

No. 13-317

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**In the Supreme Court of the United States**

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HALLIBURTON CO. AND DAVID LESAR, PETITIONERS,

*v.*

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

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

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**BRIEF OF LAW PROFESSORS AS AMICI CURIAE  
IN SUPPORT OF PETITIONERS**

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## INTEREST OF AMICI CURIAE<sup>1</sup>

Amici are law professors whose scholarship and teaching focuses on corporate law and federal securities law. Amici have an interest in ensuring that the securities laws are interpreted to accurately reflect both current financial economic scholarship and the law's historical underpinnings. Amici filed amicus briefs in *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011), and in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2012), both addressing the consideration of market impact and the fraud on the market theory at the class certification stage of Rule 10b-5 securities fraud suits.

Amici include Adam C. Pritchard, the Frances and George Skestos Professor of Law at the University of Michigan Law School; and M. Todd Henderson, Professor of Law at the University of Chicago Law School.

## SUMMARY OF ARGUMENT

In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Court held that in a Rule 10b-5 securities fraud suit, plaintiffs may invoke a “presumption of reliance” to gain class certification under Federal Rule of Civil Procedure 23(b)(3), which requires that common questions of law or fact “predominate” over questions

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<sup>1</sup> No counsel for a party authored this brief in whole or part, and no counsel or party made a monetary contribution to fund the preparation or submission of this brief. No person other than the amici curiae and their counsel made any monetary contribution to its preparation and submission. The parties have filed letters giving blanket consent to the filing of amicus briefs in this case.

particular to individual class members' claims. *Id.* at 241-48. *Basic* held that this presumption was supported by the "fraud on the market theory," which provides that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." *Id.* at 247, 250.

*Basic* grounded its holding on the understanding that "the market price of shares traded on well-developed markets reflects all publicly available information," including "any public material misrepresentations"—a concept embodied in the "efficient capital markets theory." *Id.* at 246-47 & n.24. *Basic* reasoned that because every public material misrepresentation is reflected in a security's price, an investor's reliance on a misrepresentation "may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247.

*Basic* thus combined two distinct concepts: the fraud on the market theory and the efficient capital markets hypothesis. The efficient capital markets hypothesis is not necessary to the use of the fraud on the market theory—whenever the market incorporates fraudulent information into the price, a "fraud on the market" has occurred, whether the market is efficient or not. But the two concepts can be combined to allow plaintiffs to invoke a presumption of reliance about an alleged fraud if they can demonstrate that the relevant market was "efficient," *i.e.*, that it "reflect[ed] all publicly available information." *Id.* at 246. In the years before *Basic*, scholars and lower courts championed the simultaneous application of these concepts in the belief that well-developed markets were efficient, and that their stock prices reflected all public

information. And while *Basic* claimed “not to assess the general validity of” these theories, *id.* at 242, courts have read *Basic* to accept them and to hold that a presumption of reliance is appropriate when market efficiency has been established.

*Basic*’s view of capital market efficiency was unrealistic. Rather than being totally “efficient” or “inefficient,” securities markets enjoy varying degrees of efficiency, and incorporate information at varying rates. Although some well-developed markets incorporate most information into prices relatively quickly, research conducted since *Basic* suggests that even the most open markets are not completely efficient and incorporate some information slowly (if at all). Accordingly, *Basic*’s understanding that a particular alleged fraud will necessarily be incorporated into the stock price is no longer sound.

Moreover, lower courts’ attempts to estimate efficiency have been inconsistent and empirically inaccurate. Faced with the difficult task of determining whether a market is “efficient,” courts have resorted to examining proxies for efficiency. Many such proxies are highly correlated with each other (and therefore redundant), while others have little empirical relationship with efficiency, and there is confusion about how to weigh the various factors. The result is a doctrinal and empirical muddle for both courts and litigants.

These difficulties are encountered unnecessarily because the fraud on the market theory does not require use of the efficient capital markets hypothesis to show reliance. All that is necessary is evidence of a particular misstatement’s effect on a security’s

market price. In light of the difficulties in evaluating efficiency, the Court should shift the focus of fraud on the market inquiries from a market's overall efficiency to the question whether the alleged fraud affected market price. The decision below should be reversed because it focuses on efficiency at the class certification stage, rather than on the market effect of the alleged misstatements.

In addition, this Court should clarify the connection between the form of reliance asserted by the plaintiff in a Rule 10b-5 class action and damages. The out-of-pocket measure of damages should be limited to cases in which the plaintiff can show actual reliance or that a material misstatement has distorted the market price for a security. If a plaintiff cannot make that showing, the remedy should be limited to disgorgement.

## ARGUMENT

### I. **BASIC'S USE OF MARKET EFFICIENCY AS A MEANS OF SHOWING RELIANCE IS UNNECESSARY AND COUNTERPRODUCTIVE**

Plaintiffs bringing a Rule 10b-5 securities fraud claim must prove they relied upon the company's alleged misrepresentation when deciding to trade the company's security. *Basic*, 485 U.S. at 243. Traditionally, such reliance is determined on an individualized basis. Cf. *id.* at 242; see also *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 481 (2d Cir. 2008). But in the context of securities fraud class actions, which can be maintained only when common questions of law or fact predominate over individual questions, see Fed. R. Civ. P. 23(b)(3), "[r]equiring proof of individualized reliance from each



member of the proposed plaintiff class effectively would \* \* \* prevent[] [plaintiffs] from proceeding with a class action, since individual issues then would \* \* \* overwhelm[] the common ones.” *Basic*, 485 U.S. at 242.

