

No. 09-1403

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IN THE  
**Supreme Court of the United States**

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ERICA P. JOHN FUND, INC.,

*Petitioner,*

*v.*

HALLIBURTON CO.; DAVID J. LESAR,

*Respondents.*

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

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

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## SUMMARY OF ARGUMENT

Time-tested economic theory and empirical data continue to support the circumscribed economic assumption underneath *Basic*'s fraud-on-the-market presumption, namely that in an open and well-developed market, prices for a security will typically change in response to a material misstatement. Moreover, this theory and data remain a strong foundation for this Court's post-*Basic* procedural architecture for evaluating market prices, market distortions upon material misstatements, and reliance (or transaction causation) in securities litigation. This architecture – a finding of an efficient market at class certification creates a rebuttable presumption of reliance followed by a more particularized and nuanced inquiry into loss causation at the merits stage – remains an appropriate way for trial courts to sift through economic evidence to evaluate first whether material misstatements distorted market prices and, later, whether these distortions proximately caused investors' economic losses.

Yet the Fifth Circuit performed radical surgery on *Basic v. Levinson*, 485 U.S. 224 (1988) in *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010) [hereinafter *Halliburton*] and the earlier case of *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007) [hereinafter *Oscar*]. These cases graft onto *Basic* a requirement that, to receive class certification, investors must prove loss causation. *See Oscar*, 487 F.3d at 265 (“Essentially, we require plaintiffs to establish loss causation in order to trigger the fraud-on-the-market

presumption.”). This novel condition for class certification not only conflicts with the logic of *Basic*, it presents deep problems. *Halliburton* and *Oscar* conflate reliance and loss causation, even though those are doctrinally and analytically distinct elements of a 10b-5 claim. See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005). In requiring plaintiffs to prove loss causation as a condition of class certification, *Halliburton* and *Oscar* fail to consider the predominance standard of Federal Rule of Civil Procedure 23(b)(3). Plaintiffs met this standard, as loss causation in a sufficiently efficient market presents issues that predominate with respect to all class members. See, e.g., *Schleicher v. Wendt*, 618 F.3d 679, 681 (7th Cir. 2010) (“whether the false-hoods affected the stock’s price” is a common question). Nevertheless, *Halliburton* and *Oscar* effectively require that investors win a mini-trial on the merits at class-certification contrary to *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974).

*Halliburton* and *Oscar* force a premature analysis of difficult issues of loss causation without the kind of full factual record that provides a reliable foundation for determining whether material misstatements or omissions proximately caused an economic loss to investors. *Halliburton* and *Oscar* require that, to achieve class certification, investors must prove by a preponderance of the evidence that specific misstatements or corrective disclosure caused particular stock price moves. See *Halliburton*, 597 F.3d at 341 (plaintiff is required “to demonstrate that there is a reasonable likelihood that the cause of the decline in price is due to the revelation of the truth and not the release of the unrelated negative information.”) (internal quotation marks omitted); *Oscar*,

487 F.3d at 266.<sup>1</sup> *Halliburton* and *Oscar* thus frustrate a careful untangling of possible confounding causal factors that may explain why prices did move or did not move in response to the revelation of an earlier misstatement. If investors cannot isolate at the class certification stage the causation attributable to fraud from that caused by confounding factors, *Halliburton* and *Oscar* preclude class certification. See *Halliburton*, 597 F.3d at 336; *Oscar*, 487 F.3d at 266. Moreover, *Halliburton* and *Oscar* invite defendants to mask the price effects of corrective disclosure behind the noise of other disclosure or even fresh misstatements. Without fuller discovery, courts and investors lack the ability to uncover this camouflage.

**I. Loss Causation Presents Issues that Predominate with Respect to the Proposed Class in *Halliburton*, Rendering Loss Causation an Improper Condition to Class Certification Under Rule 23.**

Despite their conflation in *Halliburton* and *Oscar*, reliance and loss causation represent doctrinally distinct elements of a Rule 10b-5 claim. See *Dura*, 544 U.S. at 342.<sup>2</sup> This distinction reflects a basic analytical

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1. “In such multi-layered loss-causation inquiries, the legal standard . . . requires that plaintiffs prove (1) that the negative “truthful” information causing the decrease in price is related to an allegedly false, non-confirmatory positive statement made earlier and (2) that it is more probable than not that it was this negative statement, and not other unrelated statements, that caused a significant amount of the decline.” *Id.* (internal quotation marks omitted).

2. The common law origins of these elements of a 10b-5 claim also highlight their conceptual differences. Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 Iowa L. Rev. 811, 829 (2009).

difference between reliance and loss causation that becomes apparent when comparing *Basic* and *Dura*. In proving that a well-developed and open market exists, investors establish a mechanism by which misstatements are shown to generate distortions in market prices. *See Basic*, 485 U.S. at 244. Price distortions, alone, however, do not prove that misstatements proximately caused economic losses to investors. *See Dura*, 544 U.S. at 344-45. The element of loss causation then handles the vexing questions of whether supervening causes other than the price distortion – for example, a business suffering losses unrelated to the misstatement – generated the subsequent economic losses to investors. *See Dura*, 544 U.S. at 342-43.

