No. 13-317

IN THE
Supreme Court of the United States

HALLIBURTON CO. AND DAVID LESAR,
PETITIONERS,
V.

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

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

BRIEF OF SECURITIES LAW SCHOLARS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

JILL E. FISCH
Counsel of Record
UNIVERSITY OF PENNSYLVANIA
LAW SCHOOL
3501 SANSOM STREET
PHILADELPHIA, PA 19104
(215) 746-3454
jfisch@law.upenn.edu

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INTEREST OF *AMICI CURIAE*[1]

Amici curiae are prominent law professors whose teaching and scholarship focus on federal securities regulation. Amici have in total published over 500 scholarly articles and a substantial share of the leading books in the field. This body of scholarship analyzes and interprets the federal securities laws and studies the impact of federal securities regulation on the capital markets and the protection of investors. *Amici*'s expertise spans a range of scholarly methods including doctrinal analysis, empirical methods and historical research. Much of this work focuses on the degree to which stock markets can be informationally efficient and is cited by Petitioners for this proposition.

Amici agree that this Court should not curtail or abandon the fraud-on-the-market presumption of reliance established in *Basic Inc. v. Levinson*, 485 U.S. 224, 241–49 (1988). Because fraud-on-the-market is based on the simple fact that the public securities markets incorporate material information into stock prices, they agree that *Basic*'s presumption is not undermined by evolving academic debates over the degree to which the markets are perfectly efficient. They also agree that the existing framework of private securities fraud litigation, in which fraud-on-the-market is an inherent part, reflects an appropriate balance between the protection of the capital markets and limiting the potential for abusive litigation. Congress played an affirmative role in structuring this balance through the enactment of the Private Securities Litigation Reform Act, Pub. L. 104-67, 109 Stat. 737 (1995) (PSLRA) and the Securities Litigation Uniform Standards Act, Pub.

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[1] No counsel for any party authored this brief in whole or in part. No person other than the *amici curiae* or their counsel has made a monetary contribution to the preparation or printing of this brief. All parties have filed letters granting blanket consent to the filing of *amicus curiae* briefs.

L. No. 105-353, 112 Stat. 3227 (codified at 15 U.S.C. § 78bb) (1998) (SLUSA).

Amici are listed below in alphabetical order:

Robert P. Bartlett, III, is Professor of Law at the University of California, Berkeley School of Law;

Barbara Black is the Charles Hartsock Professor of Law and Director of the Corporate Law Center at the University of Cincinnati College of Law;

James D. Cox is the Brainerd Currie Professor of Law at Duke School of Law;

James Fanto is Professor of Law and Co-Director of the Center for the Study of Business Law & Regulation at Brooklyn Law School;

Jill E. Fisch is the Perry Golkin Professor of Law and Co-Director of the Institute for Law and Economics at the University of Pennsylvania Law School;

Theresa A. Gabaldon is the Lyle T. Alverson Professor of Law at the George Washington University Law School;

Erik F. Gerding is Associate Professor at the University of Colorado Law School;

Thomas Lee Hazen is the Cary C. Boshamer Distinguished Professor of Law at the University of North Carolina at Chapel Hill;

Michael J. Kaufman is Associate Dean for Academic Affairs, Professor of Law and Director of Institute for Investor Protection at Loyola University Chicago School of Law;

Donald C. Langevoort is the Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center;

Ann M. Lipton is Visiting Assistant Professor of Law at Duke School of Law;

Donna M. Nagy is Interim Executive Associate Dean and C. Ben Dutton Professor of Law at Indiana University Maurer School of Law;

James Park is Professor of Law at the UCLA School of Law;

Frank Partnoy is George E. Barrett Professor of Law and Finance and Co-Director, Center for Corporate and Securities Law, at the University of San Diego School of Law;

Hillary A. Sale is the Walter D. Coles Professor of Law and Professor of Management at Washington University School of Law;

Randall S. Thomas is the John S. Beasley II Professor of Law and Business and Director of the Law & Business Program at Vanderbilt Law School;

David H. Webber is Associate Professor of Law at Boston University School of Law; and

Arthur E. Wilmarth, Jr., is Professor of Law and Executive Director of the Center for Law, Economics & Finance at George Washington University Law School

SUMMARY OF ARGUMENT

Petitioners assert that *Basic* rested on a concept of market efficiency, and that "academic consensus" and "new evidence" justify overruling it. Brief for Petitioners at 15-17. Both assertions are wrong. The fraud-on-the market presumption adopted by this Court in *Basic* rests on a simple premise: investors in the public capital markets rely on prices responding to and incorporating material information. That security prices do respond to financial information is undisputed by academics and unchanged by new economic theories such as behavioral economics. *Basic* did not rest upon a conception of perfect market efficiency or upon any particular economic theory.

Indeed, the Court's opinion explicitly stated that "[b]y accepting this rebuttable presumption, we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price." *Basic*, 485 U.S. at 249 n.28. Accordingly, developments in economic theory do not justify overruling *Basic*.

The very essence of the materiality requirement is that material information is sufficiently important to the value of the securities to have the capacity to affect stock prices. Although security prices may fail to move in response to a disclosure, this is not evidence of inefficiency; prices may fail to move for a variety of reasons such as the consistency of the disclosure with prior information (as when an issuer conceals in its announcement an adverse change in its financial condition), bundled disclosures, or prior leakage of the information into the marketplace. This is not only intuitive, but supported by the scholarship in the field.

The operation and regulation of the public capital markets is predicated upon the importance of information in pricing. The mandatory disclosure requirements of the federal securities laws require issuers to provide extensive and timely information to the markets precisely because investors require such information to make pricing decisions. This Court has long recognized that private litigation under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), provides investors with a socially valuable mechanism for assuring the reliability of such disclosure.

The structure of modern securities fraud litigation is not, as petitioners suggest, the product of unilateral and activist judicial decision-making. Rather, Congress and this Court have collaborated to strike a balance in the scope of litigation that serves the twin objectives of inves-

tor protection and limiting the potential for litigation abuse.