In *Basic*, the Court allowed class action plaintiffs to invoke a “presumption of reliance” in lieu of showing individual reliance by combining two then-new economic theories. The first of these was the semi-strong version of the efficient capital markets hypothesis, see *In re Res. Am. Sec. Litig.*, 202 F.R.D. 177, 189 n.12 (E.D. Pa. 2001), which postulates that “security prices fully reflect all available information,” Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. Fin. 1575, 1575 (1991); see *Basic*, 485 U.S. at 246. Second was the fraud on the market theory, which provides that reliance may be presumed where “a fraud affects the price of a publicly traded security [because] investors will be affected even if they trade without knowledge of the misrepresentations that influenced the price at which they traded.” *Stark Trading v. Falconbridge Ltd.*, 552 F.3d 568, 572 (7th Cir. 2009); accord *Basic*, 485 U.S. at 247.

Combining these concepts, the *Basic* Court concluded:

An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

*Id.* The Court observed that then-recent “empirical studies have tended to confirm \* \* \* that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” *Id.* at 246-47 & n.24.

Based on this language, courts and commentators have often interpreted *Basic* to allow plaintiffs to employ the fraud on the market theory only if they can demonstrate that the relevant market “reflects all publicly available information,” a quality known as “efficiency.” See, e.g., *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 368 (4th Cir. 2004) (“*Basic* clearly requires that a market be efficient in order for the fraud-on-the-market presumption of reliance to be invoked \* \* \* .”). Although *Basic* indicated that a market need only incorporate “most” information, see *Basic*, 485 U.S. at 246 n.24, other language in the opinion, see *id.* at 246, along with many of the sources it cites, state that the market must reflect “all” information to be efficient. See *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 11-12 (1st Cir. 2005) (collecting authorities).

An examination of the efficiency of markets is not, however, necessary for determining reliance or establishing the existence of a fraud on the market; it is not even the best means of determining reliance, even in the context of class actions.

#### **A. Examining Efficiency Is Unnecessary To Demonstrate “Fraud On The Market”**

Although “*Basic* seems to insist on” a showing of market efficiency to support a fraud on the market claim, Donald C. Langevoort, *Theories, Assumptions,*

*and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851, 899 (1992), there is no basis for such a requirement. To maintain a Rule 10b-5 action, a plaintiff must show only that he relied on the particular false statements. Proving that a market is generally highly efficient, and thus tends to incorporate all information quickly, is unnecessary to demonstrating that there has been a fraud on the market as to a specific statement, as long as a market functions well enough to incorporate the specific misrepresentation at issue into a security's price. See Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907, 911 (1989); Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 Va. L. Rev. 1017, 1021 (1991) ("Because security prices react quickly to new information, we can test for the relevant consideration—whether a security's price has been affected by misleading information."). Perfect market efficiency may be "a sufficient reason why an investor relying on market-price integrity would be harmed" by fraud, but is not a necessary one "because fraud can and does distort prevailing prices" even in inefficient markets. Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. 151, 161.

The fraud on the market theory effectively "shifts the inquiry from whether an individual investor was fooled to whether the market as a whole was fooled" by a misstatement. *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1479 (N.D. Cal. 1992); see also Fischel, *Efficient Capital Markets, supra*, at 907. The efficient capital markets hypothesis, in turn, provides a basis for the assumption that the market would be

fooled by *any and all* instances of fraud. But such a showing is unnecessary to demonstrate that the market was fooled by a particular statement. As one scholar observed, “[t]he only important question is whether the price was distorted” for the individual stock, not whether the market is efficient as a general matter. Langevoort, *Theories, supra*, at 898-99.

This understanding is borne out by the conception of the fraud on the market theory before *Basic*. The efficient capital markets hypothesis was first combined with the fraud on the market theory in the 1980s. See Jeffrey L. Oldham, Comment, *Taking “Efficient Markets” out of the Fraud-on-the-Market Doctrine after the Private Securities Litigation Reform Act*, 97 Nw. U. L. Rev. 995, 1006-11 (2003). Before then, the fraud on the market presumption was described “as being predicated on a showing that ‘the plaintiff establishes that a lie, misleading statement, or omission has affected the price of the stock.’” *Id.* at 1007 (quoting *Flamm v. Eberstadt*, 814 F.2d 1169, 1179 (7th Cir. 1987)); see also 4 Alan R. Bromberg & Lewis D. Lowenfels, *Bromberg & Lowenfels on Securities Fraud and Commodities Fraud* § 7:468 (2d ed. 2000) (“This text first suggested in 1967 that a 10b-5 reliance requirement in open market transactions could be satisfied by showing that an investor who traded with reference to market price and conditions could be treated as indirectly relying on a misrepresentation which affected the market.”). Thus, the inquiry concerned the effect of a particular piece of information on the stock price in question.

But courts and commentators began to employ the efficient capital markets hypothesis, emphasizing that if a plaintiff could show that a market was

efficient, then *any* material misrepresentation in a case necessarily affected the price of the security. Oldham, *supra*, at 1010-11 (citing *In re LTV Sec. Litig.*, 88 F.R.D. 134, 142-46 (N.D. Tex. 1980)); Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 9-10 (1982); see also *Peil v. Speiser*, 806 F.2d 1154, 1163 (3d Cir. 1986) (stating that “a well-developed market can reasonably be presumed to respond to even a single material misrepresentation or omission concerning a stock \* \* \* traded in that market”); Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 Wm. & Mary L. Rev. 373, 374-75 (1984). *Basic* relied on several of these sources for its conclusion that well-developed markets reflect all public information. *Basic*, 485 U.S. at 246 n.24 (citing *LTV*, Fischel, and Dennis). Conversely, it was understood that if a market were *not* completely efficient, the fraud on the market presumption would be inappropriate. See *Reingold v. Deloitte Haskins & Sells*, 599 F. Supp. 1241, 1264 (S.D.N.Y. 1984) (“In [inefficient] markets, the price of a security does not necessarily reflect all [information and] an inference of \* \* \* reliance is inapposite.” (citation omitted)). Thus, the efficient capital markets hypothesis “effectively became a proxy for showing that the misrepresentation actually affected the stock price.” Oldham, *supra*, at 1011; accord Langevoort, *Theories*, *supra*, at 890-91 (“The fraud-on-the-market theory is often understood to carry with it the second presumption that in an efficient market, a material misrepresentation or actionable omission influences the market price, and therefore removes the need to actually prove the impact.”).

