THE DETERRENCE PARADOX: HOW MAKING SECURITIES FRAUD CLASS ACTIONS MORE DIFFICULT FOR PLAINTIFFS WILL MORE STRONGLY DETER CORPORATE FRAUD

I. INTRODUCTION

Corporate America has a problem. This problem predates the "Financial Crisis" and "Great Recession" of the past two years. With average securities fraud cases settling for $62 million in 2006, more than double the average settlement of 2004,[1] plaintiffs' lawyers have it made. The largesse of this growth industry owes its existence to the current securities law regime and the litigation structure in place in federal courts. But while plaintiffs' lawyers are happy to rake in their share of lucrative settlements, defrauded shareholders lament that they are being inadequately compensated under the current regime and, worse, that the private securities fraud class action no longer provides incentives for companies to refrain from fraudulently manipulating their share prices.[2]

The impetus and engine for this growth is a legal device known as the fraud-on-the-market theory, under which shareholder plaintiffs are entitled to a rebuttable presumption of reliance that the market price at which they are trading is undistorted by corporate fraud.[3] While the theory is potentially useful at a trial on the merits, it is the plaintiffs' best weapon at the class certification stage of a case, enabling shareholder plaintiffs to win class certification motions based largely on this powerful presumption.[4] Once class certification is granted, the case is headed for settlement regardless of its merits.[5]

While this theory fueled the class action as a powerful tool for enforcement of the securities laws,[6] its use has spun out of control and must be restricted. Because companies pay settlements to end both strong cases and weak cases of securities fraud in order to avoid expensive discovery and litigation costs, there is

1. Jonathan C. Dickey, *Current Trends in Federal Securities Litigation*, PLI SEC. LITIG. & ENFORCEMENT INST. 2007, at 3 (Oct. 15, 2007), http://www.gibsondunn.com/publications/Documents/DickeySecuritiesLitigationAndEnforcementInstitute2007.pdf.

2. *See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 955 (1999) (explaining that if companies pay similarly sized settlements to both strong and weak claims, legal regime's deterrence effects are diluted).

3. Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988).

4. *See, e.g.*, *Basic*, 485 U.S. at 248 (noting certification of class because of public material representations).

5. Pritchard, *supra* note 2, at 950–59 (discussing plaintiffs' and defendants' incentives to settle all cases that survive pleadings stages).

6. *Basic*, 485 U.S. at 230–31.

no incentive to avoid the abhorrent, morally culpable, fraudulent primary corporate conduct that becomes a strong securities fraud case.

If the securities regulation regime required more in the way of proof at the class certification stage, frivolous cases would no longer be profitable for plaintiffs' attorneys. Rather than creating a diversified portfolio of securities cases, plaintiffs' lawyers would be best off expending their time and energy on strong claims. Consequently, corporate fraud will be more effectively deterred, as only strong claims based on morally culpable conduct, would be punished. Plaintiffs' lawyers will have less financial success bringing frivolous cases because these cases will no longer be blessed with settlement value that is inherent in a class certification order. Under the proposed regime, corporations will be able to avoid liability by completely and honestly disclosing information, whereas the current approach punishes innocent companies with settlement costs merely because plaintiffs' lawyers are able to win class certification motions. Thus, the proposed regime would return to the securities laws their proper and intended deterrent effects.

Therefore, this Comment sets forth a proposal for an altered regime that courts should follow, an approach that is similar to the procedure that the Court of Appeals for the Fifth Circuit has recently established.[7] The proposed approach requires proof of loss causation—proof that the fraudulent misstatement or omission actually distorted the market price—at the class certification stage.[8] By following the proposed regime, courts will reinforce and restore the efficacy of the deterrent role of securities fraud litigation[9] at little or no additional cost.[10] More importantly, requiring proof of loss causation before applying the rebuttable presumption reflects a more complete and sound understanding of the rationale underlying fraud-on-the-market theory.[11]

Parts II.A and II.B provide an overview of the current state of the law governing private securities fraud causes of action, including the elements and history of the cause of action and the fraud-on-the-market theory and its legal development. To develop a comprehensive approach, Part II.C provides a discussion of the economic and financial principles that form the conceptual foundation of fraud-on-the-market theory and that underlie much of securities regulation in general. The remaining sections of Part II demonstrate how the lower federal courts have implemented the theory in practice and how the doctrine has evolved over the last two decades.

Part III of the Comment demonstrates that establishing a requirement that plaintiffs must prove loss causation at the class certification stage as a predicate to earning the fraud-on-the-market presumption of reliance would improve the

7. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 269 (5th Cir. 2007).

8. *Oscar*, 487 F.3d at 268–69.

9. *See* Pritchard, *supra* note 2, at 955 (discussing how settlement of weak cases under current regime lowers deterrence).

10. *See Oscar*, 487 F.3d at 267 (noting small amount of discovery required).

11. See *infra* Part III.B for a complete discussion of why the loss causation approach is more theoretically sound than the current approach that most district courts employ.

function of private securities litigation. Part III.A discusses the dispositive nature of class certification decisions on the value of securities fraud claims and sets out the reasons that the suggested change is more than adequate procedurally under the Federal Rules of Civil Procedure and conceptually under current theory and precedent. Lastly, this Comment addresses several counterarguments to the suggested changes and how these counterarguments lack persuasive force considering all the benefits of the proposed change.

II. OVERVIEW

Properly evaluating proposed changes in the legal regime of securities fraud requires a basic understanding of how the rules in place developed and how the legal rules work both in theory and in practice. Part II.A discusses the historical evolution of the securities fraud cause of action, including its elements and its purposes. Part II.B then discusses the inception, history, and development of the fraud-on-the-market theory, and details the only Supreme Court opinion dealing with that theory, *Basic Inc. v. Levinson*.[12]

Part II.C provides a discussion and several viewpoints of the relevant financial and economic concepts needed to properly analyze and apply the fraud-on-the-market theory, namely market efficiency. Part II.C.1 presents the three versions of the efficient capital markets hypothesis ("ECMH") and discusses the meaning of the economic term "relative efficiency." The ECMH and concept of relative efficiency underlie the Court's decision in *Basic*, and all of fraud-on-the-market theory in general, so this Comment presents a thorough discussion of its merits, critiques, and theoretical complexities. Part II.C.2 further examines the theory, providing insight into the important distinction between fundamental and informational market efficiency.

Part II.D details and chronicles the efforts by various lower federal courts to apply *Basic* and adjudicate fraud-on-the-market cases, including cases such as *Cammer v. Bloom*,[13] in which courts attempt to describe evidence of an efficiently functioning market in order to correctly apply *Basic*'s version of the fraud-on-the-market theory. Part II.E discusses how this effort has resulted in a hugely profitable industry for plaintiffs' securities lawyers, and how Congress and the Supreme Court have made efforts to curb this cottage industry. Finally, Part II.F describes a recent Fifth Circuit decision, *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[14] in which the United States Court of Appeals for the Fifth Circuit applied *Basic* in a novel way by imposing an additional requirement for plaintiffs seeking class certification under the fraud-on-the-market theory.[15]

12. 485 U.S. 224 (1988).

13. 711 F. Supp. 1264 (D.N.J. 1989).

14. 487 F.3d 261 (5th Cir. 2007).

15. *Oscar*, 487 F.3d at 269.

A. History of Securities Fraud Claims

Congress enacted the Securities Exchange Act of 1934[16] ("1934 Act") with the "fundamental purpose" of implementing a "philosophy of full disclosure" in American securities markets.[17] The Act established the Securities and Exchange Commission[18] ("SEC"), sets forth comprehensive legislation regarding national securities exchanges,[19] governs the registration and regulation of brokers and dealers,[20] protects the investing public against manipulation of securities prices,[21] and, most importantly for this Comment, includes extensive antifraud provisions.[22] Although Congress did not expressly provide a private civil remedy for fraud in the governing statute, and the legislative history does not imply one,[23] courts have inferred one from Rule 10b-5,[24] with the tacit approval of Congress.[25] The Supreme Court has called this private remedy an "essential tool for enforcement of the 1934 Act's [antifraud] requirements."[26] This enforcement mechanism has become all the more forceful with the growing significance of

16. 15 U.S.C. §§ 78a–78nn (2006).

17. SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180, 186 (1963); *see also* Silver v. NYSE, 373 U.S. 341, 366 (1963) (explaining that precipitous stock market crash in 1929 and subsequent Great Depression compelled Congress to insist upon "highest ethical standards" in securities industry to foster public confidence in financial markets).