As this Court noted in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds,* 133 S. Ct. 1184 (2013), business interests specifically asked Congress to overturn *Basic*. Instead of doing so, Congress adopted the PSLRA which explicitly retained the class action mechanism – in which fraud-on-the-market is an essential component – but adopting reforms addressed to the potential for abuse. The PSLRA's reforms, as this Court recognized in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 82 (2006) "placed special burdens on plaintiffs seeking to bring federal securities fraud class actions."

Congress took a similar approach when it enacted SLUSA. SLUSA preempts state court litigation for covered class actions in order to further the objectives of the PSLRA. By directing its attention to class actions, SLUSA made it clear that Congress had intended the PSLRA to restructure but not eliminate securities fraud class actions. Empirical evidence indicates that the PSLRA and SLUSA struck an appropriate balance in maintaining investor protection while increasing the quality of private litigation.

Finally, this Court should reject Petitioners' efforts to import the reliance requirement from Section 18(a), 15 U.S.C. § 78r(a), into Section 10(b). The two statutory provisions differ substantially in their text, scope of covered conduct and range of permitted defendants. More particularly, Section 18(a) limits liability to misstatements contained in securities filings and is ill-suited to the scope of a statute addressed to open market fraud.

I. *Basic* is Consistent with the Modern Understanding of Market Efficiency

A. *Basic* Requires only that Material Information Affects Stock Prices

Petitioners assert that *Basic* rested on a concept of market efficiency, and that "academic consensus" and "new evidence" justify overruling it. Petitioners' Brief at 15-16. Both assertions are wrong. The fraud-on-the market presumption adopted by this Court's decision in *Basic* transformed private securities fraud litigation for open market misrepresentations. By explicitly holding that plaintiffs were not required to establish eyeball reliance in order to recover, the decision established private litigation as a viable remedy for securities fraud in the public capital markets. *Basic*'s acceptance of the fraud-on-the-market theory was particularly significant for class actions because, as this Court recognized last term in *Amgen*, "without the fraud-on-the-market theory, the element of reliance cannot be proved on a classwide basis through evidence common to the class." *Amgen*, 133 S. Ct. at 1195.

Contrary to petitioners' assertion, however, *Basic*'s holding was not revolutionary. Prior to *Basic*, most of the lower courts had recognized that requiring direct proof of reliance in public market securities litigation was both impractical and illogical. *See* Jill E. Fisch, *The Trouble with Basic: Price Distortion after Halliburton*, 90 Wash. U. L. Rev. 895, 900-903 (2013) (Fisch, *The Trouble with Basic*) (describing lower court decisions analyzing reliance requirement prior to *Basic*). Plaintiffs in public market transactions received information from a variety of sources. Disclosures were often processed by market intermediaries, including brokers, research analysts and the

financial media.[2] Investors rationally relied on these intermediaries to collect and filter the issuers' original statements rather than reviewing statutorily mandated filings directly.[3]

Nor was the application of the efficient capital markets hypothesis to formulate the fraud-on-the-market theory a recent innovation at the time of *Basic*. Professor Adolph Berle explained the nexus of the fraud-on-the-market theory in 1931, writing that, if a public company makes false statements affecting the price of its securities, "any purchaser in the market would seem to have an action in deceit or fraud for damage suffered therefrom." *See* Adolph A. Berle, Jr., *Liability for Stock Market Manipulation*, 31 Colum. L. Rev. 264, 269 (1931). In Berle's analysis, the purchaser's claim was based "on the market situation, which in turn resulted from the false statement." *Id.* at 269-70. Similarly in The Modern Corporation and Private Property (1932), one of the most influential books on corporate law of all time, Berle and his coauthor, economist Gardiner C. Means, explained that "if a corporation consciously overstated its income leading to a rise in the value of the shares, a buyer on the faith of such valuation should have no greater difficulty in recovering" than would an investor to whom false statements were directly made. *Id.* at 314 & n.1, 322.

Indeed, the observations of Berle, Means, and other scholars and policy-makers of their time about the effect of information on security prices formed the foundational

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[2] See, e.g., *Panzirer v. Wolf*, 663 F.2d 365, 367 (2d Cir. 1981), *vacated sub nom. Price Waterhouse v. Panzirer,* 459 U.S. 1027 (1982) in which plaintiff relied upon information reported by financial media based on defendants' misstatements.

[3] *See, e.g.,* Homer Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose 14–15 (1979) (discussing the widely-held belief that prospectuses were typically not read).

premise of the federal securities laws which rely on a system of mandatory disclosure to protect investors and market integrity. William O. Douglas explained in 1934 that "[E]ven 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 price market." William O. Douglas, *Protecting the Investor*, 23 Yale Rev. 521, 524 (1934). The rationale for a mandatory disclosure system was, and is, simply put, that information matters. As Professor Richard Brealey explains, public company investors "rely on the company's financial statements to provide the necessary information." Richard A. Brealey, *et al.*, Principles of Corporate Finance 704 (10th ed. 2011).

This Court has long recognized that private litigation under Section 10(b) provides investors with a socially valuable mechanism for assuring the reliability of such disclosure. As this Court explained in *Basic*, "In drafting [the Exchange] 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." *Basic*, 485 U.S. at 246. *Basic* made this statement in explaining its resort to a presumption of reliance.

The Exchange Act's legislative history confirms the understanding, expressed in §2. "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," said House Report No. 1383.[4]

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[4] H.R. Rep. No. 1383, 73d Cong., 2d Sess., at 11 (1934), *reprinted* in 5 J. S. Ellenberger & Ellen P. Mahar, LEGISLATIVE

Congress clearly intended that investors should be entitled to rely on the integrity of prices thus established, even if information was not "instantaneously" reflected. *See id.*

At the same time, courts recognized that evidence of direct reliance was potentially unreliable and self-serving. In impersonal public market trading, direct evidence of the specific factors motivating individual trading decisions was unlikely to exist. As the Court of Appeals for the Seventh Circuit observed in *Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993), *aff'd,* 58 F.3d 1162 (7th Cir. 1995) "Prices of even poorly followed stocks change in response to news, including statements by the issuers, and these changes may be better indicators of causation than litigants' self-serving statements about what they read and relied on and about what they would have paid (or whether they would have bought at all) had the issuer said something different."

