

**Damages and Reliance Under Section 10(b) of the  
Exchange Act**

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I. Introduction

More than 3,050 private class action securities fraud lawsuits were filed between 1997 and 2012.<sup>1</sup> Settlements in these actions generated more than \$73.1 billion,<sup>2</sup> and comprise six of the ten largest settlements in class action history.<sup>3</sup> Between 1997 and 2007, plaintiffs' lawyers earned nearly \$17 billion in fees in securities class action settlements,<sup>4</sup> and estimates suggest that defense counsel have earned similar amounts.<sup>5</sup> Between 2002 and 2004, class action securities fraud litigation constituted approximately 47% of all class actions pending in federal court.<sup>6</sup>

This litigation generates significant controversy. Some observers view private class action securities fraud actions as providing a necessary supplement to the Securities and Exchange Commission's own enforcement actions, and as generating valuable deterrence and

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<sup>1</sup> See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2012 YEAR IN REVIEW Figure 2 (2012), available at [http://securities.stanford.edu/clearinghouse\\_research/2012\\_YIR/Cornerstone\\_Research\\_Securities\\_Class\\_Action\\_Filings\\_2012\\_YIR.pdf](http://securities.stanford.edu/clearinghouse_research/2012_YIR/Cornerstone_Research_Securities_Class_Action_Filings_2012_YIR.pdf).

<sup>2</sup> CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2012 YEAR IN REVIEW Figure 2.

<sup>3</sup> Constance Parten, *Top Ten Class-Action Lawsuits* (2010), <http://www.cnn.com/id/35988343>.

<sup>4</sup> "It is estimated that plaintiffs' attorneys obtain 32% of the value of a settlement in fees, and in the past decade securities class action defendants settled for a total of nearly \$52 billion." U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION, THE PROBLEM, ITS IMPACT, AND THE PATH TO REFORM 19 (2008), available at [http://www.instituteforlegalreform.com/get\\_ilr\\_doc.php?docId=1213](http://www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213) (citing John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1546 & n.38 (2006); LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2007 REVIEW AND ANALYSIS 5 (2008)).

<sup>5</sup> "Defense expenditures are often 25-30% of the settlement amount, and fees to defense counsel that approach 50% and even 100% of the settlement value are not infrequent." *Id.* at 17 (citing Coffee, *Reforming the Securities Class Action*, *supra* note 4 at 1546 & n.38).

<sup>6</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 4, at 1539, Table 1. More recent data suggest that class action securities fraud litigation today constitutes a much smaller percentage of the federal judiciary's current class action docket. See EMERY G. LEE III & THOMAS E. WILLGING, THE IMPACT OF THE CLASS ACTION FAIRNESS ACT OF 2005 ON THE FEDERAL COURTS, FOURTH INTERIM REPORT TO THE JUDICIAL CONFERENCE ADVISORY COMMITTEE ON CIVIL RULES 4, 19 (Federal Judicial Center Report, 2008) (stating that "securities class actions declined from a peak of 240 in July - December 2001 to 85 in January - June 2007, a decrease of 65 percent. Securities class actions declined as a proportion of all class action activity, from 17.5 percent of all class actions in the federal courts in July - December 2001 to 3.6 percent of all class actions in January - June 2007.").

compensation.<sup>7</sup> Critics respond that these same lawsuits fail to promote either deterrence or compensation, and that they impose costs in excess of benefits.<sup>8</sup> Critics also observe that class action securities fraud lawsuits “disproportionately claim judicial time and attention” because they take longer to resolve than most other class actions, require that courts play a more active monitoring role, frequently lead to multiple motions to dismiss, and can fail to resolve all related claims in a single action, particularly in larger, more complex matters where a global resolution is most valuable.<sup>9</sup>

Litigation under Section 10(b) of the Exchange Act constitutes the largest portion of this activity.<sup>10</sup> The claim on judicial attention generated by Section 10(b) litigation is apparent in the fact that at least 28 Supreme Court decisions touch on the interpretation and application of the Section 10(b) remedy.<sup>11</sup> But notwithstanding the extensive attention applied by the Supreme Court to the interpretation and application of the Section 10(b) private right of action, the Court has yet to address the proper measure of damages in Section 10(b) private actions. And therein lies the rub.

If the question of damages is to be presented to the Supreme Court, as the Court is currently constituted,<sup>12</sup> the permissible amount of damages available under the implied Section 10(b) private right of action would likely be dramatically reduced in comparison to the amounts currently available in lower court proceedings. The implications of this change would be profound. By dramatically diminishing the recoveries available in most private actions seeking money damages under Section 10(b), the change in damage rules would significantly alter the economics of private class action securities fraud litigation. It would also make class certification far more difficult, if not impossible, in a large percentage of cases because questions of individual reliance and damages would then predominate under Rule 23(b).

Under current law, private party plaintiffs can collect out-of-pocket damages in Section 10(b) litigation absent an affirmative showing of actual “eyeball” reliance.<sup>13</sup> This result follows primarily from the Supreme Court’s decision in *Basic v. Levinson*,<sup>14</sup> where the Court accepted the fraud on the market doctrine and allowed plaintiffs a rebuttable presumption of reliance once they could demonstrate that the market for the security affected by the alleged fraud was efficient and that the alleged fraud had publicly entered the market.<sup>15</sup> *Basic*’s nominally rebuttable

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<sup>7</sup> See Part VI.A., *infra*.

<sup>8</sup> See Part VI.B., *infra*.

<sup>9</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 4, at 1540-1541.

<sup>10</sup> CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2012 YEAR IN REVIEW Figure 4. (“The percentage of filings with Rule 10b-5 claims increased to 85percent in 2012 from 71 percent in 2011. This is the highest percentage of Rule 10b-5 claims in the last five years and the second year-over-year increase since 2010.”).

<sup>11</sup> See note 79, *infra* (listing the 28 Supreme Court decisions interpreting Section 10(b)).

<sup>12</sup> It bears emphasis that this article’s analysis is presented from a positivist, non-normative perspective. The analysis focuses on how the Supreme Court, as it is currently composed, is likely to resolve a specific set of legal questions, and makes no claim as to the optimality of any decision that the Court might or might not reach. Policy considerations are relevant from this perspective only to the extent that they might influence the Court’s deliberations.

<sup>13</sup> See Part V.B., *infra*.

<sup>14</sup> 485 U.S. 224 (1988).

<sup>15</sup> *Basic*, 485 U.S. at 241-247; see also *Amgen Inc. v. Ct. Ret. Plans and Trust Funds*, 133 S.Ct. 1184, 1191 (2013) (“The fraud-on-the-market premise is that the price of a security traded in an efficient market will reflect all publicly

presumption of reliance is, however, *de facto* close to irrebuttable: examples of successful rebuttals are exquisitely rare and the showing necessary for a successful rebuttal is murky at best.<sup>16</sup> Notwithstanding this fact, the lower courts typically proceed to apply an out-of-pocket damage measure to the calculation of potential plaintiff recoveries without any concern over actual reliance by any plaintiff. This out-of-pocket rule often causes defendants to face financial exposure far in excess of any profits they may or may not have earned as a consequence of the alleged fraud. Put another way, the confluence of the fraud on the market doctrine, with its theoretically rebuttable but pragmatically irrebuttable presumption of reliance, combined with the operation of the out-of-pocket damage rule, creates a situation in which class action plaintiffs can assert large damage claims, far in excess of the measure that would be available under a disgorgement rule, without ever establishing actual reliance by even one plaintiff.

But, if a cause of action is to be defined as a “harmonious whole,” then each element of the cause of action must be construed in light of the structure of the other elements of the other causes of action in the same statute.<sup>17</sup> Thus, when a plurality of the *Basic* Court explains that its decision to adopt a rebuttable presumption of reliance “is not to be interpreted as addressing the proper measure of damages in litigation of this kind,”<sup>18</sup> the plurality expressly leaves open the possibility that subsequent consideration of the “proper measure of damages” could support an analysis that restricts the right to recover damages in a manner that was not addressed by *Basic*’s analysis of the reliance requirement. Put another way, the plurality in *Basic* expressly recognized that *Basic* was not the last word in the analysis of the private right to recover money damages under Section 10(b).

Therefore, when considering the measure of damages under Section 10(b), today’s Court would be addressing a question that was expressly reserved in *Basic* and that is unaddressed in any other Supreme Court decision.<sup>19</sup> The Court’s starting point in this analysis would be that the private right of action under Section 10(b) is implied and not express.<sup>20</sup> Congress never intended to create a private right of action when Section 10(b) was adopted in 1934, and never had occasion to define the elements of a cause of action that it had no idea would later be inferred by the courts.<sup>21</sup> Congress’ only apparent intent in adopting Section 10(b) was to fashion a “catch-

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available information about a company; accordingly, a buyer of the security may be presumed to have relied on that information in purchasing the security.”).

<sup>16</sup> See Part V. A., *infra*.

<sup>17</sup> *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) (“A court must therefore interpret the statute ‘as a symmetrical and coherent regulatory scheme,’ *Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995), and ‘fit, if possible, all parts into an harmonious whole,’ *FTC v. Mandel Brothers, Inc.*, 359 U.S. 385, 389 (1959).”); see also *Asadi v. G.E. Energy (USA), L.L.C.*, No. 12–20522, 2013 WL 3742492, at \*2 (5<sup>th</sup> Cir. July 17, 2013) (“if possible, we interpret provisions of a statute in a manner that renders them compatible, not contradictory”); 2A N. SINGER, SUTHERLAND ON STATUTORY CONSTRUCTION § 46.05 (5th ed.1992) (“each part or section [of a statute] should be construed in connection with every other part or section so as to produce a harmonious whole.”).

<sup>18</sup> *Basic*, 485 U.S. at 248 n. 28.

<sup>19</sup> The question of damages in aftermarket Section 10(b) litigation was touched upon by the Court but left unresolved in *Ute* and *Loftgaardan*. See Part V.B., *infra*.

<sup>20</sup> See Part II, *infra*.

<sup>21</sup> See Parts II & III.B., *infra*.

all” provision that could aid the Commission itself in its own enforcement proceedings.<sup>22</sup> Similarly, when the Securities and Exchange Commission adopted Rule 10b-5 in 1942, it too had no intention of creating a private right of action.<sup>23</sup> Its only apparent intent was to authorize the Commission to pursue government enforcement actions in cases involving fraud in the purchase, rather than in the sale, of securities.<sup>24</sup> The private right of action under Section 10(b) is thus entirely a creature of the judicial imagination. It therefore falls to the courts to fashion the elements of a cause of action that Congress and the Commission never initially intended to create and have never defined.<sup>25</sup>

The Supreme Court applies three distinct techniques when addressing this interpretive challenge.<sup>26</sup> First, and mostly significantly, the Court engages in “historical reconstruction.”<sup>27</sup> It applies a textualist analysis that searches for the most analogous provision among the express private rights of action that were recognized by the 73rd Congress at the time of Section 10(b)’s enactment in 1934.<sup>28</sup> The Court reasons that the elements of an implied private right of action cannot rationally be interpreted as being broader than the most analogous provision of a contemporaneously created express private right of action: “[i]t would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action.”<sup>29</sup> Second, the Court considers the relevant legislative history. Third, the Court today leans toward the narrowest interpretation of the implied Section 10(b) private right precisely because the right is implied and has never been expressly defined by Congress. The Court reasons that if Congress wants to define the judicially implied cause of action more broadly, it can always legislate in response to the Court’s decision, as it already has in other instances.

Although considerations of post-enactment legislative activity play little role in this predominantly textualist calculus,<sup>30</sup> an examination of amendments to the Securities Act and to the Exchange Act since their adoption indicates that Congress has never endorsed the current damage regime that allows for expansive recovery absent a prior showing of actual reliance.<sup>31</sup> To the contrary, subsequent amendments to the Securities Act and to the Exchange Act suggest a Congressional discomfort with private enforcement of the federal securities laws, and rejection of a fundamental premise upon which *Basic*’s rebuttable presumption of reliance rests.<sup>32</sup>

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<sup>22</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-203 (1976) (quoting Hearings on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce, 73d Cong. 115 (1934)) (emphasis supplied).

<sup>23</sup> See Part II, *infra*.

<sup>24</sup> *Id.*

<sup>25</sup> See note 68, *infra*.

<sup>26</sup> See Part III, *infra*.

<sup>27</sup> *Musick, Peeler & Garrett v. Emp’rs Ins. of Wausau*, 508 U.S. 286, 294 (1993).

<sup>28</sup> This form of analysis might more precisely be called “second order textualism” because there is no primary text to interpret and the Court must search for a secondary text in order to infer the statute’s meaning. However, for ease of reference, this article refers to the analysis simply as textualist or textualism. I am grateful to George Conway for this observation.

<sup>29</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 736 (1975).

<sup>30</sup> See Part III.A., *infra*.

<sup>31</sup> See Part IV, *infra*.

<sup>32</sup> See Part IV.A., *infra*.

All of these interpretative techniques conclude that the damages available in an implied private action under Section 10(b) can be no broader than the damages available pursuant to Section 18(a) of the Exchange Act, the most analogous express private right of action. Section 18(a), however, requires that plaintiffs affirmatively establish actual “eyeball and eardrum” reliance as a pre-condition to recovery, and the rebuttable presumption of reliance does not apply in Section 18(a) litigation.<sup>33</sup> It follows that, if the recovery available under the implied Section 10(b) cause of action cannot be broader than the recovery available under the express Section 18(a) cause of action, then plaintiffs must also demonstrate actual reliance as a precondition to recovery under Section 10(b). The fraud on the market doctrine, with its purportedly rebuttable presumption of reliance, cannot operate to override the actual reliance precondition to recovery expressly articulated by Congress in the Section 18(a) cause of action.