18. 15 U.S.C. § 78d (establishing structure and function of SEC).

19. *Id.* § 78f (defining national exchanges based on registration and other requirements).

20. *Id.* § 78o (describing registration and regulation process for broker-dealers).

21. *Id.* § 78i (setting forth prohibited practices of market manipulation).

22. *Id.* § 78j (criminalizing fraudulent, manipulative, and insider trading actions).

23. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196–97 (1976) (reasoning that although Congress did not expressly provide private civil remedy in statute, and there is no evidence that Congress or SEC considered remedy when enacting statute and promulgating rule, courts have judicially interpreted 1934 Act and Rule 10b-5 to allow for such remedy); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (noting Supreme Court's agreement with "overwhelming consensus of the District Courts and Courts of Appeals that such a cause of action did exist").

24. 17 C.F.R. § 240.10b-5 (2008). The Securities and Exchange Commission enacted Rule 10b-5 pursuant to its authority granted by the 1934 Act. 15 U.S.C. §§ 78d, 78j(b). Rule 10b-5 provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . , in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

25. *See* Basic Inc. v. Levinson, 485 U.S. 224, 230–31 (1988) (combining universal judicial interpretation of implied private remedy in Rule 10b-5 with substantial passage of time to find legislative acquiescence, or ratification, of implied remedy). To demonstrate its acquiescence, Congress has gone so far as to impose statutory restrictions on this type of action. *See, e.g.*, 15 U.S.C. § 78u-4(b) (imposing procedural requirements on private class actions brought under Rule 10b-5).

26. *Basic*, 485 U.S. at 231. *But see* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 34 (2007) (arguing that securities fraud class actions "do far more harm than good" by generating economic costs with no economic benefits, and that class actions benefit only plaintiffs' bar).

Rule 10b-5 class actions.[27] The private securities fraud cause of action, and class actions in particular, serve the dual role of compensating defrauded investors and deterring corporations from committing fraud.[28]

In fraud cases involving public market securities transactions, plaintiffs must establish the following six elements to state a claim: (1) a material misrepresentation or omission; (2) scienter; (3) connection between the misrepresentation (or omission) and a securities transaction; (4) transaction causation, or reliance; (5) economic harm; and (6) loss causation.[29]

The reliance requirement originated in the common law doctrine of deceit.[30] A person is liable for deceit when he or she makes a fraudulent misrepresentation to another who justifiably relies on that misrepresentation and incurs loss.[31] In the context of financial market transactions, reliance is established by showing that the investor-plaintiff was induced to enter into a securities deal by the misrepresentation at issue.[32] For this reason, the traditional requirement of reliance has been termed "transaction causation" in this context.[33]

B. Fraud-on-the-Market Theory and Its Development

Seeking to satisfy the reliance requirement, securities fraud plaintiffs advanced what has become known as the fraud-on-the-market theory.[34] In a traditional fraud case, proof of reliance necessarily focuses on the effect of the alleged misstatement on the plaintiff's conduct; in a fraud-on-the-market case, the inquiry delves into the degree to which the challenged statements or omissions impacted the securities market price, assuming that investors consider and rely on market prices when deciding whether or not to enter into securities

27. *See* Pritchard, *supra* note 2, at 928 (explaining that considerable trade volume in securities markets can propel class action damages into hundreds of millions of dollars).

28. *See id.* at 945–59 (discussing deterrence and compensatory roles of fraud-on-the-market class actions). Professor Pritchard discusses how this compensatory role operates at a net social loss, because the wealth transfer of a damage judgment does not compensate for transactions costs to avoid fraud. *Id.* at 938–40.

29. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (citations omitted); *see also Basic*, 485 U.S. at 231 (recounting evolution of positive and common law requirements); Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 439 (1984) (noting that elements have developed through statutory interpretation of 1934 Act and borrowed from common law tort doctrines of fraud and deceit).

30. *See Basic*, 485 U.S. at 243 (noting that courts have historically required proof of reliance in common law fraud claims); *id.* at 251–53 (White, J., concurring) (discussing implications of reliance element and stating that case law governing Rule 10b-5 actions developed from doctrines of fraud and deceit).

31. RESTATEMENT (SECOND) OF TORTS § 525 (1977).

32. Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 458 (2006).

33. *Id.*

34. Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 907–08 (1989).

transactions.[35] By shifting the inquiry to a question of the market price reaction, fraud-on-the-market plaintiffs much more easily win class certification motions under Rule 23(b)(3)[36] by showing that common questions predominate over individual ones.[37]

Put simply, fraud-on-the-market theory allows the district courts to impose a rebuttable presumption that purported class members have each satisfied the reliance requirement of a Rule 10b-5 claim.[38] A court may presume reliance on "materially misleading statements or omissions" made by companies whose shares trade "in an efficient market."[39]

Although the Supreme Court did not address it until years later, the fraud-on-the-market theory first emerged in the Ninth Circuit in *Blackie v. Barrack*.[40] In that case, the court consciously and explicitly overlooked the lack of direct proof of reliance in a stock market transaction and, instead, inferred causation from a material misstatement or omission that impacted the market.[41] Although its theoretical underpinnings would eventually call for Supreme Court clarification, the reasoning in *Blackie* was applied by a number of appellate courts over the next decade, and was never overtly rejected.[42]

35. *See Basic*, 485 U.S. at 243, 247 (noting that investor's reliance on integrity of market price may supply causal nexus between defendant's misrepresentation and plaintiff's injury).

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

37. Class certification under Rule 23(b)(3) requires that "the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy." *Id.*; *see also* Dunbar & Heller, *supra* note 32, at 461–62 (noting that proof of reliance without invoking fraud-on-the-market theory is "at best a tedious proposition for plaintiffs' counsel"); Fischel, *supra* note 34, at 908 (arguing that requiring proof of individual reliance would diminish likelihood that purported class will satisfy commonality requirement for class certification); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 891–92 (1992) (arguing that if purported class members carried burden of establishing individual reliance, "the class action as a mechanism for redressing securities fraud would be diminished severely in its efficacy, if not rendered impotent"). The Supreme Court has rejected the notion that fraud-on-the-market theory eliminates the reliance requirement altogether. *See Basic*, 485 U.S. at 243 (dismissing petitioner's assertion that Court is eviscerating reliance requirement and positing that causal linkage between plaintiff's injury and defendant's misstatement or omission, rather than direct reliance, is what legislative scheme and rule require). Professor Fischel argues, however, that the inquiry into the market effects of the challenged disclosure reaches the merits of the case and, thus, is not decided at the class certification stage. Fischel, *supra* note 34, at 908. As a result, he contends that the fraud-on-the-market presumption has removed proof of reliance as a barrier to class certification. *Id.*

38. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 264 (5th Cir. 2007). This presumption may be rebutted by "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price." *Basic*, 485 U.S. at 248.

39. *Oscar*, 487 F.3d at 264. See *infra* Part II.C for a complete discussion of market efficiency and its importance to fraud-on-the-market theory.

40. 524 F.2d 891 (9th Cir. 1975).

41. *Blackie*, 524 F.2d at 906–07.

42. *See, e.g.*, Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986) (stating, in reliance on *Blackie*, that "[m]isleading statements will . . . defraud purchasers of stock even if the purchasers do not

In *Basic Inc. v. Levinson*,[43] the Supreme Court clarified the conceptual foundation of the fraud-on-the-market theory and laid out its procedural and mechanical gravamen.[44] The Court affirmed the Sixth Circuit's application of a rebuttable presumption of reliance on an interlocutory appeal from an order certifying plaintiffs' class.[45] The Court ultimately determined that the presumption of reliance was properly applied and that it offered courts an effective balance between the substantive requirement of reliance and the procedural requirements of Rule 23.[46]

The Court noted that the rebuttable presumption generated by the fraud-on-the-market theory would be consistent with judicial policies supporting the use of presumptions in general.[47] Additionally, the *Basic* Court found that the applied presumption was consistent with the implied legislative policy of the securities laws, reasoning that by enacting legislation to facilitate investor confidence in the information concerning financial markets, Congress was recognizing that investors can be presumed to rely on such information.[48] The notion that the presumption relieved Rule 10b-5 plaintiffs who traded on the impersonal securities markets of an "unnecessarily unrealistic evidentiary burden" persuaded the Court that the presumption was proper.[49]

While the procedural mechanisms approved in *Basic* have resulted in far-reaching consequences,[50] the theoretical basis advanced by the Court in support of the fraud-on-the-market theory, namely the judicial acceptance and interpretation of the efficient capital markets hypothesis,[51] has generated a plethora of divergent scholarly responses.[52] The majority in *Basic* set out "not to

directly rely on the misstatements"); *see also* Langevoort, *supra* note 37, at 890 & n.132 (collecting cases and journal articles).

