Halliburton, Basic and Fraud on the Market: The Need for a New Paradigm

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Summary: Halliburton, Basic and Fraud on the Market: The Need for a New Paradigm

If defrauded securities plaintiffs cannot bring a class-action lawsuit, there often will be no effective remedy since the amount at stake for individual plaintiffs is not sufficient to warrant the substantial costs of litigation. To surmount the problem of individualized reliance and establish commonality, federal courts for twenty-five years have been employing the Basic fraud-on-the-market theory which posits that, in an efficient market, investors rely on the integrity of the market price.

While class certification at one time was a matter of course, today it is turning into a mini-trial, and corporations can defeat certification by the testimony of their experts as to market imperfections which purportedly undercut the “efficiency” of the market for the particular stock. Courts treat “efficiency” as a binary concept, without recognizing that there are degrees of efficiency.

In Halliburton I, the Supreme Court held that a plaintiff need not establish loss causation at the certification stage and, in Amgen, the Court held that a plaintiff need not establish materiality at the certification stage. However, in Halliburton II, the Court determined that defendants can establish a lack of price impact to rebut the Basic presumption of reliance at the certification stage. Since plaintiff will then need to respond to the issue of whether there is price impact, there will need to be a mini-trial on price impact, which necessarily implicates evidentiary matters of materiality and loss causation.

Justice Thomas, in recognizing what he sees as internal inconsistencies in the Court’s approach in Amgen and Halliburton II, would overrule Basic and eliminate the fraud-on-the-market theory, thereby leaving plaintiffs to individualized proof of reliance without the class-action remedy.

This article asserts that market efficiency is a dubious concept, with Nobel prize winners in economics on both sides of the issue. Moreover, efficiency is not a binary concept, as there are degrees of market efficiency. The article also asserts that the efficient market theory, as enunciated by many courts, requiring that information must be impounded rapidly – in as little as one day or less – is fantasyland, since this approach gives no credence to the facts that there are degrees of market efficiency, degrees of materiality, varying modes of communicating information to the market, varying probity of the sources of the information, and different degrees of complexity of the information so transmitted.

Thus, there is a need for a new paradigm for establishing commonality of reliance. The model proposed by this article relies on reality, not fantasy. Congress, through the securities laws, has established an extensive system of mandatory disclosure, complemented with voluntary disclosures by the corporation. Pursuant to the antifraud provisions of the securities
laws, Rule 10b-5 requires that such corporate disclosures not be misleading. Consequently, the article asserts that investors appropriately rely upon the truthfulness of the mix of information that management has transmitted to the market. Adopting this approach simplifies the certification process, eliminates the unreal focus on market efficiency, and leaves the major factual issues of price distortion, materiality and loss causation to trial, where they belong.

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**Halliburton, Basic and Fraud on the Market: The Need for a New Paradigm**

I. Introduction

When the Supreme Court recently handed down its decision in Halliburton Co. v. Erica P. John Fund, Inc.,\(^1\) the decision was not greeted with enthusiasm. For liberals, it was adding yet another hurdle to the class certification process.\(^2\) On the other hand, conservatives had hoped that the court would overturn the earlier decision in Basic v. Levinson,\(^3\) which had adopted the “fraud on the market” theory of reliance. Justice Thomas, in his concurring opinion, argued for just such a result.

*Halliburton* is in some respects a strange opinion. Both the majority and the concurring opinion by Justice Thomas, which is in effect a dissenting opinion, evidence both insight and tunnel vision. Justice Roberts preserved the opportunity to establish reliance in a class action, but continued to focus on market efficiency, a questionable, troublesome and, as applied, dubious concept. Justice Thomas correctly pointed out some of the flaws in the fraud on the market theory, but would require individualized proof of reliance, thereby eliminating the class action as a remedy for misrepresentations by management of publicly traded corporations. While the *Basic* theory is flawed, there is another, more straightforward way, to establish reliance by members of a class, namely that investors rely, not on the integrity of market price, but rather on the integrity of the information that corporate management inserts into the market. Arguing for this approach is the purpose of this article.

In evaluating Supreme Court jurisprudence in the securities area, it is essential to ask the question: for whose benefit were the securities laws enacted? The Securities Exchange Act of 1934 (“1934 Act”) early on provides that the purpose of the act was “to insure the maintenance of fair and honest markets,”\(^4\) while Section 10, pursuant to which Rule 10b-5 was promulgated, gives the Securities and Exchange Commission authority to promulgate anti-fraud regulations “as necessary or appropriate in the public interest or for the protection of investors.”\(^5\)

The Supreme Court itself has said that a “fundamental purpose [of the securities laws is] to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”\(^6\) The Court added that

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2. The Court determined that defendants, prior to class certification, could rebut the presumption that the stock price reflected material misrepresentations by introducing evidence on lack of price impact. *Id.*
Congress intended securities laws enacted for the purpose of avoiding frauds to be construed “not technically and restrictively, but flexibly to effectuate its remedial purposes.”

Contrariwise, the recent stance of the Supreme Court and other federal courts often is to protect corrupt management from innocent investors. Justice Thomas, in the conservative concurrence in \textit{Halliburton II}, asserted that “[l]ogic, economic realities and our subsequent jurisprudence” dictate that \textit{Basic} be overruled.  

But the Court’s prior jurisprudence in the Rule 10b-5 area is substantially flawed and, contrary to Justice Thomas’ assertion, logic and economic reality demonstrate that the conservative jurisprudence would emasculate investor protection and provide a shield for unscrupulous management.

Protecting management at the expense of investors is getting the statutory scheme upside down. It would appear that the federal courts often are living in an alternate universe: For example, the Fifth Circuit Court of Appeals believed that it had the authority under \textit{Basic}, a decision which is universally recognized as favorable to plaintiffs, “to tighten the requirements for plaintiffs seeking a presumption of reliance” in order to protect defendants from the “\textit{in terrorem} power of certification.” It was the dissent in \textit{Basic} that was worried about the \textit{in terrorem} effect of class certification; the majority stated:

The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5’s reliance requirement must encompass these differences.

Federal courts often seem more concerned with protecting management from strike suits than in protecting investors from fraud. In many instances, either the courts understanding of

\begin{itemize}
\item \textit{Id.} at 195.
\item \textit{Halliburton Co.}, 134 S. Ct. 2398, 2418.
\item Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 264-265 (5th Cir. 2007).
\item \textit{Id.} at 267.
\item \textit{Basic, Inc.}, 485 U.S. at 262 (Justice White dissenting: "I suspect that all too often the majority's role will ‘lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.’")
\item \textit{Id.} at 243-244.
\item Justice Stevens, in his dissent in \textit{Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.}, 552 U.S. 148, 175-181 (2008), took the majority to task for its efforts to undercut the vitality of a private cause of action. In true conservative fashion, Justice Stevens looked at almost a century of precedent favoring the recognition of implied private causes of action. On the other hand, the conservative members of the court have little respect for precedent. This is not conservative, but rather reactionary. Justice Scalia has said of Justice Thomas that he “doesn’t believe in \textit{stare decisis}, period.” See Kenneth Jost, \textit{Justice Thomas’s Two Decades of Rejecting Precedent}, Jost On Justice Blogspot (Oct. 31, 2011), http://jostonjustice.blogspot.com/2011/10/thomass-two-decades-of-rejecting.html. Justice Scalia himself is no fan of precedent: “\textit{stare decisis} is not an inexorable command or a mechanical formula of
business is woeful or the opinions evidence a bias in favor of management. The Supreme Court could hardly be unaware of the extensive fraud by many corporations in the cases that have come before it. Recent Supreme Court decisions have dealt with channel stuffing and lying about whether a new product was being shipped, conspiring with a supplier to inflate earnings, misrepresenting that a product did not cause patients to lose their sense of smell when management was aware of injured users, changing accounting methodology to inflate earnings, conspiring with a supplier to inflate earnings, asserting that a product did not cause patients to lose their sense of smell when management was aware of injured users, changing accounting methodology to inflate earnings, hiding wrongful conduct in connection with market timing, and asserting that an FDA meeting was not focused upon the company’s products when in fact such products were the focus of the meeting.

From the foregoing litany, it is inconceivable that the Supreme Court is not aware of the many circumstances in which ethically indifferent or corrupt management has misled the investing public. Yet, conservative members of the Court have either turned a blind eye to management fraud when issuing majority opinions or, in dissents or concurrences, have advocated positions that would undercut investor protection in favor of insulating corporations and management from accountability. There is considerable antipathy by the conservative members of the court to a private civil remedy in the first place. Justice Thomas, in his concurrence in Halliburton II, began his opinion by asserting that “[t]he implied Rule 10b-5 cause of action is ‘a relic of the heady days in which this Court assumed common-law powers to create causes of action.’”

However, former Justice Stevens has pointed out that these heady days persisted for 200 years: "Fashioning appropriate remedies for the violation of rules of law designed to protect a


16 See Alternate Universe, supra note 10, at 624-630 (discussing the court's characterization of plaintiff's channel stuffing allegation that K-Mart stores had 52 to 100 weeks of battery inventory and that Walmart had 30-50 weeks of battery inventory as being conclusory and lacking particularity. Walmart in particular is known as a leader in just-in-time inventory control), 635-639 (discussing the court's characterization of plaintiff's extensive allegations of budgets, forecasts, daily reports, monthly reports, and "Stop Ship" reports, which notified management of manufacturing problems and their impact on volume shipments, as boilerplate because other cases had also referenced internal reports as being the basis to hold senior management liable).


24 Tellabs, 551 U.S. 329-330, Justice Scalia, concurring (but arguing that an inference of scienter is established only when the plaintiffs inference is "more plausible than the inference of innocence"); Halliburton, 134 S. Ct. at 2417, Justice Thomas concurring (but arguing that Basic should be overruled).
class of citizens was a routine business of judges.” Moreover, highly regarded conservative Supreme Court justices, such as Tom Clark and John Harlan, have recognized the important role that implied private causes of actions play in the enforcement of the securities laws. Justice Clark, in recognizing a private cause of action under the proxy provisions of the 1934 Act, stated that “[w]hile this language [of the Act] makes no specific reference to a private right of action, among its chief purposes is ‘the protection of investors,’ which certainly implies the availability of judicial relief where necessary to achieve that result.” Expanding upon the Borak decision, Justice Harlan expressed his concern for the plight of small shareholders and declined to take a position that “would be bound to discourage such shareholders from the private enforcement of the proxy rules that ‘provides a necessary supplement to Commission action.’”

While courts have been concerned about the “in terrorem” impact upon corporations and management of permitting class actions to proceed, there actually is a simple way for defendants to avoid such class action certification: let management tell the truth in the first place. Now, many will regard such a solution as not only simplistic but naïve: cannot plaintiff lawyers always twist some statement to make it appear misleading? This concern is greatly overstated. The particularity demanded by Private Litigation Securities Reform Act of 1995, pursuant to which plaintiffs must allege the misleading statements with particularity without the benefit of discovery, and with their attorneys exposed to sanctions if they do not do due diligence before filing suit, dampens this concern.