Yet *Halliburton*, by extending the rule of *Oscar*, conflates loss causation and reliance by effectively making loss causation a condition to a presumption of reliance. *Basic* held that investors are entitled to a presumption of reliance if they traded in the security at issue during the proposed class period in reliance on the integrity of a price set in an open and impersonal market. *See Basic*, 485 U.S. at 244, 247. As explained in Part II of this brief, to benefit from this presumption, investors must prove that the market for a particular security has the requisite informational efficiency, such that prices in that market generally respond to material information, including material misstatements. *Cf. Basic*, 485 U.S. at 247 (“ . . . where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market may be presumed.”). Investor proof that the particular market is sufficiently efficient leads to a presumption that a material misstatement of omission distorted the market price. *See Basic*, 485 U.S. at 246-47. *Oscar*, on the other hand, requires that investors prove

the separate element of loss causation as a condition to *Basic*'s presumption and to class certification. *Oscar*'s new rule requires, in turn, proof that supervening factors other than a price distortion generated by a material misstatement or omission did not cause the economic losses to investors. *See Oscar*, 487 F.3d at 265. In his dissent in *Oscar*, Judge Dennis stated succinctly that requiring loss causation as a condition to *Basic*'s presumption of reliance “subverts the fraud-on-the-market presumption by requiring the plaintiffs to prove, as a precondition to the application of the presumption, the very facts that are to be presumed under *Basic* (i.e. that the defendant’s material misrepresentation was reflected in the stock price).” *Oscar*, 487 F.3d at 274 (Dennis, J., dissenting).

Investors indeed have to prove the separate element of loss causation. *Dura*, 544 U.S. at 342. However, they must do so at the merits stage, not as a condition to class certification. *See Schleicher*, 618 F.3d at 681 (holding that “[w]hether the false-hoods affected the stock’s price” is a common question, which would make class treatment appropriate under Rule 23(b)(3)). Whether a class should be certified turns on whether the proposed class meets the standard of Rule 23(b)(3), not on the policy views of courts on the *in terrorem* power of certification. *Compare id.* at 686 (“We do not think it appropriate for the judiciary to make its own further adjustment by reinterpreting Rule 23 to make likely success on the merits essential to class certification . . .”) *with Oscar*, 487 F.3d at 267 (“We cannot ignore the *in terrorem* power of certification . . .”).

The distinction between reliance and causation matters intensely for purposes of class certification under Rule 23(b)(3). Reliance is typically a gateway issue for class certification. As *Basic* explained, without the fraud-



on-the-market presumption, no class could have been certified in that case. *Basic*, 485 U.S. at 242 (“Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.”).<sup>3</sup> By contrast, when reliance is presumed under *Basic*’s fraud-on-the-market theory (which involves the circumscribed economic assumption and the rigorous procedure described in Part II of this brief), loss causation presents issues that do not vary from investor to investor, but instead are common to an entire class. See *Schleicher*, 618 F.3d at 681 (“whether the false-hoods affected the stock’s price” is a common question); Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. 151, 185 (reliance on a distorted price is common to all class members). More particularly, questions of whether a misstatement or subsequent corrective disclosure moved or did not move the price of a security affect the class as a whole.

Plaintiffs might lose on the issue of causation at the merits if the evidence fails to establish a causal connection between Halliburton’s misstatements and movements in the price of that company’s stock. However, this would

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3. The fraud-on-the-market presumption does not mean that common issues inevitably predominate with respect to the issue of reliance. In unique fact patterns, there may still be significant differences among plaintiffs of a proposed class that make certification inappropriate under the predominance standard of Rule 23. See, e.g., *In re Public Offering Sec. Litig.*, 471 F.3d 24, 43-44 (2d Cir. 2006) (precluding certification of class in which many institutional plaintiffs knew of, or participated in, alleged underwriter practices with respect to initial public offerings).

translate into a fatal weakness in the case of all plaintiffs.<sup>4</sup> Accordingly, under Rule 23(b)(3), common questions on the issue of loss causation predominate, and loss causation is an improper condition to the certification of a class. *See Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 623 (1997) (“The Rule 23(b)(3) predominance inquiry tests whether proposed classes are sufficiently cohesive to warrant adjudication by representation.”).<sup>5</sup>

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4. “When the concern about the proposed class is not that it exhibits some fatal dissimilarity but, rather, a fatal similarity - a failure of proof as to an element of the plaintiffs’ cause of action - courts should engage that question as a matter of summary judgment, not class certification.” Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. Rev. 97, 107 (2009).

5. Though the *level* of distortion may vary over the course of a class period, any potential variance in distortion over time would affect the amount of damages, not to the plaintiff’s ability to prove the elements of her case. *See Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1975), *cited with approval in Basic*, 485 U.S. at 245 & 247 n.25; *In re LTV Sec. Litig.*, 88 F.R.D. 134, 142 (N.D. Tex. 1980), *cited with approval in Basic*, 485 U.S. at 244 & 246 n.24; *cf. Miller v. Asensio & Co.*, 364 F.3d 223, 232 (4th Cir. 2004) (holding that the element of loss causation is satisfied if some portion of the loss was due to fraud; the precise amount is a damages question); *Robbins v. Koger Props. Inc.*, 116 F.3d 1441, 1447 n.5 (11th Cir. 1997) (same). The requirement to prove damages is itself a distinct element of Rule 10b-5 claims. *See Dura*, 544 U.S. at 342, 15 U.S.C. § 78u-4(b) (4) (2011). A class may be certified notwithstanding the necessity for individualized damages determinations. *See McLaughlin v. Am. Tobacco Co.*, 522 F.3d 215, 231 (2d Cir. 2008). *Kohen v. Pac. Inv. Mgmt. Co. LLC & PIMCO Funds*, 571 F.3d 672, 676 (7th Cir. 2009). This Court implicitly recognized as much in *Basic*, when it held that any dissipation of artificial inflation over the course of the class period should be determined at trial. *Cf.* 485 U.S. at 249 n.29. Trial courts can determine the different damages of individual plaintiffs in a class. *Schleicher*, 618 F.3d at 682.