The fact that total market efficiency is unnecessary to establish fraud on the market is not itself reason to eliminate the requirement of such a showing. But reference to market efficiency has disadvantages that counsel the use of a different mechanism for demonstrating reliance.

**B. *Basic's* Efficiency Requirement Is Poorly Tailored To Remedy Fraud On The Market**

Experience has shown that efficiency is not an especially close proxy for reliance, providing a remedy that is both underinclusive in some respects and overinclusive in others.

*Basic's* focus on the overall efficiency of a market, rather than the effect of the specific misstatement, needlessly limits investors' ability to employ the class-action mechanism with respect to less efficient markets, even when the market price reflects the alleged misstatements. Lower courts have held *Basic's* presumption of reliance to be unavailable to investors in newly issued securities, see *In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24, 42 (2d Cir. 2006); *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990), mortgage-backed bonds, see *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.*, 546 F.3d 196, 210 (2d Cir. 2008), collateralized debt obligations, see *Dodona I, LLC v. Goldman, Sachs & Co.*, 847 F. Supp. 2d 624, 651 (S.D.N.Y. 2012), and securities in less developed markets, see *Krogman v. Sterritt*, 202 F.R.D. 467, 474-78 (N.D. Tex. 2001), even when the alleged false statement is significant. The class-action mechanism is frequently unavailable because the class cannot show efficiency.

This outcome is unfortunate because it is “in \* \* \* small companies, traded over the counter or on non-traditional exchanges, that the kinds of fraud Rule 10b-5 was designed to avert are most likely to occur.” Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in Cammer v. Bloom and Its Progeny*, 10 U. Miami Bus. L. Rev. 303, 322-23 (2002); see also Advisory Comm. on Smaller Public Companies, Final Report to the U.S. Securities & Exchange Commission 139 (2006) (2006), *available at* [www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf](http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf) (noting that “small firms consistently have more misstatements and restatements of financial information, nearly twice the rate of large firms”). If the rationale for the fraud on the market presumption is that investors should be able to rely on securities markets being free from fraud,<sup>2</sup> it makes little sense to focus on market efficiency, which effectively limits the presumption of reliance to only the largest and most trustworthy securities issuers.

Just as the emphasis on efficiency is underinclusive as to potentially strong fraud cases perpetrated in less efficient markets, it is overinclusive as to weak fraud cases involving more efficient markets. “For large-cap stocks, there is seldom any debate over whether the market is efficient enough: efficiency is assumed.” Langevoort, *Basic at Twenty, supra*, at 173. Thus, plaintiffs suing

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<sup>2</sup> See *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975) (“The statute and rule [of Section 10(b) and Rule 10b-5] are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely.”).

a widely traded issuer can be certified as a class even where the market, due to the obscurity or complexity of the information (or some other reason), did not actually rely on the misstatements. Although defendants can assert a lack of actual reliance as a defense on the merits, as a practical matter, a class action is overwhelmingly likely to settle once it is certified.<sup>3</sup> Because such settlements are most easily procured from the largest and most well-traded companies (which have the most to lose and can more readily afford them), they create a significant impact on the capital markets. Such an overinclusive standard undermines deterrence by encouraging the class action bar to pursue claims against the largest companies, rather than the ones most likely to have engaged in fraud.

### **C. Market Efficiency Determinations Are Difficult For Courts To Make**

Many courts interpret *Basic* to permit plaintiffs, upon a showing of efficiency, to substitute a rebuttable presumption of reliance for a showing that the alleged misrepresentations actually influenced the market price. This substitution suggests both that the efficient capital markets hypothesis is a sound explanation for market movements and that

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<sup>3</sup> See Jordan Milev et al., *Recent Trends in Securities Class Action Litigation: 2011 Year-End Review* 12 (Dec. 14, 2011) (unpublished manuscript), available at [www.nera.com/nera-files/PUB\\_Trends\\_Year-End\\_1211\\_final.pdf](http://www.nera.com/nera-files/PUB_Trends_Year-End_1211_final.pdf) (noting that since late 1995, “there have been only 29 securities class action trials, as compared to a total number of over 3,800 filings”); Bryant G. Garth, *Studying Civil Litigation through the Class Action*, 62 Ind. L.J. 497, 501 (1987) (reporting a 78% settlement rate for certified class actions and only a 15% settlement rate for noncertified cases).



evaluating a security's overall efficiency is more practicable than determining whether the misstatement actually distorted the market price. See *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc.*, 967 F.2d 742, 748 (2d Cir. 1992) ("To saddle a plaintiff with proving the 'generally indeterminable fact of what would have happened but for \* \* \* the misrepresentations that skewed the market value of stock would reduce the protection against fraud afforded by Section 10(b).'" (brackets omitted) (quoting *duPont v. Brady*, 828 F.2d 75, 78 (2d Cir. 1987))). It is now recognized, however, that markets are rarely, if ever, totally efficient. Moreover, showing efficiency is in most cases a more difficult task than demonstrating distortion of market price caused by a particular misstatement.

**1. Since *Basic* Was Decided, Research Has Called The Efficiency Of Markets Into Question**

In employing the efficient capital markets hypothesis to support a presumption of reliance, *Basic* observed that "empirical studies have tended to confirm \* \* \* that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." 485 U.S. at 246. The decision thus relied on the understanding that "[r]esearchers agree that the efficient capital market model," which "posits that the price of a security reflects all publicly available information[,] \* \* \* accurately represents the pricing behavior of stocks." Dennis, *supra*, at 374-75; see *Basic*, 485 U.S. at 246 n.24 (citing Dennis). On that basis, courts and commentators have concluded that *Basic* implicitly endorsed the

semi-strong form of the efficient capital markets hypothesis, which theorizes that “an efficient market is one in which all publicly available information is reflected in the market price of the stock.” *PolyMedica*, 432 F.3d at 10 n.16; see also *Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010).

