No. 13-317

IN THE

Supreme Court of the United States

HALLIBURTON CO. AND DAVID LESAR,

Petitioners,

v.

ERICA P. JOHN FUND, INC., FKA ARCHDIOCESE OF MILWAUKEE SUPPORTING FUND, INC.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, NATIONAL ASSOCIATION OF MANUFACTURERS, PHARMACEUTICAL RESEARCH AND MANUFACTURERS OF AMERICA, AND BUSINESS ROUNDTABLE AS *AMICI CURIAE* SUPPORTING PETITIONERS

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INTEREST OF *AMICI CURIAE*[1]

Amici curiae are the Chamber of Commerce of the United States of America (the "Chamber"), the National Association of Manufacturers (the "NAM"), the Pharmaceutical Research and Manufacturers of America ("PhRMA"), and Business Roundtable ("BRT"). All have significant interest in the interpretation and enforcement of the federal securities laws and in the rules governing class actions in private securities litigation.

The Chamber is the world's largest business federation, representing approximately 300,000 members and indirectly representing the interests of more than three million companies and professional organizations of every size, in every industry sector, and from every region of the U.S. The Chamber's members transact business in countries around the world. An important function of the Chamber is representing its members' interests in matters before Congress, the Executive Branch, and the courts. The Chamber actively participates as *amicus curiae* in various class-action appeals, including recently in this Court.

The NAM is the preeminent association of U.S. manufacturers and the largest industrial trade association in the country. Its members include more than 12,000 manufacturing companies, and it represents the interests

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1. Letters reflecting the parties' blanket consent to the filing of *amicus* briefs have been filed with the Clerk's office. No counsel for a party has authored this brief in whole or in part, and no person other than *amici*, their members, and their counsel has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.

of small and large manufacturers in every industrial sector and all 50 States. The NAM regularly participates as *amicus curiae* in cases raising issues that affect the ability of U.S. manufacturers to stay competitive, promote economic growth, and create jobs.

PhRMA is a voluntary, nonprofit association that represents America's leading research-based pharmaceutical and biotechnology companies, which are the primary source of new drugs and biologics. PhRMA's mission is to advocate in support of public policies that encourage the discovery of life-saving and life-enhancing new medicines. PhRMA closely monitors pertinent legal issues and has frequently participated in cases before this Court.

BRT is an association of chief executive officers of leading U.S. companies with $7.4 trillion in annual revenues and more than 16 million employees. BRT member companies comprise more than a third of the total value of the U.S. stock market and invest $158 billion annually in research and development—equal to 62 percent of U.S. private R&D spending. BRT companies pay more than $200 billion in dividends to shareholders annually and give more than $9 billion per year in combined charitable contributions. BRT's member companies have a significant interest in public policy regarding securities fraud and class action litigation.

The Chamber, the NAM, PhRMA, and BRT have a keen interest in this case because of the significant burden imposed on their members by private securities class action litigation, which adversely affects access to capital markets and raises costs for American businesses of all

sizes. Experience with the application of *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), shows that the presumption of reliance it approved has imposed substantial costs on public companies and their shareholders without producing corresponding benefits to investors. Recognizing the economic drag frivolous securities fraud litigation has engendered, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737, "to curb abusive securities-fraud lawsuits." *See Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1201 (2013). However, Congress in the PSLRA did not address the relationship between Rule 23 of the Federal Rules of Civil Procedure and the judicially created presumption of reliance endorsed in *Basic*. *See id.* at 1212 n.9 (Thomas, J., dissenting). The present case offers the Court an opportunity to address the problems arising from *Basic*'s formulation of the presumption of reliance and the excessive, burdensome class action litigation it has fostered.

SUMMARY OF ARGUMENT

1. The Court should overrule or modify the *Basic v. Levinson* presumption of reliance. The presumption, both as justified by a four-Justice majority in *Basic* and as applied in the lower courts, is in conflict with the requirement that proof of actual reliance is an "essential element" of a private securities fraud claim under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, *see Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008).

The decision in *Basic* was founded on the assumption that investors who buy and sell securities in a mature

market do so in the belief that the market price of the security accurately incorporates all material public information about the issuer. That assumption, however, is false for many investors in the real world who trade precisely because they do not believe the market price accurately reflects the true value of the security. While the majority in *Basic* expected that this general premise could be challenged by defendants in particular cases, defendants, in fact, are denied that opportunity in most class actions, because plaintiffs' counsel can avoid the issue at the class certification stage through the careful selection of class representatives and the assumption becomes effectively unchallengeable once the class is certified.

Basic's presumption of reliance is also grounded in an outdated and overly simplistic understanding of market efficiency. Economists today understand that the functioning of markets and the manner in which they assimilate information into prices are more complex and more nuanced than the *Basic* majority recognized. Economic scholarship since 1988 shows that market efficiency is not a binary proposition, but exists along a continuum. Nevertheless, lower courts following *Basic* continue to apply a black-and-white test that reflexively treats virtually any market for an exchange-traded security as perfectly price efficient at all times. As a result, the presumption of reliance is far too easily invoked, and securities fraud actions have become divorced from market realities. At a minimum, the Court should modify and update *Basic*'s judge-made presumption to bring it into line with modern economic scholarship.

2. Under *Basic v. Levinson*, securities fraud plaintiffs get a near free pass to class certification, and the easy

certification of plaintiff classes has predictably led to excessive securities fraud litigation and the *in terrorem* settlement of insubstantial claims. The excess of class action litigation puts a significant economic drain on U.S. public companies and their investors, both through the direct costs of litigation and settlements and indirectly through higher insurance costs. These deadweight costs impose a burden on capital markets and increase the costs of capital and insurance for businesses of all sizes and for the U.S. economy generally. For all these negative effects, the *Basic* presumption has not delivered material benefits to investors who have been harmed by fraud; instead, it has simply resulted in the shift of money from one set of innocent investors to another and into the pockets of plaintiffs' lawyers.