From a policy perspective, a large academic literature provides significant support for a rule that would narrow the scope of aftermarket damages recoverable under Section 10(b). As long ago pointed out by Judges Posner and Easterbrook, and by many other scholars,<sup>34</sup> in aftermarket trading cases every dollar of loss by a plaintiff who unknowingly purchases a security at an inflated price generates an equal dollar of gain for a trader who unknowingly sold precisely the same security at precisely the same inflated price.<sup>35</sup> The “damage” measure generated by an “out of pocket” recovery rule in the context of aftermarket trading thus describes a wealth transfer among two sets of equally innocent and ignorant investors. This measure of wealth transfer has nothing to do with measures of disgorgeable profits that might have been earned by wrongdoers, or with traditional notions of compensatory damages or optimal deterrence as those terms are understood by economists.

Moreover, because aftermarket transactors are both purchasers and sellers over time, and because the probability of profiting by selling into an aftermarket fraud is the same as the probability of suffering a loss as a consequence of buying into an aftermarket fraud, the aggregate risk created by aftermarket fraud can be viewed as diversifiable. Indeed, on average and over time, the risk of being harmed by aftermarket securities fraud (at least as measured exclusively by stock prices) averages to zero for investors who purchase and sell with equal frequency. Further, to the extent that these damages are covered by directors and officers insurance, they are mutualized across all publicly traded firms that purchase this form of coverage, and are thus borne by all investors in those firms. Finally, to the extent that these damages are not covered by insurance, but are paid by the corporation, all stockholders of the defendant corporation wind up bearing the cost of the settlement. It is only in the exceptionally rare instance when an executive or director reaches into his or her own pocket to fund a recovery out of their personal assets<sup>36</sup> that the Section 10(b) private litigation process does not simply result in a wealth transfer among different categories of investors, net, of course, of the transactions costs generated by plaintiff and defense counsel and associated litigation frictions.<sup>37</sup> The Court will be able to cite to this extensive economic literature to support the conclusion that the current Section 10(b) damage rule is over-broad and should be cut back.

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<sup>33</sup> See notes 179-183 *infra*.

<sup>34</sup> See note 332, *infra*.

<sup>35</sup> See Part VI.B.1., *infra*.

<sup>36</sup> See note 339 *infra* and all accompanying text.

<sup>37</sup> See note 336, *infra*.



To be sure, there is also a large and credible literature arguing that private enforcement of the federal securities laws is a valuable and necessary supplement to federal and state enforcement efforts. This literature suggests that private litigation under the Section 10(b) private right of action provides valuable deterrence and offers compensation not otherwise available under the law.<sup>38</sup> Current Supreme Court doctrine, however, suggests that this policy argument – even if it is ultimately correct – is unlikely to overcome a textualist analysis consistent with legislative history and a doctrine of narrow construction, particularly when countervailing academic literature suggests that the current approach to damage calculation is irrational.

The implications of this textualist analysis of Section 10(b) can be framed as supporting two distinct, non-contradictory conclusions of law. First, the textual analysis can be viewed as addressing a damages question that was expressly reserved in *Basic*,<sup>39</sup> and as adding an actual reliance requirement as a precondition to the award of out-of-pocket damages without directly challenging *Basic*'s rebuttable presumption of reliance. Under this approach, *Basic* could remain as a valid interpretation of the Section 10(b) reliance requirement, and it would remain applicable to private injunctive actions as well as to actions seeking money damages. However, in actions seeking money damages, the additional actual “eyeball and eardrum” reliance component of Section 18(a) must also be satisfied in order that the statute remain a “harmonious whole.”

Alternatively, the textualist approach can be viewed as providing a relatively simple technique for the Court, if it is so inclined, to overturn *Basic*'s rebuttable presumption of reliance. At least four justices writing in *Amgen* invited a reconsideration of *Basic*'s continued validity.<sup>40</sup> But any reconsideration of *Basic* raises the risk of embroiling the Court in a complex web of financial, econometric, and public policy arguments regarding the validity of the semi-strong form of the efficient market hypothesis. However, as the Court has observed, policy debates of this sort are better resolved by Congress than by the judiciary. In particular, as Justice White observed in dissent in *Basic*, the judiciary lacks the economic expertise necessary to evaluate the financial market claims that underlie the efficient market hypothesis which serves as the intellectual foundation for the fraud on the market presumption.<sup>41</sup> It follows that just as the Court might have reached beyond its area of expertise when it relied on the efficient market hypothesis to support *Basic*'s fraud on the market presumption, the Court might again be asked to reach beyond its expertise to assess evidence that the efficient market hypothesis is today susceptible of critiques that were not apparent when *Basic* was decided.<sup>42</sup> In contrast, a purely

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<sup>38</sup> See Part VI.A., *infra*.

<sup>39</sup> *Basic*, 485 U.S. at 248 n.28.

<sup>40</sup> *Amgen*, 133 S.Ct. at 1204 (Alito, J., concurring) (“more recent evidence suggests that the [fraud-on-the-market] presumption may rest on a faulty economic premise. . . . In light of this development, reconsideration of the *Basic* presumption may be appropriate.”); *id.* at 1206 (Scalia, J., dissenting) (“Today's holding does not merely accept what some consider the regrettable consequences of the four-Justice opinion in *Basic* ; it expands those consequences from the arguably regrettable to the unquestionably disastrous.”); *id.* at 1208 n.4 (Thomas, J. and Kennedy, J., dissenting) (“The *Basic* decision itself is questionable.”).

<sup>41</sup> *Basic*, 485 U.S. at 253 (White, J., concurring in part and dissenting in part) (“But with no staff economists, no experts schooled in the ‘efficient-capital-market hypothesis,’ no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.”).

<sup>42</sup> See Part VI.B.2., *infra*. Justice Scalia's concurrence in *Myriad* discusses this issue: “I join the judgment of the Court, and all of its opinion except Part 1-A and some portions of the rest of the opinion going into fine details of

textualist approach would allow the Court to reverse *Basic* exclusively on grounds of statutory interpretation, a domain in which the Court can claim a comparative advantage.

An independent basis for a challenge to *Basic*'s rebuttable presumption of reliance rests on the fact that the presumption is far more rebuttable in theory much than it is in fact.<sup>43</sup> There appears to be only five reported instances of successful rebuttal of the presumption once it attaches, and each of these situations appears to raise an unusual fact pattern. Significantly, the Court has defended *Basic*'s presumption of reliance precisely because the presumption is supposed to be rebuttable. Indeed, the central logic of *Basic*'s decision,<sup>44</sup> as well as the logic of *Amgen*,<sup>45</sup> appears to rest critically on the presumption that the presumption is rebuttable. But if the presumption is *de facto* irrebuttable in all but the most unusual situations, then the presumption upon which the presumption relies is revealed to be false. The question then is whether the *Basic* court in 1988 would have supported a *de facto* irrebuttable presumption of reliance and whether the court today would support such a *de facto* irrebuttable presumption.

The *de facto* irrebuttable nature of the nominally rebuttable presumption also highlights an internal contradiction in logic that is central to both *Basic* and *Amgen*. Both decisions emphasize that the presumption was adopted to facilitate class action litigation because, absent a presumption, a class would not be certifiable.<sup>46</sup> However, the test of whether the presumption is rebutted is applied only as against the representative plaintiff.<sup>47</sup> If the presumption is successfully rebutted against one representative plaintiff, then counsel can always substitute another class member against whom the presumption will not be rebutted, assuming that counsel acts on a timely basis. Successful rebuttal of the presumption as against a proposed class representative thus constitutes a challenge to a plaintiff's typicality more than a challenge to the certifiability of the class.<sup>48</sup> The notion of a rebuttable presumption in the context of an individual Section 10(b) action, in which a successful rebuttal can terminate the proceeding, is thus fundamentally different from the notion of a rebuttable presumption in a class action context, in which a successful rebuttal as to one representative plaintiff is only a reason to find another representative plaintiff. Put another way, rebutting the presumption in a class action context is like inviting the defendant to play a game of "Whack-A-Mole," in which the moles always win. Thus, the Court's insistence that the presumption be rebuttable and that it is adopted to facilitate class action litigation is a practical contradiction in terms: if the presumption is designed to

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molecular biology. I am unable to affirm those details on my own knowledge or even my own belief." Ass'n for Molecular Pathology v. Myriad Genetics, Inc., 133 S.Ct. 2107, 2120 (2013) (Scalia, J., concurring in part).

<sup>43</sup> See Part V.A., *infra*.

<sup>44</sup> *Basic*, 485 U.S. at 248-49 (discussing several ways petitioners can rebut the presumption).

<sup>45</sup> *Amgen*, 133 S.Ct. at 1193 (noting the presumption can be rebutted by appropriate evidence).

<sup>46</sup> See *Amgen*, 133 S.Ct. at 1192 ("requiring proof of direct reliance 'would place an unnecessarily unrealistic evidentiary burden on [a] plaintiff who has traded on an impersonal market.'" (quoting *Basic*, 485 U.S. at 245)); *Basic*, 485 U.S. at 242 ("Requiring 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.").

<sup>47</sup> See, e.g., *In re Safeguard Scientifics*, 216 F.R.D. 577, 582 (E.D. Pa. 2003) (the court found "compelling reason to rebut the reliance presumption," with respect to the lead plaintiffs, and held as a result that lead plaintiffs' claims were not typical and that lead plaintiffs were not adequate representatives; "Since no proffered class representative has satisfied Rule 23(a), we need not address the Rule 23(b)(3) requirements.").

<sup>48</sup> See e.g., *id.* (motion for class certification denied due in part to named plaintiff's lack of typicality); see also note 279, *infra*.

promote class action litigation it cannot be meaningfully rebuttable and if it is to be meaningfully rebuttable then it cannot effectively promote class action litigation. The Court is trying to have it both ways when it can't.

The question then naturally presents itself as to how and why the lower courts have, for decades, interpreted the preconditions for recovery under Section 10(b) in a manner that differs so dramatically from the rule most consistent with the form of textualist analysis that is most likely to be preferred by the current Supreme Court. History provides the answer. The Supreme Court's current textualist approach to the interpretation of Section 10(b) was first expressed in 1991.<sup>49</sup> The Supreme Court's view that the implied private right under Section 10(b) should be narrowly construed is of even more recent vintage and was not expressly articulated in this manner until 2008.<sup>50</sup> In contrast, the lower court's approach to the calculation of damages in private Section 10(b) litigation was largely set by 1974<sup>51</sup> and the application of this rule has, in the absence of governing Supreme Court precedent, been entirely unaffected by the form of textualist analysis that today dominates Supreme Court thinking. As Supreme Court rejection of the approach unanimously applied by the lower courts would thus not be surprising from this historical perspective, and would not be the first time that the Supreme Court has rejected the unanimous view of the Circuit Courts of Appeal because of a failure to apply a textualist approach to the interpretation of the Section 10(b) implied private right of action.<sup>52</sup>

The implications of a rule requiring an affirmative showing of eyeball or eardrum reliance as a precondition to the recovery of aftermarket damages in Section 10(b) private actions are profound. As an initial matter, assuming that a plaintiff class can be certified at all, the class would be composed exclusively of traders who can affirmatively demonstrate actual reliance and would likely be far less numerous than the classes currently being certified. More fundamentally, however, given the highly individualized showings that plaintiffs must make in order affirmatively to demonstrate eyeball reliance, plaintiffs will likely find it extremely difficult, if not impossible, to establish sufficient commonality to support class certification under Rule 23.

It follows that the traditional form of class action securities fraud litigation involving thousands of class members alleging violations of Section 10(b) is unlikely to survive a textualist analysis. Private securities fraud class action litigation alleging violations of Section 11 and 12 of the Securities Act, or Section 14 of the Exchange Act, will continue to be viable because none of the elements of those causes of action are implicated by the adoption of an actual reliance requirement under Section 10(b). Private aftermarket claims for money damages under Section

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<sup>49</sup> See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilberston*, 501 U.S. 350, 359 (1991) (looking to "contemporaneously enacted express remedial provisions" to determine statute of limitations applicable in Section 10(b) actions); see also *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173 (1994) ("our cases considering the scope of conduct prohibited by § 10(b) in private suits have emphasized adherence to the statutory language, '[t]he starting point in every case involving construction of a statute.' We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute." (quoting *Ernst & Ernst*, 425 U.S. at 197, and citing *Chiarella v. U.S.*, 445 U.S. 222, 226 (1980) and *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977))).

<sup>50</sup> *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 167 (2008) (conclusion that secondary actors were not liable under Section 10(b) was "consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.").

<sup>51</sup> See note 298, *infra*.

<sup>52</sup> See, e.g., *Central Bank*, 511 U.S. at 168-69, 173 (rejecting aiding and abetting liability under Section 10(b) despite the fact that every court of appeals to have addressed the question had previously recognized this form of liability).

10(b) will also not completely disappear. Instead, they are likely to be pursued by larger investors, suing under either federal or state law in individual actions that raise potentially significant damage awards. These lawsuits will likely resemble the litigation market that currently emerges when large institutional investors opt out of federal class action securities trade proceedings because they calculate that they can obtain larger recoveries by pursuing individual claims. Aftermarket Section 10(b) securities fraud litigation will therefore likely morph into a scrum of individual actions pursued by sophisticated investors in large cases that promise significant recovery.

