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No. 09-1403

IN THE
# Supreme Court of the United States

ERICA P. JOHN FUND, INC.,
*Petitioner,*
v.
HALLIBURTON CO. AND DAVID J. LESAR,
*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit**

## BRIEF OF PUBLIC JUSTICE, P.C. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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## INTEREST OF *AMICUS CURIAE*

Public Justice, P.C. ("Public Justice") is a national public interest law firm dedicated to pursuing justice for the victims of corporate and government abuses. Public Justice concentrates its efforts on precedent-setting and socially significant individual and class action litigation designed to advance civil rights, civil liberties, consumer rights, workers' rights, the preservation of the civil justice system, and the protection of the poor and underrepresented. Public Justice regularly represents plaintiffs in class actions. Its experience is that the class action device often is the only meaningful way that individuals can vindicate important legal rights. Public Justice believes that the decision below, if affirmed, will unduly restrict securities class actions and weaken the only remedial mechanism available for large numbers of individuals who have each suffered a small monetary harm as a result of corporate misconduct.[1]

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[1] *Amicus*, by its counsel, is the sole author of this brief. No one other than *amicus* or its members made a monetary contribution to its preparation or submission. The parties have filed letters giving blanket consent to the filing of *amicus* briefs in this case.

## STATEMENT

On June 3, 2002, Petitioner (plaintiff below), on behalf of itself and those similarly situated, filed its initial complaint. On April 4, 2006, plaintiff submitted a Fourth Amended Complaint, asserting claims against Respondents, the defendants Halliburton Co. and David J. Lesar (its former president and chief operating officer), for intentionally misstating Halliburton Co.'s financial results and financial condition in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (as amended), 15 U.S.C. §§ 78j, 78t, and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. On March 28, 2007, the district court denied defendants' motion to dismiss and subsequently their motion for reconsideration in light of *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

On September 17, 2007, Petitioner moved for class certification. On November 4, 2008, the district court denied class certification, finding that plaintiff had not proven loss causation by a preponderance of the evidence. *See Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 3:02-CV-1152-M, 2008 WL 4791492 (N.D. Tex. Nov. 4, 2008) (citing *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 265 (5th Cir. 2007)). Plaintiff petitioned for interlocutory review of the district court's class decision pursuant to Rule 23(f) of the Federal Rules of Civil Procedure, which petition was accepted by the United States Court of Appeals for the Fifth Circuit ("Fifth Circuit").

Addressing plaintiff's arguments that it need not prove loss causation in order to invoke the presumption of reliance for class certification,

the Fifth Circuit held itself to be bound to apply *Oscar, supra,* and implemented that holding on loss causation without further analysis[2]:

> Plaintiff contends that our precedent, specifically the requirement of *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007), that class plaintiffs prove loss causation at the class certification stage, is contrary to Supreme Court and sister circuit precedent. Plaintiff may not assail *Oscar* as wrongly decided, as we are bound by the panel decision. *See Soc'y of Separationists, Inc. v. Herman,* 939 F.2d 1207, 1211 (5th Cir. 1991) ("In this circuit, one panel may not overrule the decision, right or wrong, of a prior panel in the absence of an intervening contrary or superseding decision by the court *en banc* or the Supreme Court.").

*See Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 334 n.2 (5th Cir. 2010).

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[2] No petition for certiorari was filed in *Oscar.*

**SUMMARY OF ARGUMENT**

The Fifth Circuit's holdings in both this case, *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010)("*Halliburton*"), and in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), reject the common-sense and long accepted principle that the market prices of securities reflect and react to publicly available information about those securities and their issuers. 597 F.3d at 334-35; 487 F.3d at 268-70. These decisions thus clash with the federal securities laws, Congress's intent in enacting them, and contemporaneous academic analysis and commentary concerning the basis for their enactment. When enacting the federal securities laws in the 1930's, Congress understood that the market prices of securities generally reflect and react to publicly available information about those securities and their issuers, that this mechanism is not always perfect or instantaneous, and that investors rely on the integrity of market prices in making their investment decisions.

