VI. Supreme Court Considering End to Fraud-on-the-Market Securities Litigation

A. Introduction

The Supreme Court heard oral arguments for *Halliburton Co. v. Erica P. John Fund, Inc.*,[1] on March 5, 2014.[2] The defendant-petitioners (together, "Halliburton") challenged the Fraud-On-The-Market ("FOTM") presumption, a foundation for many securities fraud class actions.[3] FOTM establishes common reliance for class certification purposes when investors chose to buy or sell a security by relying on the integrity of the stock's price.[4] This presumption is based on efficient market theory ("EMT"), which asserts that the stock price reflects all available information in an efficient market.[5] However, both EMT and FOTM have come under scrutiny since the Court embraced the theories in its 1988 decision, *Basic Inc. v. Levinson*.[6]

Halliburton may be a groundbreaking case because it presents the Court with an opportunity to evaluate the underlying rationale of FOTM.[7] If the Court were to limit FOTM, it would undoubtedly become much more difficult to certify classes in 10b-5 securities fraud cases since individual questions of reliance would emerge.[8] This article discusses *Halliburton* and its potential impact

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[1] 718 F.3d 423 (5th Cir. 2013), *cert. granted*, 82 U.S.L.W. 3295 (U.S. Nov. 15, 2013) (No. 13-317).

[2] *Halliburton Co. v. Erica P. John Fund, Inc.*, SCOTUS BLOG, http://scotusblog.com/case-files/cases/halliburton-co-v-erica-p-john-fund-inc (last visited Apr. 16, 2014).

[3] *Id*.

[4] Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988).

[5] *Id.* at 246.

[6] *See, e.g.*, Matthew M. Sanderson, *A* "*Basic*" *Misunderstanding: How the United States Supreme Court Misunderstands Capital Markets*, 43 S. TEX. L. REV. 743, 757 (2002).

[7] *See* Jacob Gershman, *Securities Class Action: Endangered Species?*, WALL ST. J., Feb. 27, 2014, at B2 ("Four justices on the current bench have publicly expressed reservations about [FOTM], including Justice Samuel Alito, who wrote that the doctrine may rest 'on a faulty economic premise.'").

[8] Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1193 (2013) ("Absent the fraud-on-the-market theory, the requirement that Rule 10b–5 plaintiffs establish reliance would ordinarily preclude certification of

on securities litigation. Part B explains the background law of securities fraud class actions. Part C traces the degradation of EMT, which in turn weakened FOTM's presumption that investors collectively rely on the integrity of the market price.[9] Part D analyzes the parties' arguments in light of *Basic* and *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds,* which seemed to limit what may be considered at the class certification stage.[10] Part E examines FOTM's role in securities fraud litigation and the competing policy considerations at play in determining whether to limit the presumption. Finally, Part F discusses the challenges the Court will likely face in deciding whether to preserve FOTM in its current form.

B. Background Law

To recover in damages in a securities fraud action under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, investors must prove that they relied upon misrepresentations or omissions in connection with the purchase or sale of securities, and suffered economic loss as a result.[11] Class actions are advantageous because individual investors may suffer "harms that are too small to merit individual litigation."[12] As a threshold matter, Federal Rule of Civil Procedure 23 requires that there be common

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a class action seeking money damages because individual reliance issues would overwhelm questions common to the class.").

[9] *See* Paul A. Ferrillo et al., *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 ST. JOHN'S L. REV. 81, 117–18 (2004). ("[T]here is not always a justifiable presumption that investors can or do rely on the integrity of market where that concept is taken to mean the property that stock prices accurately reflect available information.").

[10] *Amgen*, 133 S. Ct. at 1191 (holding that proof of materiality is not a prerequisite to class certification).

[11] *See* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2184 (2011).

[12] *Federal Jurisdiction and Procedure: Class Actions—Certification Requirements Under Sec Rule 10b-5—Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 127 HARV. L. REV. 268, 273–74 (2013) [hereinafter *Class Actions*].

"questions of law or fact" among the class.[13] It is almost always too difficult to prove that every individual investor was aware of an alleged misrepresentation, given the vastness and complexity of modern securities markets.[14] When applied, however, FOTM eliminates individual questions of reliance and thus allows for class certification in securities fraud actions.[15]

In addition to challenging the underlying premise of FOTM, Halliburton attempts to rebut the FOTM presumption by introducing evidence that alleged misrepresentations had no impact on the market price, which would in turn leave individual questions of reliance intact and preclude class certification.[16] In *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*,[17] however, the Court seemed to narrow what may be considered at the class certification stage—holding that the materiality of an alleged misrepresentation is not a prerequisite for class certification and is better suited for resolution on the merits.[18] The *Halliburton* plaintiff-respondent

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[13] FED. R. CIV. P. 23(a)(2) ("One or more members of a class may sue or be sued as representatives parties on behalf of all members only if . . . there are questions of law or fact common to the class . . . .").