3. Reversing or modifying *Basic*'s presumption of reliance would not unravel the law of securities fraud litigation or leave fraud undeterred and victims uncompensated. Governmental enforcers and motivated private plaintiffs will remain, under various theories of recovery, to deter actual cases of fraud and to compensate those investors who genuinely suffer real harm.

ARGUMENT

I. The Court Should Overrule or Modify the *Basic v. Levinson* Presumption of Reliance.

Contrary to the intent of this Court, the presumption approved in *Basic v. Levinson* improperly negates the essential element of personal reliance in securities fraud claims. The rationale for the presumption is a generalization about investor conduct that contradicts

reality and becomes effectively irrebuttable in class action litigation. The presumption is also based on an oversimplified understanding of market economics that contemporary scholarship disputes. For these reasons, *Basic*'s presumption of reliance should be eliminated or, at a minimum, substantially modified.

A. The presumption undermines the requirement that plaintiffs prove actual reliance as an essential element of the implied private right of action for securities fraud.

In reconsidering the *Basic v. Levinson* presumption, the proper starting point is to recognize that there is a fundamental contradiction between any evidentiary presumption of reliance and the essential requirement that every plaintiff must prove actual reliance to support a claim of fraud under the securities laws.

Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), was "enacted for the purpose of avoiding frauds." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972). Consistent with that purpose, Securities and Exchange Commission ("SEC") Rule 10b-5 implements section 10(b) by prohibiting market participants from using "any device, scheme, or artifice to defraud," making any untrue statement or omission of material fact, or engaging in any other "act, practice, or course of business" that operates "as a fraud or deceit upon any person" in connection with the purchase or sale of a security. 17 CFR § 240.10b-5. As is readily apparent from its terms, Rule 10b-5 was promulgated to protect investors against "fraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-13 n.32 (1976) (citing SEC, Securities

Exchange Act Release No. 3230 (May 21, 1942); 1942 Annual Report of the SEC at 10).[2]

Accordingly, when this Court endorsed an implied private right of action for violations of section 10(b) and Rule 10b-5 in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971), the Court drew upon the common law action for civil fraud in defining the elements of the implied federal cause of action for securities fraud. *See Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343-44 (2005); *Harris v. Am. Inv. Co.*, 523 F.2d 220, 224 (8th Cir. 1975); 4 Louis Loss, *et al.*, *Securities Regulation* § 11.C.4(d) (2013); *see also Herman & MacLean v. Huddleston*, 459 U.S. 375, 389-90 (1983) (adhering to the common law elements of fraud for claims under section 10(b) and Rule 10b-5 while approving variation from the common law standard of proof).

The "hornbook elements" of common law fraud are (1) that the defendant made a false representation of material fact, (2) that the defendant made the false statement with "scienter" (that is, knowing that the statement was false and intending to induce the plaintiff to rely on the statement), (3) that the plaintiff did in fact justifiably rely on the defendant's false statement, and (4) that the plaintiff suffered damages as a result of reliance on the false statement. 2 Louis Loss, *et al.*, *Securities Regulation* § 9.A.2 (2013); *accord Dobbs' Law of*

2. In proposing Rule 10b-5 to clarify that the securities laws prohibit fraudulent practices in the purchase, not just the sale, of securities, the SEC made the famous comment, "Well, we are against fraud, aren't we?" Milton V. Freeman, *Foreword*, *Happy Birthday 10b-5: 50 Years of Antifraud Regulation Colloquium*, 61 Fordham L. Rev. S1, S1-S2 (1993).

Torts § 664 (2d ed. 2013); *see, e.g.*, *Lazar v. Superior Court*, 909 P.2d 981, 984-85 (Cal. 1996); *Sears, Roebuck & Co. v. Meadows*, 877 S.W.2d 281, 282 (Tex. 1994). The elements of the implied private cause of action for securities fraud reflect this common law provenance.[3]

Proof of actual reliance by the plaintiff "is an essential element of the § 10(b) private cause of action" because it "ensures that . . . the 'requisite causal connection between a defendant's misrepresentation and a plaintiff's injury' exists as a predicate for liability." *Stoneridge Inv. Partners*, 552 U.S. at 159 (quoting *Basic v. Levinson*, 485 U.S. at 243). In *Stoneridge*, the Court rejected a section 10(b) implied cause of action against customers and suppliers who allegedly enabled an issuer to make fraudulent financial statements on the ground that the plaintiff "did not in fact rely upon [the customers' and suppliers'] own deceptive conduct." 552 U.S. at 160. Similarly, the Court refused to extend section 10(b) liability to third-party aiders and abettors because such an action would permit plaintiffs to recover damages "without any showing that [they] relied upon the aider and abettor's statements or actions," and "[a]llowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by [the Court's] earlier cases." *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994), *superseded in part by* 15 U.S.C. § 78t(e).

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3. This Court has defined the elements of a private securities fraud claim as: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance by the plaintiff on the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Amgen*, 133 S. Ct. at 1192.

Even in approving the rebuttable presumption of reliance in *Basic*, the Court reaffirmed the necessity of a plaintiff's proof of actual reliance: "We agree that reliance is an element of a Rule 10b-5 cause of action" that "provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." 485 U.S. at 243 (Blackmun, J., for a four-Justice majority). The majority in *Basic*, however, accepted the notion that a plaintiff could establish actual reliance "indirectly" where the security in question was traded in "an open and developed market," "based on the hypothesis" that "[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 price paid." *Id.* at 241, 244-45 (quoting lower court opinions) (internal quotation marks omitted).