The *Basic* Court’s confidence in the efficient capital markets hypothesis was a product of its time. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 549 (1984) (“Of all recent developments in financial economics, the efficient capital markets hypothesis \* \* \* has achieved the widest acceptance by the legal culture.”) However, as economists have deepened their understanding of capital markets, they have tempered their faith in the efficiency of markets.

Contrary to the view of efficiency *Basic* appears to have accepted, “efficiency is not a binary, yes or no question.” Langevoort, *Basic at Twenty*, *supra*, at 167. Rather, there is a spectrum of market efficiency, see Gilson & Kraakman, *supra*, at 560, and “[p]erfect efficiency is just a theoretical ideal,” Langevoort, *Basic at Twenty*, *supra*, at 167. Levels of efficiency vary even among types of information within the same market: If one piece of information is more easily collected and understood than another, it will be incorporated into the market price more quickly, even if both pieces of information concern the same security. See Brad M. Barber et al., *The Fraud-on-the-Market Theory and the Indicators of Common Stocks’ Efficiency*, 19 J. Corp. L. 285, 290-91 (1994);

Gilson & Kraakman, *supra*, at 558-59.<sup>4</sup> “For example, stock prices may reflect certain types of public information (concerning, for instance its own prices, or the interest rate on Treasury Bills) faster than other types of public information (concerning, for example, Iraq’s invasion of Kuwait).” Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 Va. L. Rev. 945, 976 (1991).

And because no real-world market is completely efficient, information—even important, publicly disseminated information—is not always rapidly incorporated into prices. For example, there is evidence of large disparities in market reaction to accounting restatements depending on the prominence of the restatement. See Rebecca Files et al., *Stealth Disclosure of Accounting Restatements* (Apr. 27, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1395768](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1395768). Similarly, there is evidence that the *Wall Street Journal*’s publication of reports of trading by corporate insiders rapidly and significantly affects that corporation’s stock price, even though the SEC usually makes such reports public several days earlier. See Saeyoung

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<sup>4</sup> See also Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. Corp. L. 656 (2003):

Information that is easy to understand and that is trumpeted in the business media—for example, merger announcements or news of a stock split—may be incorporated into market prices almost instantaneously. But information that is “public” but difficult to get hold of, or information that is complex or requires a specialist’s knowledge to comprehend, may take weeks or months to be fully incorporated into prices. Indeed it may never be fully incorporated at all.

Chang & David Y. Suk, *Stock Prices and the Secondary Dissemination of Information: The Wall Street Journal's "Insider Trading Spotlight" Column*, 33 *Fin. Rev.* 115, 115-17 (1998). And “[o]ne of the most common types of material disclosures—an earnings surprise—actually takes a while to be fully impounded, even for large-cap stocks, and even varies depending on whether it is good news or bad.” Langevoort, *Basic at Twenty*, *supra*, at 170. The efficient capital markets hypothesis would suggest that such material, public information would be quickly incorporated into stock prices, but empirical evidence indicates otherwise.

In the same vein, in *In re Merck & Co. Securities Litigation*, 432 F.3d 261 (3d Cir. 2005), information regarding Merck—a large and well-followed firm in a well-developed market—was first released to the public in a complicated format through an SEC filing, to no demonstrable market effect. *Id.* at 269-70. As one scholar has noted, “it is hard to imagine any stock more likely traded in an efficient market than Merck,” Langevoort, *Basic at Twenty*, *supra*, at 174, and so the efficient capital markets hypothesis would suggest that this information would rapidly be incorporated in price. But when an article in the *Wall Street Journal* “read[] between the lines of this disclosure” several weeks later, the result was a significant decline in price. *Merck*, 432 F.3d at 263, 265. The court of appeals determined on this basis that the information was immaterial—even though the markets’ response to the *Journal* article clearly militates against that conclusion—because “the efficient market hypothesis suggests that the market made these basic calculations months earlier.” *Id.* at 271. It is also plausible, however, that the market

had not actually incorporated the information when first released in the more obscure format. See, *e.g.*, Langevoort, *Basic at Twenty*, *supra*, at 176 (noting possibility that market missed implications of Merck’s initial disclosures). Commentators have identified many other instances in which markets have moved inefficiently.<sup>5</sup>

Early research on the efficient capital markets hypothesis—the research available at the time *Basic* was decided—focused on types of information that are usually rapidly incorporated into market prices (such as “stock splits, dividend changes, corporate mergers, and the like”). Stout, *supra*, at 653. But other “types of information highly relevant to assessing the economic health of firms appear to be incorporated into stock prices far more slowly and incompletely than the conventional view of market efficiency would suggest.” *Id.* Researchers also analyzed broad-based indices rather than individual

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<sup>5</sup> See, *e.g.*, Marlene A. Plumlee, *The Effect of Information Complexity on Analysts’ Use of That Information*, 78 *Acct. Rev.* 275, 293 (2003) (concluding that analysts fail to incorporate complex information in forecasts); Gur Huberman & Tomer Regev, *Contagious Speculation and a Cure for Cancer: A Nonevent that Made Stock Prices Soar*, 56 *J. Fin.* 387 (2001) (noting significant market effect of prominent news item concerning information that had been public for months); Peter Klibanoff et al., *Investor Reaction to Salient News in Closed-End Country Funds*, 53 *J. Fin.* 673 (1998) (concluding that well-publicized news items were more likely to move the market than redundant information found elsewhere, and that well-publicized news events created short periods in which the relevant markets reacted more quickly to changes); Thomas S.Y. Ho & Roni Michaely, *Information Quality and Market Efficiency*, 23 *J. Fin. & Quantitative Analysis* 53 (1988) (finding market effect from republication of already available information).

securities, which yielded results showing efficiency and obscured anomalous results involving particular securities. See Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 Del. J. Corp. L. 455, 525 (2006).