The Fifth Circuit rejected this common-sense proposition as "unfounded, at least as market efficiency is presently measured," based on certain critiques of the efficient market hypothesis. *See Oscar*, 487 F.3d at 269-70. Respectfully, the Fifth Circuit's reasoning does not justify either its restriction of the presumption of reliance or its narrowing of the fraud-on-the-market doctrine. First, the presumption of reliance and the fraud-on-the-market doctrine implement congressional policy as embodied in the federal securities laws, which policy remains

vital in the present era, not the efficient market hypothesis as various economists have articulated it at various times. Changes in economists' understanding of the efficient market hypothesis, or their qualifications of that theory in light of varying empirical findings, do not change congressional policy.

Second, any purported evolution in the understanding of the efficient market hypothesis is not grounds to alter the presumption of reliance. This Court's decision in *Basic, Inc. v. Levinson* adopting the presumption of reliance was grounded on congressional policy and *not* on economic scholarship regarding the efficient market hypothesis. *See* 485 U.S. 224, 245-46 (1988).

Third, the academic debates concerning the efficient market hypothesis have not changed materially since this Court's decision in *Basic* – the debates and critiques concerning the efficient market hypothesis started twenty years before this Court decided *Basic* and continued after. The positions in that debate were established, and their merits evaluated, long before this Court issued that decision. This Court was aware of that debate when it decided *Basic*. The continuing debate is thus not reason to revisit or narrow *Basic*'s presumption of reliance.

Because the Fifth Circuit's holding departs from the letter and intent of the federal securities laws, the decision of the Court of Appeals should be reversed.

## ARGUMENT

### I. THE FIFTH CIRCUIT RENOUNCED VITAL AND FUNDAMENTAL CONGRESSIONAL POLICIES AS EMBODIED IN THE FEDERAL SECURITIES LAWS.

#### A. THE FIFTH CIRCUIT REJECTED, OR GRAVELY LIMITED, THE LONG-RECOGNIZED UNDERSTANDING THAT MATERIAL MISREPRESENTATIONS MOVE MARKET PRICES FOR SECURITIES.

The rationale for the decisions in both *Halliburton* and *Oscar* contravenes a basic premise of the federal securities laws: namely that securities' prices generally reflect publicly available information (both accurate and inaccurate) concerning them and respond to changes in that information, which changes can and do include the revelation that prior material statements concerning the issuers' business or finances were false or misleading. In *Oscar* (which *Halliburton* held controlling and followed), the Fifth Circuit rejected this principle, *see* 487 F.3d at 268-70; 597 F.3d at 334 n.2, frustrating the congressional purpose of the federal securities laws.

Specifically, in *Oscar*, 487 F.3d at 268-70, the Fifth Circuit required securities plaintiffs seeking class certification to demonstrate loss causation – that is, to show that disclosure of corrective information "moved" the subject security's price – to trigger the fraud-on-the-

market doctrine and to allow a class of purchasers to be certified. In imposing this requirement at class certification, the Court of Appeals renounced the enduring congressional understanding that the prices of securities trading on the market reflect publicly available information (and misinformation) and changes therin as "unfounded, at least as market efficiency is presently measured."[3] In so ruling, however, the

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[3] The Court of Appeals explained itself in full in *Oscar* as follows, *id.* at 269-70 (footnotes omitted):

> The assumption that every material misrepresentation will move a stock in an efficient market is unfounded, at least as market efficiency is presently measured. There are two additional explanations, besides immateriality, for why a misrepresentation might fail to affect the stock price, both relevant to classwide reliance. First, it might be that even though the market for the defendant's shares has been demonstrated efficient by the usual indicia, the market is actually inefficient with respect to the particular type of information conveyed by the material misrepresentation, *i.e.*, analysts and market makers do poorly at digesting line-count information. Thus our approach gives effect to information-type inefficiencies, recognizing that "the market price of a security will not be uniformly efficient as to all types of information." A second possible explanation for a misrepresentation's failure to move the market is that the market was

Fifth Circuit rejected the congressional policy embedded in the federal securities laws and frustrated its legislative purpose.

