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Making Sure the Dice Aren't Loaded:

Market Efficiency and the Fraud-on-the-Market Theory in Securities Class Actions

By Jai Chandrasekhar

"Fraud-on-the-market." "An efficient market." These terms are used frequently throughout the course of securities litigation. But what do they mean? What significance do they carry in securities litigation? Claims under the federal securities laws require the plaintiff investor to have relied on the alleged false statement or omission by the corporate defendants. In a traditional fraud case, this means that the investor must have read or heard the misstatements and made his investment on the basis of the false information. In 1988, the United States Supreme Court, in *Basic, Inc. v. Levinson,* adopted the fraud-on-the-market theory, which benefited plaintiffs in securities class actions by establishing a presumption of reliance on the integrity of the market. To receive the benefit of this presumption, plaintiffs must show that the market for the security was efficient. Once established, plaintiffs are entitled to a rebuttable presumption that they relied upon the integrity of the market when purchasing or acquiring the securities. Recently, however, the securities defense bar has been launching attacks on the fraud-on-the-market theory and the efficient markets hypothesis, arguing that even securities traded on the New York Stock Exchange or NASDAQ did not trade in an efficient market.

By way of background, modern economic studies confirm that the prices of securities that are traded in active, liquid markets rapidly reflect all publicly available information about a company. This efficient markets hypothesis underlies the modern United States system of securities regulation, including the Securities and Exchange Commission's rules governing corporate disclosures and securities offerings, as well as the laws governing investors' remedies when companies disclose false and misleading information to the market or fail to report facts that should have been disclosed.

In 1988, the Supreme Court endorsed the efficient markets presumption of reliance in* Basic, Inc. v. Levinson. *"It is hard to imagine that there ever is a buyer or seller who does not rely on market integrity," wrote Justice Harry Blackmun for the Court. "Who would knowingly roll the dice in a crooked crap game?"

The hypothesis gained widespread acceptance among economists in the early 1970s and, under Rule 10b-5, federal courts began to permit class actions based on this presumption of reliance. Finally, in 1988, the Supreme Court endorsed the efficient markets presumption of reliance in *Basic, Inc. v. Levinson.* "It is hard to imagine that there ever is a buyer or seller who does not rely on market integrity," wrote Justice Harry Blackmun for the Court. "Who would knowingly roll the dice in a crooked crap game?" The presumption of reliance remains a central tenet in securities fraud class actions seeking to keep Wall Street from loading the dice to cheat investors.

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The efficient markets hypothesis does not hold that actively traded securities' prices reflect *all* information about the issuers. It only holds that the prices reflect *all publicly available* information. Nor does it hold that the prices necessarily reflect the publicly available information accurately, in the sense that the prices reflect the "true value" of the securities. Rather, the theory only holds that market prices reflect all publicly available information so quickly that it is impossible for traders to make trading profits on the basis of new information.

The reliance requirement under the federal securities laws poses two challenges to protecting investors from fraud in modern securities markets. First, many investors do not actually read or hear the corporate disclosures that later turn out to have been false or incomplete. Instead, they simply rely on the integrity of the market prices — for example, by buying a portfolio of many stocks based on a market index — or they employ investment advisers who make their securities purchases for them. Thus, the investors cannot claim that they themselves actually relied on the false disclosures.

Second, many securities fraud claims are brought as class actions, because most investors' losses from any particular fraud are too small for individual lawsuits to be economical. To maintain a lawsuit as a class action, the plaintiffs must establish, among other things, that legal and factual issues that are shared by all members of the class predominate over legal and factual issues that are different for different members of the class. Many courts have held that each purported class member must prove that they individually relied on issuers' false statements, and rule that the class action is not permissible — though these class members were all clearly damaged by the fraud.

The efficient markets hypothesis provides a solution for both of these challenges.

From its adoption by the lower federal courts in the 1970s until the last few years, the efficient markets hypothesis made certification of securities fraud cases as class actions almost routine. Recently, however, defendants have begun to resist class certification as vigorously as they press their motions for dismissal or summary judgment.

