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THE TROUBLE WITH *BASIC*: PRICE DISTORTION AFTER *HALLIBURTON*

JILL E. FISCH*

ABSTRACT

Many commentators credit the Supreme Court's decision in Basic, Inc. v. Levinson, which allowed courts to presume reliance rather than requiring individualized proof, with spawning a vast industry of private securities fraud litigation. Today, the validity of Basic's holding has come under attack as scholars have raised questions about the extent to which the capital markets are efficient. In truth, both these views are overstated. Basic's adoption of the fraud on the market presumption reflected a retreat from prevailing lower court recognition that the application of a reliance requirement was inappropriate in the context of impersonal public market transactions. And, contrary to arguments currently being made to the Supreme Court in the Amgen case, fraud on the market theory does not require a strong degree of market efficiency—but merely that market prices respond to information.

The Basic decision had another, less widely-recognized effect, however. It began shifting the nature of private securities fraud claims from transaction-based claims to market-based claims, a shift that was completed by the Court's later decision in Dura. The consequence of this shift was to convert the nature of the plaintiff's harm from a corruption of the investment decision to one of transacting at a distorted price.

The legal significance of price distortion was at the heart of the Halliburton decision. The lower court confused two temporally distinct concepts: ex ante price distortion, which is part of the reliance inquiry, and ex post price distortion, which is a component of loss causation. The Supreme Court limited its holding in Halliburton to identifying this confusion, leaving examination of the appropriate role of price distortion for future cases. In Amgen, the Court may be forced to tackle this question. This Article argues that Amgen highlights the incongruity of considering price distortion at the class certification stage and provides

* Perry Golkin Professor of Law, University of Pennsylvania Law School. I am grateful for helpful comments from Eric Orts, the participants at the Institute for Law and Economic Policy's Conference on the Future of Class Actions, the University of Pennsylvania Law School's ad hoc faculty seminar and the Deals Workshop of the University of Colorado Law School. My thanks to Charlotte Newell, Penn Law Class of 2012, and Melissa Deutsch, Penn Law Class of 2011, for excellent research assistance.

an opportunity for the Court to reconsider and reject Basic's insistence on retaining a reliance requirement.

INTRODUCTION

The Supreme Court's decision in *Basic, Inc. v. Levinson*¹ is widely credited with spawning a vast industry of securities fraud litigation by removing the requirement of individualized proof of reliance as an obstacle to class certification.² Modern criticisms of private litigation coupled with questions about the validity of the economic premises on which *Basic* relied have led critics to question the legitimacy of the Court's holding in *Basic*.³ Most recently, with the Supreme Court's decision to grant certiorari in *Amgen*,⁴ commentators are again speculating that the Court may use this case as an opportunity to overrule *Basic*.⁵

Generally, criticism of *Basic* mischaracterizes the decision. *Basic* did not release federal securities fraud from its moorings in common law fraud

1. 485 U.S. 224 (1988).

2. See, e.g., Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 152 (stating that "[t]ens of billions of dollars have changed hands in settlements of 10b-5 lawsuits in the last twenty years as a result of *Basic*"); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 663 (1992) (stating that "the rate at which securities fraud class action suits were filed nearly tripled between April 1988, just after *Basic* was decided, and June 1991"); Brief of Chamber of Commerce of the United States of America as *Amicus Curiae* in Support of Respondents at 4, *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (No. 09-1403), 2011 U.S. S. Ct. Briefs LEXIS 445, at *6 (*Basic* "significantly expanded the Rule 10b-5 implied right of action by creating a fraud-on-the-market presumption in order to permit securities fraud plaintiffs to meet class certification requirements under Fed. R. Civ. P. Rule 23.").

3. See, e.g., William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 77 (2011) (advocating "removing the *Basic* presumption and imposing an actual reliance requirement"); Mahoney, *supra* note 2, at 670 (arguing that "[t]he Supreme Court would benefit shareholders by confessing that it erred in *Basic* when it adopted FOTM"); Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455 (2006) (reviewing academic studies raising questions about whether investors and markets are rational to the extent necessary to support *Basic*'s reasoning).

4. *Conn. Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170 (9th Cir. 2011), *cert. granted*, 132 S. Ct. 2742 (June 11, 2012) (No. 11-1085).

5. See, e.g., Britt K. Latham & M. Jason Hale, *The Supreme Court's Review of the Amgen Decision May Cause it to Reconsider the 'Fraud-On-The-Market' Presumption*, THOMSON REUTERS NEWS & INSIGHT (Aug. 13, 2012), http://newsandinsight.thomsonreuters.com/Securities/Insight/2012/08_-_August/The_Supreme_Court%E2%80%99s_review_of_the_Amgen_decision_may_cause_it_to_reconsider_the_Fraud-On-The-Market_presumption/ ("In light of the difficulties in applying *Basic* over the years, the Supreme Court may well use *Amgen* to reconsider (and even replace) *Basic*'s 'fraud-on-the-market' presumption with an alternative."); see also Transcript of Oral Argument at 41, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds* (Nov. 5, 2012) (No. 11-1085) (Scalia, J.), available at http://www.supremecourt.gov/oral_arguments/argument_transcripts/11-1085.pdf (questioning whether the Court should "overrule *Basic* because it was certainly based upon a theory that—that simply collapses once you remove the materiality element").

and deceit. Rather, by retaining the reliance requirement in federal securities fraud litigation, *Basic* reflected judicial conservatism. Despite contemporaneous recognition by lower courts and commentators that a reliance requirement was anomalous in the context of impersonal transactions in the public securities markets,⁶ the Supreme Court refused to reject reliance outright. Instead, the Court constructed a complex theory of market integrity relying on the fact that, in an efficient market, fraudulent public statements distort stock prices.⁷ According to the *Basic* Court, the existence of this price distortion justifies a rebuttable presumption of reliance.⁸

The *Basic* presumption simplified the class certification inquiry for a time by relieving plaintiffs of the need to establish individualized reliance. The rationale for the *Basic* presumption, however, reflected a shift in the underlying objectives of securities fraud litigation. Specifically, as this Article will explain, the price distortion theory on which *Basic* was premised had the effect of converting securities fraud from a transaction-based wrong—akin to common law deceit—into a market-based claim.⁹

At the same time, because it used the fraud on the market theory (“FOTM”) as the basis for its ruling, *Basic* deflected the reliance inquiry into an analysis of market efficiency. Following *Basic*, courts rapidly limited the availability of the *Basic* presumption to cases involving

6. See *infra* Part I.A (describing context in which the Supreme Court decided *Basic*).

7. Cf. *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008) (holding that fraudulent statements that are not communicated directly to the public markets are an insufficient basis for securities fraud liability). *But see id.* at 171–72 (Stevens, J., dissenting) (explaining that “petitioner . . . alleged that respondents knew their deceptive acts would be the basis for statements that would influence the market price of Charter stock on which shareholders would rely”).

8. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). This Article uses the term “price distortion” to reflect the concept that fraudulent information has an effect on the price of a security in the sense that, absent such information, the price at which the security traded would be different. Courts and commentators have also used the term “price impact.” Although some commentators use the terms interchangeably, this Article uses price impact instead to describe a situation in which the price of a security changes in response to the dissemination of information. See Transcript of Oral Argument at 27, *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (No. 09-1403) (Respondent’s counsel arguing that Petitioners are required to show price impact—that is, that Respondent’s misrepresentations moved the market at the time of the fraud or that “price[s] decline[d] following a corrective disclosure”). Cases involving price impact are a subset of all cases in which prices have been distorted by fraudulent information.

9. Arguably, this is consistent with the evolution of federal securities laws from investor to market protection focus. For example, Congress added a requirement in the National Securities Markets Improvements Act of 1996 that, in enacting regulation, the Securities and Exchange Commission consider the degree to which its rules would “promote efficiency, competition, and capital formation.” Pub. L. No. 104-290, § 106, 110 Stat. 3416, 3434 (codified as amended at 15 U.S.C. § 77b(b) (2006)) (adding § 2(b)).

efficient markets.¹⁰ Although market efficiency is neither a necessary nor a sufficient condition to establish that misinformation has distorted prices, most courts have concluded that the threshold inquiry in *Basic* is satisfied by proof that the misrepresentations were publicly made and “that the stock traded in an efficient market.”¹¹

With a few exceptions, courts have ruled that an independent analysis of price distortion is unnecessary to obtain the *Basic* presumption.¹² One of the exceptions was the Fifth Circuit.¹³ In *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton*,¹⁴ the Fifth Circuit held that, to obtain class certification under *Basic*, the plaintiffs must prove that the defendant’s misrepresentation affected the market price of the security.¹⁵ The court explained that this price impact could be established in one of two ways—through a stock price reaction at the time of the fraudulent statement or through a stock price response to the revelation of truth.¹⁶ The latter showing is equivalent to that required to establish the element of loss causation.¹⁷

The *Halliburton* case thus offered the Supreme Court an opportunity to reexamine *Basic*’s fundamental premises, specifically, the normative implications of focusing on price distortion in defining the contours of a claim for private securities fraud. The Court declined the invitation. Reluctant to disturb the delicate balance created by its prior decisions, and

10. See *infra* Part II.

11. *Halliburton Co.*, 131 S. Ct. at 2185 (“It is common ground, for example, that plaintiffs must demonstrate that the alleged misrepresentations were publicly known (else how would the market take them into account?), that the stock traded in an efficient market, and that the relevant transaction took place ‘between the time the misrepresentations were made and the time the truth was revealed.’” (quoting *Basic*, 485 U.S. at 248 n.27)).

12. See, e.g., *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 636–37 (3d Cir. 2011) (considering and rejecting defendants’ argument that plaintiffs should be required to prove “market impact” in order to gain the benefit of the *Basic* presumption). For the exception, see, for example, *Berks County Employees’ Retirement Fund v. First American Corp.*, 734 F. Supp. 2d 533, 541 n.52 (S.D.N.Y. 2010) (finding no Rule 23(b)(3) predominance where there was “‘no evidence’ that any of the alleged misrepresentations resulted in an ‘immediate increase’ in First American’s stock price and ‘no evidence’ that any corrective disclosure ‘caused an immediate decrease’ in stock price”).

13. In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, the Fifth Circuit held that plaintiffs were required to establish loss causation by a preponderance of the evidence in order to obtain class certification. 487 F.3d 261, 269 (5th Cir. 2007). A variety of circuits have faced this question and reached varying conclusions. See, e.g., *In re DVI, Inc. Sec. Litig.*, 639 F.3d at 631; *Schleicher v. Wendt*, 618 F.3d 679, 687 (7th Cir. 2010); *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 483–84 (2d Cir. 2008).

14. 597 F.3d 330 (5th Cir. 2010).

15. *Id.* at 335.

16. *Id.*

17. See *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 342–46 (2005) (holding that allegations of price inflation, without more, were insufficient to establish loss causation).

perhaps wary of entrusting policing the markets to the Securities and Exchange Commission (SEC) in light of ongoing questions about the vigor of the agency's enforcement efforts,¹⁸ the Court eschewed a broad-based holding and relied instead on a rigid characterization of the lower court's analysis. Although it reaffirmed the vitality of the *Basic* presumption, the Court explicitly refused to consider the role of price distortion in obtaining that presumption.¹⁹

The *Halliburton* decision reflected the Fifth Circuit's confusion between two temporal concepts²⁰—price distortion at the time of the fraud and price impact when the fraud is revealed to the market—that serve distinct objectives. Understanding these objectives is critical in determining the appropriate scope of private securities fraud litigation. At the same time, the Supreme Court's narrow holding in *Halliburton* did not confront the increasing stress placed on *Basic* by the evolving approach to class certification.²¹ That issue is squarely presented to the Supreme Court in the *Amgen* case.²² In *Amgen*, the Court is specifically asked to decide whether proof of price distortion is necessary to obtain class certification.²³ This Article argues that the natural outgrowth of the Court's market-based approach to securities fraud justifies resolving the tension in *Amgen* by overruling that aspect of the *Basic* decision which retains a reliance requirement.