[14] *See* Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988) ("Requiring a plaintiff to show a speculative state of facts . . . would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.").

[15] *See id.* at 246–47 ("[W]here 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.").

[16] *Halliburton Co. v. Erica P. John Fund, Inc.*, SCOTUS BLOG, http://scotusblog.com/case-files/cases/halliburton-co-v-erica-p-john-fund-inc (last visited Apr. 16, 2014); *see also* Noam Noked, *Supreme Court to Consider Overruling "Fraud-on-the-Market" Presumption*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Dec. 4, 2013, 9:21 AM), http://blogs.law.harvard.edu/corpgov/2013/12/04/supreme-court-to-consider-overruling-fraud-on-the-market-presumption ("If the Court were to eliminate or significantly limit the 'fraud-on-the-market' presumption . . . . [T]he need for individual determinations of investor reliance would make securities fraud class certification difficult or practically infeasible in most cases, as common class-wide issues would no longer outweigh individual issues.").

[17] 133 S. Ct. 1184 (2013).

[18] *Id.* at 1191, 1196–97.

("Fund") hopes the Court will apply *Amgen's* reasoning and exclude price impact evidence from the class certification stage.[19]

C. The Role of Efficient Market Theory

The Supreme Court first adopted the FOTM rationale in *Basic Inc. v. Levinson*.[20] The Court found the presumption satisfied 10b-5's reliance requirement, recognizing that the modern securities market is characterized by millions of impersonal transactions.[21] Given the "unnecessarily unrealistic evidentiary burden" that 10b-5 plaintiffs in class actions would face if forced to prove common reliance on an alleged misrepresentation, the Court reasoned that investors could establish common reliance if they relied on the market price.[22] The Court endorsed EMT outright when it presumed "an investor[] reli[es] on any public material misrepresentations," since "most publicly available information is reflected in the market price."[23] Halliburton's argument chips away at the link between market price and actual market information in order to discredit EMT, and by association, FOTM.[24] The Fund, on the other hand, finds EMT's shortcomings less problematic.[25] It argues that the *Basic* Court never suggested markets were perfectly efficient, which allows defendants to rebut the argument that a particular market operated efficiently.[26] The Fund suggests that the Court should be satisfied as

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[19] *See* Brief for Respondent at 42–43, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Jan. 29, 2013) (arguing that "the Court's decisions in *Halliburton* and *Amgen* refuse to interject a free-flowing inquiry into the merits of the plaintiff's suit at the class-certification stage").

[20] 485 U.S. 224, 243–46 (1988).

[21] *Id.*

[22] *Id.* at 245 ("Requiring a plaintiff to show a speculative state of facts . . . would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.").

[23] *See id.* at 247.

[24] *See* Brief for Petitioners at 19, Halliburton Co. v Erica P. John Fund, Inc., No. 13-317 (U.S. argued Dec. 30, 2013) ("What is lost, of course, is the link between a market price and the stock's value as disclosed by *actual market information*.").

[25] Brief for Respondent, *supra* note 19, at 32–33.

[26] *See id.* at 33 ("Instead, *Basic* rests on a simple economic truth: markets generally react reasonably promptly to material public information.").

to common reliance, so long as "most" publicly available information is reflected in the market price.[27]

If the Court accepts the Fund's view, evidence merely suggesting that market price is an imperfect proxy for information may not persuade the Court to dispose of FOTM in its entirety, since the presumption seemingly tolerates some degree of disconnect between price and information. Still, strong evidence establishing that market price is not just imperfect, but often entirely unreliable could sway the Court to discredit EMT and critically examine whether FOTM remains justifiable.[28] In fact, Justice Alito recently signaled that newer critical evidence of FOTM's "faulty economic premise" indicates that the Court should reconsider FOTM.[29] In the 2011 iteration of its case, Halliburton highlighted the growing skepticism surrounding EMT,[30] but the Court avoided addressing the theory's validity.[31] This time, however, the Court may examine EMT since Halliburton is challenging FOTM directly.[32] As Justice White predicted in *Basic*, the Court would eventually have to acknowledge that FOTM relied on "nothing more than theories which may or may not prove accurate upon further consideration."[33]

Questions regarding the validity of EMT are not novel. For example, several "[s]tate courts [have] refuse[d] to adopt fraud-on-

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[27] *See id.* at 37–38.