The Court made it clear that this "hypothesis" of an indirect, market-based causal link between the alleged misrepresentation and the plaintiff's injury necessarily assumes that "[a]n investor who buys or sells stock at the price set by the market does so *in reliance on the integrity of that price*," meaning that "purchasers generally rely on the price of the stock *as a reflection of its value*." *Id.* at 244, 247 (emphases added) (internal quotation marks omitted). It is only if and where this underlying premise is true that the plaintiff's reliance on any public material misrepresentation affecting the market price of the security "may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247. *See id.* at 255 (White, J., dissenting in relevant part) ("At the bottom of the Court's conclusion that the fraud-on-the-market theory sustains a presumption of reliance is the assumption that individuals rely 'on the integrity of the market price' when buying or selling stock . . . .").

Moreover, to preserve the element of actual reliance, the Court further held that defendants must have the opportunity to rebut the presumption in particular cases with "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price." 485 U.S. at 248. As the Court stated, the presumption must give way if the defendant can show, among other things, (1) that the alleged misrepresentation did not in fact impact the trading price of the security, (2) that any impact the alleged misrepresentation may have had on the market price had dissipated by the time the plaintiff traded in the security; (3) that the security was not traded in an "efficient market" where it is fair to assume that all material public information was accurately reflected in the security's trading price; or (4) that an individual plaintiff did not, in fact, trade in reliance on the belief that the trading price accurately reflected the value of the security. *See id.* at 248-49.

If the Court's assumption that investors trade in reliance on the "integrity" of the market price does not hold; if the Court's belief in the perfect, friction-free price efficiency of any "open and developed" market for a security is unjustified; or if the defendant is not given a fair opportunity to rebut the presumption, such that it becomes effectively irrebuttable, then the essential element of actual reliance is negated. In that event, the implied cause of action for securities fraud is converted into "a scheme of investors' insurance" that is wholly beyond the aims of section 10(b) and Rule 10b-5. 485 U.S. at 252 (White, J., dissenting) (quoting *Shores v. Sklar*, 647 F.2d 462, 469 n.5 (5th Cir. 1981) (en banc)); *see id.* at 251 (White, J., dissenting) ("I agree with the Court that

if Rule 10b-5's reliance requirement is to be left with any content at all, the fraud-on-the-market presumption must be capable of being rebutted by a showing that a plaintiff did not 'rely' on the market price.").

As the following discussion shows, the key reliance-preserving premises on which the presumption necessarily rests are unsound, and this Court should no longer approve the presumption—at least not in its current form.

B. The presumption is based on an erroneous and effectively irrebuttable premise that investors rely on the integrity of market prices.

It is apparent that the majority in *Basic* made a blanket assumption that all rational investors who enter into securities transactions do so in the belief that the market price of a widely traded security accurately reflects the security's value, including all known material information about the issuer's business. *See* 485 U.S. at 246-47 ("It has been noted that 'it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity.'") (quoting *Schlanger v. Four-Phase Sys., Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)).

Justice White, writing for himself and Justice O'Connor in dissent, strenuously criticized this assumption on the ground that "'many investors purchase or sell stock because they believe the price *inaccurately* reflects the corporation's worth,'" and, indeed, "[i]f investors really believed that stock prices reflected a stock's 'value,' many sellers would never sell, and many buyers never buy." *Id.* at 255, 256 (White, J., dissenting) (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) (emphasis added by Justice White)). Justice White thought the majority's idea of a "just price" (*see* 485 U.S. at 246 (quoting legislative history)) was reminiscent of "the scholastics of medieval times." *Id.* at 255.

The *Basic* majority's assumption about investor conduct was wrong in 1988, and it is wrong today. Justice White was surely correct that many (if not most) investors buy or sell a security precisely because they believe the market price is *wrong*—buying when they assess the market has undervalued the stock and selling when the stock is overvalued in their estimation. So-called "value investing," for example, is a recognized investment strategy that involves systematically identifying underappreciated stocks to exploit their potential for long-term gain. This strategy is reportedly followed (with more than a little success) by Warren Buffett.[4]

By resting on the false fiction that rational investors always believe in the "integrity" of stock prices in an open and mature market, the majority's rationale for approving the presumption in *Basic* was, at its core, "incoherent and unsatisfying."[5] This fundamental flaw in *Basic*'s reasoning

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4. *See, e.g.*, Gus Lubin, *Warren Buffett Can't Believe More People Haven't Copied His Investing Strategy*, Bus. Insider, Sept. 14, 2012, *available at* http://www.businessinsider.com/warren-buffett-on-value-investing-2012-9.

5. Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market?: Reflections on* Amgen *and the Second Coming of* Halliburton, pp.15-16 (Georgetown Pub. Law & Legal Theory Research Paper No. 13-058, 2013), *available at* http://scholarship.law.georgetown.edu/facpub/1226.

is ample grounds for this Court to overrule the case in relevant part and disapprove the presumption of reliance. *See, e.g.*, *State Oil Co. v. Khan*, 522 U.S. 3, 20-21 (1997) (overruling prior antitrust case because earlier decision was based on faulty economic reasoning); *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 480, 484 (1989) (overruling prior case rejecting arbitration for certain securities law claims because it was based on outmoded "judicial hostility to arbitration").