This result will not be warmly embraced by many participants in the securities litigation process. A large part of the business model of plaintiff class action attorneys depends on the ability to collect contingent fees from large class action recoveries. Counsel who defend these actions will also suffer because if plaintiffs do not file Section 10(b) class action claims then there is no need for counsel to defend against those claims. The Securities and Exchange Commission, and many members of Congress, and the current Administration, will also likely protest that private securities fraud litigation is, as the Supreme Court has itself observed, a vital supplement to the Commission's own enforcement activity and should therefore be preserved.<sup>53</sup> In addition, given budget constraints across the federal government, the Commission will likely argue that private enforcement of the anti-fraud provisions of the federal securities laws is all the more important because of the agency's strained resources.

In response to these policy critiques – legitimate as they might be – the Court is likely to suggest that critics should address their concerns to a Congress that can legislate the problem away. Indeed, the academic literature describes many different approaches that Congress might apply to the challenge of coordinating public and private enforcement of the federal securities laws.<sup>54</sup> These alternative approaches are, of course, in addition to the simple possibility that Congress could expressly allow the recovery of out-of-pocket aftermarket damages under Section 10(b) based on the fraud-on-the-market rebuttable presumption of reliance, thereby preserving the *status quo* that currently prevails in the lower courts.

Part II provides an overview of the operation of the implied private right of action under Section 10(b) and Rule 10b-5 under current law. Part III engages in a detailed analysis of the doctrines governing the definition of the elements of the Section 10(b) implied private right of action, and concludes that plaintiffs have an affirmative obligation to demonstrate actual “eyeball or eardrum” reliance as a precondition to the recovery of money damages. Legislative activity subsequent to enactment of Section 10(b) has little if any influence on the current Court's construction of the elements of the implied private right, but Part IV demonstrates that subsequent legislative activity supports the imposition of an actual reliance requirement. Part V reviews the tests for reliance and damages as currently applied by the lower courts, and, among other matters, demonstrates that the presumption of reliance is *de facto* irrebuttable, and that the Court has been internally inconsistent in its logic adopting the presumption as a mechanism designed to facilitate class actions while simultaneously insisting that the presumption is rebuttable. Policy perspectives will likely play little role in determining the outcome of the Court's analysis, but as demonstrated in Part VI, the Court will have no trouble finding a large

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<sup>53</sup> See Part VI.A., *infra*.

<sup>54</sup> See Part VII.B., *infra*.

academic literature supporting whichever conclusion decides to reach if it ever reconsiders *Basic*. Part VII observes that an actual reliance requirement imposed either as a precondition to the recovery of damages or as a rationale for reversing *Basic* will dramatically reduce the economic incentives to bring Rule 10b-5 class action securities fraud actions and will often make class certification of these actions impossible. Critics of the actual reliance requirement will have to address their concerns to Congress, and Part VII also catalogues a broad range of reform measures that have been proposed in the academic literature. Part VIII concludes.

## II. An Overview of Section 10(b) and Rule 10b-5

Section 10(b) of the Exchange Act, as originally enacted in 1934, states:

SEC. 10. 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. . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

*See* Public Law 73-291, 48 Stat. 891 (1934).<sup>55</sup>

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<sup>55</sup> Section 10(b) has been twice amended twice since its enactment. The first amendment, in 2000, inserted “or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act),” before “any manipulative or deceptive device” in subsection (b), and added the following undesignated provision at the end of Section 10:

“Rules promulgated under subsection (b) of this section that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) of this section and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities. Judicial precedents decided under section 77q(a) of this title and sections 78i, 78o, 78p, 78t, and 78u-1 of this title, and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities.”

*See* Consolidated Appropriations Act, Pub. L. 106-554, 114 Stat. 2763 (2000). The second amendment, in 2010, struck out “(as defined in section 206B of the Gramm-Leach-Bliley Act),” following “or any securities-based swap agreement” in subsection (b), and in the matter following subsection (b), struck out “(as defined in section 206B of the Gramm-Leach-Bliley Act)” in two places. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

The current version of Section 10(b) reads:

“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

As the statutory text makes clear, Section 10(b) is not self-executing: the Commission must adopt implementing regulations in order for there to be any violation of the statute.<sup>56</sup> The text also makes it clear that Section 10(b) does not create an express right of action in favor of any private party plaintiff.<sup>57</sup> Indeed, the legislative history establishes that Congress intended that Section 10(b) would act as a “catch all” provision allowing the Commission to expand the scope of its own enforcement authority in response to the evolution of new and unpredictable fraudulent practices.<sup>58</sup> Congress never intended that Section 10(b) would support a private right of action under any circumstances.<sup>59</sup> Instead, “[t]he § 10(b) private cause of action is a judicial construct that Congress did not enact in the text of the relevant statutes.”<sup>60</sup>

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securities exchange. . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. . . Rules promulgated under subsection (b) of this section that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) of this section and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements to the same extent as they apply to securities. Judicial precedents decided under section 77q(a) of this title and sections 78i, 78o, 78p, 78t, and 78u-1 of this title, and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements to the same extent as they apply to securities.”

*See* 15 U.S.C.A. § 78j (West, Westlaw through 2013). These later amendments have no effect on this article’s analysis inasmuch as they relate exclusively to the scope of the statute’s reach and do not address the elements of the cause of action.

<sup>56</sup> *See e.g.*, *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952) (“Section 10(b) of the Securities Exchange Act does not by its terms make unlawful any conduct or activity but confers rulemaking power upon the SEC to condemn deceptive practices in the sale or purchase of securities.”); *U.S. v. McGee*, 892 F.Supp.2d 726, 731 (E.D. Pa. 2012) (noting that “[i]n § 10(b), Congress expressly delegated to the SEC the authority to define a criminal offense.”); WILLIAM A. KLEIN ET AL., *BUSINESS ASSOCIATIONS* 449 (6th ed. 2006) (noting that “§ 10(b) is not self-executing—it did not prohibit anything until the SEC adopted rules implementing it.”).

<sup>57</sup> *See, e.g.*, *Stoneridge*, 552 U.S. at 157 (“the text of the Securities Exchange Act does not provide for a private cause of action for § 10(b) violations”); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 358 (1991) (“The text of § 10(b) does not provide for private claims.”); *Ernst & Ernst*, 425 U.S. at 196 (“§ 10(b) does not by its terms create an express civil remedy for its violation”); *Blue Chip Stamps*, 421 U.S. at 729 (“Section 10(b) of the 1934 Act does not by its terms provide an express civil remedy for its violation. Nor does the history of this provision provide any indication that Congress considered the problem of private suits under it at the time of its passage.” (citing Note, *Implied Liability Under the Exchange Act*, 61 HARV. L. REV. 858, 860 (1948); A. Bromberg, *Securities Laws: Fraud – SEC Rule 10b-5* § 2.2 (300) – (340) (1968); S. Rep. No. 792, 73d Cong. 2d Sess. 5-6 (1934)); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946) (“It is also true that there is no provision in Sec. 10 or elsewhere expressly allowing civil suits by persons injured as a result of violation.”).

<sup>58</sup> *See* discussion of Section 10(b)’s legislative history in Part III.B., *infra*.

<sup>59</sup> *Central Bank*, 511 U.S. at 173 (“Congress did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme.”); *Lampf*, 501 U.S. at 358-59 (“Although this Court repeatedly has recognized the validity of such claims, [Citations], we have made no pretense that it was Congress’ design to provide the remedy afforded.”); *Ernst & Ernst*, 425 U.S. at 196 (“there is no indication that Congress. . . contemplated [an express civil] remedy” when adopting Section 10(b)); *Blue Chip Stamps*, 421 U.S. at

Rule 10b-5<sup>61</sup> was adopted by the Commission in 1942,<sup>62</sup> and is the dominant rule pursuant to which fraud is pursued under Section 10(b).<sup>63</sup> Prior its adoption, the Commission's enforcement authority was limited to prosecutions that alleged fraud in the sale of securities, and the Commission could not prosecute fraud in the purchase of securities. The articulated purpose and immediate effect of Rule 10b-5 was to extend the Commission's enforcement authority to attack fraud in purchase of securities as well as in their sale.<sup>64</sup> "[T]here is no indication that the Commission in adopting Rule 10b-5 considered the question of private civil remedies under this provision."<sup>65</sup>

It is therefore "disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5."<sup>66</sup> Consistent with this observation, the Supreme Court has "made no pretense that it was Congress' design to provide the remedy afforded."<sup>67</sup> The courts are therefore ineluctably

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737 ("it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5.").

<sup>60</sup> *Stoneridge*, 552 U.S. at 163; *see also id.* at 157 ("the Court has found a right of action implied in the words of the statute and its implementing regulation"); *Lampf*, 501 U.S. at 358 (noting that Section 10(b) private rights of action "are of judicial creation"); *Blue Chip Stamps*, 421 U.S. at 730 (noting that an implied right of action under Section 10(b) was recognized by the courts).

<sup>61</sup> 17 CFR 240.10b-5.

<sup>62</sup> *See* Securities and Exchange Commission, Exchange Act Release No. 34-3230 (May 21, 1942); *Blue Chip Stamps*, 421 U.S. at 729.

<sup>63</sup> Brief for the Securities and Exchange Commission as Amicus Curiae at 23, *Lampf*, 501 U.S. 350 (1991) ("As the law has developed, Rule 10b-5 is vastly more important in combating fraud than are the express remedies provided in the 1933 and 1934 Acts.... Section 10(b) and Rule 10b-5 have come to embrace a diversity of claims which could not have been envisioned in 1934."); 1 THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 13.2 (2d ed. 1990) ("The primary private remedy for fraud available under the Securities Exchange Act has been the one implied from SEC rule 10b-5."); CORNERSTONE RESEARCH, *SECURITIES CLASS ACTION FILINGS, 2012 YEAR IN REVIEW*, Figure 4 (2012) (noting that in 2012, 85 percent of all securities fraud actions alleged a violation of Rule 10b-5).

<sup>64</sup> *See* Securities and Exchange Commission, Exchange Act Release No. 34-3230 (May 21, 1942) ("The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities"; "The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."); 1942 Annual Report of the Securities Exchange Commission 10 ("During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities, while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers."); *Birnbaum*, 193 F.2d at 463 (noting that prior to the adoption of Rule 10b-5, "[n]o prohibition existed against fraud on a seller of securities by the purchaser if the latter was not a broker or a dealer. Consequently, on May 21, 1942 the SEC adopted Rule X-10B-5 to close this 'loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.'" (quoting Securities and Exchange Commission, Exchange Act Release No. 34-3230 (May 21, 1942))).

<sup>65</sup> *Blue Chip Stamps*, 421 U.S. at 730 (citing Securities and Exchange Commission, Exchange Act Release No. 34-3230 (May 21, 1942)); Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967); *Birnbaum*, 193 F.2d at 463; 3 L. LOSS, *SECURITIES REGULATION* 1469 n. 87 (2d ed. 1961)); *see also Ernst & Ernst*, 425 U.S. at 196 ("there is no indication that . . . the Commission when adopting Rule 10b-5. . . contemplated [an express civil] remedy").

<sup>66</sup> *Blue Chip Stamps*, 421 U.S. at 737; *accord Lampf*, 501 U.S. at 359 (1991) ("There is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated" the creation of a private right of action under Rule 10b-5 (quoting *Ernst & Ernst*, 425 U.S. at 196)).

<sup>67</sup> *Lampf*, 501 U.S. at 359 (citing *Ernst & Ernst*, 425 U.S., at 196).

“dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question.”<sup>68</sup>

Notwithstanding the evidence that neither Congress in 1934, nor the Commission in 1942, intended to create a private right of action under Section 10(b), the federal courts began implying such a private right in 1946.<sup>69</sup> Recognition of this private right spread quickly among the federal courts, in part because, prior to 1975, the federal courts accepted the view that “every wrong shall have a remedy,”<sup>70</sup> and that the available remedy should include a private right of action for money damages, and not just an enforcement right belonging exclusively to the government.<sup>71</sup> The courts therefore liberally inferred private rights, even when there was little or no evidence that Congress intended to create such causes of action.<sup>72</sup>

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<sup>68</sup> *Blue Chip Stamps*, 421 U.S. at 749; see also *id.* at 737 (recognizing the authority of federal courts to define “the contours of a private cause of action under Rule 10b-5” and “to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.”); *Musick, Peeler*, 508 U.S. at 292 (“The federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes.”).

<sup>69</sup> The Supreme Court recounted the judicial evolution of the Section 10(b) implied private right of action in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 n.10 (1983) (“The right of action was first recognized in *Kardon v. National Gypsum Co.*, 69 F.Supp. 512 (E.D. Pa. 1946). By 1961, four courts of appeals and several district courts in other circuits had recognized the existence of a private remedy under Section 10(b) and Rule 10b-5, and only one district court decision had reached a contrary conclusion. [Citation]. By 1969, the existence of a private cause of action had been recognized by ten of the eleven courts of appeals. [Citation]. When the question whether an implied cause of action can be brought under Section 10(b) and Rule 10b-5 was first considered in this Court, we confirmed the existence of such a cause of action without extended discussion. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13, n. 9, 92 S.Ct. 165, 169, n. 9, 30 L.Ed.2d 128 (1971). We have since repeatedly reaffirmed that ‘the existence of a private cause of action for violations of the statute and the Rule is now well established.’ *Ernst & Ernst v. Hochfelder*, *supra*, 425 U.S., at 196, 96 S.Ct., at 1382 (citing prior cases).”)

