Supreme Court Reconsiders Fraud on the Market

The Supreme Court heard oral argument last week in *Halliburton Co. v. Erica P. John Fund, Inc.*, a case that asks the Court to overrule or sharply limit the "fraud on the market" theory adopted by the Court 25 years ago in *Basic Inc. v. Levinson*, 495 U.S. 224 (1988). While it is impossible to predict the Court's ultimate holding, the questions posed by the justices at argument hint at changes that may make it more difficult for the plaintiffs' securities bar to get investor classes certified, and that add to the defendants' arsenal for defeating securities class actions early in the proceedings.

In *Basic*, the Court adopted the economic theory of "market efficiency," which posits that information is rapidly assimilated and reflected in the market price of securities that trade in "efficient" markets. The "fraud on the market" theory endorsed in *Basic* erected a presumption that permits investors to substitute reliance on the "integrity" of an efficient market for actual reliance on allegedly false or misleading disclosures. So long as the market is "efficient," *actual* reliance is not required. The result has been that certifying a class of investors is virtually automatic. Unless a defendant can demonstrate that the market for the security is not efficient, courts will certify investor classes alleging fraudulent disclosure, no matter how few class members ever read, saw, heard, or made their investment decision with actual knowledge of the offending statement.

Halliburton challenges that regime and asks the Court to throw *Basic* out or substantially limit its application. Among other things, the petitioners argue that the "efficient market" theory has been widely discredited. Securities prices reflect lots of things, including investor behavior as well as information. Modern trading practices, including high frequency trading and "program" trading, introduce confounding factors that move prices in ways that may be unrelated to news about the issuer. Arguing that the Court should not make class certification a foregone conclusion based upon an unsound economic theory unsupported by empirical evidence, Halliburton asked the Court to overrule *Basic* and reject the "fraud on the market" theory of liability altogether. Indeed, at least four justices signaled in opinions last year that *Basic* should at least be reexamined, or possibly eliminated.

At oral argument, sensing some hostility to completely revamping the regime *Basic* established, several justices expressed interest in a "middle ground" suggested by several law professors in an *amicus* brief. Rather than extinguishing *Basic* altogether, or letting plaintiffs continue to rely on market efficiency as a proxy for actual reliance, the "middle ground" would require a plaintiff to *prove* that the market price was *actually* distorted by the *specific* misrepresentation at issue in order to secure class certification. That could be done by using "event studies" or similar techniques to separate market movements predicated on other factors from price distortions attributable to specific disclosures claimed to be false or misleading.

If adopted by the Court, that "middle ground" would add a significant requirement to the negligible burden plaintiffs now face to secure class certification of securities cases. And it would offer defendants opportunities to defeat securities cases at that early stage. Front-end loading the requirement to prove a direct connection between a false statement and price changes into class certification proceedings, which typically occur early in a securities action, before defendants are burdened with substantial discovery and other costs, would reduce both cost and risk for defendants.

Ironically, while justices from both the liberal and conservative wings of the Court signaled interest in the "middle ground" proposal in order to avoid overruling *Basic*, the proposal stands in obvious tension with the Court's ruling on a related issue in the same case only two years ago. In *Halliburton I*, the Court held that securities fraud plaintiffs are not required to prove "loss causation" in order to obtain class certification because that is a "merits" issue to be decided at trial. The "middle ground" discussed at oral argument this week, however, is functionally similar to the "loss causation" element of a securities case. So requiring a plaintiff to prove price distortion from a misrepresentation at the class certification stage conflicts with the reasoning and holding of *Halliburton I*. If the "middle ground" is adopted, instead of overruling *Basic*, the Court may need to trim or overrule its much more recent decision.