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BASIC'S "BITTER HARVEST": THE COURT'S CONTINUED ADHERENCE TO A FLAWED ECONOMIC THEORY IN *HALLIBURTON*

*Julia Kline**

I. INTRODUCTION AND HISTORICAL FRAMEWORK

The Supreme Court's recent ruling in *Halliburton Co. v. Erica P. John Fund, Inc.*¹ permits defendants in federal securities fraud class actions to rebut the presumption that an investor relied on a security's price with evidence showing no price impact² at the class-certification stage.³ Prior to this ruling, defendants had to wait until trial to present evidence that an alleged misstatement did not actually impact the security's price.⁴ The ruling disappointed many corporate advocates and legal scholars who had hoped the Court would strike down what critics deem a controversial "judge-made rule" that fuels frivolous and expensive shareholder litigation.⁵

A. A Legal Doctrine Based on Economic Theory

Legal scholars have long contested the reliance presumption's validity as a legal doctrine.⁶ The Court first adopted the reliance

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1. 134 S. Ct. 2398 (2014).

2. *Id.* at 2414–15 (stating that evidence of no price impact is typically shown through event studies, statistical analyses that seek to isolate the effect of an alleged misstatement on price).

3. *Id.* at 2417.

4. *Id.* at 2402.

5. Daniel Fisher, *Supreme Court Leaves Fraud on Market Intact, Makes Life a Bit Harder for Securities Plaintiffs*, FORBES (June 23, 2014, 10:55 AM), <http://www.forbes.com/sites/danielfisher/2014/06/23/supreme-court-leaves-fraud-on-market-intact-but-makes-life-harder-for-securities-plaintiffs/>; see also James Bohn & Steven Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 905 (1996) ("Opportunistic plaintiffs' attorneys continuously monitor securities prices, probing for recent securities offerings that perform poorly in the aftermarket.").

6. See *Basic Inc. v. Levinson*, 485 U.S. 224, 251–56 (1988) (White, J., dissenting) (arguing that the "fraud-on-the-market" doctrine, as interpreted by some lower courts, improperly equates

presumption twenty-five years ago in *Basic Inc. v. Levinson*,⁷ which held plaintiffs in securities fraud claims did not need to demonstrate direct reliance on a company's alleged misstatement.⁸ Section 10(b) of the Securities Exchange Act of 1934 and the Securities Exchange Commission's Rule 10b-5 ("Rule 10b-5") prohibit an issuer of a security from making any "material misstatement or omission" concerning a company or its securities.⁹ This provision is frequently enforced through private-shareholder class actions.¹⁰ To recover in a Rule 10b-5 action, a plaintiff must show "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance on the misrepresentation or omission; (5) economic loss; and (6) loss causation."¹¹

In *Basic*, the Court ruled investors could show reliance by "invoking a presumption that [the stock price] reflects all public, material information—including material misstatements," therefore enabling the inference an investor relied on such information when buying the stock at market price.¹² This inference is based on the "fraud-on-the-market" doctrine, which asserts "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."¹³ The Court also reasoned that "common sense and probability" indicated most investors rely on a security's price when making decisions to buy or sell a stock.¹⁴ To invoke the reliance presumption, a plaintiff must show (1) the alleged misstatement was publicly known; (2) the alleged misstatement was material; (3) the market for the stock was "efficient"; and (4) the plaintiff traded the stock during the affected time period.¹⁵

causation with reliance when many investors do not rely on a stock's price when trading); see also *Halliburton*, 134 S. Ct. at 2418 (Thomas, J., concurring) ("Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption . . .").

7. 485 U.S. 224 (1988).

8. *Id.* at 247.

9. See *Halliburton*, 134 S. Ct. at 2407.

10. See *id.*

11. *Id.* (quoting *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1192 (2013)).

12. *Id.* at 2405.

13. *Id.* at 2408 (citing *Basic*, 485 U.S. at 246).

14. *Basic*, 485 U.S. at 246.

15. *Halliburton*, 134 S. Ct. at 2408.

