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HALLIBURTON, BASIC, AND FRAUD ON THE MARKET:
THE NEED FOR A NEW PARADIGM

CHARLES W. MURDOCK*

I. INTRODUCTION

WHEN the Supreme Court recently handed down its decision in *Halliburton Co. v. Erica P. John Fund, Inc.* (“*Halliburton II*”),¹ the decision was not greeted with enthusiasm. For liberals, it was adding yet another hurdle to the class certification process.² On the other hand, conservatives had hoped that the Court would overturn its earlier decision in *Basic Inc. v. Levinson*,³ which had adopted the “fraud on the market” theory of reliance. Justice Thomas, in his concurring opinion, argued for just such a result.

Halliburton II is in some respects a strange opinion. Both the majority opinion and Justice Thomas’s concurring opinion, which was in effect a dissenting opinion, evidence both insight and tunnel vision. Justice Roberts preserved the opportunity to establish reliance in a class action but continued to focus on market efficiency, a questionable, troublesome, and, as applied, dubious concept. Justice Thomas correctly pointed out some of the flaws in the fraud on the market theory, but he would require individualized proof of reliance, thereby eliminating the class action as a remedy for misrepresentations by management of publicly traded corporations. While the *Basic* theory is flawed, there is another, more straightforward way to establish reliance by members of a class: namely, that investors rely, not on the integrity of market price, but rather on the integrity of the information that corporate management inserts into the market. Arguing for this approach is the purpose of this Article.

In evaluating Supreme Court jurisprudence in the securities area, it is essential to ask the following question: for whose benefit were the securities laws enacted? The Securities Exchange Act of 1934⁴ (“1934 Act”) early on provides that the purpose of the Act is “to insure the maintenance of fair and honest markets,”⁵ while section 10, pursuant to which Rule 10b-5 was promulgated, gives the Securities and Exchange Commission (SEC)

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1. 134 S. Ct. 2398 (2014).
2. The Court determined that defendants, prior to class certification, could rebut the presumption that the stock price reflected material misrepresentations by introducing evidence on lack of price impact. See *id.* at 2416–17.
3. 485 U.S. 224 (1988).
4. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (current version at 15 U.S.C. § 78 (2012)).
5. 15 U.S.C. § 78b.

authority to promulgate anti-fraud regulations “as necessary or appropriate in the public interest or for the protection of investors.”⁶

The Supreme Court itself has said that a “fundamental purpose [of the securities laws is] to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”⁷ The Court added that Congress intended securities laws enacted for the purpose of avoiding frauds to be construed “not technically and restrictively, but flexibly to effectuate its remedial purposes.”⁸

Contrariwise, the recent stance of the Supreme Court and other federal courts often is to protect corrupt management from innocent investors. Justice Thomas, in the conservative concurrence in *Halliburton II*, asserted that “[l]ogic, economic realities, and our subsequent jurisprudence” dictate that “*Basic* should be overruled.”⁹ But the Court’s prior jurisprudence in the Rule 10b-5 area is substantially flawed,¹⁰ and, contrary to Justice Thomas’s assertion, logic and economic reality demonstrate that the conservative jurisprudence would emasculate investor protection and provide a shield for unscrupulous management.

Protecting management at the expense of investors is getting the statutory scheme upside down. It would appear that the federal courts often are living in an alternate universe.¹¹ For example, the Fifth Circuit Court of Appeals believed that it had the authority under *Basic*, a decision which is universally recognized as favorable to plaintiffs, “to tighten the requirements for plaintiffs seeking a presumption of reliance”¹² in order to protect defendants from the “*in terrorem* power of certification.”¹³ It was the dissent in *Basic* that was worried about the *in terrorem* effect of class certification;¹⁴ the majority stated:

The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transac-

6. *Id.* § 78m(d)(1).

7. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

8. *Id.* at 195.

9. *Halliburton II*, 134 S. Ct. 2398, 2418 (2014) (Thomas, J., concurring).

10. See generally Charles W. Murdock, *Janus Capital Group, Inc. v. First Derivative Traders: The Culmination of the Supreme Court’s Evolution from Liberal to Reactionary in Rule 10b-5 Actions*, 91 DENV. U. L. REV. 369 (2014).

11. See generally Charles W. Murdock, *The Private Securities Litigation Reform Act and Particularity: Why Are Some Courts in an Alternate Universe?*, 45 LOY. U. CHI. L.J. 615 (2014).

12. *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 264–65 (5th Cir. 2007).

13. *Id.* at 267.

14. See *Basic Inc. v. Levinson*, 485 U.S. 224, 262 (1988) (White, J., dissenting) (“I suspect that all too often the majority’s rule will ‘lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.’” (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (en banc) (Friendly, J., concurring))).

tions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences.¹⁵

Federal courts often seem more concerned with protecting management from strike suits than in protecting investors from fraud.¹⁶ In many instances, either the courts' understanding of business is woeful or the opinions evidence a bias in favor of management.¹⁷ The Supreme Court could hardly be unaware of the extensive fraud by many corporations in the cases that have come before it. Recent Supreme Court decisions have dealt with channel stuffing and lying about whether a new product was being shipped,¹⁸ conspiring with a supplier to inflate earnings,¹⁹ misrepresenting that a product did not cause patients to lose their sense of smell when management was aware of injured users,²⁰ changing accounting methodology to inflate earnings,²¹ hiding wrongful conduct in connection with market timing,²² and asserting that an FDA meeting was not focused

15. *Id.* at 243–44 (majority opinion) (footnote omitted).

16. Justice Stevens, in his dissent in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 175–81 (2008), took the majority to task for its efforts to undercut the vitality of a private cause of action. In true conservative fashion, Justice Stevens looked at almost a century of precedent favoring the recognition of implied private causes of action. On the other hand, the conservative members of the Court have little respect for precedent. This is not conservative, but rather reactionary. Justice Scalia has said of Justice Thomas that Thomas “doesn’t believe in *stare decisis*, period.” See Kenneth Jost, *Justice Thomas’s Two Decades of Rejecting Precedent*, JOST ON JUSTICE (Oct. 31, 2011, 7:41 AM), <http://jostonjustice.blogspot.com/2011/10/thomass-two-decades-of-rejecting.html>. Justice Scalia himself is no fan of precedent: “*Stare decisis* is not an inexorable command or a mechanical formula of adherence to the latest decision.” Fed. Election Comm’n v. Wis. Right to Life, Inc., 551 U.S. 449, 500 (2007) (Scalia, J., concurring) (quoting *Payne v. Tennessee*, 501 U.S. 808, 828 (1991)) (internal quotation marks omitted). Nor is Justice Alito: “It is a necessary concomitant of the doctrine of *stare decisis* that a precedent is not always expanded to the limit of its logic.” *Hein v. Freedom from Religion Found., Inc.*, 551 U.S. 587, 615 (2007).

17. See Murdock, *supra* note 11, at 624–30 (discussing court’s characterization of plaintiff’s channel stuffing allegation—that K-Mart stores had fifty to one hundred weeks of battery inventory, and that Walmart had thirty to fifty weeks of battery inventory—as being conclusory and lacking particularity). Walmart in particular is known as a leader in just-in-time inventory control. See *id.* at 635–39 (discussing court’s characterization of plaintiff’s extensive allegations of budgets, forecasts, daily reports, monthly reports, and “Stop Ship” reports, which notified management of manufacturing problems and their impact on volume shipments, as boilerplate because other cases had also referenced internal reports as being basis to hold senior management liable).

18. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 315 (2007).

19. See *Stoneridge*, 552 U.S. at 153–54.

20. See *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1314 (2011).

21. See *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2181 (2011).

22. See *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2299–301 (2011).

upon the company's products when in fact such products were the focus of the meeting.²³

From the foregoing litany, it is inconceivable that the Supreme Court is not aware of the many circumstances in which ethically indifferent or corrupt management has misled the investing public. Yet, conservative members of the Court have either turned a blind eye to management fraud when issuing majority opinions²⁴ or, in dissents or concurrences, have advocated positions that would undercut investor protection in favor of insulating corporations and management from accountability.²⁵ There is considerable antipathy by the conservative members of the Court to a private civil remedy in the first place. Justice Thomas, in his concurrence in *Halliburton II*, began his opinion by asserting that “[t]he implied Rule 10b-5 private cause of action is ‘a relic of the heady days in which this Court assumed common-law powers to create causes of action.’”²⁶

However, former Justice Stevens has pointed out that these heady days persisted for 200 years: “Fashioning appropriate remedies for the violation of rules of law designed to protect a class of citizens was the routine business of judges.”²⁷ Moreover, highly regarded conservative Supreme Court Justices, such as Tom Clark²⁸ and John Harlan,²⁹ have recognized the important role that implied private causes of action play in the enforcement of the securities laws. Justice Clark, in recognizing a private cause of action under the proxy provisions of the 1934 Act, stated that “[w]hile this language [of the Act] makes no specific reference to a private right of action, among its chief purposes is ‘the protection of investors,’ which certainly implies the availability of judicial relief where necessary to achieve that result.”³⁰ Expanding upon this statement in a later decision,

23. See *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1203 (2013).

24. See, e.g., *Janus Capital Grp.*, 131 S. Ct. at 2299–301; *Stoneridge*, 552 U.S. at 148, 153–54.

25. See, e.g., *Halliburton II*, 134 S. Ct. 2398, 2417–18 (2014) (Thomas, J., concurring) (arguing that *Basic* should be overruled); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 329–30 (2007) (Scalia, J., concurring) (arguing that inference of scienter is established only when plaintiff's inference is “*more plausible* than the inference of innocence”).

26. *Halliburton II*, 134 S. Ct. at 2417 (Thomas, J., concurring) (quoting *Correctional Servs. Corp. v. Malesko*, 534 U.S. 61, 75 (2001) (Scalia, J., concurring)).

27. *Stoneridge*, 552 U.S. at 177 (Stevens, J., dissenting). Justice Stevens referenced *Marbury v. Madison*, 5 U.S. 137 (1803), and stated, “[w]hile it is true that in the early days state law was the source of most of those rules, throughout our history—until 1975—the same practice prevailed in federal courts with regard to federal statutes that left questions of remedy open for judges to answer.” *Id.*

28. See *Making the Case: Tom C. Clark (1899–1977)*, STATE BAR OF TEX., https://www.texasbar.com/AM/PrinterTemplate.cfm?Section=Making_the_Case&Template=/CM/HTMLDisplay.cfm&ContentID=14873 (last visited Jan. 9, 2015).

29. See John Fox, *Biographies of the Robes: John Marshall Harlan, II*, PBS, http://www.pbs.org/wnet/supremecourt/rights/robes_harlan.html (last visited Jan. 9, 2015).

30. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

Justice Harlan expressed his concern for the plight of small shareholders and declined to take a position that “would be bound to discourage such shareholders from the private enforcement of the proxy rules that ‘provides a necessary supplement to Commission action.’”³¹

While courts have been concerned about the *in terrorem* impact upon corporations and management of permitting class actions to proceed, there actually is a simple way for defendants to avoid such class action certification: let management tell the truth in the first place. Now, many will regard such a solution as not only simplistic but also naïve: cannot plaintiff lawyers always twist some statement to make it appear misleading? This concern is greatly overstated. The particularity demanded by the Private Securities Litigation Reform Act of 1995³² (PSLRA) dampens this concern. Under that Act, plaintiffs must allege the misleading statements with particularity,³³ without the benefit of discovery,³⁴ and with their attorneys exposed to sanctions if they do not conduct due diligence before filing suit.³⁵

On the other hand, under the present regime, there are many meritorious cases that are not certified as class actions, and thereby generally die, because of the unrealistic requirements—as developed by the federal courts—for class action certification. Much of this revolves around whether the securities are traded in an efficient market.³⁶ This determination, in turn, is required because of the “fantasy”—in the view of Justice Thomas—that investors rely upon the integrity of the market price.³⁷ This Article asserts that investors rely not upon price, but upon the total mix of information in the marketplace. If courts do not recognize this reality, they should at least recognize that what is necessary to establish reliance is not that the stock is traded in an efficient market, but rather that the misrepresentations in question had “price impact.”³⁸

31. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 382 (1970) (quoting *Borak*, 377 U.S. at 432).

32. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

33. *See* 15 U.S.C. § 78u-4 (2012).

34. *See id.*

35. *See id.*

36. For example, see the First Circuit’s confounding analysis of whether the market is efficient in *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1 (1st Cir. 2005), followed by an absurd opinion on remand, 453 F. Supp. 2d 260 (D. Mass. 2006). For an in-depth discussion of the opinions in the *PolyMedica* litigation, see *infra* notes 121–82 and accompanying text.

37. *See Halliburton II*, 134 S. Ct. 2398, 2417 (2014) (Thomas, J., concurring).

38. *See generally* Lucian A. Bebchuk & Allen Ferrell, *Rethinking Basic*, 69 BUS. LAW. 671 (2014) (arguing that what plaintiffs should need to establish reliance is not that there is efficient market, but rather that defendants’ representations have caused fraudulent distortion of market). For a further discussion of the arguments presented by Professors Bebchuk and Ferrell, see *infra* notes 243–52 and accompanying text.

Since the *Halliburton* decisions build upon *Basic*, *Basic* and its weaknesses will first be considered in Part II. The basic flaw in *Basic* was in adopting an approach to reliance that focused upon price, which is the result of information, rather than the information itself. It is information that investors rely upon, not price.

In Part III, the flaw in *Halliburton II* is analyzed, namely, the continued reliance upon the notion of an “efficient” market as a predicate for presuming reliance. Paradoxically, this Article uses the Court’s own hypothetical to illustrate that the success of plaintiffs’ litigation should depend, not upon market efficiency, but rather upon price impact. Part IV continues the analysis of why market efficiency, particularly as interpreted by the federal courts, is an outmoded and dubious concept. The Article uses the various opinions in the *PolyMedica* litigation to illustrate the unreasonable approach federal courts have taken in determining whether the market is efficient.

