



EMORY
LAW

Emory Corporate Governance and Accountability
Review

Volume 1 | Issue 1

2014

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Recommended Citation

Jonathan Massey, *Why the U.S. Supreme Court Should Reaffirm the "Fraud-on-the-Market" Presumption in Securities Fraud Cases*, 1 Emory Corp. Governance & Accountability Rev. 37 (2014).

Available at: <https://scholarlycommons.law.emory.edu/ecgar/vol1/iss1/5>

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WHY THE U.S. SUPREME COURT SHOULD REAFFIRM THE “FRAUD-ON-THE-MARKET” PRESUMPTION IN SECURITIES FRAUD CASES

*Jonathan Massey**

On March 5, 2014, the Supreme Court heard argument in one of the most important securities law cases in decades: *Halliburton Co. v. Erica P. John Fund*, No. 13-317. The defendant company in the case, Halliburton, is asking the Court to overturn its landmark 1988 decision in *Basic Inc. v. Levinson*, which adopted a rule known as the “fraud-on-the-market” presumption, enabling securities fraud class action lawsuits to be brought.¹

The “fraud-on-the-market” rule is a rebuttable presumption that securities prices in an open and developed market like the New York Stock Exchange reflect material public information and that investors rely on the integrity of the market price.² Under this presumption, investors who bought or sold stock during the relevant time period are able to bring their fraud claims without proving that they personally knew of and relied on a misrepresentation in making their decision to buy or sell.³ It’s assumed that the information (or omission) is “baked into” the market price.⁴

Halliburton contends that the Court should overrule *Basic* and eliminate the fraud-on-the-market presumption.⁵ Here’s why it is wrong:

- There has always been bipartisan support for the presumption. In 1988, the SEC (under the Reagan Administration) urged the Supreme Court to adopt the fraud-on-the-market presumption and warned that, without it, private securities actions would face insuperable hurdles.⁶ In 1995, when Republicans held a majority in both houses, Congress considered proposals to abolish the

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¹ Petition for Writ of Certiorari at 2, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Sep. 9, 2013).

² *Basic Inc. v. Levinson*, 485 U.S. 224, 241–42, 246 (1988).

³ *See id.* at 245–50.

⁴ *Id.* at 246.

⁵ Petition for Writ, *supra* note 1.

⁶ Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 163 (2009).

fraud-on-the-market presumption and warned that, without it, private securities actions would face insuperable hurdles.⁷ In 1995, when Republicans held a majority in both houses, Congress considered and rejected proposals to abolish the fraud-on-the-market presumption.⁸ Today, the SEC continues to support the fraud-on-the-market presumption and filed a brief in *Halliburton* strongly expressing that view.⁹ Congress and the SEC are better able than the Court to evaluate the defendants' policy objections to the presumption.

- Numerous other groups and scholars filed briefs in *Halliburton* defending the presumption.¹⁰ AARP filed a brief stressing the dangers to consumers and investors if the presumption were eliminated.¹¹ Fourteen academic economists, including Eugene Fama of the University of Chicago (who shared in last year's Nobel Prize), submitted a brief supporting the presumption.¹² More than two-dozen other scholars did so as well.¹³ Charles Fried, the former solicitor general who represented the SEC in 1988, filed a brief twenty-six years later urging the Court to adhere to its prior decision in *Basic* as a matter of *stare decisis*.¹⁴ Former SEC Chairmen William H. Donaldson and Arthur Levitt, Jr. agreed,¹⁵ as did twenty-one states and the territory of Guam.¹⁶

- *Stare decisis* principles are particularly forceful in non-constitutional cases, where Congress is free to alter the Court's decisions if it wishes.¹⁷ Here, there is no basis for departing from *Basic*.¹⁸ *Halliburton*'s legal arguments are largely recycled from the dissenting opinion in *Basic* by Justices White and O'Connor.¹⁹ The Court rejected those arguments in 1988, and they are no more persuasive now.²⁰

⁷ *Id.*

⁸ Brief in Opposition at 32, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. Sep. 9, 2013).