This was the reality that motivated this Court's decision in *Basic.* As the Court held in *Basic* and reaffirmed in *Amgen*, requiring proof of direct reliance "would place an unnecessarily unrealistic evidentiary burden on [a] plaintiff who has traded on an impersonal market." *Amgen,* 133 S. Ct. at 1192, citing *Basic* at 245.

That recognition, which reflected securities trading practices in the 1970s and 1980s, is even more appropriate now. Investors today rely on a variety of sources for investment information, including the internet, the financial media and social media.[5] Most retail investors and insti-

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HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 18 (1973).

[5] The importance of information disclosed in social media in influencing stock price is vividly reflected by the SEC's recent Section 21(a) report that was triggered by a disclosure by Netflix CEO Reed Hastings about Netflix's streaming volume on his personal Facebook page. Report of Investigation Pursuant to

tutions outsource their investment research to professional advisors and rely on the bottom line recommendations of those advisors. *See, e.g., In re: Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 481 (2d Cir. 2008) (describing reliance by investors on research analyst recommendations).[6]

Those same intermediaries, through their recommendations, analysis and trading decisions, have the effect of incorporating the information that they review into market prices. It is this very incorporation of information into stock prices and investors' reliance on the process that underlies the *Basic* presumption. The fact that many investors do not review securities disclosures directly does not mean that the disclosed information has not affected the stock price on which they based their investment decision.

At its core, *Basic* is premised on investors' broad reliance on the fact that material information has the capacity to affect stock prices in public markets. Material information is explicitly defined as information that a reasonable investor would have taken into account, thereby affecting market price. *See Basic* at 244-45. Put differently, as the Court of Appeals for the Ninth Circuit explained in *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), the "sem-

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Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, SEC Release No. 69279 (Apr. 2, 2013). According to the SEC, the price of Netflix's stock rose "from $70.45 at the time of Hastings's Facebook post to $81.72 at the close of the following trading day." *Id.* at 4.

[6] Through advances in machine-learning, trading algorithms exist that even trade automatically based on publicly disclosed information. *See, e.g.,* Xiongpai Qin, *Making Use of the Big Data: Next Generation of Algorithm Trading*, ARTIFICIAL INTELLIGENCE AND COMPUTATIONAL INTELLIGENCE, LECTURE NOTES IN COMPUTER SCIENCE, Vol. 7530, at 34-41 (2012) (describing developments in algorithmic trading).

inal" pre-*Basic* fraud-on-the-market case,[7] "[m]ateriality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made." *Blackie,* 524 F.2d at 906. Materiality then is "the key component" of fraud-on-the-market theory. *Amgen,* 133 S. Ct. at 1214 (Thomas J., dissenting).

Importantly, *Basic*, as affirmed by *Amgen*, need not require that plaintiffs produce event-study type proof of a price effect at the time of the fraudulent statement. *See Amgen*, 133 S. Ct. at 1192: "If a market is generally efficient in incorporating publicly available information into a security's market price, it is reasonable to presume that a particular public, material misrepresentation will be reflected in the security's price." Evidence that the price of a security incorporates publicly available information can be demonstrated in a variety of ways. *See, e.g.,* Lucian A. Bebchuk & Allen Ferrell, *Rethinking Basic*, at 26-27 (Working Paper Dec. 2013) *available at,* http://ssrn.com/abstract=2371304 (discussing possible tools to establish or rebut the presumption that the fraudulent statement distorted stock price).

Amgen's reluctance to require proof of materiality at the class certification stage also makes sense given the empirical challenge of such a showing. While financial models have long played a role in a wide range of litigation, even non-commercial litigation, models are not perfect, and event studies that are frequently used in securities litigation are subject to some limitations. See Fisch, *The Trouble with Basic,* 90 Wash. U. L. Rev. at 919-21. Requiring evidence of ex ante price impact or "fraudulent distortion" at the class certification stage would accordingly embroil courts in a premature battle-of-experts as judges struggled to ensure that experts and their models are trustworthy. *Daubert v. Merrell Dow Pharms, Inc.*, 509 U.S. 579 (1993).

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[7] *Amgen,* 133 S. Ct. at 1213 (Thomas J., dissenting).

This is especially true because many instances of securities fraud involve attempts to avoid or delay disclosure of negative corporate developments. *See* Fisch, *The Trouble with* Basic, 90 Wash. U. L. Rev. at 922.

B. Imperfect Market Efficiency is Neither New nor Inconsistent with *Basic*

Modern financial economics recognizes that markets are imperfectly efficient. That fact is not, however a recent development but was well known at the time of the *Basic* decision.[8] Scholars have measured and debated calendar anomalies such as the January effect for many years.[9] Justice White's dissent in *Basic* cites a prominent law review article observing that the mechanisms of market efficiency were then poorly understood.[10] Recent events such as the May 6, 2010 flash crash clearly demonstrate that, at times, securities prices move for reasons other than the disclosure of information.[11] The existence of these anoma-

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[8] Economist George Taylor recognized the hemline index in 1926 before Congress even adopted the federal securities laws. *See* Michael Sincere, *Hemline Index falls out of fashion*, MarketWatch, (Nov. 24, 2010), *available at*, http://www.marketwatch.com/story/hemline-index-falls-out-of-fashion-2010-11-24 (describing the hemline index).

[9] *See* Jeremy J. Siegel, *Stocks for the Long Run: The Definitive Guide to Financial Market Returns & Long Term Investment Strategies,* at 305 (4th ed. 2007), (describing various calendar anomalies).

[10] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 549-50 (1984).