B. The Presumption's Effect on Securities Fraud Actions

The reliance presumption effectively created the securities-fraud class action because it shifted the question of reliance from the individual to one common to the class.¹⁶ Federal Rule of Civil Procedure Rule 23(b)(3) requires class-action plaintiffs to show common questions of law or fact predominate over individual questions.¹⁷ Accordingly, the reliance presumption is a “powerful tool” for plaintiffs seeking class certification, because defendants are unlikely to agree to settle claims until the court certifies the class.¹⁸ Thus, enforcing the individual reliance requirement would effectively prevent plaintiffs from joining a class action because individual questions would predominate over common ones.¹⁹ Critics of the reliance presumption argue the fraud on the market doctrine is based on an economic theory, which requires market efficiency to be properly applied in securities fraud class actions.²⁰

II. THE *HALLIBURTON* CASE

The *Halliburton* litigation arose from alleged misrepresentations by the Halliburton Company and its CEO (“Halliburton”) concerning substantive portions of its business operations.²¹ The plaintiffs, represented by the Erica P. John Fund, Inc. (the “Fund”), were shareholders who claimed to have suffered losses due to Halliburton’s “fraudulent misrepresentations” made between 1999 and 2001.²² The Fund argued the following: “(1) [Halliburton] understated its projected liability for asbestos claims; (2) it overstated its revenues by including billings whose collections were unlikely; and (3) it exaggerated the cost savings and efficiencies [the company] would derive from its 1998 merger with Dresser

16. See *Amgen Inc.*, 133 S. Ct. at 1209 (Scalia, J., dissenting) (referring to the class certification requirements of Federal Rule of Civil Procedure 23(b)(3)).

17. FED. R. CIV. P. 23(b)(3).

18. *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 755 (3d Cir. 2010).

19. See *Halliburton*, 134 S. Ct. at 2407–08.

20. See *id.* at 2418 (Thomas, J., concurring) (criticizing the reliance presumption as based on “nascent economic theory and naked intuitions about investment behavior”); see also *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931, 940 (9th Cir. 2009) (holding the presumption did not apply in an “inefficient” market); *Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 380 (5th Cir. 2007) (finding a lower court misapplied the presumption).

21. *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423, 426 (5th Cir. 2013), *vacated*, 134 S. Ct. 2398 (2014).

22. *Halliburton*, 718 F.3d at 426.

Industries.”²³ As a result, the Fund contended Halliburton’s misstatements prompted a temporary spike in its stock price, which subsequently fell after Halliburton disclosed the inaccuracies.²⁴ The Fund argued that the price drop had caused the Fund participants’ economic losses because those investors purchased shares during the relevant time frame.²⁵

In a prior ruling involving the same parties,²⁶ the Court ruled the Fund did not need to demonstrate loss causation at the class-certification phase to invoke the reliance presumption.²⁷ Accordingly, the Court left the reliance presumption undisturbed.²⁸ In the prior ruling, the Court vacated the Fifth Circuit’s judgment for Halliburton, and remanded the case to lower courts to hear “any further arguments against class certification.”²⁹

During these class-certification arguments, Halliburton attempted to rebut the reliance presumption by re-introducing evidence showing the alleged misrepresentations had not impacted its stock’s market price.³⁰ If the price had been unaffected by the alleged misstatements, then a presumption that the class had relied on the price when trading the stock would be improper. Without the reliance presumption, each plaintiff in the class would have to demonstrate direct reliance, which would mean common questions would no longer predominate, and the class would not meet the certification requirements of Rule 23(b)(3).³¹ The district court refused to certify the class because the Fund had not met the Fifth Circuit’s requirement to show loss causation.³² The Fifth Circuit affirmed, holding defendant Halliburton could not present evidence of no price impact until trial, and certified the class.³³ The Supreme Court granted certiorari to decide whether the presumption of reliance continued to be a valid legal doctrine, and if defendants in

23. *Id.*

24. *Id.*

25. *Id.*

26. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (noting loss causation is distinct from the issue of whether an investor relied on the price of a stock when trading).

27. *See Halliburton*, 134 S. Ct. at 2406.

28. *See id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

securities fraud class actions could introduce price impact evidence to rebut the reliance presumption at the class-certification stage.³⁴

Although many corporate advocates hoped the Court would use *Halliburton* to strike down the reliance presumption and effectively halt meritless securities fraud claims, the Court left the presumption intact.³⁵ The Court found no “special justification”³⁶ for overruling the reliance presumption set in *Basic*.³⁷ Reasoning that *Basic* already provided the reliance presumption could be rebutted by “price impact evidence,”³⁸ the Court reiterated the fairness rationale that requiring proof of direct individual reliance would pose an “unrealistic evidentiary burden” on the plaintiff investor.³⁹ The Court rejected Halliburton’s argument that modern capital markets are “not fundamentally efficient”⁴⁰ and investors base trading decisions on a variety of factors, many of which have nothing to do with price.⁴¹

The Court did not find any of the empirical studies⁴² sufficiently persuasive to upset *Basic*’s logic and suggested Congress could pass legislation if it determined the reliance presumption was inappropriate or had negative policy implications.⁴³ Nevertheless, the Court agreed that defendants should be able to introduce direct evidence showing the alleged misrepresentation had not impacted the stock price at the class-certification stage.⁴⁴ If defendants can successfully demonstrate there is no causal connection between the alleged misstatement and the investor’s loss, then reliance must be found on an individual basis and individual issues will predominate.⁴⁵ Therefore, the Court vacated the Fifth Circuit’s ruling precluding Halliburton from presenting price impact evidence during

34. *Id.* at 2405.