On the other hand, under the present regime, there are many meritorious cases that are not certified as class actions, and thereby generally die, because of the unrealistic requirements, as developed by the federal courts, for class-action certification. Much of this revolves around whether the securities are traded in an efficient market. This determination, in turn, is required because of the “fantasy” – in the view of Justice Thomas – that investors rely upon the integrity

25 Stoneridge, 552 U.S. at 175-77. Justice Stevens referenced Marbury v. Madison, 5 U.S. 137 (1803), and stated: "While it is true that in the early days state law was the source of most of those rules, throughout our history-until 1975-the same practice prevailed in federal courts with regard to federal statutes that left questions of remedy open for judges to answer."
26 State Bar of Texas, Making the Case: Tom C. Clark, State Bar of Texas https://www.texasbar.com/AM/PrinterTemplate.cfm?Section=Making_the_Case&Template=/CM/HTMLDisplay.cfm&ContentID=14873
32 Id.
33 Id.
34 See, e.g., the confounding analysis of whether the market is efficient by the First Circuit in In re PolyMedica Corp. Securities Litigation, 432 F.3d 1 (1st Cir. 2005), followed by an absurd opinion on remand, 453 F. Supp. 2d 260 (D. Mass. 2006), discussed infra notes 129-148.
of the market price.\textsuperscript{35} This article asserts that investors rely, not upon price, but upon the total mix of information in the marketplace. If courts do not recognize this reality, they should at least recognize that what is necessary to establish reliance is not that the stock is traded in an efficient market but rather that the misrepresentations in question had “price impact.”\textsuperscript{36}

Since the \textit{Halliburton} decisions build upon \textit{Basic}, \textit{Basic} and its weaknesses will first be considered in Part II. The basic flaw in \textit{Basic} was in adopting an approach to reliance that focused upon price, which is the result of information, rather than the information itself. It is information that investors rely upon, not price

In Part III, the flaw in \textit{Halliburton II} is analyzed, namely, the continued reliance upon the notion of an “efficient” market as a predicate for presuming reliance. Paradoxically, the article uses the Court’s own hypothetical to illustrate that the success of plaintiffs litigation should depend, not upon market efficiency, but rather upon price impact. Part IV continues the analysis of why market efficiency, particularly as interpreted by the federal courts, is an outmoded and dubious concept. The article uses the various opinions in the PolyMedica litigation to illustrate the unreasonable approach federal courts have taken in determining whether the market is efficient.

Part V looks at the internal inconsistencies between \textit{Halliburton I}, \textit{Amgen, and Halliburton II} and argues that price impact, materiality, and loss causation are all interrelated concepts that should be determined, not at the certification stage, but in a trial on the merits. While the article argues that all that need be proved at the certification stage is information distortion, not price distortion, an alternative approach using price distortion, as opposed to market efficiency, as a basis for presuming reliance is also considered.

The conclusion asserts that the normative position of federal courts should recognize that investors rely upon informational integrity, rather than price integrity, and that the interrelated, intensely factual issues of price impact, materiality, and loss causation should be reserved for trial.

II. \textbf{The Basic Flaw: Focusing on Effect Rather Than Cause}

A. The Problematic Focus on Price Integrity, Contrasted With the Underlying Policies

Basic Inc. v. Levinson\textsuperscript{37} was an unusual case from a factual perspective. Normally, when an investor claims that he or she was defrauded, the fraud arises from the company putting out

\textsuperscript{35} \textit{Halliburton}, 134 S. Ct. at 2417.
\textsuperscript{36} \textit{See infra} text at notes 197-206 (Professors Bebchuk \& Ferrell argue that what plaintiff’s should need to prove to establish reliance is not that there is an efficient market, but rather that defendants representations have caused fraudulent distortion of the market).
\textsuperscript{37} \textit{Basic}, 485 U.S. 224.
positive information, thereby inducing the investor to buy, when the situation was actually negative. Consider Tellabs Inc. v. Makor Issues & Rights, LTD.,\(^{38}\) where the CEO made a series of positive and specific statements that one key product, the Titan 5500 was experiencing continued growth and that a newer product, the Titan 6500, was ready to ship. Contrariwise, demand for the 5500 was precipitously declining and the 6500 was not yet being produced.\(^{39}\) These misrepresentations induced investors to buy. On the other hand, in Basic, the company put out negative information, namely, that no merger negotiations were taking place, when the situation was actually positive. Consequently, the plaintiff investors sold shares.

The Court considered two issues: whether the merger negotiations were material\(^{40}\) and whether the investors could establish reliance based upon the “fraud on the market” theory. According to the Court, the fraud on the market theory, “succinctly put,” is as follows:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business.... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.... The causal connection between the defendants’ fraud and the plaintiffs’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.\(^{41}\)

When the majority in Basic adopted the fraud on the market theory, the Court stated that, in accepting the presumption of reliance, “we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.”\(^{42}\) The Court also stated that, by accepting this rebuttable presumption, “we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in the market price.”\(^{43}\)

The Court, while recognizing that “reliance is an element of a Rule 10b-5 cause of action”\(^{44}\) and that reliance “provides the requisite causal connection between the defendants misrepresentation and the plaintiff’s injury,” pointed out that there is “more than one way to demonstrate the causal connection.”\(^{45}\) It acknowledged that Affiliated Ute Citizens\(^{46}\) “dispensed with a requirement of positive proof of reliance, where a duty to disclose material information has been breached, concluding that the necessary nexus between the plaintiff’s injury and the

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\(^{38}\) Tellabs Inc v. Makor Issues & Rights, LTD., 437 F.3d 588 (7th Cir. 2006).
\(^{39}\) Id. at 593.
\(^{40}\) Basic, 485 U.S. at 225.
\(^{41}\) Id. at 241-242, citing Peil v. Speiser, 806 F.2d 1154, 1160-1161 (3d Cir. 1986).
\(^{42}\) Id. at 247, n.24.
\(^{43}\) Id. at 249, n. 28.
\(^{44}\) Id. at 243.
\(^{45}\) Id.
defendants wrongful conduct had been established [by the materiality of the omitted information].”

The Basic Court should simply have built upon its analysis of Affiliated Ute Citizens. In this latter case, the Court stated that where the facts “involve[ed] primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.” Every misrepresentation also includes a failure to disclose.

For example, the again focusing on Tellabs, management stated that the Titan 5500 was experiencing continued growth and that the Titan 6500 was ready to ship. This was the misrepresentation. But management also failed to disclose that demand for the 5500 was precipitously declining and that the 6500 was not yet ready to ship. These were material facts and the failure to disclose these material facts was fraudulent. Courts today often fail to recognize that the antifraud provision embodied in Rule 10b-5 forbids not only misrepresentations [lies], but also the failure to disclose facts in order that facts stated not be misleading [half-truths].

The Basic Court clearly recognized that there needed to be a different approach with regard to reliance in transactions over “modern securities markets, literally involving millions of shares changing daily,” as contrasted with face-to-face transactions. In this regard, the Court cited Blackie v. Barrack to the effect that the “causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchase or does not ordinarily seek to purchase a loss in the form of artificially inflated stock.” The Court in effect recognized that requiring proof of individualized reliance would effectively destroy the class action as a vehicle to remedy securities fraud.

The Basic Court cited Blackie v. Barrack, in support of its assertion that the market informs the investor by impounding information into the value of the stock. There is language in Blackie to support that position:

Nevertheless, he [the investor] relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and

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47 Basic, 485 U.S. at 243.
50 Basic, 485 U.S. at 245 (citing Blackie v. Barrack, 524 F. 2d 891, 908 (9th Cir. 1975), cert. denied, 429 US 816 (1976)).
51 524 F. 2d 891, 908 (9th Cir. 1975), cert. denied, 429 US 816 (1976)
thus indirectly on the truth of the representations underlying the stock price whether he is aware of it or not.\textsuperscript{52}

But both before and after the above quoted language, the court used the \textit{Affiliated Ute} approach to causation. The \textit{Blackie} court first stated:

\begin{quote}
We think causation is adequately established in the impersonal stock exchange context by proof of purchase and the materiality of misrepresentations, without direct proof of reliance.\textsuperscript{53}
\end{quote}

Later, the \textit{Blackie} court stated:

\begin{quote}
Here, the requirement [the burden of individualized reliance] is redundant: the same causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock. Under those circumstances we think it appropriate to eliminate the burden [of individualized reliance].\textsuperscript{54}
\end{quote}

Consequently, the \textit{Basic} Court could have determined commonality under the \textit{Affiliated Ute} approach by determining that investors rely upon the materiality of the misdisclosed facts. When management speaks, investors are entitled to rely on the truthfulness of the representations. When those representations are material and false, the class action remedy should be appropriate.

When the Court in \textit{Basic} spoke of “integrity” in the market, it was referring to the integrity of information, rather than of the stock price: “Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor’s reliance on the integrity of those markets.”\textsuperscript{55} While the legislative history upon which the Court relied also referred to market price, the key phrase in the cited reports is that “the hiding and secreting of important information obstructs the operation of the markets as indices of real value.”\textsuperscript{56} As the court observed, “[w]ho would knowingly roll the dice in a crooked crap game?”\textsuperscript{57}

From a policy standpoint, what does the foregoing reflect? The Court was clearly positively inclined toward the use of the class action as a vehicle to remedy securities fraud in the public markets when it adopted the fraud on the market theory. Contrariwise, the dissent

\textsuperscript{52} Id. at 907.
\textsuperscript{53} Id. at 906.
\textsuperscript{54} Id. at 908.
\textsuperscript{55} \textit{Basic}, 485 U.S. at 246.
\textsuperscript{56} H.R.Rep. No. 1383, at 11 (1934).
\textsuperscript{57} \textit{Basic}, 485 U.S. at 247, citing \textit{Schlanger v. Four-Phase Systems Inc.}, 555 F. Supp. 535, 538 (SDNY 1982).
thought that the majority opinion was a bit of a reach. The Court also recognized the importance of accurate information to inform the market. Unfortunately, the Court got the cart before the horse. What investors rely on is the integrity of the information in the market. The information then impacts the price of the shares. But the information is the cause and the price is the effect. In focusing upon price, the fraud of the market theory is subject to criticism that investors do not believe that the stock price is “true;” investors buying stock believe that the price is too low whereas investors selling stock believe that the price is too high.

Justice White, writing for the dissenters, challenged the assertion in the cases relied upon by the majority that investors “rely on the price of the stock as a reflection of its value.” According to the dissent, “many investors purchase or sell stock because they believe the price inaccurately reflects the corporation’s worth.” Moreover, according to the dissent, “[i]f investors really believed that stock prices reflected a stock’s ‘value,’ many sellers would never sell, and many buyers never buy (given the time and cost associated with executing a stock transaction).” It is hard to quibble with the foregoing assertions since, if you asked a buyer why she purchased, she might well respond “because the stock was undervalued,” whereas, if you asked a seller of the same stock, he might well respond that “the stock was overvalued.”

However, the dissent did recognize the congressional policy reflected in the securities laws called for “widespread public disclosure and distribution to investors of material information concerning securities.” This policy “is expressed in the numerous and varied disclosure requirements found in the federal securities law scheme.” In addition to the affirmative disclosure obligations under the securities laws, Congress also enacted a catchall anti-fraud prohibition, pursuant to which Rule 10b-5 was promulgated.

B. Upon What Do Investors Actually Rely?

If investors do not rely upon price, then upon what do they actually rely? As Justice White recognized, Congress has created an elaborate system of disclosure in order that investors

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58 “Yet today, the Court embraces this theory with a sweeping confidence usually reserved for more mature legal doctrines.” Basic, 485 U.S. at 250-251. “But with no staff economists, no experts schooled in the ‘efficient-capital-market hypothesis,’ no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.” Id. at 253.