Part I of this Article places *Halliburton* in historical context, first by describing the decisions that preceded *Basic* and then by examining *Basic*'s adoption of the presumption of reliance. Part II examines the aftermath of *Basic*, including the Court's subsequent decision in *Dura*. In Part III, the Article explains the collective impact of *Basic* and *Dura*—specifically, the move to a market-based conception of securities fraud and the role of price distortion in that conception. Part IV positions

18. See Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, SEATTLE U. L. REV. (forthcoming 2013), available at <http://ssrn.com/abstract=2164423> (describing criticisms of SEC enforcement policies).

19. See Erica P. John Fund v. Halliburton Co., 131 S. Ct. 2179, 2187 (2011) (explaining that “loss causation is . . . not price impact” and that “we need not, and do not, address any other question about *Basic*, its presumption, or how and when it may be rebutted”).

20. As explained below, to distinguish between these concepts, this Article will term them “ex ante price distortion” and “ex post price distortion.”

21. See, e.g., Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2551 (2011) (observing that the district court must apply “a rigorous analysis” in determining whether the requirements of Rule 23 are satisfied (quoting Gen. Tel. Co. of the Sw. v. Falcon, 457 U.S. 147, 161 (1982))).

22. See Conn. Ret. Plans & Trust Funds v. Amgen Inc., 660 F.3d 1170 (9th Cir. 2011), cert. granted, 132 S. Ct. 2742 (June 11, 2012) (No. 11-1085).

23. Petition for Writ of Certiorari at i, *Amgen*, 660 F.3d 1170 (9th Cir. 2011) (describing questions presented).

Halliburton as the natural outgrowth of this conceptual tension and explains why *Halliburton*'s analysis of these issues was both correct and incorrect. Part V describes the evolution of the class certification analysis and explains how this evolution has complicated the *Basic* inquiry. Part VI suggests that the natural solution to this problem is to overrule *Basic* and reject a reliance requirement, and then briefly identifies the policy considerations implicit in this approach.

I. *BASIC* AND ITS PAST

A. *Early Cases and Commentary*

Many commentators cite *Basic* as the foundation of modern securities fraud litigation.²⁴ *Basic* did not reflect, however, a doctrinal shift.²⁵ From the earliest cases addressing the implied private right of action under section 10(b) of the Securities Exchange Act²⁶ and SEC Rule 10b-5, the lower courts recognized that it was impractical to impose a reliance requirement in federal securities fraud litigation.²⁷ Commentators similarly questioned the theoretical premise for requiring proof of reliance.²⁸

The reliance requirement had its origins in common law fraud, which served as the initial source of the elements of federal securities fraud.²⁹

24. See, e.g., Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences By Investors and Others*, 52 STAN. L. REV. 87, 115 (1999) (describing *Basic* as "the most important Supreme Court decision to date on open market securities fraud").

25. Cf. Bratton & Wachter, *supra* note 3, at 74 (describing *Basic* as "relaxing the reliance requirement").

26. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006).

27. See, e.g., *Green v. Wolf Corp.*, 406 F.2d 291, 301 (2d Cir. 1968) ("Carried to its logical end, [Wolf's assertion of the need for proof of reliance] would negate any attempted class action under Rule 10b-5, since as the District Courts have recognized, reliance is an issue lurking in every 10b-5 action."). The first cases to address the role of reliance under the federal securities laws did so largely in the context of proxy fraud and tender offer litigation. See, e.g., *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970). In those cases, the courts generally held, with little difficulty or discussion, that proof of materiality was sufficient without independent proof that the misrepresentation or omission would have had a decisive effect on the outcome. As the Supreme Court explained: "Proof of actual reliance by thousands of individuals would, as the [lower] court acknowledged, not be feasible . . ." *Id.* at 382 n.5.

28. See, e.g., Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 590 (1975) [hereinafter Note, *The Reliance Requirement*]; see also Brief for Amici Curiae Civil Procedure and Securities Law Professors in Support of Respondent at 4, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, No. 11-1085 (Sept. 27, 2012) (arguing that framers of Rule 23 intended to facilitate securities fraud class actions).

29. See, e.g., *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir. 1965) (describing incorporation of common law requirements of materiality and reliance); cf. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-45 (1975) ("[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial

Common law fraud included a requirement that plaintiffs prove subjective reliance.³⁰ As one court explained it, the test was “whether [an individual] plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.”³¹

Courts promptly began to question whether it was appropriate to apply the reliance requirement to federal securities fraud. The reliance requirement appeared anomalous for several reasons. The issue arose initially in the early securities fraud cases involving non-disclosure or omission.³² Proof of reliance in a non-disclosure case essentially required a counterfactual analysis. As a student commentator explained in a *Harvard Law Review* note: “Since nothing is affirmatively represented in a nondisclosure case, demanding proof of reliance would require the plaintiff to demonstrate that he had in mind the converse of the omitted facts, which would be virtually impossible to demonstrate in most cases.”³³

Second, and more generally, the entire mandatory disclosure system of federal securities regulation was based on the premise that information affects trading and market prices. As the Second Circuit explained in 1968, “It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation.”³⁴

Third, an individualized reliance inquiry became more complicated in the context of impersonal transactions in the public markets. Plaintiffs in public market transactions were exposed to a range of information from a variety of sources. Defendants often released a mixture of information in multiple public statements. Market intermediaries—including analysts, brokers, and the financial media—processed that information and communicated their conclusions to investors who, in many cases, did not

transactions to which 10b-5 is applicable.”). The basic elements required to establish a claim of federal securities fraud are: “(1) a material misrepresentation (or omission); (2) scienter, *i.e.*, a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance . . . ; (5) economic loss; and (6) ‘loss causation,’ *i.e.*, a causal connection between the material misrepresentation and the loss.” *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005) (internal citations omitted).

30. *See, e.g.*, *Kohler v. Kohler Co.*, 208 F. Supp. 808, 823 (E.D. Wis. 1962) (“With regard to the element of reliance, although there is dicta to the contrary, this element appears to be indispensable to the cause of action upon either theory Absent proof of reliance, there is no liability.”).

31. *List*, 340 F.2d at 463.

32. *See, e.g.*, *Myzel v. Fields*, 386 F.2d 718, 735–37 (8th Cir. 1967); *Epstein v. Weiss*, 50 F.R.D. 387, 392–95 (E.D. La. 1970).

33. Note, *The Reliance Requirement*, *supra* note 28, at 590.

34. *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968).

review the issuer's original statements.³⁵ In addition, the contextual nature of financial information meant that its role in an investor's decision might vary depending on the other information that was currently available in the market.

The limitations of the litigation process as a means of uncovering reliable evidence of reliance was an additional consideration. Evidence of reliance is largely limited to plaintiffs' testimony about what they saw and thought. A legal system that requires proof of subjective reliance may generate self-serving testimony.³⁶ In impersonal market trading, reliable evidence of the specific factors that influenced the parties' decisions to trade is unlikely to exist.

The class action context heightened these concerns. Not only was the inquiry into subjective reliance difficult with respect to any specific investor, but each investor's reliance inquiry in a class action might involve different factors. At the same time, the 1966 amendments to Rule 23³⁷ suggested that the Rule was intended to allow securities fraud litigation to proceed in the form of a class action.³⁸

Finally, and perhaps most importantly, a determination of materiality in a securities fraud case was, implicitly, a determination that the misinformation had the capacity to affect transactions and prices.³⁹

35. Commentators increasingly recognized that investors rarely read even statutorily-mandated disclosures. *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 are typically not read). In addition, because investors often relied on information intermediaries, it was difficult to trace the causal chain through those intermediaries. *See, e.g.*, *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981); Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877, 880 (2006) (explaining that most investors receive information through “one or more filters or intermediaries”).

36. As the court noted in *Eckstein v. Balcor Film Investors*,

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.

8 F.3d 1121, 1130 (7th Cir. 1993).

37. *See* FED. R. CIV. P. 23 (Advisory Committee's notes on the 1966 amendments).

38. *See, e.g.*, Sherman L. Cohn, *The New Federal Rules of Civil Procedure*, 54 GEO. L.J. 1204, 1214 (1966) (describing how the “complete overhaul of rule 23 significantly expand[ed] the scope of class actions”). This led courts simply to assume, with limited discussion, that the reliance requirement could not pose an obstacle to class certification. *See, e.g.*, *Kronenberg v. Hotel Governor Clinton, Inc.*, 41 F.R.D. 42, 45 (S.D.N.Y. 1966) (“The defendants' contentions that the proof of reliance and use of the mails must relate to each individual member of the class presents no difficulty not inherent in every securities class action.”). For a more extensive analysis of the appropriateness of the private securities fraud class action, see Judge Weinstein's opinion in *Dolgow v. Anderson*, 43 F.R.D. 472 (E.D.N.Y. 1968).

39. Where the transaction is accomplished through impersonal dealings, such as on a stock exchange, or for some other reason the factors that influenced the parties are not readily apparent, the

Although establishing materiality did not prove that, but for the fraud, the transaction would not have occurred, it arguably established that any transaction that did occur would have occurred on different terms in the absence of the fraud. In the context of a regulatory scheme designed to protect the efficiency of the capital markets, the imposition of liability for injecting into the market misinformation that had the capacity to distort prices appeared consistent with the statutory objectives.

Courts varied in the degree to which they attempted to devise pragmatic solutions to the complexity of proving reliance as opposed to modifying or eliminating the common law requirement. Because, at that time, private litigation under Rule 10b-5 was relatively new, many courts simply reserved decision on the question of whether the plaintiff was required to prove reliance.⁴⁰ When they did consider the reliance requirement, courts used a variety of mechanisms to avoid requiring direct proof of reliance. As the Second Circuit explained:

In fraud or 10b-5 cases decided in recent years, various rules, mechanisms, or presumptions have been put forward for mitigating the problem of showing reliance: Split trials for individual proof on reliance; inferring from the materiality of the misstatement that a reasonable investor would have relied; stressing general reliance on a common course of conduct over a period of time; dispensing with or minimizing the need to prove individual reliance in cases of nondisclosure; using the test, in instances of omission, of whether the claimant would have been influenced to act differently, if the undisclosed fact had been made known, than he in fact did.⁴¹

decisions have discussed liability in terms of constructive reliance premised on the materiality of the misrepresentation. *See Kahan v. Rosenstiel*, 424 F.2d 161, 173–74 (3d Cir. 1970); *Heit*, 402 F.2d at 912; *List v. Fashion Park, Inc.*, 340 F.2d 457, 462–64 (1965). “This constructive reliance principle is particularly appropriate in class actions where proof of actual reliance by numerous class members would be impracticable.” *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 374 (2d Cir. 1973); *see also Kahan*, 424 F.2d at 174.

40. *See, e.g., Green v. Wolf Corp.*, 406 F.2d 291, 301 (2d Cir. 1968) (“Even if Wolf is correct in its assertion of the need for proof of reliance, and *we express no views on that issue*, we must still reject the argument.”) (emphasis added); *Fischer v. Kletz*, 41 F.R.D. 377, 382 (S.D.N.Y. 1966) (“The parties are at odds over the issue of the kind and degree of reliance on the alleged misrepresentations. . . . At this juncture, I need not . . . rule on this question.”).

41. *Korn v. Franchard Corp.*, 456 F.2d 1206, 1212–13 (2d Cir. 1972) (internal citations omitted).