35. See Michael R. Smith et al., *Halliburton Ruling: High Court Affirms Basic v. Levinson and Confirms Defendants May Rebut Reliance Presumption at Class Certification by Showing Absence of Price Impact*, BUSINESS LAW TODAY (July 2014), http://www.americanbar.org/publications/blt/2014/07/keeping_current_smith.html.

36. *Halliburton*, 134 S. Ct. at 2407.

37. *Id.* at 2417.

38. *Id.* at 2407 (citations omitted).

39. *Id.* (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 245 (1988)).

40. *Id.* at 2409 (internal quotation marks omitted).

41. See *id.* at 2411 (citing the “value investor” who buys and sells based on a stock’s predicted future value, not the current price).

42. See *id.* at 2409 (referring to briefs filed by amici curiae citing evidence that stock prices do not always accurately reflect public information).

43. See *id.* at 2411.

44. *Id.* at 2414.

45. See *id.* at 2416.

class-certification arguments, but it upheld the reliance presumption's validity.⁴⁶

III. CONCLUSIONS AND ISSUES RAISED BY THE RULING

Despite the unanimous ruling in *Halliburton*, the reliance presumption remains contested, even by the Court.⁴⁷ The basis for this disagreement remains the large body of empirical evidence challenging the underpinnings of the fraud-on-the-market theory and its applicability to all modern financial markets.⁴⁸

As previously discussed, the fraud-on-the-market theory rests on two critical assumptions: that investors rely on publicly available information when making trading decisions and that financial markets are efficient.⁴⁹ The Court noted that an investor could, under certain circumstances, invoke the reliance presumption based on the following two assumptions: (1) that an investor makes a decision to buy or sell stock in reliance on efficient pricing; and (2) that the price of a stock adjusts efficiently to all publicly available information.⁵⁰ The Court dismissed recent scholarship suggesting neither of these assumptions hold in today's financial markets.⁵¹ Furthermore, the Court acknowledges that the reliance presumption, as described in *Basic*, is reasonable because "most investors" will rely on price when trading.⁵²

This Comment seeks to clarify the reliance presumption's underlying assumptions and the fraud on the market theory and explain why failure of either assumption would seriously undermine the validity of the legal doctrine. Part IV will focus on the role of

46. *Id.* at 2417.

47. *See id.* at 2418 (Thomas, J., concurring) (challenging the validity of the reliance presumption and arguing "*Basic* should be overruled"). Justice Scalia joined Justice Thomas in his concurring opinion. *Id.*

48. *See* Lucian Bebchuk & Allen Ferrell, *Rethinking Basic*, 69 BUS. LAW. 671, 671 (2014) (arguing that "fraudulent distortion" is a major factor affecting market efficiency); *see also* Grigori Erenburg et al., *The Paradox of "Fraud-on-the-Market Theory": Who Relies on the Efficiency of Market Prices?*, 8 J. EMPIRICAL LEGAL STUD. 260, 260 (2011) (noting "some cases certified for class action status do not satisfy the conditions for even weak-form efficiency").

49. *See* Erenburg et al., *supra* note 48, at 264–65 (noting the "fundamental issue" in Rule 10b-5 actions is whether "investors relied on fraudulent information").

50. *Halliburton*, 134 S. Ct. at 2408.

51. *See id.* (arguing that "subsequent developments in economic theory" are not sufficiently significant as to justify overruling *Basic*).

52. *Id.* at 2411 ("*Basic* never denied the existence of [value] investors."); *see also* Erenburg et al., *supra* note 48, at 265 (noting expert traders exploit market inefficiency to "capitalize on mispricing").

market efficiency, and why efficiency is critical to tying an alleged misstatement to causation and reliance, both of which are elements required to prove securities fraud. Part V will discuss the assumption that investors rely on price when trading, positing that many investors, in fact, do not. Finally, Part VI will discuss the implications of the Court's ruling on class action securities fraud litigation.