Part V looks at the internal inconsistencies between *Halliburton Co. v. Erica P. John Fund, Inc.* (“*Halliburton I*”),³⁹ *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*,⁴⁰ and *Halliburton II*, and argues that price impact, materiality, and loss causation are all interrelated concepts that should be determined, not at the certification stage, but in a trial on the merits. While this Article argues that all that should need to be proven at the certification stage is information distortion, not price distortion, it also considers an alternative approach using price distortion, as opposed to market efficiency, as a basis for presuming reliance.

The Article’s conclusion asserts that the normative position of federal courts should recognize that investors rely upon informational integrity, rather than price integrity, and that the interrelated, intensely factual issues of price impact, materiality, and loss causation should be reserved for trial.

II. THE BASIC FLAW: FOCUSING ON EFFECT RATHER THAN CAUSE

A. *The Problematic Focus on Price Integrity, Contrasted with the Underlying Policies*

*Basic Inc. v. Levinson*⁴¹ was an unusual case from a factual perspective. Normally, when investors claim that they were defrauded, the fraud arises from the company putting out positive information, thereby inducing the investors to buy, when the situation was actually negative. Consider *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*,⁴² where the CEO made a series of positive and specific statements that one key product (the Titan 5500) was experiencing continued growth and that a newer product (the Titan

39. 131 S. Ct. 2179 (2011).

40. 133 S. Ct. 1184 (2013).

41. 485 U.S. 224 (1988).

42. 437 F.3d 588 (7th Cir. 2006).

6500) was ready to ship. Contrariwise, demand for the 5500 was precipitously declining, and the 6500 was not yet being produced.⁴³ These misrepresentations induced investors to buy. On the other hand, in *Basic*, the company put out negative information, namely, that no merger negotiations were taking place, when the situation was actually positive. Consequently, the plaintiff investors sold shares.⁴⁴

In *Basic*, the Court considered two issues: whether the merger negotiations were material and whether the investors could establish reliance based upon the fraud on the market theory.⁴⁵ According to the Court, the fraud on the market theory, “[s]uccinctly put,” is as follows:

The 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 Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements The causal connection between the defendants’ fraud and the plaintiffs’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.⁴⁶

When the majority in *Basic* adopted the fraud on the market theory, the Court stated that, in accepting the presumption of reliance, “we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.”⁴⁷ The Court also stated that, by 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.”⁴⁸

The Court, while recognizing that “reliance is an element of a Rule 10b-5 cause of action” and that reliance “provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury,” pointed out that there is “more than one way to demonstrate the causal connection.”⁴⁹ It acknowledged that *Affiliated Ute Citizens of Utah v. United States*⁵⁰ “dispensed with a requirement of positive proof of reliance, where a duty to disclose material information had been breached, concluding that the necessary nexus between the plaintiffs’ injury and the defendant’s

43. *Id.* at 593.

44. *Basic*, 485 U.S. at 227–28.

45. *Id.* at 226.

46. *Id.* at 241–42 (alterations in original) (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3d Cir. 1986)) (internal quotation marks omitted).

47. *Id.* at 246 n.24.

48. *Id.* at 248 n.28.

49. *Id.* at 243.

50. 406 U.S. 128 (1972).

wrongful conduct had been established [by the materiality of the omitted information].”⁵¹

In *Basic*, the Court should simply have built upon its analysis from *Affiliated Ute Citizens*. In this latter case, the Court stated that where the facts “involv[ed] primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.”⁵² Every misrepresentation also includes a failure to disclose.

For example, again focusing on *Tellabs*, management stated that the Titan 5500 was experiencing continued growth and that the Titan 6500 was ready to ship. These were the misrepresentations. But management also *failed to disclose* that demand for the 5500 was precipitously declining and that the 6500 was not yet ready to ship. These were material facts, and the failure to disclose these material facts was fraudulent. Courts today often fail to recognize that the antifraud provision embodied in Rule 10b-5 forbids not only misrepresentations (lies), but also failures to disclose facts to ensure that facts stated are not misleading (half-truths).

The *Basic* Court clearly recognized that there needed to be a different approach with regard to reliance in transactions over “modern securities markets, literally involving millions of shares changing hands daily,”⁵³ as contrasted with face-to-face transactions. In this regard, the Court quoted the Ninth Circuit’s decision in *Blackie v. Barrack*,⁵⁴ to the effect that the “causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock.”⁵⁵ The Court in effect recognized that requiring proof of individualized reliance would effectively destroy the class action as a vehicle to remedy securities fraud.

The *Basic* Court also cited *Blackie* in support of its assertion that the market informs the investor by impounding information into the value of the stock. There is language in *Blackie* to support that position: “Nevertheless, [the investor] relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price whether he is aware of it or not”⁵⁶ But

51. *Basic*, 485 U.S. at 243 (citing *Affiliated Ute Citizens*, 406 U.S. at 153–54).

52. *Affiliated Ute Citizens*, 406 U.S. at 153–54.

53. *Basic*, 485 U.S. at 243. In point of fact, today billions of shares, not millions of shares, change hands daily. See *Earnings Season Anxiety Sends Shares Lower*, N.Y. TIMES (July 7, 2014), <http://www.nytimes.com/2014/07/08/business/daily-stock-market-activity.html> (noting that on New York Stock Exchange, 3.2 billion shares change hands in average trading day).

54. 524 F.2d 891 (9th Cir. 1975).

55. *Basic*, 485 U.S. at 245 (quoting *Blackie*, 524 F.2d at 908) (internal quotation marks omitted).

56. *Blackie*, 524 F.2d at 907.

both before and after the above quoted language, the *Blackie* court used the *Affiliated Ute Citizens* approach to causation. The court first stated: “We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance.”⁵⁷ Later, the *Blackie* court stated:

Here, the requirement [the burden of individualized reliance] is redundant[:] the same causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock. Under those circumstances we think it appropriate to eliminate the burden [of individualized reliance].⁵⁸

Consequently, the *Basic* Court could have determined commonality under the *Affiliated Ute Citizens* approach by determining that investors rely upon the materiality of the misdisclosed facts. When management speaks, investors are entitled to rely on the truthfulness of the representations. When those representations are material and false, the class action remedy should be appropriate.

When the Court in *Basic* spoke of “integrity” in the market, it was referring to the integrity of information, rather than of the stock price: “Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor’s reliance on the integrity of those markets”⁵⁹ While the legislative history upon which the Court relied also referred to market price, the key phrase in the cited reports is that “the hiding and secreting of important information obstructs the operation of the markets as indices of real value.”⁶⁰ As the Court observed, “[w]ho would knowingly roll the dice in a crooked crap game?”⁶¹

From a policy standpoint, what does the foregoing reflect? The Court was clearly positively inclined toward the use of the class action as a vehicle to remedy securities fraud in the public markets when it adopted the fraud on the market theory. Contrariwise, the dissent thought that the majority opinion was a bit of a reach.⁶² The Court also recognized the importance

57. *Id.* at 906.

58. *Id.* at 908 (footnote omitted).

59. *Basic*, 485 U.S. at 246.

60. *Id.* (quoting H.R. REP. NO. 1383, at 11 (1934)) (internal quotation marks omitted).

61. *Id.* at 247 (quoting *Schlanger v. Four-Phase Sys. Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)) (internal quotation marks omitted).

62. *See id.* at 250–53 (White, J., concurring in part and dissenting in part). The dissent stated, “[y]et today, the Court embraces this theory with the sweeping confidence usually reserved for more mature legal doctrines.” *Id.* at 250–51. “But with no staff economists, no experts schooled in the ‘efficient-capital-market hypothesis,’ no ability to test the validity of empirical market studies, we are not well

of accurate information to inform the market. Unfortunately, the Court got the cart before the horse. What investors rely upon is the integrity of the information in the market. The information then impacts the price of the shares. But the information is the cause, and the price is the effect. In focusing upon price, the fraud on the market theory is subject to the criticism that investors do not believe that the stock price is “true”: investors buying stock believe that the price is too low, whereas investors selling stock believe that the price is too high.

Justice White, writing for the dissenters, challenged the assertion from the cases relied upon by the majority that investors “rely on the price of a stock as a reflection of its value.”⁶³ According to the dissent, “many investors purchase or sell stock because they believe the price *inaccurately* reflects the corporation’s worth.”⁶⁴ Moreover, according to the dissent, “[i]f investors really believed that stock prices reflected a stock’s ‘value,’ many sellers would never sell, and many buyers never buy (given the time and cost associated with executing a stock transaction).”⁶⁵ It is hard to quibble with the foregoing assertions since, if you asked a buyer why she purchased, she might well respond “because the stock was undervalued;” whereas, if you asked a seller of the same stock why he sold, he might well respond that “the stock was overvalued.”⁶⁶

However, the *Basic* dissent did recognize that the congressional policy reflected in the securities laws called for “widespread public disclosure and distribution to investors of material information concerning securities.”⁶⁷ This policy “is expressed in the numerous and varied disclosure requirements found in the federal securities law scheme.”⁶⁸ In addition to the affirmative disclosure obligations under the securities laws, Congress also

equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.” *Id.* at 253.

63. *Id.* at 255 (quoting *id.* at 244 (majority opinion); *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986)) (internal quotation marks omitted).

64. *Id.* at 256 (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)) (internal quotation marks omitted).

65. *Id.*

66. For example, consider Amazon.com. Its price range for 2013 was from \$257 to \$398. One institutional investor sold its stake in Amazon last year. See Deepa Seetharaman, *Analysis—Amazon’s Far-Reaching Ambitions, Lack of Profits, Unnerve Investors*, REUTERS (July 27, 2014, 8:30 AM), <http://in.reuters.com/article/2014/07/27/amazon-com-ambitions-idINKBN0FW01Y20140727>. Obviously, someone on the other side bought, and the price of Amazon did rise to a high of \$408 in 2014, before slumping to \$320. One analyst has now downgraded Amazon. See *id.* Yet, Forbes is touting Amazon as a rare buying opportunity. See Gene Marcial, *Why Scorned Amazon.com Is Now a Rare Opportunistic Buy*, FORBES (July 29, 2014, 6:59 PM), <http://www.forbes.com/sites/genemarcial/2014/07/29/why-scorned-amazon-com-is-now-a-rare-opportunistic-buy>.

67. *Basic*, 485 U.S. at 258 (White, J., concurring in part and dissenting in part).

68. *Id.* at 258–59 (citing 15 U.S.C. §§ 78m, 78o(d)).

enacted a catchall anti-fraud prohibition, pursuant to which Rule 10b-5 was promulgated.

B. *Upon What Do Investors Actually Rely?*

If investors do not rely upon price, then upon what do they actually rely? As Justice White recognized, Congress has created an elaborate system of disclosure in order that investors be informed. Are not investors entitled to rely on the presumption that corporations and their management comply with the securities laws and make honest, accurate, and truthful disclosures? When people buy drugs, are they not entitled to rely on the fact that the drugs meet FDA requirements? When they purchase meat, are they not entitled to rely on the fact that the meat meets U.S. Department of Agriculture labeling standards? As noted earlier, “[w]ho would knowingly roll the dice in a crooked crap game?”⁶⁹ Congress clearly was concerned with “fair and honest markets,”⁷⁰ and with the “protection of investors.”⁷¹

Unfortunately, the Rehnquist and Roberts Courts have become not just conservative, but reactionary in their approach to enforcement of the securities laws.⁷² According to the dissent in *Basic*, “[i]nvestors act on inevitably incomplete or inaccurate information, [consequently] there are always winners and losers; but those who have ‘lost’ have not necessarily been defrauded.”⁷³ This cavalier approach to disclosure has had untoward consequences. The *Dirks v. SEC*⁷⁴ decision, which was the source of this quote, was a disaster, precipitating a dramatic increase in insider trading.⁷⁵

It is true that, in the securities world, there are winners and losers. Supposedly, the market reflects the present worth of a company’s stream of income out into the future. Some people are more adroit than others at analyzing the business plan of the company and the probability and magnitude of its stream of income. Thus, there are winners and losers. In

69. *Id.* at 247 (majority opinion) (quoting *Schlanger v. Four-Phase Sys. Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)) (internal quotation marks omitted).

70. 15 U.S.C. § 78b (2012).

71. *Id.* § 78l.

72. See generally Murdock, *supra* note 10.

73. *Basic*, 485 U.S. at 256 (White, J., concurring in part and dissenting in part) (second alteration in original) (quoting *Dirks v. SEC*, 463 U.S. 646, 667 n.27 (1983)) (internal quotation marks omitted).

74. 463 U.S. 646 (1983).

75. See H.R. REP. NO. 98-355, at 5 (1984) [hereinafter 1984 ITSA Report], reprinted in 1984 U.S.C.C.A.N. 2274, 2278 (“The current commission has made the prosecution of insider trading a priority, and has brought more such cases during the past four years than in all previous years combined.”); see also JAMES B. STEWART, DEN OF THIEVES (1992). *Dirks* is discussed at length in Murdock, *supra* note 10, at 378 n.50. The *Dirks* majority determined that a tippee was not liable for his insider trading unless the tipper had sinned—breached a common-law fiduciary duty—and that the tipper did not sin unless he received a pecuniary or a reputational benefit. See *Dirks*, 463 U.S. at 653–64.

addition, the price of a company's stock may be affected by unexpected and unanticipated events, such as a typhoon or tsunami affecting the available supply of materials that the company needs,⁷⁶ or a financial meltdown caused by a real estate bubble.⁷⁷ Or, a company's management may turn out to be incompetent.⁷⁸ These are all risks to which all investors are subject. But investors should not expect to bear the risk of securities fraud, which is why the securities laws were enacted to prevent it.

Thus, investors do rely upon the integrity of the information in the securities markets about a company's operations. When management misrepresents the company's operations and potential earnings, and investors buy at an inflated price, they should be able to bring a class action lawsuit to recover the difference between the amount they paid—which was inflated by management's misrepresentations—and the value at the time of purchase of the securities—which often may be calculated by reference to the drop in price when the true state of facts becomes public.

