SEARCHING FOR MARKET EFFICIENCY

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INTRODUCTION

In their Articles, Professors Langevoort and Miller each address the problem of defining market efficiency for fraud-on-the-market purposes in the wake of *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*").[1] As their analyses highlight, the fundamental difficulty of the fraud-on-the-market doctrine is its fuzziness around the edges—there are few guideposts for how broadly or narrowly it should apply. Until now, courts have dealt with this fuzziness by adopting an extremely narrow definition of market efficiency.[2] *Halliburton II*, however, appears to alter the balance by broadening the concept of market efficiency, while simultaneously permitting district courts to police the application of the fraud-on-the-market doctrine on a case-by-case basis. It remains to be seen how much *Halliburton II* will change the legal landscape, but what is certainly true is that district courts will continue to search for ways to cabin the doctrine's potential scope.

I. IMPERFECT EFFICIENCY

In an ordinary, common law fraud claim, a plaintiff must establish that he or she *relied* on the defendant's false representation to his or her detriment.[3] When the Supreme Court adopted the fraud-on-the-market doctrine for § 10(b)[4] fraud claims in *Basic Inc. v. Levinson*, it allowed plaintiffs to satisfy the reliance requirement with two presumptions: when a security trades in an "impersonal, well-developed market," courts will presume first, that public, material misstatements distort the security's price, and second, that investors who purchase that security subjectively rely, at least in part, on that market price, to communicate some relevant information.[5] The presumption of price impact, coupled with the presumption of investor reliance, equals, in syllogistic fashion,

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

2. *See* Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market: Reflections on* Amgen *and the Second Coming of* Halliburton, 57 ARIZ. L. REV. 37, 53 (2015).

3. RESTATEMENT (SECOND) OF TORTS § 537 (1977).

4. 15 USC § 78j(b) (2012) (codification of § 10(b) of the Securities Exchange Act of 1934).

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

reliance on the original false statement in a manner sufficient to satisfy the reliance element in a § 10(b) claim.[6]

The issue on which Professors Langevoort and Miller focus is, how should we define an "impersonal, well-developed market" after *Halliburton II*?

Though *Basic* itself only made passing references to the concept of market "efficiency," courts interpreting *Basic* have seized upon "efficiency" as the standard for determining whether a market is sufficiently developed to justify application of the fraud-on-the-market doctrine.[7] Borrowing concepts from economic literature, courts generally require plaintiffs to prove that the market price of a security fully reflects all available public information before permitting them the benefit of *Basic*'s presumptions.[8]

The difficulty is that, while the economic evidence may suggest that a security's price responds to new information with greater or lesser rapidity, the economic evidence cannot define the *legal* test for how rapidly is rapidly *enough*. No market is perfect[9]—the best we can achieve even as a theoretical matter is the point at which transaction costs exceed the benefits of arbitrage. Thus, as Professor Langevoort explains, left without any standards for how to gauge when the point of *sufficient* rapidity has been achieved, courts have required very extreme levels of rapidity, permitting *Basic*'s presumptions to apply only to the most developed of markets.[10]

Courts' approaches to detecting the presence of market "efficiency" have come under considerable scholarly fire because they often appear disconnected from the underlying inquiry—namely, the reasonableness of the presumptions they are meant to support. That is, even relatively "inefficient" markets still respond somewhat promptly, if not instantaneously, to new information. It should therefore not be necessary for plaintiffs to show that markets immediately react to new information in order to benefit from the fraud-on-the-market presumptions.[11]

Halliburton II, according to Professors Langevoort and Miller, may represent a change in the status quo.[12] This is because the *Halliburton II* Court's vision of an "efficient" market for fraud-on-the-market purposes is not at all a perfect one. To the contrary, Chief Justice Roberts defined an "efficient" market simply as one where "public information generally affects stock prices"[13]—a

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6. *Id.* at 247.

7. *See, e.g.*, *In re* PolyMedica Sec. Litig., 432 F.3d 1, 19 (1st Cir. 2005).

8. *Id.*

9. Jeanne L. Schroeder, *The End of the Market: A Psychoanalysis of Law and Economics*, 112 HARV. L. REV. 483, 516 (1998).