IV. MARKET EFFICIENCY

A. The Court Was Inconsistent in Its cursory Review of Empirical Evidence Against Market Efficiency

The fraud-on-the-market theory espoused in *Basic* assumes financial markets are “mechanically” efficient, or that prices react swiftly to public information, but that is not always the case.⁵³ There is not always an immediate cause-and-effect reaction.⁵⁴ Whereas the *Basic* Court justified creating an evidentiary presumption with empirical evidence showing large financial markets were efficient,⁵⁵ the *Halliburton* Court dismissed similar evidence against market efficiency.⁵⁶ Such inconsistent reasoning is bound to occur when the Court relies on economic theories rather than legal analysis.⁵⁷

The Court not only dismissed the very same type of evidence it had used to create the reliance presumption but also improperly assumed the markets had not changed in twenty-five years. In *Basic*, the Court argued that the reliance presumption was appropriate for a market that “involve[ed] millions of shares changing hands daily.”⁵⁸ To justify applying the reliance presumption, the *Basic* Court considered “recent empirical studies” concerning financial markets and decided to eliminate one of the traditional elements required to

53. See William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 852 (2005).

54. See Michael Hartzmark & H. Nejat Seyhun, *The Curious Incident of the Dog That Didn't Bark and Establishing Cause-and-Effect in Class Action Securities Litigation*, 6 VA. L. & BUS. REV. 415, 418, 423 (2012).

55. *Halliburton*, 134 S. Ct. at 2409 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988)).

56. See *id.* at 2410 (arguing that whether the market was efficient was “largely beside the point”).

57. See *Basic*, 485 U.S. at 252 (White, J., dissenting) (warning confusion is “inevitable” when legal analysis is replaced with “economic theorization”).

58. *Id.* at 243–44.

prove fraud.⁵⁹ However, the *Halliburton* Court dismissed similar modern empirical studies, arguing these studies were insufficient justification for overruling *Basic* and the reliance presumption.⁶⁰

Furthermore, the Court failed to acknowledge that modern trading takes place on many types of securities markets, thus a “one size fits all” evidentiary presumption may not apply to all securities fraud plaintiffs. *Basic* concerned a company whose stock had traded on the New York Stock Exchange,⁶¹ a market for larger, heavily traded issuers.⁶² In contrast to twenty-five years ago when *Basic* was decided, the overwhelming majority of modern public companies are small,⁶³ and their stocks are inherently more volatile than those of their larger counterparts.⁶⁴ Less than 6 percent of companies on the Wilshire 5000, an index of U.S. equities, are classified as “large-cap” issuers⁶⁵ with market capitalizations over \$10 billion.⁶⁶ “Even in the absence of fraud,” any trading activity can have a disproportionate effect on a small- or micro-cap stock’s price.⁶⁷

The Court also failed to consider that a large portion of trading now occurs on small, less transparent markets.⁶⁸ Approximately 40 percent of all domestic trades occur off the major exchanges—the

59. *See id.* at 246.

60. *Halliburton*, 134 S. Ct. at 2409–10.

61. *Basic*, 485 U.S. at 228.

62. *See Minimum Numerical Standards—Domestic Companies—Equity Listings*, NYSE, http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp_1_2_2_1&manual=%2Ffcm%2Fsections%2Ffcm-sections%2F (last visited Jan. 3, 2014) (listing, among other requirements, New York Stock Exchange issuers must have an “aggregate market value of publicly-held shares of \$40,000,000”).

63. *See* Michael Santoli, *The Stock Market Is ‘Shrinking,’ Despite Record-High Indexes*, YAHOO FINANCE (Dec. 6, 2013, 1:32 PM), <http://finance.yahoo.com/blogs/michael-santoli/the-stock-market-is--shrinking---despite-record-high-indexes-171141756.html> (reporting fewer public companies with more companies falling into the “small-stock” category).

64. *Microcap Stock: A Guide for Investors*, U.S. SEC. AND EXCH. COMM’N, <http://www.sec.gov/investor/pubs/microcapstock.htm> (last visited Oct. 23, 2014) (“Even in the absence of fraud, microcap stocks historically have been more volatile and less liquid than the stock of larger companies.”).

65. *The Case for Mid-Cap Stocks in Today’s Volatile Markets*, ROXBURY CAPITAL MGMT., http://www.roxcap.com/PDF%20Files/White%20Papers/Mid_Cap_Stocks_The_Case_for_06032005.pdf (last visited Oct. 23, 2014).

66. *Large Cap—Big Cap*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/large-cap.asp> (last visited Oct. 23, 2014).