Furthermore, when combined with the class action procedures of Rule 23 of the Federal Rules of Civil Procedure, *Basic*'s faulty assumption has become effectively irrebuttable, contrary to the intent of the majority in *Basic*. Given that most public companies with exchange-traded stock have numerous investors who trade in the stock during any particular period of time, plaintiffs' lawyers who file securities fraud class actions have little trouble finding lead plaintiffs who will attest that they bought or sold the stock in sincere reliance on the integrity of the trading price as an accurate measure of the stock's value. *See* James D. Cox and Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 Colum. L. Rev. 1587, 1603-04 (2006).

Once the plaintiff class is certified under Rule 23 and the lead plaintiffs stand in as class representatives for purposes of litigating the merits of the claim, the defendant has no further effective opportunity prior to a judgment on liability to challenge the blanket assumption that the absent members of the class traded in reliance on the integrity of the stock price. *See, e.g.*, *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, No. 02-C-5893, 2005 WL 3801463, at *3-4 (N.D. Ill. Apr. 18, 2005) (rejecting

post-certification discovery into individual reliance as irrelevant to issues of class-wide liability); *In re Qwest Commc'ns Int'l, Inc. Sec. Litig.*, 283 F.R.D. 623, 626 (D. Colo. 2005); *In re Lucent Techs. Inc. Sec. Litig.*, Civ. No. 00-621, 2002 WL 32818345, at *2 (D.N.J. May 9, 2002).[6] Thus, in the typical class action context, the presumption of reliance is conclusive, for all practical purposes, once the trial court determines that the security was traded in an "efficient market." Not surprisingly, as Professor Joseph Grundfest of Stanford Law School has shown, cases where *Basic*'s presumption of reliance is successfully rebutted notwithstanding a finding of market efficiency are "as rare as hens' teeth."[7]

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6. Courts have held that defendants may take discovery from absent class members post-class certification in certain circumstances, provided such discovery is necessary for trial of the class claims as a whole, rather than individual claims, and is not burdensome. *See, e.g.*, *Brennan v. Midwestern United Life Ins. Co.*, 450 F.2d 999, 1005-06 (7th Cir. 1971). While limited discovery into the individual circumstances of absent class members' purchases has been allowed where the plaintiff class is quite small, *see, e.g.*, *Easton & Co. v. Mut. Benefit Life Ins. Co.*, Civ. No. 91-4012, 1994 WL 248172 (D.N.J. May 18, 1994) (magistrate judge order permitting such discovery under limited conditions where plaintiff class included only 160 bond purchasers), most courts have not permitted it in cases, such as the typical securities fraud class action, involving large plaintiff classes. *See, e.g.*, *Lawrence E. Jaffe Pension Plan*, 2005 WL 3801463, at *3 (distinguishing *Easton & Co.* as inapposite where plaintiff class included hundreds of thousands of investors); *In re Lucent Techs. Inc.*, 2002 WL 32818345, at *2 (similarly distinguishing *Easton & Co.*).

7. Joseph A. Grundfest, *Damages and Reliance under Section 10(b) of the Exchange Act*, p.47 (Rock Ctr. for Corp. Governance Working Paper No. 150, 2013), 69 Bus. Law. (forthcoming Feb. 2014) (finding only five such instances as of August 2013), *available at* http://ssrn.com/abstract=2317537.

Because the assumption that plaintiffs rely on the integrity of market prices has proven to be essentially beyond challenge in the typical class action context, the presumption of reliance, as applied in the lower courts, has become the "scheme of . . . insurance" for some investors (at the expense of other innocent shareholders) that the Court in *Basic* disavowed. For this reason, too, the presumption should be abandoned.

C. At a minimum, the Court should modify the *Basic* presumption in light of developments in the economic understanding of markets.

The majority in *Basic* cited "[r]ecent empirical studies" on "efficient-capital-market theory" in support of the premise that "an impersonal, well-developed market" is highly efficient at quickly and accurately assimilating all publicly available information into the trading price of a security. *See* 485 U.S. at 246-47 & n.24. That premise does not hold up in light of more recent economic analysis of the price efficiency of capital markets. *See Amgen*, 133 S. Ct. at 1204 (Alito, J., concurring) (citing Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. 151, 160, 175-76 (2009) ("Langevoort, Basic *at Twenty*")); *id.* at 1209 n.4 (Thomas, J., dissenting). *See generally* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Nw. U. L. Rev. 135 (2002).

Economic scholarship since 1988 shows that the attributes of efficient markets are more complicated and more nuanced than the Court in *Basic* understood them to be. It is now more widely accepted that there is no perfect correlation between stock price and market

information, even in an "open and developed market." *See, e.g.*, Bradford Cornell & James C. Rutton, *Market Efficiency, Crashes, and Securities Litigation*, 81 Tul. L. Rev. 443, 466 (2006) ("Cornell & Rutton"); Langevoort, Basic *at Twenty*, *supra*, at 175-176. Congress evidently accepted this modern view of markets when it enacted, as part of the PSLRA, a limit on securities fraud damages in cases where the stock price "bounces back" from an initial drop following a corrective disclosure. *See* 15 U.S.C. § 78u-4(e). Commentators have pointed out that the PSLRA's limit on damages reflects a theory of capital markets inconsistent with *Basic*'s assumption that stock prices reflect all available information. *See* Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line*, 34 Pepp. L. Rev. 927, 969 n.260 (2007).

There is also less uniformity today among economists about how and when markets incorporate information into prices. The 2013 Nobel memorial prize in economics highlights the academic variation, since the prize was awarded to two economists (Eugene F. Fama of the University of Chicago and Robert J. Shiller of Yale University) with opposing views on efficient market theory. *See Methods for All Moments*, The Economist, Oct. 19, 2013, *available at* http://www.economist.com/news/finance-and-economics/21588059-nobel-prize-economics-reveals-how-little-we-know-about-behaviour; Binyamin Appelbaum, *Economists Clash on Theory, but Will Still Share the Nobel*, N.Y. Times, Oct. 14, 2013, at A1 ("[I]n jointly honoring the work of Mr. Fama and Mr. Shiller, the committee also highlighted how far the economics profession remains from agreeing on the answer to a basic and consequential question: How do markets work?").