<sup>70</sup> See, e.g., *Stoneridge*, 552 U.S. at 176 (Stevens, J., dissenting) (“Fashioning appropriate remedies for the violation of rules of law designed to protect a class of citizens was the routine business of judges.”); see also *Tex. & Pac. R. Co. v. Rigsby*, 241 U.S. 33, 39 (1916) (“A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied”).

<sup>71</sup> See e.g., *Baird v. Franklin*, 141 F.2d 238, 245 (2d Cir. 1944) (“The fact that the statute provides no machinery or procedure by which the individual right of action can proceed is immaterial. It is well established that members of a class for whose protection a statutory duty is created may sue for injuries resulting from its breach and that the common law will supply a remedy if the statute gives none”), *cert. denied*, 323 U.S. 737 (1944); *Kardon*, 69 F. Supp. at 514 (“[T]he right to recover damages arising by reason of violation of a statute ... is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly”); see also Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963, 990 (1994) (noting that in *Kardon*, the SEC filed an amicus brief urging the court to imply a private right of action under Section 10(b)).

<sup>72</sup> See *Stoneridge*, 552 U.S. at 177-78 (Stevens, J., dissenting) (noting that prior to 1975, “the Supreme Court recognized implied causes of action on numerous occasions” and collecting cases (quoting *Leist v. Simplot*, 638 F.2d 283, 298-299 (2d Cir. 1980))); *Cannon v. Univ. of Chicago*, 441 U.S. 677, 698 (1979) (“during the period between the enactment of Title VI in 1964 and the enactment of Title IX in 1972, this Court had consistently found implied remedies.”); Grundfest, *Disimplying Private Rights of Action*, *supra* note 71, at 991 (noting that “[f]or twenty-five years following *Kardon*, the lower courts, acting without Supreme Court guidance, built a virtually unanimous body of largely unreasoned precedent supporting the implied private right of action under Rule 10b-5. . . when the Supreme Court directly confronted the question for the first time in *Superintendent*,” it “simply stated in a



In 1975, however, the Supreme Court changed its approach to the implication of private rights of action and adopted a stricter, more textualist doctrine that called for clear evidence that Congress intended to create a private right prior to the judicial implication of any such right.<sup>73</sup> Section 10(b) was then cast into a jurisprudential twilight zone. Under the newly enunciated Supreme Court doctrine, no private right of action would be implied under Section 10(b) because there was no support for the proposition that the enacting Congress ever intended to create a private right. On the other hand, decades of precedent had clearly recognized the existence of such a right.<sup>74</sup> The court recognized this quandary and, given the pervasive judicial acceptance of the Section 10(b) implied private right, as well as evidence that could be interpreted as Congressional acquiescence in the existence of that implied private right, the Court determined to respect the continued existence of the implied private right under Section 10(b) as “beyond peradventure.”<sup>75</sup>

Recognizing the continued existence of an implied right is, however, far simpler than defining its contours. Because the private right of action under Section 10(b) is implied, it is entirely a creature of the judicial imagination, and it comes as no surprise that the courts have played a crucial role in the evolution of Section 10(b) jurisprudence. As the Supreme Court itself has observed, “[t]he text of § 10(b) provides little guidance where we are asked to specify elements or aspects of the 10b–5 apparatus unique to a private liability arrangement, including a statute of limitations, a reliance requirement, a defense to liability, or a right to contribution.”<sup>76</sup> “Having made no attempt to define the precise contours of the private cause of action under § 10(b), Congress had no occasion to address how to limit, compute, or allocate liability arising

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footnote that “it is now established that a private right of action is implied under § 10(b)” (quoting *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n. 9 (1971)).

<sup>73</sup> *Cort v. Ash*, 422 U.S. 66, 78 (1975) (constraining courts to use a strict four-factor test to determine whether Congress intended a private cause of action); see also *Alexander v. Sandoval*, 532 U.S. 275, 276 (2001) (refusing to “revert to the understanding of private causes of action. . . that. . . was abandoned in *Cort v. Ash*. . .,” and holding there is no private right of action to enforce disparate-impact regulations promulgated under Title VI of Civil Rights Act of 1964); *Cannon*, 441 U.S. at 698-99 (adhering to the “strict approach” mandated by *Cort v. Ash* in 1975); Grundfest, *Disimplying Private Rights of Action*, *supra* note 71, at 992 (discussing the four-part test articulated in *Cort v. Ash*).

<sup>74</sup> *Lampf*, 501 U.S. at 358 (noting that private 10(b) “claims are of judicial creation, having been implied under the statute for nearly half a century”); *Ernst & Ernst*, 425 U.S. at 196-97 (noting that “[d]uring the 30-year period since a private cause of action was first implied under s 10(b) and Rule 10b-5, a substantial body of case law and commentary has developed as to its elements”); *Superintendent*, 404 U.S. at 13 n. 9 (“It is now established that a private right of action is implied under s 10(b)”).

<sup>75</sup> *Herman & MacLean*, 459 U.S. at 380; see also *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (recognizing the Section 10(b) implied right of action); *Stoneridge*, 552 U.S. at 157 (“[t]hough the text of the Securities Exchange Act does not provide for a private cause of action for § 10(b) violations, the Court has found a right of action implied in the words of the statute and its implementing regulation” (citing *Superintendent*, 404 U.S. at 13 n.9)); *id.* at 165 (noting that Congress “ratified the implied right of action [under Section 10(b)] after the Court moved away from a broad willingness to imply private rights of action.” (citing *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 71-82 (2006))); *Basic*, 485 U.S. at 230-31 (“Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act’s requirements.”).

<sup>76</sup> *Music, Peeler*, 508 U.S. at 295 (internal citations omitted).

from it.”<sup>77</sup> The task of defining the implied Section 10(b) private right of action thus falls to the judiciary,<sup>78</sup> and the complexity of that task is reflected, in part, by the fact that there are at least 28 Supreme Court opinions interpreting the scope of the Section 10(b) right of action.<sup>79</sup> Defining

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<sup>77</sup> *Musick Peeler*, 508 U.S. at 295; *see also Lampf*, 501 U.S. at 359 (noting that because private actions under Section 10(b) “are of judicial creation, having been implied under the statute for nearly half a century,” it is “no surprise that the provision contains no statute of limitations.”).

<sup>78</sup> *Musick Peeler*, 508 U.S. at 292 (“The federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes.”); *id.* at 294 (recognizing that Congress left to the courts the task of defining the 10b-5 right of action); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 303-5 (1985) (defining the scope of the *in pari delicto* defense in Section 10(b) actions); *Blue Chip Stamps*, 421 U.S. at 737 (recognizing the authority of federal courts to define “the contours of a private cause of action under Rule 10b-5” and “to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.”). *See also* cases cited at note 79, *infra*.

<sup>79</sup> *See Amgen*, 133 S. Ct. at 1191 (holding proof of materiality of alleged misrepresentations is not a prerequisite to class certification in a securities fraud action based on a fraud on the market theory); *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) (“For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.”); *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2184 (2011) (holding plaintiffs in a Section 10(b) action need not prove loss causation in order to obtain class certification); *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1313-14, 1318-23 (2011) (holding the materiality of an alleged false or misleading statement or omission for purposes of pleading a violation of Section 10(b) is inherently fact-specific, depending upon whether a “reasonable investor” would have viewed the relevant information “as having significantly altered the total mix of information made available,” and declining to apply a “bright-line rule” that only “statistically significant” information is sufficiently material to support a Rule 10b-5 claim based on a failure to disclose); *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2884 (2010) (holding Section 10(b) extends only to “transactions in securities listed on domestic exchanges, and domestic transactions in other securities”); *Merck & Co. v. Reynolds*, 559 U.S. 633, 130 S. Ct. 1784, 1789-90 (2010) (holding “that a cause of action accrues [under Section 10(b)] (1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, ‘the facts constituting the violation’—whichever comes first”); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008) (“The § 10(b) implied private right of action does not extend to aiders and abettors. The conduct of a secondary actor must satisfy each of the elements or preconditions for liability. . . .”); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322-23 (2007) (holding that courts, when faced with a motion to dismiss a Section 10(b) action, “must take into account plausible opposing inferences “ “in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter”); *Merrill Lynch*, 547 U.S. at 84-85 (giving a broad construction to the phrase “in connection with the purchase or sale of any security” as used in Section 10(b) and Rule 10b-5); *Dura Pharm.*, 544 U.S. at 342-46 (holding that plaintiffs cannot plead or prove loss causation in a Section 10(b) action by merely establishing that they purchased stock at an artificially inflated price); *SEC v. Zandford*, 535 U.S. 813, 820 (2002) (adopting a broad reading of the phrase “in connection with the purchase or sale of any security” as used in Section 10(b) and Rule 10b-5); *The Wharf Holdings Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588, 594-97 (2001) (holding Rule 10b-5 applied to oral agreement to sell securities, and that sale of option with secret intent not to honor it violated Rule 10b-5); *United States v. O’Hagan*, 521 U.S. 642, 647 (1997) (holding criminal liability under § 10(b) of Securities Exchange Act may be predicated on the misappropriation theory); *Central Bank*, 511 U.S. at 177-78 (holding private plaintiff may not maintain aiding and abetting suit under Securities Exchange Act § 10(b)); *Musick, Peeler*, 508 U.S. at 297-98 (“Those charged with liability in a 10b-5 action have a right to contribution against other parties who have joint responsibility for the violation”); *Lampf*, 501 U.S. at 361 (holding statute of limitations applicable to actions under § 10(b) is the one-and-three-year structure provided for in the express causes of action contained in the Securities Act and the Exchange Act); *Basic*, 485 U.S. at 232, 239-40, 247 (holding (1) standard of materiality set forth in *TSC Industries* is appropriate in § 10(b) and Rule 10b-5 context; (2) materiality in merger context depends on the facts of each case; and (3) courts could properly apply a rebuttable presumption of reliance in 10(b) actions, supported in part by the fraud-on-the-market theory); *Randall v. Loftsgaarden*, 478 U.S. 647, 667 (1986) (holding that any rescission remedy available under section 10(b) is not subject to offset for tax benefits received by investor while owning the security);

the elements of this cause of action and continuing to manage its evolution has consumed a non-trivial proportion of the Supreme Court's energy.<sup>80</sup>

Taken together, these 28 opinions explain (among many other considerations) that a private party plaintiff seeking money damages for a violation of Section 10(b) and Rule 10b-5 must demonstrate a: “(1) material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”<sup>81</sup> But these 28 opinions do not resolve every question regarding the interpretation or application of the private right of action under Section 10(b). In particular, the two elements of the Section 10(b) cause of action that are most susceptible of further litigation and that are of central importance to this article's analysis are the definition of reliance and the preconditions for demonstrating a claim that can support an award of money damages.

As for reliance, the Supreme Court has observed that “[r]eliance ... ‘is an essential element of the § 10(b) private cause of action’ because ‘proof of reliance ensures that there is a proper connection between a defendant's misrepresentation and a plaintiff's injury.’”<sup>82</sup> However,

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*Bateman Eichler*, 472 U.S. at 305 (holding that securities professionals and corporate officers who have allegedly engaged in fraud should not be permitted to invoke the *in pari delicto* defense to shield themselves from the consequences of their fraudulent misrepresentation); *Dirks v. SEC*, 463 U.S. 646, 660, 662 (1983) (“a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach”); whether a tip constitutes a breach of fiduciary duty depends on “whether the insider personally will benefit, directly or indirectly, from his disclosure”); *Chiarella v. US*, 445 U.S. 222, 235 (1980) (holding Section 10(b) is not violated when a person trades securities without disclosing inside information unless the trader has an independent duty of disclosure); *Aaron v. Securities and Exchange Commission*, 446 U.S. 680, 691-95, 701 (1980) (holding SEC is required to establish scienter as an element of a civil enforcement action to enjoin violations of § 10(b) of the Securities Exchange Act of 1934); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (“language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception”); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (holding that for purposes of Section 14(a) liability, which was later extended to Section 10(b) “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”); *Ernst & Ernst*, 425 U.S. at 213-14 (holding 10(b) does not extend to negligent conduct and that plaintiffs must establish scienter); *Blue Chip Stamps*, 421 U.S. at 725-749 (holding a private damages action under Section 10(b) is confined to actual purchasers or sellers of securities); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-54 (1972) (holding that “[u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery [under Rule 10b-5]. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.”); *Superintendent*, 404 U.S. at 9-11 (holding a cause of action had been stated under Section 10(b), and finding it irrelevant that the injured party was a corporation rather than an individual, that the fraud was perpetrated by a corporate officer and his outside collaborators, that the transactions was not conducted through a securities exchange or an organized market, that the proceeds due the seller were misappropriated, and that the creditors of the defrauded corporate seller may be the ultimate victims).

<sup>80</sup> See, e.g., *SEC v. Nat'l Sec., Inc.*, 393 U.S. 453, 465 (1969) (noting that “§ 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws”); CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2012 YEAR IN REVIEW Figure 4 (2012) (noting that in 2012, 85 percent of all securities fraud actions alleged a violation of Rule 10b-5, 10 percent alleged a violation of Section 11, and 9 percent alleged a violation of Section 12(a)(2)).