67. *See Microcap Stock*, *supra* note 64, and accompanying text.

68. *See* John McCrank, *Dark Markets May Be More Harmful Than High-Frequency Trading*, REUTERS (Apr. 6, 2014, 8:26 AM), <http://www.reuters.com/article/2014/04/06/us-dark-markets-analysis-idUSBREA3508V20140406> (reporting “around 40 percent of all U.S. stock trades . . . now happen ‘off exchange,’ up from around 16 percent six years ago”).

NASDAQ and the NYSE.⁶⁹ In such markets, broker intermediaries “internalize trades” and are not required to provide any information to the market prior to executing the trade such that price is not adjusted until afterward.⁷⁰ The efficient and timely incorporation of public information into a stock’s market price is precisely what enables the inference that a material public misstatement about a company or its stock caused an investor’s loss.⁷¹ Therefore, the presumption that investors relied on the stock’s price would only apply in “well-developed” markets that efficiently process information and prices adjust accordingly.⁷² In an efficient market, misleading or inaccurate statements will defraud investors even if they did not individually rely on that information when buying or selling the stock.⁷³ However, in “dark” markets and smaller, inefficient markets composed of “under-followed” stocks, information is often not incorporated into the stock’s price in an efficient or timely manner.⁷⁴

If the legal presumption of class-wide reliance rests on an efficient market’s existence, courts should analyze market efficiency using a widely accepted means such as an event study.⁷⁵ Although the Supreme Court has not provided a test for determining market efficiency, federal appeals courts often look to the factors provided in *Cammer v. Bloom*.⁷⁶ These factors include (1) a large weekly trading volume; (2) analyst following; (3) the presence of market makers; (4) issuer qualification for use of an S-3 registration statement; and (5) facts showing causal relationship between information and stock price.⁷⁷ Courts most often rely on the fifth

69. *Id.*

70. *Id.*

71. *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2404 (2014) (“*Basic* allows plaintiffs to establish price impact indirectly by showing that a stock traded in an efficient market and that a defendant’s misrepresentations were public and material.”).

72. *Id.* at 2408 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988)).

73. *See* Hartzmark & Seyhun, *supra* note 54, at 420–21 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1168 (3d Cir. 1986)).

74. *See* McCrank, *supra* note 68, at 1; *see also* Santoli, *supra* note 63, at 4 (noting that many micro- and small-cap stocks are typically not followed by industry analysts).

75. *See* Fisher, *supra* note 53, at 878 (arguing event studies can prove “reliance, materiality, loss causation, and damages”).

76. *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989); *see* Fisher, *supra* note 53, at 858–59.

77. *See* Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc., No. 06-3794-cv, 2006 U.S. Dist. LEXIS 52991 (S.D.N.Y. Aug. 1, 2006) at *11–13; Hartzmark & Seyhun, *supra* note 54, at 421–22.

factor as most determinative of efficiency.⁷⁸ The Court did not conduct a *Cammer*-style analysis in *Halliburton* because the issue was limited to what evidence could be introduced at the class-certification stage.⁷⁹ However, the reliance presumption's applicability turns on whether the market was efficient for the stock in question, so the Court's failure to address market efficiency before allowing the plaintiff to invoke a key evidentiary presumption was substantially unfair.

B. The Abundance of Market-Distorting Factors Render the Reliance Presumption Improper

As suggested previously, stock prices do not always efficiently reflect all available public information, which calls into question the reliance presumption's validity.⁸⁰ The Court discounted non-fraudulent market distorting factors such as undervaluation,⁸¹ bubble-bursting,⁸² day trading,⁸³ short selling,⁸⁴ and third-party stock manipulation, all of which are unrelated to fraudulent conduct on the issuer's part.⁸⁵ The Court in *Halliburton* dismissed the impact of short selling and arbitrage trading on market efficiency.⁸⁶ But short sales account for 31% of all sales for NASDAQ listed stocks and 24% of all NYSE listed stocks.⁸⁷ As opposed to investors who make trading decisions based on a stock's perceived value, short sellers

78. See Hartzmark & Seyhun, *supra* note 54, at 423.

79. See *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407 (2014).

80. See Bebchuk & Ferrell, *supra* note 48, at 671.

81. *Undervalued*, INVESTOPEDIA, <http://www.investopedia.com/terms/u/undervalued.asp> (last visited Oct. 23, 2014) (defining undervalued as a stock "selling for a price presumed to be below the investment's true intrinsic value" based on typical indicators of financial performance including "cash flow, return on assets, [and] profit retention").