43. 485 U.S. 224 (1988).

44. *See* Langevoort, *supra* note 37, at 893 (noting that Court's opinion in *Basic* "leaves relatively little undone for purposes of structuring the theory").

45. *Basic*, 485 U.S. at 229–30, 245–47.

46. *Id.* at 242, 250.

47. *See id.* at 245–46 (noting that presumptions are employed to assist court when requiring direct proof is unjustly difficult and that they are "useful devices for allocating the burdens of proof between parties" that support considerations of judicial economy, fairness, probability, and public policy).

48. *Id.* at 245–46.

49. *Id.* at 245 (disapproving of scenario that would require plaintiffs to prove how they would have acted had defendant not made misstatement or omission).

50. *See* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 176 (2002) (positing that fraud-on-the-market presumption is little more than practical judicial economy tool that substitutes proof of causation for proof of reliance as most effective way to facilitate this type of private litigation).

51. See *infra* Part II.C for a more complete discussion of the efficient capital markets hypothesis.

52. Efficiency theorists routinely praise judicial acceptance of what they believe to be such a powerful analytical tool. *See, e.g.*, Fischel, *supra* note 34, at 911 (noting clear link between efficient capital markets hypothesis and fraud-on-the-market theory and arguing that the more efficient the market, the more sensible the application of fraud-on-the-market theory); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549–50 (1984) (describing role of efficient market hypothesis in any debate over securities or financial market regulation and its growing impact on judicial opinions and law practice). Some critics argue that the Court's articulation

assess the general validity of the [fraud-on-the-market] theory," but rather to test whether the theory supported the presumption applied by the lower courts.[53]

The *Basic* Court quoted and adopted the theory as articulated by the Third Circuit in a case decided two years prior, *Peil v. Speiser*.[54] That court succinctly summarized the fraud-on-the-market theory's theoretical construction as follows:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.[55]

By adopting this formulation, the Court stressed that the substantive requirement of reliance would survive the adoption of the new theory.[56]

In addition, the Court noted that the result of the case was dictated by "common sense and probability."[57] The support noted by the Court is found in the lower courts' acceptance of the fraud-on-the-market theory[58] and in scholarly praise of the new theory.[59] While not treading too deeply into economic academia, the Court noted its tacit acceptance of some ingredients of economic theory.[60] In its statement adopting the efficient markets hypothesis, the Court

and application of the efficient markets hypothesis in *Basic* is imprecise or conceptually flawed. *See, e.g.*, Ian Ayres, *Back to* Basics*: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 997–98 (1991) (drawing distinction between informational efficiency and fundamental value efficiency, which is distinction that plagues cohesive understanding of *Basic* rationale); Langevoort, *supra* note 37, at 895–96 (detailing why prevailing reading of *Basic* misuses efficient market hypothesis by using it to predict individual investor behavior when individual rationality assumption is undercut by investors seeking habitually to beat market); Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson, 77 VA. L. REV. 1017, 1049 (1991) (arguing that inquiry into market efficiency is too complex and should be replaced by simpler inquiry into whether there is any significant market response to allegedly fraudulent information). Another class of scholars attacks this opinion on grounds relating to the merits of the efficient capital markets hypothesis itself. See *infra* Part II.C for a discussion of the merits and critiques of the ECMH.

53. Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988).

54. 806 F.2d 1154 (3d Cir. 1986).

55. *Basic*, 485 U.S. at 241–42 (quoting *Peil*, 806 F.2d at 1160–61).

56. *See id.* at 243–44 (restating that reliance is required under Rule 10b-5 as proof that defendant's conduct caused plaintiff's injury, and highlighting that causal link may, and indeed must, be proven in different manner if judicial interpretation will account for modernization of securities transactions since passage of Rule 10b-5). The Court was careful to note later in the opinion that the presumption would be rebutted by anything that severed the link between defendant's misrepresentation or omission and plaintiff's transaction decision or price. *Id.* at 248–49.

57. *Id.* at 246. Paradoxically though, the Court felt compelled to support its assertion of common sense with citations to scholarly articles published in law journals. *Id.* at 246 n.24.

58. *Basic*, 485 U.S. at 247 & n.25.

59. *Id.* at 247 & n.26.

60. *Id.* at 246 n.24.

advised that it would not be necessary to debate the merits of the theory itself.[61] Instead, the Court noted that to justify "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."[62] Subsequently, the Court held that investors in securities markets necessarily rely on the integrity of market price, and because market prices react to "most publicly available information," such an investor's reliance on material misrepresentations may properly be presumed.[63] The Court noted in a footnote a desire to divorce this decision from any particular version of market efficiency, saying that it did "not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price."[64]

In dissent, Justice White found fault in the majority's application of fraud-on-the-market doctrine.[65] He foresaw "[c]onfusion and contradiction" in the lower courts as a result of the majority's adoption of economic theory.[66] More specifically, his arguments that the Court is not properly equipped to evaluate the merits of the efficient market hypothesis and that the empirical results are not conclusive compelled his argument that if securities law is to adapt to modernized market transactions, it is the job of the legislature to do so.[67] While many of his concerns dealt with the proper relative roles of the courts and the legislature,[68] he also pointed out flaws in the conceptual basis for the fraud-on-the-market theory as expounded by the majority.[69]

C. Efficient Capital Markets Hypothesis and Its Evolution

Much of the debate over fraud-on-the-market theory in securities fraud cases really centers on the merits of its underlying theory, known as the efficient capital markets hypothesis.[70] While the theory is required study in basic economics and finance courses, it is not without its detractors: many scholars

61. *Id.*

62. *Id.*

63. *Basic*, 485 U.S. at 247. The Court went on to note several ways in which defendants might rebut that presumption, including showing that the truth effectively reached the market, thereby dissolving the effect of the misrepresentation, and showing that plaintiffs traded in spite of knowledge that market price was distorted. *Id.* at 248–49.

64. *Id.* at 248 n.28.

65. *Id.* at 250–63 (White, J., dissenting).

66. *Id.* at 252.

67. *Basic*, 485 U.S. at 253–55.

68. *See id.* at 253–59 (imploring Court to refrain from altering course of securities litigation when Congress would be better equipped and more empowered to do so). Justice White argued that the result reached by the majority was not in line with congressional policy and that the facts did not properly dictate the majority's result. *Id.*

69. *See id.* at 255–56 (asking what integrity of market price, as used by majority opinion, actually implies, given that securities have no widely accepted intrinsic value other than market price itself).

70. *See id.* at 248 n.27 (majority opinion) (requiring that plaintiffs demonstrate that shares were traded in efficient market before fraud-on-the-market presumption applies).

argue over its relative predictive value versus its descriptive value, and still others question whether its findings are valid at all.[71] Moreover, different types of market efficiency merit discussion, and most experts agree that efficiency as a concept is a matter of degree, rather than simple stratification into discrete classes.[72] Part II.C.1 discusses the three forms of the ECMH, their developmental origins, and their foundational premises. Part II.C.2 identifies the important distinction between informational efficiency and fundamental efficiency and the consequences of that distinction.

1. Three Versions of the ECMH and the Meaning of Relative Efficiency

The conceptual economic premise behind the ECMH states that in perfectly functioning capital markets, with negligible transaction or information costs, market forces will dictate that securities will be priced at a value equivalent to that which would be predicted by all relevant and available information.[73] Even though real-world markets are not perfectly functioning, assuming transactions and information-gathering cost money and take time, the efficacy and import of the theory is not lost.[74] The metric or relative market efficiency can effectively be judged, and can be defined as the speed with which prices reflect new information.[75]

In his seminal work on the ECMH, Eugene Fama proposed a trichotomy to describe forms of relative efficiency—weak, semistrong, and strong—with the three classes representing different observable market responses to subsets of information in empirical study.[76] Each form of the theory then asks whether empirical tests support the hypothesis that the market price of a security incorporates all available information falling into one of the given categories.[77]

The weak form of the theory is the most generally accepted,[78] and deals with past price data as the universe of information.[79] The accepted theory provides that when transactions costs are considered, past price information does not give an investor enough information to beat the market.[80] In sum, the weak form ECMH asks whether empirical tests support the notion that the market price of a security incorporates all the information contained in its price history; the consensus is that it does.[81]

71. See *infra* note 88 for a discussion of various criticisms of the ECMH.

72. *See, e.g.*, Gilson & Kraakman, *supra* note 52, at 560 (defining concept of relative efficiency).

