials to decide whether defendants could rebut the presumption of reliance for any particular plaintiff.³²⁶ In one case, after a jury found that the defendant had failed to rebut the presumption of reliance on a class-wide basis, the court denied plaintiff's motion for entry of judgment, holding that defendant still had "an opportunity to rebut the presumption of reliance on an individual basis." In denying plaintiff's motion, the court held that "courts in securities fraud actions have

³²⁴ See Fed. R. Civ. P. 20(a)(1).

³²⁵ Prior to *Basic*, some courts permitted separate phases of litigation after liability had been established for individuals to prove reliance and damages. Robert L. Hickok, *Fraud-on-the-Market Presumption of Reliance May Be Overruled*, Pepper Hamilton LLP (Feb. 2014), http://www.pepperlaw.com/publications_article.aspx?ArticleKey=2805. See, e.g., *Green v. Wolf Corp.*, 406 F.2d 291, 301 (2d Cir. 1968) (reversing an order striking class action allegations from a securities fraud complaint: "We see no sound reason why the trial court, if it determines individual reliance is an essential element of the proof, cannot order separate trials on that particular issue, as on the question of damages, if necessary"); *Feder v. Harrington*, 52 F.R.D. 178, 183 (S.D.N.Y. 1970) (granting motion to certify a class alleging securities fraud: "In the event the issues of reliance and damages are found to be individual, it is well established that they will not defeat the class action but merely may necessitate separate trials on these issues").

³²⁶ See *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 583-587 (S.D.N.Y. 2011).

consistently recognized that issues of individual reliance can and should be addressed after a class-wide trial, through separate jury trials if necessary.”³²⁷

3. Individual Actions by Large Position Holders

An oft-stated rationale for class actions is that they make it financially practical for a plaintiff to seek redress for a class-wide injury that would be financially impractical to pursue individually. Yet it is becoming more common for investors with sufficiently sizable investment holdings in a defendant-issuer to opt-out of securities class actions³²⁸ to pursue individual securities fraud actions instead.³²⁹ A recent Cornerstone Research report stated that large position holders – typically institutional investors, like pension funds, mutual funds, hedge funds, and other investment companies – opted-out of 38 securities class actions between January 1, 1996 and December 31, 2011 to pursue individual cases against the defendants,³³⁰ 53% of class actions with class settlements of at least \$500 million had at least one related opt-out case,³³¹ and opt-out plaintiffs achieved higher recoveries. According to the Cornerstone report: “In the average case with an opt-out, an additional 12.5 percent is paid to plaintiffs who opted out, and in six cases, more than 20 percent was paid to these plaintiffs.”³³²

However, individual plaintiffs face stiff headwinds. To begin, they can be exposed to costs generally borne by the class in class actions. Individual actions are smaller than class

³²⁷ *Id.* at 584-585.

³²⁸ *See* Fed. R. Civ. P. 23(c)(2)(B)(v).

³²⁹ *Halliburton II* Chamber of Commerce Br.

³³⁰ *See* Amir Rozen et al., *Opt-Out Cases in Securities Class Action Settlements*, Cornerstone Research at 1, 3 (2013), (<http://www.cornerstone.com/getattachment/7cf8bd53-9e0b-45be-b4b3-3d810dfe2be3/Opt-Out-Cases-in-Securities-Class-Action-Settlement.aspx>). Other parties interpret this data somewhat differently, pointing out that, during this period, opt-outs occurred in only 3% of all securities class action settlements. *See Halliburton II* Council of Institutional Investors Br. at 20.

³³¹ *See id.*

³³² *See id.* at 6.

actions in terms of the relief sought and the number of plaintiffs and, therefore, the proportion of plaintiffs' out-of-pocket attorneys' fees and other expenses might be higher.³³³ The Cornerstone report acknowledges this challenge in the opt-out context: "Because legal expenses, such as attorneys' fees, filing fees, and discovery and expert expenses, are spread out among fewer plaintiffs than in a class action, individual plaintiffs may not wish to bring an opt-out case unless their losses are sufficiently deep to justify the subsequent legal costs."³³⁴ That calculus likely holds true for large position holders in deciding at the outset whether to bring individual securities actions. And retail investors with limited financial resources likely would find it cost prohibitive to pursue individual securities actions, even if they could prove actual reliance.

Another challenge: the opt-out "premium" identified in the Cornerstone report might be explained, at least in part, by the defendant's desire to achieve global peace by settling all at once with the class members and the opt-out plaintiffs. Absent a class, the opt-out premium might vanish. That, along with the burden of financing an individual action, might change the calculus for even large position holders.