82. Fisher, *supra* note 53, at 895 (arguing that cultural and behavioral factors spurred aggressive trading during the late 1990s, which saw "huge swings" in market index and "bizarre" individual company valuations).

83. *Id.* at 922 n.202 (defining a "day trader" as an unlicensed individual who trades frequently based on short-term interests, and whose ability to trade is based on "real time" access to exchanges).

84. *Id.* at 913, 914 n.181 (referring to selling shares not yet owned by borrowing against funds held in a margin account, then closing the position and delivering those shares to the buyer).

85. See Bebchuk & Ferrell, *supra* note 48, at 671 (arguing fraudulent distortion, not efficiency, should be dispositive in determining whether the reliance presumption applies).

86. See *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2410–11 (2014).

87. See Merrit B. Fox et al., *Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y.L. SCH. L. REV. 645, 646 (2009–2010) (reporting that in 2009, short sales accounted for 31 percent of all sales for NASDAQ-listed stocks and 24 percent of all NYSE-listed stocks).

place an order to sell a stock based on the expectation that the price will drop before they close their position or finalize the sale.⁸⁸

Short selling arguably yields some benefits to the market such as balancing overvaluation or “bubbles” caused by irrational “noise trading,” increasing liquidity, and allowing brokerages to make a market for securities in the face of heavy selling.⁸⁹ Short selling also offers incentives and opportunities to manipulate stock values.⁹⁰ One method is to offer to buy a stock at a future price below the current traded value, resell, spread negative misinformation with the intent to drive the price down, then cover the transaction (close the position) at the lower price.⁹¹ Additionally, short sellers can disseminate false positive news that drives up a stock’s price, then short sell at the inflated price anticipating that the price will fall when the market learns the truth.⁹²

While Rule 10b-5 prohibits market manipulation,⁹³ the large number of online forums for spreading such false information enables short sellers’ to conduct these strategies with anonymity. Many Internet sites purport to offer a medium for traders to exchange information about stocks but allow users to create pseudonyms so anyone can post unverified information about a company.⁹⁴

The active presence of short sellers and the effect on market efficiency raises causation issues for investors seeking to recover in Rule 10b-5 class actions. When investors exploit a stock’s inefficiency, through their own activities or those of third parties, less informed traders cannot rely on market efficiency, and their

88. *Short Selling*, INVESTOPEDIA (Aug. 13, 2014), <http://www.investopedia.com/terms/s/shortselling.asp>.

89. Fox et al., *supra* note 87, at 651–52.

90. *Id.* at 652–53.

91. *Id.* at 656.

92. *Id.*

93. 17 C.F.R. § 240.10b-5 (2014) (prohibiting any activity that would “operate as fraud” in the sale or purchase of any security).

94. See, e.g., *About Seeking Alpha*, SEEKING ALPHA, http://seekingalpha.com/page/about_us (last visited Oct. 1, 2014) (purporting its articles “move stocks” because they are widely viewed by financial professionals and bloggers); see also *Tips for Short Selling Penny Stocks*, ALTCOIN NEWSLETTER (Aug. 18, 2014), <http://altcoinnewsletter.com/short-sell-penny-stocks/> (suggesting “negative financial news or bearish trader sentiment on social media will move [stock] prices” and help traders “profitably short penny stocks”).

losses—at least in part—may be due to trading a stock that is heavily shorted and would not be fully attributable to the alleged fraud.⁹⁵

If these factors frequently result in an inefficient market, then it follows that a blanket reliance presumption is improper. Although event studies can help explain stock price fluctuations, market variables that can impact a stock's price make it difficult to isolate causation with precision.⁹⁶

V. THE FAULTY ASSUMPTION THAT MOST INVESTORS TRADE BASED ON EFFICIENT MARKET PRICE

The reliance presumption assumes investors rely on efficient market pricing. The Court in *Basic* noted the presence of value investors, professionals who aim to take advantage of inaccurate prices to profit from future price adjustments, but reasoned these investors had relied on the fact the stock would “eventually reflect material information.”⁹⁷ The Court's reasoning does not reconcile these strategies with the reliance presumption's premise that an investor relies on price at the time she transacts.⁹⁸ This flawed reasoning failed to convince all members of the *Basic* Court⁹⁹ and continued to trouble at least three of the Justices in *Halliburton*.¹⁰⁰ If a trader buys or sells based on perceived under- or overvaluation, then that trader does not rely on an efficient market price “at the time he transacts.”¹⁰¹

In addition to the prevalence of trading strategies unrelated to price, modern markets are flooded with information from a variety of credible and non-credible sources.¹⁰² The amorphous numbers of variables that affect trading decisions render the presumption that most investors rely on efficient pricing improper. Many investors

95. See generally Erenburg et al., *supra* note 48 (supporting the general premise that modern markets are often inefficient due to price-distorting factors).