61 Id.


63 Basic, 485 U.S. at 259.

be informed. Are not investors entitled to rely on the presumption that corporations and their management comply with the securities laws and make honest, accurate and truthful disclosures? When people buy drugs, are they not entitled to rely on the fact that the drugs meet FDA requirements? When they purchase meat, are they not entitled to rely on the fact that the meat meets U.S. Department of Agriculture labeling standards? As noted earlier, “[w]ho would knowingly roll the dice in a crooked crap game?”\(^65\) Congress clearly was concerned with “fair and honest markets,”\(^66\) and with the “protection of investors.”\(^67\)

Unfortunately, the Rehnquist and Roberts courts have become, not just conservative, but reactionary in their approach to enforcement of the securities laws.\(^68\) According to the dissent in Basic, “investors act on inevitably incomplete or inaccurate information, [consequently] there are always winners and losers; but those who have ‘lost’ have not necessarily been defrauded.”\(^69\) This cavalier approach to disclosure has had untoward consequences. The Dirks decision, which was the source of this quote, was a disaster, precipitating a dramatic increase in insider trading.\(^70\)

It is true that, in the securities world, there are winners and losers. Supposedly, the market reflects the present worth of a company’s stream of income out into the future. Some people are more adroit than others at analyzing the business plan of the company and the probability and magnitude of its stream of income. Thus, there are winners and losers. In addition, the price of a company’s stock may be affected by unexpected and unanticipated events, such as a typhoon or tsunami affecting the supply availability of materials that the company needs,\(^71\) or a financial meltdown caused by a real estate bubble.\(^72\) Or a company’s management may turn out to be incompetent.\(^73\) These are all risks to which all investors are

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\(^65\) Id. at 247, citing Schlanger v. Four-Phase Systems Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982).
\(^68\) The Supreme Court’s Evolution, supra note 9.
\(^70\) See H.R. Rep. No. 98-355 (1983) (hereinafter ”1984 ITSA report”), reprinted in 1984 U.S.C.C.A.N. 2274, 2278 (“The current commission has made the prosecution of insider trading a priority, and has brought more such cases during the past four years than in all previous years combined.”). See also JAMES B. STEWART, DEN OF THIEVES (1992). Dirks is discussed at length in The Supreme Court's Evolution, supra note 7 (The Dirks majority determined that a tippee was not liable for his insider trading unless the tipper had sinned – breached a common-law fiduciary duty – and that the tipper did not sin unless he received a pecuniary or a reputational benefit.)
\(^72\) After the financial meltdown, real estate lending dried up, thereby adversely affecting many businesses.
\(^73\) Consider the bailout of General Motors because of decades of mismanagement; also consider the necessity to bail out major banks in the United States as a result of their improvident investing in toxic securities that led to the financial meltdown. More recently, after the London whale debacle, in which J.P. Morgan lost about $6 billion, the stock of J.P. Morgan dropped as much as twenty-four percent in a month.
subject. But investors should not expect to bear the risk of securities fraud. To prevent this is why the securities laws were enacted.

Thus, investors do rely upon the integrity of the information in the securities markets about a company’s operations. When management misrepresents the company’s operations and potential earnings, and investors buy at an inflated price, they should be able to bring a class-action lawsuit to recover the difference between the amount they paid, which was inflated by management’s misrepresentations, and the value at the time of purchase of the securities, which often may be calculated by reference to the drop in price when the true state of facts becomes public.

Consider once again the Tellabs situation. In 2000, Tellabs was a highflying tech company, with a major product, the Titan 5500, and an upgraded version, the Titan 6500, which was supposedly ready to ship. The stock was a growth stock, reaching a high of $67 per share and selling at almost 40 times turnings. To maintain such a price, continued growth was essential.

From December, 2000 through April, 2001, the CEO made, or caused to be made, a series of positive statements about the company that were designed to assure investors that the existing growth would continue. On December 11, 2000, a press release was issued to the effect that the 5500 was experiencing continuing growth and that the 6500 was now available. On January 23, 2001 there was another press release and an investor conference call in which “robust growth” was touted and the fact that “customers are buying more and more of our products” was asserted. On February 14, 2001 a letter was sent to the Tellabs’ shareholders toting “robust growth,” asserting that sales of the 5500 had soared 56% in 2000, and stating that the customers were embracing the 6500. The accompanying annual report stated that the 5500

75 Earnings-per-share in 2000 were $1.75. Annual Meetings: Tellabs, Minuteman, Fortune Brands, FMC, Exelon, Crain’s Chicago Business (April 28, 2001), http://www.chicagobusiness.com/article/20010428/ISSUE01/100016335/annual-meetings-tellabs-minuteman-fortune-brands-fmc-exelon?template=printart., and the stock reached a high of $67. Tellabs, 437 F.3d at 592; thus, the price-earnings ratio was almost 40.
76 When stock sells at a high price/earnings ratio, the value of the stock is heavily dependent upon the anticipated growth rate.

\[ CR = \frac{DR}{G}. \]

Therefore, the larger the growth rate, the lower the capitalization rate. The capitalization rate is inversely proportional to the price-earnings multiple. Thus, the larger the growth rate, the higher the price-earnings multiple. Since a rudimentary approach to the value of a company is earnings times the price-earnings multiple, a decrease in earnings [and, consequently, growth] is a double whammy: it reduces the earnings, and the reduced earnings lower growth and thereby increase the capitalization rate, consequently reducing the price-earnings ratio.

77 Id.
78 Id.
79 Id.
was going strong. In March, there was another investor telephone call at which it was stated that the 5500 was maintaining its growth rate and that demand for the 6500 continued to grow.

In March, the first quarter revenue projection was reduced from $865-$890 million to $830-$865 million. On April 6, the first quarter revenue projection was reduced to 772 million, and the price of the stock dropped to about $30 a share. It gradually moved up to $38 per share but, on June 19, 2001, Tellabs announced a substantial reduction in its second quarter projections from $780-$820 million to only $500 million and, at another investor conference call, the CEO announced that the reduction “was almost entirely because of an enormous reduction in TITAN 5500 sales.” The price plummeted to about $16 per share. Tellabs had been engaged in channel stuffing, and the channel stuffing was so extensive that, “[a]ccording to the plaintiffs' confidential sources, Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns.”

Tellabs management clearly knew that sales of the 5500 were in the process of dropping dramatically.

Justice Thomas, in his concurring opinion in Halliburton, asserted that courts should employ “logic” and observe “economic realities.” Then let us look at the logic and economic realities of the Tellabs situation. First of all, the information in the marketplace in the first quarter of 2001 was that Tellabs was continuing as a high-tech growth company. Someone buying stock in Tellabs would have that view of the company, a view that management sought to reinforce by its comments from December 2000 to March 2001.

That is the factual milieu upon which anyone purchasing Tellabs’ stock would operate. That is the factual milieu which would determine the price of the Tellabs’ stock. Investors universally rely upon the business plan of the company and the cash flow generated by its operations pursuant to that business plan; the stock price then follows. Information about a company’s business plan and the results of its operations are disclosed to the market through the

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80 Id. at 592-593
81 Id. at 593.
82 Id.
83 The practice of channel stuffing, and its impact upon earnings and stock price, is discussed extensively in Alternate Universe, supra note 10, at 625-632.
84 Tellabs, 437 F.3d at 598.
85 “By January 2001, the complaint asserts, demand for Tellabs's ‘best seller'-the TITAN 5500-was drying up. Verizon, Tellabs's largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001. Customers in Latin America and Central America were no longer buying the product. By late 2000, according to a couple of the confidential sources, Tellabs had excess TITAN 5500s on hand because of the lack of demand. One confidential source informed the plaintiffs that Tellabs paid Probe Research, an outside company, $100,000 to forecast demand for the TITAN 5500. Completed ‘in or about early 2001,’ the report showed that the market need for the TITAN 5500 was evaporating. Based on this research, Tellabs's marketing strategy department distributed an internal memorandum that concluded that revenue from the TITAN 5500 would decline by about $400 million.” Id. at 597.
86 Halliburton, 134 S. Ct. at 2418.
87 It is important to draw a distinction between investors and traders. Traders, particularly high-speed traders, make their money on market volatility. Thus they are only indirectly concerned with the company’s business plan and operations. See generally Michael Lewis, Flash Boys, and Scott Patterson, Dark Pools.
securities laws mandatory disclosure system and management’s discussions and releases complementing this disclosure system. Thus, investors rely upon the total mix of information in the marketplace. This mix of information presumptively is the same for all investors. Some investors may bring more skilled analysis to this information than other investors. But the mix of information upon which they are operating is the same and thus the reliance element in Rule 10b-5 is one that is common to all investors.

Some investors may have been directly aware of some of this information, for example, those who sat in on the investor conference call. Others may have been aware of this mix of information indirectly, through reports in the media or recommendations of their stockbroker. But all are operating on the same mix of information. If we were to require individual reliance, some institutional investors who were following Tellabs stock could bring suit directly and might have a sufficient economic stake to bear the risk of litigation.

But no small investor would have a sufficient economic stake to bring an individual cause of action. I personally bought 1000 shares of Tellabs stock around this time. But even if I were to lose $30 a share, from the standpoint of time, it would not be worth it to me to file suit on my own behalf. A non-attorney investor is in even a worse place. She must engage a lawyer sufficiently sophisticated in securities litigation to represent her at $300-$400 per hour or even higher. The attorney must conduct a substantial due diligence investigation prior to bringing suit or be subject to sanctions pursuant to the Private Litigation Securities Reform Act (“PLSRA”).

The complaint must be drafted with great detail (particularity) pursuant to PLSRA in order to defeat a motion to dismiss and there is no discovery prior to the hearing on the motion to dismiss. Thus, an individual investor could expect to front a substantial amount of money, which could end up exceeding any possible recovery. And no attorney would take such a suit on a contingency basis. There simply is not a sufficient economic stake to warrant the time, cost and risk of litigation. Thus, were the courts to rule out class-action status, the net result would be to leave the small investor without a remedy. Should the securities laws be premised on the basis that only some institutional investors are entitled to the protection of the law?

Consequently, Basic appropriately recognized that, in these situations, reliance must be based on that which provides commonality to all investors. The error in Basic was in adopting a doctrine based on an economic theory that an individual investor could not beat the market.

This transferred the reliance element from a focus on the information to focus upon the price of the stock that flows from the information. Federal courts should leave economic theory to economists and instead deal with that with which the Federal Courts have dealt for decades: the

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89 In Re PolyMedica, Corp. Securities Litigation, 432 F.3d 1, 8 (1st Cir. 2005): “The efficient market hypothesis began as an academic attempt to answer the following question: Can an ordinary investor beat the stock market, that is, can such an investor make trading profits on the basis of new information? In an efficient market, the answer is ‘no,’ because the information that would have given the investor a competitive edge and allowed the investor to ‘beat’ the market is already reflected in the market price.”
disclosure obligations of a company and the fraudulent misrepresentations by those in control of a company which are aimed at defrauding the market in general.

III. The Halliburton Flaw: Retaining the Focus on Market Efficiency

A. The Halliburton II Decision

Halliburton II\textsuperscript{90} differs markedly from Halliburton I.\textsuperscript{91} The first Halliburton decision was short, was adopted unanimously, and focused upon only one issue: whether plaintiff must establish loss causation at the certification stage.\textsuperscript{92} The second Halliburton decision was lengthy, produced various opinions though only one judgment, and dealt with three issues: (i) whether Basic should be overruled, (ii) whether plaintiff should be required to establish price impact at the certification stage, and (iii) whether defendant should have the opportunity to establish lack of price impact at the certification stage.

With respect to the first issue, the Court in Halliburton II found no policy reason to overrule Basic. However, the court did engage in some convoluted analysis to justify the “reliance on price” aspect of Basic and, unfortunately, retained “market efficiency” as one of the four prerequisites for invoking the presumption of reliance.\textsuperscript{93} The other three prerequisites are publicity, materiality, and market timing.\textsuperscript{94} Plaintiff has the burden of proving these prerequisites and, with the exception of materiality,\textsuperscript{95} they must be satisfied before class certification.\textsuperscript{96} As will be addressed below, the Court’s own logic supports the argument that what plaintiff must establish is not market efficiency, but rather price impact.\textsuperscript{97}

The Court also rejected Halliburton’s argument that plaintiff should be required to prove that “defendant’s misrepresentation actually affected the stock price – so-called ‘price impact’ – in order to invoke the Basic presumption.” According to the Court, “[w]hat is called the Basic presumption actually encompasses two constituent presumptions:”

First, if a plaintiff shows that the defendant’s misrepresentation was public and material and that the stock traded in a generally efficient market, he is entitled to a presumption that the misrepresentation affected the stock price.

\textsuperscript{92} The Court determined that plaintiff need not.
\textsuperscript{93} Halliburton, 134 S. Ct. at 2416, 24.
\textsuperscript{94} Id. at 2412.
\textsuperscript{95} In Amgen, discussed infra text at notes 177-185, the Court, in a conflictual opinion, determined that plaintiff need not establish materiality at the certification stage.
\textsuperscript{96} Halliburton Co., 134 S. Ct. 2398.
\textsuperscript{97} See infra at notes 101-105.
Second, if the plaintiff also shows that he purchased the stock at the market price during the relevant period, he is entitled to a further presumption that he purchased the stock in reliance on the defendant’s misrepresentation.98

According to the Court, “[b]y requiring plaintiffs to prove price impact directly, Halliburton’s proposal would take away the first constituent presumption.”99 The Court concluded that “[f]or the same reasons we declined to completely jettison the Basic presumption, we decline to effectively jettison half of it by revising the prerequisites for invoking it.”