10. Langevoort, *supra* note 2, at 52-53.

11. Bradford Cornell & James C. Rutten, *Market Efficiency, Crashes, and Securities Litigation*, 81 TUL. L. REV. 443, 456 (2006); James D. Cox, *Fraud on the Market After* Amgen, 9 DUKE J. CONST. L. & PUB. POL'Y 1, 14–16 (2013); Donald Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 172.

12. Langevoort, *supra* note 2, at 53-54; Geoffrey Miller, *The Problem of Reliance in Securities Fraud Class Actions*, 57 ARIZ. L. REV. 61, 65 (2015).

13. Halliburton Co. v. Erica P. John Fund, Inc. (*Halliburton II*), 134 S. Ct. 2398, 2410 (2014).

standard so loose that Professor Miller questions whether *Halliburton II*'s vision of efficiency is "properly defined with the tools of corporate finance."[14]

II. IMPACT OF WHAT?

In Professor Langevoort's view, *Halliburton II*'s looser approach to the concept of market efficiency is a step in the right direction; he would direct courts to apply the fraud-on-the-market presumptions to any market where passive investing is reasonable.[15]

Professor Miller would go further. He believes that the standards set by *Halliburton II* are so loose that they might apply even to consumer markets, because the general principles of supply and demand support the presumption that false statements will cause prices to rise.[16]

Both proposals would expand fraud-on-the-market concepts to a large class of securities and products to which the doctrine has not previously been applied. In regards to Professor Miller's proposal, courts have thus far resisted application of fraud-on-the-market concepts to consumer markets.[17] Indeed, courts have rejected application of the fraud-on-the-market doctrine even to primary markets for *securities*—which, like consumer markets, involve sales directly from the issuer or its intermediary.[18]

Professor Langevoort's passive-investment proposal is similarly broad because passive investing is, as he recognizes, a technique for diversification[19]—investors do not passively invest in a single security, but rather in a broad portfolio of securities. Many different types of securities may be reasonably included in such a portfolio, including ones that are relatively illiquid and/or minimally responsive to the news of the day. Very few preferred stocks or bonds are deemed to trade "efficiently" under current standards,[20] but a diverse, passive portfolio could easily include securities of these types.

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14. Miller, *supra* note 12.

15. Langevoort, *supra* note 2.

16. Miller, *supra* note 12, at 66. In fact, it has been argued that applying fraud-on-the-market doctrine to consumer markets would result in more efficient levels of deterrence against misconduct. *See* Alon Klement & Yuval Procaccia, An Economic Analysis of Reliance in Market Fraud and Negligent Misrepresentation 25 (Dec. 29, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2372922.

17. *See, e.g.*, McLaughlin v. Am. Tobacco Co., 522 F.3d 215, 224 (2d Cir. 2008); Farmers Ins. Exch. v. Benzing, 206 P.3d 812, 822 (Colo. 2009).

18. *See, e.g.*, Malack v. BDO Seidman, LLP, 617 F.3d 743, 751–52 (3d Cir. 2010); Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1130–31 (7th Cir. 1993); Freeman v. Laventhol & Horwath, 915 F.2d 193, 200 (6th Cir. 1990).

19. Langevoort, *supra* note 2, at 51 n.84.

20. *Cf.* Aranaz v. Catalyst Pharm. Partners Inc., No. 13-CV-23878-UU, 2014 U.S. Dist. LEXIS 136684 (S.D. Fla. Sept. 29, 2014); *In re* Fed. Home Loan Mortg. Corp. (Freddie Mac) Secs. Litig., 281 F.R.D. 174 (S.D.N.Y. 2012); Schleicher v. Wendt, No. 1:02-CV-1332-DFH-TAB, 2009 U.S. Dist. LEXIS 24810 (S.D. Ind. Mar. 20, 2009) (all refusing to certify classes including preferred stockholders). *See generally* Michael L. Hartzmark & H. Nejat Seyhun, *Understanding the Efficiency of the Market for Preferred*

Yet despite the breadth of both proposals, there is a certain intuitive appeal to the idea that, if someone bothers to intentionally lie about something, of course it has an impact on price—why else would they even bother? Surely we can adopt a presumption that if the fraudster thinks it is important enough to mislead people about, it is probably something important enough to make a difference to purchasers and thus impact pricing.

The problem with this intuition is that, as a matter of *process*, fraud-on-the-market cases—actual cases that are filed and litigated—are not initiated based on *lies*, but on misconduct.