Post-*Basic* research has identified significant limitations on the efficient capital markets hypothesis. Markets *sometimes* rapidly incorporate most public information, but there are substantial exceptions to this generalization, even as to material information in relatively efficient markets. In light of this research, *Basic*'s assumption that a market deemed efficient will promptly and reliably incorporate a *particular misstatement* into a security's price—which is, at bottom, what courts consider to be a “fraud on the market”<sup>6</sup>—does not reflect the current understanding in financial economics.

## **2. Courts And Commentators Have Struggled With Determining When A Particular Market Is Sufficiently “Efficient” To Support A Presumption of Reliance**

*Basic* requires courts to determine whether markets are “efficient” or “not efficient.” But as discussed above, markets exist along a spectrum of efficiency rather than at either end, and *Basic* offers no guidance about the point at which a market becomes efficient enough to qualify for the

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<sup>6</sup> See *Verifone*, 784 F. Supp. at 1479 (“The fraud-on-the-market theory \* \* \* shifts the inquiry from whether an individual investor was fooled to whether the market as a whole was fooled.”).

presumption of reliance. Moreover, a determination of efficiency is inherently difficult to make. Not even financial economists have been able to develop an agreed-upon test to prove efficiency. Because economists “do not know how to [c]alculate the price that fully reflects the available information,” it is difficult at best to test whether a market fully reflects all publicly available information. Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. Corp. L. 517, 525 (2003); Fama, *supra*, at 1575 (“[M]arket efficiency per se is not testable.”). Perfect efficiency is not a realistic scenario. See Fama, *supra*, at 1575.

If efficiency determinations are difficult (if not impossible) for economists, they are harder still for courts: Determining efficiency “requires courts to drift far from their institutional competence.” Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. Chi. L. Rev. 879, 905 (1998). Because of difficulties in determining market efficiency, courts have resorted to examining proxies associated with efficient markets. If the proxies indicate a sufficiently large and developed market, the market is deemed efficient. The most prominent of the tests courts have developed is that set forth in *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989). The proxies *Cammer* employed were the percentage of shares traded weekly; whether “a significant number” of analysts follow and report on the stock; the existence of market makers trading the stock; whether the issuer was qualified to use an S-3 registration statement with the SEC; and whether the plaintiff can “allege empirical facts showing a cause and effect relationship between unexpected corporate events or

financial releases and an immediate response in the stock price.” *Id.* at 1286-87. Courts have also looked to other proxies, including market capitalization, see *Krogman*, 202 F.R.D. at 478, bid-ask spread, *id.*, percentage of stock held by insiders, *id.*, and volume of trading by institutional investors, *O’Neil v. Appel*, 165 F.R.D. 479, 503 (W.D. Mich. 1996). But these indicators are only proxies for efficiency. See *In re Countrywide Fin. Corp. Sec. Litig.*, 273 F.R.D. 586, 613 (C.D. Cal. 2009) (stating that many *Cammer* factors “indirectly assess market efficiency”); Bradford Cornell & James C. Rutten, *Market Efficiency, Crashes, and Securities Litigation*, 81 Tul. L. Rev. 443, 455 (2006) (“[T]he *Cammer* and *Krogman* factors \* \* \* are best understood as constituting an indirect test by which courts *infer* efficiency for reliance purposes.”). These courts, then, took *Basic*’s already-relaxed concept of reliance—essentially a proxy for individual reliance adopted to allow more plaintiffs to bring securities class actions—and relaxed it further by allowing proxies for efficiency rather than the inquiry into actual efficiency that *Basic* required.

What is more, the factors lower courts consider in determining efficiency frequently are unmoored from efficiency. Apart from being highly correlated with each other (and therefore redundant),<sup>7</sup> research indicates that some often-considered factors, such as the number of market makers, issuer size, bid-ask spread, and institutional holdings, are not

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<sup>7</sup> Barber et al., *supra*, at 293 (“[G]iven that most efficiency drivers are correlated, as the volume of trade and firm size are, they cannot be considered as independent efficiency indicators.”).



empirically correlated with efficiency. See Barber et al., *supra*, at 285-86; Victor L. Bernard et al., *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of Fraud-on-the-Market Theory*, 73 Neb. L. Rev. 781, 796 (1994). As a result of this research, some courts have reduced the emphasis on market makers. See, e.g., *Unger v. Amedisys Inc.*, 401 F.3d 316, 324 (5th Cir. 2005). But even these courts persist in considering other less reliable factors, and many other courts continue to use all the *Cammer* factors. See, e.g., *In re Dynex Capital, Inc. Sec. Litig.*, No. 05 Civ. 1897, 2011 WL 781215, at \*5 (S.D.N.Y. Mar. 7, 2011) (examining market makers); *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 635 (N.D. Ala. 2009); *In re Infineon Techs. AG Sec. Litig.*, 266 F.R.D. 386, 396-97 (N.D. Cal. 2009). And even the *Cammer* factor most closely correlated with efficiency—the speed at which the stock incorporated other information in the past—may not say much about how quickly the market incorporated the information in a particular case, because different types of information, and information disclosed through different sources, are incorporated at different rates.

This problem is compounded by the fact that many proxies closely correlated with efficiency do not actually test efficiency. See David Tabak, *Use and Misuse of Event Studies to Examine Market Efficiency 2* (Apr. 30, 2010) (unpublished manuscript), available at [www.nera.com/nera-files/PUB\\_Use\\_Misuse\\_of\\_Event\\_Studies\\_0410\\_final.pdf](http://www.nera.com/nera-files/PUB_Use_Misuse_of_Event_Studies_0410_final.pdf) (noting that, with the exception of response of prices to new information, “factors cited by courts are designed to be conditions that are likely to either be conducive to or the result of an efficient market”). Thus, their correlation with

efficiency may be diminished in the future. For example, the studies noted above, which demonstrate that dollar trading volume is indicative of efficiency, were published in 1994. Since then, internet trading has risen in popularity, increasing the number of novice investors and adding to trading volume.<sup>8</sup> This added volume does not mean that the market became more efficient—in fact, internet traders and day traders often add to stock volatility without causing the price to reflect available information more quickly. See William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 Emory L.J. 843, 930 (2005) (noting that “large trading volume does not—if significantly including day trading and other online retail brokerage transactions—signal that the mechanism for efficient market pricing is actively working on the stock price”). Thus, trading volume probably is not as closely correlated with efficiency now as it was in 1994.