B. Ute—*Reliance in Omission Cases*

The Supreme Court dealt a setback to lower court experimentation with ways to avoid requiring direct proof of reliance with its decision in *Ute*.⁴² *Ute* was decided just one year after the Supreme Court first formally acknowledged the existence of a private right of action under Rule 10b-5⁴³ and sixteen years before its decision in *Basic*. Rather than concluding, for any of the reasons noted above, that a reliance requirement was anomalous within the context of federal securities fraud litigation, the Court in *Ute* reaffirmed that reliance was, in fact, a required component of a 10b-5 claim.⁴⁴ Nonetheless, the Court held that, within the context of the case-specific facts before it, affirmative proof of reliance was not required.⁴⁵

Ute did not involve anonymous transactions in the public markets⁴⁶—it involved individualized face-to-face transactions between eighty-five plaintiff-sellers and the individual defendants.⁴⁷ In some cases, the defendants purchased the plaintiffs' shares for their own accounts; in others, they facilitated transactions for third-party buyers, for which they received commissions.⁴⁸ The defendants did not make any public statements, the litigation was not brought as a class action, and the decisions involved an appeal after a full trial, not the resolution of a motion for class certification.⁴⁹ Accordingly, many of the considerations that affected the lower court decisions were not present in *Ute*.

The Tenth Circuit found that, although several of the transactions involved affirmative misrepresentations by the defendants as to the prevailing market price, the record did not contain any evidence as to reliance, and that proof of reliance was required.⁵⁰ In addition, the Tenth Circuit held that the defendants were only liable with respect to transactions conducted for their personal accounts.⁵¹ The Supreme Court

42. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152–54 (1972).

43. *See Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

44. *Ute*, 406 U.S. at 152–53.

45. *Id.* at 153–54.

46. Nor could the market for the stock in *Ute* have been characterized as efficient. *See id.* at 155 (describing the market as being “so isolated and so thin”).

47. *Id.* at 144.

48. *Id.* at 152.

49. *See id.* at 139–50.

50. *Reyes v. United States*, 431 F.2d 1337, 1348 (10th Cir. 1970), *aff'd in part, rev'd in part sub nom. Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). This finding was somewhat anomalous in that the court, three paragraphs earlier, stated, “The record shows that the plaintiffs considered these defendants to be familiar with the market for the shares of stock and relied upon them when they desired to sell their shares.” *Id.* at 1347.

51. *Id.* at 1345–46.

disagreed with both conclusions.⁵² Specifically, the Court concluded that the defendants had not merely made misrepresentations (in violation of Rule 10b-5(2)), but had engaged in a course of business that operated as a fraud—operating as, in effect, marketmakers with respect to the securities in question.⁵³ As a result, the Court concluded that the defendants owed the plaintiffs an affirmative duty of disclosure.⁵⁴ The Court then held that independent proof of reliance was not required: “All that is necessary is that the facts withheld be material”⁵⁵ The link between materiality might be viewed as establishing a type of objective reliance (whether a reasonable investor would rely) as opposed to subjective reliance (whether the specific plaintiffs did, in fact, rely), although the Court did not offer that characterization.⁵⁶ As the Court stated, the defendants’ actions “reasonably could have been expected to influence [the plaintiffs’] decisions to sell.”⁵⁷

Despite this reasoning, the Court did not state that objective reliance was sufficient to establish 10b-5 liability.⁵⁸ *Ute*’s legacy was narrow. As the Court explained, “Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery.”⁵⁹

The *Ute* decision is somewhat anomalous. It appears unlikely that the Supreme Court granted certiorari in *Ute* to address the reliance requirement in federal securities fraud. The case, as mentioned above, does not present the impersonal capital markets type of transaction that was causing the most difficulty in the lower courts. Moreover, the Supreme Court’s opinion addressed novel issues concerning sovereign immunity and the interpretation of the statutory scheme for allocation of Indian mineral rights.⁶⁰ In addition, the factual record in *Ute* is somewhat unclear. Although the Supreme Court characterized the case as one primarily involving omissions, for example, as noted above, the Tenth Circuit found that “the record shows that the individual defendants made a misstatement of a material fact in representing, in those instances wherein

52. *Ute*, 406 U.S. at 153–54.

53. *Id.* at 153.

54. *Id.*

55. *Id.*

56. This distinction becomes important in the context of class certification.

57. *Id.*

58. In *Mills v. Electric Auto-Lite Co.*, the Supreme Court held that similar proof of objective reliance was sufficient to establish causation in a claim for federal proxy fraud. 396 U.S. 375, 385 (1970).

59. *Ute*, 406 U.S. at 153.

60. *See, e.g., id.* at 141–43.

they purchased stock for sale at a personal profit, that the prevailing price or market price was the figure at which their own purchase was made.”⁶¹ Thus the *Ute* opinion did not explicitly signal the broader implications of the Court’s holding for the reliance requirement.

The application of *Ute* created questions for the lower courts. Specifically, although the Supreme Court did not use the term “presumption,” the lower courts, virtually without exception, concluded that *Ute* established only a presumption of reliance⁶²—a presumption that might be rebutted under appropriate circumstances. Because it did not speak to the issue, *Ute*’s language did not offer guidance as to what those circumstances might be.⁶³ In addition, the lower courts relied on the Supreme Court’s characterization of the facts to conclude that *Ute* applied only to omission cases.⁶⁴ The courts reasoned that proof of subjective reliance was difficult in an omission case because of the challenge in demonstrating reliance on information that was not provided.⁶⁵ Again, this analysis was not contained in the *Ute* decision itself.

The counterfactual nature of the reliance inquiry is not, however, limited to omissions cases, but extends to misrepresentation cases as well. In addition, as noted above, there were a number of challenges to establishing subjective reliance in impersonal public market transactions.⁶⁶ The lower courts responded by going beyond *Ute*’s holding⁶⁷ to create an

61. *Reyes v. United States*, 431 F.2d 1337, 1347 (10th Cir. 1970), *aff’d in part, rev’d in part sub nom. Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

62. “Courts applying *Affiliated Ute* have doctrinally invoked a rebuttable presumption of reliance based on proof of materiality in cases alleging deception by non-disclosure of information.” *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 359 (5th Cir. 1987). *But see* *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 400 (2d Cir. 1973) (Mansfield, J., concurring in part and dissenting in part) (arguing that the Supreme Court’s decision in *Ute* did not create a presumption but held that reasonable reliance was established “as a matter of law” on the basis of materiality).

63. *See, e.g., Rifkin v. Crow*, 574 F.2d 256, 262 (5th Cir. 1978) (“If defendant can prove that plaintiff did not rely, that is, that plaintiff’s decision would not have been affected even if defendant had disclosed the omitted facts, then plaintiff’s recovery is barred.”).

64. *Id.* (citing cases indicating a general pattern of limiting *Ute* to omissions cases).

65. *See, e.g., Vervaecke v. Chiles Heider, & Co.*, 578 F.2d 713, 717 (8th Cir. 1978) (noting the “difficulty of proving reliance on the negative” (quoting Note, *The Reliance Requirement*, *supra* note 28, at 590)).

66. Dispensing with subjective reliance can be justified on the ground that, in the impersonal capital markets, with extensive sources of information, trading strategies, and investor types, the extent to which a single factor affected an investor’s decision to trade is largely unknowable. *See* Note, *The Reliance Requirement*, *supra* note 28, at 594 (arguing for extension of *Ute* to “deception affecting market conditions”). “In such cases the difficulty of proving reliance and the probative value of materiality justify placing the burden of persuasion on the defendant once the plaintiff can establish that there was a material misrepresentation or omission.” *Id.* at 606.

67. Courts initially took this step in cases involving proxy fraud and tender offer fraud, reasoning that, as with omission cases, it was simply too difficult to require proof that, absent the

alternative mechanism by which plaintiffs could avoid the requirement of demonstrating subjective reliance—the “fraud on the market theory.”⁶⁸

FOTM developed as an aggregation of several strains of reasoning. The first court to use the “fraud on the market” terminology was the Southern District of New York in *Herbst v. Able*.⁶⁹ There the court explained that the effect of the defendant’s fraud was to distort market price and that this distortion, in turn, induced reliance by the plaintiffs.⁷⁰ To some degree, this approach was similar to that of constructive reliance.⁷¹

In *Blackie v. Barrack*,⁷² the earliest Court of Appeals decision to adopt FOTM, the Ninth Circuit explained that: “We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance.”⁷³ The court explained that the reliance requirement “imposes an unreasonable and irrelevant evidentiary burden.”⁷⁴ Critically, *Blackie* established the rationale upon which the Supreme Court would come to rely in *Basic*. As the court explained, whether or not an investor relies directly on a specific false statement, “he relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations.”⁷⁵

The Second Circuit took a somewhat different approach to FOTM in *Panzirer v. Wolf*.⁷⁶ In that case, the plaintiff, Panzirer, alleged an indirect chain of causation in which the defendants’ misrepresentations contributed to the inclusion of the subject securities in a *Wall Street Journal* article

misrepresentation, the plaintiffs would have acted differently. *See, e.g., Crane Co. v. Westinghouse Air Brake Co.* 419 F.2d 787 (2d Cir. 1969).

68. *Herbst v. Able*, 47 F.R.D. 11, 16 (S.D.N.Y. 1969) (“If plaintiffs can prevail in their ‘fraud on the market’ theory, this may be sufficient to sustain a recovery under Section 10(b) . . .”).

69. *Id.*

70. *Id.* (“The relevant impact of the misrepresentations was *on the market*. It was the artificially heightened market price, pure and simple, which operated on plaintiffs and other members of the class to induce conversion.” (quoting plaintiffs’ brief)).

71. Courts adopted the constructive reliance approach, which held that reliance followed upon a showing of materiality, for federal proxy and tender offer fraud. *See Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970) (adopting a rule of constructive reliance); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 374 (2d Cir. 1973) (terming this approach “constructive reliance”).

72. 524 F.2d 891 (9th Cir. 1975).

73. *Id.* at 906.

74. *Id.* at 907.

75. *Id.*

76. 663 F.2d 365 (2d Cir. 1981).

upon which she relied.⁷⁷ Terming the claim one of “secondary reliance,”⁷⁸ the court found Panzirer’s allegations sufficient.⁷⁹ “Where the plaintiff acts upon information from those working in or reporting on the securities markets, and where that information is circulated after a material misrepresentation or omission, plaintiff has stated a sufficient claim of reliance on the misrepresentation or omission.”⁸⁰

Arguably, the most extreme approach was taken by the Fifth Circuit in *Shores v. Sklar*.⁸¹ Rejecting the trial court’s holding that fraud on the market was limited to open market transactions, the Fifth Circuit held that allegations that the defendant’s fraud allowed the bonds in question to be marketed were sufficient to establish causation.⁸² Terming its “fraud created the market” approach “very similar to the fraud-on-the-market theory,”⁸³ the Fifth Circuit held that allegations of subjective reliance on the offering documents were not required because, if the plaintiffs’ allegations were true, the securities would never have been marketed.⁸⁴

Importantly, the lower court cases that employed fraud on the market or some variation thereof, all converted the common law subjective reliance requirement into one of objective reliance or what some courts termed causation. Proof that a particular plaintiff would have behaved differently in the absence of the fraud was simply unnecessary. As the Court stated in *Blackie*, “proof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market.”⁸⁵

C. Basic *Itself*

Although lower court decisions varied in both their reasoning and their expansiveness, by the time of the *Basic* decision, FOTM was well-established. As Donald Langevoort states: “all courts of appeals that had considered the question had invoked some kind of reliance presumption in order to make fraud-on-the-market class-action lawsuits certifiable.”⁸⁶ Daniel Fischel, who would eventually become a highly influential

77. *Id.* at 366.

78. *Id.* at 367.

79. *Id.*

80. *Id.*

81. 610 F.2d 235 (5th Cir. 1980), *aff’d en banc*, 647 F.2d 462 (5th Cir. 1981).

82. *Id.* at 240.

83. *Id.* at 239.

84. *Id.* at 240.

85. *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975).