### B. THE FEDERAL SECURITIES LAWS EMBODY THE PRINCIPLES OF THE FRAUD-ON-THE-MARKET DOCTRINE.

In the 1930's, when it enacted the federal securities laws, Congress well understood (a) that market prices for securities reflected publicly available information and misinformation about those securities, (b) that misinformation concerning securities could artificially inflate or depress their prices, and (c) that the correction of misinformation would usually affect securities prices in the market. Congress also was aware that securities markets could be flawed and thus would not necessarily react perfectly or

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strong-form efficient with respect to that type of information, *i.e.*, due to insider trading, the restated line count was reflected by the stock price well before the 4Q01 corrective disclosure. Both explanations resist application of the semi-strong efficient-market hypothesis, the theory on which the presumption of classwide reliance depends. This court honors both theory and precedent in requiring plaintiffs to demonstrate loss causation before triggering the presumption of reliance. The trial court erred in ruling that the class certification stage is not the proper time for defendants to rebut lead Plaintiffs' fraud-on-the-market presumption.

instantaneously to changes in publicly available information. Cognizant of both the strengths and limits of securities markets, Congress encoded the basic premise that markets respond to public information (and misinformation) throughout the federal securities laws, endorsing as a basic premise the notion that correct and accurate information would create a market with correct and accurate pricing and that misrepresentations could work frauds on the market as a whole. Respected commentary from the period of the securities laws' enactment provides further evidence that the laws were understood to incorporate this notion.

For example, in the legislative history of the Securities Act of 1933 (the "Securities Act"), Congress explicitly recognized that an issuer's statements about a security determine the price of that security and are thus relied on by an investor, even if an investor is unaware of the statements:

> The statements for which they are responsible, although they may never actually have been seen by the prospective purchaser, because of their wide dissemination, determine the market price of the security, which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase. The connection between the statements made and the purchase of the security is clear, and, for this reason, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements.

H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933).

Likewise, the legislative history of the Securities Exchange Act of 1934 (the "Exchange Act") reflects that market price is an equilibrium price determined by the activities of buyers and sellers in an open market with access to full and complete information about a security, that misrepresentation skews that equilibrium price, and that information eventually – even if not instantaneously – works its way into market price:

> No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors *may not instantaneously be reflected in market value*, but despite the intricacies of security values truth does find relatively quick acceptance on the market.

H.R. Rep. No. 1382, 73d Cong., 2nd Sess. (1934) (emphasis added). The 1932-34 Senate Banking and Currency Committee investigation (known as

the Pecora Hearings) provided Congress with ample illustration of schemes where financial disclosures were manipulated for the purpose of defrauding the market, having an unquestionable impact on market prices. 1 Louis Loss, Joel Seligman & Troy Paredes, *Securities Regulation* 301-03 (4th ed. 2006). Congress sought to correct such abuses with the federal securities laws.

Congress, having witnessed the spectacular run up in the stock market and its collapse,[4] certainly understood that prices in financial markets sometimes inaccurately valued securities. Nonetheless, when framing the federal securities laws, Congress placed strong emphasis on the dissemination of accurate market information and recognized that the information would be encoded in market prices.

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[4] The Seventy-Third Congress took office in the wake of the most profound market crash in United States, if not world, history. Preceding that crash was an astonishing stock market bubble from 1927 through September 1929, one of the ten largest economic bubbles in history. *See* Charles P. Kindleberger & Robert Aliber, *Manias, Panics, and Crashes: A History of Financial Crises* 9 (5th ed. 2005). During that period, the Dow Jones Industrial Average rose from approximately 155 on January 3, 1927 to peak at 381.17 on September 3, 1929, before collapsing to 198.69 by November 13, 1929, and ultimately reaching a nadir of 41.22 in July 8, 1932, an 89.19% decline from its 1929 high.

Prominent commentators, writing at the time the Securities Act and Exchange Act were enacted, were familiar with the concept that market prices encode information. In 1931, Adolf Berle, surveying United States securities law, recognized that (a) publicly available information about securities must be accurate because it impacts market prices and (b) courts were imposing liability based on the fraud-on-the-market doctrine, even if that doctrine was not yet known by that name:

> [A] free market contemplates appraisal of the value of the stock by both buyer and seller. *Appraisal is necessarily on the basis of information.* Accordingly, *all markets move in a nexus of information gathered from all sources* and circulated in a variety of ways, recognized and unrecognized. ... Most of the information circulated, however, and that dealt with here, is information relating to a specific stock, and designed to bear upon the value of that stock. *It seems to be an established rule of law that any statement of any kind issued by anyone and intended to affect the price of, or to be used in appraising a security must be accurate; and that the knowing publisher of false information is liable in an action of fraud to anyone who relies on it, or, probably, even to anyone who acts to his loss in the open market on a false valuation as a result of such statement.*