What the Court did determine was that the defendant could introduce evidence to establish a lack of price impact in the particular case so as to rebut the presumption of reliance. The court held that “defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.”100

This is basically gobbledygook. The Court acts as though it is doing plaintiffs a favor by rejecting the requirement for plaintiffs to show “price impact” specifically, but the Court retains the requirement to show that the market was efficient – a requirement which necessitates plaintiff establishing price impact generally, rather than specifically. Additionally, by permitting the defendant to prove the lack of price impact, the court indirectly requires plaintiff to litigate price impact at the certification stage. Plaintiff would have been better off if the court had required plaintiff to prove price impact at the certification stage but had jettisoned the requirement to establish “market efficiency,” a concept which is not just amorphous and disputed, but which also adds substantially to the cost of litigation by generating a battle of the experts on a generalized proposition.

Litigation would be much more efficient if the role of the experts were limited to determining whether, in this particular case, there was a price impact from the misrepresentation. And determining price impact is basically the same concept as loss causation, which the Court determined that plaintiff need not establish at the certification stage. Thus, as discussed in the analysis of Basic, all plaintiff should need to show at the certification stage is that the defendants introduced misrepresentations into the marketplace which altered the mix of reliable information upon which investors rely. But this is basically the definition of materiality which the Court has determined need not be established until the trial stage. Thus, logically, price impact, materiality and loss causation are related concepts which should be litigated at the trial on the merits.

B. The Courts Hypothetical – A Two-Way Street

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98 Halliburton, 134 S. Ct. at 2414 (paraphrasing not in original).
99 Id.
100 Id. at 2417.
In holding that defendants must be afforded the opportunity to rebut the presumption of reliance by establishing that the misrepresentation did not affect the market price, the Court used this hypothetical:

Suppose a defendant at the certification stage submits an event study looking at the impact on the price of its stock from six discrete events, in an effort to refute the plaintiffs’ claim of general market efficiency. All agree the defendant may do this. Suppose one of the six events is the specific misrepresentation asserted by the plaintiffs. All agree that this too is perfectly acceptable. Now suppose the district court determines that, despite the defendant’s study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit. The evidence at the certification stage thus shows an efficient market, on which the alleged misrepresentation had no price impact.101

In this hypothetical situation, the market for the stock is generally efficient, which would normally suffice to establish the fraud on the market presumption. But the particular misrepresentation that is being litigated did not affect the price of the stock. The Court thought that it would be bizarre102 to enable the plaintiff to get past the certification stage by virtue of indirect evidence when direct evidence was available to show the plaintiff was not injured.103 The Court concluded:

While Basic allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant’s direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock’s market price and, consequently, that the Basic presumption does not apply.104

The court’s position would seem reasonable. If the price were not affected by the alleged misrepresentation, then either the misrepresentation was not material or plaintiff is not suffered any loss. Why proceed to trial?

On the other hand, the converse of the courts hypothetical can demonstrate why the fraud on the market theory is flawed as a result of its focus upon market efficiency. Suppose, as the Supreme Court did, that there was a situation in which there were six event studies, one of which was the specific representation in the instant suit. Assume further that five of the events studies showed no price impact, but that the specific representation in the instant suit did show a marked impact on price. Defendant could make the case that the market was not efficient and that, therefore, the fraud on the market presumption was not applicable. Consequently, class certification would fail and, most likely, the suit would die, particularly if plaintiffs were only

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101 Id. at 2415.
102 Id.
103 Id. at 2416. The fact that the misrepresentation did not affect the price of the stock could mean either that the misrepresentation was not material or the plaintiff had not established loss causation.
104 Id.
small investors who could not afford to bring a direct action. This would be so even though plaintiff established that the corrective disclosure caused the market price to drop dramatically, thereby leaving her with worthless stock. Does this make sense?

A much more sensible regime would be to have a presumption, which is not really a presumption but rather a reality, that investors rely upon the total mix of information in the market; when this mix is fraudulently created by the misrepresentations of management, affected investors can bring a class-action lawsuit. This should suffice for class certification. This is what should be the normative position for federal courts to take.

But, if more be needed, then require plaintiff to establish “price impact.” Under this variation, plaintiffs’ burden would be less than exists at present to establish that the misrepresentation took place in an efficient market, since plaintiff need deal only with one event-study – the current misrepresentation – rather than a multitude of event studies. Moreover, plaintiff would not be assaulted by the various views as to whether all information must be incorporated into the price of the stock, or whether merely most publicly available information must be so incorporated, or how quickly the information must be incorporated into the price.

But evidence establishing price impact would probably also establish materiality and loss causation. In effect, we would be moving the trial from the merits stage to the class certification stage. Better to presume reliance based upon the defendant’s insertion of misleading information into the market, grant class certification, and leave any factual issues for trial. Otherwise, as Professor Langevoort has stated:

A detailed resolution of market-impact and loss-causation issues at the class-the certification stage substitutes fact finding by the judge on an extraordinary complex issue at an early stage of the proceeding for fact-finding by the jury at trial and gives appellate courts far greater authority to review those findings.105

IV. Retaining a Focus on Market Efficiency Is Unreasonable and Outdated, and Is Merely a Device to Increase Litigation Costs and Thwart Meritorious Litigation

The converse of Justice Roberts’ hypothetical, discussed above, illustrates one reason why requiring market efficiency as a condition for reliance is irrational. What difference does it make whether or not other information is integrated into the market price if the plaintiff can demonstrate that the misrepresentation of which she complains did affect market price? A market could be fairly inefficient but, if the misrepresentation were significant enough, it could affect market price and adversely impact plaintiffs, thereby causing their loss.

Moreover, as Professors Prichard and Henderson assert in their brief to the Supreme Court in the Halliburton II case, “proving the efficiency of the market as a whole is only an indirect

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105 Donald C. Langevoort, Basic at Twenty: Rethinking Fraud on the Market, 2009 Wisc. L. Rev. 151, 185-186.
means of proving that the market relied on the particular statement. …[D]etermining whether a misstatement distorted the market is typically easier than demonstrating efficiency of the market as a whole. It is also a more direct means of inquiring into reliance, and a more reliable method of showing whether the complained-of fraud was, in fact, a “fraud on the market.””

A. Polymedica: A Leading Case Exemplifying the Unreasonable Application of Market Efficiency

1. The Polymedica Facts

The stock of Polymedica, a distributor of diabetes testing supplies, traded as high as $58.25 during the quarter ended December 31, 2000. Apparently because of short selling pressure, the high in the following quarter was 44. Toward the end of that quarter, CIBC World Markets announced that there was an investigation into PolyMedica for Medicare fraud. The stock plummeted from $33 to $17. The next business day, March 26, 2001, PolyMedica held an investor conference call reassuring investors and extolling its efficient systems and highly trained and dedicated personnel. A company official referenced a two-year-old complaint to Health and Human Services and asserted that, in view of 60,000 to 90,000 shipments PolyMedica made per month, there will always be some customer complaints. Thereafter the stock rose to $48 in the quarter ending September 30, 2001. However, in late July of that quarter, the New York Stock Exchange declined to list PolyMedica stock and, on August 6, Barron’s disclosed that a federal grand jury was looking into possible Medicare and investor fraud. The stock dropped to $22 after the Barron’s article and further dropped to $14 when, a couple of days later, PolyMedica finally admitted that a criminal investigation was in process. The stock eventually dropped to $11.25.

According to PolyMedica’s employees, the company often shipped products to customers that the customers did not order and, even though these products were often returned, “[o]ver 90% of returns are not refunded to Medicare.” If, at the end of the month on Friday, the company was 10,000 orders short of goal, magically the 10,000 orders appeared by the close of

109 Polymedica annual report, supra note 107.
110 SmartMoney, supra note 108; also see Polymedica annual report, supra note 107.
111 Polymedica annual report, supra note 107.
113 Id.
115 Endgame, supra note 112.
day on Saturday. The company would also load up trucks from its warehouses and then have the truck sit in the warehouse parking lot because there were no orders. When employees tried to inform management of improper activity, they were met with silence or reprimands. PolyMedica eventually settled the criminal charges with the Justice Department by paying $35 million.

One would think that the foregoing situation would be a matter of concern for the federal courts. Medicare fraud is a serious matter. Consequently it will be instructive to contrast the approaches of the District Court in its initial opinion granting certification, with the Circuit Court opinion reversing on the basis of its definition of an efficient market and the District Court opinion on remand, applying the Circuit Court’s view on market efficiency.

2. The Initial District Court Opinion: A Sensible Approach Applying Basic

Judge Keeton’s opinion in PolyMedica granting class certification is a joy to read: it is clear, concise and cogent. In applying the fraud on the market theory, he relies upon the Supreme Court opinion in Basic, rather than upon academics arguing about the concept of an efficient market, and courts relying upon the academics. He essentially adopted plaintiff’s assertion that “the essential factor in determining market efficiency is whether the stock price was affected by the material information available in the market.”

Looking to Basic, he relied upon three statements by the Basic Court:

(i) The presumption is supported by common sense and probability…. Because most publicly available information is reflected in market prices, an investor’s reliance… may be presumed.

(ii) We need not determine by adjudication what economists and social scientists have debated…. [W]e need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.

(iii) [W]e do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.

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116 Id.
117 Id.
118 Id.
120 PolyMedica, 224 F.R.D. 27, rev’d 432 F. 3d 1 (1st Cir. 2005).
122 Id. at 40.
123 Id. citing F.T.C. v. Sperry & Hutchinson Co., 405 U.S. at 247 (emphasis by Judge Keeton).
124 Id. citing Basic, 485 U.S. at 246, n. 24 (emphasis by Judge Keeton).
125 Id. at 40-41 citing Basic, 485 U.S. at 249, n.9.
Based upon the foregoing, he concluded:

Considering the three statements together, I conclude that an “efficient” market in the context of the “fraud on the market” theory is not one in which a stock price rapidly reflects all publicly available material information. Rather, the “efficient” market required for “fraud on the market” presumption of reliance is simply one in which “market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.”

Applying the above standard to the facts presented to him, Judge Keeton noted:

(i) There was a cause-and-effect relationship between unexpected disclosures regarding the corporation and an immediate response in the stock price: “In particular, at five points in 2001 … PolyMedica stock price ‘rose [dramatically] on news of greater than expected growth and fell [dramatically] on negative news about the Company.’”

(ii) The average weekly trading volume exceeded 1 million shares which was around 10% of the shares outstanding.

(iii) 18 different securities analysts followed PolyMedica and at least four securities analysts issued at least 17 analyst reports.

(iv) There were 283 market makers in the PolyMedica stock.

(v) The market capitalization exceeded $200 million.

From the foregoing, Judge Keeton, in the opinion of the author, reasonably concluded that the market was efficient, and that the fraud on the market presumption applied.

3. The Circuit Court and the District Court on Remand: An Example of Courts in an Alternate Universe

a. The Circuit Court: A Stringent Definition of Market Efficiency

At the outset of the Circuit Court’s opinion, it acknowledged that, according to plaintiff, PolyMedica’s stock had lost more than 80% of its value and PolyMedica had engaged in welfare fraud. At the time of its opinion, in December 2005, these facts were easily verifiable. While judges are supposed to be bias free (an illusion since everybody’s decision-making is affected by bias), would not the instinct of someone who was concerned about fraud in the securities

126 Id. at 41 citing Basic, 485 U.S. at 246, n. 24.
127 Id. at 43.
128 Id.
129 PolyMedica, 432 F.3d 1, 3 (1st Cir. 2005).
130 See, e.g. Daniel Kahneman, a Nobel Prize winner for his work in behavioral economics, whose recent book, THINKING, FAST AND SLOW (Farrar, Straus & Giroux 2011), discusses two systems of thinking: “thinking fast” which operates automatically and quickly with little effort, and “thinking slow” which is deliberative and analytical. However, the first system initially produces the information upon which the second system thoughtfully operates. That is how bias can creep into decisions which we believe are thoughtfully made. For a more extensive discussion,
markets be to certify the class to determine what the facts really were? This would be particularly so when presented with the clear, concise and cogent analysis of Judge Keeton.