Some courts and commentators associate the *Basic* presumption of reliance with the so-called "semi-strong" efficient market theory, which posits that stock prices reflect all historical information about the issuer's business and will quickly assimilate and reflect any new information that becomes publicly available to the market. *See In re DVI Sec. Litig.*, 639 F.3d 623, 631 (3d Cir. 2011); *Schleicher v. Wendt*, 618 F.3d 679, 684-85 (7th Cir. 2010) (Easterbrook, J.); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851, 852 n.7 (1992).[8] But the "intellectual dominance" of the semi-strong hypothesis has declined markedly since *Basic*, and economists now recognize significant variation in how, and how quickly, markets process information under different circumstances. *See* Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. Econ. Perspectives 59, 60 (2003).

Economists today acknowledge that if markets were perfectly price efficient, there would be no incentive for investors to engage in the kind of information discovery that drives market efficiency. *See id.* at 80. It is more common now to treat efficiency as existing along a continuum, *see* Cornell & Rutton, 81 Tul. L. Rev. at 448, such that efficiency can vary between short- and long-term perspectives, depending on the type of information at issue, *see* Malkiel, *supra*, at 61—be it basic versus technical information, *see* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J.

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8. The "weak" efficient-market theory posits that market prices will reflect only historical information, not the latest news, while the "strong" version of the theory would hold that market prices efficiently reflect all relevant information, both public and private. *See In re DVI Sec. Litig.*, 639 F.3d at 631 n.11; *Schleicher*, 618 F.3d at 685.

Corp. L. 635, 653-54 (2003), or positive versus negative information, *see* Robert J. Shiller, *From Efficient Markets to Behavioral Finance*, 17 J. Econ. Perspectives 83, 97-98 (2003) (noting that practical difficulties in shorting particular stocks at particular times can affect a market's ability to incorporate information).

Adhering to *Basic*'s example, however, lower courts continue to follow a simplistic binary approach to market efficiency, in which a market is either deemed price efficient as a matter of law or wholly "inefficient." *See* Langevoort, Basic *at Twenty*, *supra*, at 167, 174-75. Most courts look to the five factors identified in *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989), in deciding whether a market is "open and developed": (1) the average weekly trading volume of the security during the relevant period; (2) the number of security analysts following and reporting on the security; (3) the extent to which market makers traded the security; (4) the issuer's eligibility to file an SEC registration Form S-3 (generally limited to established public companies); and (5) evidence (such as by event studies) showing a cause-and-effect relationship between release of significant news about the issuer's business and changes in the security's price. *See id.* at 1286-87. *See also Krogman v. Sterritt*, 202 F.R.D. 467, 478 (N.D. Tex. 2011) (considering, in addition to the *Cammer* factors, the issuer's market capitalization and the size of the public float for the security).

All but one of these factors hang market efficiency entirely on the size of the issuer and the size and trading volume of the market for the security, and in practice, the *Cammer* analysis leads to the near automatic application of the *Basic* presumption, and thus the certification

of a plaintiff class (unless analysis of price impact is permitted), in virtually any securities fraud case where the security at issue traded in large volumes on an established exchange—true for the stock of most large companies. *See, e.g.*, *In re Merck & Co., Inc. Sec., Derivative & ERISA Litig.*, MDL No. 1658, 2013 WL 396117, at *11 (D.N.J. Jan. 30, 2013) (declining to consider challenge to market efficiency because defendant's stock trades on the New York Stock Exchange); *In re Moody's Corp. Sec. Litig.*, 274 F.R.D. 480, 489 n.3 (S.D.N.Y. 2011) (same); *Bovee v. Coopers & Lybrand*, 216 F.R.D. 596, 606-07 (S.D. Ohio 2003) (same). Accordingly, commentators have criticized the *Cammer* factors as a crude and inadequate approach to analyzing the price efficiency of securities markets. *See, e.g.*, William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 Emory L. J. 843, 864-65 (2005); David Tabak, Nat'l Econ. Res. Assocs. ("NERA"), *Do Courts Count* Cammer *Factors*?, p.1 (Aug. 2012) (finding that in 98 percent of cases, courts' purported "balancing" of *Cammer* factors produced the same results as simply counting the factors), *available at* http://www.nera.com/nera-files/PUB_Cammer_Factors_0812.pdf.[9]

9. Even the fifth *Cammer* factor (considering empirical evidence of correlation between news events and price changes for the security at issue) often leads to arbitrary line drawing. The court of appeals in *DVI Sec. Litig.*, for example, upheld a finding that a market was "efficient" for *Basic* purposes where event studies showed that the stock price moved within two days of the release of significant news about the company, but reaffirmed a prior holding that a market is "inefficient" if the price does not move within four days. 639 F.3d at 635. *See also In re Retek Inc. Sec. Litig.*, 236 F.R.D. 431, 436-37 (D. Minn. 2006) (certifying class notwithstanding lack of evidence on fifth *Cammer* factor because court believed "empirical evidence is not necessary to demonstrate market efficiency").