The cliché in the § 10(b) context, of course, is that plaintiffs' attorneys rush to the courthouse whenever there has been disclosure of "bad news" about a company, often pleading nothing but "fraud by hindsight," i.e., the idea that because a problem occurred at Time 2, there must have been fraud at Time 1.[21]

Even if that were ever an accurate characterization of the typical § 10(b) action, it is likely that the formidable hurdles imposed by the Private Securities Litigation Reform Act[22] have severely dampened, if not eliminated, that kind of claim.

But what remains true is that a fraud-on-the-market case depends first on a disclosure of misconduct or internal problems at the company, *after which* plaintiffs' attorneys search for statements that, in light of the new information, appear to have been false (and known to be false) at the time they were made. It could hardly be otherwise because, by definition, there is no single investor who can or should testify that he or she actually relied upon every corporate representation. The plaintiffs' attorney's choice is therefore either to poll every investor or analyst in the market to determine what information they actually considered when investing, or—as is actually done—the attorney can go back through every public statement released by the company in search of statements that, based on what they know now, might be characterized as "false." And in today's highly regulated market, that is a lot of statements. That is every press release, every website posting, every news interview—as well as every page of every SEC filing, which, for a two- or three-year class period, can amount to hundreds of pages of fine-print disclosures.

The fraud-on-the-market doctrine does not draw distinctions between any of these statements—what is trumpeted as a headline in a press release gets the same consideration as the footnoted sentence at the bottom of page 147 of a 173-page Form 10-K.[23] This system results in a number of cases where the representation that forms the basis for the fraud-on-the-market claim does *not* appear to have been a lie calculated to mislead investors—or calculated to

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Stock, 8 VA. L. & BUS. REV. 149 (2014) (arguing that the factors used to determine market efficiency are inappropriate for securities other than common stock).

21. *See, e.g.*, Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978).

22. *See generally* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in various places).

23. In 2004, the average 10-K was 165 pages long. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1547 (2007).

influence anyone at all. Rather, the statement might be so much boilerplate, such as a generic representation that the company complies with the law,[24] or that its success is the result of good "customer service," when in fact the success was the result of bribery or antitrust violations.[25] The "fraud" is less about trying to influence the market with false *statements* than it is to avoid revealing to the market some *other* kind of misconduct that is not, per se, the subject of the securities laws. In fact, these cases may not seem like "securities fraud" at all, in the sense of trying to "dupe" investors—they may seem more like incidents of strikingly poor corporate governance.[26] Yet with the presumption of price impact, all of these kinds of claims are imported into the "fraud" category.

Professor Langevoort describes this as a problem of counterfactuals.[27] In his view, when a company tells a lie, the proper comparator may not be to what the price would have been had the company disclosed the truth, but to what the price would have been if the company had remained silent.[28] If silence would leave the price in the same place as the false statement, then the presumption of price impact improperly assumes harm caused by a lie where no harm actually exists.[29]

This does not, in my view, fully capture the problem. First, the extensive SEC disclosure requirements often remove the "silence" option altogether—which may be viewed as a deliberate attempt to backdoor a kind of regulation of corporate behavior into the federal securities laws.[30] But perhaps more importantly, it is not implausible that the statements involved in these kinds of claims do influence market prices, at least some of the time. At the very least, a company's sudden *failure* to proclaim compliance with the law when it had previously done so would likely be noticed, particularly in today's world of computerized analysis of public disclosures.[31] Indeed, courts have previously found that *silence* when speech was expected can be equivalent to disclosure of a problem.[32] Nonetheless, without the ability to modulate the presumption of price impact based on the prominence and importance of misstatements, courts may

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24. *See* Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 745 (9th Cir. 2008).

25. *See* City of Roseville Emps. Ret. Sys. v. Horizon Lines, Inc., 713 F. Supp. 2d 378, 390 (D. Del. 2010).

26. The Supreme Court has long held that Section 10(b) prohibits only fraud, and not mere mismanagement. *See* Santa Fe Indus. v. Green, 430 U.S. 462, 477–79 (1977). Courts have a variety of subtle tools to jettison cases that take the *form* of a fraud complaint, but *feel* like a governance complaint—including through the determination of scienter. *See* Ann M. Lipton, *Slouching Towards* Monell: *The Disappearance of Vicarious Liability Under Section 10(b)*, 92 WASH. U. L. REV. (forthcoming April 2015).