[11] *See, e.g.,* Henry T.C. Hu, *Efficient Markets and the Law: A Predictable Past and an Uncertain Future*, 4 Ann. Rev. Fin. Econ. 179 (2012). (describing the flash crash as a "radical departure[] from market efficiency.").

lies is neither a recent discovery nor inconsistent with the premise that that the markets are efficient.

While *Basic* requires materiality to establish reliance, its holding does not depend on a high level of market efficiency but simply on markets that are sufficiently efficient to ensure that material information, as a general matter, will be reflected in stock prices.[12] Petitioners' claim that

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[12] Indeed, information affects prices even in markets that are not efficient. *See* Jim Cox, *Fraud on the Market After Amgen*, 9 Duke J. Const. L. & Pub. Pol. 101 (Dec. 11, 2013), *available at,* SSRN: http://ssrn.com/abstract=2366450 (Cox, *After Amgen*) (describing studies showing price response to information even in small capitalization firms whose trading is typically rejected as inefficient under *Basic* analysis). The Securities Exchange Act recognizes as much in Section 9. Section 9(a)(1) prohibits certain manipulative transactions entered "[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange*, or a false or misleading appearance with respect to the market for any security*." 15 U.S.C.§ 9(a)(1) (emphasis added). Section 9(a)(3) makes it unlawful for a dealer broker or other person "to induce the purchase or sale of any security registered on a national securities exchange [or] *any security not so registered* . . . by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any 1 or more persons conducted for the purpose of raising or depressing the price of such security." 15 U.S.C. § 78i(a)(3) (emphasis added). Thus the statute extends its protection to securities traded in both efficient markets and inefficient markets and recognizes that manipulation can affect securities prices in inefficient markets. *See also* Fisch, *The Trouble with Basic,* 90 Wash. U. L. Rev. at 898 (explaining that "market efficiency is neither a necessary nor a sufficient condition to establish that misinformation has distorted prices"). Bebchuk & Ferrell, *Rethinking Basic*, (Working Paper) at 1 (arguing that, in a fraud-on-the-market case, classwide reliance should not depend on the efficiency of the market for the issuer's securities).

Basic relies on "a robust view of market efficiency," Petitioners' Brief at 14-15, is flatly wrong.

Equally wrong is the claim that academic consensus has rejected *Basic*'s view of market efficiency. Brief for Petitioners at 15. Legal and finance scholars widely accept that the public capital markets demonstrate the required level of efficiency – that prices respond to and incorporate material information.[13] *See, e.g.,* Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. Fin. 1575, 1607 (1991); Daniel Fischel, *Efficient Capital Markets, the Crash and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907 (1989). Nobel Prize winner Robert Shiller, in noting his disagreement with co-winner Eugene Fama explained "Of course prices reflect available information." Robert J. Shiller, *We'll Share the Honors, and Agree to Disagree*, N.Y. Times, Oct. 27, 2013, at BU6. It is that almost common-sense conception of market efficiency that *Basic* requires, nothing more. Notable conservative Judge and Law and Economics Scholar Frank Easterbrook recently observed that the semi-strong version of the efficient capital markets hypothesis, on which fraud-on-the-market theory rests, is "widely accepted." *Schleicher v. Wendt*, 618 F. 3d 679 (7th Cir. 2010).

To be clear, this is not perfect efficiency in the sense that all information is incorporated into prices instantaneously. As Professor Donald Langevoort explains, "perfect efficiency is just an ideal; all markets fall short, some more than others." Donald Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, Wis. L. Rev. 151, 167

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[13] In rare cases, the price of some securities, such as those that are thinly traded or where there is a substantial controlling shareholder, may not fully incorporate material information. Basic recognizes this potential by allowing defendants to rebut the fraud-on-the-market presumption by coming forward with evidence of these and other conditions.

(2009). Moreover, informational efficiency is a spectrum, not a binary concept, meaning that the speed with which information is impounded into stock prices varies according to the issuer's information environment and the type of information involved. *See* Tarun Chordia, *et al.*, *Evidence on the speed of convergence to market efficiency*, 76 J. Fin. Econ. 271 (2005). As Professor Langevoort has observed, *Basic* "was not insisting on anything approaching perfect efficiency." Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market?: Reflections on Amgen and the Second Coming of Halliburton*, Working Paper at 18 n.66, (Nov. 16, 2013) *available at*, http://ssrn.com/abstract=2281910 (Langevoort, *Judgment Day*), citing, *Owens v. Okure*, 488 U.S. 235, 247 n.24 (1989).

Moreover, *Basic* does not require that market prices be equal to fundamental or true value. Fundamental value efficiency, which means that "the real price of stocks is close to the intrinsic value" is the theory that Robert Shiller termed "one of the most remarkable errors in the history of economic thought." Robert J. Shiller, Market Volatility, 8 (1992). Thus the notion that market prices are intrinsically correct is highly contestable within the financial and economics literature and is not the same as informational efficiency. *See* Richard Thaler, *Markets Can be Wrong and the Price is Not Always Right*, Fin. Times Aug. 4, 2009 (explaining the confusion between information efficiency and fundamental value efficiency). In addressing the issues in this case, the Court should focus only on informational efficiency.

The growing behavioral finance literature has produced substantial evidence that prices likely do not reflect intrinsic value, but even this observation is not testable. Importantly, academics generally agree that we lack sufficiently precise methods for the concept of "correct" prices to be conceptually meaningful. Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. Corp. L. 517, 518-19 (2003).

See James D. Cox, *Understanding Causation in Private Securities Lawsuits: Building on Amgen*, 66 Vand. L. Rev. 1719, 1728 (2013) (Cox, *Building on Amgen*) ("there are no reliable models for determining the 'correct' price of a security").

So long as departures from fundamental value are unbiased, however, in the sense that the deviations are random, they do not undermine informational efficiency. That prices may be inaccurate does not detract from the fact that false information affects those prices, which is all that *Basic* requires. *Schleicher,* 618 F.3d at 679.