The legacy of *Basic*'s unquestioning acceptance of fraud-on-the-market theory based on the state of economic scholarship in 1988 is that plaintiffs in the great majority of securities fraud cases secure class certification as a matter of course. Even before this Court's decisions in *Amgen* and *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011), when lower courts at times permitted defendants to contest materiality or loss causation at the class certification stage, 75 percent of decided certification motions in securities litigation resulted in certification of a class under Rule 23. *See* Renzo Comolli, *et al.*, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2012 Full-Year Review*, p.20 (2013) (examining results of class certification motions in securities cases from 2000 to 2012), *available at* http://www.nera.com/nera-files/PUB_Year_End_Trends_2012_1113.pdf; *see also Schleicher*, 618 F.3d at 682 (describing class certification as "routine" in securities fraud cases when suitable class representatives come forward).

The present case gives this Court the opportunity to restore the element of actual reliance in private securities fraud litigation by overturning *Basic*'s unquestioning and outmoded approach to market efficiency. At a minimum, even if the Court were to retain the presumption of reliance in some circumstances, the Court should recognize the variation and complexities in economic scholarship since 1988 and require a more demanding test for application of the presumption to bring it into line with market realities. In doing so, the Court should make it clear to lower courts that a binary approach to market efficiency is inappropriate. Instead, lower courts should determine efficiency based on evidence about the

full context of the alleged misrepresentations at issue and the particulars of the market for the relevant security. Rather than simply ask whether the market for a security is "open and developed," courts should, if the presumption is retained, be required to determine that the market actually incorporated the relevant misrepresentations into price—the reason for looking to efficiency in the first place—before concluding that the presumption is applicable.

II. The Easy Certification of Class Claims under *Basic* Has Generated Excessive Costs for Businesses and Hampered Capital Markets.

The near certainty of class certification under the *Basic* presumption of reliance encourages insubstantial securities fraud claims that bear little relation to any real culpability and serve only to extract large settlements from insured businesses by the threat of class-wide damages. The excessive wave of securities fraud class action litigation fostered by *Basic* imposes enormous deadweight losses on U.S. businesses, innocent shareholders, and the economy generally, through higher costs of capital and insurance. At the same time, the easy certification of class claims for securities fraud does not effectively deter those who engage in fraudulent conduct or provide meaningful compensation for investors actually harmed by fraud.

This Court has frequently acknowledged the threat of abuse and unfair settlement pressures that often attend the class treatment of fraud claims. *See AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1752 (2011) (recognizing that consumer fraud class actions create

the risk of *in terrorem* settlement); *Stoneridge Inv. Partners*, 552 U.S. at 164 ("[E]xtensive discovery and the potential for uncertainty and disruption in a [securities fraud] lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies."). Private securities fraud litigation is particularly susceptible to abuse. The Court has noted that class action litigation under section 10(b) and Rule 10b-5 poses "a danger of vexatiousness different in degree and kind from that which accompanies litigation in general." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975).

Settlement is the only reasonable option for many securities fraud defendants. Virtually no securities fraud cases are tried to verdict, as nearly all that survive motions to dismiss are settled.[10] Indeed, studies have found that settlements often have more to do with the defendant's insurance limits than with the strength of plaintiffs' claims. *See Schleicher*, 618 F.3d at 686 (citing studies). Because all businesses with publicly traded securities must carry insurance against securities fraud claims, and because the insurers play a central role in the defense of such claims, defendants are put in a position where settlement is virtually inevitable following class certification.

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10. *See* Stanford Law School Securities Class Action Clearinghouse & Cornerstone Research, *Securities Class Action Filings: 2013 Mid-Year Assessment*, pp.15-17 (2013) (case resolution statistics showing that for cases filed in 2006, the most recent year for which all cases are completed, 43% of filed cases were dismissed and 57% settled), *available at* http://securities.stanford.edu/clearinghouse_research/2013_YIR/Cornerstone-Research-Securities-Class-Action-Filings-2013-MYA.pdf.

Plaintiffs' targeting of defendants likewise often has little to do with the merits. While the implied private right of action under section 10(b) and Rule 10b-5 is intended to provide a remedy for investors who suffer genuine injury from securities fraud, securities class actions are routinely filed in the wake of almost any negative announcement by a company that corresponds to a stock price decline. Statistics on class action securities fraud litigation from the Stanford Law School Securities Class Action Clearinghouse ("Stanford Clearinghouse") demonstrate that suits often target particular industry sectors, in many cases ensnaring a large portion of the publicly traded companies in a given industry.[11] For example, in 2010, new securities fraud class actions were filed against 5.4 percent of S&P 500 companies, but the figures were 15.4 percent for healthcare companies, 10.3 percent for financial companies, and 7.7 percent for energy companies. *Id.*[12] These lawsuits do not only target the largest companies; suits increasingly target companies with smaller market capitalizations, including companies that are not traded on the major exchanges. *See id.* at 14.

These suits impose a tremendous cost on American business. For example, according to the Stanford

11. *See* Stanford Clearinghouse & Cornerstone Research, *Securities Class Action Filings: 2013 Mid-Year Assessment*, p.8 (2013), *available at* http://securities.stanford.edu/clearinghouse_research/2013_YIR/Cornerstone-Research-Securities-Class-Action-Filings-2013-MYA.pdf.

12. Because securities fraud cases can take multiple years to resolve, the filing of a significant number of cases against an industry in one year can mire that industry in litigation for years to come.

Clearinghouse, securities fraud class actions led to $2.9 billion in settlements in 2012, with an average settlement of $54.7 million per case.[13] As they drag on, these cases generate significant litigation expenses as well, with a median time to settlement of 3.3 years and approximately 19 percent of cases taking more than 5 years. *Id.* at 6 (examining cases settled from 2007-2011). Defense costs in these cases have been estimated to range from 25 to 35 percent of the settlement value. *See* John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1546 (2006). Costs are borne not only by those companies sued but by public companies in general, as the higher costs of insurance spread the risks across companies that access capital markets, and these higher costs hamper the competitiveness of American public companies versus their rivals overseas. Ultimately, investors themselves pay the costs of securities fraud litigation through a lower return on their investments.