27. Langevoort, *supra* note 2, at 57.

28. *Id.*

29. *Id.*

30. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 879–81 (2003).

31. The SEC, for example, has launched an initiative that uses computerized analysis of language choices in corporate filings to identify red flags of fraud. *See* Ethan Rouen, *Fraud detection approaches its 'Minority Report' moment*, FORTUNE (Sept. 26, 2013, 2:37 PM), http://fortune.com/2013/09/26/fraud-detection-approaches-its-minority-report-moment/. If the SEC can do it, hedge funds can as well.

32. Hunt v. Enzo Biochem, Inc., 530 F. Supp. 2d 580 (S.D.N.Y. 2008).

simply be uncomfortable presuming price impact in anything but the most perfect markets they can identify, i.e., the markets where small changes in language will most likely trigger additional scrutiny.

The power of the presumption of price impact can be seen in the relative incoherence of fraud-on-the-market's corollary, the "truth-on-the-market" doctrine. Courts are notoriously all over the map in terms of when they will find that an offsetting "truth" mitigates the effects of an otherwise misleading statement. For example, in *Meyer v. Greene*,[33] the court rejected the plaintiffs' argument that an expert financial presentation "revealed" a company's overvaluation of assets to the market, because the raw data on which the presentation was based was publicly available and thus presumably had already been incorporated into the company's stock price.[34] In *Nguyen v. Radient Pharmaceuticals Corp.*,[35] by contrast, the court held that even a publicly available SEC filing could not be assumed to have been incorporated into stock price, and thus would not be presumed to offset lies contained in a later-issued corporate press release.[36]

Professor Langevoort cites *In re Merck & Co. Securities Litigation*[37] as an example of the Third Circuit's irrationality on the subject of truth-on-the-market,[38] an argument he has made in more detail elsewhere.[39] I am sympathetic to Professor Langevoort's position, as I was one of the attorneys who represented the *Merck* plaintiffs. But I will argue against interest, and defend the Third Circuit's decision in order to highlight the difficulties posed in this Comment.

In *Merck*, the basic allegation was that Merck's subsidiary, Medco, improperly accounted for certain revenues.[40] There was a dispute about whether Medco's accounting method could, under any interpretation, comply with Generally Accepted Accounting Principles ("GAAP"),[41] and, in fact, Medco's competitors used a different, more conservative, method.[42] But what was certainly true was that Merck had *misdescribed* Medco's revenue recognition policy in the footnotes to its financial statements.[43] Thus, even if Medco's method *could* comply with GAAP as a theoretical matter, Merck had acted improperly by falsely describing its policy as comparable to that of its competitors.

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33. 710 F.3d 1189 (11th Cir. 2013).
34. *Id.* at 1198.
35. No. SA-CV-11-0406-DOC, 2011 U.S. Dist. LEXIS 122533 (C.D. Cal. Oct. 20, 2011).
36. *Id.* at *19–21.
37. 432 F.3d 261 (3d Cir. 2005).
38. Langevoort, *supra* note 2, at 46 n.54.
39. Langevoort, *supra* note 11, at 173–78.
40. *Merck*, 432 F.3d at 264.
41. *In re* Merck & Co., Inc. Secs. Litig., No. 02-CV-3185 (SRC), 2004 U.S. Dist. LEXIS 28930, at *32 (D.N.J. July 6, 2004) (concluding that plaintiffs failed to demonstrate that Merck's accounting was "so beyond the 'range of reasonable treatments' so as to run afoul of GAAP").
42. Brief for Appellants at 36, *Merck*, 432 F.3d at 261 (No. 04-3298).
43. *Merck*, 432 F.3d at 264.