[28] *See* Ferrillo et al., *supra* note 9, at 107 ("Since the mid-1980s, empirical literature had been finding stock market anomalies at an astounding pace.").

[29] Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1204 (2013) (Alito, J., concurring).

[30] Brief for Respondents at 22, Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011) (No. 09-1403) ("*Basic*, moreover, rested on an efficient-market theory that was hotly disputed even when *Basic* was decided.").

[31] *See* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2187 (2011) (deciding on "loss causation" grounds rather than EMT).

[32] *See* Daniel Fisher, *Supreme Court Takes Halliburton's Fontal Assault On Securities Class Actions*, FORBES (Nov. 16, 2013, 10:29 AM), http://forbes.com/sites/danielfisher/2013/11/16/supreme-court-takes-halliburtons-frontal-assault-on-securities-class-actions (stating that "[a]t issue . . . is the fraud-on-the-market theory" and considering "that doctrine's narrow escape in a decision earlier this year—Justice Samuel Alito said he would have given it closer scrutiny").

[33] Basic Inc. v. Levinson, 485 U.S. 224, 254 (1988) (White, J., dissenting in part).

the-market" precisely because EMT is "unreliable."[34] Moreover, the Court harbored doubts over EMT's assumptions when it decided *Basic*.[35] Justice White's dissent questioned whether markets were truly efficient when he pointed out that "many investors purchase or sell stock because they believe the price *inaccurately* reflects the corporation's worth."[36] Subsequent research has since vindicated Justice White's position, finding that the fact that "some investors . . . consistently outperform the market using equal information illustrates the inefficiency of the market."[37] Indeed, if markets were as efficient as the majority in *Basic* suggested, then "the arbitrage of opportunity would not exist and would render market out-performance impossible."[38] Moreover, even if the market price reflects all available information,[39] assuming that investors rely on that price may be improper because investors do not always behave rationally.[40] External factors such as "accounting information, media, and comments from traders outside the market," influence investors and cause them to "consistently overprice past winners, and underprice past failures."[41]

Still, the Fund argues that resolving the question of whether price reflects all available information in a particular market does not require rejecting FOTM altogether.[42] Rather, defendants can attempt to rebut the FOTM presumption by offering evidence that the

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[34] Matthew M. Sanderson, *A* "*Basic*" *Misunderstanding: How the United States Supreme Court Misunderstands Capital Markets*, 43 S. TEX. L. REV. 743, 757 (2002).

[35] *Basic*, 485 U.S. at 254 ("For while the economists' theories which underpin the fraud-on-the-market presumption may have the appeal of mathematical exactitude and scientific certainty, they are-in the end-nothing more than theories which may or may not prove accurate upon further consideration.").

[36] *Id. at* 256 (White, J., dissenting in part) (quoting Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 455 (1984)).

[37] Sanderson, *supra* note 34, at 759.

[38] *Id.*

[39] *But cf.* Brad M. Barber et al., *The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiency*, 19 J. CORP. LAW 285, 289 (1994) ("It is now widely accepted that different investors are at any point in time endowed with different levels and qualities of information.").

[40] *See* Sanderson, *supra* note 34, at 760.

[41] *Id.*

[42] Brief for Respondent, *supra* note 19, at 38.

particular market at issue does not operate efficiently.[43] This may not be a satisfying solution for defendants, however, since the *Basic* Court did not explain what proving an inefficient market entails.[44] As Halliburton argues,[45] determining whether a market is efficient, and thus whether FOTM is triggered, has proven to be a highly imprecise endeavor because there is no "systematic body of evidence" to establish whether a stock is efficiently traded.[46] To resolve this issue, lower courts have resorted to applying a variety of factors, which overlap with each other and even conflict at times.[47] Some courts, for example, emphasize the "trading volume of a stock," while others place greater importance on the "volatility" of the stock, or the presence of "a cause and effect relationship" between company announcements and stock price.[48] As a result, the lack of a concrete framework for determining market efficiency has led lower courts to apply numerous factors inconsistently, yielding a veritable "hodgepodge of cases and outcomes."[49] Ultimately, it is difficult to determine whether the market for a given security is efficient without empirical backing.[50] Justice White's dissent in *Basic* anticipated the "[c]onfusion and contradiction" that would arise from applying FOTM.[51] In his view, FOTM's reliance on EMT was problematic from the beginning because courts had "no staff economists" at their disposal to "test the validity of empirical market studies."[52]