The Circuit Court recognized the Basic pronouncements relied upon by the District Court but also focused upon other statements, such as “[t]he market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price,” and that “the market price of shares traded on well-developed markets reflects all publicly available information, and hence, any material misrepresentations.” The Circuit Court concluded that the Supreme Court’s language in Basic could support either the lower court’s interpretation of efficiency or the view adopted by most lower courts that the stock price must “fully reflect all publicly available information.”

The problem with this formulation, as discussed in the next section, is that the “fully reflect all publicly available information” is impossible of proof, relying upon the conjecture of so-called experts, and not realistic, particularly when coupled with the Circuit Court’s add on that the information must be “incorporate[d] rapidly or promptly.” The court stated that:

By “fully reflect,” we mean that the market price responds so quickly to new information that ordinary investors cannot make trading profits on the basis of such information. This is known as “informational efficiency.”

Although the court did not require “fundamental value efficiency,” which means that the market price is also accurate, it did recognize that fundamental value efficiency could be relevant to informational efficiency.

Again, as developed in the next section, it is clear that markets incorporate different types of information at different rates, depending upon the complexity and mode of distribution of the information.

b. The District Court on Remand: An Unreasonable Application of a Stringent Standard

(i) Plaintiffs’ Strong Evidence of Market Efficiency

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131 PolyMedica, 432 F.3d at 11, (quoting Basic, 485 U.S. at 244, 246) (emphasis added by the Circuit Court).
132 Id. at 11-13.
133 Id. at 12.
134 Id. at 19.
135 Id.
136 Id.
On remand, the District Court\textsuperscript{137} looked at plaintiffs evidence which primarily focused upon the five \textit{Cammer} factors, which many courts have used to determine whether the market for a particular stock is efficient.\textsuperscript{138} The court analyzed them as follows:\textsuperscript{139}

(i) Average trading volume: the average weekly trading volume was 4,140,232 shares, which was 31\% of the 13,280,000 total shares outstanding. \textit{Cammer} suggested that a 2\% weekly trading volume wanted a strong presumption of market efficiency.

(ii) Number of securities analysts: seven analysts followed the stock and there were 348 articles mentioning PolyMedica. A previous decision in the First Circuit had approved efficiency even though there was only one analyst.\textsuperscript{140} The court said that the strength of this factor is uncertain because there exists “no coherent yardstick against which to measure it,” even though it also recognized that, according to one study, this factor “is one of only two which actually have statistically significant, empirical support.”\textsuperscript{141}

(iii) Presence of market makers: there were 193 market makers of whom 27 traded over 1 million shares each. Previous First Circuit decisions had approved class certification with substantially less market-making activity. However, the court stated that, since there is “no accepted standard” to determine the minimum number, the court would place little weight on this factor.

(iv) Eligibility to file an S-3 registration statement: in order to use this form, the SEC requires a market capitalization of $75 million not counting stock held by management. The rationale behind this is that, at this level of market capitalization, there will be sufficient analyst and investor interest to ensure that information is widely disseminated and integrated. The court acknowledged that “Courts have found that the SEC permits an S–3 Registration statement ‘only on the premise that the stock is already traded on an open and efficient market, such that further disclosure is unnecessary.’”\textsuperscript{142} The market capitalization of PolyMedica during the class period was about $500 million.

\textsuperscript{137} In the interim, Judge Keeton had retired and the case was reassigned to Judge Young. \textit{In re Polymedica Corporation Securities Litigation}, 453 F. Supp. 2d 260 (D. Mass. 2006).

\textsuperscript{138} \textit{Cammer v. Bloom}, 711 F.Supp. 1264, 1286-1287 (D. N.J.1989): (1) the stock’s average trading volume; (2) the number of securities analysts that followed and reported on the stock; (3) the presence of market makers and arbitrageurs; (4) the company’s eligibility to file a Form S–3 Registration Statement; and (5) a cause-and-effect relationship, over time, between unexpected corporate events or financial releases and an immediate response in stock price.

\textsuperscript{139} \textit{PolyMedica}, 432 F.3d at 3-7.

\textsuperscript{140} \textit{In re Xcelera.com Securities Litigation}, 430 F.3d 503 (1st Cir. 2005).

\textsuperscript{141} \textit{PolyMedica}, 432 F.3d at 4.

\textsuperscript{142} \textit{Id.} at 6.
(v) Cause and effect relationship: plaintiffs expert, Miller, presented a chart which listed the price change in PolyMedica stock on five days, each of which had significant news events:

- Reports of consumer complaints to government investigators (Mar. 23, 2001: 49.54% decline);
- PolyMedica’s response that those reports were rumors and that it had not been contacted by any government agency (Mar. 26, 2001: 42.65% rise);
- Announcement that shares would no longer be listed on the NYSE (July 23, 2001: 29.52% decline);
- Report that PolyMedica may be indicted for Medicare and investor fraud (Aug. 6, 2001: 32.17% decline);
- PolyMedica announced that the U.S. attorney for the Southern District of Florida was conducting an investigation into one of its units (Aug. 8, 2001: 17.65% decline).

Miller also presented a side-by-side comparison of movements in the PolyMedica stock price, “peer group” stock prices, and the NASDAQ index and stated that “the dramatic price increases and declines in the price of PolyMedica stock during the disputed period in response to new company-specific information were not mirrored in price movements of the NASDAQ Composite Index or the comparable company index.”

I would expect that most persons, reviewing the foregoing facts, would conclude that PolyMedica traded in an efficient market. To disregard or fail to see the significance of facts such as average weekly trading volume of 31% of the outstanding shares, seven analysts following the stock, 193 market makers of whom 27 traded over 1 million shares each, and a market capitalization of about $500 million (whereas a market capitalization of only 75 million would be sufficient to be eligible to file an S-3 [short form] registration statement), suggests a lack of objectivity and an outcome determinative mentality for the court.

(ii) The District Court’s Unrealistic Reliance upon Defendant’s Expert

According to the district court, the foregoing analysis by Plaintiffs’ expert “leaves much to be desired.” To support this conclusion, the court relied upon the following testimony of Dunbar, PolyMedica’s expert:

[Y]ou went and searched for the largest price drops. That’s not a scientific study. A scientific study is one where you draw a sample and then you compare a test statistic from that sample to another sample.... All you did was went and picked the largest stock price drops and said, oh, gee, that just shows that it’s informationally efficient. You picked five

143 Id.
days out of about 160 trading days. What you should do is look at all 160 trading days and do a scientific study to see if there’s a difference between the news days and the non-news days. And if you would have done that you would have found that there wasn’t any difference between them.

... [I]f you picked news days as a sample, all news days, not just the ones you self selected. I mean, you selected the few news days that would prove your point. But there’s many other news days in that contested period, anywhere from 23 to 59, versus [sic] on how you want to count them. If you want to look at what the stock price reaction is on those news days versus the non-news days, you’ll find that you can’t say that the news days were drawn from a different sample than the non-news days. In other words, they were providing as much information to the market as the non-news days.

This testimony is both irrelevant and incoherent, particularly the last two sentences. Moreover, Dunbar indicated that there were between 23 and 59 news days. This is a wide range of uncertainty, which also raises questions about the materiality of the information on these various days, and whether any particular news item was within the expectations of the market or, on the other hand, was a surprise. Moreover, was any of the information on the so-called news days as dramatic as the allegations of Medicare fraud, denial of listing by the New York Stock Exchange, or possible criminal indictment?

The following is the only stock graph during the relevant period that I have been able to access.

![Stock Graph](image)

It shows a precipitous drop on March 26 upon news of the government’s investigation into Medicare fraud. It shows a subsequent rise the following Monday when PolyMedica’s investor conference call assured investors there were no problems. If further shows a sharp decline when it was announced that the New York Stock Exchange would not be listing PolyMedica shares. The graph ends before the announcement that PolyMedica might be indicted for Medicare fraud, when another substantial drop in price occurred. The extent to which the market moved on the 150 or so days when there was either no news or “less significant” news is irrelevant to the efficiency of the market with respect to the dramatic news reports about PolyMedica. As discussed in the next section, PolyMedica’s expert fell into the trap of assuming that all news is digested immediately by the market without recognizing that the significance, complexity, and mode of disclosure all affect the pace at which the market processes news.

Nevertheless, the Court endorsed the above criticism of Miller and stated with respect to plaintiffs expert: “Miller’s mere listing of five days on which news was released and which exhibited large price fluctuations proves nothing. Miller’s only marginally useful analysis—which
he oddly labels “not a significant factor”—is his unscientific comparison of PolyMedica Stock to the NASDAQ index.”

It is incomprehensible that a court could look at the price movements reflected in the above graph and as set forth by plaintiff’s expert and conclude that they prove nothing, particularly when the testimony is not in connection with a trial on the merits but rather relates to the issue of whether plaintiff has presented sufficient evidence of commonality for class certification. Moreover, in point of fact, the analysis by plaintiff’s expert is considered scientific. Comparing the price movements in the defendant company’s stock with price movements of peer stocks and an index such as NASDAQ is a scientific way of establishing that the price movement with respect to the defendant company was caused by factors over and above whatever factors impacted the movement of peer stocks or the market as a whole.

(iii) The District Court’s Unrealistic Reliance on the Lack of Shares Available for Short Selling

The District Court was also influenced in determining that the market for PolyMedica stock was not efficient by the situation with regard to short selling. By April, 2001 there was a huge amount of short interest. This made obtaining additional shares to short difficult. In addition, a typical loan fee for lending stocks was 1%; during the summer of 2001; however, the loan fee with regard to PolyMedica was between 15% and 35%. According to Dunbar, this meant the market was inefficient because persons who would have liked to have shorted the stock were not able to do so; thereby the market was denied the information that additional shortselling would have brought to the market. As Dunbar stated, “the constraints on shorts will prevent people who don’t own the stock from providing their viewpoints to the market.” The Court agreed that this was another significant factor supporting a lack of market efficiency.

What is paradoxical about this analysis is that the extent of shortselling shows that many sophisticated investors believed that PolyMedica stock was overpriced. The large premium charged for lending the stock also reflected the fact that the holder was worried that the stock might drop precipitously before the holder received the stock back from the short seller. Thus, the shortselling, and the impediments to additional shortselling, confirm the fact that PolyMedica was overpriced because of the misrepresentations of defendant. Instead of focusing on this, the court rejected efficiency because the market did not have all the shortselling information that the court believed it should have had. Contrary to the court’s opinion, the extent of shortselling, the loan fee charged, and the difficulty in accessing shares to short are all facts that are in the public domain.

In addition, if stock is not available to loan to bearish investors to enable them to sell it short, there is another vehicle for “bears” to show the market that they believe the stock is overvalued – they could purchase “put” options. But this possibility was never considered by the court.

(iv) The Unreasonable “One Day” Standard for “Informational Efficiency”

Finally, the court determined that the time within which the market must react to new

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144 Id at 273-275.
145 Id at 276.
information in order to be efficient was one day:

This Court, however, holds that the First Circuit’s definition and relevant explanation of efficiency in *PolyMedica*, which stated that stock price must quickly and fully reflect the release of public information such that ordinary investors cannot profitably trade on the basis of it, requires that the reaction to news be fully completed on the same trading day as its release – and perhaps even within hours or minutes.  

Once again, the court fell into the trap of assuming that all news is digested immediately by the market without recognizing that the significance, complexity, and mode of disclosure all affect the pace at which the market processes news. Moreover, paradoxically, the negative disclosures about PolyMedica and relied upon by Miller, plaintiffs’ expert, all had a dramatic negative impact on the price of the stock within one day. Consequently, these disclosures thereby met the District Court’s standard that the information be impounded into the market in one day. On the other hand, the positive information injected by PolyMedica’s investor conference call probably took longer for the market to fully incorporate because many potential buyers were probably waiting to see if confirmation of the negative disclosures was in the offing.