Under Rule 23, a class action may be maintained if Rule 23(a) is satisfied and *any* one of the three elements of Rule 23(b) is satisfied. In rejecting class certification, *Halliburton* and *Oscar* ignore the last of these three elements, the predominance standard of Rule 23(b) (3). The failure of *Halliburton* and *Oscar* to base their rulings on whether the proposed class satisfies Rule 23(b) contravenes *Eisen*, in which this Court stated, “[i]n determining the propriety of a class action, the question is not whether the plaintiff or plaintiffs have stated a cause of action or will prevail on the merits, but rather whether the requirements of Rule 23 are met.” *Eisen*, 417 U.S. at 178.

**II. *Basic*’s Fraud-on-the-market Presumption Remains Justified, Its Limited Economic Assumption Remains Grounded in Economic Research, and Its Procedural Framework Provides Appropriate Mechanisms to Ensure that Prices in a Specific Market Would Respond to Material Information.**

*Halliburton* and *Oscar* introduce confusion regarding the current state of economic theory and evidence on market efficiency and their implications for *Basic*’s rebuttable fraud-on-the-market presumption. We believe that Judge Easterbrook’s analysis in *Schleicher*, 618 F.3d 679, reflects a well-considered and concise analysis of the rationale and circumscribed economic assumption behind *Basic*’s fraud-on-the-market presumption. Judge Easterbrook has been influential in the development of the fraud-on-the-market theory in the courts and in the academy. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. at 164. Although we may not all agree with every detail of his analysis, we write to reinforce generally Judge Easterbrook’s reasoned support for *Basic* and his criticism of *Oscar* in *Schleicher*.

Below, we underscore the sensible purpose for which *Basic* created the fraud-on-the-market presumption, the circumscribed economic assumption behind this presumption, and the fact that this assumption does not rise or fall on current research on the Efficient Market Hypothesis (EMH) as a general economic proposition. *See Basic*, 485 U.S. at 246 n.24. Instead, *Basic*'s limited economic assumption depends on a reasonable procedural framework for determining that prices in the market for a particular security typically change in response to new material information. Understanding the purpose of the fraud-on-the-market presumption, the limited assumption underlying the presumption, and the rigorous procedure for triggering the presumption ensures that fast-and-loose translations of descriptive research and empirical questions on the EMH do not result in ill-considered changes to time-tested legal rules. These time-tested, durable, and reasonable rules include the nuanced procedural framework created by this Court in *Basic* and radically altered by *Halliburton* and *Oscar*. This framework includes a requirement that investors prove by a preponderance of evidence that the market for the security at issue is sufficiently efficient at the class certification stage. *Cf. Basic*, 485 U.S. at 248. By proving that the market for the particular security in question has the requisite efficiency, investors both establish that a material misstatement would distort the market price and trigger the fraud-on-the-market presumption. *Cf. id.* at 247-48. Defendants can rebut this presumption. *Id.* at 248. Moreover, plaintiffs must then prove the separate element of loss causation. *See Dura*, 544 U.S. at 342-43. This procedural framework, when combined with the other requirements for a Rule 10b-5 claim, remains an appropriate way for trial courts to sift through economic evidence in Rule 10b-5 actions.

*Basic* held that the presence of an impersonal and well-developed market permitted a presumption that investors could rely on the integrity of the market price (not that they actually relied). *See Basic*, 485 U.S. at 245-47. This reveals the rationale for the fraud-on-the-market presumption. The Court held that the presumption facilitated investor reliance on the integrity of the market price, or, in other words, that the price was undistorted by fraud. *See id.* at 245-47. The presumption thus serves the same rationale as common law fraud rules, which allow parties to rely on representations of others without regard to their trustworthiness in order to facilitate confidence and economic exchange. *See Blackie*, 524 F.2d at 907 (“The statute and rule are designed to foster an expectation that securities markets are free from fraud - an expectation on which purchasers should be able to rely.”); Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. at 161, Richard A. Posner, *Economic Analysis of Law* 111-14 (7th ed. 2007). The pragmatism of the presumption lies at the heart of the folksy, yet profound insight in *Basic*: “[w]ho would knowingly roll the dice in a crooked crap game?” *Basic*, 485 U.S. at 247.<sup>6</sup>

*Basic*’s fraud-on-the-market presumption in turn rests on a very limited, but fundamental economic assumption, namely that, in a particular market with sufficient informational efficiency a material misstatement, typically

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6. *Basic* was not the first time this Court created a presumption of reliance. In *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128 (1972), the Court created a presumption of reliance in the case of a failure to disclose. *Id.* at 153-54. Without that judicially-created presumption, investors could offer little proof that their investment decisions would have changed but for omitted statements and much fraud would go un-checked.

affects and distorts the market price of a security (or, alternatively, prices would have changed but for a material omission). *See id.* at 246-47. Without relying on technical economic research, *Basic* assumed that when the market for a company's securities was open and developed, material misstatements would typically impact and distort the price of those securities. *See id.* If investors meet the burden of proving that a particular market is sufficiently efficient, then *Basic* creates a rebuttable presumption that the reliance element of a 10b-5 claim is satisfied. *See id.* at 248. The economic assumption that undergirds *Basic*'s holding is tightly circumscribed. *Basic* does not rest on more ambitious claims that prices in a particular market reflect some "intrinsic" value of the security in question. *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 14-16 (1st Cir. 2005).<sup>7</sup> Nor, as we explain below, does the fraud-on-the-market presumption depend on whether prices in a particular market incorporate *all* public information or instantaneously react to information, or that exceptions to the tendency of prices to change on disclosure of material information do not exist. Nor did *Basic* premise the fraud-on-the-market presumption on an actual belief by investors that a market is efficient.<sup>8</sup>