Consider once again the Tellabs situation. In 2000, Tellabs was a highflying tech company⁷⁹ with a major product, the Titan 5500, and an upgraded version, the Titan 6500, which was supposedly ready to ship. The stock was a growth stock, reaching a high of \$67 per share and selling at almost forty times earnings.⁸⁰ To maintain such a price, continued growth was essential.⁸¹

76. See, e.g., Tim Mojonnier, *Reducing Risk in the Automotive Supply Chain*, BUS. THEORY: BUS. BEST PRACTICES, <http://businesstheory.com/reducing-risk-automotive-supply-chain-2/> (last visited Jan. 11, 2015) (discussing complexity of automotive supply chain and how disruptions in production can result from shortage of even one part); see also Linda Conrad, *Japan One Year Later: The Long View on Tech Supply Chains*, FORBES (Mar. 13, 2012, 8:09 PM), <http://www.forbes.com/sites/ci-ocentral/2012/03/13/japan-one-year-later-the-long-view-on-tech-supply-chains/> (describing how shortage in supply of critical parts in automotive industry after earthquake and ensuing tsunami in Japan halted production for suppliers and subcontractors).

77. After the financial meltdown, real estate lending dried up, thereby adversely affecting many businesses.

78. Consider the bailout of General Motors resulting from decades of mismanagement; also consider the necessity to bail out major banks in the United States as a result of their improvident investing in toxic securities that led to the financial meltdown. More recently, after the London Whale debacle, in which J.P. Morgan lost about \$6 billion, the stock of J.P. Morgan dropped as much as 24% in a month.

79. See Anna Marie Kukec, *Naperville's Tellabs to Be Acquired for \$891 Million*, DAILY HERALD (Oct. 22, 2013, 7:36 AM), <http://www.dailyherald.com/article/20131021/business/710219902/>.

80. Earnings-per-share in 2000 were \$1.75. See Steve Daniels, *Annual Meetings: Tellabs, Minuteman, Fortune Brands, FMC, Exelon*, CRAIN'S CHI. BUS. (Apr. 28, 2001), <http://www.chicagobusiness.com/article/20010428/ISSUE01/100016335/annual-meetings-tellabs-minuteman-fortune-brands-fmc-exelon?template=printart>. The stock also reached a high of \$67. See *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 593 (7th Cir. 2006). Thus, the price-earnings ratio was almost forty.

81. When stock sells at a high price/earnings ratio, the value of the stock is heavily dependent upon the anticipated growth rate:

$$CR = DR - G$$

From December 2000 through April 2001, the CEO made, or caused to be made, a series of positive statements about the company that were designed to assure investors that the existing growth would continue. On December 11, 2000, a press release was issued to the effect that the 5500 was experiencing continuing growth and that the 6500 was now available.⁸² On January 23, 2001, there was another press release and an investor conference call in which “robust growth” was touted and the fact that “customers are buying more and more Tellabs equipment” was asserted.⁸³ On February 14, 2001, a letter was sent to Tellabs’ shareholders toting “robust growth,” asserting that sales of the 5500 had soared 56% in 2000, and stating that customers were embracing the 6500.⁸⁴ The accompanying annual report stated that the 5500 was going strong. In March, there was another investor telephone call at which it was stated that the 5500 was maintaining its growth rate⁸⁵ and that demand for the 6500 continued to grow.⁸⁶

In March, the first quarter revenue projection was reduced from a range of \$865–\$890 million to \$830–\$865 million.⁸⁷ On April 6, the first quarter revenue projection was reduced to \$772 million, and the price of the stock dropped to about \$30 a share.⁸⁸ It gradually moved up to \$38 per share, but, on June 19, 2001, Tellabs announced a substantial reduction in its second quarter projections—from \$780–\$820 million to only \$500 million—and, at another investor conference call, the CEO announced that the reduction “was almost entirely because of an enormous reduction in TITAN 5500 sales;” the price plummeted to about \$16 per share.⁸⁹ Tellabs had been engaged in channel stuffing,⁹⁰ and the channel stuffing was so extensive that, “[a]ccording to the plaintiffs’ confidential sources, Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns.”⁹¹ Tellabs manage-

Therefore, the larger the growth rate, the lower the capitalization rate. The capitalization rate is inversely proportional to the price-earnings multiple. Thus, the larger the growth rate, the higher the price-earnings multiple. Since a rudimentary approach to the value of a company is earnings times the price-earnings multiple, a decrease in earnings (and, consequently, growth) is a double whammy: it reduces the earnings, and the reduced earnings lower growth and thereby increase the capitalization rate, consequently reducing the price-earnings ratio.

82. *Tellabs*, 437 F.3d at 592.

83. *Id.*

84. *Id.*

85. *Id.* at 592–93.

86. *Id.* at 592.

87. *Id.*

88. *Id.* at 593.

89. *Id.*

90. The practice of channel stuffing, and its impact upon earnings and stock price, is discussed extensively in Murdock, *supra* note 11, at 625–32.

91. *Tellabs*, 437 F.3d at 598.

ment clearly knew that sales of the 5500 were in the process of dropping dramatically.⁹²

Justice Thomas, in his concurring opinion in *Halliburton II*, asserted that courts should employ “logic” and observe “economic realities.”⁹³ Then let us look at the logic and economic realities of the Tellabs situation. First of all, the information in the marketplace in the first quarter of 2001 was that Tellabs was continuing as a high-tech growth company. Someone buying stock in Tellabs would have that view of the company, a view that management sought to reinforce by its comments from December 2000 to March 2001.

That is the factual milieu upon which anyone purchasing Tellabs’ stock would operate. That is the factual milieu which would determine the price of the Tellabs stock. Investors⁹⁴ universally rely upon the business plan of the company and the cash flow generated by its operations pursuant to that business plan; the stock price then follows. Information about a company’s business plan and the results of its operations are disclosed to the market through the securities laws’ mandatory disclosure system and management’s discussions and releases complementing this disclosure system. Thus, investors rely upon the total mix of information in the marketplace. This mix of information presumptively is the same for all investors. Some investors may bring more skilled analysis to this information than other investors. But the mix of information upon which they are operating is the same, thus the reliance element in Rule 10b-5 is one that is common to all investors.

Some investors may have been directly aware of some of this information, for example, those who sat in on the investor conference call. Others may have been aware of this mix of information indirectly, through re-

92. The Seventh Circuit described the situation as follows:

By January 2001, the complaint asserts, demand for Tellabs’s “best seller”—the TITAN 5500—was drying up. Verizon, Tellabs’s largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001. Customers in Latin America and Central America were no longer buying the product. By late 2000, according to a couple of the confidential sources, Tellabs had excess TITAN 5500s on hand because of the lack of demand. One confidential source informed the plaintiffs that Tellabs paid Probe Research, an outside company, \$100,000 to forecast demand for the TITAN 5500. Completed “in or about early 2001,” the report showed that the market need for the TITAN 5500 was evaporating. Based on this research, Tellabs’s marketing strategy department distributed an internal memorandum that concluded that revenue from the TITAN 5500 would decline by about \$400 million.

Id. at 597.

93. *Halliburton II*, 134 S. Ct. 2398, 2418 (2014) (Thomas, J., concurring).

94. It is important to draw a distinction between investors and traders. Traders, particularly high-speed traders, make their money on market volatility. Thus, they are only indirectly concerned with the company’s business plan and operations. *See generally* MICHAEL LEWIS, *FLASH BOYS* (2014); SCOTT PATTERSON, *DARK POOLS* (2013).

ports in the media or recommendations of their stockbrokers. But all are operating on the same mix of information. If we were to require individual reliance, some institutional investors who were following Tellabs stock could bring suit directly and might have a sufficient economic stake to bear the risk of litigation.

But no small investor would have a sufficient economic stake to bring an individual cause of action. I personally bought 1000 shares of Tellabs stock around this time. But even if I were to lose \$30 a share, from the standpoint of time, it would not be worth it to me to file suit on my own behalf. A non-attorney investor is in an even worse place. She must engage a lawyer sufficiently sophisticated in securities litigation to represent her at \$300 to \$400 per hour or even higher. The attorney must conduct a substantial due diligence investigation prior to bringing suit or be subject to sanctions pursuant to the PSLRA.⁹⁵ The complaint must be drafted with great detail (particularity) pursuant to the PSLRA, in order to defeat a motion to dismiss, and there is no discovery prior to the hearing on the motion to dismiss. Thus, an individual investor could expect the need to front a substantial amount of money to bring suit, which could end up exceeding any possible recovery. And no attorney would take such a suit on a contingency basis. There simply is not a sufficient economic stake to warrant the time, cost, and risk of litigation. Thus, were the courts to rule out class action status, the net result would be to leave the small investor without a remedy. Should the securities laws be premised on the basis that only some institutional investors are entitled to the protection of the law?

Consequently, *Basic* appropriately recognized that, in these situations, reliance must be based on that which provides commonality to all investors. The error in *Basic* was in adopting a doctrine based on an economic theory that an individual investor could not beat the market.⁹⁶ This transferred the reliance element from a focus on the information to a focus on the price of the stock that flows from the information. Federal courts should leave economic theory to economists and instead deal with that with which the federal courts have dealt for decades: the disclosure obligations of a company and the fraudulent misrepresentations by those in control of a company that are aimed at defrauding the market in general. Therefore, courts should recognize that all investors rely upon the total mix of information in the market, most of which—practically all the misleading information—is introduced to the market by corporate management.

95. See 15 U.S.C. § 78u-4 (2012).

96. See *In re PolyMedica Corp. Sec. Lit.*, 432 F.3d 1, 8 (1st Cir. 2005) (“The efficient market hypothesis began as an academic attempt to answer the following question: Can an ordinary investor beat the stock market, that is, can such an investor make trading profits on the basis of new information? In an efficient market, the answer is ‘no,’ because the information that would have given the investor a competitive edge and allowed the investor to ‘beat’ the market is already reflected in the market price.” (citing Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 639 (2003))).

As a caveat to this approach, it should be recognized that a particular statute, section 18 of the 1934 Act,⁹⁷ provides a cause of action for a misleading statement in any document filed with the SEC. With respect to this cause of action, courts have held that individualized reliance must be alleged and proven.⁹⁸ Thus, supposedly by analogy, since the mix of information in the marketplace includes documents filed with the SEC, it could be argued that individualized reliance, and not a presumption of common reliance, is necessary when dealing with misleading corporate filings.

However, two factors militate against importing the section 18 approach to reliance into a Rule 10b-5 class action case. First of all, the mix of information in the marketplace includes not just documents filed with the SEC but also much additional material. As illustrated by the previous discussion with respect to Tellabs, misleading information produced by corporate management may be promulgated through press releases, letters to shareholders, or investor conference calls. Thus, a cause of action under Rule 10b-5 conceivably could rely exclusively upon statements made outside of documentation filed with the SEC.

More importantly, even if some of the misleading statements are included in documents filed with the SEC, a cause of action under Rule 10b-5 differs substantially from a cause of action under section 18. Under section 18, courts have held that plaintiffs need not allege scienter,⁹⁹ whereas under Rule 10b-5, scienter must be pleaded with particularity.¹⁰⁰

III. THE *HALLIBURTON* FLAW: RETAINING THE FOCUS ON MARKET EFFICIENCY

A. *The Halliburton II Decision*

*Halliburton II*¹⁰¹ differs markedly from *Halliburton I*.¹⁰² The *Halliburton I* decision was short, was adopted unanimously, and focused upon only one issue: whether plaintiffs must establish loss causation at the certification stage.¹⁰³ The *Halliburton II* decision was lengthy, produced various

97. 15 U.S.C. § 78r.

98. See, e.g., *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 283 (3d Cir. 2006) (“SSF Plaintiffs concede that to state their claim under Section 18, they were required to plead actual, as opposed to presumed, reliance upon a false or misleading statement.”); *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1063 (9th Cir. 2000) (“[C]ourts have required a purchaser’s actual reliance on the fraudulent statement under § 18(a), as opposed to the constructive reliance, or fraud-on-the-market, theory available under § 10(b).”); see also Brief on Behalf of Appellants at 44, *In re Suprema Specialties.*, 438 F. 3d 256 (No. 04-3755), 2004 WL 5327687 (citing *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968)).

99. See, e.g., *In re Suprema Specialties*, 438 F.3d at 283 (“A Section 18 plaintiff, however, bears no burden of proving that the defendant acted with scienter or any particular state of mind.”).

100. See 15 U.S.C. § 78u-4(b)(2).

101. 134 S. Ct. 2398 (2014).

102. 131 S. Ct. 2179 (2011).

103. The Court determined that plaintiffs need not. See *id.* at 2184–87.

opinions, though only one judgment, and dealt with three issues: (i) whether *Basic* should be overruled, (ii) whether plaintiffs should be required to establish price impact at the certification stage, and (iii) whether defendants should have the opportunity to establish lack of price impact at the certification stage.¹⁰⁴

With respect to the first issue, the Court in *Halliburton II* found no policy reason to overrule *Basic*. However, the Court did engage in some convoluted analysis to justify the “reliance on price” aspect of *Basic* and, unfortunately, retained “market efficiency” as one of the four prerequisites for invoking the presumption of reliance.¹⁰⁵ The other three prerequisites are publicity, materiality, and market timing.¹⁰⁶ Plaintiffs have the burden of proving these prerequisites, and, with the exception of materiality,¹⁰⁷ they must be satisfied before class certification.¹⁰⁸ As will be addressed below, the Court’s own logic supports the argument that what plaintiffs must establish is not market efficiency, but rather price impact.¹⁰⁹

The Court also rejected Halliburton’s argument that plaintiffs should be required to prove that “defendant’s misrepresentation actually affected the stock price—so-called ‘price impact’—in order to invoke the *Basic* presumption.”¹¹⁰ According to the Court:

What is called the *Basic* presumption actually incorporates two constituent presumptions: First, if a plaintiff shows that the defendant’s misrepresentation was public and material and that the stock traded in a generally efficient market, he is entitled to a presumption that the misrepresentation affected the stock price. Second, if the plaintiff also shows that he purchased the stock at the market price during the relevant period, he is entitled to a further presumption that he purchased the stock in reliance on the defendant’s misrepresentation.¹¹¹

According to the Court, “[b]y requiring plaintiffs to prove price impact directly, Halliburton’s proposal would take away the first constituent presumption.”¹¹² The Court concluded that “[f]or the same reasons we declined to completely jettison the *Basic* presumption, we decline to effectively jettison half of it by revising the prerequisites for invoking it.”¹¹³

104. See *Halliburton II*, 134 S. Ct. at 2405.

105. See *id.* at 2416, 2424.

106. See *id.* at 2412.

107. In *Amgen*, discussed *infra* at notes 222–31 and accompanying text, the Court, in a conflictual opinion, determined that plaintiffs need not establish materiality at the certification stage.