86. Langevoort, *supra* note 2, at 153.

professor and Dean at the University of Chicago Law School, published an article in 1982 arguing that fraud on the market was supported by prevailing understandings of economics and finance and that it offered a more coherent approach to securities fraud litigation than the traditional approach.⁸⁷ As Fischel explained, “Because the rational course for investors is simply to accept the market price, it is of no consequence whether a plaintiff can demonstrate that he relied upon a particular piece of information.”⁸⁸

At that time, however, the Supreme Court was in the process of retreating from its earlier expansionist approach to private securities fraud litigation.⁸⁹ In a series of decisions outside the reliance context, the Supreme Court read the requirements of a securities fraud restrictively and, in some cases, warned of the dangers of an expanding private cause of action.⁹⁰

In that context, the Supreme Court decided *Basic*. At the outset, the Court expressly reaffirmed the continued vitality of the reliance requirement, stating, “We agree that reliance is an element of a Rule 10b-5 cause of action.”⁹¹ The Court then explained that its version of FOTM was simply a way of demonstrating reliance in the context of open market transactions.⁹² In the stock market, the Court explained, investors justifiably rely on the market as their agent, to price their securities.⁹³ Because investors reasonably rely on the integrity of market price, it may be presumed that they rely on misrepresentations that distort that market price.⁹⁴ Reliance on market price offered a practical substitute for direct proof of reliance on the defendants’ statements.

The *Basic* decision stated that the “threshold facts for”⁹⁵ establishing FOTM were a showing that the defendants “made public, material misrepresentations and [respondents] sold *Basic* stock in an impersonal, efficient market.”⁹⁶ In a footnote that has subsequently generated

87. Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982).

88. *Id.* at 8.

89. See Jayne W. Barnard, *The Supreme Court and the Shareholder Litigant: Basic, Inc. v. Levinson in Context*, 16 PEPP. L. REV. 985 (1989) (recounting the Supreme Court’s conservative trend in its securities fraud decisions leading up to *Basic*).

90. *Id.*

91. *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

92. *Id.* at 247–48.

93. *Id.* at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980).

94. *Id.* at 247.

95. *Id.* at 248.

96. *Id.*

disagreement in the lower courts,⁹⁷ the opinion further noted that the lower court held that, in order to invoke the presumption, the plaintiffs must allege and prove:

- (1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.⁹⁸

Importantly, the *Basic* presumption was rebuttable. As the Court explained, the presumption could be rebutted by “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price”⁹⁹ This last statement was critical in that it retained both the subjective and objective components of the reliance requirement.

Basic explicitly justified its presumption in terms of policy considerations, explaining that presumptions are widely used in circumstances in which direct proof is difficult to produce. The Court noted that its decision was supported by “considerations of fairness, public policy, and probability, as well as judicial economy.”¹⁰⁰

In light of its history and the prevailing reasoning in the lower courts, *Basic* is properly understood not as a revolution, but a retrenchment. The Supreme Court could have eliminated the requirement that plaintiffs establish reliance in 10b-5 cases.¹⁰¹ Alternatively, the Court could have held that proof of causation was sufficient to establish reliance.¹⁰² *Basic* could have extended *Ute*'s holding to include misrepresentation cases by holding that proof of materiality was sufficient to establish reliance.¹⁰³ Finally, the Court could have rejected the claim that subjective reliance—the motivation for individual plaintiff decisions—was a required element of 10b-5 liability. The Court did none of these. *Basic* reaffirmed the need for an inquiry into reliance and, importantly, preserved this inquiry for a

97. See, e.g., *Conn. Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170, 1176 (9th Cir. 2011) (criticizing other courts for “misread[ing] the *Basic* footnote”).

98. *Basic*, 485 U.S. at 248 n.27.

99. *Id.* at 248.

100. *Id.* at 245.

101. *Langevoort*, *supra* note 2, at 153.

102. *Id.*

103. Indeed, this approach would have been analogous to the manner in which the Court had previously addressed proxy fraud. See *supra* note 27.

threshold stage of the litigation—the class certification decision. Subsequent developments in doctrines of civil procedure have given new significance to this approach.

II. AFTER *BASIC*

A. *Reliance Analysis After Basic*

As indicated above, *Basic*'s language appears to contemplate a continued role for subjective reliance. At least some members of the *Basic* plurality likely intended lower courts to continue to examine both market effects (objective reliance) and individual investor decisions (subjective reliance). Attempts by litigants in the lower courts to rebut or overcome *Basic*'s presumption, however, largely focused on objective reliance.¹⁰⁴ The dominant form of challenges to class certification, post-*Basic*, was to challenge the efficiency of the market in which the securities traded.¹⁰⁵ Lower courts responded to these challenges by developing an elaborate test for analyzing market efficiency.¹⁰⁶

104. Cf. *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 300–01 (S.D.N.Y. 2003) (rejecting defendants' argument that because some named plaintiffs were passive indexed investors, *Basic*'s presumption of reliance should not apply). It is unclear why *Basic* did not lead defendants to bring more challenges to subjective reliance. One possible answer is that defeating market efficiency would result in dismissal, while knocking out some plaintiffs would not. See Barnard, *supra* note 89, at 1021 (observing that resourceful plaintiffs' attorneys can readily find substitute class representatives).

105. See, e.g., Allen Michel, et al., *Fraud-on-the-Market Theory: Is a Market Efficient?*, 24 AM. BANKR. INST. J. 58 (2005) ("The key to satisfying the reliance requirement in a fraud-on-the-market case is the demonstration that the securities market on which the security in question trades is efficient."); William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 852 (2005) ("This mechanical notion of an 'efficient market' has come to dominate securities litigation."). The focus on analyzing the extent to which the market was "sufficiently" efficient developed despite *Basic*'s statement that "[f]or 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." *Basic*, 485 U.S. at 247 n.24.

106. One of the most frequently cited cases for the evaluation of market efficiency is *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989). The court in *Cammer* cited five factors that should be considered in determining whether the security traded in a sufficiently efficient market for purposes of the *Basic* presumption: (1) the stock's "average weekly trading volume"; (2) the "number of securities analysts" who follow the stock; (3) the "existence of market makers and arbitrageurs" active in the stock; (4) eligibility to file an SEC Form S-3 registration statement; and (5) a showing that the stock price responded to "unexpected corporate events or financial releases." *Id.* at 1286–87; see also Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in Cammer v. Bloom and its Progeny*, 10 U. MIAMI BUS. L. REV. 303 (2002) (discussing *Cammer* decision and subsequent reliance on factors discussed therein); David Tabak, *Do Courts Count Cammer Factors?*, NERA ECONOMIC CONSULTING (Aug. 7, 2012), http://www.nera.com/nera-files/pub_cammer_factors_0812.pdf (finding that, in an empirical analysis of decisions on market efficiency, courts appear to count the *Cammer* factors).

Basic's emphasis on market efficiency left its analysis open to criticism.¹⁰⁷ As Macey and Miller demonstrate, the *Basic* Court did not fully articulate the conception of the Efficient Capital Markets Hypothesis ("ECMH") upon which it relied or the theoretical foundations of its opinion.¹⁰⁸ Because there are variations in economic theories of efficiency,¹⁰⁹ *Basic*'s analysis led to difficulties in applying FOTM.¹¹⁰ Perhaps the most substantial criticism was that *Basic*'s presumption required markets to be fundamental value efficient in a way that subsequent empirical studies have demonstrated they are not.¹¹¹ Fundamental value efficiency means that securities' prices reflect the securities' fundamental values.¹¹² Few scholars believe that the public capital markets are fundamental value efficient.¹¹³ Information efficiency, in contrast, means that securities prices rapidly incorporate publicly available information.¹¹⁴ Most scholars believe that the markets are information efficient to some degree.¹¹⁵

Even if *Basic* only requires information efficiency, critics have questioned the extent of that efficiency and, as a result, the validity of assuming that information distorts stock prices.¹¹⁶ For example,

107. See, e.g., Carol R. Goforth, *The Efficient Capital Market Hypothesis—An Inadequate Justification For the Fraud-On-The-Market Presumption*, 27 WAKE FOREST L. REV. 895, 902 (1992).

108. Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1077–79 (1990).

109. See generally Jonathan R. Macey, et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 VA. L. REV. 1017, 1018 (1991) (“[S]ubstantial disagreement exists about to what degree markets are efficient, how to test for efficiency, and even the definition of efficiency.”).

110. See, e.g., L. Brett Lockwood, Comment, *The Fraud-on-the-Market Theory: A Contrarian View*, 38 EMORY L.J. 1269, 1302 (1989) (arguing that “efficient market theory is subject to too many reservations to be an adequate foundation for the fraud-on-the-market theory”).

111. *Id.* at 1302–11; see also *In re PolyMedica Corp. Sec. Litig.*, 453 F. Supp. 2d 260, 271–72 (D. Mass. 2006).

112. See Robert G. Newkirk, Comment, *Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context*, 58 U. CHI. L. REV. 1393, 1398–99 (1991) (explaining the difference between information efficiency and fundamental value efficiency).

113. See, e.g., Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591 (1986) (citing evidence indicating the absence of fundamental value efficiency); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 649 (1995) (noting scholars’ “[i]ncreasing disillusionment with the concept of fundamental value efficiency”).

114. Newkirk, *supra* note 112, at 1396–97.

115. See, e.g., Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003); Donald C. Langevoort, *Foreword: Revisiting Gilson and Kraakman's Efficiency Story*, 28 J. CORP. L. 499 (2003).

116. See generally Paul A. Ferrillo et al., *The “Less Than” Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 ST. JOHN'S L. REV. 81, 107–16 (2004) (identifying various challenges to the efficient market hypothesis). The plurality in *Basic* recognized the potential flaw in its analysis, noting that there might be an incongruity between its

commentators have questioned the claim that markets react instantaneously to information, pointing to numerous examples of long-term price distortions.¹¹⁷ Similarly, markets may systematically overreact or underreact to different types of information.¹¹⁸ Other commentators have suggested that developments in behavioral economics undercut the claim that traders rely on expectations of price or market integrity.¹¹⁹

A strong version of market efficiency should not, however, be a predicate for application of the *Basic* presumption. The connection that the *Basic* decision identified between fraud and stock price depends only on the weakest conception of market efficiency—the premise that information affects securities prices.¹²⁰ Prices need not respond accurately, instantaneously, or rapidly to information to justify the claim that, if the market contains misinformation, securities trades are likely to occur at different prices than in a market free from fraud.¹²¹ Price distortion, not market efficiency, is, in reality, the core concept on which the *Basic*'s reasoning depends.

Importantly, however, when fraud distorts securities prices, it produces a market-based harm. In the presence of a price distortion, all investors trade at the wrong price. Wrong, as used here, does not depend on notions of fundamental value—it simply means that the price is different from what it would have been in the absence of misinformation. The injury

description of the trading market for Basic stock and the allegation that the price of Basic shares could remain distorted for fourteen months on the basis of three public statements. *Basic Inc. v. Levinson*, 485 U.S. 224, 249 n.29 (1988).

117. *E.g.*, Goforth, *supra* note 107, at 902–903.

118. *See, e.g.*, Paul C. Tetlock, *All the News That's Fit to Reprint: Do Investors React to Stale Information?*, 24 *REV. FIN. STUD.* 1481 (2011) (showing that markets overreact to stale information); Timm O. Sprenger & Isabell M. Welpel, *News Or Noise? The Stock Market Reaction to Different Types of Company-Specific News Events* 4 (Jan. 20, 2011) (Working Paper), available at <http://ssrn.com/abstract=1734632> (finding that “the market reaction differs substantially across various types of news events”); Navin Chopra et al., *Measuring Abnormal Performance: Do Stocks Overreact?*, 31 *J. FIN. ECON.* 235 (1992).