73. *Id.* at 552.

74. *See id.* (noting ECMH prediction that markets without costless, immediate access to information will behave as though information was costless and immediately accessible).

75. *Id.* at 560.

76. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970); *see also* Gilson & Kraakman, *supra* note 52, at 555–56 (defining tripartite categories of tests of price behavior).

77. Dunbar & Heller, *supra* note 32, at 463.

78. *Id.* at 462–63; Gilson & Kraakman, *supra* note 52, at 555 n.25.

79. Dunbar & Heller, *supra* note 32, at 463.

80. *Id.*

81. *Id.*; Gilson & Kraakman, *supra* note 52, at 555 n.25.

At the opposite end of the spectrum, the strong form looks at the universe of information, both public and private, available to the most informed market participants.[82] Data suggests that insiders and exchange specialists do outperform the market and, thus, this form of the hypothesis has largely been rejected.[83] The general conclusion then is that certain insiders who are privy to certain nonpublic information can capitalize on that knowledge and, therefore, the strong form ECMH has generally been rejected.[84]

The so-called semistrong form of the ECMH, which limits the universe of information under study to all publicly available information, "asks whether an analyst can use all publicly available information to do better than the market."[85] This inquiry is critically important to investors[86] and the legal system alike, as it is this form of the theory that has provided the theoretical support for securities litigation since *Blackie*.[87] With respect to its legal implications, scholars have neither uniformly supported, nor criticized, this form of the theory, but it has generated a wealth of analytical responses.[88]

2. Informational Efficiency Versus Fundamental Efficiency

Much of the previous section differentiating between the three forms of the ECMH focused on analyzing the concept of relative efficiency, that is, the speed

82. *See* Dunbar & Heller, *supra* note 32, at 463 (focusing study on those with more access than general public to information, such as portfolio managers, corporate insiders, exchange specialists, and professional analysts).

83. *Id.* at 464; *see also* Fama, *supra* note 76, at 409–13 (discussing empirical tests of strong form efficiency theory).

84. Dunbar & Heller, *supra* note 32, at 464.

85. *Id.* at 463.

86. *See id.* (noting that if market is efficient in semistrong form and prices reflect all publicly available information, there is no value to fundamental analysis of companies for individual investors).

87. Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975). This semistrong form of the ECMH closely resembles the language used by the majority in *Basic*: "[M]ost publicly available information is reflected in market price." Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988); *see, e.g.*, Fischel, *supra* note 34, at 911 (noting rough equivalence of *Basic*'s central premise underlying fraud-on-the-market theory and semistrong form of ECMH).

88. Critics of the semistrong form of market efficiency take note of individual circumstances that compel inconsistent responses. *See, e.g.*, Langevoort, *supra* note 50, at 140 (noting anomaly that media reports containing no new information can have significant effect on stock price fluctuations, although semistrong ECMH would suggest that only new publicly available information should have this power). Professor Langevoort also points out as part of his "inefficiency hypothesis" that the driving force behind the "case against market efficiency is not the strength of any individual claim, but their aggregate weight." *Id.* at 141. He notes that the *Basic* court failed to consider the costs associated with a broad liability rule. Langevoort, *supra* note 37, at 900. Other commentators have noted the difficulty inherent in applying a standard of relative efficiency that will justify the presumption. *See, e.g.*, Fischel, *supra* note 34, at 912 (suggesting set of factors for determining requisite degree of relative efficiency that will justify presumption). Supporters of the semistrong version of the ECMH typically note the weight that investors place on public information. *See* Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451, 463 (1995) ("Few scholars would suggest that information is irrelevant in the development of market price.").

with which market prices react to new information.[89] Notably absent from that discussion as it relates to the legal import of the fraud-on-the-market theory is a discussion of the propriety of equilibrium market prices themselves.[90] Professor Langevoort makes this distinction succinctly: "Fundamental efficiency refers to prices that at all times conform to a consensus rational expectation about fundamental value. By contrast . . . informational efficiency assumes only that prices promptly respond to news, without any claim of close coupling with fundamental value. Thus, informationally efficient markets can be quite volatile."[91] Belief in the notion that not only will market prices react to information but that they will react correctly, or rationally, requires an additional analytical leap.[92]

D. Application of Fraud-on-the-Market Theory Since Basic

Since *Basic* the lower federal courts have sought workable standards for determining in a given case if a market is relatively efficient enough to justify the application of the fraud-on-the-market presumption of reliance.[93] At the class certification stage, *Basic* paints the district courts into the precarious corner of having to elicit a yes-or-no answer to the question, often considered a matter of degree, of whether a given market is efficient.[94]

A number of courts and scholars have agreed that in determining relative market efficiency, district courts should follow *Cammer v. Bloom*[95] for its multifactor inquiry. Factors include whether the security is traded on a national exchange, trade volume and other statistical data, the existence of market-makers, and whether the stock is covered by professional analysts.[96] Although

89. Gilson & Kraakman, *supra* note 52, at 560.

90. *See id.* (distinguishing fundamental and informational efficiency); Donald C. Langevoort, *Foreword: Revisiting Gilson and Kraakman's Efficiency Story*, 28 J. CORP. L. 499, 502 (2003) (noting Gilson and Kraakman's singular focus on informational efficiency as opposed to fundamental efficiency).

91. Langevoort, *supra* note 50, at 182.

92. *See* Langevoort, *supra* note 90, at 502 (recognizing that "markets can have a rapid speed of adjustment without necessarily producing a rational equilibrium" and that Gilson and Kraakman's article reflects possibility that noisy stock prices in informationally efficient markets can exist); Langevoort, *supra* note 50, at 140 n.18 (pointing out that economic theory or empirical test is needed to justify further step that assumes market price movements to be rational).

93. The *Basic* Court itself ducked the question, leaving it to lower courts to determine what factors and standards to apply to the efficiency decision. Basic Inc. v. Levinson, 485 U.S. 224, 248 n.28 (1988).

94. *See* Langevoort, *supra* note 37, at 899 (identifying *Basic* Court's insistence that district courts deal with "well-acknowledged practical and conceptual difficulties" and other "conundra" that accompany chore of treating efficiency as yes-or-no threshold inquiry).

95. 711 F. Supp. 1264, 1285–87 (D.N.J. 1989). See *infra* note 97 for a discussion of courts that have followed the *Cammer* approach.

96. *Cammer*, 711 F. Supp. at 1285–87 (listing numerous allegations plaintiffs could make to justify fraud-on-the-market presumption, including high weekly trading volume, significant analyst coverage, presence of market-makers, entitlement to file S-3 Registration Statement with SEC, and price movement in response to unexpected corporate events or financial releases); *see also* Fischel, *supra*

rare, a few cases have held that publicly traded securities changed hands in markets that did not meet the threshold of efficiency for the purposes of a class certification motion under Rule 23.[97]

Considering the practical reality that class certification leads to big settlements,[98] the value of a given case often turns on the question of class certification.[99] On that question, most jurisdictions require allegations of the presence of market efficiency factors such as float, weekly trading volume, analyst coverage, and market-makers similar to those discussed in *Cammer*; thus class certification, and the accompanying settlement value, is achieved by alleging market efficiency as described by the *Cammer* decision.[100]

E. The Cottage Industry of Securities Fraud Class Actions

With this mechanism in place for class certification, securities fraud class actions have become "the 800-pound gorilla that dominates and overshadows other forms of class actions."[101] Once plaintiffs win class certification, both sides have incentive to settle,[102] and the average size of those settlements has increased from $28 million in 2004 to $62 million in 2006.[103] Some argue that securities fraud class actions have become a cottage industry that is controlled by and for the benefit of the plaintiffs' bar.[104]

Both Congress and the Supreme Court have attempted to remedy this perceived problem in securities regulation with the Private Securities Litigation Reform Act of 1995 ("PSLRA")[105] and the recent decision in *Stoneridge*

note 34, at 912 (suggesting factors and statistical techniques relevant to determining relative efficiency).