⁹ *Halliburton Co. v. Erica P. John Fund, Inc.*, SCOTUS BLOG (2013), <http://www.scotusblog.com/case-files/cases/halliburton-co-v-erica-p-john-fund-inc/>.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Brief of Legal Scholars as Amici Curiae With Respect to *Stare Decisis* in Support of Respondent at 4–8, *Halliburton Co. v. Erica P. John Fund Inc.*, SCOTUSBLOG (2013), <http://www.scotusblog.com/case-files/cases/halliburton-co-v-erica-p-john-fund-inc/>.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

- Meanwhile, *Basic* has become a firmly settled, indispensable part of securities law. Without the fraud-on-the-market presumption, securities class actions would face enormous hurdles, because each individual stockholder would have to show that he or she knew of and relied on the misrepresentation, and the case could not be tried in class form. Millions of investors would be left without a remedy, because the costs of trying individual claims would exceed the potential damages.

- Even separate suits by large institutional investors rely on the fraud-on-the-market presumption, so overturning *Basic* would threaten individual suits by investors as well as class actions.

- Institutional investors increasingly use passive investment strategies (such as index investing) that rely on the integrity of the market (within the meaning of *Basic*) and the presumption that relevant public information is incorporated into price.²¹ These investment strategies are built on the bedrock premise that prices reflect available public information. If the Supreme Court were suddenly to hold that this assumption is false, it would call into question the central pillar of many investing strategies.²² Institutional investors representing millions of pension beneficiaries and over \$1.36 trillion of assets under management warned the Supreme Court in the *Halliburton* case that overturning *Basic* would force the re-evaluation of many settled investment practices and the adoption of new and unpredictable guidelines.²³ At the very least, institutional investors would face a host of additional burdens and expenses, because they would be forced to collect and review the disclosures of thousands of companies if they sought to retain any possibility of asserting a fraud claim by showing the kind of individualized “eyeball” reliance that *Halliburton* argues is required. Institutional investors have warned that this might lead them to narrow their portfolios and increase risk.²⁴

- Without the important check provided by *Basic* and private securities actions, the integrity of U.S. capital markets will be diminished, and investor confidence in the fundamental fairness of the financial system will decline.

²¹ Lisa Gilbert & Jonathan Massey, *What's Right With Securities Class Action Lawsuits: A Response to the U.S. Chamber's Institute for Legal Reform*, 2014 PUB. CITIZEN, U.S. CHAMBER WATCH REPORT 1, 4.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

Studies show that private actions play a key role in deterring securities fraud.²⁵ For example, one recent study by Stephen Choi, professor of law at NYU, and A.C. Pritchard, professor of law at the University of Michigan, found that private class actions are more effective than SEC investigations at deterring securities fraud and lead to a higher incidence of top officer resignations.²⁶ Another study by Jonathan M. Karpoff of the University of Washington, D. Scott Lee of the University of Nevada, Las Vegas, and Gerald S. Martin of American University examined data from 1978 through 2004 and confirmed the importance of private actions.²⁷

- Private actions are also far more effective at returning compensation to victims than government suits.²⁸ For example, in actions against Enron and aiders and abettors in the Enron fraud, the SEC recovered \$440 million while investors recovered about \$7.3 billion from private suits.²⁹ The SEC settlement fund in connection with WorldCom was \$750 million—at the time the largest in the agency’s history compared to \$6.1 billion recovered in the private action.³⁰ Notably, the private settlement with WorldCom included \$24.25 million from individual directors, while the SEC fine was paid only by the company.³¹

- Regulation of financial markets in the U.S. actually enhances its competitive position against other markets. Recent studies have found that foreign companies listing their stocks on their home exchanges and in the United States are able to raise capital on better terms, at a lower net cost than companies that list only outside the United States.³² Economists refer to this as

²⁵ Stephen J. Choi & Adam C. Pritchard, SEC Investigations and Securities Class Actions: An Empirical Comparison, 1 (N.Y. Univ. School of Law, Working Paper No. 12-38, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739.

²⁶ *Id.*

²⁷ Jonathan M Karpoff et al., *The Legal Penalties for Financial Misrepresentation*, 3 (Working Paper, 2007), available at <http://ssrn.com/abstract=933333>.