The market provides ample evidence that prices react to information and that prices can underreact and overreact to it. Consider for example the SEC's announcement of its lawsuit against Goldman Sachs arising out of the infamous Abacus transaction. Upon release of the news to the market, Goldman's stock price fell by 13%, erasing $12 billion of market capitalization in a single day. Gregory Zuckerman *et al.*, *Goldman Sachs Charged With Fraud,* Wall St. J., Apr. 17, 2010. This price drop may have been an overreaction in that Goldman subsequently settled with the SEC for a far less dramatic $550 million. *See* SEC Press Release no: 2010-123, *Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO*, July 15, 2010.

Similarly when Apple announced the release of the first iPhone in 2007, its stock price jumped by 8.3%. Chip Cutter, *AAPL Down On iPhone 4S: Why Apple's Stock Falls After New Product Announcements,* Huff Post Tech. (Oct. 5, 2011) *available at*, http://www.huffingtonpost.com/2011/10/05/aapl-iphone-4s_n_995786.html. This rise may have been an under reaction. In the subsequent five years, the iPhone became the most profitable product in the world, accounting for almost two-thirds of Apple's profits. Henry Blodget, *In Case You Had Any Doubts About*

Where Apple's Profit Comes From . . ., Bus. Insider (Aug 2, 2012), *available at*, http://www.businessinsider.com/iphone-profit-2012-8.

Neither underreactions nor overreactions to information are problematic for fraud-on-the-market. If the market underreacts to a fraudulent statement, then the market price is less distorted, reducing the extent of plaintiff's harm. In the case of an extreme underreaction, plaintiff may not be damaged at all. *See, e.g., Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2187 (2011) (describing Halliburton's argument that "[i]f the price is unaffected by the fraud, the price does not reflect the fraud"). To be noted here is that Congress directly addressed problems that flow from short-term market overreactions; if the market overreacts, plaintiff's damages are not calculated based on that overreaction but rather are limited by the PSRLA's loss causation requirement, coupled with the statutory 90-day lookback provision.[14]

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[14] Congress accepted the premise that markets can overreact to information when it adopted, in the PSLRA, a 90-day trading window as a limit on recoverable damages. Securities Exchange Act § 21D(e), 15 U.S.C. § 78u-4(e). *See* Conference Report, H. Rep. No. 104-369, at 42, n.25 (Nov. 28, 1995) (explaining the necessity for the provision by reference to Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 Stan. L. Rev. 7, 12 (1994)). Notably Lev and de Villier explicitly state that "crashes are consistent with both the informational version of the efficient capital markets theory and with the fraud- on-the-market theory." *Id.* at 21. *See also* James D. Cox, *Amgen and the Path Forward* (Working Paper 2013) (arguing that the 90 day window was intended by Congress as "a means to address one concern for noisy markets").

II. Congress Accepted Fraud-on-the Market as Striking an Appropriate Balance in Securities Fraud Enforcement

A. Congress Enacted the Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act to Refine, not Eliminate, the Class Action Mechanism

The structure of modern securities fraud litigation is not, as petitioners suggest, the product of unilateral and activist judicial decision-making. Rather, this Court and Congress have collaborated to strike a balance in the scope of litigation that serves the twin objectives of protecting investors and limiting the potential for litigation abuse. The Court has sought to balance these objectives. As the Court observed in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007), "This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)." In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994), the Court based its rejection of aiding and abetting liability under Section 10(b) in part on the fact that securities fraud litigation presented "a danger of vexatiousness." And in *Stoneridge Inv. Partners LLC* v. *Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the Court justified its decision not to extend the scope of 10b-5 liability to secondary defendants by a concern over "extensive discovery and the potential for uncertainty and disruption in a lawsuit." *Id.* at 163.

At the same time, however, the Court recognized that, in adopting the PSLRA, Congress "accepted the §10(b) private cause of action as then defined . . .." *Stoneridge* 552 U.S. at 165-66. This included the class action. Section

21D(a) of the PSLRA is explicitly entitled "Private Class Actions" and introduces a range of reforms that are targeted specifically to the class action mechanism. The statute makes multiple improvements to the conduct of securities fraud class actions such as the required certification by the plaintiff as a representative party, a mechanism for judicial appointment of a lead plaintiff defined as "the member … of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members…", provisions concerning payment of costs to the class representative, disclosure of the settlement terms to class members, and provisions concerning fee awards to the attorneys for the plaintiff class. *See, e.g.,* Jill E. Fisch, *Class Action Reform: Lessons From Securities Litigation*, 39 Ariz. L. Rev. 533, 536 (1997) (describing reforms adopted by the PSLRA "that targeted the class action structure in particular").

These reforms, as this Court recognized in *Dabit,* "placed special burdens on plaintiffs seeking to bring federal securities fraud class actions." *Dabit*, 547 U. S. at 82. The scope of their application reflects an implicit decision to retain the class action mechanism and, thereby, the fraud-on-the-market theory that makes the class action possible. As Professor Langevoort explains, "the structure of the PSLRA makes no sense except when read as a political compromise that preserves the foundation of the fraud-on-the market class action while making it harder for plaintiffs to bring, plead and prove a successful claim through a variety of reforms." Langevoort, *Judgment Day*, at 6 (Working Paper). Professor Barbara Black explains "Congress chose not to eliminate the securities fraud class action, but to cure it and thus confirmed its importance to the integrity of the U.S. capital markets." Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, Colum. Bus. L. Rev. 802, 810 (2009).

As this Court noted in *Amgen*, business interests specifically asked Congress to overturn *Basic* in the Common Sense Legal Reform Act. *See* Common Sense Legal Reform Act of 1995, H.R. 10, 104th Cong. (1995). Fraud-on-the-market litigation was a core component of the political debate leading up to the adoption of the PSLRA. *See* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 Bus. Law. 355 (1996) (recounting the legislative and political history of the PSLRA).