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[43] Basic Inc. v. Levinson, 485 U.S. 224, 248 & n.27 (1988).
[44] Barber et al., *supra* note 39, at 288.
[45] Brief for Petitioners, *supra* note 24, at 22–23.
[46] Barber et al., *supra* note 39, at 290.
[47] *Id.* at 293.
[48] Ferrillo et al., *supra* note 9, at 102.
[49] *Id.*; *see also* Jeffrey L. Oldham, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995, 1016 (2003) ("Given the loose and largely undefined set of factors that can inform courts' decisions, district courts have, as a result, struggled to apply these factors clearly and coherently.").
[50] Barber et al., *supra* note 39, at 29.
[51] Basic Inc. v. Levinson, 485 U.S. 224, 252 (1988) (White, J., dissenting in part).
[52] *Id.* at 253.

D. Price Impact and Materiality

If the Court finds that market price is an unreliable and outdated measure of available information, the actual distortion of market price by defendants' misrepresentations or omissions may be dispositive in determining whether FOTM applies.[53] The *Basic* Court made clear that "[a]ny showing that severs the link between the alleged misrepresentation and . . . the price . . . will be sufficient to rebut the presumption of reliance."[54] The crux of Halliburton's argument is that evidence that may rebut FOTM—such as proof regarding market efficiency or whether a company made a public disclosure—ultimately serves to prove price impact, albeit indirectly.[55] The Court, therefore, should treat direct evidence of price impact as a "predicate" to FOTM that is equally relevant, if not more so, to class certification.[56] The Fund, on the other hand, equates evidence of price impact with evidence of materiality.[57] This is significant since the Court's holding in *Amgen* states that materiality is an issue for trial and not relevant at the certification stage.[58] The majority in *Amgen* distinguished "proof on the issues of market efficiency and publicity," from "the prospect of individualized proof of reliance" and "the failure of common proof on the issue of materiality," either of which could "end[] the case for the class."[59] Thus, the *Amgen* Court reasoned "the issue of materiality would not undermine the predominance of questions common to the class."[60]

During the first iteration of Halliburton's case in 2011, the Court dodged the question of whether market price was actually affected by the alleged misrepresentation by focusing its analysis on

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[53] *Id.* at 248.
[54] *Id.*
[55] *See* Brief for Petitioners, *supra* note 24, at 54 ("It would make no sense to allow defendants at the certification stage to indirectly rebut price impact by rebutting the presumption's publicity and market-efficiency 'predicates' while prohibiting defendants from directly contraverting price impact.").
[56] *See id.* at 54–55 ("Indeed, the need for certification-stage rebuttal is more acute for price impact than for market efficiency or publicity.").
[57] Brief for Respondent, *supra* note 19, at 50–52 ("The fact that materiality is an element of the claim, while price impact is technically not, is a distinction without a difference.").
[58] Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1191 (2013).
[59] *Id.* at 1199.
[60] *Id.* at 1204.

the appellate court's improper treatment of loss causation at the class certification stage.[61] Now that the Court must address price impact, it will be difficult to avoid questions of materiality in the context of discussing what may and may not be considered at the class certification stage. In *Amgen*, Justice Scalia's dissent suggested that whether an alleged misrepresentation is "material" or "affected the market price" should indeed be relevant at the class certification stage because it would otherwise make "no sense to 'presume reliance' on the misrepresentation merely because the plaintiff relied on the market price."[62] Likewise, Justice Thomas's dissent pointed out that "[t]he failure to establish materiality retrospectively confirms that fraud on the market was never established, that questions regarding the element of reliance were not common under Rule 23(b)(3), and, by extension, that certification was never proper."[63]

The *Amgen* majority may have preferred to leave materiality for resolution on the merits because it is a "fact-specific" inquiry that would benefit from "full discovery."[64] On the other hand, "courts now routinely hear expert testimony" and deal with complex issues at the class certification stage.[65] Interestingly, more than five years after the Fund filed its initial complaint against Halliburton and "after Halliburton produced over *600,000 pages*" of documents, the Fund never claimed that "insufficient discovery" precluded it from showing that alleged misrepresentations had any impact on market price.[66]

E. "The Most Powerful Engine of Civil Liability"[67]

Halliburton's amici declare FOTM the "most powerful engine of civil liability" because it opened the floodgates of