96. See Hartzmark & Seyhun, *supra* note 54, at 425–26 (noting difficulties with separating market- and industry-wide variation from firm-specific price movement).

97. *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2411 (2014).

98. *Id.* at 2423 (Thomas, J., concurring).

99. See *Basic Inc. v. Levinson*, 485 U.S. 224, 251 (1988) (White, J., dissenting) (arguing an investor who “sells a stock ‘short’ days before the misrepresentation is made” cannot be said to have relied on the price).

100. *Halliburton*, 134 S. Ct. at 2423 (Thomas, J., concurring).

101. *Id.*

102. See Jane Thayer, *Investors Trust Dubious Sources for Stock News*, ACCT. TODAY (Jan. 4, 2011), <http://www.accountingtoday.com/news/Investors-Trust-Dubious-Sources-Stock-News-56806-1.html>.

now rely on secondary sources of information rather than information released directly from the issuer, as recommended by regulatory authorities.¹⁰³ Since *Basic*'s ruling twenty-one years ago, financial markets have been inundated with information from online information reporting websites,¹⁰⁴ analysts,¹⁰⁵ and financial blogs.¹⁰⁶

Whereas analysts and market professionals or arbitrageurs can enhance price efficiency,¹⁰⁷ less reputable investors who are vocal on financial blogs can easily distort the market for a micro-cap stock.¹⁰⁸ Many investors base trading decisions on “momentum strategies” rather than market price or available information.¹⁰⁹ Amateur investors are more likely to trade based on tips from other online investors.¹¹⁰ These investors communicate with other investors and the market by establishing anonymous profiles on “online bulletin boards or electronic chat rooms” where they purport to have credible information about a company's stock value.¹¹¹ Investors on websites may target specific stocks and suggest opportunities to profit from “shorting” the stock.¹¹² For example, during periods of heavy selling, an investor may anticipate an individual stock's price may fall as a

103. See *Managing Investment Risk*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/ManagingInvestmentRisk/> (last visited Oct. 7, 2014) (recommending investors evaluate risk by researching issuer-sourced information such as SEC reports and financial statements).

104. See, e.g., *Investor Protection*, OTC MARKETS, <http://www.otcmarkets.com/learn/otc-company-overview> (last visited Oct. 7, 2014) (claiming it organizes and disseminates stock information, company information, thereby increasing investors' access to information).

105. *Analyst*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/analyst.asp> (last visited Feb. 4, 2015) (defining an analyst as a “financial professional who has expertise in evaluating investments and puts together . . . [specific trading] recommendations”).

106. *Financial Blog*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/financialblog.asp> (last visited Feb. 4, 2015) (noting financial blogs often share or comment on information, but also provide free “analysis” that often “reflect[s] personal opinion”).

107. See Fisher, *supra* note 53, at 854–55 (referring to *Basic*, in which the Court noted “shrewd” market professionals who trade based on anticipated future value increase market and price efficiency).

108. See *supra* Part IV.A and accompanying footnote (noting even minimal trading activity can distort the price of micro-cap stocks).

109. See Erenburg et al., *supra* note 48, at 261.

110. See The Aleph Blog, *The Tip Culture in Amateur Investing*, YAHOO FINANCE (Aug. 16, 2014, 9:03 PM), <http://finance.yahoo.com/tumblr/blog-the-tip-culture-in-amateur-investing-080824959.html> (noting the “tip culture” of inexperienced investors).

111. Fisher, *supra* note 53, at 925.

112. See, e.g., Kapitall, *16 Microcap Stocks Being Targeted by Short Sellers*, SEEKING ALPHA (Oct. 26, 2011, 9:04 AM), <http://seekingalpha.com/article/302247-16-micro-cap-stocks-being-targeted-by-short-sellers> (“If you're looking for micro-cap short ideas, [see] the following list . . .”).

result of the general market momentum and decide to sell.¹¹³ That investor does not rely on the stock's current price when trading. To allow traders who traded for reasons unrelated to price to nevertheless invoke the reliance presumption is a miscarriage of justice.¹¹⁴