Not only did Congress decide not to overrule *Basic* or legislate a requirement of eyeball reliance, it enacted a statutory mechanism that expressly contemplated continuing the existing private class action structure for enforcing the prohibition of securities fraud. In so doing, Congress accepted this Court's prior judgment that a balanced enforcement mechanism was the best way to protect the capital markets. As the Court noted in *Tellabs*, 551 U.S. at 321 n.4: "Nothing in the [PSLRA], casts doubt on the conclusion 'that private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses'—*a matter crucial to the integrity of domestic capital markets*." *Id.* quoting *Dabit*, 547 U. S. at 81 (emphasis added).

Petitioners argue that the Court is free to overrule *Basic* because Congress has been silent with respect to the propriety of the fraud-on-the-market theory. Brief for Petitioners at 34. Contrary to Petitioners' claim, the PSLRA does not reflect mere "congressional silence," however.[15]

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[15] This situation is quite different from that examined by Professor William Eskridge. Eskridge observes that the Court's reliance on Congressional acquiescence is most defensible when legislative inaction "sheds light on current legislative preferences." William N. Eskridge, Jr., *Reneging on History? Playing the Court/Congress/President Civil Rights Game,* 79 Calif. L. Rev. 613, 670 (1991). With respect to fraud-on-the-market,

Id. Not only did Congress pay specific attention to fraud-on-the-market when it adopted the PSLRA, it adopted an entire statutory section that established new procedures applicable exclusively to private class actions. In restructuring the scope of class actions, Congress clearly rejected the alternative reform approach that critics had explicitly advocated – eliminating class actions entirely – and cannot be understood as a "failure to express any opinion." Brief for Petitioners at 34, quoting *Rapanos* v. *United States*, 547 U.S. 715, 750 (2006) (plurality op.).

These modifications to the class action mechanism were in the context of a specific Congressional focus on Section 10(b). As the Senate Report explained, litigation pursuant to Section 10(b) was the target of Congress' legislative action:

> Congress has never expressly provided for private rights of action when it enacted Section 10(b). Instead, courts have held that Congress impliedly authorized such actions. As a result, 10(b) litigation has evolved out of judicial decisionmaking not specific legislative action. . . . The Committee has determined that now is the time for Congress to reassert its authority in this area.

Senate Report No. 104-98 (1995).

Congress took a similar approach when it subsequently enacted SLUSA. Following the adoption of the PSLRA, some plaintiffs began to file class actions in state court in an effort to avoid the requirements of the PSLRA such as the heightened pleading requirement and the discovery stay. In response to the concern that this state court liti-

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Congress's preference with respect to the continued existence of private securities fraud class actions is clear not simply by inference, but from the statutory text.

gation was "being used to frustrate the objectives" of the PSLRA, Congress preempted such litigation by enacting SLUSA.

Specifically SLUSA preempts state court litigation for "covered class actions," not for all securities fraud claims. A "covered class action" is defined as a class action where "damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, *without reference to issues of individualized reliance on an alleged misstatement or omission*, predominate . . .." 15 U.S.C. § 78bb(f)(5)(B)(i) (emphasis added). This definition explicitly incorporates the fraud-on-the-market presumption in determining whether a state securities class action is similar enough to a federal securities class action so it should be preempted.[16] By directing its attention to class actions, and in particular those involving listed companies whose shares are defined as "covered securities," SLUSA made it clear that Congress had intended in the PSLRA, to restructure but not eliminate securities fraud class actions.

That Congress has recognized the utility of the private class action as a valuable tool for enforcing the antifraud

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[16] A report by the Committee of Banking, Housing, and Urban Affairs explained:

> [T]he Supreme Court stated in *Basic, Inc. v. Levinson* . . . that 'requiring proof of individualized reliance would * * * prevent plaintiffs from proceeding with a class action, since individual issues would * * * overwhelm the common ones." To avoid this problem, the definition provides that the predominance inquiry must be undertaken without reference to issues of individualized reliance, so that the necessity of proving reliance on an individualized basis would not defeat treatment of the suit as a class action.

S. Rep. No. 182, 105th Congress, 2d Sess. 7 (1998).

provision is clear.[17] The Statement of Managers Accompanying the Conference Report containing the PSLRA termed private securities litigation "an indispensable tool" both for protecting investors and for "promot[ing] public and global confidence in our capital markets . . ." H.R. Rep. No. 104-369, 104th Cong., 1st Sess. (1995). Congress' rejection of the specific request to overturn *Basic*, as well as the PSLRA and SLUSA Exchange Act amendments that retain and refine securities fraud class actions, provide compelling reasons to affirm the judgment of the court below.

In addition, the Securities and Exchange Commission has long supported the utility of private class actions as a supplement to public enforcement of the antifraud provision. Many factors limit the ability of public enforcement to serve as an adequate substitute for private litigation. *See, e.g.,* Edward Labaton, *Consequences, Intended and Unintended, of Securities Law Reform*, 29 Stetson L. Rev. 395, 401 n.43 (1999) (quoting testimony of SEC Chair Richard C. Breeden before Congress in 1991 that "Private actions under Sections 10(b) and 14(a) of the Exchange Act have long been recognized as a 'necessary supplement' to actions brought by the Commission and as an 'essential tool' in the enforcement of the federal securities laws.").

Given the importance of the class action mechanism in allowing private litigation to function, overturning *Basic* would create a void in the existing enforcement structure that Congress has created. Moreover, numerous market participants use investment strategies that depend for their viability on markets that are untainted by fraud. Their fiduciary duties would not allow them to invest as

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[17] That Congress valued private securities fraud litigation is further evidenced by its decision, in the Sarbanes-Oxley Act to extend the statute of limitations in private litigation. Sarbanes-Oxley Act § 804, Pub. L. No. 107-204, 116 Stat. 745 (2002).

they do without such good faith *reliance* not only on the fairness of markets but also on the fact that market prices reflect public information.[18] As Professor James Cox explains, "The changes in markets, especially the moves toward increasing amounts of passive investing, are a testament to investors' foundational belief that markets are fair." Cox, *Building on Amgen*, 66 Vand. L. Rev. at 1752. Eyeball reliance is, however, inconsistent with indexing and other low cost investment strategies, increasing the need for fraud-on-the-market.