The relationship between analyst following and efficiency has been questioned in light of similar market trends. See *id.* at 966-68 (noting that analyst bias during the dot-com bubble of 1998-2001 rendered analyst following an unsound predictor of efficiency during that period). More broadly, because most of the *Cammer* factors “are largely *descriptive*, not

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<sup>8</sup> See Brad M. Barber & Terrance Odean, *The Internet and the Investor*, 15 J. Econ. Persp. 41, 41, 47 (2001) (stating that “[f]rom 1995 through mid-2000, investors opened 12.5 million on-line brokerage accounts” and that evidence suggests that access to internet trading leads to a greater volume of trading); Gregory La Blanc & Jeffrey J. Rachlinski, *In Praise of Investor Irrationality*, in *The Law and Economics of Irrational Behavior* 542, 558-59 (Francesco Parisi & Vernon L. Smith eds. 2005).

*predictive,*” and cannot “be used directly to predict efficiency,” Rapp, *supra*, at 319, there is a risk that changes such as the internet trading explosion will undermine the factors’ correlation with market efficiency. Because there inevitably will be lag time in understanding changes in the securities market, when such changes occur, courts may not apprehend their significance for years. Thus, courts’ tests for efficiency may include factors that have little or no connection to market efficiency.

In addition, courts are inconsistent in applying these factors. The case law is unclear about how much of a factor (or a combination of factors) is necessary to show efficiency. Courts are “ill-equipped to determine and analyze the fundamentals of market efficiency; *i.e.*, \* \* \* ‘how many’ analysts [a]re needed to ensure that information concerning a company finds its way, through buy and sell recommendations, into the price of a company’s stock, and ‘how many’ market makers [a]re needed to ensure the market’s ‘swift’ incorporation of company news into the price of a company’s stock.” Paul A. Ferillo et al., *The “Less Than” Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 St. John’s L. Rev. 81, 93 (2004) (citations omitted). Thus, courts applying *Cammer* factors have come to disparate conclusions when evaluating similar facts. See Rapp, *supra*, at 309-17, 328. The result is “a massive hodgepodge of \* \* \* outcomes.” Ferillo, *supra*, at 102 (reviewing cases and concluding “most courts will come to very individual conclusions” on efficiency and find different factors persuasive).

In view of the difficulties courts face in determining market efficiency, this Court should reconsider the role *Basic* has assigned to the efficiency determination in assessing reliance. As set forth below, this Court should abandon *Basic*'s insistence upon a demonstration of efficiency in favor of a showing that the particular misrepresentation caused a market distortion.

## **II. IN DETERMINING RELIANCE, COURTS SHOULD LOOK TO MARKET MOVEMENT CAUSED BY AN ALLEGED MISREPRESENTATION, RATHER THAN TO OVERALL MARKET EFFICIENCY**

Judicial inquiry into market efficiency, despite its difficulties, might still be worthwhile if it were the most reliable means of establishing whether to apply the fraud on the market presumption. But it is not. Apart from the fact that courts have difficulty making determinations of efficiency, see *supra* at 18-24, proving the efficiency of the market as a whole is only an indirect means of proving that the market relied on a particular statement. And as discussed below, determining 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 into reliance, and a more reliable method of showing whether the complained-of fraud was, in fact, a "fraud on the market."

### **A. The Event Study Is The Best Available Tool To Examine Market Distortion And Show Reliance**

The central issue in determining whether the fraud on the market presumption may be invoked is

“whether the challenged disclosure artificially inflated ([or] deflated) the market price of the particular security. Inquiry into whether the market price was inflated ([or] deflated) replaces individualized inquiry into the extent to which particular investors were aware of a challenged disclosure.” Fischel, *Efficient Capital Markets, supra*, at 908. But even without relying on the general efficiency of markets, there remains a reliable and practicable method for courts to determine whether misstatements distorted the market: the event study.

“An event study is a regression analysis that measures the effect of an event, such as a firm’s earnings announcement, on a firm’s stock price.” Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of Dura Pharmaceuticals, Inc. v. Broudo*, 63 Bus. Law. 163, 166 (2007). “[A]n event study [can] determine whether the alleged misrepresentations caused any statistically significant stock price movements when made or when a supposedly corrective disclosure was made, controlling for other possible causes of stock price movements (such as movements of the overall market) and random fluctuations.” Daniel R. Fischel, *Market Evidence in Corporate Law*, 69 U. Chi. L. Rev. 941, 948 (2002). Event studies “are commonly used to isolate the effects on the stock price of the disclosure of the withheld information.” Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421, 1433 (1994). Thus,

[i]f an event study shows that a misrepresentation or a corrective disclosure had a statistically significant effect on the

price of a stock, then the market may be said to have “relied” on the misrepresentation. And, by the fraud-on-the-market theory, all of the investors who bought (or sold) the stock also “relied” by buying or selling at a market price that included a component reflecting the falsity.

Fisher, *supra*, at 874. Conversely, if an event study shows that a misrepresentation or corrective disclosure<sup>9</sup> had no statistically significant effect on the stock price, then the market cannot be said to have relied on the misrepresentation.