<sup>81</sup> *Matrixx*, 131 S.Ct. 1309, 1317 (2011) (citing *Stoneridge*, 552 U.S. 148, 157 (2008)).

<sup>82</sup> *Amgen*, 133 S.Ct. at 1192 (quoting *Halliburton*, 131 S. Ct. at 2184); see also *Matrixx*, 563 U.S. at 1317 (citing *Stoneridge*, 552 U.S. at 157 (internal quotation marks omitted)).

the practical difficulty associated with establishing reliance in the classic sense, which requires a demonstration of “actual reliance” by each individual plaintiff, was greatly reduced by the Supreme Court’s decision in *Basic v. Levinson*. There, the Court created a rebuttable presumption of reliance in favor of plaintiffs who can establish that: (1) the market for the affected security affected by the alleged fraud is sufficiently “open and developed,” or, in the argot of modern financial economics, “efficient”;<sup>83</sup> (2) that the allegedly fraudulent information entered the market;<sup>84</sup> and (3) that the allegedly fraudulent information was material.<sup>85</sup>

This rebuttable presumption of reliance obviates the need ever to demonstrate actual reliance in the vast majority of lawsuits. It also makes class action securities fraud litigation possible because, absent this presumption, individualized question of reliance would predominate and thus preclude class certification.<sup>86</sup> The entire economics of the Section 10(b) class action securities fraud litigation industry thus hinges essentially on *Basic*’s rebuttable presumption of reliance.<sup>87</sup>

This presumption of reliance is, however, highly controversial with the current Supreme Court, as four sitting justices have recently called for reconsideration of *Basic* and of its rebuttable presumption of reliance.<sup>88</sup> Although the presumption is nominally described as “rebuttable,” the practical reality is that once a plaintiff establishes that the relevant market is efficient, and that the alleged misrepresentation or omission has adequately entered the market, the presumption has historically been essentially irrebuttable.<sup>89</sup> An independent question therefore arises as to whether *Basic*’s practical implementation is consistent with the *Basic*’s stated intent to create a rebuttable presumption of reliance.

Moreover, although the Supreme Court has addressed the definition of several elements of the Section 10(b) cause of action, the court has never addressed the appropriate measure of damages in aftermarket fraud actions. Indeed, in *Basic*, the court expressly reserved its views on

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<sup>83</sup> *Basic*, 485 U.S. at 247 (“nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed.”); *see also Amgen*, 133 S. Ct. at 1192-93 (“courts may presume that investors trading in efficient markets indirectly rely on public, material misrepresentations through their reliance on the integrity of the price set by the market.”) (internal quotation marks omitted).

<sup>84</sup> *Basic*, 485 U.S. at 247.

<sup>85</sup> Materiality is an essential predicate of the fraud-on-the-market theory, but materiality need not be established at the class certification stage. *Amgen*, 133 S. Ct. at 1195-97.

<sup>86</sup> *George v. China Automotive Systems, Inc.*, No. 11 Civ. 7533, 2013 WL 3357170, at \*3 (S.D.N.Y. July 3, 2013) (“Absent the fraud-on-the- market theory, the requirement that Rule 10b-5 plaintiffs establish reliance would ordinarily preclude certification of a class action seeking money damages because individual reliance issues would overwhelm questions common to the class.” *Amgen*, 133 S. Ct. at 1193; *see also Basic*, 485 U.S. at 242.”).

<sup>87</sup> *Amgen*, 133 S. Ct. at 1195 (“And without the fraud-on-the-market theory, the element of reliance cannot be proved on a classwide basis through evidence common to the class.”); *Basic*, 485 U.S. at 242 (“Requiring 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.”).

<sup>88</sup> *See* note 40, *supra*.

<sup>89</sup> *See* notes 267-276, *infra*.

the question.<sup>90</sup> The confluence of the open question regarding the proper measure of damages in aftermarket Section 10(b) litigation, together with *Amgen*'s invitation to re-assess the validity of *Basic*'s rebuttable presumption of reliance, creates an opportunity, for better or for worse, for a major doctrinal shift that can lead to a dramatic reduction in the incidence and magnitude of private Section 10(b) class action liability for money damages.

### III. Defining the Elements of the Section 10(b) Implied Private Right of Action

What is the measure of money damages in a private Section 10(b) action alleging aftermarket fraud? Which preconditions must private parties satisfy as a precondition to the award of damages?

There are no easy answers to these basic questions because the Section 10(b) private right of action is implied and the contours of the right of action have never been defined by Congress.<sup>91</sup> Although these questions have been addressed in numerous lower court decisions,<sup>92</sup> they have yet to be considered by the Supreme Court.

To address challenges of this sort, the Supreme Court applies three different interpretive techniques. The court's primary mode of interpretation is textual and relies on a technique of "historical reconstruction."<sup>93</sup> The court identifies the element of the express private right of action in existence as of the time of Section 10(b)'s adoption most analogous to the element the court is called upon to infer.<sup>94</sup> The court reasons that Congress would not have defined the elements of an implied private right of action more broadly than the elements of the most analogous express private right. A second mode of analysis looks to the legislative history for guidance as to how the 1934 Congress would have resolved the question had it been posed at that time. Third, the Court has more recently announced a principle of narrow construction in which it adopts a restrictive interpretation of the implied private right of action, precisely because it is an implied private right of action. While Supreme Court opinions have, in the past, cited to policy consideration, the current analytic methodology minimizes the significance of policy considerations, particularly if the relevant statutory language "is sufficiently clear in its context and not at odds with [its] legislative history."<sup>95</sup> Moreover, as explained in Part VI, even if the Supreme Court takes policy considerations into account, the policy literature is sufficiently rich and conflicted that the Court will be able to find policy support for whichever position it decides to adopt for whatever reason it prefers.

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<sup>90</sup> *Basic*, 485 U.S. at 248 n.28 ("our decision today is not to be interpreted as addressing the proper measure of damages in litigation of this kind.") See also Part V.B., *infra* for a discussion of two Supreme Court cases, *Affiliated Ute* and *Randall v. Loftsgaarden*, which touch upon but do not resolve the question of the appropriate measure of damages in aftermarket Section 10(b) litigation.

<sup>91</sup> *Musick Peeler*, 508 U.S. at 292-293. ("We must confront the law in its current form. The federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes. As we recognized in a case arising under § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a), 'where a legal structure of private statutory rights has developed without clear indications of congressional intent,' a federal court has the limited power to define 'the contours of that structure.'" (quoting *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1104 (1991))).

<sup>92</sup> See Part V.B., *infra*.

<sup>93</sup> *Musick Peeler*, 508 U.S. at 294.

<sup>94</sup> See notes 99-100, *infra*.

<sup>95</sup> *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986) (quoting *Aaron*, 446 U.S. at 695 (1980)).

All three of these interpretive techniques conclude that the measure of damages in an aftermarket Section 10(b) private right of action can be no more expansive than the recovery allowed pursuant to Section 18(a) of the Exchange Act, which requires that plaintiffs affirmatively demonstrate actual “eyeball and eardrum” reliance as a precondition to the recovery of out-of-pocket damages.

#### A. Inference from Contemporaneous Text

The Supreme Court infers the elements of the implied Section 10(b) private right of action by examining the express private rights of action that existed in the ’33 Act and ’34 Act at the time of Section 10(b)’s enactment.<sup>96</sup>

“When the text of § 10(b) does not resolve a particular issue, we attempt to infer ‘how the 1934 Congress would have addressed the issue had the 10b–5 action been included as an express provision in the 1934 Act.’ For that inquiry, we use the express causes of action in the securities Acts as the primary model for the § 10(b) action. The reason is evident: Had the 73d Congress enacted a private § 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the securities Acts.”<sup>97</sup>

Put another way, “determining the elements of the 10b–5 private liability scheme, has posed difficulty because Congress did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme. We thus have had ‘to infer how the 1934 Congress would have addressed the issue[s] had the 10b–5 action been included as an express provision in the 1934 Act.’”<sup>98</sup>

But how is the Court to infer what Congress would have done under the counterfactual assumption that it intended to create a private right of action under Section 10(b)? “We can imagine no clearer indication of how Congress would have balanced the policy considerations implicit in any limitations provision than the balance struck by the same Congress in limiting similar and related protections. When the statute of origin contains comparable express remedial provisions, the inquiry usually should be at an end.”<sup>99</sup> The Court also reasons that “[i]t would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes

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<sup>96</sup> This approach is “[t]he chief means of inferring congressional intent . . .” Erez Reuveni, *Extraterritoriality as Standing: A Standing Theory of the Extraterritorial Application of the Securities Laws*, 43 U.C. DAVIS L. REV. 1071, 1106 (2010). See also *Central Bank*, 511 U.S. at 179 (“From the fact that Congress did not attach private aiding and abetting liability to any of the express causes of action in the securities Acts, we can infer that Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action.”); *Musick, Peeler*, 508 U.S. at 297 (“[C]onsistency requires us to adopt a like contribution rule for the right of action existing under Rule 10b–5”); *Lampf*, 501 U.S. at 359-61 (looking to contemporaneous express causes of action to ascertain statute of limitations applicable to Section 10(b)); *Blue Chip Stamps*, 421 U.S. at 736 (noting that it would be “anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action.”).

<sup>97</sup> *Central Bank*, 511 U.S. at 178 (citing *Musick, Peeler*, 508 U.S. at 294-297).

<sup>98</sup> *Central Bank*, 511 U.S. at 173 (citing *Musick, Peeler*, 508 U.S. at 294).

<sup>99</sup> *Lampf*, 501 U.S. at 359 (citing *DelCostello v. Int’l Brotherhood of Teamsters*, 462 U.S. 151, 171 (1983); *United Parcel Service, Inc. v. Mitchell*, 451 U.S. 56, 69-70 (1981) (opinion concurring in judgment)).

of action.”<sup>100</sup> The imputed element of the implied private right of action can thus be no broader than the comparable provision of the most analogous express private right of action.

The Court engages in this textual analysis “not to assess the relative merits of the competing rules, but rather to attempt to infer how the 1934 Congress would have addressed the issue had the 10b–5 action been included as an express provision in the 1934 Act.... We do this not as an exercise in historical reconstruction for its own sake, but to ensure that the rules established to govern the 10b–5 action are symmetrical and consistent with the overall structure of the 1934 Act and, in particular, with those portions of the 1934 Act most analogous to the private 10b–5 right of action that is of judicial creation.”<sup>101</sup>

The objective “in establishing limits for the 10b–5 action” is thus “to ensure the action does not conflict with Congress' own express rights of action, ... to promote clarity, consistency, and coherence for those who rely upon, or are subject to, 10b–5 liability, ... and to effect Congress' objectives in enacting the securities laws.”<sup>102</sup> No other approach is as consistent with the Court’s emphasis that “the starting point in every case involving constitution of a statute” is the text of the statute,<sup>103</sup> and its caution that an extension of the Section 10(b) implied private liability beyond the contours of the analogous express private rights of action would “thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.”<sup>104</sup>

The Supreme Court has identified seven express private rights of action that existed in the Securities Act and Exchange Act as of the Exchange Act’s 1934 date of adoption.<sup>105</sup> Sections 11,<sup>106</sup> 12,<sup>107</sup> and 15<sup>108</sup> of the Securities Act and Sections 9,<sup>109</sup> 16,<sup>110</sup> 18,<sup>111</sup> and 20<sup>112</sup> of the

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<sup>100</sup> *Blue Chip*, 421 U.S. at 736.

<sup>101</sup> *Musick, Peeler*, 508 U.S. at 294.

<sup>102</sup> *Musick Peeler*, 508 U.S. at 294-295 (citing *Ernst & Ernst*, 425 U.S. at 210; *Blue Chip Stamps*, 421 U.S. at 737-744; *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-478 (1977)).

<sup>103</sup> *Central Bank*, 511 U.S. at 173 (“[O]ur cases considering the scope of conduct prohibited by § 10(b) in private suits have emphasized adherence to the statutory language, ‘[t]he starting point in every case involving construction of a statute.’ . . . We have refused to allow 10b–5 challenges to conduct not prohibited by the text of the statute.” (quoting *Ernst & Ernst*, 425 U.S. at 197)).

<sup>104</sup> *Ernst & Ernst*, 425 U.S. at 210.

<sup>105</sup> The Supreme Court has been inconsistent in its count of contemporaneous express private rights in the Exchange Act. *Musick Peeler*, 508 U.S. at 296, lists eight express liability provisions, Sections 11, 12, and 15 of the Securities Act, and Sections 9, 16, 18, 20, and 20A of the Exchange Act, but observes that Section 20A was added to the securities laws in 1988 (citing *Lampf*, 501 U.S. at 361). In *Herman & MacLean*, 459 U.S. at 380 n. 8, the Court identified six express private rights (citing Securities Act. §§ 11, 12, 15, 15 U.S.C. §§ 77k, 77l, 77o; Exchange Act, §§ 9, 16, 18, 15 U.S.C. §§ 78i, 78p, 78r). In *Central Bank*, 511 U.S. at 179, and *Lampf*, 501 U.S. at 354-55, 359-60, the Court identified five contemporaneous private rights of action (listing §§ 11 and 12 of the Securities Act, and §§ 9, 16, and 18 of the Exchange Act). In *Musick Peeler*, 508 U.S. at 295-296, the Court lists eight (adding § 15 of the Securities Act and § 20 of the Exchange Act.) The analysis in this article considers the broadest class of contemporaneous provisions, identified by the Court, excluding Section 20A, which the Court recognizes as not being contemporaneous with Section 10(b) as initially adopted.

