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Supreme Court Will Review Fraud-on-the-Market Presumption of Reliance in Securities Suits

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The Supreme Court recently granted certiorari in *Halliburton Co. v. Erica P. John Fund, Inc.,* setting the stage for the Court to review and possibly reconsider the presumption of reliance based on the fraud-on-the-market theory that has undergirded securities fraud class actions for over 25 years. Oral argument is scheduled for March 5, 2014.

In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court held, by a 4-2 majority, that in a securities fraud class action under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, a court can properly apply a rebuttable presumption that the plaintiff shareholders relied upon the company's alleged misrepresentations, whether they were individually aware of the misrepresentations or not, because it was reflected in the stock price. This so-called "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.'" *Id.* at 241-42 (quoting *Peil v. Speiser*, 806 F. 2d 1154, 1160-61 (3rd Cir. 1986)).

The fraud-on-the-market presumption of reliance has been crucial to the ability of shareholder plaintiffs' counsel to bring class actions. As the Court observed in *Basic*, "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones." *Id.* at 242.

But the efficient market hypothesis that underlies the presumption of reliance has long been questioned by some economists. After the "Black Monday" market crash in October 1987, Yale economist (and 2013 Nobel Prize winner) Robert Shiller went so far as to say that

> **"The efficient-market hypothesis is the most remarkable error in the history of economic theory."**

Wall Street Journal, Oct. 23, 1987. And earlier this year Justice Alito observed that "reconsideration of the *Basic* presumption may be appropriate" in light of evidence that "the presumption may rest on a faulty economic premise." *Amgen Inc. v. Conn. Ret. Plans*, 133 S. Ct. 1184, 1204 (2013) (Alito, J., concurring).

The *Halliburton* case **presents two questions**:

1. Whether this Court should overrule or substantially modify the holding of *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory.
2. Whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.

The Supreme Court's answers to those questions could have as significant an impact on the future of securities fraud class actions as *Basic* had 25 years ago.

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