108. See *Halliburton II*, 134 S. Ct. at 2412.

109. See *infra* notes 110–14 and accompanying text.

110. *Halliburton II*, 134 S. Ct. at 2413

111. *Id.* at 2414.

112. *Id.*

113. *Id.*

What the Court did determine was that the defendant could introduce evidence to establish a lack of price impact in the particular case so as to rebut the presumption of reliance. The Court held that “defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.”¹¹⁴

This is basically gobbledygook. The Court acts as though it is doing plaintiffs a favor by rejecting the requirement for plaintiffs to show “price impact” specifically, but the Court retains the requirement to show that the market was efficient—a requirement which necessitates plaintiffs establishing price impact generally, rather than specifically. Additionally, by permitting defendants to prove the lack of price impact, the Court indirectly requires plaintiffs to litigate price impact at the certification stage. Plaintiffs would have been better off if the Court had required plaintiffs to prove price impact at the certification stage but had jettisoned the requirement to establish “market efficiency,” a concept which is not just amorphous and disputed, but which also adds substantially to the cost of litigation by generating a battle of the experts on a generalized proposition.

Litigation would be much more efficient if the role of experts were limited to determining whether, in this particular case, there was a price impact from the misrepresentation. And, determining price impact is basically the same concept as loss causation, which the Court determined plaintiffs need not establish at the certification stage. Thus, as discussed in the analysis of *Basic*, all plaintiffs should need to show at the certification stage is that the defendants introduced misrepresentations into the marketplace which altered the mix of reliable information upon which investors rely. But this is basically the definition of materiality, which the Court has determined need not be established until the trial stage. Thus, logically, price impact, materiality, and loss causation are related concepts that should be litigated at a trial on the merits.

B. *The Court’s Hypothetical—A Two-Way Street*

In holding that defendants must be afforded the opportunity to rebut the presumption of reliance by establishing that the misrepresentation did not affect the market price, the Court used this hypothetical:

Suppose a defendant at the certification stage submits an event study looking at the impact on the price of its stock from six discrete events, in an effort to refute the plaintiffs’ claim of general market efficiency. All agree the defendant may do this. Suppose one of the six events is the specific misrepresentation asserted by the plaintiffs. All agree that this too is perfectly acceptable. Now suppose the district court determines that, despite the defen-

114. *Id.* at 2417.

dant's study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit. The evidence at the certification stage thus shows an efficient market, on which the alleged misrepresentation had no price impact.¹¹⁵

In this hypothetical situation, the market for the stock is generally efficient, which would normally suffice to establish the fraud on the market presumption. But the particular misrepresentation that is being litigated did not affect the price of the stock. The Court thought that it would be "bizarre"¹¹⁶ to enable the plaintiff to get past the certification stage by virtue of indirect evidence when direct evidence was available to show the plaintiff was not injured.¹¹⁷ The Court concluded: "While *Basic* allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply."¹¹⁸

The Court's position would seem reasonable: if the price were not affected by the alleged misrepresentation, then either the misrepresentation was not material or the plaintiff had not suffered any loss. Why proceed to trial?

On the other hand, the converse of the Court's hypothetical can demonstrate why the fraud on the market theory is flawed as a result of its focus upon market efficiency. Suppose, as the Supreme Court did, that there was a situation in which there were six event studies, one of which was the specific representation in the instant suit. Assume further that five of the event studies showed no price impact, but that the specific representation in the instant suit did show a marked impact on price. A defendant could make the case that the market was not efficient, and, therefore, the fraud on the market presumption was not applicable. Consequently, class certification would fail, and, most likely, the suit would die, particularly if plaintiffs were only small investors who could not afford to bring a direct action. This would be so even though the plaintiffs established that the corrective disclosure caused the market price to drop dramatically, thereby leaving plaintiffs with worthless stock. Does this make sense?

A much more sensible regime would be to have a presumption—which is not really a presumption but rather a reality—that investors rely upon the total mix of information in the market; when this mix is fraudulently created by the misrepresentations of management, affected inves-

115. *Id.* at 2415.

116. *Id.*

117. *Id.* at 2416. The fact that the misrepresentation did not affect the price of the stock could mean either that the misrepresentation was not material or the plaintiff had not established loss causation.

118. *Id.*

tors can bring a class action lawsuit. This should suffice for class certification. This is what should be the normative position for federal courts to take.

But, if more be needed, then require plaintiffs to establish “price impact.” Under this variation, plaintiffs’ burden would be less than exists at present to establish that the misrepresentation took place in an efficient market, since plaintiffs need deal only with one event-study—the current misrepresentation—rather than a multitude of event studies. Moreover, plaintiffs would not be assaulted by the various views as to whether all information must be incorporated into the price of the stock, or whether merely most publicly available information must be so incorporated, or how quickly the information must be incorporated into the price.

But evidence establishing price impact would probably also establish materiality and loss causation. In effect, we would be moving the trial on the merits stage to the class certification stage. It is better to presume reliance based upon the defendant’s insertion of misleading information into the market, grant class certification, and leave any factual issues for trial. Otherwise, as Professor Langevoort has stated:

A detailed resolution of market-impact and loss-causation issues at the class-certification stage substitutes fact finding by the judge on an extraordinarily complex issue at an early stage of the proceeding for fact finding by the jury at trial and gives appellate courts far greater authority to review those findings.¹¹⁹

IV. RETAINING A FOCUS ON MARKET EFFICIENCY IS UNREASONABLE, OUTDATED, AND IS MERELY A DEVICE TO INCREASE LITIGATION COSTS AND THWART MERITORIOUS LITIGATION

The converse of Justice Roberts’s hypothetical, discussed above, illustrates one reason why requiring market efficiency as a condition for reliance is irrational. What difference does it make whether or not other information is integrated into the market price if the plaintiff can demonstrate that the misrepresentation of which the plaintiff complained did affect market price? A market could be fairly inefficient but, if the misrepresentation were significant enough, it could affect market price and adversely impact plaintiffs, thereby causing their loss.

Moreover, as Professors Prichard and Henderson assert in their brief to the Supreme Court in the *Halliburton II* case:

[P]roving the efficiency of the market as a whole is only an indirect means of proving that the market relied on a particular statement. . . . [D]etermining whether a misstatement distorted the market is typically *easier* than demonstrating efficiency of the market as a whole. It is also a more direct means of inquiring

119. Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. REV. 151, 185–86 (2009).

into reliance, and a more reliable method of showing whether the complained-of fraud was, in fact, a “fraud on the market.”¹²⁰

A. *PolyMedica: A Leading Case Exemplifying the Unreasonable Application of Market Efficiency*

1. *The PolyMedica Facts*

The stock of PolyMedica, a distributor of diabetes testing supplies, traded as high as \$58.25 during the quarter ending December 31, 2000.¹²¹ Apparently because of short selling pressure,¹²² the high in the following quarter was \$44.¹²³ Toward the end of that quarter, CIBC World Markets announced that there was an investigation into PolyMedica for Medicare fraud. The stock plummeted from \$33 to \$17.¹²⁴ The next business day, March 26, 2001, PolyMedica held an investor conference call, reassuring investors and extolling its efficient systems and highly trained and dedicated personnel.¹²⁵ A company official referenced a two-year-old complaint to Health and Human Services and asserted that, in view of the 60,000 to 90,000 shipments PolyMedica made per month, there will always be some customer complaints.¹²⁶ Thereafter, the stock rose to \$48 in the quarter ending September 30, 2001.¹²⁷ However, in late July of that quarter, the New York Stock Exchange declined to list PolyMedica stock, and, on August 6th, *Barron's* disclosed that a federal grand jury was looking into possible Medicare and investor fraud.¹²⁸ The stock dropped to \$22 after the *Barron's* article, and it further dropped to \$14 when, a couple of days later, PolyMedica finally admitted that a criminal investigation was underway.¹²⁹ The stock eventually dropped to \$11.25.¹³⁰

120. Brief of Law Professors as Amici Curiae in Support of Petitioners at 24, *Halliburton II*, 134 S. Ct. 2398 (2014) (No. 13-317) [hereinafter *Brief of Law Professors*], 2014 WL 60721.

121. See PolyMedica Corp., Annual Report (Form 10-K), at 9 (Mar. 31, 2002) [hereinafter *PolyMedica Annual Report*], available at <http://www.sec.gov/Archives/edgar/data/878748/000095013502003171/b43472pce10vk.txt>.

122. See *Medical-Device Maker PolyMedica Plunges Amid Short Sales*, SMART MONEY (Mar. 23, 2001, 8:57 PM) [hereinafter *PolyMedica Plunges*], available at <http://boards.fool.com/news-about-sell-off-14621230.aspx?sort=whole>.

123. See PolyMedica Annual Report, *supra* note 121, at 9.

124. See *PolyMedica Plunges*, *supra* note 122; see also PolyMedica Annual Report, *supra* note 121, at 9.

125. See *PolyMedica Plunges*, *supra* note 122.

126. See *id.*

127. See PolyMedica Annual Report, *supra* note 121, at 9.

128. See Cheryl Strauss Einhorn, *Endgame?: Subpoenas Are Flying as a Grand Jury Probes PolyMedica*, BARRON'S (Aug. 6, 2001, 12:01 AM), <http://online.barrons.com/news/articles/SB996889574847436135?tesla=y>.

129. See Cheryl Strauss Einhorn, *Coming Clean: PolyMedica Admits Feds Seek Criminal Charges*, BARRON'S (Aug. 13, 2001, 12:01 AM), <http://online.barrons.com/news/articles/SB997481781738978939?tesla=y>.

130. See PolyMedica Annual Report, *supra* note 121.

According to PolyMedica's employees, the company often shipped products to customers that the customers did not order, and, even though these products were often returned, "[o]ver 90% of returns are not refunded to Medicare."¹³¹ At the end of one month on a Friday, the company was 10,000 orders short of their goal; magically, the 10,000 orders appeared by the close of the day on Saturday.¹³² The company would also load up trucks from its warehouses and then have the trucks sit in the warehouse parking lot because there were no orders.¹³³ When employees tried to inform management of improper activity, they were "met with silence or reprimand."¹³⁴ PolyMedica eventually settled the criminal charges with the Justice Department by paying \$35 million.¹³⁵

One would think that the foregoing situation would be a matter of concern for the federal courts. Medicare fraud is a serious matter. Consequently, it will be instructive to contrast the approach of the district court in its initial opinion granting certification, with the circuit court opinion reversing on the basis of its definition of an efficient market, and the district court opinion on remand, applying the circuit court's view on market efficiency.

2. *The Initial District Court Opinion: A Sensible Approach Applying Basic*

Judge Keeton's opinion in *In re PolyMedica Corp. Securities Litigation*,¹³⁶ which granted class certification, is a joy to read: it is clear, concise, and cogent. In applying the fraud on the market theory, he relied upon the Supreme Court's opinion in *Basic*, rather than upon academics arguing about the concept of an efficient market and courts relying upon the academics.¹³⁷ He essentially adopted the plaintiffs' assertion that "the essential factor in determining market efficiency is whether the stock price was affected by the material information available in the market."¹³⁸

Looking to *Basic*, Judge Keeton relied upon three statements by the *Basic* Court:

- (i) The presumption is support [sic] by common sense and probability Because *most* publicly available information is reflected in market price, an investor's reliance . . . may be presumed¹³⁹

131. Einhorn, *supra* note 128.

132. *Id.*

133. *Id.*

134. *Id.*

135. *PolyMedica Settles with the Feds; \$35-Million Deal Ends 5-Year Probe*, HME NEWS (Nov. 30, 2004), <http://www.hmenews.com/article/polymedica-settles-feds-35-million-deal-ends-5-year-probe>.

136. 224 F.R.D. 27 (D. Mass. 2004), *rev'd*, 432 F.3d 1 (1st Cir. 2005).

137. *See id.* at 39.

138. *Id.* at 40.

139. *Id.* (first alteration in original) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988)).

- (ii) We need not determine by adjudication what economists and social scientists have debated [W]e need only believe that market professionals *generally* consider *most* publicly announced material statements about companies, thereby *affecting* stock market prices.¹⁴⁰
- (iii) [W]e do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.¹⁴¹

Based upon the foregoing, he concluded:

Considering the three statements together, I conclude that an “efficient” market in the context of the “fraud on the market” theory is *not* one in which a stock price rapidly reflects all publicly available material information. Rather, the “efficient” market required for “fraud on the market” presumption of reliance is simply one in which “market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.”¹⁴²

Applying the above standard to the facts presented to him, Judge Keeton noted the following:

- (i) There was a cause-and-effect relationship between unexpected disclosures regarding the corporation and an immediate response in the stock price: “In particular, at five points in 2001 . . . , PolyMedica stock price rose [dramatically] on news of greater than expected growth and fell [dramatically] on negative news about the Company.”¹⁴³
- (ii) The average weekly trading volume exceeded one million shares, which was around 10% of the shares outstanding.¹⁴⁴
- (iii) “[E]ighteen different securities analysts followed PolyMedica” and “at least four securities analysts issued at least seventeen analyst reports.”¹⁴⁵
- (iv) There were “at least 283 market makers [] in the market for PolyMedica common stock”¹⁴⁶

140. *Id.* (quoting *Basic*, 485 U.S. at 246 n.24).