B. Empirical Evidence Suggests that the PSLRA Struck an Appropriate Balance

The PSLRA was a legislative compromise with two major goals. Congress sought to reform securities class actions by giving courts greater power to dismiss cases without merit, while enabling investors with the largest losses to serve as lead plaintiff in order to increase recoveries in cases with merit. *See Tellabs*, 551 U.S. at 322 (explaining that Congress intended the PSLRA to "curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."). An extensive body of empirical literature establishes that this compromise is working as intended – more meritless cases are being dismissed, and plaintiffs are recovering significant amounts in cases with merit.

The PSLRA requires any fraud-on-the-market class action complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with" scienter or face dismissal without the opportunity to conduct

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[18] Pension fund giant CalPERS, for example, invests more than half of its $255 billion portfolio passively and is considering a move to a totally indexed portfolio. *See* Jason Kephart, *Passive Investing: If Its Good Enough for CalPERS . . .* (Mar. 24, 2013) *available at*, http://www.investmentnews.com/article/20130319/Blog3/130319912#.

discovery. 15 U.S.C. § 78u-4(b). One purpose of this requirement was to encourage the pursuit of securities fraud cases with merit. *See, e.g.,* S. Rep. No. 98, 104th Cong., 1st Sess. 4 (1995) (noting that the PSLRA was intended to "encourage plaintiffs' lawyers to pursue valid claims and defendants to fight abusive claims.").

The PSLRA's heightened pleading requirement has increased the ability of courts to dismiss meritless securities class actions. In a 2006 study, Professor Stephen Choi found that dismissal rates increased from 13.7% for cases filed prior to the PSLRA to 25.8% for cases filed after the PSLRA. *See* Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?,* J. L. Econ. & Org. 598, 617 (2006). A number of other studies have found that dismissal rates increased after the passage of the PSLRA. *See, e.g.*, James D. Cox, *et al.*, *Do Differences in Pleading Standards Cause Forum Shopping in Securities Class Actions?: Doctrinal and Empirical Analyses*, Wisc. L. Rev. 421, 442 (2009) ; A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. Emp. Legal Stud. 125, 142 (2005).

The increase in dismissals has reduced the costs of litigation. A study of all securities class actions filed between 2006 and 2010 concludes that "38% of cases ended relatively quickly and painlessly for the defendants." Michael Klausner, *et al., When Are Securities Class Actions Dismissed, When Do They Settle, and For How Much? – An Update*, PLUS Journal 7 (April 2013).

Congress in passing the PSLRA was not solely concerned with dismissing cases without merit but also in ensuring adequate recoveries in meritorious cases. *See, e.g.*, S. Rep. No. 98, 104th Cong., 1st Sess. 6 (1995) (observing that "a 1994 Securities Subcommittee Staff Report found 'evidence * * * that plaintiffs' counsel in many instances

litigate with a view toward ensuring payment for their services without sufficient regard to whether their clients are receiving adequate compensation in light of evidence of wrongdoing."'). The PSLRA sought to remedy this problem by creating a statutory lead plaintiff to oversee the litigation. *See* 15 U.S.C. § 78u-3(b)(iii)(I)(bb).

Studies show that the lead plaintiff provision has had its intended effect of encouraging institutional investors to become involved in securities fraud litigation. *See, e.g.*, Stephen J. Choi, *et al., Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 Wash. U. L. Q. 869, 889 (2005) (finding public pension funds went "from no representation in the pre-PSLRA period to over 10% of the cases in the post-PSLRA period."). Importantly, multiple studies have found that institutional involvement in securities class actions is associated with higher settlements. *See, e.g.*, Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, 9 J. Emp. Legal Stud. 368, 383-84 (2012) ("public pension participation in securities class actions does indeed lead to higher settlement amounts, all else equal."); C.S. Agnes Cheng, *et al., Institutional monitoring through shareholder litigation*, 95 J. Fin. Econ. 365, 356 (2010) ("securities class actions with institutional owners as lead plaintiffs are less likely to be dismissed and have larger monetary settlements than securities class actions with individual lead plaintiffs."); James D. Cox, *et al., Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 Colum. L. Rev. 1587, 1624 (2006) ("institutional investor cases exhibit much larger settlements").

Soon after the PSLRA encouraged institutional involvement in securities class actions, there was an extraordinary period of corporate wrongdoing. Companies such as Enron, WorldCom, Tyco, Global Crossing,

HealthSouth, Cendant, Conseco, and Waste Management committed significant securities frauds. Notably, the securities fraud class actions during this period, a period of substantial fraud, provided billions of dollars in investor recoveries. *See, e.g.*, Todd Foster *et al., Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High - But are these Trends Reversing?*, NERA Economic Consulting, 1 (Sept. 2007), *available at*, http://www.nera.com/extImage/PUB_Recent Trends_Sep2007-FINAL_4color.pdf (reporting that in 2006-2007, "all of the top ten shareholder class action settlements exceeded $1 billion"). *See also* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 Va. L. Rev. 707, 729 (2009) (observing that private "securities fraud class action settlements peaked at over $17 billion" in 2006 and observing that "private enforcement obtains greater recoveries than public enforcement.").

After the PSLRA, as Congress intended, the outcome of a securities class action is likely to be driven by the merits, not by the fact that a class has been certified. Cases without merit are dismissed. Meritorious cases result in more substantial recoveries.