<sup>106</sup> 15 U.S.C. 77k (West, Westlaw through 2013).

<sup>107</sup> 15 U.S.C. 77l (West, Westlaw through 2013).

<sup>108</sup> 15 U.S.C. 77o (West, Westlaw through 2013).

<sup>109</sup> 15 U.S.C. § 78i (West, Westlaw through 2013).

<sup>110</sup> 15 U.S.C. § 78p (West, Westlaw through 2013).

<sup>111</sup> 15 U.S.C. § 78r (West, Westlaw through 2013).

Exchange Act.<sup>113</sup> The challenge then is to identify the express private right of action from among these seven candidates that is most analogous to the implied private right of action under Section 10(b). The easy answer is that Section 18(a) is the “most analogous express private right of action,”<sup>114</sup> but close familiarity with the statute is necessary to appreciate the strength of this conclusion.

Causes of action under the federal securities laws are cumulative.<sup>115</sup> Therefore, if a defendant’s conduct simultaneously violates Sections 11 and 12 of the Securities Act, as well as Section 10(b) of the Exchange Act, plaintiffs can assert claims under all three provisions. That fact makes it more difficult to identify the characteristics of the Section 10(b) cause of action that defines the core of Section 10(b) aftermarket litigation. Modern litigation trends, however, clearly demonstrate that the claims unique to Section 10(b) litigation are characterized by situations involving misrepresentations or omissions affecting the aftermarket prices of publicly traded securities, without regard to whether those misrepresentations appeared in filings with the Securities and Exchange Commission or elsewhere.<sup>116</sup> The express private right most similar to Section 10(b) (without regard to claims that are cumulative) would therefore be one that supports a private right of action for money damages as a consequence of a misrepresentation or omission affecting the aftermarket price of publicly traded securities.

This simple observation quickly focuses the analysis. As an initial matter, the Supreme Court has observed that the Securities Act was designed primarily to regulate the initial issuance of securities whereas the Exchange Act was designed primarily to regulate aftermarket trading.<sup>117</sup> Accordingly, express rights arising under the Securities Act that refer to violations

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<sup>112</sup> 15 U.S.C. § 78t (West, Westlaw through 2013).

<sup>113</sup> *Musick Peeler*, 508 U.S. at 296.

<sup>114</sup> *Musick Peeler*, 508 U.S. at 296 (describing Sections 9 and 18 of the ’34 Act as the provisions most analogous to the implied Section 10(b) private right of action and observing that “both target the precise damages that are the focus of §10(b)” and that “the intent motivating all these sections is the same – ‘to deter fraud and manipulative practices in the securities markets and to ensure full disclosure of information material to investment decisions’”); *Lampf*, 501 U.S. at 360-361. (“Section 9 of the 1934 Act, 15 U.S.C. § 78i, pertaining to the willful manipulation of security prices, and § 18, 15 U.S.C. § 78r, relating to misleading filings, target the precise dangers that are the focus of § 10(b). Each is an integral element of a complex web of regulations. Each was intended to facilitate a central goal: ‘to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.’” (quoting *Ernst & Ernst*, 425 U.S. at 195)); *Ernst & Ernst*, 425 U.S. at 211 n.31 (looking to legislative history of section 18 in interpreting the scope of the 10b-5 cause of action).

<sup>115</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382-87 (1983) (finding “[a] cumulative construction of the securities laws. . . furthers their broad remedial purposes.”).

<sup>116</sup> *See, e.g., IBEW Local 90 Pension Fund v. Deutsche Bank AG*, No. 11 Civ. 4209 (KBF), 2013 WL 1223844, \*1 (S.D.N.Y. Mar. 27, 2013) (“Most lawsuits alleging violations of Section 10(b) of the Securities Exchange Act of 1934 are based on purported misstatements or omissions. Typically, plaintiffs assert a series of alleged misstatements . . . [or] course of conduct [that] amounts to a fraudulent scheme designed to mislead investors.”); *see also* Robert A. Prentice, *Scheme Liability: Does it Have a Future after Stoneridge?*, 2009 WIS. L. REV. 351, 360 (2009) (“The vast majority of section 10(b) cases over the years has involved subsection (b) of rule 10b-5 and its ban on the making of untrue representations (or omissions)”); Eric Berry, *Stoneridge and the Short-Lived Experiment of Scheme Liability*, 4 N.Y.U. J.L. & BUS. 355, 358 (2007) (“The majority of § 10(b) cases deal with deception in the form of misstatements or omissions”).

<sup>117</sup> *See, e.g., Central Bank*, 511 U.S. at 171 (“The 1933 Act regulates initial distributions of securities, and the 1934 Act for the most part regulates post-distribution trading.”); *Blue Chip Stamps*, 421 U.S. at 752 (“the 1934 Act. . . is general in scope but chiefly concerned with the regulation of post-distribution trading on the Nation’s stock



affecting the original issuance of securities are unlikely to be as analogous to the Section 10(b) cause of action as express rights that arising under the Exchange Act that refer to violations that affect the aftermarket trading of securities.<sup>118</sup>

Section 11. The Supreme Court has distinguished Section 11 of the Securities Act from Section 10(b) of the Exchange Act on grounds that Section 11 creates liability only for misrepresentations or omissions in a registration statement as declared effective by the Securities and Exchange Commission, whereas a misrepresentation or omission in any other context can be challenged under Section 10(b).<sup>119</sup> Section 11 is thus “limited in scope” whereas “Section 10(b) is a ‘catchall’ antifraud provision,”<sup>120</sup> and “Section 11 and Section 10(b) address different types of wrongdoing.”<sup>121</sup> Further emphasizing this distinction, is the fact that “[w]hile a Section 11 action must be brought by a purchaser of a registered security, must be based on misstatements or omissions in a registration statement, and can only be brought against certain parties, a Section 10(b) action can be brought by a purchaser or seller of ‘any security’ against ‘any person’ who has used ‘any manipulative or deceptive device or contrivance’ in connection with the purchase or sale of a security.”<sup>122</sup> Indeed, the text of Section 11 creates liability on behalf of purchasers in the offering and it is only because of the evolution of the “tracing doctrine,” which has been developed by the lower courts without any Supreme Court review, that subsequent purchasers of shares covered by the registration statement at issue have Section 11 standing at all.<sup>123</sup> Aftermarket purchasers of entirely fungible shares that experience identical market

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exchanges and securities trading markets. The 1933 Act is a far narrower statute chiefly concerned with disclosure and fraud in connection with offerings of securities—primarily, as here, initial distributions of newly issued stock from corporate issuers.” (citing I L. LOSS, SECURITIES REGULATION 130–31 (2d ed.1961)); *see also* United States v. Naftalin, 441 U.S. 768, 777–778 (1979) (“[T]he 1933 Act was primarily concerned with the regulation of new offerings”).

<sup>118</sup> *Musick Peeler*, 508 U.S. at 296 (“[O]f the eight express liability provisions contained in the 1933 and 1934 Acts, §§ 9 and 18 impose liability upon defendants who stand in a position most similar to 10b–5 defendants for the sake of assessing whether they should be entitled to contribution. All three causes of action impose direct liability on defendants for their own acts as opposed to derivative liability for the acts of others; all three involve defendants who have violated the securities law with scienter; all three operate in many instances to impose liability on multiple defendants acting in concert; and all three are based on securities provisions enacted into law by the 73d Congress. The Acts’ six other express liability provisions, on the other hand, stand in marked contrast to the implied § 10 remedy: § 15 of the 1933 Act (15 U.S.C. § 77 o ) and § 20 of the 1934 Act (15 U.S.C. § 78t) impose derivative liability only; §§ 11 and 12 of the 1933 Act (15 U.S.C. §§ 77k and 77 l ) and § 16 of the 1934 Act (15 U.S.C. § 78p) do not require scienter in all instances; § 12 of the 1933 Act and § 16 of the 1934 Act do not often create joint defendant liability; and § 20A of the 1934 Act (15 U.S.C. § 78t–1) was not an original liability provision in that Act, having been added to the securities laws in 1988.”) (internal citations omitted).

<sup>119</sup> *See, e.g., Herman & MacLean*, 459 U.S. at 381–82 (Section 11 “was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.”).

<sup>120</sup> *Herman & MacLean*, 459 U.S. at 382.

<sup>121</sup> *Herman & MacLean*, 459 U.S. at 382 (emphasis supplied in the original).

<sup>122</sup> *Id.*

<sup>123</sup> The majority of circuit courts, including the Second, Fifth, Eighth, Ninth, and Tenth, have held that stock purchased in the aftermarket is subject to Rule 11 if the purchaser can affirmatively “trace” his shares back to securities that were covered by the defective registration statement. *See, e.g., Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 498 (5th Cir. 2005) (stating Section 11 is available to aftermarket purchaser whose “shares are traceable to the registration statement in question”); *Demaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003) (“aftermarket purchasers who can trace their shares to an allegedly misleading registration statement have standing to sue under § 11 of the 1933 Act”); *Lee v. Ernst & Young, LLP*, 294 F.3d 969, 978 (8th Cir. 2002) (holding aftermarket

movements have no Section 11 standing, and must pursue Section 10(b) claims, unless they can satisfy strict tracing requirements.<sup>124</sup>

Section 11 also defines a complex set of requirements for establishing liability that are contingent on the role that identified defendants played in the offering process.<sup>125</sup> The issuer is strictly liable for any material misrepresentation or omission in the registration statement,<sup>126</sup> whereas other defendants can avail themselves of various gradations of a due diligence defense that is often compared to a negligence standard.<sup>127</sup> In contrast, a Section 10(b) plaintiff has the

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purchasers have standing if they can trace their shares to the registration statement); *Joseph v. Wiles*, 223 F.3d 1155, 1159 (10th Cir. 2000) (“we conclude that an aftermarket purchaser has standing to pursue a claim under section 11 so long as he can prove the securities he bought were those sold in an offering covered by the false registration statement”); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1082 (9th Cir. 1999) (“purchasers in the aftermarket are within the group of purchasers provided a cause of action by Section 11”); *Barnes v. Osofsky*, 373 F.2d 269, 273 (2d Cir.1967) (Section 11 extends “liability to open-market purchasers of the registered shares”); Marc I. Steinberg & Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism*, 63 RUTGERS L. REV. 1, 27 (2010); Brian Murray, *Aftermarket Purchase Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN’S L. REV. 633, 636 (1999). “That is, [the purchaser] must show that the security was issued under, and was the direct subject of, the prospectus and registration statement being challenged.” *APA Excelsior III L.P. v. Premiere Techs., Inc.*, 476 F.3d 1261, 1271 (11<sup>th</sup> Cir. 2007).

<sup>124</sup> Aftermarket purchasers who acquire their shares when only registered shares exist in the market can generally satisfy the tracing requirement, at least in those jurisdictions that recognize aftermarket standing. *See, e.g., Krim*, 402 F.3d at 496 (noting that the “traceability requirement is satisfied, as a matter of logic, when stock has only entered the market via a single offering”); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 873 (5<sup>th</sup> Cir. 2003) (“because there was only one offering of Azurix stock, all of the plaintiffs’ stock is traceable to the challenged registration statement”); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9<sup>th</sup> Cir. 1999) (“finding standing for aftermarket purchaser because “the only Dignity stock ever sold to the public was pursuant to the allegedly misleading registration statement at issue in this case”). However, if shares that were already traded in the open market at the time of the offering remain in the market after the offering, or if additional, identical shares enter the market after the offering, tracing becomes exceptionally difficult. *See, e.g., In re Century Aluminum Co. Sec. Litig.*, No. 11–15599, 2013 WL 11887, at \*2 (9<sup>th</sup> Cir. Jan. 2, 2013) (“experience and common sense tell us that when a company has offered shares under more than one registration statement, aftermarket purchasers usually will *not* be able to trace their shares back to a particular offering”); *Barnes*, 373 F.2d at 272 (noting appellants’ argument “that it is often impossible to determine whether previously traded shares are old or new, and that tracing is further complicated when stock is held in margin accounts in street names since many brokerage houses do not identify specific shares with particular accounts but instead treat the account as having an undivided interest in the house’s position”); *Harden v. Raffensperger, Hughes & Co.*, 933 F. Supp. 763, 766-67 (S.D. Ind. 1996) (noting difficulties associated with tracing in the open market); *see also* Brian Murray, *Aftermarket Purchase Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN’S L. REV. 633, 636 (1999) (“If other securities of the same type at issue in a case were traded prior to the issuance of the false or misleading registration statement, tracing securities purchased in the open market back to the registration statement is very difficult.”).

<sup>125</sup> *See Escot v. BarChris Construction Co.*, 283 F. Supp. 643, 684-703 (S.D.N.Y. 1968) (analyzing the potential Section 11 liability of non-issuer defendants with great attention to the specific circumstances of their roles in the offering and at the company and treating each category of defendants separately, thereby effectively creating a sliding scale of liability).

<sup>126</sup> *Herman & MacLean*, 459 U.S. at 382 (noting that in Section 11 actions, “[l]iability against the issuer of a security is virtually absolute, even for innocent misstatements.”); *In re Morgan Stanley Information Fund Sec. Litig.*, 592 F.3d 347, 359 (2d Cir. 2010) (same).