The event study is the “gold standard” technique for determining whether the market relied on a misstatement. Madge S. Thorsen et al., *Rediscovering the Economics of Loss Causation*, 6 J. Bus. & Sec. L. 93, 109 (2006). It is accepted by courts, academics, and the SEC for that purpose. See *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 245 F.R.D. 147, 170 (S.D.N.Y. 2007) (finding “numerous courts have held that an event study is a reliable method for determining market efficiency”), *rev’d on other grounds*, 574 F.3d 29 (2d Cir. 2009); *In re N. Telecom Ltd. Sec. Litig.*, 116 F. Supp. 2d 446, 460

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<sup>9</sup> When the fraud at issue involves an alleged omission or a misstatement to meet expectations (and accordingly has no effect on stock price), plaintiffs can use an event study to discern the market effect of the corrective disclosure. See David Tabak, *Loss Causation and Damages in Shareholder Class Actions: When It Takes Two Steps to Tango* 6 (May 27, 2004) (unpublished manuscript), available at [http://www.nera.com/extImage/200405Tabak\\_Loss\\_Causation.pdf](http://www.nera.com/extImage/200405Tabak_Loss_Causation.pdf). However, amici do not contend that the presumption of reliance in cases of pure omissions created by *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), should be altered.

(S.D.N.Y. 2000); *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993); Fischel, *Market Evidence*, *supra*, at 948 (describing an event study as a “simple statistical technique, used in thousands of academic studies and employed routinely in securities fraud litigation brought under the federal securities laws”); 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, 572-84 (1994) (describing SEC enforcement actions using event study analysis).

Event studies are routinely employed to show that a market is efficient at the class certification stage. See, e.g., *Teamsters*, 546 F.3d at 207-10; *In re Xcelera.com Sec. Litig.*, 430 F.3d 503, 512-14 (1st Cir. 2005); *In re Nature’s Sunshine Prods. Inc. Sec. Litig.*, 251 F.R.D. 656, 664-65 (D. Utah 2008). Such studies examine the market effect of various news items relating to an issuer; if the security “change[s] rapidly, and in the expected direction, in response to new information,” it supports a finding of market efficiency. *Schleicher*, 618 F.3d at 684; see also *Teamsters*, 546 F.3d at 207-08 (“Evidence that unexpected corporate events or financial releases cause an immediate response in the price of a security has been considered ‘the most important[] *Cammer* factor.’” (quoting *Xcelera.com*, 430 F.3d at 512)).

Thus, courts are already considering experts’ event studies examining the effect of disclosures at the class certification stage to prove that a market generally incorporates information into prices, to trigger the *Basic* presumption of reliance. But the

same experts could conduct the same analyses to determine directly whether the alleged misstatement was incorporated into the stock price—the added step of determining efficiency as a general matter is unnecessary. Event studies can examine market effects of particular affirmative misstatements by looking to the effect at the time of disclosure; in cases involving omissions, they can look to the date the information was corrected. See David Tabak, *Making Assessments about Materiality Less Subjective through the Use of Content Analysis* 4-5 (Mar. 13, 2007) (unpublished manuscript), available at [http://www.nera.com/extImage/PUB\\_Tabak\\_Content\\_Analysis\\_SEC1646-FINAL.pdf](http://www.nera.com/extImage/PUB_Tabak_Content_Analysis_SEC1646-FINAL.pdf).

Amici submit that a direct analysis of the market impact of a specific alleged misstatement, rather than examination of general market efficiency, is a more straightforward and reliable test for whether the fraud on the market theory should be invoked. Such an approach conforms *Basic* to current finance theory and research, and by limiting the over- and underinclusiveness of the current approach, it offers better prospects for allowing meritorious class actions to continue while preventing baseless ones.

Respondent relies on scholarship stating that “finding measurable [price] distortion is often hard” to attack the use of a market-impact test for the fraud on the market presumption. See Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market?: Reflections on Amgen and the Second Coming of Halliburton* 10 (Nov. 16, 2013) (unpublished manuscript), available at <http://scholarship.law.georgetown.edu/facpub/1226>; Br. in Opp. 24 n.5. This scholarship posits that event studies cannot always



measure market impact. Langevoort, *Judgment Day*, *supra*, at 10-12. But while it may be more difficult in such instances to show price distortion as a result of a particular misstatement, this increased difficulty should not prevent the adoption of a market-impact inquiry in class actions.

As an initial matter, a market-impact requirement is reasonable and theoretically sound because it demands that a putative class show the presence of a true fraud on the market. A “fraud on the market” occurs if a fraud affects the price of a security. See *Basic*, 485 U.S. at 247; *Stark Trading*, 552 F.3d at 572. Requiring a showing of market impact simply compels that a putative class demonstrate the occurrence of such an event. Indeed, by not requiring proof that an alleged misstatement moved the market, and instead accepting an imprecise proxy for market movement fashioned out of indirect efficiency evidence, a putative class in essence receives the benefits of two presumptions instead of one: first, the presumption of the reliance requirement through the fraud on the market theory, and second, the presumption of an instance of fraud on the market itself, through the proxy of efficiency. Simply put, a class wishing to avail itself of the fraud on the market presumption of reliance should be required to show that a fraud on the market actually occurred.

In addition, worries that a market-impact requirement would improperly frustrate class certification where a fraud on the market has truly taken place are overblown. Although one commentator argues that such frustration would “often” occur, see Langevoort, *Judgment Day*, *supra*,

at 10-12, that same commentator noted that “[e]vent-study-methodology works acceptably well even for thinly traded stocks,” Langevoort, *Basic at Twenty, supra*, at 179. Commentators have also noted that economic analysis can resolve common event-study issues such as confounding events. See Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class Action Lawsuits*, 2009 Wis. L. Rev. 199, 227-41 (noting that content analysis can separate and clarify the impact of multiple simultaneous events); Ferrell & Saha, *supra*, at 170 (explaining the use of shorter event windows to avoid confounding events); David I. Tabak & Frederick C. Dunbar, *Materiality and Magnitude: Event Studies in the Courtroom*, in *Litigation Services Handbook 19.2* (Roman L. Weil et al. eds., 2001) (noting that economists can disentangle the effects of multiple announcements on a single day if the effect of nonfraudulent announcements on that day can be estimated, perhaps through analogues on other days). At least for showing the existence of some market impact (and thus the presence of a fraud upon the market)—even if the precise magnitude of such impact is debatable—event studies are the best available tool.