These costs come without corresponding benefits. The *Basic* approach to securities fraud lawsuits was originally designed to give investors protection from fraud beyond that provided at common law, *see Basic*, 485 U.S. at 244 n.22, and to deter fraud. Yet, class actions built on the fraud-on-the-market theory and the *Basic* presumption of reliance have not delivered either protection for investors or meaningful deterrence benefits. *See generally* William M. Bratton & Michael Wachter, *The Political Economy of*

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13. Stanford Clearinghouse & Cornerstone Research, *Securities Class Action Settlements: 2012 Review and Analysis*, p.3 (2013), *available at* http://securities.stanford.edu/Settlements/REVIEW_1995-2012/Settlements_Through_12_2012.pdf.

Fraud on the Market, 160 U. Pa. L. Rev. 69, 72-73 (2011) ("Bratton & Wachter"). Instead, these class actions have become a virtual entitlement to a payoff following almost any sudden decline in stock prices.

The *Basic* presumption of reliance has failed to benefit investors in part because of the circular nature of private securities fraud class actions. In the typical case, the putative class of investor plaintiffs purchased the defendant's stock during a period in which, the plaintiffs allege, the price was inflated due to the defendant company's misrepresentations. Thus, the class of purchasing shareholders seeks recovery from all current shareholders, whose equity interests in the defendant company are negatively affected by the company's cost of defending the litigation as well as by any resulting increase in the company's insurance premiums. The shareholders who (innocently) benefited from the alleged fraud by selling their shares during the period of inflated price are out of the scene, so any costs incurred by the company will impact the shareholders who are not only innocent but also could not have benefited from any fraud.[14] While individual executives are often named as

14. Class treatment of securities fraud claims can also raise serious due process issues because of differences among investors in the putative class. *See Broussard v. Meineke Disc. Muffler Shops, Inc.*, 155 F.3d 331, 338 (4th Cir. 1998) ("due process requires that named plaintiffs possess undivided loyalties to absent class members"); *see also* Timothy S. Bishop, *et al.*, 20th Annual Fed. Sec. Inst., *Defeating Class Certification in Securities Fraud Actions*, p.13 (2002), *available at* http://www.appellate.net/articles/tsb.pdf. Because recovery from a defendant corporation reduces the value of stock in the corporation, class members who still hold shares are in a different position from class members

defendants, they are sued almost exclusively for their insurance coverage,[15] the costs of which are spread across public companies in general.

As a result, any recovery the class obtains from the company is a transfer of wealth from one set of innocent shareholders to another, with significant litigation costs incurred in between and, of course, healthy payouts to the lawyers:

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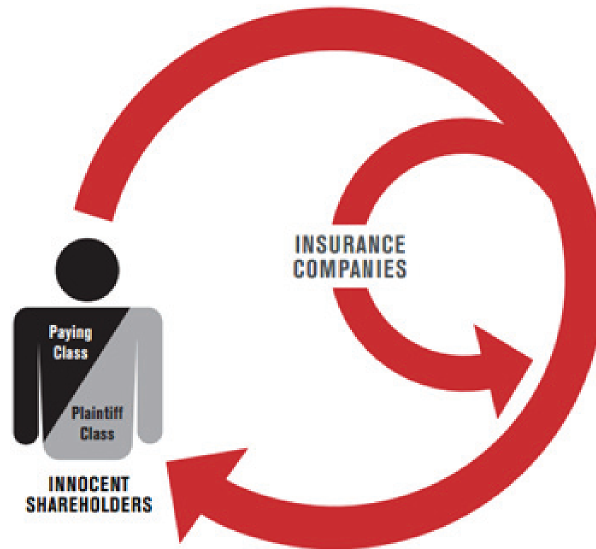
who sold shares and may have different interests in the outcome of the litigation. *See, e.g.*, *Ruggiero v. Am. Bioculture, Inc.*, 56 F.R.D. 93, 95 (S.D.N.Y. 1972) (concluding in derivative case that interests of current and former shareholders were in conflict). Similarly, where the nature of the misrepresentations or share price effects change during the class period, those who bought and sold at different times may be in conflict with respect to what facts they are trying to establish. *See, e.g.*, *In re Warner Commc'ns Sec. Litig.*, 618 F. Supp. 735, 744-45 (S.D.N.Y. 1985) (approving class settlement but noting difficulties posed by volatility in share price throughout the class period).

15. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639, 648 n.43 (1996) ("[I]n the average settlement, 68.2% comes from the insurer and 31.4% from the issuer, with only 0.4% coming from individual defendants.") (citing Frederick C. Dunbar, *et al.*, NERA, *Recent Trends III: What Explains Settlements in Shareholder Class Actions?*, p.v (1995)).

Securities Fraud Class Actions – A Circular System[16]



The system makes even less sense when it is understood that most investors rely on portfolios of securities. To the extent undiscovered fraud inflates a stock price, the average investor is just as likely to be a buyer of shares, and thus an unwitting victim of such fraud, as he is to be a seller and thus an unwitting beneficiary. *See* Bratton & Wachter, *supra*, at 94-95. Because investors often own stock in diversified portfolios, they gain about as much as they lose from undiscovered fraud. *See* Anjan V. Thakor, *The Economic Reality of Securities Class Action Litigation*, p.1 (U.S. Chamber Institute for Legal Reform research paper, 2005), *available at* http://www.nytimes.com/packages/pdf/business/27suit.pdf. Thanks to this

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16. Source: U.S. Chamber Institute for Legal Reform, *Securities Class Action Litigation: The Problem, Its Impact, and the Path to Reform*, p.16 (2008), *available at* www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213.

dynamic, only a narrow set of fortunate investors receives any corrective justice at all from the system of securities class actions. *See* Bratton & Wachter, *supra*, at 94-99.