C. The Court Should Not Import a Reliance Requirement from Section 18 into Section 10(b)

Petitioners assert that *Basic* was wrongly decided by pointing to Section 18(a) of the Securities Exchange Act, 15 U.S.C. § 78r(a), which Petitioners say is "the closest textual analogue to the Section 10(b) action." Brief for Petitioners at 12. They argue, largely by reference to the legislative history of Section 18(a), that an actual reliance requirement should be imported into Section 10(b). *See*

Brief for Petitioners at 13; *see also* Brief of Former SEC Commissioners *et al.* as *Amici Curiae* at 11-18.[19]

This Court's decision in *Musick, Peeler & Garrett v. Emp'rs Ins.*, 508 U.S. 286, 294 (1993), does indeed instruct the Court to borrow from the "most analogous" cause of action. Arguments about "borrowing" from other statutory provisions must proceed cautiously, however. What may make sense in one statutory context may not necessarily fit well in another, and Section 10(b) and Section 18(a) differ in many key respects. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 n.31 (1976) (declining to borrow affirmative good faith defense from Section 18 and instead adopting scienter requirement for Section 10(b) based on identified differences between Section 10(b) and Section 18).

Critically, the language of the two statutes is different. Section 18(a) expressly includes language requiring actual reliance, language that is absent from Section 10(b). Specifically, Congress used the words "in reliance" in Section 18(a). In contrast, Section 10(b) does not contain the words "in reliance." Whatever one might conclude about the judicial development of Section 10(b), it is inconsistent with the text of Section 10(b) to suggest that it contains an "eyeball reliance" requirement.

Nor is this the only difference between Section 18(a) and Section 10(b). Section 18(a), by its terms, applies only to misstatements in documents, applications or reports filed with the SEC. Thus Section 18(a) does not encompass press releases, oral statements by corporate officials,

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[19] Notably, this argument was presented to the Court in *Basic*; the Court rejected it. *See, e.g.*, *Basic*, 485 U.S. at 243 ("Petitioners . . . argue that because the analogous express right of action includes a reliance requirement, *see, e.g.*, § 18(a) of the 1934 Act, as amended, 15 U. S. C. § 78r(a), so too must an action implied under § 10(b).").

misleading products information, and the many other sources of fraudulent misinformation that this Court has held actionable under Section 10(b).[20] *See, e.g., Basic*, 485 U.S. at 227, n.4 (premising liability on fraudulent press release and statement by company official). Similarly Section 18(a) extends liability not just to those who make fraudulent statements but those who "cause [such statements] to be made," thereby including within its scope a range of secondary defendants that this Court has held are beyond the scope of Section 10(b). *See Stoneridge*, 552 U.S. at 148. Finally, Section 18(a) does not explicitly require scienter.[21]

Petitioners' attempt to import the legislative history of Section 18(a) should be unpersuasive to anyone who begins analyzing a statute by reading its text. Rather, a careful textual analysis indicates that Congress knew how to require actual reliance and chose to do so when such a requirement was a necessary component of the statutory scheme. In Section 18(a), which imposes liability specifically on misleading statements contained in filed documents, Congress provided a cause of action for investors who relied directly on those misstatements. Section 18(a) does not speak, however, to the scope of the entirely different type of liability imposed by Section 10(b) upon those who engage in open market fraud.

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[20] Similarly Section 18(a) does not apply to the periodic reports issued by the thousands of public companies that are not required to file those reports with the SEC, such as the many companies that are going public pursuant to the provisions of the Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012).

[21] This Court has not ruled on the question, but lower courts have concluded that Section 18(a) does not contain a scienter requirement. *See, e.g., Deephaven Private Placement Trading, Ltd. v. Grant Thornton & Co.*, 454 F.3d 1168, 1172 (10th Cir. 2006*). See also Ernst*, 425 U.S. at 211 n.31

If Section 10(b) is to be understood by reference to another statutory provision, a far closer analogy is Section 9(f) of the Exchange Act which, like Section 10(b) deals with a form of market manipulation.[22] Section 9(f) provides that "any person who willfully participates in any act or transaction in violation of subsection (a) . . . shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction." 15 U.S.C. § 78i(f). Notably the statute contains an express private right of action, but it requires no reliance by the purchaser beyond a purchase at an affected price.

Further evidence that *Basic*'s use of fraud-on-the-market is consistent with Congressional intent can be found in the statutory language of the Securities Act of 1933. Specifically in 1934, Congress amended section 11 of the Securities Act to require that investors demonstrate reliance if they purchase securities after the release of a year's worth of audited financials "covering a period of at least twelve months beginning after the effective date of" a registered offering of these securities. 15 U.S.C. § 77k(a).

Notably, Congress excused from proving reliance those who purchased the offered securities prior to the release of the audited financials. Presumably the reason for this decision was Congress' belief that the information contained in the registration statement determined the market price --- that, after all, was the purpose of the mandated disclosure. *See* William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L. J. 171, 176 (1933) (during the early life of a security "the registration statement will be an important conditioner of the market."

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[22] Section 10(b), by its plain terms, prohibits "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b). This Court has noted the relationship between Section 10(b) and Section 9. *See, e.g., Musick, Peeler,* 508 U.S. at 295-96.

If plaintiff buys in the open market "he may be as much affected by misstatements as if he had read and understood the statement.").

The registration statement's effect would likely have been dissipated, however, by the subsequent release of audited financial statements. As the Conference Report explained, the basis for the change was "that in all likelihood the purchase and price of the security purchased after publication of such an earning statement will be predicated on that statement rather than upon the information disclosed upon registration." H. R. Conf. Rep. No. 1838, 73d Cong., 2d Sess., at 41 (1934).

In addition, even after Congress required proof of reliance, it explicitly provided that "reliance may be established without proof of the reading of the registration statement." 15 U.S.C. § 77k(a). Congress thus also recognized the impracticality of limiting recovery by investors in the public capital markets to cases in which they could demonstrate eyeball reliance. This history makes it clear that the 73rd Congress understood both the concept of reliance on market price, and that such reliance can be established without proof that the investor ever saw the misrepresentations in question.

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

JILL E. FISCH
Counsel of Record
UNIVERSITY OF PENNSYLVANIA
LAW SCHOOL
3501 SANSOM STREET
PHILADELPHIA, PA 19104
(215) 746-3454
jfisch@law.upenn.edu

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Counsel for Securities Law Scholars as Amici Curiae *in Support of Respondent*