Eventually, at the direction of its auditor, Merck corrected the description of its accounting policy as part of its attempt to spin Medco off as a separate company, but did not change the substantive revenue-recognition method.[44] After a few months, a *Wall Street Journal* reporter caught wind of the correction and calculated that it amounted to billions of dollars in questionably reported revenues. The reporter subsequently wrote an article on the subject, causing Merck's stock price to plummet.[45]

To the disdain of many scholars,[46] the Third Circuit held that Merck's revenue recognition method must have been immaterial to investors, and thus had not fraudulently inflated Merck's stock price; otherwise, in an efficient market, Merck's stock price would have immediately dropped in reaction to the disclosure of the truth.[47] This hardly seems plausible because, if the information was immaterial, why did the stock price drop in response to the *Wall Street Journal* exposé? But despite this flawed reasoning, the Third Circuit faced a real challenge in that the actual misstatement—the most concrete allegation of a *falsehood*—was *not* Merck's prominently displayed revenues,[48] but the fine-print description of its accounting policy.[49] And no one seems to have noticed when Merck changed that description, at least not initially, and perhaps the change would have gone unnoticed if not for the increased scrutiny brought by the proposed Medco IPO. That suggests that no one noticed the original falsehood, and to the extent anyone was misled by Merck's reported numbers, it was not because Merck had adopted an *improper* accounting policy, but because Merck had adopted an *unusual* one, and investors *assumed* that Merck's accounting matched that of its competitors. In other words, it was not clear whether it was the *lie* that caused the damage, or investors' assumptions of regularity—exactly as might be said of cases where the lie is simply a company's claim that it is in compliance with the law. The problem is akin to Professor Langevoort's "silence" counterfactual—it is difficult to tell whether the *lie* is harming investors, or whether investors simply make certain assumptions about the businesses in which they invest. But, as in most cases, *silence* was not an option in *Merck* because one way or another, Merck was required to describe its accounting policy—thus raising the question, was anyone listening?

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44. *Id.*

45. *Id.* at 265.

46. *See* Langevoort, *supra* note 11; Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosure that Require Investors to Calculate the Bottom Line*, 34 PEPP. L. REV. 927 (2007).

47. *Merck*, 432 F.3d at 269–70.

48. Of course, even "technically" correct accounting may still be misleading and thus violate Section 10(b). *See* United States v. Simon, 425 F.2d 796, 805–06 (2d Cir. 1969); *In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 342 (S.D.N.Y. 2004). But plaintiffs always prefer to emphasize clear false statements rather than "literally" true ones, and *Merck* was no different.

49. To be fair, the plaintiffs strenuously (and, if I do say so myself, persuasively) argued that the accounting policy itself was improper, but they were hobbled in this effort by the fact that Merck's auditors apparently approved it, so long as it was disclosed.

In consumer markets, courts have developed a solution to this problem: they treat "big" statements differently from "little" ones. Courts will presume reliance when the lie was so fundamental to the transaction that the mere fact that the plaintiffs engaged in the transaction at all indicates that they were misled.[50] In these cases, the plaintiffs still have the burden of proving their reliance on the representation itself—reliance on price, as Professor Miller suggests, is not sufficient—but courts will ease plaintiffs' evidentiary burden by considering circumstantial evidence surrounding the purchase.[51]

When it comes to securities, *Affiliated Ute Citizens v. United States*[52]—a precursor to *Basic*—may well be viewed as endorsing a similar rule. The formal holding in *Affiliated Ute* is simply that reliance may be presumed when fraud consists of a material *omission* under § 10(b)[53] (a rule that, taken literally, is quite broad, given the open-endedness of the standard for determining materiality in the first place[54]). However, in *Affiliated Ute*, the concealed facts were particularly egregious: the defendants had purchased securities from the plaintiffs with the undisclosed intention of flipping them to their own customers at markups that were 25%–100% of the original purchase price.[55] That is an omission of information so basic to the transaction that the Court may well have thought that the plaintiffs' willingness to sell their securities at all proved they must have "relied" on the omissions. Given that *Affliated Ute* was actually decided *before* the Court formally defined "materiality" for the purposes of the securities laws,[56] it is difficult not to suspect that the Court meant "material" in a much more extreme sense than the rule defining materiality that the Court would eventually adopt.

But unlike the rules used in consumer cases, or that the Court may have thought it was adopting in *Affiliated Ute*, the fraud-on-the-market doctrine is a very blunt instrument. So long as the lie (or the undisclosed fact) meets the relatively modest threshold of "materiality," the doctrine does not permit

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50. *See, e.g.*, Peterson v. H & R Block Tax Servs., 174 F.R.D. 78, 84–85 (N.D. Ill. 1997).

51. Consumer markets may also address "fundamental" lies in other ways: through, for example, direct product regulation, and the imposition of mandatory warranties.

52. 406 U.S. 128 (1972).