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7. *PolyMedica* explains that *Basic*'s fraud-on-the-market presumption requires courts to gauge whether prices in a particular market respond to material information, not whether prices respond "correctly" or whether they accurately reflect "fundamental value." *Id.*

8. In fact, if all investors believed either the semi-strong or strong versions of efficiency described below, they would have little incentive to trade, as they would not expect to make a profit. The informational efficiency of markets depends on a sufficient number of investors trading off the belief that they can profit off information and this trading then quickly closing any

Understanding the limited purpose of *Basic*'s presumption and the limited economic assumption on which it is based clarifies the relationship of the presumption to the EMH. This clearer understanding warns against oversimplified claims that empirical findings of exceptions to the EMH must mean that *Basic*'s fraud-on-the-market presumption is no longer reasonable. The EMH speaks to the informational efficiency of securities markets, *i.e.* the impact and speed by which information influences security prices, and comes in three forms. The "weak form" posits that current stock prices reflect all information on past price changes, the "semi-strong form" posits that stock prices reflect all publicly available information, and

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opportunities. See Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 Am. Econ. Rev. 393, 404 (1980) (redefining EMH by showing how trading of informed investors on small information inefficiencies drives markets towards equilibrium of information efficiency).

Many courts have recognized that the fraud-on-the-market presumption does not depend on investors believing that the market meets perfect efficiency. See *Schleicher*, 618 F.3d at 685 (7th Cir. 2010) ("Short sellers play a role in aligning prices with information under any version of the efficient capital market hypothesis."); *cf. McGuire v. Dendreon Corp.*, 267 F.R.D. 690, 695 (W.D. Wash. 2010) ("The price per share reflects all the publicly available information and the beliefs of both investors like Wilczynski, who believe the stock is undervalued, and short-sellers, who believe the stock is overvalued."); *Cf. Blackie*, 524 F.2d at 907 (9th Cir. 1975) ("A purchaser on the stock exchanges may be either unaware of a specific false representation, or may not directly rely on it; he may purchase because of a favorable price trend, price earnings ratio, or some other factor. Nevertheless, he relies generally on the supposition that the market price is validly set . . .").

the “strong form” holds that prices reflect all existing information both public and nonpublic. *See* Eugene F. Fama, *Efficient Capital Markets: a Review of Theory and Empirical Work*, 25 J. Fin. 383, 414 (1970). Empirical support for the strong form of the EMH is weak, as even the most influential economists who developed the EMH admit. *See* Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. Fin. 1575, 1603 (1991). The ability of insiders to profit off non-public information undermines claims of strong form efficiency. *See* Joseph E. Finnerty, *Insiders and Market Efficiency*, 31 J. Fin. 1141, 1148 (1976). However, the depth of evidence supporting the semi-strong form, which holds that prices in markets quickly impound all public information, spans several decades. *See, e.g., Schleicher*, 618 F.3d at 685; Fama, *Efficient Capital Markets: II*, 46 J. Fin. at 1601-02 (1991); Tarun Chordia et al., *Evidence on the Speed of Convergence to Market Efficiency*, 76 J. Fin. Econ. 271 (2005). It is a version of this semi-strong form of the EMH that influences the *Basic* presumption. *See* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907, 911 (1989).

However, we highlight the difference between the semi-strong version of the EMH, which claims that markets generally will quickly reflect all publicly available information, and *Basic*’s sharply circumscribed economic assumption that the price for a security in a particular market that has sufficient informational efficiency will change when a defendant makes a material misstatement. *See Basic*, 485 U.S. at 248 n. 28 (“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.”)<sup>9</sup> Under *Basic*, market prices need not incorporate *all* public information, but only materially misleading information. *See id.* at 246-48. The reasonableness of this assumption is buttressed by the several decades of studies cited above that support the even more expansive claims of the semi-strong version of the EMH.

The reasonableness of the limited assumption in *Basic* endures notwithstanding empirical studies (grouped in a loose field called “behavioral finance”) that report anomalies in the pricing of securities in some liquid markets.<sup>10</sup> Anomalies of interest to economists in academic

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9. The Court held,

We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory. *For purposes of accepting the presumption of reliance in this case*, we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices. 485 U.S. at 246 n.24 (emphasis added).

10. A number of behavioral finance scholars have posited that investor “irrationality” (sometimes called “noise trading” or “investor sentiment”) accounts for discrete anomalies in which prices in liquid markets seemingly do not instantaneously reflect all publicly available information. Burton G. Malkiel, *The Efficient Market and Its Critics*, 17 J. Econ. Persp. 59, 61-72 (2003). One example of an anomaly is the “January effect,” which refers to evidence that stocks experienced abnormal-risk adjusted returns in the month of January compared to the rest of the year. *See* Robert A. Haugen & Josef Lakonishok, *See The Incredible January Effect: the Stock Market’s Unsolved Mystery* (1988). Should these anomalies occur, they may create discrete

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opportunities for investors to profit based on price trends (an anomaly to the weak form of the EMH) or public information (an anomaly to the semi-strong form). *See* Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in *Handbook of the Economics of Finance Vol. 1B* 1054 (George M. Constantinides et al. eds., 2003).