Adolf A. Berle, *Liability for Stock Manipulation*, 31 Colum. L. Rev. 263, 268 (1931) (emphasis added; footnote omitted) (citing *Stewart v. Joyce*, 201 Mass. 301, 87 N.E. 613 (1909); *Kilgore v. Bruce*, 166 Mass. 136, 44 N.E. 108 (1896)). Addressing

liability to purchasers for false statements, Berle was even more explicit:

> *Is it necessary that the purchaser knows of the specific false statement? Probably not*; the only decision on the point indicates that where the effect of the statement was to create a false valuation or appraisal by the entire market, and the buyer relied upon the state of the market, he had, at second hand as it were, relied on the statement itself. The chain of causation between the statement relied upon and price adopted by the investor is slightly longer than in the ordinary case of deceit, but is no less direct. If the X corporation states that its earnings are $13 a share when, in fact, its income statement should really show a loss, and the market estimates the value of the stock at $130 on the basis of such statement, and *the investor buys at the market price, he has relied on the market situation, which in turn resulted from the false statement.*

*Id.* at 269-70 (emphasis added; footnote omitted) (citing *Ottinger v. Bennett*, 203 N.Y. 554, 96 N.E. 1124 (1911); *Bedford v Bagshaw*, 4 H. & N. 538, 157 Eng. Rep. 951 (Exch. 1859)).

Then-professor William O. Douglas, who was intimately associated with the drafting of the Securities Act, similarly understood the Act to be premised on the vital importance of public information to the market prices for securities. As he wrote for a general audience in the Yale Review in early 1934:

> The truth about securities having been told, the matter is left to the investor. The Act presupposes that the glaring light of

> publicity will give the investors needed protection. But those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or the intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant. And wise and conservative investors will find the Securities Act useful but not necessary and from it will gain but little real protection against an occasional Kreuger or Insull. This means that the results of the Act so far as investors are concerned are primarily twofold: (1) the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity; (2) even though an investor has neither the time, money, nor intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price. Through them investors who seek advice will be able to obtain it. And so during the early months of the life of a security the registration statement will serve as a healthy conditioner of the market.

William O. Douglas, *Protecting the Investor*, 23 Yale Rev. 522, 523-24 (1934).

In writing about the Exchange Act, James William Moore and Frank Wiseman similarly recognized the pervasive relevance of available

issuer information to share pricing and the need for comprehensive disclosure to promote accurate pricing:

> [T]ransactions on the exchange affect not only the securities there handled, but serve as a yardstick to measure the tremendous immobile holdings of like securities throughout the country. Proper attention to pricing is therefore essential. Before market quotations can be accepted as an accurate appraisal of a security, the market must be free and open, both in the sense of liquidity – the continuous operations of buyers and sellers, and in the sense that price is honestly chancered. To effect the latter, buyers and sellers must have adequate financial information and the opportunity to trade on an unrigged market.

James William Moore and Frank M. Wiseman, *Market Manipulation and the Exchange Act*, 2 U. Chi. L. Rev. 46, 48 (1934) (certain footnotes omitted). In footnote 12 (*see id.* at 48 n.12), the authors continued,

> In appraising values, information is needed on at least general business conditions; the condition of the industry involving the particular security; the financial record of the company and perhaps of other like companies for comparative purposes; and the demand for, and the resulting price of, the security.

In recognition of its understanding of markets and the role of public information in

them, Congress adopted numerous disclosure requirements and penalties for false statements in 1933 and 1934.[5]

In sum, the proposition that "material misrepresentation[s] will move a stock in an efficient market" is a common-sense principle that guided Congress in the design of the federal securities laws and was incorporated by Congress into the structure of those laws. Equally, Congress was aware that this generalization had its exceptions and that securities prices did not always react instantaneously or perfectly to public information. In rejecting the principle that material misrepresentations can be presumed to move prices of securities that trade on open and well-developed markets, the Fifth Circuit has contravened the congressional understanding of the securities markets and frustrated its regulation of them.