<sup>127</sup> 15 U.S.C. § 77k(b)(3) (outlining the due diligence defense); *Herman & MacLean*, 459 U.S. at 382 (noting that in Section 11 actions, all defendants other than the issuer “bear the burden of demonstrating due diligence” to avoid liability); *see also Musick, Peeler*, 508 U.S. at 296 (noting that Section 11 plaintiffs, unlike Section 10(b) plaintiffs, need not establish scienter in all instances); *Herman & MacLean*, 459 U.S. at 382-84 (same); *see also Ernst & Ernst*, 452 U.S. at 208 (“express recognition of a cause of action premised on negligent behavior in s 11 stands in sharp contrast to the language of s 10(b”).

affirmative obligation to establish scienter with respect to all defendants.<sup>128</sup> Further, because of the lower standard of proof in Section 11 cases, “each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct, see ss 11, 12(2), 15 ... is subject to significant procedural restrictions not applicable under s 10(b).”<sup>129</sup>

Section 12. Section 12(a)(1) creates strict liability for the sale of unregistered securities in violation of Section 5 of the Securities Act.<sup>130</sup> No misrepresentation or omission need be established to demonstrate a violation of Section 12(a)(1).<sup>131</sup> This transaction-based form of strict liability, which is not contingent on the existence of a misrepresentation or omission, is in sharp contrast to Section 10(b) liability which requires a material misrepresentation or omission, or some other form of manipulative conduct, as well as a finding of scienter, in order to establish liability.<sup>132</sup>

As for Section 12(a)(2), whereas Section 11 creates liability for material misrepresentations or omission in registration statements as declared effective, Section 12(a)(2) allows for rescission or damages if the seller used a false or misleading prospectus or oral statement in making a sale.<sup>133</sup> Section 12(a)(2) also does not apply to secondary market

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<sup>128</sup> *Ernst & Ernst*, 425 U.S. at 201 (holding “that s 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.”); *Herman & MacLean*, 459 U.S. at 382 (noting that “a Section 10(b) plaintiff carries a heavier burden than a Section 11 plaintiff. Most significantly, he must prove that the defendant acted with scienter, *i.e.*, with intent to deceive, manipulate, or defraud.”).

<sup>129</sup> *Ernst & Ernst*, 425 U.S. at 409-9 (noting, among other things, Section 11(e) of the 1933 Act, which “authorizes the court to require a plaintiff bringing a suit under s 11, s 12(2), or s 15 thereof to post a bond for costs, including attorneys' fees, and in specified circumstances to assess costs at the conclusion of the litigation.”).

<sup>130</sup> 15 U.S.C. § 771(a)(1) (West, Westlaw through 2013) (providing that any person who “offers or sells a security in violation of section 77e of this title [Section 5 of the 1933 Act] ... shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction...”); *In re Kummerfeld*, 444 B.R. 28, 43 (S.D.N.Y. 2011) (Section 12(a)(1) “imposes strict liability” “on any person who offers to sell, or sells, such security when it is not registered”); *In re Laser Arms Corp. Sec. Litig.*, 794 F.Supp. 475, 481 (S.D.N.Y. 1989) (“Since liability for the sale of unregistered securities is absolute under section 12(1), ‘[a] purchaser may recover regardless of whether he can show any degree of fault, negligent or intentional, on the seller’s part.’” (quoting *Lewis v. Walston & Co.*, 487 F.2d 617, 621 (5th Cir.1973))).

<sup>131</sup> *Laser Arms Corp. Sec. Litig.*, 794 F.Supp. at 481 (“To state a claim under section 12(1), a plaintiff must establish: (1) the sale or offer to sell securities by the defendant; (2) the absence of a registration statement; and (3) the use of the mails or the facilities of interstate commerce in connection with the sale or offer.”).

<sup>132</sup> *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005) (identifying six elements of a 10(b) cause of action: (1) a material misrepresentation (or omission); (2) scienter, *i.e.*, a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as “transaction causation,”; (5) economic loss; and (6) “loss causation,” *i.e.*, a causal connection between the material misrepresentation and the loss).

<sup>133</sup> Compare 15 U.S.C. 77k(a) (West, Westlaw through 2013) (“In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . .”) with 15 U.S.C. 771(a)(2) (making liable any person who “offers or sells a security. . .by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication. . . “ and allowing plaintiff “to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.”); see also *In re Morgan Stanley Information Fund Sec. Litig.*, 592 F.3d 347, 358 (2d Cir. 2010) (“Section 11 applies to registration statements, and section 12(a)(2) applies to prospectuses and oral communications.”).

transactions,<sup>134</sup> and several lower courts have also held that Section 12(a)(2) liability does not attach to offerings made by private placement memoranda.<sup>135</sup> Defendants in Section 12(a)(2) cases must also be in privity with plaintiffs.<sup>136</sup> In a Section 12(a)(1) action the Supreme Court has held that liability is limited only to the “owner who passes title, or other interest in a security, to the buyer for value” or a person “who successfully solicit[ed] a purchase of securities . . . motivated at least in part by a desire to serve his own financial interests or those of the securities owner.”<sup>137</sup> Although the Court expressly refused to extend this definition of the term “seller” to Section 12(a)(2) liability,<sup>138</sup> the trend in lower courts is to apply this 12(a)(1) definition to 12(a)(2) claims as well.<sup>139</sup> Further, there is no scienter requirement under Section 12(a)(2),<sup>140</sup> and defendant sellers have the affirmative “due diligence” defense that neither knew, nor could, in the exercise of reasonable care, have known of the untruth or omission.<sup>141</sup> The effect is to turn Section 12(a)(2) into a negligence statute with the burden on defendants to prove lack of negligence.<sup>142</sup> Reliance, however, is unnecessary under Section 12(a)(1) or 12(a)(2).<sup>143</sup> Again,

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<sup>134</sup> *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995); *Yung v. Lee*, 432 F.3d 142, 147-48 (2d Cir. 2005).

<sup>135</sup> *See Lewis v. Fresne*, 252 F.3d 352, 357-58 (5th Cir. 2001) (“Section 12 of the 1933 Act does not apply to private transactions.”); *Maldonado v. Dominguez*, 137 F.3d 1, 8 (1st Cir. 1998) (concluding that Section 12(a)(2) action “is not available to” claimants who purchased securities in private placement); *Whirlpool Financial Corp. v. GN Holdings, Inc.*, 67 F.3d 605, 609 n.2 (7th Cir. 1995) (holding that § 12(a)(2) did not apply to a transaction involving a private placement memorandum); *Vannest v. Sage, Ruddy & Co.*, 960 F.Supp. 651, 654-55 (W.D.N.Y.1997) (“because the Pfeiffer House offering was made by a Private Placement Memorandum, and because the stated intent at the time was to characterize the offering as private, it was not a ‘public’ offering” for purposes of section 12(a)(2)); *In re J.W.P. Inc. Sec. Litig.*, 928 F.Supp. 1239, 1259 (S.D.N.Y. 1996) (“Courts in this district have held that under *Gustafson*, private placement memoranda like those at issue are not ‘prospectuses’ for the purposes of a claim under § 12(2)”; *Glamorgan Coal Corp. v. Ratner’s Grp. PLC*, No. 93 CIV. 7581, 1995 WL 406167, \*2-\*3 (July 10, 1995) (offering made by private placement memorandum not public for Section 12(2) purposes).

<sup>136</sup> *Thompson v. RelationServe Media, Inc.*, 610 F.3d 628, 676 (11th Cir. 2010) (“The major difference between [Sections 11 and 12 of the Securities Act] is that § 12 imposes a privity requirement not found in § 11 and § 12 allows liability for ‘oral communications.’”); *Joseph v. Wiles*, 223 F.3d 1155, 1161 (10th Cir. 2000) (observing that section 12(a)(2) contains “an express privity requirement, giving a cause of action only to individuals who purchase securities directly from a person who sells the securities by means of a prospectus. Section 11, in contrast, has no such requirement.”)

<sup>137</sup> *Pinter v. Dahl*, 486 U.S. 622, 623 (1988).

<sup>138</sup> *Id.* at 642 n. 20.

<sup>139</sup> *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1214 (1st Cir. 1996), *abrogated by statute on other grounds*, 15 U.S.C. § 78u(4)(b)(2) (“*Pinter*’s analysis of “seller” for purposes of Section 12(1) applies with equal force to the interpretation of “seller” under Section 12(2)”; *Smith v. Am. Nat’l Bank & Trust Co.*, 982 F.2d 936, 941-42 (6th Cir. 1992) (applying *Pinter* to 12(a)(2) claims); *Ryder Int’l Corp. v. First Am. Nat’l Bank*, 943 F.2d 1521, 1527-30 (11th Cir. 1991) (same); *Ackerman v. Schwartz*, 947 F.2d 841, 844-45 (7th Cir. 1991) (same); *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 536 (9th Cir.1989) (same); *Crawford v. Glenss, Inc.*, 876 F.2d 507, 510 (5th Cir.1989) (test for § 12(2) status reformulated in light of *Pinter*); *In re Craftmatic Sec. Litig.*, 890 F.2d 628, 635 (3d Cir.1989) (“given the identical language of sections 12(1) and 12(2), as well as the Securities Act’s overall objective of disclosure, we see no reason to distinguish the scope of ‘seller’ for purposes of § 12(1) and § 12(2)”; *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir.1989) (same).

<sup>140</sup> *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145, 156 (2d Cir. 2012) (“Neither scienter, reliance, nor loss causation is an element of § 11 or § 12(a)(2) claims”); *Panther Partners Inc. v. Ikanos Commc’ns, Inc.*, 681 F.3d 114, 120 (2d Cir.2012) (same).

<sup>141</sup> 15 U.S.C. § 771(a)(2); *Gilbert v. Nixon*, 429 F.2d 348, 357 (10th Cir. 1970).

<sup>142</sup> *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 507 (5th Cir. 1990) (“Defendants can only be found liable under Section 12(2) for these omissions if they were negligent in not knowing about them”).

<sup>143</sup> *See Pinter*, 486 U.S. at 652 (“no congressional intent to incorporate tort law doctrines of reliance and causation into § 12(1) emerges from the language or the legislative history of the statute”); *NECA-IBEW Health & Welfare*

this form of liability is in sharp contrast to Section 10(b), which commonly applies to aftermarket trading, has no privity requirement, does not limit liability to persons denominated as “sellers” no matter how defined, imposes an affirmative obligation on plaintiff to demonstrate scienter, and requires reliance.

**Section 15.** Section 15 of the Securities Act creates secondary joint and several liability for control persons of persons who violate Sections 11 or 12 of the Securities Act.<sup>144</sup> The Supreme Court has distinguished this provision from Section 10(b) on grounds that Section 15 imposes derivative liability only, whereas Section 10(b) imposes direct liability.<sup>145</sup> The Supreme Court has further noted that Section 15 permits recovery for negligent conduct, subject to significant procedural restrictions not applicable under Section 10(b),<sup>146</sup> while Section 10(b) requires proof of scienter.<sup>147</sup> In addition, liability under Section 15 is limited to persons who satisfy the definition of “control” persons,<sup>148</sup> whereas Section 10(b) liability is not so constrained. Further, there is a split among the circuits as to whether a control person must also be a “culpable participant” in the alleged wrongdoing,<sup>149</sup> whereas the law is clear that plaintiffs must establish each defendant’s scienter as a condition of prevailing under Section 10(b).<sup>150</sup>

**Section 16.** Section 16 of the Exchange Act is also easily distinguished. It “regulates short swing trading by owners, directors, and officers,”<sup>151</sup> and is unrelated to the existence of a

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*Fund*, 693 F.3d at 156 (reliance is not an element of § 12(a)(2) claim); *Panther Partners Inc.*, 681 F.3d at 120 (same);

<sup>144</sup> 15 U.S.C.A. § 77o (West, Westlaw through 2013); Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 Bus. Law. 1 (1997).

<sup>145</sup> *Musick*, 508 U.S. at 296.

<sup>146</sup> See *supra* note 129.

<sup>147</sup> See, e.g., *Ernst & Ernst*, 425 U.S. at 208-10. “Section 15 of the 1933 Act, as amended by s 208 of Title II of the 1934 Act, makes persons who ‘control’ any person liable under s 11 or s 12 liable jointly and severally to the same extent as the controlled person, unless he ‘had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.’ 15 U.S.C. s 77o.” *Id.* at 209 n.27.

<sup>148</sup> Control is defined as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” 17 C.F.R. § 230.405. There is, however, dispute among the lower courts as to the application of this standard. Paul Vizcarrondo, Jr., *Liabilities Under the Federal Securities Laws* § IV.A.1., p.122 (2012) (noting that “exactly who meets” the control person standards of section 15 “has never been completely clear”); see also *Laperriere v. Vesta Ins. Grp., Inc.*, 526 F.3d 715, 723 (11<sup>th</sup> Cir. 2008) (“Circuit courts have recognized, however, that the control regulation, like the statute, does not attempt to formulate a precise definition of ‘control’ applicable to all cases, but is intended only to provide some guidance, leaving a determination as to whether control exists dependent on the particular factual circumstances of each case”); *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1441 (9<sup>th</sup> Cir. 1987), (“the concept of control, in the context of the securities law, is an elusive notion for which no clear-cut rule or standard can be devised”) *superseded by statute on other grounds as stated in Hockey v. Medhekar*, 30 F.Supp.2d 1209 (N.D.Cal 1998).

<sup>149</sup> *Vizcarrondo, Liabilities Under the Federal Securities Laws, supra* note 148, at § IV.A.1., p.122-23 (noting that “[t]he circuits remain split as to whether a plaintiff must establish that the defendant was a ‘culpable participant’ in the alleged violation in order to qualify as a ‘controlling person’ for purposes of § 15 and § 20” and collecting cases).