141. *Id.* at 40–41 (quoting *Basic*, 485 U.S. at 249 n.9).

142. *Id.* at 41 (quoting *Basic*, 485 U.S. at 246 n.24).

143. *Id.* at 43 (second and third alterations in original) (internal quotation marks omitted).

144. *See id.*

145. *Id.*

146. *Id.*

(v) The market capitalization exceeded \$200 million.¹⁴⁷

From the foregoing, Judge Keeton, in the opinion of the Author, reasonably concluded that the market was efficient and that the fraud on the market presumption applied.¹⁴⁸

3. *The Circuit Court and the District Court on Remand: An Example of Courts in an Alternate Universe*

a. The Circuit Court: A Stringent Definition of Market Efficiency

At the outset of the First Circuit's opinion in *PolyMedica*,¹⁴⁹ it acknowledged that, according to the plaintiff, PolyMedica's stock had lost more than 80% of its value, and PolyMedica had engaged in welfare fraud.¹⁵⁰ At the time of its opinion, in December 2005, these facts were easily verifiable. While judges are supposed to be bias free (an illusion since everyone's decision-making is affected by bias¹⁵¹), would not the instinct of someone who was concerned about fraud in the securities markets be to certify the class to determine what the facts really were? This would be particularly so when presented with the clear, concise, and cogent analysis of Judge Keeton.

The circuit court recognized the *Basic* pronouncements relied upon by the district court but also focused upon other statements, such as:

“[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,” and that “the market price of shares traded on well-developed markets reflects *all publicly available information*, and hence, any material misrepresentations.”¹⁵²

The circuit court concluded that the Supreme Court's language in *Basic* could support either the lower court's interpretation of efficiency or the view adopted by most lower courts that the stock price must “fully reflect all publicly available information.”¹⁵³

147. *See id.*

148. *See id.*

149. *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1 (1st Cir. 2005).

150. *See id.* at 3.

151. *See generally* DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* (2011). Kahneman is a Nobel Prize winner for his work in behavioral economics. His recent book discusses two systems of thinking: “thinking fast,” which operates automatically and quickly with little effort, and “thinking slow,” which is deliberative and analytical. The first system initially produces the information upon which the second system thoughtfully operates. That is how bias can creep into decisions which we believe are thoughtfully made. For a more extensive discussion, see Charles W. Murdock & Barry Sullivan, *What Kahneman Means for Lawyers: Some Reflections on Thinking, Fast and Slow*, 44 *LOY. U. CHI. L.J.* 1377 (2013).

152. *PolyMedica*, 432 F.3d at 11 (quoting *Basic Inc. v. Levinson*, 485 U.S. 244, 246 (1988)).

153. *Id.* at 12–13.

The problem with this formulation, as discussed in the next section, is that the “*fully reflect all publicly available information*” standard is impossible to prove, relies upon the conjecture of so-called experts, and is not realistic, particularly when coupled with the circuit court’s add-on that the information must be “incorporate[d] rapidly or promptly.”¹⁵⁴ The court stated that, “[b]y ‘fully reflect,’ we mean that market price responds so quickly to new information that ordinary investors cannot make trading profits on the basis of such information. This is known as ‘informational efficiency.’”¹⁵⁵ Although the court did not require “fundamental value efficiency,” which means that the market price is also accurate, it did recognize that fundamental value efficiency could be relevant to informational efficiency.¹⁵⁶

Again, as developed in the next section, it is clear that markets incorporate different types of information at different rates, depending upon the complexity and mode of distribution of the information.¹⁵⁷

b. The District Court on Remand: An Unreasonable Application of a Stringent Standard

(i) Plaintiffs’ Strong Evidence of Market Efficiency

On remand, the district court¹⁵⁸ looked at the plaintiffs’ evidence, primarily focusing upon the five *Cammer* factors, which many courts have used to determine whether the market for a particular stock is efficient.¹⁵⁹ The court analyzed them as follows:

- (1) Average trading volume: the average weekly trading volume was 4,140,232 shares, which accounted for 31% of the 13,280,000 total shares outstanding. *Cammer* suggested that a 2% weekly trading volume “warranted a strong presumption of market efficiency.”¹⁶⁰
- (2) Number of securities analysts: seven analysts followed the stock, and there were 348 articles mentioning

154. *Id.* at 12.

155. *Id.* at 19.

156. *See id.*

157. *See id.*

158. *In re Polymedica Corp. Sec. Litig.*, 453 F. Supp. 2d 260 (D. Mass. 2006). In the interim, Judge Keeton had retired, and the case was reassigned to Judge Young. *See id.* at 264.

159. *See Cammer v. Bloom*, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989). The factors are: (1) the stock’s average trading volume; (2) the number of securities analysts that followed and reported on the stock; (3) the presence of market makers and arbitrageurs; (4) the company’s eligibility to file a Form S–3 Registration Statement; and (5) a cause-and-effect relationship, over time, between unexpected corporate events or financial releases and an immediate response in stock price. *See id.*

160. *See PolyMedica*, 453 F. Supp. 2d at 267.

PolyMedica.¹⁶¹ A previous decision in the First Circuit had approved efficiency even though there was only one analyst.¹⁶² The court said that the strength of this factor “is uncertain because there exists no coherent yardstick against which to measure it,” even though the court also recognized that, according to one study, this factor “is one of only two which actually have statistically significant, empirical support.”¹⁶³

- (3) Presence of market makers: there were 193 market makers, of whom 27 traded over one million shares each.¹⁶⁴ Previous First Circuit decisions had approved class certification with substantially less market-making activity.¹⁶⁵ However, the court stated that, since there is “no accepted standard” to determine the minimum number, the court would place little weight on this factor.¹⁶⁶
- (4) Eligibility to file an S-3 registration statement: in order to use this form, the SEC requires a market capitalization of \$75 million, not counting stock held by management.¹⁶⁷ The rationale behind this requirement is that, at this level of market capitalization, there will be sufficient analyst and investor interest to ensure that information is widely disseminated and integrated. The court acknowledged that “[c]ourts have found that the SEC permits an S-3 Registration statement ‘only on the premise that the stock is already traded on an open and efficient market, such that further disclosure is unnecessary.’”¹⁶⁸ The market capitalization of PolyMedica during the class period was about \$500 million.
- (5) Cause and effect relationship: plaintiffs’ expert, Miller, presented a chart which listed “the price change in PolyMedica stock on [] five days, each of which had significant news events:
 - Reports of consumer complaints to government investigators (Mar. 23, 2001: 49.54% decline);

161. *See id.*

162. *See In re Xcelera.com Sec. Litig.*, 430 F.3d 503, 514–15 (1st Cir. 2005).

163. *PolyMedica*, 453 F. Supp. 2d at 267.

164. *See id.* at 268.

165. *See, e.g., Xcelera.com*, 430 F.3d at 516 (approving class certification where there were only twenty market makers and seven that traded over one million shares).

166. *PolyMedica*, 453 F. Supp. 2d at 268.

167. *See id.*

168. *Id.* (quoting *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, No. 05 Civ. 1898(SAS), 2006 WL 2161887, at *7 (S.D.N.Y. Aug. 1, 2006)).

- PolyMedica's response that those reports were rumors and that it had not been contacted by any government agency (Mar. 26, 2001: 42.65% rise);
- Announcement that shares would no longer be listed on the NYSE (July 23, 2001: 29.52% decline);
- Report that PolyMedica may be indicted for Medicare and investor fraud (Aug. 6, 2001: 32.17% decline);
- PolyMedica announcement that the U.S. attorney for the Southern District of Florida was conducting an investigation into one of its units (Aug. 8, 2001: 17.65% decline).¹⁶⁹

Miller also presented "a side-by-side comparison of movements in the PolyMedica stock price, 'peer group' stock prices, and the NASDAQ index and [stated] that 'the dramatic price increases and declines in the price of PolyMedica stock during the disputed period in response to new company-specific information were not mirrored in price movements of the NASDAQ Composite Index or the comparable company index.'"¹⁷⁰

I would expect that most persons, reviewing the foregoing facts, would conclude that PolyMedica traded in an efficient market. To disregard or fail to see the significance of facts such as an average weekly trading volume of 31% of the outstanding shares, seven analysts following the stock, 193 market makers of whom 27 traded over one million shares each, and a market capitalization of about \$500 million (whereas a market capitalization of only \$75 million would be sufficient to be eligible to file an S-3 (short form) registration statement), suggests a lack of objectivity and an outcome determinative mentality from the court.

(ii) The District Court's Unrealistic Reliance upon Defendant's Expert

According to the district court, the foregoing analysis by plaintiffs' expert "leaves much to be desired."¹⁷¹ To support this conclusion, the court relied upon the following testimony of Dunbar, PolyMedica's expert:

[Y]ou went and searched for the largest price drops. That's not a scientific study. A scientific study is one where you draw a sample and then you compare a test statistic from that sample to another sample All you did was went and picked the largest stock price drops and said, oh, gee, that just shows that it's informationally efficient. You picked five days out of about 160 trading days. What you should do is look at all 160 trading days and do a scientific study to see if there's a difference between the news days and the non-news days. And if you would have done that

169. *Id.* at 269 (bulleted list as appears in original).

170. *Id.*

171. *Id.*

you would have found that there wasn't any difference between them. . . .

[I]f you picked news days as a sample, all news days, not just the ones you self selected. I mean, you selected the few news days that would prove your point. But there's many other news days in that contested period, anywhere from 23 to 59, versus [sic] on how you want to count them. If you want to look at what the stock price reaction is on those news days versus the non-news days, you'll find that you can't say that the news days were drawn from a different sample than the non-news days. In other words, they were providing as much information to the market as the non-news days.¹⁷²

From the standpoint of rebutting plaintiffs' evidence, it is the above opinion of defendant's expert that "leaves much to be desired." Dunbar indicated that there were between twenty-three and fifty-nine news days. This is a wide range of uncertainty, which also raises questions about the materiality of the information on these various days, and whether any particular news item was within the expectations of the market or, on the other hand, was a surprise. Moreover, was any of the information on the so-called news days as dramatic as the allegations of Medicare fraud, denial of listing by the New York Stock Exchange, or possible criminal indictment?

The following is the only stock graph during the relevant period that I have been able to access.¹⁷³



It shows a precipitous drop on March 26th, upon news of the government's investigation into Medicare fraud. It shows a subsequent rise the

172. *Id.* at 269–70 (alterations and error in original).

173. *Polymedica Dips on Report*, CNN MONEY (Aug. 6, 2001, 12:29 PM), <http://money.cnn.com/2001/08/06/companies/polymedica/>.

following Monday, when PolyMedica's investor conference call assured investors there were no problems. The graph further shows a sharp decline when it was announced that the New York Stock Exchange would not be listing PolyMedica shares. The graph ends before the announcement that PolyMedica might be indicted for Medicare fraud, when another substantial drop in price occurred. The extent to which the market moved on the 150 or so days when there was either no news or "less significant" news is irrelevant to the efficiency of the market with respect to the dramatic news reports about PolyMedica. As discussed in the next section, PolyMedica's expert fell into the trap of assuming that all news is digested immediately by the market, without recognizing that the significance, complexity, and mode of disclosure all affect the pace at which the market processes news.

Nevertheless, the court endorsed the above criticism of Miller and stated with respect to the plaintiffs' expert: "Miller's mere listing of five days on which news was released and which exhibited large price fluctuations proves nothing. Miller's only marginally useful analysis—which he oddly labels 'not a significant factor'—is his unscientific comparison of PolyMedica Stock to the NASDAQ index."¹⁷⁴

It is incomprehensible that a court could look at the price movements reflected in the above graph, and as set forth by plaintiffs' expert, and conclude that they prove nothing. This is particularly true when the testimony is not in connection with a trial on the merits but rather relates to the issue of whether the plaintiff has presented sufficient evidence of commonality for class certification. Moreover, in point of fact, the analysis by plaintiffs' expert is considered scientific. Comparing the price movements in the defendant company's stock with price movements of peer stocks and an index such as NASDAQ is a scientific way of establishing that the price movement with respect to the defendant company was caused by factors over and above whatever factors impacted the movement of peer stocks or the market as a whole.

(iii) The District Court's Unrealistic Reliance on the Lack of Shares Available for Short Selling

The district court was also influenced, in determining that the market for PolyMedica stock was not efficient, by the situation with regard to short selling.¹⁷⁵ By April 2001, there was a huge amount of short interest; this made obtaining additional shares to short difficult.¹⁷⁶ In addition, a typical loan fee for lending stocks was 1%; during the summer of 2001, however, the loan fee with regard to PolyMedica was between 15% and 35%.¹⁷⁷ According to Dunbar, this fact meant the market was inefficient because persons who would have liked to have shorted the stock were not

174. *PolyMedica*, 453 F. Supp. 2d at 270.

175. *See id.* at 273–75.

176. *See id.* at 273.

177. *See id.* at 274.

able to do so; thereby the market was denied the information that additional short selling would have brought to the market. As Dunbar stated, “the constraints on shorts will prevent people who don’t own the stock from providing their viewpoints to the market.”¹⁷⁸ The court agreed that this was another significant factor supporting a lack of market efficiency.¹⁷⁹

What is paradoxical about this analysis is that the extent of short selling shows that many sophisticated investors believed that PolyMedica stock was overpriced. The large premium charged for lending the stock also reflected the fact that the holder was worried that the stock might drop precipitously before the holder received the stock back from the short seller. Thus, the short selling, and the impediments to additional short selling, confirms the fact that PolyMedica was overpriced because of the misrepresentations of the defendant. Instead of focusing on this, the court rejected efficiency because the market did not have all the short selling information that the court believed it should have had. Contrary to the court’s opinion, the extent of short selling, the loan fee charged, and the difficulty in accessing shares to short are all facts that are in the public domain.