Other economists have criticized the methodology used to find behavioral finance anomalies and argued that these anomalies disappear with changes in the sampling and measurement of data, including proper calculations of changes in the risk of stock. *See, e.g.*, Eugene F. Fama, *Market Efficiency, Long-term Returns, and Behavioral Finance*, 49 *J. Fin. Econ.* 283, 304 (1998); Eugene F. Fama & Kenneth R. French, *Multifactor Explanations of Asset Pricing Anomalies*, 51 *J. Fin.* 55 (1996).

In addition, both proponents of the EMH and behavioral finance scholars agree that the occurrence of many of the anomalies that would conflict with the EMH occur with much greater frequency for issuers with smaller market capitalization. *See* Barberis & Thaler, *A Survey of Behavioral Finance*, in *Handbook of the Economics of Finance Vol. 1B* at 1112; *see* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindsight Bias*, 28 *Iowa J. Corp. L.* 715, 735 (2003) (“many of the long-term pricing anomalies that cut against the efficiency of market prices largely disappear when analysts control for company size”). Scholars attribute the tendency of anomalies to occur in smaller capitalization stocks with the presence of fewer arbitrageurs, sophisticated investors who bet against anomalies. Barberis & Thaler, *A Survey of Behavioral Finance*, in *Handbook of the Economics of Finance Vol. 1B* at 1112; Gilson & Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindsight Bias*, 28 *Iowa J. Corp. L.* at 734-36.

Some economists and legal scholars have described an emerging synthesis in which empirical research shows that in developed securities markets either the weak or semi-strong form

debates on the EMH may not be significant enough to undermine the limited economic assumption of *Basic*. Concededly an anomaly may create a “mispricing” that would enable an arbitrageur to earn an abnormal risk-adjusted profit. See Gilson & Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindsight Bias*, 28 Iowa J. Corp. L. at 723-24. Yet these mispricings may not be large enough to demonstrate that material misstatements would not affect market prices. Moreover, many of these anomalies in market prices vanish with time, presumably as traders in liquid markets recognize and exploit the opportunities to profit. See Malkiel, *The Efficient Market and Its Critics*, 17 J. Econ. Persp. at 80. See also Chordia et al., *Evidence on the Speed of Convergence to Market Efficiency*, 76 J. Fin. Econ. 271.

Even if prices in a market do not adjust quickly and precisely to new information, the critical question for *Basic*'s fraud on the market presumption is not the speed of adjustment, but rather whether a market generally reacts to material information, such that a material misstatement or omission would distort the market price. See Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. at 169-70.

Of course, any good economist will insist on empirical data to justify a claim, including one that market prices generally respond to material information, including

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of EMH generally holds, but that anomalies and exceptions may apply from time to time. Gregory La Blanc & Jeffrey J. Rachlinski, *In Praise of Investor Irrationality*, in *The Law and Economics of Irrational Behavior* 542, 559-60 (Francesco Parisi & Vernon L. Smith eds., 2005) (describing behavioral finance as synthesis of empirical research on investor irrationality with widespread empirical support for the EMH).

material misstatements. So too do courts insist that plaintiffs prove every element of a 10b-5 claim. *Basic* and this Court's existing procedural framework insist on rigorous proof from plaintiffs of each element of their claim, yet require this proof in stages to allow for appropriate information gathering and minimize error in interpreting market data. Several procedural mechanisms together ensure that *Basic*'s presumption is only available when the market for a particular security is sufficiently informationally efficient.<sup>11</sup>

First, plaintiffs must prove by a preponderance of the evidence at class certification that the market for a particular security typically has the requisite level of informational efficiency. *Basic* 485 U.S. at 245-47. In measuring efficiency, economists, including those who search for market anomalies, rely heavily on event studies, statistical methods that test whether specific events affected the market price of a security.<sup>12</sup> As a tool, event

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11. Moreover, plaintiffs must prove damages or economic loss. Neither *Basic* nor earlier cases which created a presumption of reliance such as *Affiliated Ute* relaxed this requirement for plaintiffs. See *Basic*, 485 U.S. at 248 n.28 (“... our decision today is not to be interpreted as addressing the proper measure of damages in litigation of this kind.”); Cf. *Affiliated Ute*, 406 U.S. at 154-57 (evaluating damages).

12. See Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part I: Technique and Corporate Litigation*, 4 Am. L. & Econ. Rev. 141, 143 (outlining uses and proper methodology for event studies); Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 Am. L. & Econ. Rev. 380, 397-400 (2002) (outlining use of event studies in private securities litigation in wake of *Basic*); Fama, *Efficient Capital Markets: II*, 46 J. Fin. at 1599-1607 (summarizing results of decades of event studies as tests for EMH).

studies have gained wide acceptance in the community of economics and finance scholars, as well as by a wide range of federal courts in securities litigation. Bhagat & Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 Am. L. & Econ. Rev. at 397-400. Event studies can show that a market price for a particular security typically reacts to new information, demonstrating informational efficiency. *See, e.g., In re NetBank, Inc., Sec. Litig.*, 259 F.R.D. 656, 673 n.9 (N.D. Ga. 2009). However, event studies generally work less well when other causal factors, including those intentionally introduced by defendants, may confound the impact of the event being studied.<sup>13</sup> (Part III of this brief discusses how this problem is exacerbated by *Halliburton*'s unique requirement that, as a condition to class certification, investors prove that specific misstatements or corrective disclosures led to specific price movements.) Lower courts also consider a series of pragmatic factors that serve as proxies for market efficiency.<sup>14</sup>

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13. Event studies can lead to erroneous conclusions that particular event did not have a causal effect when other causes may mask the causal relationship. *See generally*, Vern R. Walker, *Restoring the Individual Plaintiff to Tort Law by Rejecting "Junk Logic" About Specific Causation*, 56 Ala. L. Rev. 381, 426 (2004) ("True causal relationships may be masked by the causal influence of other events and not revealed unless researchers manipulate and monitor the masking events."). *See also* Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. at 187.