## II. IN *BASIC, INC. V. LEVINSON* THIS COURT IMPLEMENTED CONGRESSIONAL POLICY WHEN IT ACCEPTED THE PRESUMPTION OF RELIANCE.

Starting with *Kardon v. National Gypsum Co.* in 1946, the federal courts embraced private rights of action under Section 10(b) and SEC Rule 10b-5 as implementing congressional policy in the federal securities law. *See* 69 F. Supp. 512 (E.D. Pa. 1946). Subsequently, the Courts of Appeals uniformly endorsed the presumption of reliance

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[5] *See, e.g.*, 15 U.S.C. §§ 77g, 77h, 77k, 77*l*, 77q, 78f(b)(5), 78f(f), 78j, 78*l*, 78m, 78p.

and the fraud-on-the-market doctrine in the 1970's and early 1980's as a further implementation of the congressional objectives embedded in the federal securities laws. These courts held that plaintiffs would be entitled to a presumption of reliance (*i.e.*, transaction causation) whenever the defendant made false statements in connection with securities that traded in a developed, impersonal market. *See, e.g.*, *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986) ("plaintiffs who purchase in an open and developed market need not prove direct reliance on defendants' misrepresentations, but can satisfy their burden of proof on the element of causation by showing that the defendants made material misrepresentations") (footnote omitted); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 & n.9 (8th Cir. 1986) ("False or misleading information, such as that involved in this case, can actually harm investors directly – through actual reliance, or indirectly – by affecting the market upon which the investor relied and traded."); *Blackie v. Barrack*, 524 F.2d 891, 905-08 (9th Cir. 1975) ("causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations").[6]

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[6] *See also Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984); *T.J. Raney & Sons, Inc. v. Fort Cobb Irrigation Fuel Auth.*, 717 F.2d 1330, 1332-33 (10th Cir. 1983), *Panzirer v. Wolf*, 663 F.2d 365, 367-68 (2d Cir. 1981), *vacated and remanded on other grounds sub nom. Price Waterhouse v. Panzirer*, 459 U.S. 1027 (1982);

In 1988, in *Basic, Inc. v. Levinson*, 485 U.S. 224, 245-46 (1988), this Court itself adopted the presumption of reliance because that presumption was "consistent with" and "support[ed]" the "congressional policy embedded in the 1934 Act." 485 U.S. at 245. The Court specifically noted that "[i]n drafting that Act, 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." *Id.* at 245-46.

The Court found additional support for adopting the presumption of reliance in "common sense and probability," *id.* at 246, and found it wholly improbable that investors would not rely on the integrity of market prices for securities. *See id.* at 246-47 ("It has been noted that 'it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?'") (quoting *Schlanger v. Four-Phase Sys. Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)).

Finally, the Court also relied on the universal endorsement of the presumption of reliance in the Courts of Appeals. *Id.* at 247 & n.25 (collecting cases).

The *Basic* Court also drew support from economic research. *See id.* The efficient market hypothesis, as a technical economic theory about the way in which financial markets work, was first formulated in the 1960's in various articles by

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*Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979).

Eugene Fama,[7] culminating in a 1970 article in the *Journal of Finance*.[8] The economic statement of the efficient market hypothesis was almost immediately subject to theoretical critiques and empirical challenges, which continued in the twenty years prior to this Court's decision in *Basic*.[9]

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[7] *See, e.g.*, Eugene Fama, *et al.*, *The Adjustment of Stock Prices to New Information*, 10 Int'l Econ. Rev. 1 (1969); Eugene Fama, *Risk, Return and Equilibrium*, Rep. No. 6831, Univ. Chi. Ctr. for Math. Studies in Bus. & Econ. (1968); Eugene Fama and Marshall Blume, *Filter Rules and Stock Market Trading* Profits, 39 J. Bus. 226 (1966); Eugene Fama, *The Behavior of Stock Market Prices*, 38 J. Bus. 34 (1965).

The intuition that public information is relevant to the pricing of securities in the financial markets was known decades before Dr. Fama began his investigations. *See, e.g.*, Berle, *supra*.

[8] *See* Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383 (1970).