119. *See, e.g.*, *In re PolyMedica Corp. Sec. Litig.*, 453 F. Supp. 2d 260, 272 n.10 (D. Mass. 2006) (“The emerging field of behavioral finance suggests that differing investor assessments of value appear to be the rule, rather than the exception. Because the notion of information efficiency upon which the fraud-on-the-market presumption rests is crumbling under sustained academic scrutiny, the future of securities fraud class action litigation—dependent on this presumption—may be in jeopardy.”) (internal citations omitted).

120. Indeed, misinformation does not require an efficient market to distort prices; it has a distorting effect even in individualized face-to-face transactions. *See* AMERICAN LAW INSTITUTE, *PRINCIPLES OF THE LAW OF LIABILITY INSURANCE*, COUNCIL DRAFT NO. 1 § 11(a), at 60–64 (2012) (proposing price adjustment as remedy for negligent misrepresentations in insurance contracts).

121. Note that this principle does not apply to all securities transactions. The manner in which prices are set in the IPO market, for example (underwriters, underpricing) may lead to the conclusion that such prices are not affected by the presence of misinformation.

created by a distorted price is common to all investors regardless of their individualized reasons for trading, which is why it satisfies the commonality requirement of Rule 23.¹²² The solution has a price, however. A focus on price distortion shifts the focus of a 10b-5 claim from protecting the autonomy of the investment decision to protecting the ability to trade at a price undistorted by fraud.

This then reveals an internal tension in *Basic*'s analysis. To the extent that misinformation distorts securities prices, it affects all market participants regardless of their reasons for trading. The premise of the reliance requirement, however, is the effect of the fraud on trading decisions. Reliance is required precisely because the common law perceives fraud as transaction-based and views the defendants' misrepresentations as compromising the autonomy of investor decision-making.

B. *Dura*

To satisfy *Basic*, plaintiffs needed to allege that they traded at a distorted (typically an artificially inflated) stock price.¹²³ The *Basic* court did not, however, explain the legal significance of this price distortion. In *Dura*,¹²⁴ the Court addressed that issue further. *Dura* involved an analysis of loss causation, which lower courts had distinguished from reliance, analogizing it to common law proximate cause.¹²⁵ Congress codified the loss causation requirement in the Private Securities Litigation Reform Act of 1995,¹²⁶ although it did not define loss causation in the statute.

The *Dura* plaintiffs attempted to establish loss causation by demonstrating that, at the time of their purchase, *Dura*'s stock had been artificially inflated due to the defendants' misrepresentations.¹²⁷ Essentially, plaintiffs' argument was that they were harmed by overpaying for their stock. The Court in *Dura* rejected this claim, holding that reliance and loss causation were two distinct components of a federal securities

122. See FED. R. CIV. P. 23.

123. See *Basic Inc. v. Levinson*, 485 U.S. 224, 245–47 (1988).

124. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005).

125. See Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 820–22 (2009) (describing evolution of the loss causation requirement in federal securities fraud litigation).

126. Pub. L. No. 104-67, § 101(b), § 21D(b)(4), 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(4) (2006)).

127. 544 U.S. at 339–40. The plaintiffs further argued that their damages consisted of their overpayment for the *Dura* stock. *Id.*

fraud claim and that plaintiffs could not establish economic harm simply through the price distortion reflected in *Basic*'s analysis.¹²⁸

Dura's holding was limited to two principles. First, the plaintiffs must establish a causal connection between the defendant's fraud and their economic harm.¹²⁹ Second, an inflated purchase price is not, in itself, the equivalent of economic harm.¹³⁰ According to the *Dura* Court, trading at a distorted price does not inevitably cause investors to experience economic harm.¹³¹ Price distortion only results in outcome harm if the investor does not subsequently recover the amount of the distortion.¹³² The easiest illustration, as noted by the *Dura* Court, is a case in which an investor purchases a security at a distorted price and then resells that security while the price remains distorted.¹³³ *Dura* noted that even when the plaintiff subsequently sells at a lower price, the price drop may have resulted from factors unrelated to the fraud.¹³⁴

Dura's gloss on *Basic* establishes that price distortion at the time of the plaintiffs' purchase establishes the potential for, but not the actuality of, economic harm. Economic harm can only be determined by an analysis of whether there is price distortion at a second point in time—when the fraud is revealed to the market. This second type of price distortion, what might be termed “ex post” price distortion is, according to the *Dura* court, the measure of the plaintiff's harm. *Dura* held that ex post price distortion, as demonstrated by the price reaction to the revelation of the fraud, was required to establish loss causation.¹³⁵ Critically, by holding that overpayment itself was not a recoverable economic harm,¹³⁶ *Dura* extended *Basic*'s market-based conception of securities fraud. Under *Dura*'s theory, the plaintiff's economic loss is the amount of the original price distortion that remains in the stock until the corrective disclosure, as measured by the market's response to the disclosure of the original misrepresentation.¹³⁷ *Dura* rejected the effect of the fraud on investor autonomy as an actionable harm.

128. *Id.* at 346–47.

129. *Id.* at 345–46.

130. *Id.* at 347.

131. *Id.* at 342–43.

132. See Fisch, *supra* note 125, at 843 (explaining outcome harm).

133. *Dura*, 544 U.S. at 342.

134. *Id.* at 342–43.

135. *Id.* at 344.

136. *Id.* at 342.

137. See *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 336 (5th Cir. 2010) (inquiring as to whether the correction of the fraud affects the market price—in essence removing the price distortion and thereby causing the plaintiff's losses).

III. THE IMPLICATIONS OF PRICE DISTORTION

A. A Market-Based Approach

Basic held that courts can presume that distorted prices affect investor decisions,¹³⁸ but *Dura* rejected the effect of the fraud on those decisions as a basis for recovery, looking instead to the market's reaction to the fraud.¹³⁹ A market-based approach to 10b-5 liability leads to a dramatic shift in the conceptualization of the plaintiffs' harm.¹⁴⁰ Under a common law fraud theory, plaintiffs' theory is that they would not have traded in the absence of the misrepresentation. Reliance supplies the causal link between the fraud and their decision to trade.¹⁴¹

Under a market-based approach, plaintiffs are only deceived to the extent that their trades occur at a price different from what it would have been in the absence of fraud. They are not deceived into trading, but merely into trading at the wrong price. Notably, price distortion affects all investors, regardless of the subjective motivation for their trading decisions. Specifically, the fraud affects the terms on which all investors trade, including investors that trade for reasons wholly independent of the misrepresentations such as indexed investors, program traders, and short sellers. Indexed investors, for example, are forced to buy securities that are contained in the index; thus, a misrepresentation cannot be said to affect their trading decisions. Nonetheless, such investors pay a higher price for their "forced" purchases if management has fraudulently inflated the issuer's earnings.

A market-based approach also affects the proper calculation of damages. Under common law fraud, a plaintiff can claim recessionary, opportunity loss, or even expectation damages.¹⁴² These measures are inappropriate under *Basic/Dura* because the court presumes that plaintiff would have traded irrespective of the fraud. Plaintiff's only damage, therefore, is a price adjustment.

The facts of *Basic* illustrate the impact of shifting to a market-based approach. The plaintiffs in *Basic* claimed to have been misled by Basic's denial of merger negotiations into prematurely selling their stock before the eventual announcement of the merger and the resulting spike in stock

138. See *supra* text accompanying notes 96 and 98.

139. See *supra* text accompanying notes 129–36.

140. The Court in *Basic* explicitly noted that its decision did not address the proper measure of damages. *Basic Inc. v. Levinson*, 485 U.S. 224, 249 n.28 (1988).

141. See *supra* notes 29–30 and accompanying text.

142. See Fisch, *supra* note 125, at 821.

price.¹⁴³ In the absence of the false denials, plaintiffs argued, they would have held onto their stock until the merger was announced.¹⁴⁴ They were harmed to the extent of the difference between the price at which they sold and the price at which they could have sold once the merger was announced.¹⁴⁵

Under a price distortion theory, plaintiffs are only harmed by (at most) the extent of the price distortion. The harm effected by Basic's lie was the difference between the price at which the plaintiffs sold and the price at which Basic's stock would have traded had the true facts about Basic's merger negotiations been revealed to the market.¹⁴⁶ Because the negotiations were, by all accounts, still in a preliminary stage at the time of the Basic lies, it is fair to assume that this price difference would have been far less than under a reliance-based theory.¹⁴⁷ Specifically, the value of Basic stock would have been affected only marginally by merger negotiations that were at a preliminary stage.¹⁴⁸

The foregoing analysis reveals the true extent to which the *Basic* decision reflected judicial conservatism. *Basic*'s theory authorizes courts to confine plaintiffs' recovery to far more limited damages than would be available under a common law approach. *Dura* extends this perspective by holding that, although artificial price inflation may serve as a starting point for the damage inquiry, recoverable damages may be even less because of intervening events that reduce the stock price.¹⁴⁹ In contrast, common law

143. *Basic*, 485 U.S. at 227–28.

144. *See id.*

145. *See Levinson v. Basic Inc.*, 786 F.2d 741, 745 (6th Cir. 1986) (noting that the acquirer's original tender offer was "at a price substantially in excess of that at which the plaintiffs sold their shares").

146. *Cf. Affiliated Ute Citizens v. United States of Utah*, 406 U.S. 128, 154 (1972) (stating that "the correct measure of damages . . . is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct").

147. As Adam Pritchard explains, Justice Blackmun recognized these competing theories of damages at the time of the *Basic* decision, but the *Basic* opinion does not resolve the issue. *See A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2008 CATO SUP. CT. REV. 217, 221 & n.16 (citing Letter from Harry A. Blackmun to William J. Brennan, Jr., No. 86-279, *Basic v. Levinson* (Jan. 15, 1988) (Thurgood Marshall Collection, Lib. of Congress)). Pritchard explains that Blackmun agreed to defer the damages question at the behest of Justice Stevens. *Id.* at 221.

148. Notably, *Basic*'s initial denial of the merger negotiations occurred fourteen months before the parties reached a deal. *Basic*, 485 U.S. at 228.

149. *See supra* text accompanying note 134. I have criticized *Dura*'s approach to intervening events elsewhere. *See Fisch, supra* note 125.

fraud would disregard the effect of intervening events on the stock price when a plaintiff was fraudulently induced into the transaction.¹⁵⁰

The normative appeal of the market-based approach is unclear, and a full examination of its effects is beyond the scope of this Article. The approach is likely both to expand the size of plaintiff classes and to reduce the damages that are recoverable by class members. The approach may be more consistent with the realities of securities market trading than the transaction-based approach, but, by ignoring investor behavior, it may create poor incentives. From a procedural perspective, however, the practicality of the market-based approach depends critically on the difficulty of establishing price distortion. The next section considers this issue.

B. Empirical Analysis of Price Distortion

Premising both the reliance and causation inquiries on price distortion generates the obvious question: how do the litigants establish price distortion? Economic theory suggests that the effect of a misrepresentation on stock prices should be ascertainable through empirical methods such as an event study.¹⁵¹ Indeed the feasibility of such analysis was a key factor in Fischel's defense of the price distortion inquiry as a means of simplifying securities fraud litigation.¹⁵² Following *Dura*, courts have widely accepted the use of event studies to establish ex post price distortion or loss causation.¹⁵³ Indeed, courts have frequently required an event study or similar empirical analysis.¹⁵⁴

150. *See id.* at 842–43.

151. For an explanation of this use of the event study methodology, see Esther Bruegger & Frederick C. Dunbar, *Estimating Financial Fraud Damages with Response Coefficients*, 35 J. CORP. L. 11, 15–30 (2009).

152. *See* Fischel, *supra* note 87, at 17–19.

153. *See, e.g.,* *Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse First Bos.*, No. 02-12146-NMG, 2012 U.S. Dist. LEXIS 4566, at *4 (D. Mass. Jan. 13, 2012) (“An event study is an accepted method of measuring the impact of alleged securities fraud on a stock price and often plays a ‘pivotal’ role in proving loss causation and damages in a securities fraud case.”); *FindWhat Investor Grp. v. FindWhat.com*, 658 F.3d 1282, 1313 n.31 (11th Cir. 2011) (“The methodology of event studies has been sustained by many circuits”); Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of Dura Pharmaceuticals, Inc. v. Broudo*, 63 BUS. LAW. 163, 166–67 (2007) (describing event study analysis as “a ubiquitous tool in assessing claims of loss causation”).