97. Courts that address the question typically cite *Cammer* for its set of factors. *See* Binder v. Gillespie, 184 F.3d 1059, 1064–65 (9th Cir. 1999) (applying *Cammer* factors to decertify class that had been certified solely on evidence that so-called "pink sheets" or over-the-counter market was efficient based on presence of market-makers alone); Krogman v. Sterritt, 202 F.R.D. 467, 479 (N.D. Tex. 2001) (finding, among other factors, that low proportion of shares held by public, which is a statistical measure known as "float," compelled holding that presumption was not warranted by market efficiency); Serfaty v. Int'l Automated Sys., Inc., 180 F.R.D. 418, 423 (D. Utah 1998) (alluding to low weekly trade volume, lack of analyst coverage, and small float as factors weighing against finding of market efficiency).

98. *See* Pritchard, *supra* note 2, at 950–56 (noting defendants' incentive to settle any cases that get past pleading stages to avoid personal liability for managers and because settlement is cheaper and less risky than litigation, regardless of strength of claim).

99. *See id.* at 952–53 (emphasizing that any case that reaches discovery has positive settlement value to avoid disruption and substantial costs of lengthy discovery and huge attorneys' fees).

100. 711 F. Supp. at 1285–87.

101. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006).

102. Pritchard, *supra* note 2, at 950–59.

103. Dickey, *supra* note 1, at 3.

104. Pritchard, *supra* note 2, at 965–66.

105. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

Investment Partners, LLC v. Scientific-Atlanta, Inc.,[106] respectively. The PSLRA legislative history reveals that the act's purpose is to curtail the "abusive practices committed in private securities litigation," including plaintiffs filing claims "against issuers of securities . . . whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action."[107]

Likewise, the Court held in *Stoneridge* that there is no private cause of action under a scheme liability approach to Rule 10b-5 against a third party charged with enabling fraud.[108] In that case, the plaintiff class "sought to impose liability on entities who, acting both as customers and suppliers, agreed to arrangements that allowed the investors' company to mislead its auditor and issue a misleading financial statement affecting the stock price."[109] The Court found that, as a matter of law, investors do not rely on the statements or representations of the third-party defendant.[110] This holding reflects the approach that the scope of securities fraud class actions must be restricted rather than expanded, and the Court did so by limiting the universe of potential defendants against whom plaintiffs may state a valid Rule 10b-5 claim.[111] In a manner similar to Congress, the Court reasoned that "extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies."[112]

While its import remains to be seen, commentators have labeled *Stoneridge* as the most important securities case in a decade and a securities lawyer's *Roe v. Wade* because the arguments transcend the facts of the case and fundamentally differ on the value of private securities fraud litigation.[113] The plaintiffs argued that scheme liability would enhance the compensatory and deterrent roles thought to be played by private securities fraud litigation.[114] Ultimately though, the Court sided with the defendants' position that expanding private securities fraud litigation contributes to the groundswell of abusive private litigation in this area, saying that it would "allow plaintiffs with weak claims to extort settlements from innocent companies."[115]

While discussing the questionable utility of the compensatory function of private securities fraud litigation because of the abuses just discussed, Professor Pritchard noted that the deterrent role of private securities fraud litigation has

106. 128 S. Ct. 761 (2008).

107. H.R. Rep. No. 104-369, at 41 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

108. *Stoneridge*, 128 S. Ct. at 769, 772–73.

109. *Id.* at 766.

110. *Id.* at 769.

111. *Id.*

112. *Id.* at 772.

113. Barbara Black, Stoneridge Investment Partners v. Scientific-Atlanta (8th Cir. 2006)*: What Makes it the Most Important Securities Case in a Decade?* 1 (Univ. of Cincinnati Public Law Research Paper No. 07-21, 2007), *available at* http://ssrn.com/abstract=1020102.

114. *Id.*

115. *Stoneridge*, 128 S. Ct. at 772.

also been compromised under the current securities regime, stating that "[i]f both weak and strong cases lead to settlements, and if the settlements are not substantially greater in strong cases, the deterrent effect of class actions is diluted."[116]

F. Fifth Circuit Requires Proof of Loss Causation

Aside from *Stoneridge*, the other recent and notable securities case is the Fifth Circuit case, *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[117] which held that, at the class certification stage, the district court should require a showing of loss causation, or "proof that the misstatement *actually moved* the market."[118] In that case, plaintiffs alleged that the defendant, a telecommunications company, misstated its line count. The appeals court reversed the district court's class certification decision on the grounds that plaintiffs had not established that defendant's misstatement caused a change in the company's stock price. The court justified its change of course in the following manner:

> In short, class certification was a light step along the way, divorced from the merits of the claim. Whatever reality this treatment was responsive to, it is not that of a class exceeding purchasers of millions of shares in a volatile and downward-turning market over a ten-month period, claiming injury from one of several simultaneous disclosures of negative information.[119]

By so doing, the decision recognized the resounding force of a class certification decision and noted its accord with revised Rule 23.[120]

The former version of Rule 23 required class certification orders to be "conditional" and issued "as soon as practicable."[121] The Fifth Circuit held that the current rule, which was revised in 2003 to require certification rulings to be made "at an early practicable time,"[122] recognizes the import of class certification in bestowing settlement leverage on plaintiffs and mandates an analysis of all factors relevant to market efficiency at this stage.[123] The court then concluded that, because loss causation is a "fraud-on-the-market prerequisite" that properly relates to class-wide reliance, plaintiffs must show loss causation by a preponderance of available evidence in order to meet their Rule 23 burden.[124]

116. Pritchard, *supra* note 2, at 955.

117. 487 F.3d 261 (5th Cir. 2007).

118. *Oscar*, 487 F.3d at 265.

119. *Id.* at 266.

120. FED. R. CIV. P. 23(c)(1)(A).

121. FED. R. CIV. P. 23(c)(1) (1998) (amended 2003).

122. FED. R. CIV. P. 23(c)(1)(A).

123. *Oscar*, 487 F.3d at 267–68. The Advisory Committee Notes to the 2003 Amendments reflect an understanding that courts need time to gather necessary information before making a class certification decision, mentioning that "it is appropriate to conduct controlled discovery into the 'merits,' limited to those aspects relevant to making the certification decision on an informed basis." FED. R. CIV. P. 23, notes of Advisory Committee on 2003 Amendments (2003).

124. *Oscar*, 487 F.3d at 268–69. In passing, the court noted that requiring a showing of loss

III. DISCUSSION

The Fifth Circuit's decision in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[125] provides the optimal procedural framework for applying the fraud-on-the-market presumption. It does so in a way that allows courts to apply the *Cammer v. Bloom*[126] rubric of relative efficiency, which has the benefit of continuity and lends some predictability to the decision. Further, the requirement that loss causation be proven at an earlier stage in the litigation is no affront to the theoretical bases underpinning fraud-on-the-market theory, namely the efficient capital markets hypothesis,[127] because proving loss causation or market movement in response to information is consistent with behavior that is predicted and observed in efficiently functioning capital markets.

Most importantly, the *Oscar* approach recognizes that the gravamen of these claims lies at the class certification stage.[128] Therefore, it is only logical that the courts should take a closer look before making that decision, a decision that is ultimately going to be largely responsible for determining the settlement value of the case.[129]

Part III.A discusses why class certification is so important to securities fraud cases. Part III.B discusses why the *Oscar* approach represents a more cohesive and theoretically correct application of *Basic Inc. v. Levinson*'s[130] edict than the alternative approaches. Finally, Part III.C acknowledges and evaluates the major counterarguments to the proposed approach.

A. Class Certification Is Practically Dispositive in Fraud-on-the-Market Cases

Both plaintiffs and defendants have strong incentives to settle fraud-on-the-market cases that survive the pleadings stage and warrant class certification.[131] Defendant corporations will be eager to settle to avoid discovery costs, attorneys' fees, and the bad press associated with a securities fraud trial.[132] Meanwhile, corporate officers will be personally motivated to settle because settlements, as opposed to final judgments, fall within directors' and officers' insurance policies, and will insulate executives from personal liability.[133]

Plaintiffs are motivated to settle because of simple risk and the time value of money; a class certification order has a fairly certain, positive settlement value today while a trial provides plaintiffs with the possibility of not being paid for

causation will require little in the way of discovery because evidence will be in the form of market data and public information. *Id.* at 267.

125. 487 F.3d 261 (5th Cir. 2007).

126. 711 F. Supp. 1264 (D.N.J. 1989).

127. See *supra* Part II.C for a complete discussion of the ECMH and its relationship with the fraud-on-the-market theory.