[9] *See, e.g.*, Barr Rosenberg, Kenneth Reid, & Ronald Lanstein, *Persuasive Evidence of Market Inefficiency*, J. Portfolio Management, Spr. 1985, at 9; Ronald J. Gilson & Reinier H. Kraakman, *Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984); Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 Am. Econ. Rev. 393 (1980); Sanjoy Basu, *Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios: A*

This Court cited such research in support of its recognition that public statements affect prices. However, although noting that "[r]ecent empirical studies have tended to confirm Congress's premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations," this Court expressly *disavowed* basing its holding on the vagaries of economic research:

> We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory. For purposes of accepting the presumption of reliance in this case, we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.

*Id.* at 246 n.24. This Court, in *Basic*, was thus aware of the critiques of the efficient market hypothesis. *See also id.* at 253 & n.4 (White, J., dissenting) (discussing various critiques).

*Basic* endorsed the fraud-on-the-market presumption notwithstanding these criticisms. An accurate reading of *Basic* thus reveals that

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*Test of the Efficient Markets Hypothesis*, 32 J. Fin. 663 (1977); Francis Nicholson, *Price-Earnings Ratios in Relation to Investment Results*, 24 Fin. Analysts J. 105 (1968); Ray Ball & Philip Brown, *An Empirical Evaluation of Accounting Income Numbers*, 6 J. Acct. Res. 159 (1968).

this Court neither adopted the efficient market hypothesis, as it is formulated in the economic and financial literature, nor relied on that academic literature in adopting the presumption of reliance or endorsing the fraud-on-the-market doctrine.

Accordingly, neither the fraud-on-the-market doctrine nor the presumption of reliance are restatements of economic theory or research concerning market efficiency. They are legal principles concerning what allegedly defrauded purchasers (or sellers) of a security need prove in order to establish, at trial, his or her reliance on a misrepresentation (or omission) concerning a security. These legal principles serve to implement congressional purpose, not to encapsulate current social science. "Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult." *Basic*, 485 U.S. at 245.

## III. CONGRESS EMBRACED THE FRAUD-ON-THE-MARKET DOCTRINE AND THE PRESUMPTION OF RELIANCE WHEN AMENDING THE FEDERAL SECURITIES LAWS AFTER *BASIC*.

Congress has extensively amended the securities laws in regard to private actions three times since *Basic*, and twice specifically addressed the subject of class action litigation under the federal securities laws. Each time, Congress has not chosen to alter the presumption of reliance. Indeed, in 1995, Congress reformulated the measure of plaintiffs' damages for securities fraud, on the premise that market prices for securities eventually react correctly to changing

disclosures of material information, albeit neither perfectly nor instantaneously.

In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA"). *See* Pub. L. No. 104-67, 109 Stat. 737, codified in pertinent part at 15 U.S.C. § 77z-1 and 15 U.S.C. § 78u-4, *et seq.* Significantly, Congress enacted a damages limitation in the PSLRA explicitly premised on the notion that markets generally – but not *perfectly* – incorporate public information. Specifically, the provision states:

> the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

15 U.S.C. § 78u-4(e)(1). This provision adopted the premise that when corrective information is released publicly, market prices correct themselves. This provision also recognizes, in its use of the 90-day average, that market reaction may be neither instantaneous nor perfect (*i.e.*, the market may initially over-react before fully equilibrating to the revealed information).[10] *See*

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[10] To the extent that Congress intended to curb securities class litigation, it did so by imposing heightened pleading standards, *see* 15 U.S.C. § 78u-4(b), staying discovery pemding

Bradford Cornell & James C. Rutten, *Market Efficiency, Crashes, and Securities Litigation*, 81 Tul. L. Rev. 443, 469-70 (2006). Moreover, although the PSLRA imposed a heightened standard for alleging scienter at the pleading stage, Congress declined to create any standard requiring pleading or proof by a preponderance of the evidence with respect to loss causation at any time prior to trial.

In 1998, Congress enacted the Securities Litigation Uniform Standards Act ("SLUSA"). *See* Pub. L. No. 105-353, 112 Stat. 3227 (1998), codified in pertinent part at 15 U.S.C. §§ 77p(d), 77p(f), 78bb(f). SLUSA, generally speaking, requires private securities class action claims to be litigated under federal law rather than under state law. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 87 (2006). Because class action claims under Section 10(b) almost always rest on the fraud-on-the-market doctrine, in enacting SLUSA, Congress implicitly recognized the vitality of the doctrine while leaving it undisturbed.