First, the theory provides a sound basis for presuming that investors who buy securities in reliance on the integrity of the market price are indirectly relying on the accuracy of the issuer's public disclosures, regardless of whether they actually read or heard those disclosures, because the market price reflects all publicly available information about the company. Second, by eliminating the need to prove that every member of a plaintiff class read or heard the statements, the efficient markets hypothesis makes the presumption of reliance into an issue that is common to all members of the class, so that shared issues predominate and a class action may be maintained.

From its adoption by the lower federal courts in the 1970s until the last few years, the efficient markets hypothesis made certification of securities fraud cases as class actions almost routine. Instead, the pre-trial battles in securities cases occurred when defendants asked the courts to dismiss the cases for failure to plead legally adequate claims, or after fact discovery, when defendants later sought summary judgment. Recently, however, defendants have begun to resist class certification as vigorously as they press their motions for dismissal or summary judgment.

Defendants' increased resistance to class certification follows a 1998 amendment to the Federal Rules of Civil Procedure that permits immediate appeals of trial court certification decisions. Before this rule change, these decisions generally could not be appealed. As a result, cases that were certified as class actions were usually settled, because defendants could not afford the risk of trial, and classes that were denied certification were generally abandoned by plaintiffs. The increased litigation over class certification also reflects a shift by the courts, which in earlier years determined certification of the class by relying largely on plaintiff's allegations in the complaint. Now courts typically permit defendants to introduce extensive evidence in opposition to class certification. Both plaintiffs and defendants present financial expert reports and other evidence on class certification in the trial court, and pursue appeals if they lose.

There are two primary battlegrounds in the class certification struggle. First, the fraud-on-the-market presumption of reliance under *Basic Inc. v. Levinson* may be rebutted if defendants are able to present evidence that the named plaintiff in fact did not rely on the integrity of the market price. Defendants therefore seek documents and testimony from the court-appointed lead plaintiff, attempting to establish that the lead plaintiff did not rely on the market. Courts have generally rejected arguments by defendants that institutional investors who rely on investment advisers cannot establish reliance on the market. On the other hand, plaintiffs who are short sellers, betting that the stock price will decline, or who testify that they believed the issuer's disclosures were false, or that

the market for its securities did not reflect the publicly available information about it, have been found by some courts not to have relied on the market, defeating class certification.

The second major battleground is whether the market for the particular securities at issue in the case is efficient. Stocks that are actively traded on the New York Stock Exchange, NASDAQ National Market System, or American Stock Exchange are typically found to trade in an efficient market. Smaller stocks, stocks of companies that have only recently gone public, preferred securities, bonds, and unregistered securities that trade only in the Rule 144A institutional market are often the subject of heated litigation over whether their markets promptly reflect all publicly available information such that the presumption of reliance should apply.

Plaintiffs may try to establish that the market for a security is efficient by presenting evidence about its trading activity. A variety of analyses help to demonstrate that publicly available information rapidly instructs behavior, such as: the average weekly trading volume as a percentage of total outstanding shares; the number of securities analysts following and reporting on the securities; the extent of market maker and arbitrager trading in the securities; the company's eligibility to register securities with the SEC on the short-form registration statement on Form S-3 (which is available only to larger issuers that have filed periodic reports with the SEC for 12 months); the company's market capitalization; the bid-ask spread for the securities; and the company's float (publicly held shares not owned by insiders).

Most importantly, plaintiffs must establish that the securities price responds promptly to unexpected corporate news, because courts and economists recognize this as the heart of the efficient market hypothesis. There is no legal requirement that plaintiffs present expert testimony at the class certification stage, but the likelihood that defendants will present expert testimony claiming the market is not efficient means that in close cases, plaintiffs today are well advised to put forward their own economic expert report. Typically, the experts on both sides present statistical "event studies," in which they analyze the particular security's volatility relative to market indices, calculate how much of the security's price change on particular days is attributable to changes in the overall market index and how much is unique to the particular security, and seek to show that the price did — or did not — change to a statistically significant extent in response to company-specific news.

The courts' adoption of the efficient market hypothesis uses sophisticated economic theory to protect investors and maintain the honesty and integrity of the United States capital markets. By allowing defrauded investors to benefit from the presumption that they relied on the issuer's public statements, the fraud-on-the-market theory enables investors to maintain class actions to recover their losses. Defendants in securities fraud cases, however, have seized on the complexities of the theory to make class certification into another hard-fought battle in which plaintiff investors must prevail before they can be compensated for their losses. ■

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