14. Many federal courts follow *Cammer v. Bloom*, which sets forth factors for determining the requisite efficiency for the *Basic* fraud-on-the-market presumption such as (i) average weekly trading volume of a security, (ii) number of analysts covering a security, (iii) presence of market makers or arbitrageurs in a particular market, (iv) whether an issuer is eligible to file Form

Whether through event studies or the factors described above, plaintiffs must prove that markets have the requisite efficiency to trigger *Basic*'s fraud-on-the-market presumption. The case at bar does not require this Court to address the requisite level of efficiency for the fraud-on-the-market presumption of reliance nor the appropriate methods by which trial courts should determine this level of efficiency. In fact, the respondents

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S-3 with the Securities and Exchange Commission, and (v) tests of whether a stock price has reacted to unexpected information in the past. *Cammer v. Bloom*, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989). This last factor could be proven by event studies. *See, e.g., Wagner v. Barrick Gold Corp.*, 251 F.R.D. 112, 119 n.7 (S.D.N.Y. 2008). Other courts use several additional factors added by *Krogman v. Sterritt*, 202 F.R.D. 467 (N.D. Tex. 2001) including (vi) the market capitalization of the issuer, (vii) bid-ask spreads for the security, and (viii) public float, that is, the number of shares held by non-insiders. *Id.* at 471-78.

Many of these factors address the limitations that behavioral finance scholars admit exists in their study of anomalies. For example, many behavioral finance scholars believe that the active presence of arbitrageurs (a factor under *Cammer*) reduces anomalies and promotes informational efficiency. Barberis & Thaler, *A Survey of Behavioral Finance*, in *Handbook of the Economics of Finance Vol. 1B* at 1112. In addition, many anomalies disappear when economists study larger issuers. *Id.*; *see also* Gilson & Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindsight Bias*, 28 Iowa J. Corp. L. at 734-36. Several of the factors above, including Form S-3 eligibility, market capitalization, and public float, may mean that courts are less likely to find an efficient market for those smaller issuers most likely to experience anomalies identified by behavioral finance. (In addition, the occurrence of an anomaly does not equate with a market being so informationally inefficient that material misstatements do not register in price changes).

in this case did not contest that the market for Halliburton stock was efficient. *See Halliburton*, 597 F.3d at 335 (“the parties ... do not dispute the efficiency of the market”). However, we note the many cases in which courts have ruled that investors have failed to prove that particular markets have the requisite efficiency and denied class certification. *E.g.*, *Teamsters Local 445 Freight Division Pension Fund v. Bombardier, Inc.*, 546 F.3d 196, 210 (2d Cir. 2006) (affirming denial of certification in market for mortgage backed securities).<sup>15</sup>

The rebuttable nature of *Basic*'s presumption of reliance provides an second mechanism for courts to ensure the reasonableness of *Basic*'s assumption that, in an efficient market, material misstatements (or omissions) have an impact on price. This second mechanism operates by screening out cases in which, even in a well-developed, impersonal market for a security, prices may not move after material disclosures. The defendant may rebut the fraud-on-the-market presumption by “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price . . .” *Basic*, 485 U.S. at 248. The rebuttable fraud-on-the-market presumption presents an appropriate balance between continued widespread empirical support for the limited assumption

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15. *See also In re Safety-Kleen Corp. Bondholders Litig.*, 2004 U.S. Dist. LEXIS 31099, \*25 (D.S.C. Oct. 29, 2004) (decertifying class where market for bonds was not efficient); *Unger v. Amedisys, Inc.*, 401 F.3d 316, 322-325 (5th Cir. 2005) (vacating class certification for insufficient evidence of efficiency in market for securities of small cap issuer); *Freeman v. Laventhal & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990) (finding a market for newly issued municipal bonds is not efficient).

of *Basic* – that, in a sufficiently efficient market, prices will generally react to material misstatements – with empirical evidence from behavioral finance of discrete cases of anomalies.

A common method of rebutting the presumption, for instance, is the so-called “Truth on the Market” defense fashioned by some lower courts. *See Schleicher*, 618 F.3d at 686-87. This defense flows from Justice Powell’s statement in *Basic* that a defendant might rebut the fraud-on-the-market presumption upon a showing that, notwithstanding a material misstatement, truthful news “credibly entered the market and dissipated the effects of the misstatements.” *Basic*, 485 U.S. at 248-49. Significantly, however, those courts that consider this defense routinely address it at the summary judgment stage rather than the class certification stage and only after a defendant has put forth evidence indicating why truthful statements might have counteracted the pricing effect of the misrepresentation. *See, e.g., In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989); *see also Schleicher*, 618 F.3d at 686-87. In the process, these cases illustrate how some courts have found substantive protections for defendants in the fraud-on-the-market theory. Moreover, these cases demonstrate the procedural mechanism by which these protections are to be examined.