53. *See id.* at 152–54.

54. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) ("[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976))). *Basic* and *TSC* also emphasize the fact-specific nature of the materiality inquiry that generally renders it unsuited for determination on the pleadings or at summary judgment. *See Basic*, 485 U.S. at 236; *TSC*, 426 U.S. at 450.

55. *See Affiliated Ute*, 406 U.S. at 146–47; *see also* Cox, *supra* note 11, at 5 n.16.

56. That definition would not appear until 1976. *See TSC*, 426 U.S. at 449. To be fair, dicta in *Affiliated Ute* anticipated the standard that would ultimately be adopted in *TSC* and then *Basic*, see *Affiliated Ute*, 406 U.S. at 153, but *Affiliated Ute* itself did not appear to involve any serious dispute about the importance of the undisclosed facts at issue in that case.

distinctions between "big" lies and little ones. And there are only so many cases courts can dismiss for lack of materiality.[57]

One could argue, of course, that other elements of the § 10(b) cause of action can weed out claims based on obscure statements that do not actually influence prices. Loss causation, for example, or damages, might be impossible to show for statements that the market never considered. But, as Professor Langevoort explains, these are tricky issues.[58] The main problem is that when the "truth" is revealed—that the company did violate the antitrust laws, or bribed foreign officials to obtain business, or violated safety regulations—the resulting stock-price drop could just as easily be attributed to that *substantive* problem rather than to the impact of the misstatement. To put it another way, even if the company never represented that its success was due to great customer service, its stock price would probably still drop upon announcement of a Justice Department indictment for Sherman Act violations.

In sum, the presumption of price impact invites claims based on all sorts of behavior that goes beyond, strictly speaking, *lies*. It provides no guide for distinguishing public from *public*, or even material from *material*. While in general, plaintiffs would much rather claim fraud based on prominent lies than obscure ones, certainly many a case has been built on misstatements in the fine print, which is precisely why courts seek the assurance of a "high" level of efficiency before presuming that anyone did the reading.

III. WHAT DOES PRICE MEAN?

The fraud-on-the-market doctrine also permits plaintiffs a presumption that investors, as a psychological matter, rely on market prices.[59]

As Professor Langevoort points out, it has never been precisely clear why this presumption is even necessary.[60] If "reliance" as an element of a fraud claim exists merely to satisfy the requirement of *causation*, it would be a simple matter to eliminate references to investors' thought processes, and to only require that plaintiffs prove that the fraud "caused" their harm by impacting prices. This is already the law in the context of claims brought under the Racketeer Influenced and Corrupt Organizations Act: reliance is not a required element, and plaintiffs are permitted to establish causation by demonstrating that *third parties* "relied" on the misconduct, resulting in harm to themselves.[61] This paradigm would seem to be perfect for § 10(b) fraud-on-the-market actions because the harm to an "unrelying" investor does, in fact, arise from the reliance of third parties—the other market participants who hear, and act upon, the false representation.

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57. There are, in fact, so many cases that courts can dismiss for lack of materiality. *See* Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 116 n.94 (2002) (explaining that in one survey, 70% of securities dismissals held that at least one alleged misstatement was immaterial).

58. Langevoort, *supra* note 2, at 44-46.

59. *Basic*, 485 U.S. at 246–47.

60. Langevoort, *supra* note 2, at 49-50.

61. Bridge v. Phoenix Bond & Indem. Co., 553 U.S. 639, 640, 648–49 (2008).

However, the *Basic* Court chose not to go this route. Instead, it predicated half of the fraud-on-the-market doctrine on a presumption regarding the investors' inner motivations—specifically, their subjective "reliance" on market price.[62] The Court thus "erroneously invoked the [efficient-markets hypothesis] as a description of investor behavior, rather than the functioning of markets."[63]

Professor Langevoort challenges the *Basic* Court's assumption that investors "rely" upon market prices because, he argues, investors know that fraud is an all-too-common risk.[64] At best, then, he views the presumption of psychological reliance as less of a description of how investors actually think than as an act of "juristic grace" that *entitles* investors to markets that are untainted by fraud.[65]

In fact, the tension between the concept of reliance and the (known) risk of fraud inherent in any transaction exists even in the context of ordinary fraud. After all, there is no good reason for anyone to rely on a self-interested seller's representations. At best, purchasers "rely" on the legal system to vindicate them should the seller's representations prove false. As a result, some courts have required that sophisticated buyers protect themselves by arranging for special warranties against fraud by the seller, the absence of which will establish that the buyer's reliance was not justifiable.[66] Conversely, some courts do the opposite, and treat a privately negotiated warranty as "proof" that the buyer did not "rely" on the seller's representations at all, but rather contractually allocated the risks associated with falsehood.[67] These cases are in the vein of Professor Langevoort's "juristic grace" model: they struggle with the tension between the concept of reliance, and the (known) risk of fraud inherent in any transaction.