4. Collateral Estoppel³³⁵

A variant on the individual action, consolidation of individual actions, or joinder of plaintiffs in a single action, is a series of individual actions in which individual plaintiffs leverage collateral estoppel principles to benefit from the results of an earlier filed lead individual action. A certified class requires other potential litigants to either object to, or opt-out

³³³ See *id.* at 5.

³³⁴ See *id.*

³³⁵ Collateral estoppel bars re-litigation of an issue where "(1) the identical issue was raised in a previous proceeding; (2) the issue was actually litigated and decided in the previous proceeding; (3) the party had a full and fair opportunity to litigate the issue; and (4) the resolution of the issue was necessary to support a valid and final judgment on the merits." *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998).

of, the class. However, if *Basic* were overruled, it likely would result in a proliferation of individual suits. Even if settlements could be negotiated in these actions, such settlements would not preclude suits by other purchasers of the same securities based on the same alleged misrepresentations or omissions, as there would be no due process procedure to bind them.³³⁶ Indeed, it is possible that a trend would develop of random follow-up suits brought by smaller plaintiffs' firms after the larger cases had settled. Furthermore, the doctrine of collateral estoppel would apply to cases litigated to verdict, possibly, to the detriment of defendants. For example, if a court were to find that a defendant made a material misrepresentation in a securities fraud action brought by an individual investor, the defendant might then be estopped from contesting materiality or falsity in other cases. Other plaintiffs would only need to prove actual reliance, which, in many cases, would be a relatively simple and straightforward process, potentially satisfied by the filing of an affidavit.

Plaintiffs who have opted-out of securities fraud class actions have successfully invoked collateral estoppel to bar defendants from re-litigating issues that were previously decided against them in class actions.³³⁷ For example, in *In re Vivendi Universal, S.A. Securities Litigation*, after a jury found that the plaintiffs had proven falsity, materiality, scienter, and loss causation in a securities fraud class action, the court granted certain opt-out plaintiffs' motion for collateral estoppel on those same issues in a separate action.³³⁸ Similarly, in a post-*Basic* world, individual plaintiffs could seek to bar the defendant from re-litigating issues that were previously

³³⁶ *Green*, 406 F.2d at 301.

³³⁷ *See, e.g., In re Vivendi Universal*, 910 F. Supp at 503.

³³⁸ *Id.* at 503-505. Vivendi went on to file an *amicus* brief in *Halliburton* arguing that the subsequent failure of certain of these opt-out plaintiffs to prove actual reliance, based on their utilization of a proprietary method of valuation of Vivendi's stock, rather than on the integrity of the market price, illustrates the problems with the *Basic* presumption. *See* Brief for Vivendi S.A. as *Amicus Curiae* in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-1307 (U.S. Jan. 6, 2014).

decided against it in another – or a lead – individual action based on the same misrepresentations or omissions.

Of course, a daisy chain of individual actions might face a practical problem of timeliness. More fundamentally, it could lead to the undesired practice of plaintiffs adopting a “wait and see” attitude “in the hope that the first action by another plaintiff will result in a favorable judgment.”³³⁹ Indeed, the “general rule should be that in cases where a plaintiff could easily have joined in the earlier action ... a trial judge should not allow the use of offensive collateral estoppel.”³⁴⁰ The court acknowledged this concern in *Vivendi*, but ultimately allowed the opt-out plaintiffs to rely on collateral estoppel in their separate action.³⁴¹ As a result, if *Basic* is overruled and more individual actions are filed, courts might be left to grapple with deciding in which cases individual plaintiffs may rely on collateral estoppel to bar a defendant from re-litigating an issue previously decided against it in another action. This potential issue militates in favor of consolidating similar individual securities actions, which could potentially reduce the frequency of plaintiffs’ attempting to rely on collateral estoppel.

V. CONCLUSION

The Supreme Court’s decision in *Halliburton II* – whatever that decision may be – will be a landmark event in the world of class action securities litigation. In anticipation of this shot heard ‘round the securities litigation community (so to speak), the New York City Bar Association’s Securities Litigation Committee prepared this report in an effort to contribute to

³³⁹ *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 330 (1979).

³⁴⁰ *Id.* at 331.

³⁴¹ See *Vivendi*, 910 F. Supp. 2d at 505 (“the preferable approach for dealing with these problems in the federal courts is not to preclude the use of offensive collateral estoppel, but to grant trial courts broad discretion to determine when it should be applied”) (quoting *Parklane Hosiery*, 439 U.S. at 331).

the ongoing debate and dialogue about the issues presented by this case. Each member of the Committee looks forward to learning from any forthcoming publications by legal practitioners, economists, and other interested parties about these issues.

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