The opinion on remand was also not true to the Circuit Court’s reading of *Basic*. To counter Judge Keeton’s analysis of basic, the Circuit Court quoted other provisions in *Basic* in which the Supreme Court referred to all information: “[t]he market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price,” and that “the market price of shares traded on well-developed markets reflects all publicly available information.” Note that the language of *Basic* that the Circuit Court quoted did not unqualifiedly refer to “all information.” Rather it referred to all the “available” information. Arguably, then, if shortselling information was not available to the market, it was not relevant under *Basic*. Again, paradoxically, much of the information the court discussed in determining that the market lacked the information of putative short-sellers was actually available to the market.

The opinions of the Circuit Court and the District Court on remand are classic examples which illustrate that a little knowledge can be a dangerous thing. These opinions also support the conclusion that a legal liability structure predicated upon a determination of whether or not the market for a particular stock is efficient is based on whimsy, rather than reality.

2. Scholarly Rejection of Using Market Efficiency to Determine Reliance

Early on, *Basic* was criticized for arguably requiring an efficient market in order to create a presumption of reliance. A joint effort of law and business professors asserted “substantial disagreement exists about to what degree markets are efficient, how to test for efficiency, and

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147 Id at 278.
even the definition of efficiency.”\textsuperscript{149} The same criticism holds true today.\textsuperscript{150} Moreover, two Nobel prize winners in economics, Eugene Fama\textsuperscript{151} and Robert Shiller,\textsuperscript{152} have taken opposing positions on whether the market is efficient, Fama arguing that it is efficient and Shiller arguing that it is not.

The logic employed by many courts is that reliance depends upon market efficiency and market efficiency depends upon speed of adjustment. Thus, if market adjustment is “slow,” then the investor does not rely for purposes of achieving class certification. Professor Langevoort, in his seminal article on the history of 	extit{Basic}, raises the fundamental question about market efficiency and its reliance upon speed of market adjustment: “what does speed of adjustment have to do with reliance on stock-price integrity?”\textsuperscript{153} He asserts that “fraud can and does distort prevailing prices even when adjustment is delayed or incomplete.”\textsuperscript{154}

By way of illustration, Professor Langevoort used 	extit{In re Merck & Co., Inc. Securities Litigation}.\textsuperscript{155} Merck, in 2002, ranked 24\textsuperscript{th} on the Fortune 500 list;\textsuperscript{156} you would expect a market for its shares to be efficient. However, the question in 	extit{Merck} was not whether the market was efficient, but rather the point in time when information would be impounded into the market and affect the price. Medco, a wholly-owned subsidiary of Merck, recognized income attributable to a copayment made by a pharmacy customer to the pharmacy, even though the subsidiary did not handle these copayments. In a registration statement filed April 17, 2002, in connection with a spinoff of Medco, Merck disclosed for the first time that Medco had been recognizing revenue on this basis, but did not disclose the total amount of revenue which had been improperly recognized. On the day the registration statement was filed, Merck stock price went up from $55.02 to $55.05.\textsuperscript{157}

Almost 2 months later, on June 21, 2002, the Wall Street Journal reported that Medco had been recognizing copayments as revenue and estimated that, in 2001, $4.6 billion had been thereby recognized. That day Merck stock dropped $2.22, from $52.20 to $49.98. Merck filed an amended registration statement on July 5, 2002 and disclosed that Medco had recognized over $12.4 billion in “copayment” revenue, of which $5.537 billion was recognized in 2001. Merck stock declined to $43.57 on July 10.\textsuperscript{158}

\textsuperscript{150} See generally, Basic at Twenty supra note 105. \\
\textsuperscript{153} Basic at Twenty, supra note 105, at 169. \\
\textsuperscript{154} Id. at 161. \\
\textsuperscript{155} In re Merck & Co., Inc. Securities Litigation, 432 F. 3d 261 (3d Cir. 2005). \\
\textsuperscript{157} Merck, 432 F.3d at 270. \\
\textsuperscript{158} Id. \end{flushleft}
The court noted that the Wall Street Journal reporter had derived her figure by subtracting home delivery prescriptions from total prescriptions filled in order to determine the number of retail prescriptions and then assumed an average $10 copayment for each retail prescription. She then multiplied the two numbers together to arrive at the conclusion that $4.6 billion had been improperly recognized. However, according to the Circuit Court, the market made this determination on April 17 when the price of Merck stock rose $.03, thereby demonstrating that the information was not material: “The Journal reporter simply did the math on June 21; the efficient market hypothesis suggests that the market made these basic calculations months earlier.”

In a very telling quote, the court stated: “If these analysts [who followed Merck and focused on revenue growth] were unable for two months to make a handful of calculations, how can we presume an efficient market at all?” My conclusion from this data is that the analysts were capable of making these computations but did not, which in turn suggests that the market is not necessarily all that efficient, even for a stock as significant and widely traded as Merck.

Also consider Enron. At the beginning of 2001, Enron stock was trading at about $84. On March 5, 2001, it was trading at about $70 when Bethany McLean wrote her famous article in Fortune, Is Enron Overpriced? That week, Enron trading was essentially flat; in fact the high on Friday was higher than the high on Monday. The following week Enron dropped about 10 points to about 60. For the next month there was a 10% dip and then a rise back to 60 in early May. So much for the diligence and perspicaciousness of analysts!

By September, Enron stock had steadily dropped to 35 and by the end of the year it was worthless. Granted that the Enron business model was more complicated than that of Medco; however, that complexity should have led an “efficient” market, and the many analysts who covered Enron, to be suspicious and inquisitive. As Ms. McLean pointed out, Enron was the “It Girl” of Wall Street. While Enron was secretive about its business plan, warning signs were out there, including the disparity between cash flow and income and the risky business model that it was employing.

Apropos to the subject of analyst diligence is the multi-analyst scandal in connection with the dot-com bubble, which came to light in spring 2002. New York State Attorney General Eliot Spitzer uncovered a number of e-mails written by Merrill Lynch investment analysts, describing the stock of various companies as “junk,” “crap,” and “a disaster,” unbelievably, they publicly

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159 Id. at 271.
162 Id.
rated these stocks as a “buy.” Analysts hyped their ratings, not just to obtain investment banking work for their firms, but sometimes for personal profit, such as getting their daughters into nursery school.

Merrill Lynch settled for $100 million and agreed to revise its practices with respect to analysts. Within a year of Merrill Lynch being sued, ten top United States investment banking firms agreed to pay a total of $875 million in penalties and disgorgement for similar practices. Pursuant to the settlement agreements, Wall Street agreed not to pressure analysts to give unwarranted ratings. However, a couple of years later, Rodman and Renshaw fired an analyst because he would not raise his price target for a particular stock. So much for assuming the integrity of analysts!

What the foregoing demonstrates is the folly of creating a legal structure predicated upon the efficiency of the market and the competence and integrity of analysts.

There is a classic joke about an imprisoned economist who said that he planned to escape by assuming a ladder. This, in tongue-in-cheek fashion, illustrates the extent to which economic theory is predicated upon assumptions. Unfortunately, some of the assumptions in the efficient market theory are questionable. The basic idea is that arbitrageurs will respond to information by driving the price in the right direction. If they believe the price is too low, they will buy; if they believe the price is too high, they will sell short. This requires that these arbitrageurs “should face no capital constraints and have infinite horizons. More precisely, they must have sufficient capital and long enough horizons to await patiently the revelation of information or the reversal

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164 See Lawyershop.com, Merrill Lynch, http://www lawyershop.com/practice-areas/criminal-law/white-collar-crimes/securities-fraud/lawsuits/merrill-lynch/ (last visited Apr. 6, 2010). Other examples include: “Internet Capital Group (ICGE): E-mail: October 5, 2000 – ‘Going to 5?’ (strong sell),” “October 6, 2000 – ‘No helpful news to relate, I’m afraid. This has been a disaster- there really is no floor to the stock,’” “Investor advice: October 5, 2000 – 2-1 rating (buy to strong buy),” “Excite@home (ATHM): E-mail: June 3, 2000 – ‘ATHM is such a piece of crap!’” “Investor advice: June 3, 2000 – 2-1 rating (buy to strong buy),” “Lifeminders (LFMN) E-mail: December 4, 2000 – ‘I can’t believe what a POS that thing is,”” and “Investor advice: December 4, 2000 – 2-1 rating (buy to strong buy).” Id.

165 Jack Grubman, one of the leading analysts on Wall Street, sent an e-mail stating that his boss, Sanford Weill, the chairman of Citigroup and a member of the Board of Directors of AT&T, helped Grubman to get his twin daughters enrolled in an exclusive nursery school after Grubman began recommending AT&T stock. Mr. Weill has acknowledged that he asked Grubman to “take a fresh look at AT&T,” which was code on Wall Street for changing your opinion. See Gretchen Morgenson & Patrick McGeehan, Wall Street and the Nursery School: A New York Story, N.Y. TIMES, Nov. 14, 2002, available at http://query.nytimes.com/gst/fullpage.html?res=9C03E3D71630F937A25752C1A9649C8B63&fta=y.


168 The analyst originally had an “outperform” recommendation with a price target of $2.88. As the stock approached this price, he sought to downgrade his recommendation to “market perform.” But instead, his director of research recommended that he increase his price target. See Gretchen Morgenson, Did Wall Street Really Learn its Lesson, N.Y. TIMES, Apr. 9, 2006, at BU 12, available at http://query.nytimes.com/gst/fullpage.html?res=9905E6D91130F93AA35757C0A9609C8B63.
of sentiment underlying the mispricing.”169 Particularly with respect to short selling, where the risk is unlimited if the stock moves in the wrong direction, there are substantial impediments to the idealized theory as to what the bearish arbitrageur will commit to do.170 In addition, both momentum traders171 and the existence of herding172 can lead to inefficiency.

Again, is this the foundation upon which to build a legal theory?

Another problem with the efficient market theory that is raised by Prof. Langevoort is that it is binary – either a market for a company’s security is inefficient or it is not efficient.173 “But there is no such thing as a perfectly efficient market, and so it becomes easy for a court to miss the forest for the trees by accepting too readily the defendants’ statistical evidence of imperfection as reason not to certify.”174 One critique of the PolyMedica decision is that the court never considered that “different kinds of information are likely impounded at different rates of speed, even for the same issuer.”175 The same is true of the court in Merck.

It is Alice in Wonderland type thinking to assume that all information, irrespective of its significance, complexity, mode of disclosure, and context of disclosure would be assimilated at the same rate, particularly within one day. The pattern of the Merck stock movement actually illustrates this. Is the market as likely to respond to an arguably buried fact in a multipage registration statement in as quick and decisive a manner as it would to a thoughtful and clearly laid out article in the Wall Street Journal, which in turn must be contrasted with an affirmative, clear, detailed acknowledgment by the company? To hold that all information is rapidly, i.e. within one day, assimilated by the market irrespective of its complexity and mode of distribution is to endow the market with omniscience.

At a minimum, even if reliance is related to stock price integrity per Basic, rather than informational integrity, “rigorous insistence on a showing of market impact would seem to obviate the need to also show market efficiency.”176

### IV. The Interrelationship of Reliance, Materiality and Loss Causation

#### A. Fraud on the Market Reliance and Materiality: The Amgen Confusion

170 *Id.* at 480-483.
171 *Id.* at 497.
172 *Id.* at 494-495.
173 *Basic at Twenty, supra* note 105, at 167.
174 *Id.* at 173.
175 *Id.* at 170.
Justice Ginsburg’s opinion in *Amgen*\(^{177}\) – in rejecting the requirement that plaintiff must prove materiality in order that a class be certified – was characterized by the dissenters as simplistic and illogical\(^{178}\) and further muddied the waters as to what must be proved and when.