128. *See Oscar*, 487 F.3d at 267 (cautioning courts against "*in terrorem* power of certification").

129. *Id.*

130. 485 U.S. 224 (1988).

131. Pritchard, *supra* note 2, at 950–59.

132. *Id.* at 950–56.

133. *Id.*

years into the future as the litigation process unfolds, or worse, the chance of receiving nothing at all.[134] Because these cases are largely controlled by the plaintiffs' bar, settlement is attractive because it eliminates the chance of years of work going unrewarded.[135] Instead, settlement provides a substantial contingent fee for a case very early in the litigation process.[136]

The importance of the fact that a class certification order compels settlement in most cases cannot be overstated. The *Oscar* opinion noted that "a district court's certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it."[137] While it is not a formal final judgment on liability, the district judge in determining the propriety of class certification and the parameters of the class is effectively levying the consequences of a verdict, while leaving the damage award to be negotiated by the parties.

Considering both the compensatory and deterrence roles that securities fraud actions are thought to serve,[138] and in light of the goals of Congress and the SEC in promulgating Rule 10b-5,[139] defendant corporations deserve a more detailed inquiry before class certification orders are granted. Fortunately, amended Rule 23 allows for one.

Rule 23, which governs the class certification process in federal courts, was recently amended in 2003 to require certification "at an early practicable time,"[140] rather than the former "as soon as practicable" edict.[141] While these phrasings are very similar, a familiar canon of rule interpretation requires that some meaning be given to every word or phrase changed, lest courts assume that rule makers make changes designed to have no impact whatsoever.[142] The only sensible reading of the amended version is recognition that while timeliness is still a major concern in Rule 23 motions and orders, there are some concerns that trump the desire to make the decision sooner, such as fairness to the litigants and the goals and policies supported by fraud-on-the-market class actions, including a recognition of the practical consequences of certification.[143]

134. *See Oscar*, 487 F.3d at 267 (recognizing that "district court's certification order often bestows upon plaintiffs extraordinary leverage"); Pritchard, *supra* note 2, at 950–51 (noting that plaintiffs' attorneys are best advised to diversify their portfolio of lawsuits of this kind rather than invest too much time in one case, which results in increased desire to settle).

135. *See* Pritchard, *supra* note 2, at 965–66 (noting that plaintiffs' attorneys control class actions).

136. *See id.* at 948–49 (identifying post-*Basic* class actions as "cottage industry" for plaintiffs' bar because settlements often lead to huge rewards of attorney's fees).

137. *Oscar*, 487 F.3d at 267.

138. *See* Langevoort, *supra* note 37, at 900 (identifying compensatory and deterrence roles securities class actions are widely believed to play).

139. See *supra* notes 17–22 and accompanying text for a discussion of the legislative goals of informing the investing public.

140. FED. R. CIV. P. 23(c)(1)(A).

141. FED. R. CIV. P. 23(c)(1)(A) (1998) (amended 2003).

142. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 267 (5th Cir. 2007) (noting that in making textual changes to Rule 23, the Advisory Committee's "collective wisdom must not be brushed aside").

143. *See id.* at 266–67 (stating that power of fraud-on-the-market and efficient market doctrines

As far as fairness to the litigants is concerned, it bears repeating that settlement negotiation is the endgame for nearly any case that survives class certification.[144] Before a judge certifies the class and deems a case worthy of settlement, it seems undoubtedly fair that he or she should require plaintiffs to show that every predicate for applying the fraud-on-the-market presumption is indeed present in the case at bar.[145] What *Oscar* provides is a chance for both parties to contest the presence of those predicates, albeit in a summary setting, before a judge who has yet to make the determination that will ultimately decide the result of the case.[146] This opportunity is vital to ensure fairness to both parties.[147]

Defendant corporations want the chance to show that the *Basic* assumption is inapplicable to a given case because the market is not efficient, or because the misstatement did not move the market, before a judge certifies the class and locks them into settling an admittedly weak case.[148] Plaintiffs too deserve the chance to demonstrate that a particular stock trades in a particular market at a given time that was functioning as a relatively efficient market, thereby justifying the presumption of class-wide reliance.[149] Defrauded plaintiffs are no less deserving of compensation simply because the shares traded on the over-the-counter market, or something other than a national exchange that a trial court has deemed inefficient,[150] even though efficiency is best thought of as a continuum.[151] They deserve the forum and opportunity to make a fair showing of why the presumption is warranted in their case.

The court's ruling on a motion for class certification is often dispositive of the dispute because of its tendency to compel defendants to settle, or plaintiffs to drop their case.[152] Because the consequences are felt at this stage of litigation, courts should take a longer look at the question that will ultimately be the crux

are among concerns that shaped evolution of Rule 23); Unger v. Amedisys Inc., 401 F.3d 316, 325 (5th Cir. 2005) (concluding that "[b]ecause Rule 23 mandates a complete analysis of 'fraud on the market' indicators, district courts must address and weigh factors both for and against market efficiency").

144. *See* Pritchard, *supra* note 2, at 950–59 (noting plaintiffs' lawyers and defendant corporations both have strong settlement incentives).

145. *See Oscar*, 487 F.3d at 269 (holding that at class certification stage, complete analysis of fraud-on-the-market indicators, including loss causation, mandates that courts find facts favoring class certification).

146. *Id.*

147. *See id.* at 267 (recognizing that there are "'important due process concerns of both plaintiffs and defendants inherent in the certification decision'" (quoting *Unger*, 401 F.3d at 321)).

148. *See* Pritchard, *supra* note 2, at 952–54 (noting that defendants' incentive to settle stems from expense of litigation rather than strength of claim).

149. See *supra* Part II.B for a discussion of the utility and justifications of the presumption of reliance.

150. *See* Cammer v. Bloom, 711 F. Supp. 1264, 1280–87 (D.N.J. 1989) (finding that over-the-counter market has potential to be efficient despite not being listed as national securities exchange under 15 U.S.C. § 78j).

151. See *supra* Part II.C.1 for a discussion of the notion of relative efficiency.

152. *See* Pritchard, *supra* note 2, at 952 (noting defendants' incentive to settle and plaintiffs' incentive to drop individual claims due to prohibitive litigation risks and costs).

of the dispute—the question of reliance.[153] *Oscar* allows that, and does so in the context of the amended Rule 23.[154]

B. Loss Causation and Market Efficiency—A Basic *Prerequisite*

Having established the procedural and practical efficacy of the *Oscar* approach to fraud-on-the-market cases,[155] one has to ask perhaps a more fundamental, or a more *Basic* question: does it make theoretical sense? In light of the discussion about the fraud-on-the-market theory and the ECMH, both from their proponents and detractors,[156] how does the requirement of loss causation fit into the theoretical and conceptual analysis?

The short answer is that the Fifth Circuit correctly and prudently identified loss causation as a prerequisite for applying *Basic*'s rebuttable presumption,[157] making the *Oscar* approach not only theoretically tolerable under the ECMH, but making it the preferable method of applying the command set out in *Basic*.[158]

The *Basic* opinion cautioned lower courts against overuse of the presumption, noting that defendants could rebut the presumption at the class certification stage upon "[a]ny showing that severs the link" between the misstatement or omission made by a defendant and either the market price of the security or plaintiff's decision to buy or sell that security at fair market price.[159] Specifically, the Court mentioned that if a defendant made a showing that "the market price would not have been affected by their misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone."[160] In *Oscar*, the Fifth Circuit held that loss causation was a fraud-on-the-market prerequisite, essentially requiring that plaintiffs fully establish the causal link by showing that a defendant's alleged misstatement or omission "*actually moved* the market."[161]

The logical basis is clear in *Basic*'s terms: if plaintiffs cannot show that the fraudulent misrepresentation or omission actually moved the market, then the link between the alleged misrepresentation or omission and a given plaintiff's transaction is lacking.[162] To demonstrate, the *Oscar* court set out a series of

153. See *supra* Part II.B for a discussion of the fraud-on-the-market theory and its rebuttable presumption of reliance.

154. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 267–70 (5th Cir. 2007).

155. See *supra* Part III.A for a discussion of the Fifth Circuit's approach as it relates to the practical and procedural aspects of securities fraud cases.

156. See *supra* Part II.C.1 for a discussion of the ECMH and its relationship to the fraud-on-the-market doctrine.

157. *Oscar*, 487 F.3d at 266–70.