With that said, confusion in the fraud-on-the-market context goes further. Some courts have indicated a problem with the existential question of what the price actually should be taken to *represent*—i.e., its significance in the minds of investors—such that the Supreme Court deems that investors may "rely" upon it. Assuming, as investors are legally entitled to do, that the price is untainted by fraud, what significance does that price hold? The answer that the Supreme Court has given is that for *most* investors, the price represents the best assessment of the security's "true" value.[68]

Yet courts often seem uncomfortable with the idea that price itself can be a misrepresentation absent some particular, additional indicia of that price's reliability. This is why courts have repeatedly rejected the "fraud-created-the-

62. *Basic*, 485 U.S. at 246–47.
63. Cox, *supra* note 11, at 12.
64. Langevoort, *supra* note 2, at 49.
65. *Id.* at 17.
66. *See, e.g.*, ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., 106 A.D.3d 494, 502 (N.Y. App. Div. 2013).
67. Universal Enter. Group, L.P. v. Duncan Petroleum Corp., No. 4948-VCL, 2013 Del. Ch. LEXIS 162 (Del. Ch. July 1, 2013); Slaymaker v. Westgate State Bank, 241 Kan. 525, 535–36 (1987).
68. *See* Halliburton Co. v. Erica P. John Fund, Inc. (*Halliburton II*), 134 S. Ct. 2398, 2411 (2014); Basic, Inc. v. Levinson, 485 U.S. 224, 244 (1988).

market" theory of reliance.[69] Absent a presumption that the price reflects all available information—if, by hypothesis, the price is "incomplete" because of market inefficiencies—courts have said that investors behave *irrationally* in relying on it.[70] As a policy matter, courts want to encourage investors to investigate the securities that they buy,[71] but more fundamentally, an "incomplete" price is deemed to have minimal informational value.[72] Courts take it as a given that a price in an *inefficient* market is inherently "unreliable," not only because it may be tainted by fraud, but simply because a price that does not reflect all material information is, by definition, inaccurate.

In truth, there is no reason why the law should be so distrustful of prices as a source of information. Adolf Berle wrote that the "highest appraisal of the value of a security is that actually reached by a buyer and a seller and consumated [sic] through the agreement to buy and sell,"[73] a statement as true for inefficient markets as for efficient ones (and primary markets as well as secondary markets, at least for arm's length transactions). Indeed, that presumption is built into the securities laws themselves. Section 11, for example, permits investors to bring claims based on a false registration statement without requiring a showing of reliance, and without regard for the efficiency of the market in which the security trades,[74] because Congress assumed that the security's price—at offering or in the secondary market—would reflect the false information.[75] Section 9 permits investors to bring claims based on market manipulation.[76] But market manipulation is only likely to be successful in thinly traded, inefficient markets, once again demonstrating that it is possible for investors to be *psychologically* misled by price even in the absence of market efficiency.[77] Car buyers regularly

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69. The fraud-created-the-market theory posits that a security's mere presence in the public market is some indicia of its quality. *See, e.g.*, Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1130–31 (7th Cir. 1993).

70. *See In re* PolyMedica Corp. Secs. Litig., 432 F.3d 1, 16 (1st Cir. 2005); Freeman v. Laventhol & Horwath, 915 F.2d 193, 198 (6th Cir. 1990).

71. *See* Malack v. BDO Seidman, LLP, 617 F.3d 743, 750 (3d Cir. 2010).

72. *See PolyMedica*, 432 F.3d at 16; *Freeman*, 915 F.2d at 198.

73. A.A. Berle, Jr., *Liability for Stock Market Manipulation*, 31 COLUM. L. REV. 264 (1931).

74. 15 U.S.C. § 77k (2012).