In addition, if stock is not available to loan to bearish investors to enable them to sell it short, there is another vehicle for “bears” to show the market that they believe the stock is overvalued—they could purchase “put” options.¹⁸⁰ But this possibility was never considered by the court.

(iv) The Unreasonable “One Day” Standard for “Informational Efficiency”

Finally, the court determined that the time within which the market must react to new information in order to be efficient was one day:

This Court, however, holds that the First Circuit’s definition and relevant explanation of efficiency in *PolyMedica*, which stated that stock price must quickly and fully reflect the release of public information such that ordinary investors cannot profitably trade on the basis of it, requires that the reaction to news be fully completed on the same trading day as its release—and perhaps even within hours or minutes.¹⁸¹

Once again, the court fell into the trap of assuming that all news is digested immediately by the market, without recognizing that the significance, complexity, and mode of disclosure all affect the pace at which the market processes news. Moreover, paradoxically, the negative disclosures

178. *Id.* at 276.

179. *See id.*

180. *See, e.g., Most-Active Options*, YAHOO FIN., <http://finance.yahoo.com/options/lists/> (last visited Jan. 11, 2015).

181. *PolyMedica*, 453 F. Supp. 2d at 278 (footnote omitted).

about PolyMedica relied upon by Miller, plaintiffs' expert, all had a dramatic negative impact on the price of the stock within one day. Consequently, these disclosures thereby met the district court's standard that the information be impounded into the market within one day. On the other hand, the positive information injected by PolyMedica's investor conference call probably took longer for the market to fully incorporate because many potential buyers were probably waiting to see if confirmation of the negative disclosures was in the offing.

The opinion on remand was also not true to the circuit court's reading of *Basic*. To counter Judge Keeton's analysis of *Basic*, the circuit court quoted other provisions in *Basic* in which the Supreme Court referred to *all information*: "[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," and that "the market price of shares traded on well-developed markets reflects *all publicly available information*." Note that the language of *Basic* that the circuit court quoted did not unqualifiedly refer to "all information." Rather it referred to all the "available" information. Arguably, then, if short selling information was not available to the market, it was not relevant under *Basic*. Again, paradoxically, much of the information the court discussed in determining that the market lacked the information of putative short sellers was actually available to the market.¹⁸²

The opinions of the circuit court and the district court on remand are classic examples which illustrate that a little knowledge can be a dangerous thing. These opinions also support the conclusion that a legal liability structure predicated upon a determination of whether or not the market for a particular stock is efficient is based on whimsy, rather than reality.

B. *Scholarly Rejection of Using Market Efficiency to Determine Reliance*

Early on, *Basic* was criticized for arguably requiring an efficient market in order to create a presumption of reliance. A joint effort of law and business professors asserted "substantial disagreement exists about to what degree markets are efficient, how to test for efficiency, and even the definition of efficiency."¹⁸³ The same criticism holds true today.¹⁸⁴ Moreover, two Nobel Prize winners in economics, Eugene Fama¹⁸⁵ and Robert

182. See, e.g., *NYSE Group Short Interest*, NYSE MARKET DATA, <http://www.nyxdata.com/Data-Products/NYSE-Group-Short-Interest> (last visited Jan. 11, 2015); *Short Interest*, NASDAQ, <http://www.nasdaq.com/quotes/short-interest.aspx> (last visited Jan. 11, 2015); see also *How Do I Sell a Stock Short*, INTERACTIVE BROKERS, <https://ibkb.interactivebrokers.com/article/232> (last visited Jan. 11, 2015); *Short Interest*, SHORT SQUEEZE, <http://shortsqueeze.com/> (last visited Jan. 11, 2015).

183. Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 VA. L. REV. 1017, 1018 (1991).

184. See generally Langevoort, *supra* note 119.

185. See generally NOBEL MEDIA, *Eugene F. Fama—Facts*, NOBELPRIZE.ORG, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2013/fama-facts.html (last visited Jan. 11, 2015).

Shiller,¹⁸⁶ have taken opposing positions on whether the market is efficient, Fama arguing that it is efficient and Shiller arguing that it is not.

The logic employed by many courts is that reliance depends upon market efficiency, and market efficiency depends upon speed of adjustment. Thus, if market adjustment is “slow,” then the investor does not rely for purposes of achieving class certification. Professor Langevoort, in his seminal article on the history of *Basic*, raises the fundamental question about market efficiency and its reliance upon speed of market adjustment: “what does speed of adjustment have to do with reliance on stock-price integrity?”¹⁸⁷ He asserts that “fraud can and does distort prevailing prices even when adjustment is delayed or incomplete.”¹⁸⁸

By way of illustration, Professor Langevoort used *In re Merck & Co. Securities Litigation*.¹⁸⁹ Merck, in 2002, ranked 24th on the Fortune 500 list;¹⁹⁰ you would expect a market for its shares to be efficient. However, the question in *Merck* was not whether the market was efficient, but rather at what point in time would information be impounded into the market and affect the price. Medco, a wholly-owned subsidiary of Merck, recognized income attributable to a copayment made by a pharmacy customer to the pharmacy, even though the subsidiary did not handle these copayments.¹⁹¹ In a registration statement filed April 17, 2002, in connection with a spinoff of Medco, Merck disclosed for the first time that Medco had been recognizing revenue on this basis, but did not disclose the total amount of revenue that had been improperly recognized.¹⁹² On the day the registration statement was filed, Merck stock price went up from \$55.02 to \$55.05.¹⁹³

Almost two months later, “[o]n June 21, 2002, *The Wall Street Journal* reported that Medco had been recognizing co-payments as revenue and estimated that in 2001 \$4.6 billion in co-payments had been [thereby] recognized.”¹⁹⁴ That day Merck stock dropped \$2.22, from \$52.20 to \$49.98.¹⁹⁵ Merck filed an amended registration statement on July 5, 2002, and disclosed that Medco had recognized over \$12.4 billion in “copay-

186. See generally NOBEL MEDIA, *Robert J. Shiller—Facts*, NOBELPRIZE.ORG, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2013/shiller-facts.html (last visited Jan. 11, 2015).

187. Langevoort, *supra* note 119, at 169.

188. *Id.* at 161.

189. See *id.* at 173–78 (discussing *In re Merck & Co. Sec. Litig.*, 432 F.3d 261 (3d Cir. 2005)).

190. See *Fortune 500: 2002 Full List*, FORTUNE, http://archive.fortune.com/magazines/fortune/fortune500_archive/full/2002/ (last visited Jan. 11, 2015).

191. See *Merck*, 432 F.3d at 264.

192. See *id.*

193. See *id.*

194. *Id.* at 265.

195. *Id.*

ment” revenue, of which \$5.537 billion was recognized in 2001.¹⁹⁶ Merck stock declined to \$43.57 on July 10th.¹⁹⁷

The court noted that the *Wall Street Journal* reporter had derived her figure by subtracting home delivery prescriptions from total prescriptions filled in order to determine the number of retail prescriptions and then assumed an average \$10 copayment for each retail prescription. The reporter then multiplied the two numbers together to arrive at the conclusion that \$4.6 billion had been improperly recognized.¹⁹⁸ However, according to the circuit court, the market made this determination on April 17th when the price of Merck stock rose \$.03, thereby demonstrating that the information was not material: “The *Journal* reporter simply did the math on June 21; the efficient market hypothesis suggests that the market made these basic calculations months earlier.”¹⁹⁹

In a very telling quote, the court stated: “If these analysts [who followed Merck and focused on revenue growth] were unable for two months to make a handful of calculations, how can we presume an efficient market at all?”²⁰⁰ My conclusion from this data is that the analysts were capable of making these computations but did not, which in turn suggests that the market is not necessarily all that efficient, even for a stock as significant and widely traded as Merck.

Also consider Enron. At the beginning of 2001, Enron stock was trading at about \$84.²⁰¹ On March 5, 2001, it was trading at about \$70, when Bethany McLean wrote her famous article in *Fortune*, *Is Enron Overpriced?*²⁰² That week, Enron trading was essentially flat; in fact the high on Friday was higher than the high on Monday.²⁰³ The following week, Enron dropped roughly 10 points to about \$60.²⁰⁴ For the next month, there was a 10% dip and then a rise back to \$60 in early May.²⁰⁵ So much for the diligence and perspicaciousness of analysts!

By September, Enron stock had steadily dropped to \$35, and by the end of the year, it was worthless.²⁰⁶ Granted, the Enron business model was more complicated than that of Medco; however, that complexity should have led an “efficient” market, and the many analysts who covered Enron, to be suspicious and inquisitive. As McLean pointed out, Enron

196. *Id.*

197. *Id.*

198. *See id.* at 270.

199. *Id.* at 271.

200. *Id.* at 270.

201. *See* Cara Ellison, *Enron Historical Stock Price*, <https://caraellison.files.wordpress.com/2009/09/enron-historical-data.pdf> (last visited Jan. 12, 2015).

202. Bethany McLean, *Is Enron Overpriced?*, CNN MONEY (Jan. 19, 2006, 11:34 AM), http://money.cnn.com/2006/01/13/news/companies/enronoriginal_for_tune/ (reposting article which originally appeared in *Fortune* on March 5, 2001).

203. *See* Ellison, *supra* note 201.

204. *See id.*

205. *See id.*

206. *See id.*

was the “It Girl” of Wall Street. While Enron was secretive about its business plan, warning signs were out there, including the disparity between cash flow and income and the risky business model that it was employing.²⁰⁷

Apropos to the subject of analyst diligence is the multi-analyst scandal in connection with the dot-com bubble,²⁰⁸ which came to light in spring 2002. New York State Attorney General Eliot Spitzer uncovered a number of e-mails written by Merrill Lynch investment analysts, describing the stock of various companies as “junk,” “crap,” and “a disaster;” unbelievably, they publicly rated these stocks as a “buy.”²⁰⁹ Analysts hyped their ratings, not just to obtain investment banking work for their firms, but sometimes for personal profit, such as getting their daughters into nursery school.²¹⁰

Merrill Lynch settled for \$100 million and agreed to revise its practices with respect to analysts.²¹¹ Within a year of Merrill Lynch being sued, ten top United States investment banking firms agreed to pay a total of \$875 million in penalties and disgorgement for similar practices.²¹² Pursuant to the settlement agreements, Wall Street agreed not to pressure

207. See McLean, *supra* note 202.

208. See *Merrill Ordered to Reform Ratings: New York AG Wins Court Order Finding Brokerage Firm Issued ‘Misleading Stock Ratings’*, CNN MONEY, (Apr. 8, 2002, 8:35 PM), <http://money.cnn.com/2002/04/08/news/companies/merrill/index.htm>.

209. *Merrill Lynch*, LAWYERSHOP.COM, <http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/securities-fraud/lawsuits/merrill-lynch/> (last visited Jan. 12, 2015). Other examples include:

a. Internet Capital Group (ICGE):

1. E-mail: October 5, 2000—“Going to 5?” (strong sell); October 6, 2000—“No helpful news to relate, I’m afraid. This has been a disaster—there really is no floor to the stock.”
2. Investor advice: October 5, 2000—2-1 rating (buy to strong buy);

b. *excite@home* (ATHM):

1. E-mail: June 3, 2000—“ATHM is such a piece of crap!”
2. Investor advice: June 3, 2000—2-1 rating (buy to strong buy);

c. Lifeminders (LFMN):

1. E-mail: December 4, 2000—“I can’t believe what a POS that thing is.”
2. Investor advice: December 4, 2000—2-1 rating (buy to strong buy).

Id.

210. Jack Grubman, one of the leading analysts on Wall Street, sent an e-mail stating that his boss, Sanford Weill, the chairman of Citigroup and a member of the Board of Directors of AT&T, helped Grubman to get his twin daughters enrolled in an exclusive nursery school after Grubman began recommending AT&T stock. Mr. Weill has acknowledged that he asked Grubman to “take a fresh look at AT&T,” which was code on Wall Street for changing your opinion. See Gretchen Morgenson & Patrick McGeehan, *Wall Street and the Nursery School: A New York Story*, N.Y. TIMES (Nov. 14, 2002), <http://query.nytimes.com/gst/fullpage.html?res=9C03E3D71630F937A25752C1A9649C8B63&fta=y>.

211. See *The Merrill Lynch Settlement: Good for Merrill, Not for Investors*, WHARTON (June 5, 2002), <http://knowledge.wharton.upenn.edu/article/the-merrill-lynch-settlement-good-for-merrill-not-for-investors/>.

212. See Joint Press Release, SEC, Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Invest-

analysts to give unwarranted ratings. However, a couple of years later, Rodman and Renshaw fired an analyst because he would not raise his price target for a particular stock.²¹³ So much for assuming the integrity of analysts!

What the foregoing demonstrates is the folly of creating a legal structure predicated upon the efficiency of the market and the competence and integrity of analysts.

There is a classic joke about an imprisoned economist who said that he planned to escape by assuming a ladder. This, in tongue-in-cheek fashion, illustrates the extent to which economic theory is predicated upon assumptions. Unfortunately, some of the assumptions in the efficient market theory are questionable. The basic idea is that arbitrageurs will respond to information by driving the price in the right direction. If they believe the price is too low, they will buy; if they believe the price is too high, they will sell short. This requires “that these arbitrageurs should face no capital constraints and have infinite horizons. More precisely, they must have sufficient capital and long enough horizons to await patiently the revelation of information or the reversal of sentiment underlying the mispricing.”²¹⁴ Particularly with respect to short selling, where the risk is unlimited if the stock moves in the wrong direction, there are substantial impediments to the idealized theory as to what the bearish arbitrageur will commit to do.²¹⁵ In addition, both momentum traders²¹⁶ and the existence of herding²¹⁷ can lead to inefficiency. Again, is this the foundation upon which to build a legal theory?