Yet *Oscar* misread *Basic* and transformed the defendant’s right to rebut the *Basic* presumption into a requirement that plaintiffs affirmatively prove loss causation – and imposed this requirement at the class certification stage. *Oscar* reasons that *Basic*’s standard – that a defendant make “any showing that severs the link” – could be met by the mere presence of “publicly available



evidence that the corrective disclosure was buried in other bad news.” *Oscar*, 487 F.3d at 265 *citing Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657 at 665 (5th Cir. 2004). Thus, under *Oscar*, a court could rule that the mere fact of a defendant making multiple simultaneous disclosures could be enough to require investors to prove the separate element of loss causation as a condition to a class being certified. *See Oscar*, 487 F.3d at 271-76 (Dennis, J., dissenting). Under no reasonable reading of *Basic*, can defendants meet the standard for rebutting the presumption “by simply asserting that a particular change in the market price could have been related to something other than the defendant’s misrepresentations.” *Id.* at 274-75. Again, *Oscar* overhauled *Basic*’s clear and carefully considered procedural framework.

### **III. Requiring a Mini-Trial on Loss Causation at Class Certification Frustrates Courts and Investors in Untangling the Effects of Mixed Statements, True and False, on Price Moves.**

Loss causation creates a third, finer filter by which courts can review the causal connection between material misstatements and economic loss. Yet *Dura* clarifies the subtle, but important distinction between reliance and loss causation. If investors prove, and defendants do not rebut, that a market has sufficient efficiency, then the fraud-on-the-market presumption will establish reliance, because, a material misstatement distorts the price of a security in a market with sufficient information efficiency. *Cf. Basic*, 485 U.S. at 245-47. Investors must then prove that the price distortion was the proximate cause of their economic loss. *See Dura*, 544 U.S. at 342. Even if Rule 23(b)(3) did not render loss causation inappropriate as a

condition to class certification, proof of loss causation by a preponderance of the evidence would remain an improper condition for class certification. *Halliburton* requires that, to achieve class certification, investors must prove by a preponderance of the evidence that specific misstatements or corrective disclosure caused particular stock price moves. See *Halliburton*, 597 F.3d at 335. Consequently, *Halliburton* and *Oscar* frustrate a careful untangling of possible confounding causal factors that may explain why prices did move or did not move. See *Schleicher*, 618 F.3d at 686.<sup>16</sup>

The facts of *Halliburton* demonstrate the unreasonableness of the requirement that investors prove loss causation at an early stage as a condition to class certification. The Fifth Circuit denied class certification because the plaintiffs did not prove that Halliburton's corrective disclosure was the cause of its share price drop. *Halliburton*, 597 F.3d at 336, 341-42, 344. *Halliburton* holds that “[b]y relying on a decline in price following a corrective disclosure as proof of causation, a plaintiff need prove that its loss resulted directly *because* of the correction to a prior misleading statement; otherwise there would be no inference raised that the original false statement caused an inflation in the price to begin with.” *Id.* at 336 (emphasis in original). Thus, under *Halliburton*, unless investors can isolate, at the class certification stage, the causation solely attributable to fraud from any confounding factors, class certification is precluded.

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16. See Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 Iowa L. Rev. at 840-842 (discussing difficulty determining causation in securities litigation).

The problem with *Halliburton* is that many other factors – some of Halliburton’s own devising – could easily mask the price decline after corrective disclosure. For example, an issuer making a corrective statement may simultaneously make other negative disclosures that may move prices in the same direction as a revelation of alleged fraud. Indeed, this is precisely what happened in *Halliburton*. The court found that plaintiffs did not prove that corrective disclosure on the costs savings of a merger with Dresser caused the price drop because that disclosure was made simultaneously with “multiple pieces of negative news.” See *Halliburton*, 597 F.3d at 341. The co-mingled bad news – the timing of which was completely controlled by Halliburton – included disclosures of lower than expected profits from the Dresser business, business declines in various Halliburton units, and lower than expected earnings in Halliburton’s energy services group. See *id.* at 341-42.

Alternatively, the issuer’s “unrelated” disclosures may, in fact, be related to the facts revealed in the corrective disclosure. In *Oscar*, the issuer revealed that it had overstated the number of telephone lines it installed, while simultaneously disclosing that it had missed analyst expectations on earnings per share and suffered higher than expected losses. See *Oscar*, 487 F.3d at 263. The court rejected class certification because plaintiffs could not isolate the effects of the corrective disclosure on telephone lines installed from the other negative disclosure. See *id.* at 266. The court ignored the very real possibility that the company’s lower earnings and higher losses might in fact have stemmed from the non-existent phone lines not providing revenue.

Requiring investors in the early stages of litigation to disentangle the causal effects of various simultaneous statements a prerequisite to class certification imposes an inappropriately high, and sometimes impossible, burden on them. The Fifth Circuit supposes that investors can untangle causal effects with publicly available data and event studies. *See Oscar*, 487 F.3d at 267. However, event studies struggle to distinguish the causal effect of multiple simultaneous events on stock price.<sup>17</sup>

Moreover, single-firm event studies of the type used to demonstrate loss causation may very well require information obtainable only through discovery. For instance, specification of an appropriate regression equation may require the use of a multi-factor model to control for potential confounding events but identification of the appropriate factors to use (e.g., the stock returns of relevant competitors or peer firms) may be difficult to discern from public records alone. *See, e.g., Jonathan Klick & Robert H. Sitkoff, Agency Costs, Charitable Trusts, And Corporate Control: Evidence from Hershey's Kiss-Off*, 108 Colum. L. Rev. 749, 806-814 (2008) (illustrating the use of a multi-factor regression model using competitor-based controls). As a result, forcing plaintiffs to rely at the class certification stage on event studies using only publicly-available data may effectively force plaintiffs to use misspecified pricing equations.