²⁸ Compare Securities and Exchange Commission, *Enron*, U.S. SECURITIES AND EXCHANGE COMMISSION (May, 14, 2007) <http://www.sec.gov/divisions/enforce/claims/enron.htm>, with Kristen Hays, *Enron Settlement: \$7.2 Billion to Shareholders*, HOUSTON CHRONICLE (Sep. 9, 2008), <http://www.chron.com/business/enron/article/Enron-settlement-7-2-billion-to-shareholders-1643123.php>.

²⁹ *Id.*

³⁰ Compare AccountingWeb, *\$750 Million MCI/WorldCom Settlement is Largest in SEC History*, ACCOUNTINGWEB (Jul. 7, 2003) <http://www.accountingweb.com/topic/750-million-mciworldcom-settlement-largest-sec-history>, with *Settlements*, WORLD.COM SECURITIES LITIGATION (visited Jan. 5, 2014), <http://www.worldcomlitigation.com/html/citisettlement.html>. The website <http://www.worldcomlitigation.com> is the information site administered by Lead Counsel.

³¹ *Id.*

³² Craig Doidge et al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time* 5, 29 (Fisher Coll. of Bus., Working Paper No. 2007-03-012, 2007), available at

a cross-listing premium.³³ By contrast, companies that cross-list in their home exchanges and London, which is widely recognized to have less rigorous regulations than the United States, do not enjoy the cross-listing premium.³⁴

This premium exists in the United States because of the superior protections that the regulatory regime in the United States provides investors.³⁵

- After the financial crisis of 2008, many small investors fled U.S. stock markets out of concern that the system was stacked against them. Many such investors are only now beginning to return. The Supreme Court should not create a major roadblock to private securities fraud actions, given the important enforcement role it plays in assuring investor confidence.

- The SEC simply does not have the resources to police the markets without the essential supplement of private securities litigation. The drastic expansion of the SEC's responsibilities under Dodd-Frank and other laws, coupled with the astonishing growth of trading technologies and strategies, means that the SEC cannot be the sole entity responsible for the enforcement of the nation's securities laws. The SEC's responsibilities have come at the cost of enforcement of securities laws, particularly in a time of budgetary sequester and government shutdown. In the words of one federal judge, "the SEC has been hard hit by budget limitations," which have forced the agency to husband its resources and instead "to focus on the smaller, easily resolved cases that will beef up their statistics when they go to Congress begging for money."³⁶

- The evidence also demonstrates that the criticisms of private securities actions are exaggerated. For example, the so-called "in terrorem" effect of securities class actions is not supported by the data: 77 percent of securities class actions are resolved before a motion for class certification is even filed.³⁷ NERA Economic Consulting "did not find reliable statistical relationships

<http://www.ssrn.com/abstract=982193>; Luzi Hail and Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulations Matter?*, 44 J. OF ACCOUNTING RES. 485, 485 (2006).

³³ *Id.* at 30.

³⁴ *Id.* at 31.

³⁵ *Id.* at 29.

³⁶ Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, THE NEW YORK REVIEW OF BOOKS (Jan. 9, 2014), <http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions/>.

³⁷ Renzo Comolli et al., *Recent Trends in Securities Class Action Litigation: 2012 Full-Year Review 20*, NERA (2013), http://www.nera.com/nera-files/PUB_Year_End_Trends_2012_1113.pdf.

between the resolution of a motion for class certification and expected settlements.”³⁸

Summary: Private securities lawsuits play a vital role in enforcing the federal securities laws. They deter wrongdoing, compensate investors, and help ensure the integrity of the capital markets. The SEC cannot perform the job alone. There is bipartisan recognition of the importance of private lawsuits, and the Supreme Court should reaffirm the “fraud-on-the-market” presumption.

³⁸ Ronald I. Miller, *Dynamic Litigation Analysis: Predicting Securities Class Action Settlements as a Case Evolves*, NERA (2013), http://www.nera.com/nera-files/PUB_Dynamic_Litigation_Analysis_0114.pdf.