VI. *HALLIBURTON* DID LITTLE TO REMEDY *BASIC*'S
"BITTER HARVEST"

The implications of the Court's ruling in *Halliburton* are potentially significant, particularly with respect to class action litigation strategy. The ruling will not likely result in an overwhelming reduction in Rule 10b-5 class actions as many issuers and corporate advocates hoped because investors can still invoke the reliance presumption. The Court's adherence to the old reliance presumption allows investors to proceed through class certification but only if their claims can survive a price impact attack. Many corporate litigators, however, expect the ruling to increase the amount of resources defendant corporations spend on the certification stage because of the potential to defeat certification with evidence of an absence of price impact.¹¹⁵ Introducing price impact evidence requires additional expert witnesses to testify using complex event studies; both the expert witnesses and the studies are costs defendants will assume.¹¹⁶

Upholding the reliance presumption but allowing defendants to rebut it with price impact evidence holds the gates open for lucrative securities class actions but increases the already heavy burden on trial courts.¹¹⁷ *Halliburton*'s direct implication will be that trial court judges will now have the difficult job of distinguishing price impact

113. See Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 22 (1994).

114. See *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2422 (2014) (Thomas, J., concurring) (arguing that "*Basic*'s critical fiction falls apart" when applied to an investor who did not trade based on what he thought was an efficient price).

115. See Smith et al., *supra* note 35.

116. See *id.*

117. See Jared L. Kopel, *Viewpoint: In Halliburton Ruling, a Few Tweaks, But No Overhaul of Securities Class Actions*, THE RECORDER (June 25, 2014), available at <http://www.therecorder.com/id=1202723759021/Viewpoint-SEC-Eyes-Cybersecurity-Disclosure-Regs>.

evidence from evidence on the absence of causation and materiality, which is prohibited at class certification.¹¹⁸

One possible implication of *Halliburton* on litigants is that plaintiffs' firms may select cases with facts likely to withstand a vigorous price impact challenge or involving larger damage amounts.¹¹⁹ Furthermore, claims that survive class certification will be worth more in settlement.¹²⁰ Defendants may also be more willing to settle if a price impact rebuttal fails.

Ultimately, investors will carry the burden of the Court's *Halliburton* ruling. Higher costs for companies will negatively impact shareholder returns, since profits will decrease from increased litigation and insurance expenses.¹²¹ Companies may also undertake planning measures that anticipate these extra litigation costs such as purchasing larger director and officer insurance plans.¹²²

The Court should have seized a ripe opportunity to strike down an erroneous legal doctrine based on an economic theory contradicted by modern empirical evidence. Its failure to do so will likely result in continued inconsistency as federal courts strive to discern when economic conditions warrant applying the reliance presumption.¹²³ As Justice Thomas noted in his *Halliburton* concurrence, a legal doctrine should not be based on a "judicial hunch."¹²⁴ As a result of the holding, the reliance presumption continues to be available to all investors who trade during the allegedly affected time frame regardless of whether they ever saw or

118. *See id.*

119. *See id.* (noting at least one prominent plaintiffs' attorney expected firms to "consolidate their resources, formally or informally").

120. *See id.*

121. *See* Andrew J. Pinkus, *Why The Supreme Court's Decision in Halliburton Is Bad News for Investors and the Public*, CLASS DEFENSE BLOG (June 24, 2014), <http://www.classdefenseblog.com/2014/06/24/why-the-supreme-courts-decision-in-halliburton-is-bad-news-for-investors-and-the-public/> (citing a study that reported "investors' 'total wealth loss' from securities class actions 'averages to about \$39 billion per year, in order to collect an average of \$6 billion in settlements per year'").

122. *See id.*; *see, e.g., The Halliburton, Co. v. Erica P. John Fund, Inc. Decision: The Event Study Endorsement*, AIG, http://www.aig.com/halliburton-d-and-o_3171_611162.html (last visited Mar. 6, 2015) (responding to *Halliburton's* ruling by offering to "D&O policyholders the Event Study endorsement, a policy endorsement that ensures primary D&O policy funds are immediately available to clients named as defendants in securities class actions for the preparation of event studies").

123. *See* *Basic Inc. v. Levinson*, 485 U.S. 224, 252 (1988) (White, J., concurring in part and dissenting in part) ("Confusion and contradiction in court rulings are inevitable . . .").

124. *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2422 (2014) (Thomas, J., concurring).

traded on the alleged misinformation. Thus, the flow of meritless claims will continue to burden the federal courts and cost investors billions.¹²⁵

125. *See Malack v. BDO Seidman, LLP*, 617 F.3d 743, 755 (3d Cir. 2010) (“An increase in frivolous litigation drives up the overall costs of issuing securities, ultimately harming everyone involved.”).