Justice Ginsburg acknowledged that materiality “indisputably “is an “essential predicate of the fraud-on-the-market theory.”’\(^{179}\) She also acknowledged that materiality is an essential element of a Rule 10b-5 cause of action.\(^{180}\) However, since materiality is an objective standard, the issue of materiality is common to all class members and thus need not be proved at the class certification stage.\(^{181}\) Rather, it is an element of a Rule 10b-5 action that will be determined on the merits at trial. Thus far the opinion makes sense.

However, Justice Thomas, speaking for the dissenters, noted that materiality is an element of the fraud on the market theory and critiqued the majority opinion on the basis that “the Court transforms the predicate certification inquiry into a novel either-or inquiry occurring much later on the merits.”\(^{182}\) He argued:

According to the Court, either (1) plaintiffs will prove materiality on the merits, thus demonstrating *ex post* that common questions predominated at certification, or (2) they will fail to prove materiality, at which point we learn *ex post* that certification was inappropriate because reliance was not, in fact, a common question. In the Court’s second scenario, fraud on the market was never established, reliance for each class member was inherently individualized, and Rule 23(b)(3) in fact should have barred certification long ago. The Court suggests that the problem created by the second scenario is excusable because the plaintiffs will lose anyway on alternative merits grounds, and the case will be over.\(^{183}\)

Justice Ginsburg’s holding that materiality need not be proved at the class certification stage would seem to be sophistry if, in establishing reliance through fraud on the market, materiality must be proved at the class certification stage as an element of the fraud on the market doctrine. On the other hand, her opinion would make sense if either there are two different aspects of materiality, or if materiality is not an element of the fraud on the market hypothesis.

Justice Ginsburg’s holding could be justified on the basis that there is materiality in general and materiality specific to plaintiffs claim. Consider again Justice Roberts’ hypothetical in *Halliburton II* in which there were six events studies, one of which involved the specific

\(^{177}\) *Amgen*, 133 S. Ct. 1184 (2013).

\(^{178}\) *Id.* at 1206.

\(^{179}\) *Id.* at 1195.

\(^{180}\) *Id.* at 1191.

\(^{181}\) *Id.* at 1197.

\(^{182}\) *Id.* at 1211.

\(^{183}\) *Id.*
misrepresentation alleged by plaintiffs as the basis for their suit; even though there was no price impact with respect to the specific misrepresentation challenged in the suit, the evidence showed an efficient market. To Justice Roberts, it would make no sense to certify the class action in such a situation.

But what if defendant and/or plaintiff had provided price impact with respect to five events, none of which involved the current alleged misrepresentation, but all of which showed price impact, consequently compelling the conclusion that the market was efficient? Here we have an alleged misrepresentation which is made in an efficient market which, under Basic, should support a presumption of reliance – and the materiality of the misrepresentation which led to the present litigation would be determined at trial. This is an example of materiality in general but not with respect to the particular case. While this is a possibility, it is not a very likely possibility.

The materiality of the litigated misrepresentation is not necessarily relevant to the question of whether the market is efficient. Arguably, the market impounds all information, both material and immaterial, since the price of the stock impounds many pieces of information, any one of which might not be significant but could become significant in the aggregate. Consequently, whether the alleged misrepresentations were material or not does not necessarily impact reliance. The investor would rely upon the integrity of the market price, according to Basic, or on the total mix of information in the market, according to this article, in purchasing the stock – irrespective of whether the investor was defrauded through misrepresentations or otherwise. Whether the investor relied and whether the investor was defrauded are two separate questions.

This conclusion is supported by the facts of the Basic case. The District Court certified the class on the fraud on the market theory, but granted a motion for summary judgment on the ground that the misrepresentations were not material. Thus, at the District Court level, the court certified a class irrespective of the materiality of the representations.

Notwithstanding the foregoing defense of Justice Ginsburg’s opinion, if materiality is an element of the fraud on the market theory, that it makes no sense to litigate the issue twice. Arguably, if lack of materiality is established in the certification process, then issue preclusion should prevent relitigation of this issue. But, according to Justice Thomas, what is the point of continuing the litigation if, at the certification stage, we know the plaintiff cannot prevail?

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184 Halliburton, 134 S. Ct. at 2415.
185 His discussion of the consequences of the foregoing is confusing since he posits that there is an efficient market but in summarizing plaintiff’s view, states that the “action should be certified and proceed as a class-action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed.” Id. But, if the class were to be certified, this would mean that the fraud-on-the-market theory did apply. The paradox is that the class action could proceed even though the ultimate result is already known, namely, the plaintiff must fail because plaintiff cannot establish price impact, which means either that the misrepresentation was not material or that there were no damages.
B. Materiality, Price Impact and Loss Causation

Price impact, materiality, and loss causation are all intensely factual issues which should be determined in a trial on the merits, before a trier of fact which could well be a jury, not in a mini-trial at the class certification stage, with a judge determining the factual issues. Previous Supreme Court decisions have determined that neither materiality\textsuperscript{186} nor loss causation\textsuperscript{187} need be proved by plaintiff at the class certification stage, but Justice Roberts, in \textit{Halliburton II}, determined that “defendants may introduce price impact evidence at the class certification stage, so long as it is for the purpose of countering a plaintiff’s showing of market efficiency, rather than directly rebutting the presumption [of reliance].”\textsuperscript{188}

But, price impact, materiality, and loss causation are all interrelated. Thus, evidence related to all three will be adduced at a class certification stage and, if plaintiff is successful in achieving certification, again at the trial on the merits stage. For example, the expert report of plaintiffs in \textit{Halliburton II}\textsuperscript{189} dealt with market efficiency (of which price impact is a factor),\textsuperscript{190} materiality,\textsuperscript{191} and loss causation.\textsuperscript{192} With respect to materiality, Ms. Nettesheim, plaintiffs’ expert, stated:

\begin{quote}
It must be noted that a statistically significant change in a company’s security’s price (net of market and industry effects) is an indicator that new company-specific information has dramatically changed the total mix of information about a company.... Information “important enough to affect security prices when publicly released provides compelling evidence that a reasonable investor would consider the information important in making an investment decision.”\textsuperscript{193}
\end{quote}

Thus, the correlation of price impact upon materiality; further, without price impact, there would be no loss causation.

\textsuperscript{186} \textit{Amgen, discussed supra} text at notes 177-185.
\textsuperscript{187} \textit{Halliburton I, discussed supra} text at notes 91-92.
\textsuperscript{188} \textit{Halliburton II}, 2014 WL 2807181, at 15.
\textsuperscript{190} \textit{Id.} at 167a-208a.
\textsuperscript{191} \textit{Id.} at 208a-213a.
\textsuperscript{192} \textit{Id.} at 213a-262a.
If investors are rational, and there is thinking that questions that,\textsuperscript{194} and if there is no market manipulation,\textsuperscript{195} then immaterial information, by itself, should have no impact on price and material information should affect the price. Much of the alleged fraud in publicly traded securities arises from the attempt of management to maintain the price of the stock when management knows that the position of the company is deteriorating. In such a situation, the arguably material misrepresentation takes place at one point in time and the price impact is reflected at another point in time, when the truth comes out. But the materiality of the information will be evidenced by the price impact when the truth comes out.

Again, consider the \textit{Tellabs} situation. In December, 2000 through March, 2001, the CEO made the misleading statements with respect to the continued growth of the company. In June, \textsuperscript{194} Arguably, markets are plagued by herding behavior and groupthink. See Jeremy Clift, \textit{Questioning a Chastened Priesthood}, Int'l Monetary Fund, Sept 2009, \textit{available at} http://www.imf.org/external/pubs/ft/fandd/2009/09/people.htm; see generally, Martin Sewell, \textit{Behavioral Finance} (rev’d 2010), http://www.behaviouralfinance.net/behavioural-finance.pdf. See also Kahneman, \textit{supra} note 122. \textsuperscript{195} When the market goes up and the economic and political news is negative, it could be asserted that either the market is not rational or that the market is being manipulated. In the last six months, the Dow Jones Industrial Average has moved from under 16,000 to over 17,000 before, in the first part of August, 2014, falling back to the middle of that range. The only positive domestic economic news has been in job gains, but the wages in the new jobs are 23\% lower than the jobs that were lost in the recession. U.S. Conf. of Mayors, U.S. Metro Economies – Income and Wage Gaps across the U.S., p.2, fig. 1, \textit{available at} http://www.usmayors.org/metroeconomies/2014/08/report.pdf. Thus, purchasing power is lagging. Capital expenditures are 15\% less than the pattern prior to the recession; businesses are holding onto $1.8 trillion in cash, rather than investing to create jobs and increase productivity. Jamie McGeever, \textit{’Capex’ Mystery Confounds Experts}, Chi. Trib., Aug. 12, 2014, at §2, p.1. Externally, the economy of Europe is shaky, growth in China has dropped, Russia is threatening war with the Ukraine, Israel and Hamas are at war, and Iraq and Syria are in chaos. What is the news that is driving the overall market?

The market for individual stocks is also of questionable rationality. When you compare the price of Amazon on August 1, 2013 with that of August 1, 2014, the price would appear to be essentially flat. Amazon closed at 305 on August 1, 2013, and at 307 on August 1, 2014. But the price of Amazon dropped to 279 on August 28, 2013 and then rose to 399 on December 2, 2013. This is a 43\% increase in a little over three months. It rose to 408 on January 22, 2014 but then dropped to 337 on February 5, 2014. This is a 17\% drop in two weeks. It then rose to 383 on March 13, 2014, or 13\% increase in a little over a month, before dropping to 284 on May 9, 2014. This is a 25\% drop in less than two months. It then rose to 364 on July 24, 2014, a 28\% increase in a little over two months, before dropping to 304 on August 1, 2014, a 16\% drop in a week. Amazon’s P/E ratio is almost 500. Data \textit{available at} http://finance.yahoo.com/q/hp?s=AMZN+Historical+Prices. The volatility of Netflix was even greater. Its price rose from 319 on January 15, 2014 to 457 on February 25, 2014, a 42\% increase in less than a month and a half. It then dropped to 299 on April 28, 2014 a 34\% drop in two months. Finally it rose to 475 on July 2, 2014, a 58\% increase in a little over two months. Netflix P/E ratio is around 160. Data \textit{available at} http://finance.yahoo.com/q?s=NFLX&ql=0. At best, this is a pattern of trading, not investing, and, at worst, raises a question of manipulation. The market for the stocks would certainly seem to be “efficient.” Amazon has a market capitalization over $140 billion and an average daily volume of about 3.8 million shares. Netflix has a market capitalization of about $26 billion and an average daily volume of about 2.7 million shares. There appears to be little in the way of “news” that would justify price swings of such magnitude.
when the truth came out, namely, that sales of a major product had markedly decreased, the price of the stock plummeted. This is a pattern that repeats itself over and over again. Consequently, there is a clear correlation between the materiality of an alleged misrepresentation, the price impact of such misrepresentation, and plaintiff’s damages. It would seem logical and efficient that these issues would then be litigated at the same time.

Justice Roberts, in *Halliburton I*, determined that loss causation need not be established at the class certification stage since reliance relates to the transaction causation and not loss causation. Thereafter, Justice Ginsburg, in *Amgen*, determined that materiality need not be proved at the class certification stage, because materiality is common to all plaintiffs as it is an objective standard. But if price impact is litigated at the class certification stage, according to Justice Roberts in *Halliburton II*, then we are once again bifurcating issues that ought to be tried together. From the standpoint of judicial economy and cost of litigation, these intensely factual issues should be determined in a trial on the merits. This would be possible if we backed away from the current interpretation of fraud on the market as indicating reliance on price integrity and recognized that what the market relies upon is information integrity.

V. Fraudulent Distortion.

As this article was nearing completion, a very thoughtful article by Professors Bebchuk and Ferrell was published in the Business Lawyer. While the article was published after the Supreme Court decided *Basic*, an earlier draft of the article had been circulated before the briefing of the case and was cited by the main briefs of both sides. Briefly stated, the authors would replace reliance on the efficiency of the market with “reliance on the market price not being impacted by (and thus reflecting) misstatements and omissions” or, in other words, not being impacted by fraudulent distortion.