Finally, in 2002, Congress once again revised the federal securities laws in the Sarbanes-Oxley Act, to extend the limitations period for private actions under Section 10(b) and Rule 10b-5. *See* Pub. L. No. 107-204, § 804, 116

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motions to dismiss, *see id.*, and expressly regulating the selection of lead plaintiffs and the conduct of class actions, *see* 15 U.S.C. § 78u-4(a). It did not revisit or alter the presumption of reliance.

Stat. 745, 801 (2002) (codified at 28 U.S.C. § 1658). Once again Congress imposed no new requirements for pleading or proving a presumption of reliance, as the Fifth Circuit has subsequently done by judicial fiat.

The Securities and Exchange Commission has similarly based its regulations on the premise that markets, with reasonable efficiency, respond to material information (and misinformation). *See, e.g.*, Proposed Rule: Selective Disclosure and Insider Trading, Release Nos. 33-7787, 64 FR 72590, 72591 (1999) ("Full and fair disclosure of information by issuers of securities to the investing public is a cornerstone of the federal securities laws. In enacting the mandatory disclosure system of the Exchange Act, Congress sought to promote disclosure of "honest, complete, and correct information" to facilitate the operation of fair and efficient markets.") (footnotes omitted); Shelf Registration, Securities Act Release No. 33-6499, 48 Fed. Reg. 52,889, 52,892 (1983) (integrated disclosure "recognizes the applicability of the efficient market theory"); Adoption of Integrated Disclosure Systems, Securities Act Release No. 33-6383, 47 Fed. Reg. 11,380, 11,382 n.9 (1982) ("information regularly furnished to the marketplace ... may be reflected in the price of the outstanding securities"); Exchange Act Release No. 6331, 46 Fed. Reg. 41,902 (Aug. 13, 1981) (setting forth "the Commission's belief that the market operates efficiently for these companies, *i.e.*, that the disclosure in Exchange Act reports and other communications by the registrant, such as press releases, has already been disseminated and accounted for by the market place").

In sum, in the years since *Basic* was decided, Congress has legislated three times on the subject of private securities fraud litigation. In two of those instances, Congress sought to curb private class litigation. Yet Congress did not seek to make it more difficult for class plaintiffs to prove their reliance on misrepresentations or omissions, even while, in the PSLRA, reformulating the measure of plaintiffs' damages. Congress's reformulation embraced the fraud-on-the-market doctrine while simultaneously acknowledging that the doctrine does not depend on "perfect" or "immediate" informational efficiency.

## IV. THE FIFTH CIRCUIT'S *DE FACTO* REJECTION OF THE FRAUD-ON-THE-MARKET DOCTRINE FRUSTRATES CONGRESSIONAL PURPOSE AND DEFIES THE PRECEDENT OF THIS COURT.

In light of the foregoing, the Fifth Circuit's departure from established law in *Oscar* is without warrant. Its conjecture that "[t]he assumption that every material misrepresentation will move a stock in an efficient market is unfounded, at least as market efficiency is presently measured", 487 F.3d at 269, is both unsound in itself and insufficient grounds for recasting congressional purpose in the federal securities laws or departing from this Court's precedent.

The notion that "material misrepresentation[s] will move a stock" is not an "assumption" in any usual sense of that word – it was Congress's premise and policy in enacting the federal securities laws, as shown above. The Fifth Circuit

is not free to substitute its take on the way securities markets work in place of Congress's understanding.

Moreover, the congressional "assumption" reflected in the presumption of reliance is not as the Fifth Circuit portrays it. It is not that "every material misrepresentation will" always "move a stock" (as the Fifth Circuit implies with its muscular language). Congress's understanding, as well as this Court's in *Basic*, is that changes in material, public information (including misrepresentations) generally affect securities prices in a well developed securities market and the presumption can be rebutted by defendants at trial. This common-sense generalization is far more modest than the Fifth Circuit's characterization of it, and it amply supports the presumption of reliance.