Indeed, the reliability of event studies is supported by their adoption by courts in determining damages under *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). *Dura* requires 10b-5 plaintiffs to show that a stock drop is due to fraud and not “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price,” *id.* at 343, and many courts have found

event studies indispensable for this purpose.<sup>10</sup> The primacy of event studies in securities class actions in other stages of litigation belies the assertion that they are unworkable at class certification to show market impact.

Moreover, cases in which no market movement can be discerned through current economic methods would likely ultimately fail at the merits stage under *Dura* for lack of demonstrable damages. See *Dura*, 544 U.S. at 346-47 (holding fraud claim insufficient in absence of price drop for corrective disclosure). This is not to say that a market-impact inquiry is a merits-only inquiry that must wait until after class certification. Rather, the concern for putative classes that cannot show market movement may be misplaced, because claims brought by such classes are likely to fail under *Dura*'s current demands.

For these reasons, putative classes that cannot show that a fraud on the market took place through

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<sup>10</sup> See, e.g., *United States v. Schiff*, 602 F.3d 152, 173 n.29 (3d Cir. 2010) (observing that event studies are the technique “most often used by experts to isolate the economic losses caused by the alleged fraud”) (quoting *In re Apollo Grp. Inc. Sec. Litig.*, 509 F. Supp. 2d 837, 844 (D. Ariz. 2007)); *In re Diamond Foods, Inc., Sec. Litig.*, -- F.R.D. --, 2013 WL 1891382, at \*12 (N.D. Cal. May 6, 2013) (discussing widespread use of event studies in calculating damages and citing cases); *Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse First Boston*, 853 F. Supp. 2d 181, 186 (D. Mass. 2012) (“An event study is an accepted method of measuring the impact of alleged securities fraud on a stock price and often plays a ‘pivotal’ role in proving loss causation and damages in a securities fraud case. Given the difficulty inherent in proving the effect, if any, of a single news item on the price of a stock, many courts require them in such cases.”) (quoting *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195, 1272 (N.D. Okla. 2007)).

proof of market impact should not receive the benefit of a broad presumption of reliance.

**B. A Proposed Class Unable To Show Market Impact Should Be Entitled To Disgorgement Remedies Only**

*Basic* reserved the question of the proper measure of damages in cases relying on the fraud on the market theory. See 485 U.S. at 248 n.28. Although putative classes unable to show either actual reliance or an instance of fraud on the market through market impact should not, for the reasons above, enjoy a presumption of reliance, recovery for such classes need not be completely foreclosed. Rather, a class using only evidence of market efficiency to gain class certification could receive disgorgement damages rather than out-of-pocket damages.

Such an approach is supported by the overall structure of the securities laws. This Court has instructed that “[w]hen the text of § 10(b) does not resolve a particular issue, we attempt to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act. For that inquiry, we use the express causes of action in the securities Acts as the primary model for the § 10(b) action.” *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 178 (1994).

The implied right of action in Section 10(b) does not address the appropriate measure of damages in cases in which reliance is shown only through efficiency proxies, rather than through direct evidence or proof of market impact. Consequently, it is appropriate to look to the explicit causes of action

provided by Congress. The private causes of action created by Congress suggest that where reliance is absent, disgorgement is the proper remedy. For example, Sections 11 and 12(a)(2) of the Securities Act of 1933 do not require reliance, but they limit damages to the offering price—in essence, a disgorgement remedy. See 15 U.S.C. §§ 77k, 77l. This measure of recovery is also stipulated for the private causes of action for insider trading in Sections 16(b) and 20A of the Exchange Act of 1934. See *id.* §§ 78p, 78t-1.

In contrast to these causes of action for which reliance is not required, Section 18 of the Exchange Act—perhaps the statutory provision most similar to Rule 10b-5—allows investors purchasing or selling securities “in reliance upon” a misstatement in the company’s SEC filings to recover “damages caused by such reliance.” *Id.* § 78r. Courts have held that indirect forms of reliance, such as the fraud on the market presumption, do not satisfy Section 18’s reliance requirement.

Thus, in the private causes of action expressly created by Congress, recovery is limited to some measure of the defendant’s benefit (the disgorgement measure of unjust enrichment). Only when the plaintiff can show reliance on the misstatement has Congress provided for the out-of-pocket measure of damages.

Following *Central Bank*’s instruction to look to the explicit causes of action provided by Congress under the federal securities laws as the model for the Rule 10b-5 cause of action, the remedy for plaintiffs resorting to a fraud on the market presumption based

on indirect efficiency evidence should be disgorgement. Out-of-pocket damages in Rule 10b-5 cases should be limited to actual reliance, or cases in which the plaintiff can establish that the price was distorted by the material misstatement, as outlined above.

In addition to according with the statutory structure enacted by Congress for dealing with securities fraud, limiting plaintiffs using indirect efficiency evidence to disgorgement would more directly deter fraud. In most fraud on the market cases, the corporation does not benefit from the relevant misrepresentation; rather, executives perpetrating the fraud benefit through performance bonuses or stock-option profits. In fact, rather than benefiting the issuer, fraud perpetrated by these executives harms an issuer because it forces that company to pay undeserved bonuses and benefits inflated by fraud. Notwithstanding the lack of benefit to the corporation, the combination of the fraud on the market presumption and the out-of-pocket measure of damages encourages class action plaintiffs to pursue claims against the corporation, rather than wrongdoing officers.

A disgorgement remedy could better allocate remedial sanctions to those most culpable for fraud: the corporate officers who make material misstatements with scienter. Such a remedial scheme would empower investors to strip wrongful gains from those individuals who actually made actionable misstatements, enhancing deterrence. Of equal importance, it would eliminate frequently draconian sanctions for issuers that do not benefit from fraud.

**CONCLUSION**

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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