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[61] Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2186–87 (2011).
[62] *Amgen*, 133 S. Ct. at 1205 (Scalia, J., dissenting).
[63] *Id.* at 1207 (Thomas, J., dissenting).
[64] Michael J. Miarmi & Nicholas Diamand, *Fraud on the Market in A Post-Amgen World*, TRIAL, Nov. 2013, at 40, 45.
[65] Brief for Respondents, *supra* note 30, at 40.
[66] *Id.* at 44.
[67] Brief for Former SEC Commissioners et al as Amici Curiae Supporting Petitioners at 3, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Oct. 11, 2013).

securities fraud class actions.[68] In the same vein, Halliburton put forth several policy arguments against FOTM, claiming that the presumption "poorly compensates investors," burdens shareholders with the costs of litigation, and forces settlements.[69] Indeed, the "inconsistent" application of FOTM by lower courts has tended to introduce more uncertainty and difficulty for defendants who have every incentive to "settle more quickly and at higher costs."[70] Moreover, evidence suggests that despite the enormous expense that securities class actions entail, they "fail to deter fraud" since judgments are paid out by insurance.[71] Corporate officers are often shielded from personal liability as Directors' and Officers' insurance typically pays for large class action securities fraud settlements.[72] This rationale is so deeply entrenched that some commenters predict that Directors' and Officers' insurance premiums will likely correlate with the Court's decision on FOTM.[73]

Justice Scalia voiced similar concerns in his *Amgen* dissent, recognizing that class certification is "often, if not usually, the prelude to a substantial settlement by the defendant because the costs and risks of litigating further are so high."[74] The Court should thus seek a favorable balance between addressing the shortcomings of FOTM while maintaining investors' access to securities fraud class litigation. As the majority observed in *Amgen*, requiring a finding of materiality at the class certification stage would not comport with the

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[68] *Id.*

[69] Brief for Petitioners, *supra* note 24, at 40–45; *see* Gershman, *supra* note 7, at B1 ("Between 1997 and 2013, more than 3,200 securities class actions were filed, yielding over $75 billion in settlements and billions in fees for plaintiffs' and defense lawyers . . . .").

[70] Oldham, *supra* note 49, at 1018.

[71] *See Recent Cases: Securities Litigation-Class Certification—Fifth Circuit Holds That Plaintiffs Must Prove Loss Causation Before Being Certified as a Class.—Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir. 2007)*, 121 HARV. L. REV. 890, 896–97 (2008).

[72] *Id.*

[73] *See*, *e.g.*, Judy Greenwald, *Supreme Court agrees to hear big D&O case: Halliburton ruling could reshape market*, BUS. INS., Dec. 2, 2013, at 1 ("A high court decision to overturn the Basic rule could lead to lower D&O rates, experts say.").

[74] Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1206 (2013) (Scalia, J., dissenting).

policy rationale behind securities fraud class actions,[75] which "compensate victims for harms" that would otherwise be too negligible "to merit individual litigation."[76] Moreover, even if the threat of class action litigation does not always deter securities fraud, it may nevertheless play an important role in moderating executive behavior.[77] Therefore, the Court faces an arduous task of addressing the question of price impact without amending FOTM to include a materiality requirement or eliminating a class's ability to prove common reliance. At the same time, the Court must address the underlying principles and shortcomings of FOTM in order to justify its relaxation of 10-b's reliance requirement.

F. Conclusion

It seems the Court can no longer ignore the questionable premise of FOTM. Although the *Basic* Court adopted FOTM in recognition of the realities of modern securities markets,[78] it appears that this "reality" has changed now that economists have discredited EMT. Asserting that a class relied on an inherently unreliable indicator—market price—may be inadequate to satisfy 10b-5's reliance requirement. Still, without FOTM, questions of individual reliance will reappear, threatening to destroy securities fraud class actions. If the Court is willing to preserve FOTM, proving some form of materiality under "price impact" may be necessary, albeit more difficult. However, this may be preferable to maintaining a legal theory based on a discredited economic theory and allowing plaintiffs to acquire large settlements in securities fraud cases without proving reliance.

Adriana Henquen[79]

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[75] *Id.* at 1201 ("[M]eritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions . . . . We have no warrant to encumber securities-fraud litigation by adopting an atextual requirement of precertification proof of materiality that Congress, despite its extensive involvement in the securities field, has not sanctioned." (internal quotations omitted)).
[76] *Class Actions*, *supra* note 12, at 273–74.
[77] *See id.* at 274–75.
[78] Basic Inc. v. Levinson, 485 U.S. 224, 243–44 (1988).
[79] Student, Boston University School of Law (J.D. 2015).