Another problem with the efficient market theory that is raised by Professor Langevoort is that it is binary—either a market for a company’s security is efficient or it is not efficient.²¹⁸ “But there is no such thing as a perfectly efficient market, and so it becomes easy for a court to miss the forest for the trees by accepting too readily the defendants’ statistical evidence of imperfection as reason not to certify.”²¹⁹ One critique of the *PolyMedica* decision is that the court never considered that “different kinds

ment Banking (Apr. 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm>.

213. The analyst originally had an “outperform” recommendation, with a price target of \$2.88. As the stock approached this price, he sought to downgrade his recommendation to “market perform,” but instead, his director of research recommended that he increase his price target. See Gretchen Morgenson, *Did Wall Street Really Learn Its Lesson?*, N.Y. TIMES (Apr. 9, 2006), <http://query.nytimes.com/gst/fullpage.html?res=9905E6D91130F93AA35757C0A9609C8B63>.

214. Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 483 (2006).

215. See *id.* at 480–83.

216. See *id.* at 496–97.

217. See *id.* at 494–95.

218. See Langevoort, *supra* note 119, at 167.

219. *Id.* at 173.

of information are likely impounded at different rates of speed, even for the same issuer.”²²⁰ The same is true of the court in *Merck*.

It is *Alice in Wonderland* type thinking to assume that all information—irrespective of its significance, complexity, mode of disclosure, and context of disclosure—would be assimilated at the same rate, particularly within one day. The pattern of the Merck stock movement actually illustrates this fact. Is the market as likely to respond to an arguably buried fact in a multipage registration statement in as quick and decisive a manner as it would to a thoughtful and clearly laid out article in the *Wall Street Journal*, which in turn must be contrasted with an affirmative, clear, detailed acknowledgment by the company? To hold that all information is rapidly (i.e., within one day) assimilated by the market, irrespective of its complexity and mode of distribution, is to endow the market with omniscience.

At a minimum, even if reliance is related to stock price integrity per *Basic*, rather than informational integrity, “rigorous insistence on a showing of market impact would seem to obviate the need to also show market efficiency”²²¹

V. THE INTERRELATIONSHIP OF RELIANCE, MATERIALITY, AND LOSS CAUSATION

A. *Fraud on the Market Reliance and Materiality: The Amgen Confusion*

Justice Ginsburg’s opinion in *Amgen*²²²—in rejecting the requirement that plaintiffs must prove materiality in order for a class to be certified—was characterized by the dissenters as simplistic and illogical²²³ and further muddied the waters as to what must be proved and when.

Justice Ginsburg acknowledged that materiality “indisputably” “is an essential predicate of the fraud-on-the-market theory”²²⁴ She also acknowledged that materiality is an essential element of a Rule 10b-5 cause of action.²²⁵ However, since materiality is an objective standard, the issue of materiality is common to all class members and thus need not be proven at the class certification stage.²²⁶ Rather, it is an element of a Rule 10b-5 action that will be determined on the merits at trial.²²⁷ Thus far the opinion makes sense.

However, Justice Thomas, speaking for the dissenters, noted that materiality is an element of the fraud on the market theory and critiqued the majority opinion on the basis that “the Court transforms the predicate

220. *Id.* at 170.

221. *Id.* at 179 (citing Macey et al., *supra* note 183, at 1018).

222. 133 S. Ct. 1184 (2013).

223. *See id.* at 1206–07 (Thomas, J., dissenting).

224. *Id.* at 1195 (majority opinion).

225. *See id.* at 1191–92.

226. *See id.* at 1197.

227. *See id.*

certification inquiry into a novel either-or inquiry occurring much later on the merits.”²²⁸ He argued:

According to the Court, either (1) plaintiffs will prove materiality on the merits, thus demonstrating *ex post* that common questions predominated at certification, or (2) they will fail to prove materiality, at which point we learn *ex post* that certification was inappropriate because reliance was not, in fact, a common question. In the Court’s second scenario, fraud on the market was never established, reliance for each class member was inherently individualized, and Rule 23(b)(3) in fact should have barred certification long ago. The Court suggests that the problem created by the second scenario is excusable because the plaintiffs will lose anyway on alternative merits grounds, and the case will be over.²²⁹

Justice Ginsburg’s holding that materiality need not be proven at the class certification stage would seem to be sophistry if, in establishing reliance through fraud on the market, materiality must be proven at the class certification stage as an element of the fraud on the market doctrine. On the other hand, her opinion would make sense if either there are two different aspects of materiality, or if materiality is not an element of the fraud on the market hypothesis.

Justice Ginsburg’s holding could be justified on the basis that there is materiality in general and materiality specific to plaintiffs’ claims. Consider again Justice Roberts’s hypothetical in *Halliburton II*, in which there were six event studies, one of which involved the specific misrepresentation alleged by plaintiffs as the basis for their suit; even though there was no price impact with respect to the specific misrepresentation challenged in the suit, the evidence showed an efficient market.²³⁰ To Justice Roberts, it would make no sense to certify the class action in such a situation.²³¹

But what if the defendant and/or plaintiffs had provided price impact with respect to five events, none of which involved the current alleged misrepresentation, but all of which showed price impact, consequently

228. *Id.* at 1211 (Thomas, J., dissenting).

229. *Id.* (footnote omitted).

230. *See* *Halliburton II*, 134 S. Ct. 2398, 2415 (2014).

231. His discussion of the consequences of the foregoing is confusing, as he posits that there is an efficient market, but in summarizing the plaintiffs’ view, states that the “action should be certified and proceed as a class action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed.” *Id.* But, if the class were to be certified, this would mean that the fraud on the market theory did apply. The paradox is that the class action could proceed even though the ultimate result is already known, namely, the plaintiffs must fail because the plaintiffs cannot establish price impact, which means either that the misrepresentation was not material or that there were no damages.

compelling the conclusion that the market was efficient? Here we have an alleged misrepresentation made in an efficient market, which, under *Basic*, should support a presumption of reliance—and the materiality of the misrepresentation which led to the present litigation would be determined at trial. This is an example of materiality in general but not with respect to the particular case. While this is a possibility, it is not a very likely possibility.

The materiality of the litigated misrepresentation is not necessarily relevant to the question of whether the market is efficient. Arguably, the market impounds all information, both material and immaterial, since the price of the stock impounds many pieces of information, any one of which might not be significant but could become significant in the aggregate. Consequently, whether the alleged misrepresentations were material does not necessarily impact reliance. The investor would rely upon the integrity of the market price, according to *Basic*, or on the total mix of information in the market, according to this Article, in purchasing the stock—irrespective of whether the investor was defrauded through misrepresentations or otherwise. Whether the investor relied and whether the investor was defrauded are two separate questions.

This conclusion is supported by the facts of the *Basic* case. The district court certified the class on the fraud on the market theory, but it granted a motion for summary judgment on the ground that the misrepresentations were not material. Thus, at the district court level, the court certified a class irrespective of the materiality of the representations.

Notwithstanding the foregoing defense of Justice Ginsburg's opinion, if materiality is an element of the fraud on the market theory, then it makes no sense to litigate the issue twice. Arguably, if lack of materiality is established in the certification process, then issue preclusion should prevent re-litigation of this issue. But, according to Justice Thomas, what is the point of continuing the litigation if, at the certification stage, we know the plaintiff cannot prevail?

B. *Materiality, Price Impact, and Loss Causation*

Price impact, materiality, and loss causation are all intensely factual issues which should be determined in a trial on the merits, before a trier of fact—which could well be a jury—not in a mini-trial at the class certification stage, with a judge determining the factual issues. Previous Supreme Court decisions have determined that neither materiality²³² nor loss causation²³³ need to be proven by plaintiffs at the class certification stage. But Justice Roberts, in *Halliburton II*, determined that “defendants may introduce price impact evidence at the class certification stage, so long as it is for the purpose of countering a plaintiff's showing of market

232. See *Amgen*, 133 S. Ct. at 1197.

233. See *Halliburton I*, 131 S. Ct. 2179, 2184–87 (2011).

efficiency, rather than directly rebutting the presumption [of reliance].”²³⁴

But, price impact, materiality, and loss causation are all interrelated. Thus, evidence related to all three will be adduced at the class certification stage, and, if plaintiffs are successful in achieving certification, again at the trial on the merits. For example, the expert report of the plaintiffs in *Halliburton I*²³⁵ dealt with market efficiency (of which price impact is a factor),²³⁶ materiality,²³⁷ and loss causation.²³⁸ With respect to materiality, Jane D. Nettesheim, plaintiffs’ expert, stated:

It must be noted that a statistically significant change in a company’s security’s price (net of market and industry effects) is an indicator that new company-specific information has dramatically changed the total mix of information about a company Information “important enough to affect security prices when publicly released provides compelling evidence that a reasonable investor would consider the information important in making an investment decision.”²³⁹

Thus, the correlation of price impact upon materiality; further, without price impact, there would be no loss causation.

If investors are rational—and there is thinking that questions that assumption²⁴⁰—and if there is no market manipulation,²⁴¹ then immaterial

234. *Halliburton II*, 134 S. Ct. at 2414–15.

235. See *Report of Jane D. Nettesheim*, in Joint Appendix Volume I at 163a–262a, *Halliburton I*, 131 S. Ct. 2179 (2011) (No. 09-1403), 2011 WL 705206.

236. See *id.* at 167a–208a.

237. See *id.* at 208a–13a.

238. See *id.* at 213a–62a.

239. *Id.* at 211a (quoting Mark L. Mitchell & Jeffrey M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 BUS. LAW. 545, 549 (1994)).

240. See, e.g., Jeremy Clift, *Questioning a Chastened Priesthood*, 46 FIN. & DEV. 4, 4 (Sept. 2009), available at <http://www.imf.org/external/pubs/ft/fandd/2009/09/people.htm> (“[M]arkets are plagued by herding behavior and groupthink”); see also KAHNEMAN, *supra* note 151. See generally MARTIN SEWELL, BEHAVIOURAL FINANCE (Apr. 2010), available at <http://www.behaviouralfinance.net/behavioural-finance.pdf>.

241. When the market goes up and the economic and political news is negative, it could be asserted that either the market is not rational or that the market is being manipulated. From February to August 2014, the Dow Jones Industrial Average moved from under 16,000 to over 17,000 before—in the first part of August 2014—falling back to the middle of that range. The only positive domestic economic news had been in job gains, but the wages in the new jobs were 23% lower than the jobs that were lost in the recession. See U.S. CONFERENCE OF MAYORS, U.S. METRO ECONOMIES: INCOME AND WAGE GAPS ACROSS THE U.S. 2 fig.1 (Aug. 2014), available at <http://www.usmayors.org/metroeconomies/2014/08/report.pdf>. Thus, purchasing power was lagging. Capital expenditures were 15% less than the pattern prior to the recession; businesses were holding onto \$1.8 trillion in cash, rather than investing to create jobs and increase productivity. See Jamie McGeever, ‘Capex’ Mystery Confound Experts, CHI. TRIB. (Aug. 12, 2014), <http://ireader.olivesoft>

information, by itself, should have no impact on price and material information should affect the price. Much of the alleged fraud in publicly traded securities arises from management's attempt to maintain the price of the stock when it knows that the position of the company is deteriorating. In such a situation, the arguably material misrepresentation takes place at one point in time, and the price impact is reflected at another point in time, when the truth comes out. But the materiality of the information will be evidenced by the price impact when the truth comes out.

Again, consider the *Tellabs* situation. In December 2000 through March 2001, the CEO made misleading statements with respect to the continued growth of the company. In June, when the truth came out—namely, that sales of a major product had markedly decreased—the price of the stock plummeted. This is a pattern that repeats itself over and over again.²⁴² Consequently, there is a clear correlation between the materiality of an alleged misrepresentation, the price impact of such misrepresentation, and the plaintiffs' damages. It would seem logical and efficient that these issues would then be litigated at the same time.

ware.com/Olive/iReader/chicagotribune/SharedArticle.ashx?document=CTC%5C2014%5C08%5C12&article=Ar03902. Externally, the economy of Europe was shaky, growth in China had dropped, Russia was threatening war with the Ukraine, Israel and Hamas were at war, and Iraq and Syria were in chaos. What was the news that was driving the overall market?

The market for individual stocks is also of questionable rationality. When you compare the price of Amazon on August 1, 2013 with that of August 1, 2014, the price would appear to be essentially flat. Amazon closed at \$305 on August 1, 2013, and at \$307 on August 1, 2014. But the price of Amazon dropped to \$279 on August 28, 2013, and then rose to \$399 on December 2, 2013. This is a 43% increase in a little over three months. It rose to \$408 on January 22, 2014, but then dropped to \$337 on February 5, 2014. This is a 17% drop in two weeks. It then rose to \$383 on March 13, 2014, or a 13% increase in a little over a month, before dropping to \$284 on May 9, 2014. This is a 25% drop in less than two months. It then rose to \$364 on July 24, 2014, a 28% increase in a little over two months, before dropping to \$304 on August 1, 2014, a 16% drop in a week. Amazon's P/E ratio is almost 500. See *Amazon.com Inc. (AMZN) Historical Prices*, YAHOO FIN., <http://finance.yahoo.com/q/hp?s=AMZN+Historical+Prices> (last visited Jan. 12, 2015).

The volatility of Netflix was even greater. Its price rose from \$319 on January 15, 2014, to \$457 on February 25, 2014, a 42% increase in less than a month and a half. It then dropped to \$299 on April 28, 2014, a 34% drop in two months. Finally, it rose to \$475 on July 2, 2014, a 58% increase in a little over two months. Netflix's P/E ratio is around 160. See *Netflix, Inc. (NFLX) Historical Prices*, YAHOO FIN., <http://finance.yahoo.com/q/hp?s=NFLX+Historical+Prices> (last visited Jan. 12, 2015).

At best, this is a pattern of trading, not investing, and, at worst, raises a question of manipulation. The market for the stocks would certainly seem to be "efficient." Amazon had a market capitalization of over \$140 billion and an average daily volume of about 3.8 million shares. Netflix had a market capitalization of about \$26 billion and an average daily volume of about 2.7 million shares. There appears to be little in the way of "news" that would justify price swings of such magnitude.