154. *See* *Bricklayers*, 2012 U.S. Dist. LEXIS 4566, at *10; *In re Vivendi Universal, S.A.*, Sec. Litig., 634 F. Supp. 2d 352, 364 (S.D.N.Y. 2009) (terming the event study “almost obligatory”); Jonah B. Gelbach et al., *Valid Inference in Single-Firm, Single-Event Studies*, AM. L. & ECON. REV. (forthcoming) (manuscript at 1), available at <http://ssrn.com/abstract=1442222> (discussing use of event studies in securities fraud litigation).

Although event studies are used extensively, they are imperfect tools for measuring the effect of a disclosure on stock prices. First, their application presents a number of methodological challenges. The expert must focus on the correct event day, addressing the possibility that the information previously “leaked” into the market.¹⁵⁵ The expert must choose an appropriate event window reflecting a reasonable time period for the market to react to the disclosure.¹⁵⁶ The expert must identify potential confounding events—other industry or company-specific information released to the market unrelated to the fraud—and control for their impact.¹⁵⁷

The aggregation or bunching of information events creates a particular concern. Large public companies are subject to a large volume of company-related news, and a reliable event study must disaggregate the effects of all the different information events that could potentially affect the stock price during the event window, separating out those events related to the fraud from other events. As the court observed in *Bricklayers*, this creates a “herculean task” for the expert.¹⁵⁸ The challenge is particularly great when managers disclose information in “bunches,” and some scholarship suggests that, in a variety of circumstances, managers will prefer to bunch corporate disclosures.¹⁵⁹

A simple example illustrates the problem of bunched or bundled disclosures. Suppose, hypothetically, that Apple falsely disclosed in July 2006, that Steve Jobs was in perfect health, despite knowing that he had been diagnosed with pancreatic cancer. Six months later, at the 2007 Macworld Expo, Jobs simultaneously announced the release of the iPhone and the corrective disclosure that he had pancreatic cancer and was

155. See Sanjai Bhagat & Roberta Romano, *Event Studies and the Law—Part I: Technique and Corporate Litigation* 5–6 (John M. Olin Ctr. for Studies in Law, Econ., & Pub. Policy, Working Paper No. 259, 2001), available at http://digitalcommons.law.yale.edu/lepp_papers/259 (explaining why the selection of the correct event date is “nontrivial”). Bradford Cornell and Gregory Morgan demonstrate how information leakage is likely to affect the results of an event study. See Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 905–10 (1990).

156. One tool for addressing leakage is to expand the size of the event window, but this has the effect of increasing the number of potentially confounding events. See Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II—Empirical Studies and Corporate Law* 18 (John M. Olin Ctr. for Studies in Law, Econ., & Pub. Policy, Working Paper No. 260, 2001), available at http://digitalcommons.law.yale.edu/lepp_papers/260.

157. See *In re Omnicom Grp., Inc. Sec. Litig.*, 541 F. Supp. 2d 546, 554 (S.D.N.Y. 2008).

158. *Bricklayers*, 2012 U.S. Dist. LEXIS 4566, at *7.

159. See, e.g., Ronald A. Dye, *Disclosure “Bunching,”* 48 J. ACCT. RES. 489 (2010) (identifying various conditions in which disclosure bunching is optimal for managers). A related concern is that a company may deliberately manipulate the timing of its disclosures in an effort to minimize its potential liability. See Fisch, *supra* note 125, at 852.

expected to die within six months. Presumably the market would view the iPhone as good news¹⁶⁰ and Jobs's illness as bad news, but it is difficult to see how an expert could reliably disaggregate the effect of the two announcements on the share price of Apple stock.

In addition to these standard methodological issues, event studies raise particular concerns when they are used in securities fraud litigation because they focus on a single firm and a single or small number of information events.¹⁶¹ Gelbach et al. show that the standard event study methodology produces a large number of errors when applied to a single firm and single event, unless the firm's true distribution of excess returns is normal.¹⁶² Their results suggest "the presence of a potentially severe bias against finding an event effect."¹⁶³ According to the authors, "this suggests the potential for considerable anti-plaintiff bias in the context of securities litigation."¹⁶⁴

Finally, courts using event studies have failed to recognize the significant difference between a study that demonstrates an empirical relationship between an information event and stock price and a so-called "null result." An event study is far more reliable in proving a positive relationship than disproving one.¹⁶⁵ That is, an event study seeks to identify a statistically significant correlation between an event and stock price; the study's failure to identify such a correlation does not necessarily mean there is no relationship.¹⁶⁶ A non-result is inconclusive and may be due to a number of factors including flaws in the study design or merely a

160. Indeed, Apple stock reacted dramatically to the announcement of the iPhone, reaching an all-time high the following day. See *Apple Media Events*, WIKIPEDIA (July 29, 2012, 5:46 PM), http://en.wikipedia.org/wiki/Apple_media_events.

161. The standard approach is to consider a sample of firms because the volatility of an individual firm's stock returns increases the size of the standard error. Bhagat & Romano, *supra* note 155, at 8. See also *id.* at 10–11 (explaining that the "the statistical power with a sample of one is likely to be quite low.").

162. Gelbach et al., *supra* note 154.

163. *Id.* at 20.

164. *Id.* at 21.

165. See DAMODAR N. GUJARATI, BASIC ECONOMETRICS 134 (4th ed. 2003) ("If on the basis of a test of significance, say, the *t* test, we decide to 'accept' the null hypothesis, all we are saying is that on the basis of the sample evidence we have no reason to reject it; we are not saying that the null hypothesis is true beyond any doubt.")

166. See *id.* at 127 (explaining that a result outside the confidence interval allows the researcher to reject the null hypothesis; if a result "falls within the . . . confidence interval, we do not reject the null hypothesis"). Importantly, however, a result within the confidence interval does not confirm the null hypothesis. *Id.*

lack of statistical power in the test.¹⁶⁷ The limitations of the event study methodology for measuring the effect of a single event on a single firm compound the problem.

The foregoing limitations do not mean that event studies are unreliable or should not be used, but merely that their results should be viewed with caution. Until better empirical tools are developed, event studies are likely to be a dominant evidentiary tool for addressing the loss causation analysis required by *Dura*.¹⁶⁸ Nonetheless, their limitations should lead courts to treat litigant efforts to present their results as dispositive with a degree of caution.¹⁶⁹

The widespread use of event studies to determine whether there has been ex post price distortion for purposes of loss causation analysis raises the question of whether event studies are also appropriate in analyzing ex ante price distortion. In some cases, defendants have sought to introduce event studies to disprove ex ante price distortion in an effort to defeat class certification.¹⁷⁰

Ex ante price distortion, for purposes of the application of *Basic*, raises additional complications, however. In particular, not every material misrepresentation moves stock prices at the time it is conveyed to the market. Many instances of securities fraud involve attempts to avoid or delay disclosure of negative corporate developments such as a decline in earnings, problems with a product, and the like. The fraud may take the form of failing to disclose new developments or repeating overly positive disclosures from the past that are no longer accurate. Because the fraud merely confirms existing market expectations, it is unlikely to have any immediate effect on stock price.¹⁷¹ Misrepresentations that effectively confirm market expectations are, as Frank Torchio explains,

167. *Id.* Statistical power is the test's ability to detect abnormal performance when it is present. See S.P. Kothari & Jerold B. Warner, *Econometrics of Event Studies*, 1 HANDBOOK CORP. FIN. 15 (2007).

168. See *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 342–43 (2005).

169. See Michael J. Kaufman & John M. Wunderlich, *Regressing: The Troubling Dispositive Role of Event Studies in Securities Fraud Litigation*, 15 STAN. J.L. BUS. & FIN. 183 (2009) (arguing that courts are inappropriately giving events studies too great a role in resolving securities fraud litigation).

170. See Martis Alex & Michael W. Stocker, *Role of the Event Study in Loss Causation Analysis*, CORPORATE COUNSEL, (Aug. 20, 2009), <http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202433177190> (describing defendants' argument in *In re Marsh & McLennan Securities Litigation*, No. 04-cv-08144 (S.D.N.Y. Apr. 19, 2006)).

171. See *Alaska Elec. Pension Fund v. Pharmacia Corp.*, 554 F.3d 342, 349 (3d Cir. 2009) (observing that misrepresentations that confirm prior market expectations are unlikely to move stock prices); Alex & Stocker, *supra* note 170 (“If a misrepresentation or omission merely confirms market expectations, there will be no reactionary price impact.”).

“ubiquitous.”¹⁷² The absence of a contemporaneous price movement does not mean the fraud has not distorted prices. The amount of the price distortion cannot be demonstrated through an event study, however, and requires counterfactual analysis—the extent to which the market would have reacted if accurate disclosure had been made.

The difficulty in applying the event study methodology to ex ante price distortion is that it creates the potential for litigants to seek to introduce event studies of ex post price distortion at the class certification stage. Plausibly, at least in some cases, a price response to a corrective disclosure could provide circumstantial evidence of ex ante price distortion, but there is no systematic relationship between ex ante and ex post price distortion. Specifically, ex ante and ex post price distortion involve market reactions to different information and typically occur months apart in time.

First, as commentators have observed, the market may react differently to a corrective disclosure than to accurate statements in the absence of fraud, making the ex post price reaction a poor measure of the extent of the ex ante price distortion.¹⁷³ Second, various factors may limit the reaction of the market to a corrective disclosure, including other corporate disclosures that precede or accompany the correction.¹⁷⁴ As I have explained elsewhere, corporate officials may have an incentive to structure their disclosures in an attempt to minimize their market impact.¹⁷⁵ Third, intervening corporate and market developments may change the impact of the fraudulent statements when they are subsequently disclosed, making the corrective disclosure more or less important to market price than it would have been at the initial fraud.¹⁷⁶ Thus the failure of market prices to react to a corrective disclosure does not prove that prices were not distorted, ex ante, as a result of the fraud.

172. Frank Torchio, *Proper Event Study Analysis in Securities Litigation*, 35 J. CORP. L. 159, 165 (2009).

173. See Michael J. Kaufman & John M. Wunderlich, *The Judicial Access Barriers to Remedies for Securities Fraud*, 75 L. & CONTEMP. PROBS. 55, 88 (2012) (explaining why stock price drop in response to a corrective disclosure may be a poor measure of the amount of initial price inflation).

174. See, e.g., Jay W. Eisenhofer et al., *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419 (2004) (providing an example of this scenario).

175. Fisch, *supra* note 125, at 852.

176. In the extreme case, an intervening event can so damage the company as to render the disclosure of the fraud irrelevant. Cf. *Dillon v. Twin State Gas & Elec. Co.*, 163 A. 111, 114–15 (N.H. 1932) (intervening effect of electrocution killed the plaintiff, rendering his fall from a girder irrelevant in causing him additional damage).

IV. *HALLIBURTON*

The relationship between reliance and causation¹⁷⁷—or between ex ante and ex post price distortion—forms the background to *Halliburton*.¹⁷⁸ The reasoning of the Fifth Circuit’s decision¹⁷⁹ is premised on the theory that *Basic*’s presumption of reliance can be rebutted by evidence that the alleged fraud did not distort the market.¹⁸⁰ If the alleged fraud did not distort the market price, the integrity of the market was not compromised.¹⁸¹

The Fifth Circuit went further in *Halliburton*, however. Reasoning that price distortion was required for both loss causation and reliance,¹⁸² the court appeared to view the two price distortion inquiries as equivalent. Specifically, the court stated first that the plaintiffs were required to establish so-called price impact at the class certification stage.¹⁸³ The court then described this price impact as “loss causation.”¹⁸⁴

Ex ante and ex post price distortion are different, however, as the preceding Part of this Article has explained and as the Supreme Court held.¹⁸⁵ Price distortion at the time of the initial representation is part of

177. Justice Kennedy’s opinion in *Stoneridge* added to the conflation of these two concepts. *See Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 160 (2008) (stating that “reliance is tied to causation, leading to the inquiry whether [suppliers’] deceptive acts were immediate or remote to the injury”).

178. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011).

179. *Archdiocese of Milwaukee Supporting Fund., Inc. v. Halliburton Co.*, 597 F.3d 330, 335 (5th Cir. 2010).

180. As the court explained in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, the link can be severed by “publicly available information that the misrepresentation didn’t move the stock price.” 487 F.3d 261, 265 (5th Cir. 2007).

181. *See Archdiocese of Milwaukee v. Halliburton*, 597 F.3d at 335. Other courts have faced this question as well. *See, e.g., In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 638 (3d Cir. 2011) (holding that *Basic*’s presumption can be rebutted by showing of no price impact at class certification stage); *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485 (2d Cir. 2008) (holding that defendants should have the opportunity to rebut the *Basic* presumption, at the class certification stage, by showing the absence of price impact). *But see Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010) (concluding that whether the false statements materially affected stock price is a merits question).

182. *Archdiocese of Milwaukee v. Halliburton*, 597 F.3d at 335–36.

183. *Id.* at 335; *see also Halliburton*, 131 S. Ct. at 2187 (explaining that “‘Price impact’ simply refers to the effect of a misrepresentation on a stock price”).

184. *Id.* The Fifth Circuit said, “Plaintiff must prove that the complained-of misrepresentation or omission ‘materially affected the market price of the security.’ In other words, Plaintiff must show that an alleged misstatement ‘actually moved the market.’ Thus, ‘we require plaintiffs to establish loss causation in order to trigger the [FOTM] presumption.’” *Archdiocese of Milwaukee v. Halliburton*, 597 F.3d at 335 (quoting *Oscar*, 487 F.3d at 265). That proof must be by a preponderance of the evidence. *Id.* After a detailed analysis of the proof, including expert testimony, the circuit court concluded that plaintiffs failed to adequately establish loss causation. *Id.* at 337.

185. *Halliburton*, 131 S. Ct. at 2186 (“Loss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.”).

the *Basic* analysis;¹⁸⁶ price distortion at the time of the corrective disclosure is necessary under *Dura*.¹⁸⁷ Where the Fifth Circuit went wrong was in conflating the two.

The defendants argued that the plaintiffs had the burden of establishing price impact at the class certification stage, an argument that the Supreme Court found unnecessary to consider.¹⁸⁸ They went on to argue that plaintiffs could show price impact in one of two ways.

They can show price inflation upon a misrepresentation, which, as this Court made clear in *Dura*, is not synonymous with loss causation. Or failing that—and they could not show that here because their own proof showed that none of the alleged misrepresentations moved the market. So, the alternative way to show price impact is simply to show a price decline following a corrective disclosure.¹⁸⁹

This argument is misconceived. As previously explained, the failure of market prices to move in response to a misrepresentation does not establish the absence of a price distortion, particularly in cases when the misstatement fraudulently conceals a change in the status quo. Similarly, and consistent with *Dura*, ex ante price distortion is not the same as ex post price distortion, and the failure of prices to respond to a corrective disclosure does not sever the link between the defendants' misrepresentation and a price distortion at the time that misrepresentation was made.¹⁹⁰

The Supreme Court's opinion in *Halliburton* may seem overly technical. If a plaintiff must, in the end, establish both ex ante and ex post price distortion, what difference does it make if the price distortion analysis is framed in terms of loss causation or not? The answer stems from *Basic*'s proceduralist foundations. *Basic*'s presumption was a tool to overcome a potential obstacle to class certification. As such, *Basic*'s price distortion analysis must be considered in light of the evolving nature of the class certification inquiry. In the next Part, this Article briefly describes the post-*Basic* developments in the class certification inquiry and considers their effect on the *Basic* decision.

186. See *supra* Part III.A.

187. See *supra* text accompanying notes 127–36.

188. Transcript of Oral Argument at 26, *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (No. 09-1403).

189. *Id.* at 27.

190. The court's analysis in *Berks County Employees' Retirement Fund v. First American Corp.*, 734 F. Supp. 2d 533 (S.D.N.Y. 2010), was similarly flawed.

V. THE EVOLUTION OF RULE 23 AND ITS EFFECT ON *BASIC*

As noted in Part I above, *Basic* was decided in the context of a broadening acceptance of the class action and, in particular, the widespread view that the application of the class action to securities fraud litigation was particularly appropriate.¹⁹¹ Since *Basic* was decided, many courts and commentators have become more critical of class actions in general and securities fraud class actions in particular.¹⁹²

As some commentators have noted, although Rule 23 of the Federal Rules of Civil Procedure sets out the factors that courts are to consider in ruling on a motion for class certification, it does not specify the applicable legal standard that courts should apply.¹⁹³ The 1966 amendments to the Rule made the class action mechanism much more practical,¹⁹⁴ a development that was aided by the Supreme Court's 1974 decision in *Eisen v. Carlisle & Jacquelin*.¹⁹⁵ In *Eisen*, the Court held that, in ruling on a motion for class certification, courts may not "conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action."¹⁹⁶ The *Eisen* decision was critical for class action litigation in that it led most lower courts to "limit their class action analysis to the pleadings, perhaps with superficial consideration of limited extrinsic evidence, such as expert reports."¹⁹⁷

The Court sounded a cautionary note in 1982. In *General Telephone Co. of Southwest v. Falcon*,¹⁹⁸ the Court stated that Rule 23 requires more than mere allegations.¹⁹⁹ The Court explained that, to obtain class certification, a plaintiff must show that each of the requirements of the Rule has been met.²⁰⁰ A class action "may only be certified if the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied."²⁰¹

191. See *supra* notes 37–38 and accompanying text.

192. See, e.g., Bratton & Wachter, *supra* note 3.

193. Ian Simmons et al., *Without Presumptions: Rigorous Analysis in Class Certification Proceedings*, 21 ANTITRUST 61, 62 (2007).

194. See Robert G. Bone & Davis S. Evans, *Class Certification and Substantive Merits*, 51 DUKE L.J. 1251, 1259–60 (2002) (describing the effect of the 1966 amendments).

195. 417 U.S. 156 (1974).

196. *Id.* at 177.

197. Simmons et al., *supra* note 193, at 62; see also Geoffrey P. Miller, *Review of the Merits in Class Action Certification*, 33 HOFSTRA L. REV. 51, 51 (2004) (describing *Eisen*'s holding as "a pillar of class action practice").

198. 457 U.S. 147 (1982).

199. *Id.* at 157.

200. *Id.* at 156.

201. *Id.* at 161.

Although the response of the lower courts to the *Falcon* decision varied, over the past few years, the trend toward increased scrutiny of motions for class certification spread.²⁰² Significantly, many courts noted potential problems with widespread use of class actions, including the fact that the high stakes involved increase the pressure on defendants to settle even weak cases.²⁰³

In this context,²⁰⁴ in 2008, the Third Circuit issued an important decision in the *Hydrogen Peroxide* case, an antitrust class action.²⁰⁵ The court specifically found that the district court erred in applying too lenient a standard of proof to class certification and articulated the legal standards that they should apply in ruling on a motion for class certification.²⁰⁶ The court stated that the plaintiffs must prove all the elements of Rule 23 by a preponderance of the evidence in order to obtain class certification and that the trial courts were required to resolve all disputed issues of fact regarding these elements.²⁰⁷ In conducting their analysis, the Third Circuit explained that the courts were to make a “rigorous assessment of the available evidence and the method or methods by which plaintiffs propose to use the evidence to prove impact at trial.”²⁰⁸

The Supreme Court endorsed this analysis in *Wal-Mart Stores, Inc. v. Dukes*.²⁰⁹ In *Dukes*, the Court “confirmed that courts must apply a more

202. See Steig D. Olson, “Chipping Away”: *The Misguided Trend Towards Resolving Merits Disputes as Part of the Class Certification Calculus*, 43 U.S.F. L. REV. 935 (2009) (describing the cases as “chipping away” at *Eisen*).

203. See *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007); see also *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 162 (3d Cir. 2001) (stating that “denying or granting class certification is often the defining moment in class actions (for it may sound the ‘death knell’ of the litigation on the part of plaintiffs, or create unwarranted pressure to settle nonmeritorious claims on the part of defendants)”). The *Newton* court further noted that “[i]rrespective of the merits, certification decisions may have a decisive effect on litigation.” *Id.* at 167.

204. Linda S. Mullenix, *Dropping the Spear: The Case for Enhanced Summary Judgment Prior to Class Certification*, 43 AKRON L. REV. 1197, 1199 n.13 (2010) (“The Third Circuit’s *Hydrogen Peroxide* decision joins a series of similar appellate decisions requiring heightened certification requirements and merits-determinations at class certification.”).

205. *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 307–09 (3d Cir. 2008). The Second Circuit reached a similar conclusion at around the same time. See *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485 (2d Cir. 2008) (stating that case law requires courts to make a “definitive assessment that the Rule 23(b)(3) predominance requirement has been met”) (internal quotations omitted).

206. *Hydrogen Peroxide*, 552 F.3d at 321.

207. *Id.* at 307.

208. *Id.* at 312. The court also explained that “the court’s obligation to consider all relevant evidence and arguments extends to expert testimony, whether offered by a party seeking class certification or by a party opposing it.” *Id.* at 307.

209. 131 S. Ct. 2541 (2011).

stringent standard to class certification motions.²¹⁰ *Dukes* involved the commonality requirement of Rule 23(a)(2).²¹¹ In analyzing this requirement for purposes of class certification, the Court clarified its prior language in *Eisen*, observing that a Rule 23 inquiry might frequently “entail some overlap with the merits of the plaintiff’s underlying claim.”²¹² The Court observed that such overlap “cannot be helped.”²¹³ Moreover, as the Court’s analysis demonstrated, assessing the plaintiffs’ showing might involve evaluating expert testimony.²¹⁴

Although the extent to which *Dukes* was limited to the employment discrimination context was unclear,²¹⁵ two lower courts promptly extended it to antitrust cases.²¹⁶ The question presented by the *Amgen* case, currently pending before the Supreme Court, is the effect of *Dukes* on the manner in which plaintiffs are required to establish the FOTM presumption. Specifically, Amgen argues to the Supreme Court that proof of materiality is required to establish FOTM.²¹⁷ Because FOTM is necessary to obtain *Basic*’s presumption of reliance, Amgen argues that it is necessary for plaintiffs not merely to allege materiality but to prove it in order to obtain class certification.²¹⁸ Moreover, the “rigorous analysis” required by *Dukes*²¹⁹ should, according to Amgen, allow it to rebut the FOTM presumption at the class certification stage by presenting evidence that the alleged misstatements were not material.²²⁰

VI. REJECTING RELIANCE

The proceduralist jurisprudence described in the preceding section complicates the application of the *Basic* presumption. As this Article has

210. Wesley R. Powell & Shireen Hilal, Client Memorandum, *Two District Courts Interpret Dukes To Require “Rigorous Analysis” in Antitrust Class Certification Decisions*, WILLKIE FARR & GALLAGHER LLP, Apr. 4, 2012, at 2, available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/4040/Two_District_Courts_Interpret_Dukes1.pdf.

211. *Dukes*, 131 S. Ct. at 2551.

212. *Id.*

213. *Id.*

214. *See id.* at 2553–54.

215. *See* Ellen Meriwether, *The “Hazards” of Dukes: Antitrust Class Action Plaintiffs Need Not Fear the Supreme Court’s Decision*, 26 ANTITRUST 18 (2011).