75. *See* APA Excelsior III L.P. v. Premiere Techs., 476 F.3d 1261, 1273–75 (11th Cir. 2007) (citing legislative history). The legislative history of Section 11 also demonstrates that Congress expected that investors would rely on the prices set by underwriters. *See* 78 CONG. REC. 10186 (1934) ("When an issue of securities is proposed, a banking house will investigate the financial statement of the corporation. Based upon the statements contained in the registration statement of the corporation, a banking house will offer the securities at a certain price. Therefore, the market value is fixed by the false statement of the corporation. The individual investor relies upon the investigation made by the banker."). And indeed today, offering prices are set only after underwriters conduct due diligence not only of the issuer, but also of the market for the security and the prices that investors are willing to pay—an offering price does, therefore, carry at least some informational value regarding the demand for the security.

76. 15 U.S.C. § 78i.

77. Charles R. Korsmo, *Mismatch: The Misuse of Market Efficiency in Market Manipulation Class Actions*, 52 WM. & MARY L. REV. 1111 (2011).

rely on the prices listed on the Kelley Blue Book website, even though it is plain that cars are not bought and sold in anything like the "impersonal, well-developed market" envisioned by *Basic*.

What underlies courts' insistence on efficiency is likely a fear that, unless they limit the types of markets to which the fraud-on-the-market presumptions apply, the doctrine will functionally do away with the reliance requirement altogether. Once there is no need to show that a price was set in some kind of "valid" manner, there is no limit to the types of markets in which fraud-on-the-market may be used—precisely as Professor Miller illustrates.[78] Courts cling to the "efficiency" criterion because without it, any price at all can be the source of purchaser "reliance."[79] Such a result could easily interject courts into the dangerous area of simply policing *prices*.

In other words, courts' overly demanding standards for market efficiency may have little to do with any doctrinal misunderstanding, and may instead represent merely an unvarnished attempt to draw a line in the sand regarding the doctrine's scope. And if that's true, courts are unlikely to accept *Halliburton II*'s invitation to loosen the standards for evaluating market efficiency.

But, as both Professors Miller and Langevoort suggest, there is a third possibility for how courts will evaluate market efficiency post-*Halliburton II*.[80] By allowing plaintiffs to retain their presumptions, but then giving defendants the opportunity to rebut them, what the Supreme Court has truly accomplished is to give district courts additional *discretion* to allow cases to proceed (or not) as they see fit. Among other things, courts may use this discretion to conclude, for example, that fraud-on-the-market doctrine may be applied to imperfect markets, but that investors may only justifiably *rely* on markets when they *appear* near-perfect to the reasonable investor.[81] Courts may even use this discretion to "find" that banal statements had no impact on price, thus using *Halliburton II* to serve as a pressure point to distinguish claims based on *lies* from claims where the lies seem incidental to a harm based on *conduct*.

CONCLUSION

The fraud-on-the-market presumption may reflect a reasonable observation about the operation of markets, but it fails to give courts much guidance as to its precise scope. *Halliburton II* suggests that courts have been too strict in searching for some theoretical ideal of perfect efficiency, but that alone

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78. Miller, *supra* note 12, at 66.

79. Robert Cialdini tells the story of a jewelry-store owner who, frustrated by a lack of sales, left a hurried note to her saleswoman declaring that everything in one display case should be sold at half price. The saleswoman misread the note to mean that the display case's prices should be *doubled*. The owner returned to find that the case had sold out—presumably because purchasers had "relied" upon the high prices as indicative of the jewelry's quality. *See* ROBERT B. CIALDINI, INFLUENCE: SCIENCE AND PRACTICE 1–2, 4–5 (3d ed. 1993).

80. Langevoort, *supra* note 2, at 47; Miller, *supra* note 12, at 69.

81. *See In re* Initial Pub. Offering Secs. Litig., 260 F.R.D. 81, 105 (S.D.N.Y. 2009) (holding that during the early days of trading, the market for certain internet stocks was so chaotic and irrational that no investor could have reasonably relied on price).

does not solve the fundamental problem. As a result, courts may either be reluctant to accept *Halliburton II*'s invitation to loosen their restrictions on the definition of efficiency, or may simply use their new discretion to cabin the scope of the fraud-on-the-market doctrine on an ad hoc basis, creating even more uncertainty and inconsistency.