242. See generally *Murdock*, *supra* note 11 (discussing cases that illustrate this pattern).

Justice Roberts, in *Halliburton I*, determined that loss causation need not be established at the class certification stage since reliance relates to the transaction causation and not loss causation. Thereafter, Justice Ginsburg, in *Amgen*, determined that materiality need not be proven at the class certification stage, because materiality is common to all plaintiffs as it is an objective standard. But if price impact is litigated at the class certification stage, according to Justice Roberts in *Halliburton II*, then we are once again bifurcating issues that ought to be tried together. From the standpoint of judicial economy and cost of litigation, these intensely factual issues should be determined in a trial on the merits. This would be possible if we backed away from the current interpretation of fraud on the market as indicating reliance on price integrity and recognized that what the market relies upon is information integrity.

VI. FRAUDULENT DISTORTION

As this Article was nearing completion, a very thoughtful article by Professors Bebchuk and Ferrell was published in *The Business Lawyer*.²⁴³ While the article was published after the Supreme Court decided *Halliburton II*,²⁴⁴ an earlier draft of the article had been circulated before the briefing of the case and was cited by the main briefs of both sides.²⁴⁵ Briefly stated, the authors would replace reliance on the efficiency of the market with “reliance on the market price not being impacted by (and thus reflecting) misstatements and omissions”²⁴⁶ or, in other words, not being impacted by fraudulent distortion.

The foregoing authors do an excellent job of arguing against the continued reliance on market efficiency as a basis for presuming reliance. While the courts, in dealing with the fraud on the market presumption, have treated efficiency as a binary concept—the market is either efficient or not efficient—Professors Bebchuk and Ferrell also argue that efficiency is a “continuum.”²⁴⁷

While the approach of Professors Bebchuk and Ferrell is superior to the present focus on market efficiency, it poses two difficulties. First of all, it is phrased in the negative, namely, that investors rely upon an absence of fraudulent distortion; secondly, it posits that investors rely upon a result rather than a cause. Once again, consider *Tellabs*. When management states that one major product is experiencing high demand, whereas in fact demand is drying up, and that a successor product is ready to ship, when in fact it is not, the market price is maintained at an artificially high

243. See Bebchuk & Ferrell, *supra* note 38.

244. The article was published in the May issue of *The Business Lawyer*, but it was not distributed until late July or early August. The decision of the Supreme Court in *Halliburton II* came down on June 23, 2014.

245. See Bebchuk & Ferrell, *supra* note 38, at 675.

246. *Id.* at 686.

247. See *id.* at 689–90.

level. This situation is in fact fraudulent distortion. But what investors rely upon is that the information introduced into the market by management is in fact truthful and accurate. If management had said that Tel-labs' business was substantially declining, investors would not have bought at the then existing market price. What investors rely upon is the truthfulness of the information in the market.

Moreover, any liability regime which posits reliance on the price of a security remains open to those who argue that investors do not rely on the price of the security. Professors Bebchuk and Ferrell assert that “[u]nder our approach, market prices need not be relied on or assumed by investors to reflect true value. Fraudulent distortion merely turns on whether the market price is different from what it otherwise would have been absent the fraud.”²⁴⁸ What then do investors rely upon? If you assert that they rely upon a price not affected by fraudulent misrepresentations, are you not really asserting that they rely upon the truthfulness of the mix of information in the marketplace?

The professors phrased the fraud on the market rule as consisting of three propositions:

- (A1) The price of a security traded in an efficient market will reflect all publicly available information about a company;
- (A2) Accordingly, a buyer of the security in an efficient market may be presumed to have relied on public information in purchasing the security; and
- (A3) Where the market for a security is inefficient, a plaintiff cannot invoke the fraud on the market presumption.²⁴⁹

They then recast the foregoing propositions as follows:

- (B1) The price of a security traded in an efficient *a public* market will reflect all *some* publicly available information about a company;
- (B2) Accordingly, a buyer of the security in an efficient *a public* market may be presumed to have relied on public information in purchasing the security *on the market price not being fraudulently distorted, i.e., not being different from what it would have been absent the disclosure deficiency*; and
- (B3) Where the market *price* for a security is inefficient *not fraudulently distorted*, a plaintiff cannot invoke the fraud-on-the-market *classwide reliance* presumption.²⁵⁰

248. *Id.* at 688.

249. *Id.* at 685.

250. *Id.* at 686 (strikethroughs indicating deletions and italics indicating additions).

Let's examine this new proposition. First of all, it recognizes that a public market need not impound all publicly available information before investors can be defrauded by misleading statements from corporate management. This is sound. Secondly, it recognizes that misleading information may have the effect of distorting price. This also is sound. But the third proposition then uses the presence or absence of price distortion to determine reliance, whereas the existence of price distortion, or the lack thereof, much more logically relates to both materiality and loss causation. In addition, this approach arguably is also subject to the issues raised by Justice White in his dissent in *Basic*.

As stated earlier, what investors really rely upon is the truthfulness of the information that is in the public markets. In the *Tellabs* example, investors relied upon public information that the sales of the 5500 continued apace and that the 6500 was ready for shipment and customers were eagerly awaiting it. If management had told the truth, investors would not have bought, and the price of Tellabs' stock would have plummeted, as it did when the truth was revealed.

Let me paraphrase what I have been asserting in this Article as a modification of Professors Bebchuk and Ferrell's modification of the three *Basic* propositions. Thus:

- (i) The price of a security traded in a public market will reflect some publicly available information about a company (thus, my first proposition would be identical to the theirs, although I would accept substituting "most" for "some");
- (ii) Accordingly, a buyer of the security in a public market may be presumed to have relied on public information in purchasing the security; and
- (iii) A defendant may rebut the presumption of reliance by proving that the misrepresentation did not affect the decision of a typical investor to purchase, i.e., the misrepresentation was not objectively material.²⁵¹

This is clearly a simpler approach to the issue of reliance. Arguably, it is also more straightforward. Adopting this approach would undoubtedly enrage defense counsel and the Business Roundtable, because it would simplify the certification process and eliminate all of the litigation over market efficiency. It would then leave the issues of materiality and loss causation to trial since they are factual issues common to all the plaintiffs. On the other hand, if an alleged material misstatement is so insubstantial

251. All of these three-proposition formulations are assuming that the plaintiff is a purchaser. This assumption is because most of the time management is trying to support the price of the shares and the purchaser overpays. In other words, management is putting good news into the marketplace. However, *Basic* itself dealt with a "bad news" situation, i.e., that no merger negotiations were taking place. In such a situation, the focus would be upon the seller being defrauded.

as to be determined immaterial as a matter of law, this could be dealt with at the class certification stage, or on a motion to dismiss or for summary judgment. All that would need to be established at the class certification stage is that the defendant company, and its management, inserted misleading material into the public marketplace. I would also accept a limited determination of materiality at the class certification stage: namely, whether the alleged misrepresentations were of the kind that a reasonable investor would normally rely upon.

Another way of comparing this approach to that of Professors Bebchuk and Ferrell is that their approach would permit, at the class certification stage, what Justice Roberts ultimately held in *Halliburton II*: that “defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.”²⁵² While Professors Bebchuk and Ferrell did not take a definitive position on whether the plaintiff or the defendant, at the class certification stage, should have the burden of proof on price impact, Justice Roberts appears to make the lack of price distortion an affirmative defense, with respect to which the defendant should have the burden. Putting that issue to one side, their approach clearly presents this issue of price impact for resolution at the certification stage, with the bifurcation of issues that ought to be tried together.

On the other hand, under the approach advocated by this Article, reliance flows from “information distortion,” not price distortion. Accordingly, at the certification stage, the only issue for resolution is whether the defendant corporation and its management introduced misleading information into the marketplace. If they have, reliance should be presumed. It could be argued that the effect of this approach is to make class certification a routine matter. And that is correct. It should be a routine matter, as it was before courts started using the class certification process to hold a mini-trial. As has been developed in this Article, factual matters, such as materiality, price distortion, and loss causation, together with science, should be developed in one proceeding at trial.

VII. CONCLUSION

Where are we after the *Sturm und Drang* of three United States Supreme Court decisions in three years²⁵³ grappling with the contours of the fraud on the market theory? I would argue that the present legal regime for private securities litigation is irrational, wasteful and inefficient, biased in favor of management as opposed to investors, and built upon illusion, not reality. The Supreme Court is wandering in an illogical thicket from which it cannot extricate itself. It is ideologically divided: the conserva-

252. *Halliburton II*, 134 S. Ct. 2398, 2417 (2014).

253. See, e.g., *Halliburton II*, 134 S. Ct. 2398; *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013); *Halliburton I*, 131 S. Ct. 2179 (2011).

tives are on a mission to protect business and management, sometimes corrupt management, from the onslaught of consumers, employees, and investors, while the liberals are fighting a rearguard action to prevent as much damage as possible.

Consider the contours of a private securities case. The plaintiff files a complaint which must set forth the misrepresentations with specificity—sufficient particularity to satisfy the sometimes unreasonable expectations of the federal courts—and must also set forth facts giving rise to a strong inference of scienter. The plaintiff is then met with a motion to dismiss which is to be heard before the plaintiff has an opportunity for discovery. The detail expected by federal courts often can only be obtained through confidential informants. However, confidential informants are viewed with a high degree of suspicion by federal courts.²⁵⁴

If the plaintiff surmounts the motion to dismiss and the expectations of pleading particularity, the next step is class certification. Some courts bifurcate discovery between that necessary for certification and that necessary for the trial on the merits. Supposedly, the discovery for class certification would be limited but, as a result of *Halliburton II*, the defendant can now raise price impact, which is intimately related to materiality and loss causation. However, the plaintiff is entitled to a presumption of reliance, or transaction causation, as a result of the fraud on the market theory. But one of the elements of the fraud on the market theory, according to the courts, is materiality, which, according to *Amgen*, is a matter to be addressed at a trial on the merits. Is this the clarity we would expect when billions of dollars are at stake?

According to most courts, the benefit of the fraud on the market presumption is only available when the market is efficient. Market efficiency is a concept developed by economics and finance professors to support the arguable proposition that the individual investor cannot beat the market. Its origins had nothing to do with securities fraud. The Nobel Prize in economics has been awarded to two professors who have opposing viewpoints on whether the market is efficient. Courts seem to regard market efficiency as a binary proposition and expect that, in an efficient market, material information will be quickly—in as little time as one day—impounded into the price of the company's stock. They give no credence to the idea that there are degrees of market efficiency, degrees of materiality, varying modes of communicating information to the market, varying probability of the sources of the information, and different degrees of complexity of the information so transmitted—all of which logically would affect the time necessary for information to be impounded into the market. This is a legal structure built upon an illusion.

254. See, e.g., *Higginbotham v. Baxter Int'l Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (Easterbrook, J.) (asserting that information supplied by confidential sources must be “discounted,” usually “steep[ly]”).

Since the reality is that there is no such thing as a perfectly efficient market, as one scholar has stated, “it becomes easy for a court to miss the forest for the trees by accepting too readily the defendants’ statistical evidence of imperfection as reason not to certify.”²⁵⁵

If the plaintiff does not succeed in obtaining class certification, that is usually the end of the litigation because most individual plaintiffs do not have a sufficient economic stake to carry on the cost of litigation on their own. If the plaintiff does succeed in certification, we then move on to discovery on the merits and eventually to trial.

Materiality, price distortion, and loss causation are all intertwined and highly factual issues. But the effect of these three Supreme Court decisions is to bifurcate these issues. This bifurcation only adds to the expense and confusion of litigation.

After almost seventy years of private securities litigation, it is time to step back and examine whether there is a more sensible approach. The starting place would be the securities laws themselves and the purposes for which they were enacted. The prevalence of fraud in the securities markets was clearly an impetus for the enactment of the securities laws; it is further clear that the securities laws were enacted for the protection of investors and to insure the maintenance of fair and honest markets. Moreover, as former Justice Stevens has stated, “[f]ashioning appropriate remedies for the violation of rules of law designed to protect a class of citizens was the routine business of judges,”²⁵⁶ or at least it was until a supposedly conservative, but in reality reactionary, Supreme Court began cutting away at investor protection.

As other scholars have recognized, “proving the efficiency of the market as a whole is only an indirect means of proving that the market relied on a particular statement.”²⁵⁷ *Basic*, in discussing materiality, focused on the fact that investors would be guided by the total mix of information available. It is this total mix of information upon which the investment community relies and which determines the price of the stock. Mandatory reporting under the securities laws provides much of this mix of information, while voluntary corporate disclosures, such as press releases and investor conference calls,²⁵⁸ provide additional information. These sources of information are supplemented by analyst reports and other third-party-generated information.

Since a major purpose of the securities laws was to provide investors with information, and since the purpose of the antifraud provisions is to ensure truthfulness, it seems far more logical to presume that investors rely upon this total mix of information, rather than believing the fantasy

255. Langevoort, *supra* note 119, at 173.

256. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 177 (2008) (Stevens, J., dissenting).

257. Brief of Law Professors, *supra* note 120, at 24.

258. See *What Is an Earnings Conference Call?*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/04/052104.asp> (last visited Jan. 12, 2015).

that they rely upon the integrity of market prices. What they rely upon is the integrity of the information that corporate management has introduced into the market. The integrity, or lack thereof, of market prices is a matter for a damage determination, namely, loss causation, not for reliance, transaction causation.

If this view of reliance is adopted, then the meaty factual issues of materiality, price distortion, and loss causation can be addressed at trial—which is where they belong. Rejecting the focus on market efficiency will, first, eliminate the present practice of ruminating about some idealized notion of an efficient market. Second, it will eliminate the use of minor imperfections in this idealized model to justify dismissal of class certification, and thus effectively avoid the termination of lawsuits that may well be meritorious. The focus of courts should be upon protecting investors and holding management accountable; too often the converse is true.