216. Powell & Hilal, *supra* note 210.

217. Brief for Petitioners at 16–22, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, No. 11-1085 (Aug. 8, 2012).

218. *Id.* at 19–22.

219. *Dukes*, 131 S. Ct. at 2551.

220. *See* *Conn. Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170, 1177 (9th Cir. 2011) (describing Amgen’s effort to rebut the FOTM presumption). Specifically, Amgen sought to rebut the presumption by establishing a “truth-on-the-market” defense. *Id.* at 1177.

argued, *Basic* is premised on the notion of price distortion. Price distortion is closely related to materiality in that the essence of a material misstatement is its capacity to distort stock prices, although a full consideration of the appropriate role of event studies or other empirical analyses in proving materiality is beyond the scope of this Article.²²¹

Basic itself did not require proof of materiality,²²² but the importance of price distortion in the conception of the market-based approach leads naturally to the petitioner's argument in *Amgen* that materiality should be part of the *Basic* inquiry.²²³ If misinformation does not distort market price—because the information is not material, because the market is not sufficiently efficient, or because the misinformation is not credible to the market—then plaintiffs have not been deceived in the *Basic* sense of the term because they have not traded at a distorted price.²²⁴

But price distortion becomes part of the class certification analysis only because *Basic* retained proof of reliance as an element of federal securities fraud.²²⁵ The questions presented to the Supreme Court in *Amgen* about the appropriate scope of the class certification inquiry arise only because Rule 23 requires a degree of commonality that is threatened by the necessity of establishing individual investor reliance.²²⁶ In the absence of a reliance requirement, securities fraud litigation does not present individualized factual or legal questions that threaten the commonality necessary to certify a class.

221. The very essence of a material misstatement is its capacity to distort stock prices. *See, e.g.,* *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (Alito, J.) (“[I]n an efficient market the concept of materiality translates into information that alters the price of the firm’s stock” (internal quotation marks omitted)); *Dunbar & Heller, supra* note 3, at 509 (“The definition of immaterial information . . . is that it is already known or . . . does not have a statistically significant effect on stock price in an efficient market.”); *see also* *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”).

222. As discussed previously, footnote twenty-seven in the Supreme Court’s *Basic* opinion has generated some question about whether *Basic* also required proof of materiality. *See supra* notes 98–99 and accompanying text. The Court in *Halliburton* declined to address this issue. *See Halliburton*, 131 S. Ct. at 2187 (“[W]e need not, and do not, address any other question about *Basic*, its presumption, or how and when it may be rebutted.”).

223. *See supra* note 217 and accompanying text.

224. Donald Langevoort is correct in arguing that, in some cases, material information may not affect securities prices. *See* Langevoort, *supra* note 2, at 173–77 (discussing *In re Merck & Co. Sec. Litig.*, 432 F.3d 261 (3d Cir. 2005)). But it would clearly be an expansion of the *Basic* principles to allow a plaintiff to bring a claim in reliance on a distorted market price if the market has erroneously failed to respond to a disclosure.

225. *See supra* Part I.C.

226. *Cf. In re Am. Int’l Grp., Inc. Sec. Litig.*, 689 F.3d 229, 241–43 (2d Cir. 2012) (noting that failure to satisfy the prerequisites for application of FOTM does not necessarily preclude satisfaction of the predominance requirement for purposes of certifying a settlement class).

The developments in class certification analysis, coupled with the illogic of inquiring into individualized reliance, both with respect to impersonal market transactions generally and, in particular, under the *Basic/Dura* market-based approach, provide a compelling reason to overrule that aspect of *Basic* that retains reliance as a required element of federal securities fraud. As this Article has demonstrated, the reliance requirement is illogical in the context of a cause of action that is focused on market-based harm. Dan Fischel made this point years ago: reliance is simply inconsistent with the theory on which FOTM is based, and with the shift in *Basic* and *Dura* to a market-based approach.²²⁷ Moreover, by focusing on harm to the market rather than harm to individual investor decisions, the market-based approach creates the commonality that the Court found missing in *Dukes*.

Overruling *Basic* to eliminate the reliance requirement avoids the need to determine, at the class certification stage, the extent to which a misrepresentation has distorted stock price. Proof of a public misrepresentation²²⁸ and an efficient market would be sufficient to establish commonality for purposes of Rule 23.²²⁹ Whether the *Amgen* Court should fully embrace the market-based approach is a more difficult question. Moving to a market-based approach implicates policy choices about the nature of the harm to which private securities fraud litigation should be addressed. A full analysis of these questions is beyond the scope of this Article, although I have questioned *Dura*'s rejection of a transaction-based approach to economic harm elsewhere.²³⁰

Nonetheless, here are a few preliminary thoughts on the question. As a starting point, a market-based approach offers several advantages over the common law. It provides a solution to the difficult enterprise of extracting causal components in modern securities trading on impersonal capital markets. It eliminates the unreliable inquiry into the extent to which particular information factored into individual trading decisions. It reflects the reality that, although disclosures may be important to the market as a whole, there are entire components of market trading that occur without

227. See Fischel, *supra* note 87, at 11 (“The logic of the fraud on the market theory dictates that the reliance requirement as conventionally interpreted be discarded altogether.”).

228. In *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, the Court held that plaintiffs could not establish reliance because the misstatements at issue were not communicated to the market. 552 U.S. 148, 159 (2008).

229. As noted earlier, lower courts may have overstated the extent of market efficiency that is required for a misrepresentation to distort stock prices. See *supra* notes 105–06 and accompanying text.

230. Fisch, *supra* note 125.

reference to those disclosures. It also eliminates the challenge presented by intermediated investment decisions and causal chains, in which market information is analyzed, combined, and disseminated through brokers, analysts, and the financial media.

A market-based approach is also consistent with the ongoing shift in the focus of federal securities regulation from investor protection to market protection.²³¹ Absent a concern for individual investor autonomy, there is little theoretical justification for focusing on investor-specific as opposed to market-wide responses.²³² And protecting individual investment decisions may be anomalous in a market increasingly characterized by institutional intermediation.

At the same time, a market-based approach sacrifices investor autonomy and reduces incentives for investors to engage in informed trading. The efficiency of the capital markets depends on the presence of information traders, and elimination of reliance seems to belittle the importance of reviewing corporate disclosures.²³³

A market-based approach is also subject to criticism for its inherent reliance on the largely discredited idea that the market is value efficient. Although, as noted earlier, FOTM is generally based on information efficiency, a theory of securities fraud that is premised on price distortion risks drawing upon largely-discredited notions of value efficiency for its legitimacy.²³⁴ Absent some degree of value efficiency, for example, it is difficult to assume that a misrepresentation necessarily moves the stock price further away from its underlying value than the price at which it would have traded in the absence of the fraud. More generally, it may be difficult to insulate the inquiry from all considerations of value.²³⁵ Should defendants face liability, for example, for a misrepresentation that can be

231. This shift is reflected in the addition of section 2(b) by the National Securities Markets Improvements Act of 1996. *See supra* note 9. It is also reflected in academic commentary suggesting that deterrence rather than compensation should be the primary regulatory objective. *See, e.g.*, Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297 (describing deterrence rationale for private civil litigation). Arguably, a market-based approach is more closely tied to section 10(b)'s prohibition of manipulation than the more commonly-emphasized prohibition of deception.

232. *See Langevoort, supra* note 2, at 165–66 (arguing that the reliance inquiry unduly emphasizes compensation as a regulatory goal).

233. *See, e.g.*, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 569–70 (1984) (observing that the rapidity of price adjustments in the market depends on the volume of informed trading).

234. *See supra* notes 112–15 and accompanying text.

235. *See, e.g., In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 16 (1st Cir. 2005) (observing that “as a matter of logic, we cannot say that fundamental value efficiency has no place in applying the fraud-on-the-market presumption of reliance at the class-certification stage”).

shown to make market price more accurately reflect fundamental value? What significance should be given to abnormal returns that correlate with disclosure, but that are directionally inconsistent with plaintiffs' theory?

This concern is heightened by the tendency for event studies to be presented not simply as evidence of a price effect but as a quantification of the size of that effect—as in event studies that are used to establish loss causation or damages.²³⁶ Most circuits have required plaintiffs, in proving loss causation, not merely to show that the corrective disclosure correlated with a decline in stock price, but that it was a “substantial cause” of that decline.²³⁷ This inquiry injects an implicit significance not just to the fact but to the extent of the stock price reaction.

As discussed above, the market-based approach also creates a fundamental shift in both the victim class and the scope of recoverable harm.²³⁸ There may be policy reasons that counsel in favor or against that shift, based on the information about existing recoveries from securities fraud litigation.²³⁹ More problematically, it is possible to read *Basic* and *Dura*, in combination, as limiting recoverable damages to the lesser of ex ante or ex post price distortion.²⁴⁰ To the extent that a market-based approach has this effect, it is likely to reduce overall damage awards because of the effect of external causal factors on stock price as time passes between the misrepresentation and the fraud.

CONCLUSION

The Supreme Court's decision in *Basic* gave investors, as “an act of juristic grace,”²⁴¹ the right not to trade securities at a price distorted by fraud. Although this right was founded upon a sophisticated understanding of the realities of public market securities trading, the Court grounded the right in the antiquated common law concept of reliance.²⁴² As the Court has recognized elsewhere, however, common law tort principles have only

236. See *supra* note 145.

237. See, e.g., *In re Oracle Corp. Sec. Litig.*, 627 F.3d 376, 388 (9th Cir. 2010).

238. See *supra* Part III.A.

239. See Fisch, *supra* note 125, at 868–69. Alternatively, it is possible to separate the liability inquiry from the damage analysis. See *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 389–97 (1970).

240. Note that *Basic* can, but need not, be read to set an alternative limit on recoverable damages that is lower than that established by *Dura*.

241. Langevoort, *supra* note 2, at 195.

242. See *supra* Part I.C.

limited relevance in determining the appropriate regulatory structure to protect the public securities markets.²⁴³

Halliburton offered the Supreme Court the opportunity to consider directly the role of price distortion analysis in defining the contours of 10b-5 liability. Critically, the Court's opinion appeared to reiterate the centrality of price distortion²⁴⁴ but did not offer the lower courts guidance in how to analyze the issue. Instead, by focusing exclusively on the Fifth Circuit's characterization of its inquiry in terms of loss causation, *Halliburton* retained, without justification, the antiquated reliance inquiry.

An evolving judicial approach to the class certification inquiry has rendered the *Basic* inquiry increasingly problematic. Although price distortion may be critical to the market-based theory of securities fraud on which *Basic* and the Court's later cases are based, importing the event study methodology into the courts' analysis of class certification threatens to give questionable empirical methodologies undue legal significance.

One possible solution is to overrule *Basic* to eliminate the FOTM presumption. Although some commentators have advocated this approach, a better choice is to eliminate the reliance requirement altogether. Rejecting reliance removes the complex analysis of price distortion from the class certification analysis and is consistent with the modern realities of the public securities markets.

Solving the litigation problems presented in *Halliburton* and *Amgen* is, of course, only a partial solution. This Article does not address the larger questions of how courts should analyze the relationship between price distortion and materiality, and the extent to which empirical studies should inform that analysis.²⁴⁵ Going forward, however, these decisions highlight the crucial need for courts and regulators to understand more fully the effects of price distortion on the securities markets and to evaluate the consequences of providing a remedy for those effects.

243. See, e.g., *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 340 (2005) (observing that a private claim for federal securities fraud “resembles, but is not identical to, common-law tort actions for deceit and misrepresentation”).

244. See *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186 (2011) (describing “*Basic*’s fundamental premise—that an investor presumptively relies on a misrepresentation so long as it was reflected in the market price at the time of his transaction”) (emphasis added).

245. For discussion of this question, see Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line*, 34 PEPP. L. REV. 927 (2007) (identifying difficulty of equating materiality analysis with price movements).