This problem may afflict investors at trial to some extent as well. However, investors would then have

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17. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. at 187. *See generally*, Walker, *Restoring the Individual Plaintiff to Tort Law by Rejecting "Junk Logic" About Specific Causation*, 56 Ala. L. Rev. at 426.

the benefit of discovery which would, at a minimum, allow investors to uncover evidence that the defendants manipulated the issuer's disclosure in order to conceal the effect of false statements. The discovery that comes at the merits stage is appropriate because of the perverse incentives that *Halliburton* and *Oscar* create. *Halliburton* invites defendants to mask the price effects of corrective disclosure behind the noise of other disclosure or even fresh misstatements. Cf. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 Iowa L. Rev. at 852;<sup>18</sup> James C. Spindler, *Why Shareholders Want Their CEO to Lie More After Dura Pharmaceuticals*, 95 Geo. L.J. 653, 691 (2007). Without full discovery, investors have inadequate tools to uncover whether defendants made additional disclosures to camouflage the effects of corrective disclosure. This risks skewing judicial determinations of loss causation and rewarding obfuscation by defendants.

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18. There are several ways in which defendants can time disclosure to frustrate the ability of plaintiffs to prove loss causation.

Faced with the need to reveal their fraud, defendants can deliberately introduce additional causal factors. For example, before disclosing a fraud, corporate officials may release "unrelated" negative information that preemptively reduces stock price. This behavior is sometimes described as "walking down the stock price." Defendants also may bundle a corrective disclosure with good news that offsets the effect of the negative information on stock price. Still another alternative is to delay a corrective disclosure until immediately after market or industry bad news has caused stock prices to fall. *Id.*

A plaintiff class must still prove loss causation even amidst a “tangle of factors.” *See Dura*, 544 U.S. at 342-43. However, courts can better analyze investor proof at the merits stage. Lower courts applying *Dura* insist on rigorous proof even when market-wide downturns present difficulties for plaintiffs and their experts in proving that specific material misstatements caused the economic loss. *See, e.g., In re Williams Sec. Litig. – WCG Subclass*, 558 F.3d 1130 (10th Cir. 2009) (affirming exclusion of expert testimony and awarding summary judgment against plaintiff class for failure to prove loss causation in light of market factors that included general boom and crash of telecommunications stocks).<sup>19</sup> Making determinations on loss causation at the summary judgment stage allows courts to conduct a more rigorous, fact-based inquiry into complex issues of causation.

In contrast, *Oscar* employs speculative theories about the efficiency of the market to cut off the inquiry at the class certification stage. *Oscar* further justifies its requirement that investors prove loss causation as a condition to certifying a class by arguing that the market may alternatively be either strong form efficient or inefficient with respect to specific types of information. *See Oscar*, 487 F.3d at 269. *Oscar* speculates that the market might be strong form efficient with respect to information on telephone line installations and thus insider trading might have corrected the market price well before the company’s corrective disclosure. *See id.*

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19. Moreover, a number of courts have ruled against plaintiffs in summary judgment (not in deciding to certify a class) based on the so-called “truth-on-the-market” defense described above. Although the truth-on-the-market defense is not before this Court, its adoption by lower courts indicates that market efficiency can also cut against plaintiffs on the merits.

at 269. Alternatively, *Oscar* speculates that a market might inefficiently process information on telephone line installations even though it was otherwise information efficient. *See id.* Requiring plaintiffs to prove neither of these speculative states of the market holds before a class is certified is improper.

*Oscar* offers no reason to believe that the market is likely to be strong form efficient (reflecting *all* public and non-public information) with respect to certain types of information like telephone line installations. Indeed, as noted above, there is scant economic evidence for strong efficiency. It is therefore inappropriate for class certification procedures to include a substantive inquiry based on the strong form. *Oscar* effectively creates a burden on investors to disprove strong form efficiency, speculating that insider trading could have changed the stock price before the corrective disclosure. *See Oscar*, 487 F.3d. at 269. Yet asking plaintiffs to disprove the effects of any insider trading would require them to prove a negative. Moreover, uncovering whether insider trading existed would be impossible without further discovery. We also note here that even though insider trading frequently is alleged in connection with market frauds, the presence of such trading may nonetheless be of insufficient volume to move the particular security the security's price. *Oscar* insists, however, that investors would not need additional discovery to prove their case. *See id.* at 267 ("Little discovery from defendants is demanded by the fraud-on-the-market regime. Its 'proof' is drawn from public data and public filings, as in this case.")<sup>20</sup>

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20. Moreover, *Oscar's* speculation is internally inconsistent. If a market were strong-form efficient, insider trading would not be profitable because the non-public information would already be

Moreover, a larger problem plagues *Oscar*'s expectation that investors prove that the market was neither inefficient nor strong form efficient with respect to certain types of information. The same capacity of confounding factors and mixed disclosure to blur the effects of particular defendant statements on particular price movements would here again frustrate the ability of plaintiffs and trial courts to untangle complex causal skeins.

Proving loss causation presents a daunting task for plaintiffs in any case. The economic analysis required by *Dura* raises substantial challenges. These challenges are raised to a new level, however, by the requirement of *Halliburton* and *Oscar* that plaintiffs provide this proof at the class certification stage. *Halliburton* and *Oscar* require plaintiffs and trial courts to perform delicate surgery, while operating in dim light without full discovery.

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reflected in the market price. Cf. Finnerty, *Insiders and Market Efficiency*, 31 J. Fin. 1141, 1148 (1976).



**CONCLUSION**

For the foregoing reasons, the judgment of the Fifth Circuit should be reversed.

Respectfully submitted,

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March 1, 2011