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SCOTUS Clarifies "Fraud on the Market" Procedure in Securities Class Actions

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Investors suing for damages in a private securities fraud action under the U.S. securities laws must prove, among other things, that they relied on the defendant's misstatement when they bought or sold a security. In *Basic v. Levinson*, the U.S. Supreme Court allowed these investors to establish a rebuttable presumption of their reliance on defendant's misstatements under what the Court dubbed the "fraud on the market" theory. This theory holds that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." So whenever an investor "buys or sells stock at the market price, his 'reliance on any public material misrepresentations ... may be presumed for purposes of a Rule 10b-5 action.'" A plaintiff seeking to invoke a presumption of reliance must satisfy the four-element test developed in *Basic* to establish that the fraud impacted the stock price purchased by the plaintiff:

1. The alleged misstatements by defendants were publicly known
2. They were material
3. The stock plaintiffs bought or sold traded in an efficient market
4. The plaintiffs traded the stock between the time when the misstatements were made and when the truth was revealed.

The first three elements are directed at "price impact" — "whether the alleged misrepresentation affected the market price in the first place." Once these elements are established, a plaintiff is entitled a presumption of reliance.

In *Erica P. John Fund, Inc. v. Halliburton Co.* (*"Halliburton I"*), the Court found that its holding in *Basic* did not require securities fraud plaintiffs to prove "loss causation" — "a causal connection between the defendants' alleged misrepresentations and plaintiffs' economic losses" — at the class certification stage in order to establish the presumption of reliance under *Basic*. *Halliburton I* said loss causation could be proven in the merits stage. On remand of this decision, Halliburton argued that class certification was still inappropriate because its direct evidence proved that its misrepresentations did not impact its stock price, that the absence of this "price impact" rebutted the *Basic* presumption of plaintiffs' reliance on defendants' misrepresentations, that each class plaintiff would thus have to prove individual reliance, which meant individual issues would predominate over common ones, which made class certification under Federal Rule of Civil Procedure 23(b)(3) inappropriate. The district court declined to consider this argument and the Fifth Circuit affirmed.

In *Erica P. John Fund, Inc. v. Halliburton Co.* ("*Halliburton II*"), decided June 23, 2014, the Court considered Halliburton's new argument and issued the following seminal holdings:

1. *Basic*'s presumption of reliance under its "fraud on the market" theory is still the law —Halliburton failed to show any "special justification" for overruling *Basic*.
2. Securities fraud plaintiffs in private actions do not have to "directly" prove price impact at the class certification stage; price impact may be presumed "indirectly" if plaintiffs satisfy the "fraud on the market" test.
3. Securities fraud plaintiffs must prove the publicity and market efficiency elements of the test before class certification; the Court held last year that the materiality element of the theory had to be decided in the merits

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stage because it did not bear on the predominance requirement of Rule 23(b)(3), *see Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds*.

4. A securities fraud defendant can rebut the presumption of reliance before class certification with direct evidence of a lack of price impact.

This last holding is arguably the most significant. Under this holding, if a defendant successfully rebuts the presumption of price impact of its fraud with direct evidence (which may be "event studies" which perform a regression analysis of events that show the misrepresentation event did not impact the price of defendant's stock) at the class certification stage, then a plaintiff cannot satisfy the "fraud on the market" test. If a plaintiff cannot satisfy the test, then the plaintiff is not entitled to a presumption of reliance, which means each plaintiff will have to prove reliance individually. This means that common issues would not "predominate," and the securities fraud class cannot be certified under Rule 23(b)(3). "Price impact is thus an essential precondition for any Rule 10b-5 class action."

In theory, this finding in *Halliburton II* provides an opportunity for defendants in securities fraud class actions to rebut at the class certification stage the powerful presumption of reliance imposed by *Basic*'s "fraud on the market" theory. Allowing defendants to engage in this "battle of the experts" at the class certification stage is important, because once securities classes are certified, settlement (many times on grounds other than the merits) is almost certain.

In their concurrence in the judgment, Justices Thomas, Scalia, and Alito joined to opine that *Basis* should be overruled and that securities fraud plaintiffs should have to prove actual reliance, "not the fictional 'fraud on the market' version." These concurring justices offered the following reasons for their opinion:

- Today's economic realities undermine the foundation of the *Basic* Court's reliance presumption
- *Basic* was an inappropriate judicial construct on a judicially created cause of action rather than a proper interpretation of duly enacted securities legislation
- *Basic* incorrectly presumes all investors buy stock in reliance on the integrity of the price (noting that "value investors" buy stock because its price does not accurately reflect its value, or because transacting parties disagree on the validity of a stock price);
- *Basic's* presumption of reliance conflicts with the Court's more recent decisions clarifying the importance of affirmatively demonstrating compliance with Rule 23, including Rule 23(b)(3)'s predominance requirement.
- In practice *Basic's* "rebuttable" presumption is largely irrebuttable because of the ease with which class counsel can find a single shareholder to withstand defendant's reliance challenge at the class certification stage, and the almost certainty of a settlement after the class is certified, a settlement which will likely not have much to do with the merits of reliance.

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