III. Eliminating or Modifying the *Basic* Presumption Will Not Undermine Fraud Deterrence or Investor Compensation in Cases of Actual Fraud.

Even if "[r]equiring proof of individualized reliance from each member of [a] proposed plaintiff class effectively would" prevent some plaintiffs "from proceeding with a class action, since individual issues then would" predominate over "common ones," *Basic*, 485 U.S. at 242, securities fraud will still be deterred and investors who are harmed by fraud will still obtain compensation if *Basic*'s presumption of reliance is eliminated or substantially modified. The presumption and the class action industry it has spawned are not the essential keystone of fraud deterrence and compensation. Various potent mechanisms to accomplish these ends will remain unaffected.

First, the element of reliance required for private securities fraud claims does not apply to the SEC and the Department of Justice, and these federal enforcers will continue to police securities fraud with the mission of investor protection. The SEC, in particular, will retain its full arsenal of statutory causes of action and its prime responsibility for deterring and redressing securities fraud through enforcement actions that seek monetary penalties, including restitution for investors harmed by material misrepresentations. Government enforcement offers effective compensation for investors, as both the SEC and Justice Department can and do pursue restitution for investors harmed by fraud. *See* SEC, *FY 2014 Congressional Budget Justification*, p.33

(2013), *available at* http://www.sec.gov/about/reports/secfy14congbudgjust.pdf; U.S. Dep't of Justice, *What Is Restitution?*, http://www.justice.gov/usao/briefing_room/vw/returning_money.html (last visited Dec. 22, 2013).

Second, individual investors who can show reliance on misstatements will retain their ability to bring 10b-5 claims. Investors often have large enough claims that they have an economic incentive to sue, particularly given the option to consolidate such claims. Even when class actions are available, large investors, including pension funds and mutual funds, have frequently brought their own claims in opt-out groups and have obtained significant recoveries that have the same or greater deterrence potential as class actions. *See, e.g.*, Amir Rozen, *et al.*, Cornerstone Research, *Opt-Out Cases in Securities Class Action Settlements*, p.4 (2013) (highlighting major opt-out cases such as the AOL-Time Warner securities litigation, where over 100 individual plaintiffs obtained more than $764 million in settlement, and Qwest Communications securities litigation, in which settlements for individual investor claims exceeded the settlement for the class), *available at* http://www.cornerstone.com/Publications/Press-Releases/Securities-Report-Provides-Class-Action-Opt-Out-Statistics. Large institutional investors like pension funds are more prone to sue than ever, *see id.* at 2 n.6, and, because of the significant role large institutional investors play in capital markets, their suits carry great weight with issuers. If the *Basic* presumption goes away, such heavyweight plaintiffs are likely to play an even greater role in addressing alleged fraud.[17]

17. *See* Karen Freifeld, *Q&A: Stanley Bernstein on game changers in class action litigation*, Reuters Legal (Dec. 9, 2013) (quoting Stanley Bernstein, a leading plaintiffs' counsel who "represents state, city and county pension funds in securities

Similarly, overruling or modifying *Basic* will not prevent the securities plaintiffs' bar from pursuing class actions under section 11 or section 12 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*(a)(2). Unlike private claims for fraud in connection with open market transactions under section 10(b) and Rule 10b-5, claims may be brought under section 11 or 12 for false or misleading misrepresentations made in registration statements or prospectuses in connection with the offering of securities.[18] Plaintiffs bringing claims under section 11 or 12 do not ordinarily need to prove scienter or reliance, so *Basic*'s presumption is unnecessary for these claims. *See Herman & MacLean*, 459 U.S. at 382. These claims do not suffer from the circular payment problem that infects 10b-5 secondary trading claims, as investors will have purchased the securities at issue in the section 11 or 12 claims in connection with an offering, and so any recovery the plaintiffs obtain will be a refund from the issuer defendant of money received for the plaintiffs' shares and will thereby reduce the defendant's proceeds from the offering to what they would have been absent the alleged false statement.[19]

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cases," as confidently predicting, "Should *Halliburton* throw out the 'fraud-on-the-market' presumption, . . . the largest investors will have the means to sue for their losses and will likely recover even larger amounts than under the present system."), *available at* http://t.co/0nVDzelBiC.

18. Several courts of appeals have permitted section 11 claims by secondary purchasers who are able to "trace" the sales history of their shares from prior owners to prove the securities were purchased in the offering at issue. *See, e.g.*, *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 872 (5th Cir. 2003).

19. In contrast, the typical 10b-5 plaintiff will have purchased shares from another investor in the secondary market. Because that investor cannot be found, the plaintiff's money is gone, and

In sum, this Court should reaffirm the importance of the element of actual reliance in private securities fraud cases by eliminating or substantially modifying the *Basic* presumption. Doing so will not cause securities fraud to go undeterred or leave investors who are harmed by fraud without effective means to recover their losses.

CONCLUSION

For the foregoing reasons, *amici curiae* urge the Court to reverse the judgment of the court of appeals.

recovery will have to come indirectly from other innocent investors (or insurers or, in theory but not in practice, executives). In section 11 or 12 cases, the issuer defendant is returning to the plaintiff investor the money received by the issuer for the shares purchased by the investor.

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