Finally, there has been no fundamental change in the "measure[]" of market efficiency – or in the understanding of the effect of new information on market prices for securities – since *Basic* that would warrant narrowing or otherwise revisiting the presumption of reliance in the context of class certification.[11]

The two circumstances the Fifth Circuit specifically noted in *Oscar* as grounds to deviate from the proposition that "material misrepresentation[s] will move a stock in an efficient market" – specifically, (a) that a market might not react to some kinds of information or (b) that a

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[11] *See, supra,* at n.7-9 and accompanying text; *infra,* at n.13 and accompanying text.

market might have already reacted to corrective information prior to its public disclosure, *see* 487 F.3d at 269 – are old ideas that were discussed in the legal and economic literature prior to this Court's decision in *Basic.*[12] For example, *Oscar*

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[12] *See, e.g.*, Thomas R. Dyckman & Dale Morse, *Efficient Capital Markets and Accounting: A Critical Analysis* 28-29 (1986); James H. Lorie, Peter Dodd & Mary Hamilton Kimpton, *The Stock Market: Theories and Evidence* (2d ed. 1985); James R. Vertin, *Passive Equity Management Strategies*, in *Readings in Investment Management* 113 (F. Fabozzi ed., 1983); Frank K. Reilly & Eugene F. Drzycimski, *Short Run Profits From Stock Splits*, 10 Fin. Mgmt. 64 (1981); Jerome B. Baesel & Garry R. Stein, *The Value of Information: Inferences From the Profitability of Insider Trading*, 14 J. Fin. & Quant. Analysis 553 (1979); Robert S. Kaplan, *The Information Content of Financial Accounting Numbers: A Survey of Empirical Evidence*, in *The Impact of Accounting Research on Practice and Disclosure* 134, 167 (A. Abdel-Khalik & T. Keller eds., 1978); Larry Y. Dann, David Mayers & Robert J. Raab, *Trading Rules, Large Blocks, and the Speed of Adjustment*, 4 J. Fin. Econ. 3 (1977); James M. Patell, *Corporate Forecasts of Earnings per Share and Stock Price Behavior: Empirical Tests*, 14 J. Acct. Res. 246 (1976); Arnold B. Moore, *Some Characteristics of Changes in Common Stock Prices*, in *The Random Character of Stock Market Prices* 139 (P. Cootner, rev. ed. 1967); Clive W.J. Granger & Oskar Morgenstern, *Spectral Analysis of New York Stock*

cited to the notion that earnings information is incorporated into share prices over time. *See Oscar*, 487 F.3d at 269 n.43 (citing Macey & Miller, 42 Stan. L. Rev. at 1083). That idea, however, was documented in 1968 – a full twenty years before *Basic*. *See* Ball & Brown, *supra* n.13.

Indeed, that the economic debate continues and focuses on the purported limited anomalies in the theory is only proof of the strength of the general proposition. These minor imperfections provide no grounds for revisiting or narrowing

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*Market Prices*, 16 Kyklos 1 (1963). *See also supra*, at n.9.

The Fifth Circuit's reliance on Jonathan Macey and Geoffrey Miller's 1990 article, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 Stan. L. Rev. 1059 (1990), as documenting a change in the understanding of market efficiency is ironic – that article was published only two years after *Basic* was decided, and nine of its ten sources evaluating the efficient market hypothesis were issued before *Basic* was decided (and the one issued after *Basic* supports the efficient market hypothesis). *Id.* at 1080-81 & nn.110-126. Macey and Miller's article is an argument that *Basic* was wrongly decided, not a demonstration that evolving empirical research invalidates *Basic*. Tellingly, Macey and Miller submit that the second scenario to which the Fifth Circuit referred (that a market might have already reacted to corrective information prior to its public disclosure) is without empirical support. *See* 42 Stan. L. Rev. at 1078 n.100.

*Basic*'s presumption of reliance, particularly in the face of more than seven decades of congressional policy premised on the fundamental – and common sense – concept that material information (or misinformation) impacts market prices for securities.

## CONCLUSION

For the foregoing reasons, and those submitted by Petitioner and other *amici*, the ruling of the Fifth Circuit should be reversed and this case remanded with instructions that the proposed class be certified.

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