The foregoing authors do an excellent job in arguing against the continued reliance on market efficiency as a basis for presuming reliance. While the courts, in dealing with the fraud on the market presumption, have treated efficiency as a binary concept – the market is either efficient or does not efficient – Professors Bebchuk and Ferrell also argue that efficiency is a continuum.

While the approach of Professors Bebchuk and Ferrell is superior to the present focus on market efficiency, it poses two difficulties. First of all, it is phrased in the negative, namely, that investors rely upon an absence of fraudulent distortion and, secondly, it posits that investors rely

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196 See, e.g., the cases discussed in *Alternate Universe, supra* note 10.
198 The article was published in the May issue of The Business Lawyer, but was not distributed until late July or early August. The decision of the Supreme Court was on June 23, 2014.
199 *Rethinking Basic, supra* note 197, at 675.
200 Id.
201 Id. at 689-690.
upon a result rather than a cause. Once again, consider *Tellabs*. When management states that one major product is experiencing high demand, whereas in fact demand is drying up, and that a successor product is ready to ship, when in fact it is not, the market price is maintained at an artificially high level. This is in fact fraudulent distortion. But what investors rely on is that the information introduced into the market by management is in fact truthful and accurate. If management had said that Tellabs’ business was substantially declining, investors would not have bought at the then existing market price. What investors rely upon is the truthfulness of the information in the market.

Moreover, any liability regime which posits reliance on the price of a security remains open to those who argue that investors do not rely on the price of the security. Professors Bebchuk and Ferrell assert that “[u]nder our approach, market prices need not be relied on or assumed by investors to reflect true value. Fraudulent distortion merely turns on whether the market price is different from what it otherwise would have been absent the fraud.” 202 What then do investors rely upon? If you assert that they rely upon a price not affected by fraudulent misrepresentations, are you not really asserting that they rely upon the truthfulness of the mix of information in the marketplace?

The professors phrased the fraud on the market rule as consisting of three propositions:

- (i) The price of a security traded in an efficient market will reflect all publicly available information about a company;
- (ii) Accordingly, a buyer of the security in an efficient market may be presumed to have relied on public information and purchasing the security;
- (iii) Where the market for a security is inefficient, a plaintiff cannot invoke the fraud-on-the-market presumption.

They then recast the foregoing propositions as follows:

- (i) The price of a security traded in an efficient public market will reflect all some publicly available information about a company;
- (ii) Accordingly, a buyer of the security in an efficient public market may be presumed to have relied on public information in purchasing the security on the market price not being fraudulently distorted, i.e., not being different from what it would have been absent the disclosure deficiency; and
- (iii) Where the market price for a security is inefficient not fraudulently distorted, a plaintiff cannot invoke the fraud-on-the-market class-wide reliance presumption.

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202 *Id.* at 688.
203 *Id.* at 685.
204 *Id.* at 686.
Let’s examine this new proposition. First of all, it recognizes that a public market need not impound all publicly available information before investors can be defrauded by misleading statements by corporate management. This is sound. Secondly, it recognizes that misleading information may have the effect of distorting price. This also is sound. But their third proposition then uses the presence or absence of price distortion to determine reliance, whereas the existence of price distortion, or the lack thereof, much more logically relates to both materiality and loss causation. In addition, this approach arguably is also subject to the issues raised by Justice White in his dissent in Basic.

As stated earlier, what investors really rely upon is the truthfulness of the information that is in the public markets. In the Tellabs example, investors relied upon the public information that the sales of the 5500 continued apace and that the 6500 was ready for shipment and customers are eagerly awaiting it. If management had told the truth, investors would not have bought and the price of Tellabs’ stock would have plummeted, as it did when the truth was revealed.

Let me paraphrase what I have been asserting in this article as a modification of Professors Bebchuk and Ferrell’s modification of the three Basic propositions. Thus:

(i) The price of a security traded in a public market will reflect some publicly available information about a company; [thus, my first proposition would be identical to the theirs, although I would accept substituting “most” for “some”]

(ii) Accordingly, a buyer of the security in a public market may be presumed to have relied on public information in purchasing the security; and

(iii) A defendant may rebut the presumption of reliance by proving that the misrepresentation did not affect the decision of the investor to purchase.205

This is clearly a simpler approach to the issue of reliance. Arguably, it is also more straightforward. Adopting this approach would undoubtedly enrage defendants’ counsel and the Business Roundtable since it would simplify the certification process and eliminate all the litigation over market efficiency. It would then leave the issues of materiality and loss causation to trial since they are factual issues common to all the plaintiffs. On the other hand, if an alleged material misstatement is so insubstantial as to be determined immaterial as a matter of law, this could be dealt with at the class certification stage or on a motion to dismiss or for summary judgment. All that would need to be established at the class certification stage is that the defendant company, and its management, inserted misleading material in the public market place. I would also accept a limited determination of materiality at the class certification stage,

205 All of these three-proposition formulations are assuming that the plaintiff is a purchaser. This is because most of the time management is trying to support the price of the shares and the purchaser overpays. In other words, management is putting good news into the marketplace. However, Basic itself dealt with a “Bad news” situation, i.e., that no merger negotiations were taking place. In such a situation the focus would be upon the seller being defrauded.
namely, whether the alleged misrepresentations were of the kind that a reasonable investor would normally rely upon.

Another way of comparing this approach to that of Professors Bebchuk and Ferrell is that their approach would permit, at the class certification stage, what Justice Roberts ultimately held in Halliburton II: that “defendants must be afforded an opportunity before class certification to defeat the presumption to evidence that an alleged misrepresentation did not actually affect the market price of the stock.” While Professors Bebchuk and Ferrell did not take a definitive position on whether the plaintiff or the defendant, at the class certification stage, should have the burden of proof on price impact, Justice Roberts appears to make the lack of price distortion an affirmative defense, with respect to which the defendant should have the burden. Putting that issue to one side, their approach clearly presents this issue of price impact for resolution at the certification stage, with the bifurcation of issues that ought to be tried together.

On the other hand, under the approach advocated by this article, reliance flows from “information distortion,” not price distortion. Accordingly, at the certification stage, the only issue for resolution is whether the defendant corporation and its management had introduced misleading information into the marketplace. If they have, reliance should be presumed. It could be argued that the effect of this approach is to make class certification a routine matter. And that is correct. It should be a routine matter, as it was before courts started using the class certification process for a mini trial. As has been developed in this article, factual matters, such as materiality, price distortion and loss causation, together with scienter, should be developed in one proceeding at trial.

Conclusion

Where are we after the Sturm und Drang of three United States Supreme Court decisions in three years grappling with the contours of the fraud on the market theory? I would argue that the present legal regime for private securities litigation is irrational, wasteful and inefficient, biased in favor of management as opposed to investors, and built on illusion, not reality. The Supreme Court is wandering in an illogical thicket from which it cannot extricate itself. It is ideologically divided: the conservatives are on a mission to protect business and management, sometimes corrupt management, from the onslaught of consumers, employees and investors, while the liberals are fighting a rearguard action to prevent as much damage as possible.

Consider the contours of a private securities case. Plaintiff files a complaint which must set forth the misrepresentations with specificity – sufficient particularity to satisfy the sometimes unreasonable expectations of the federal courts – and must also set forth facts giving rise to a strong inference of scienter. Plaintiff is then met with a motion to dismiss which is to be heard before plaintiff has an opportunity for discovery. The detail expected by federal courts often can

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206 Halliburton, 134 S. Ct. at 2417.
only be obtained through confidential informants. However, confidential informants are viewed with a high degree of suspicion by federal courts.\textsuperscript{208}

If plaintiff surmounts the motion to dismiss and the expectations of pleading particularity, the next step is class certification. Some courts bifurcate discovery between that necessary for certification and that necessary for the trial on the merits. Supposedly, the discovery for class certification would be limited but, as a result of \textit{Halliburton II}, defendant can now raise price impact, which is intimately related to materiality and loss causation. However, plaintiff is entitled to a presumption of reliance, or transaction causation, as a result of the fraud on the market theory. But one of the elements of the fraud on the market theory, according to the courts, is materiality which, according to \textit{Amgen}, is a matter to be addressed at trial on the merits. Is this the clarity we would expect when billions of dollars are at stake?

According to most courts, the benefit of the fraud on the market presumption is only available when the market is efficient. Market efficiency is a concept developed by economic and finance professors to support the arguable proposition that the individual investor cannot beat the market. Its origins had nothing to do with securities fraud. The Nobel Prize in economics has been awarded to two professors who have opposed viewpoints on whether or not the market is efficient. Courts seem to regard market efficiency as a binary proposition and expect that, in an efficient market, material information will be quickly – in as little time as one day – impounded into the price of the company’s stock. They give no credence to the idea that there are degrees of market efficiency, degrees of materiality, varying modes of communicating information to the market, varying probity of the sources of the information, and different degrees of complexity of the information so transmitted – all of which logically would affect the time necessary for information to be impounded into the market. This is a legal structure built upon an illusion.

Since the reality is that there is no such thing as a perfectly efficient market, as one scholar has stated, “it becomes easy for a court to miss the forest for the trees by accepting too readily the defendants’ statistical evidence of imperfection as reason not to certify.”\textsuperscript{209}

If plaintiff does not succeed in obtaining class certification, that is usually the end of the litigation since most individual plaintiffs do not have a sufficient economic stake to carry on the cost of litigation on their own. If plaintiff does succeed in certification, we then move on to discovery on the merits and eventually to trial.

Materiality, price distortion, and loss causation are all intertwined and highly factual issues. But the effect of these three Supreme Court decisions is to bifurcate these issues. This only adds to the expense and confusion of litigation.

\textsuperscript{208} See, e.g., \textit{Higginbotham v. Baxter Int’l Inc.}, 495 F.3d 753, 757 (7th Cir. 2007) (Judge Easterbrook asserted that information supplied by confidential sources must be "discounted," usually "steep[ly].")

\textsuperscript{209} \textit{Id.} at 173.
After almost 70 years of private securities litigation, it is time to step back and examine whether or not there is a more sensible approach. The starting place would be the securities laws themselves and the purposes for which they were enacted. The prevalence of fraud in the securities markets was clearly an impetus for the enactment of the securities laws; it is further clear that the securities laws were enacted for the protection of investors and to insure the maintenance of fair and honest markets. Moreover, as former Justice Stevens has stated, “[f]ashioning appropriate remedies for the violation of rules of law designed to protect a class of citizens was a routine business of judges,”210 or at least it was until a supposedly conservative, but in reality reactionary, Supreme Court began cutting away at investor protection.

As other scholars have recognized, “proving the efficiency of the market as a whole is only an indirect means of proving that the market relied on the particular statement.”211 Basic, in discussing materiality, focused on the fact that investor would be guided by the total mix of information available. It is this total mix of information upon which the investment community relies and which determines the price of the stock. Mandatory reporting under the securities laws provides much of this mix of information, while voluntary corporate disclosures, such as in press releases and investor conference calls,212 provide additional information. This is supplemented by analyst reports and other third-party generated information.

Since a major purpose of the securities laws was to provide investors with information and since the purpose of the antifraud provisions is to ensure truthfulness, it seems far more logical to presume that investors rely upon this total mix of information, rather than the fantasy that they rely upon the integrity of market prices. What they rely upon is the integrity of the information the corporate management has introduced into the market. The integrity, or lack thereof, of market prices is a manner for a damage determination, namely, loss causation, not for reliance – transaction causation.

If this view of reliance is adopted, then the meaty, factual issues of materiality, price distortion, and loss causation can be addressed at trial – which is where they belong. Rejecting the focus on market efficiency will, first, eliminate the present practice of ruminating about some idealized notion of an efficient market and, second, eliminate the use of minor imperfections in this idealized model to justify dismissal of class certification, and thus effectively terminate what may well be a meritorious lawsuit. The focus of courts should be upon protecting investors and holding management accountable; too often the converse is true.

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211 Brief of Law Professors, supra note 106, at 24.