158. Basic Inc. v. Levinson, 485 U.S. 224 (1988).

159. *Basic*, 485 U.S. at 248.

160. *Id.*

161. *Oscar*, 487 F.3d at 265.

162. *Basic*, 485 U.S. at 248.

scenarios in which a material misstatement or omission failed to move a market that, by all the typical factors, looks like an efficient market.[163]

First, where a market demonstrates the usual indicia of efficiency such as high float, high trade volume, and analyst coverage,[164] it may be that the market functions inefficiently with respect to the type of information conveyed (or withheld) by the alleged misstatement (or omission).[165] In the *Oscar* case, the court noted that telecommunications analysts may not digest line-count information, which was the misstatement at issue in the case, giving "effect to *information-type inefficiencies*."[166] In that scenario, the misstatement may be material to a class of plaintiffs and may be disseminated into a market that by all accounts looks to be efficient.[167] But if the misstatement does not affect the stock price because it is information of the type that analysts and market participants do not digest, the link between the misstatement and class-wide reliance is missing.[168] The class of plaintiffs must have invested for reasons other than reliance on market price, since the market price remains undistorted.[169] If that is indeed the case, then while the elements of fraud may still be present, the commonality requirement for class certification is lacking.[170] Similarly, in a market that is strong-form efficient with respect to the certain type of information, the trading actions of insiders and those in the know can counteract the effects of a fraudulent disclosure long before the corrective disclosure is made.[171]

So while the *Oscar* approach fits squarely within the contours of the Supreme Court's edict in *Basic*, it is important to consider whether *Oscar* does any damage to the theoretical underpinnings of *Basic*, namely the ECMH.[172] Commentators and scholars harshly criticized the Supreme Court majority that decided *Basic* for its adoption of a novel and oft-disputed economic theory.[173] Indeed, what the ECMH provides in intellectual allure and conceptual force it lacks in uniform support and agreement,[174] but the Court in *Basic* actually imported precious little from the controversial theory into legal practice.

163. *Oscar*, 487 F.3d at 269–70.

164. Cammer v. Bloom, 711 F. Supp. 1264, 1285–87 (D.N.J. 1989).

165. *Oscar*, 487 F.3d at 269–70.

166. *Id.* (emphasis added).

167. *Id.* at 269.

168. *Id.* at 269–70.

169. *Id.* at 269.

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

171. *Oscar*, 487 F.3d at 269.

172. See *supra* Part II.C.1 for a discussion of the ECMH in detail and its relationship to *Basic*.

173. See *supra* Parts II.B–C for a discussion of *Basic*'s use of the ECMH.

174. See *supra* Part II.C for general discussion of the ECMH, including criticisms of its application and conclusions.

Basic focused on informational efficiency.[175] The Court's essential thrust was that in an informationally efficient market, a misstatement or omission that distorts market price is sufficient to allow a district court to presume that investors' transactions during the relevant time period were made in reliance on the "integrity" of that market price.[176] The only logical reading of this much-debated phrase is to assume that the Court understood the dichotomy between informational and fundamental efficiency and chose to impose the former.[177] Under this view, an investor is not entitled to rely on the market price being fundamentally correct, but is legally entitled to rely on that price being undistorted by fraudulent misstatements or omissions.[178]

In order to put this Supreme Court command into effect, most lower courts have followed an approach more or less congruent to that articulated by *Cammer*.[179] This approach involves a multifactor inquiry into the usual indicia of market efficiency, based on empirical studies and the ECMH.[180]

Under *Oscar*, like its predecessor *Basic*, investors are still legally entitled to a presumption that the information disseminated into an efficient market leads to a market price that is unaffected by fraud.[181] Indeed, this was the congressional command from the inception of secondary market securities regulation, the Securities Exchange Act of 1934,[182] which was intended to increase public confidence in the stock market and information relating to it.[183]

175. *See* Basic Inc. v. Levinson, 485 U.S. 224, 246 n.24 (1988) (stating that to justify "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"). Stated another way, the presumption is valid so long as market professionals consider information in making their trading decisions, which implies informational efficiency. See *supra* Part II.C.2 for a complete discussion of informational efficiency.

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

177. *See In re* Polymedica Corp. Sec. Litig., 432 F.3d 1, 16 (1st Cir. 2005) ("[F]or purposes of establishing the fraud-on-the-market presumption of reliance, investors need only show that the market was informationally efficient.").

178. *Id.*

179. *See, e.g.*, Binder v. Gillespie, 184 F.3d 1059, 1064–65 (9th Cir. 1999) (agreeing with district court's application of *Cammer* factors and affirming decision to decertify class on grounds that existence of market-makers was insufficient on its own to prove over-the-counter market was efficient); Krogman v. Sterritt, 202 F.R.D. 467, 478 (N.D. Tex. 2001) (finding among other factors that low proportion of shares held by public compelled holding that presumption was not warranted by market efficiency); Serfaty v. Int'l Automated Sys., Inc., 180 F.R.D. 418, 423 (D. Utah 1998) (alluding to low weekly trade volume, lack of analyst coverage, and small float as factors weighing against finding of market efficiency).

180. *Cammer*, 711 F. Supp. at 1285–87.

181. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 264 (5th Cir. 2007).

182. 15 U.S.C. §§ 78a–78nn (2006).

183. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); *see also* Silver v. NYSE, 373 U.S. 341, 366 (1963) (explaining that precipitous stock market crash in 1929 that preceded Great Depression compelled Congress to require "highest ethical standards" in securities industry).

As the Court itself noted in *Basic*, "Who would knowingly roll the dice in a crooked crap game?"[184]

Oscar is less reliant than other courts on the ECMH, though, in applying the presumption.[185] Rather than rely on indicia that are typically present in efficient markets to demonstrate and recognize an efficient market as *Basic* does, *Oscar* asks, in addition to those usual indicia, for some demonstration that the market was affected by the challenged disclosure or omission.[186] If it was, then the issue of market efficiency is really secondary, because the court is looking only to determine that the stock price has been artificially and fraudulently manipulated, and investors are legally entitled to rely on the absence of such manipulations.[187]

Basic distorts the contours of the ECMH and tests its utility by asking courts for a yes-or-no answer to a concept that is best viewed on a continuum.[188] To achieve this end, courts are constantly forced to ask themselves at a quick glance if a market *looks* like the picture of an efficient market painted in cases like *Cammer*.[189] Where *Oscar* improves this process is by adding an additional inquiry asking if this market at this time is behaving, with respect to this information, as an efficient market would.[190] For nearly twenty years, courts have been certifying plaintiffs' classes using the *Basic* presumption because the market looked like a duck and quacked like a duck, as a duck is described in *Cammer*.[191] *Oscar* allows a court to look at the specific market, the particular disclosure, and the particular time, to get a better sense of just how "duck-like" this particular animal appears.[192]

C. Arguments Against the Oscar *Approach*

There are several counterarguments to the *Oscar* approach this Comment has advocated. The first is strictly procedural: arguably, requiring plaintiffs to prove loss causation inappropriately shifts the burden as laid out in *Basic*.[193] According to this argument, *Basic* allocated to the defendant the burdens of production and persuasion in making its showing that would sever the causal link and rebut the presumption of reliance[194] and, therefore, requiring plaintiffs to

184. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) (quoting Schlanger v. Four-Phase Systems Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982)).

185. *See Oscar*, 487 F.3d at 269 (noting that "loss causation speaks to the semi-strong efficient market hypothesis on which classwide reliance depends").

186. *Id.*

187. *See Basic*, 485 U.S. at 247 (holding that investors are entitled to rely on integrity of market prices).

188. See *supra* Part II.C for a discussion of relative efficiency.

189. Cammer v. Bloom, 711 F. Supp. 1264 (D.N.J. 1989).

190. *See Oscar*, 487 F.3d at 268–70 (requiring proof of loss causation as fraud-on-the-market prerequisite).

191. *Cammer*, 711 F. Supp. at 1280–83.

192. *Oscar*, 487 F.3d at 268–69.

193. *See* Nathenson v. Zonagen Inc., 267 F.3d 400, 413 (5th Cir. 2001) (interpreting *Basic* to place burden on defendant to rebut fraud-on-the-market presumption).

194. Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988).

prove loss causation is inapposite with that approach.[195] This argument is appealing in light of the language in *Oscar* that says "we require proof that the misstatement *actually moved* the market."[196]

Upon reflection, however, the *Oscar* approach taken as a whole does no damage to the structure of the respective burdens borne by plaintiffs and defendants.[197] Loss causation is a *Basic* prerequisite in the sense that if the preponderance of available evidence cannot show market movement in response to the alleged fraud, then a presumption that investors were induced to act in reliance on the misstatement is misplaced.[198] In short, an investor investing at a market price that was unaffected by a fraudulent misstatement should have to prove that he or she relied directly and individually on the misstatement itself; the intermediate causal link between the market price and a class of investors choosing to enter into transactions is lacking.[199] If market price is unchanged, investors must have each been relying on something other than that market price, and such individual questions of reliance are not appropriately handled by class actions.[200]

Alternatively, the burden can be borne by defendants to establish, by the same preponderance of available evidence standard, that loss causation is absent, so long as a proper forum is available to them at the class certification stage.[201] Whoever bears the burden of proof, there must be a fair and full opportunity to establish the existence, or lack, of loss causation, as it is a prerequisite to *Basic*'s presumption of class-wide reliance.[202] In practice, there is little distinction between these two approaches, as defendants in the position to do so will be happy to provide evidence that loss causation is lacking to rebut the presumption and defeat class certification.[203]

195. *Oscar*, 487 F.3d at 274 (Dennis, J., dissenting) (noting that requiring proof by plaintiffs subverts fraud-on-the-market presumption).

196. *Id.* at 265 (majority opinion).

197. *See id.* (noting loss causation requirement is "not plucked from the air," but rather is logical extension of holding in *Basic*).

198. *See id.* at 269 (demonstrating circumstances in which presumption of common class-wide reliance would be inappropriate since material information would fail to move market). See *supra* notes 163–71 and accompanying text for a discussion of how misstatement or omission may fail to move the market.

199. *See Basic*, 485 U.S. at 248 (noting that "[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, will be sufficient to rebut the presumption of reliance").

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

201. Rather than require plaintiffs to show loss causation, a similarly beneficial approach could merely allow a judge to presume loss causation, but allow defendants to rebut that presumption at the class certification stage. Such an approach would enjoy many of the same benefits of the *Oscar* approach without the potentially improper burden shifting. The crux of this Comment is to show that loss causation is properly seen as a fraud-on-the-market prerequisite that must be demonstrated as loss causation, regardless of who bears that burden.

202. *Oscar*, 487 F.3d at 266.

203. *See id.* at 267 (noting that little discovery is required to show loss causation); Pritchard, *supra* note 2, at 952–53 (noting defendants' desire to settle any case that surpasses pleading stages).

Notably, such a scheme would not require much additional expense. While the majority of cases that survive class certification settle to avoid discovery and litigation costs,[204] such costs are not present on the issue of loss causation.[205] The only information relevant to whether the misstatement moved the market in the required way is public information that can be gathered from market data and event studies.[206] No significant discovery, production, or depositions are necessary for this inquiry and, thus, costs are effectively controlled.[207] Further, the incremental additional costs incurred will be well served to ferret out weak claims that plaintiffs' lawyers bring knowing that any case that they can navigate through the class certification process will mean a potentially lucrative settlement.[208] Therefore, while the class action mechanism can once again be successful in deterring the primary conduct of corporate fraud,[209] now there can be some deterrent effect to plaintiffs' attorneys from bringing frivolous claims hoping they will survive class certification and a motion to dismiss in order to gain settlement value.[210]

The strongest objection to the Fifth Circuit's decision in *Oscar* is grounded on separation of powers principles.[211] Essentially, this case does mark another step forward from the approach applied by the other circuit courts.[212] While this approach can be reconciled with the command in *Basic*,[213] the fact remains that the *Basic* decision was itself questioned two decades ago on the grounds that Congress, rather than the Court, should be the one to change securities regulation so completely.[214]

The most favorable aspect of the *Oscar* approach is its tacit recognition that these cases for all intents and purposes are lost and won at the class certification stage—if the class certification motion is granted, plaintiffs earn a big settlement;

204. *See* Pritchard, *supra* note 2, at 953–54 (noting high litigation costs, especially for discovery).

205. *See Oscar*, 487 F.3d at 267 (noting that little discovery is required to show loss causation).

206. *Id.* These costs will be undertaken by companies so long as they remain less than the cost for the corporate defendant to settle the case, but since class certification will be more difficult, companies will have a greater cost-based incentive to contest certification.

207. *See* Pritchard, *supra* note 2, at 953–54 (noting that high litigation costs are driven by discovery and document requests).

208. *See id.* at 955 (noting that even weak cases can lead to settlements).

209. *See id.* at 957–59 (implying that when fewer frivolous claims result in settlement, corporations have greater incentive to avoid fraudulent behavior).

210. *Id.* at 952–53.

211. *See Oscar*, 487 F.3d at 276 (Dennis, J., dissenting) (asserting that majority impermissibly changed elements of statutory claim).

212. *See, e.g.*, Cammer v. Bloom, 711 F. Supp. 1264 (D.N.J. 1989) (failing to require plaintiffs to show loss causation).

213. Basic Inc. v. Levinson, 485 U.S. 224, 249–50 (1988).

214. *Basic*, 485 U.S. at 255 (White, J., dissenting) ("I cannot join the Court in its effort to reconfigure the securities laws, based on recent economic theories, to better fit what it perceives to be the new realities of financial markets. I would leave this task to others more equipped for the job than we.").

if not, the case dies quietly.[215] With this reality in mind, it is imperative that somebody, whether it be the SEC, Congress, the Supreme Court, or even the Fifth Circuit, develops a method of adjudicating these disputes more fairly to all involved. The Fifth Circuit in *Oscar* found an appropriate balance between keeping the viability of the fraud-on-the-market presumption alive, and, thus, keeping the force of private enforcement of Rule 10b-5 alive, versus making sure the presumption is rightly, justly, and correctly applied to keep the plaintiffs' bar from continuing its cottage industry.

More directly, the separation of powers objection to the proposed approach is properly viewed as an objection as applicable to *Basic* itself as it is to *Oscar*. Once the judiciary implied a private cause of action under Rule 10b-5 with tacit Congressional approval,[216] separation of powers concerns became moot. Further, when the Supreme Court first incorporated the fraud-on-the-market theory into this judicially created cause of action, the Court, as the Fifth Circuit noted, intentionally allowed "each of the circuits room to develop its own fraud-on-the-market rules."[217] Therefore, the proposed approach taken by *Oscar* represents no affront to separation of powers principles since it merely amended a judicially created cause of action, and did so with the Supreme Court's blessing.

Ultimately, the Fifth Circuit approach, by filtering out weak claims before class certification is granted, should also help restore private securities fraud litigation to its role of deterring corporate fraud.[218] Paradoxically, the judicial system can strengthen the deterrence effects of fraud-on-the-market cases by interpreting the doctrine more restrictively and by limiting its use by plaintiffs seeking class certification.[219]

IV. CONCLUSION

While it may seem like an incremental step toward correcting the out-of-control securities class action industry, the decision in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[220] marks a move in the right direction, as does *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*[221] and the Private Securities Litigation Reform Act of 1995.[222] *Oscar* calls for another restrictive interpretation of the fraud-on-the-market theory, which can only improve the theory and its application in the federal courts on both theoretical

215. *See* Pritchard, *supra* note 2, at 952–54 (noting defendants' incentive to settle and plaintiffs' incentive to drop individual claims due to prohibitive litigation risks and costs).

216. See *supra* notes 16–28 and accompanying text for discussion of the history of the cause of action.

217. Abell v. Potomac Ins. Co., 858 F.2d 1104, 1117–18, 1120 (5th Cir. 1988).

218. *See* Pritchard, *supra* note 2, at 955 (noting that deterrent effect of class action mechanism is diluted when both weak and strong claims lead to similar settlements).

219. *Id.* at 960.

220. 487 F.3d 261 (5th Cir. 2007).

221. 128 S. Ct. 761 (2008).

222. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

and practical bases.[223] Most importantly, *Oscar* allows for fraud-on-the-market to continue as a viable theory in valid cases, while ferreting out the weaker cases at an earlier stage in the litigation process. Lastly, because *Oscar* correctly interprets the Supreme Court's version of the fraud-on-the-market theory in *Basic Inc. v. Levinson*,[224] the other circuits can immediately follow the approach without any congressional or Supreme Court action.

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223. See *supra* Part III.A for a discussion of the practical efficacy of *Oscar*, and Parts III.B–C for a discussion of its theoretical merit.

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

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