<sup>150</sup> *Ernst & Ernst*, 425 U.S. at 201; *Herman & MacLean*, 459 U.S. at 382.

<sup>151</sup> *Central Bank*, 511 U.S. at 179. As one court has put it, leaving out officer and directors, “[t]he elements of a Section 16(b) claim are ‘(1) a purchase and (2) a sale of securities (3) by... a shareholder who owns more than ten percent of any one class of the issuer’s securities (4) within a six-month period.’” *Log on Am., Inc. v. Promethean*

misrepresentation or omission in any context whatsoever. The statute imposes strict liability; defendants need not have utilized inside information, and issuers need not have been injured.<sup>152</sup> “No showing of actual misuse of inside information or unlawful intent is necessary to compel disgorgement. Section 16(b) operates mechanically, and makes no moral distinctions, penalizing technical violators of pure heart, and bypassing corrupt insiders who skirt the letter of the prohibition.”<sup>153</sup>

Again, in stark contrast, Section 10(b) liability hinges critically on whether defendants were “pure of heart” or acted with scienter, which is defined as a “mental state embracing an intent to deceive,”<sup>154</sup> and whether there was fraud, deception or manipulation. As the Supreme Court has explained, Section 16(b) “differs in focus from § 10(b),”<sup>155</sup> and is a mechanistic rule unrelated to the existence of an actual fraud, whereas Section 10(b) is highly measured and is targeted expressly at wrongful conduct. In addition, whereas Section 16(b) gives all stockholders a right of action against corporate insiders using their position to profit in the sale or exchange of corporate securities, only defrauded purchasers and sellers of securities can raise a claim under Section 10(b).<sup>156</sup>

Section 20. Section 20 of the Exchange Act, like Section 15 of the Securities Act, is a secondary liability provision that creates joint and several liability for persons who control violators of any provision of the Exchange Act.<sup>157</sup> Section 20 is typically interpreted in a manner identical to Section 15,<sup>158</sup> and the same distinctions with Section 10(b) therefore apply.

Working through this process of elimination leaves Sections 9 and 18 of the Exchange Act as candidates for the provision most similar to the implied Section 10(b) private right of action. The Supreme Court has observed that Sections 9 and 18 “both ‘target the precise dangers that are the focus of § 10(b)’”<sup>159</sup> and that “the intent motivating all three sections is the same – ‘to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions.’”<sup>160</sup> Section 18 is, however, clearly the closer analogue to Section 10(b) in situations involving misrepresentations or omissions affecting aftermarket trading.

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Asset Mgmt. L.L.C., 223 F. Supp. 2d 435, 449 (S.D.N.Y. 2001) (citing *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir.1998)).

<sup>152</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 13.2 (2013); *see also Gwozdzinsky*, 156 F.3d at 308 (“The statute requires disgorgement to the company of any profit derived from the matching of any purchase and any sale of an ‘equity security’ (other than an exempted security) within a six-month period by a statutory insider, *irrespective of intent* or whether overall trading during that six months (*i.e.*, all sales and purchases combined) resulted in a loss.”) (emphasis added).

<sup>153</sup> *Magna Power Co. v. Dow Chem. Co.*, 136 F.3d 316, 320-21 (2d Cir. 1998).

<sup>154</sup> *Ernst & Ernst*, 425 U.S. at 193 n.12.

<sup>155</sup> *Lampf*, 501 U.S. at 360 n.5.

<sup>156</sup> *Blue Chip Stamps*, 421 U.S. at 731-34.

<sup>157</sup> 15 U.S.C. § 78t (West, Westlaw through 2013).

<sup>158</sup> Vizcarrondo, *Liabilities Under the Federal Securities Laws*, *supra* note 148, at § IV.A.1., p.121; THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 7.12[2] (2013).

<sup>159</sup> *Musick Peeler*, 508 U.S. at 296 (citing *Lampf*, 501 U.S. at 360).

<sup>160</sup> *Musick Peeler*, 508 U.S. at 296 (citing *Loftgarden*, 478 U.S. at 664).

Section 9. Section 9 of the Securities Act “prohibits any person from engaging in manipulative practices such as wash sales, matched orders, and the like,”<sup>161</sup> but creates no liability for misrepresentations or omissions in aftermarket trading absent a prohibited manipulative practice. The Supreme Court has found that “[m]anipulation” is “virtually a term of art when used in connection with securities markets.” The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.”<sup>162</sup> In contrast, Section 10(b) has a far broader reach and addresses situations in which there are misrepresentations or omissions that affect a security’s price, and not just situations involving active manipulation. Further, Section 9, as originally adopted, was “expressly limited to securities traded on one of the national stock exchanges,”<sup>163</sup> whereas Section 10(b) was not so constrained and could reach fraud wherever it occurs.<sup>164</sup> In addition, in Section 9 actions, as is the case in Section 10(b) private actions, plaintiffs must demonstrate that the defendant acted with scienter,<sup>165</sup> but some cases indicate that the state of mind required under Section 9, a form of “willfulness,” is even more stringent than the mental state of scienter required to demonstrate a violation of Section 10(b).<sup>166</sup> This stricter mental state requirement, along with the fact that an injury under Section 9(e) must be a close rather than remote consequence of the prohibited activity, “make the section 9(e) remedy a very limited one.”<sup>167</sup> Evidently, Section 9 violations are a small subset of Section 10(b) violations, and “[i]t is difficult to imagine any violation of § 9(a)(2)...that would not also fall within the broad scope of proscribed activity set forth in Rule 10b-5.”<sup>168</sup>

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<sup>161</sup> *Central Bank*, 511 U.S. at 179.

<sup>162</sup> *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977) (quoting *Ernst & Ernst*, 425 U.S. at 199).

<sup>163</sup> *Perry v. Eastman Kodak Co.*, 1991 U.S. Dist. LEXIS 20914, at \*17-18 (S.D. Ind. 1991), *affirmed*, 1992 U.S. App. LEXIS 11753 (7<sup>th</sup> Cir. 1992).

<sup>164</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.1[2][A] (2013). Section 9 was amended in 2010 “to cover manipulation using an instrumentality of interstate commerce. . . .Section 9 and 10 now have similar coverage.” THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.1[2][A] (2013).(citing 15 U.S.C.A. § 78i(a), as amended by Pub.L. 111-203, § 929L(1) (A) (2012)).

<sup>165</sup> *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1969) (“Sections 9(a)(2) and 9(e) contain requirements of both manipulative motive and willfulness.”); *see also In re The Federal Corporation., Exchange Act Release No. 34-3909* (Jan. 29, 1947); H.R. Rep. No. 73-1383, at 20 (1934) (“Transactions become unlawful only when they are made for the purpose of raising or depressing the market price. . . .” “If a person is merely trying to acquire a large block of stock for investment, or desires to dispose of a big holding, his knowledge that in doing so he will affect the market price does not make his action unlawful.”); THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.1[2][A] (2013) (“In order to prevail in a suit charging manipulation, it must be proven that the defendant’s primary intent in entering the transaction was price manipulation”).

<sup>166</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.1[4][A] (2013) (“Liability under section 9(f) is expressly limited to persons ‘willfully’ participating in the manipulative conduct; willfulness would seem to be an even stricter requirement than scienter, which is required generally in suits under Rule 10b-5. It must be remembered that, in addition to the defendant’s willful participation, the substantive violation requires proof of manipulative intent.”).

<sup>167</sup> *Id.*; *see also Lowenfels, Sections 9(a)(1) and 9(a)(2) of the Securities Exchange Act of 1934*, *supra* note 144, at 707 (“proof of manipulation under Section 9(a)(2) requires proof that the person engaged in the manipulation have ‘the purpose of inducing the purchase or sale of such security by others’ while proof of manipulation under Sections 10(b), 14(e), 15(c)(1) and 15(c)(2) and Section 17(a) of the 1933 Act has no such requirement”).

<sup>168</sup> *Walck v. Am. Stock Exchange*, 565 F. Supp. 1051, 1063 (E.D. Pa. 1981) (“It is well settled that the manipulative activities expressly prohibited by § 9(a)(2) of the Exchange Act with respect to a listed security are also violations of...§ 10(b) of the Exchange Act when the same activities are conducted with respect to an over-the-counter security.”).

Section 18(a). The vast majority of litigation under Section 10(b) and Rule 10b-5 does not, however, implicate allegedly manipulative activity that falls within the four corners of Section 9. Instead, the prototypical private action under Section 10(b) and Rule 10b-5 alleges a material misrepresentation or omission that affects the aftermarket price of securities.<sup>169</sup> Only one express private right of action in existence as of the time of Section 10(b)'s enactment addresses misrepresentations or omissions that affect aftermarket prices: Section 18(a).

Section 18(a) provides an express private right of action in favor of aftermarket purchasers or sellers who transact at a price “affected” by a misrepresentation or omission in “any application, report, or document filed” with the Commission pursuant to the Exchange Act, where the statement is “false or misleading with respect to any material fact.”<sup>170</sup> The purchaser-seller requirement of Section 18(a) is construed identically with the purchase-seller requirement of Section 10(b).<sup>171</sup> Liability extends to anyone who “shall make or cause to be made” the false or misleading statement giving rise to the complaint,<sup>172</sup> including directors and accountants.<sup>173</sup> “Liability is limited, however, in the important respect that the defendant is accorded the defense that he acted in ‘good faith and had no knowledge that such statement was false or misleading.’ Consistent with this language the legislative history of the section suggests something more than negligence on the part of the defendant is required for recovery.”<sup>174</sup> “Section 18(a)’s putting the defendant to the burden of proving the absence of knowledge and the presence of good faith creates an easier *prima facie* showing than is required in a 10b-5 action where the plaintiff must prove scienter.”<sup>175</sup> Liability under Section 18(a), however, is limited to false or misleading statements in documents filed with the Commission: if a false or misleading statement is made outside a filing, no liability attaches.<sup>176</sup>

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<sup>169</sup> See note 116, *supra*; CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2012 YEAR IN REVIEW Figure 4 (2012) (documenting that in 2012, 95 percent of all securities class action filings alleged misrepresentations in financial statements).

<sup>170</sup> Section 18 states, in part: “Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title [concerning registration and regulation of brokers and dealers], which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys’ fees, against either party litigant.” 15 U.S.C. 78r(a) (West, Westlaw through 2013).

<sup>171</sup> See, e.g., *Phillips v. TPC Commc’ns, Inc.*, 532 F.Supp. 696, 698 (W.D. Pa. 1982); *Weisman v. Darneille*, No. 77 Civ. 2110 (LFM), 1978 U.S. Dist. LEXIS 20308, at \*7 (S.D.N.Y. Jan. 6, 1978).

<sup>172</sup> 15 U.S.C. 78r(a) (West, Westlaw through 2013).

<sup>173</sup> *Ernst & Ernst*, 425 U.S. at 211 n. 31 (holding accountants liable); *Kramer v. Scientific Control Corp.*, 452 F. Supp. 812, 817 (E.D. Pa. 1978) (directors held liable); *Fischer v. Kletz*, 266 F. Supp. 180, 189 (S.D.N.Y. 1967) (accountants held liable).

<sup>174</sup> *Ernst & Ernst*, 425 U.S. at 211 n. 31.

<sup>175</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.18[3] (2013).

<sup>176</sup> Misleading statements not filed with the Commission cannot support Section 18(a) liability, even if mandatorily provided or furnished to the Commission. See *In re Digi Int’l Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1103 (D. Minn. 1998), *aff’d*, 14 F. App’x 714 (8<sup>th</sup> Cir. 2001); *Cohen v. Stevanovich*, 722 F. Supp. 2d 416, 427 (S.D.N.Y. 2010)



The parallel to liability under Section 10(b) and Rule 10b-5 is apparent. Only Section 18(a) expressly provides for private causes of action arising from false and misleading statements affecting aftermarket trading. To be sure, the Section 10(b) implied private right has been interpreted more broadly to allow for recovery even if the alleged misrepresentation or omission is unrelated to any filing with the Commission but the fact remains that Section 18(a) is the only express private right of action extant in 1934 that provides for a remedy as a result of a materially false or misleading statement affecting aftermarket trading. In contrast, Section 9 of the Exchange Act attacks only manipulative practices, narrowly defined as a term of art, and does not reach misrepresentation unattached to these manipulative practices. Section 16 of the Exchange Act is unrelated to the making of any false statement. Sections 11 and 12 of the Securities Act relate to false statements in registration statements or offering documents that are used in connection with the initial sale of securities, not with aftermarket trading. And, Section 15 of the Securities Act and Section 20 of the Exchange Act are derivative control person liability provisions that require a violation of some other provision of the statute as a precondition for liability.

The strongest distinction, however, between Section 18(a) and the current interpretation of Section 10(b) liability by the lower courts relates to the element of reliance. The plain language of Section 18(a) provides for recovery only by persons who “in reliance upon” the allegedly false or misleading statement “purchased or sold a security at a price which was affected by such statement.”<sup>177</sup> The relevant legislative history makes it clear that Congress intended to require that plaintiffs bear the burden of establishing actual reliance in its traditional form.<sup>178</sup> Consistent with this history, judicial precedent interprets Section 18(a) as requiring a demonstration of actual “eyeball” reliance.<sup>179</sup> Thus, a plaintiff must plead and prove that he actually read a copy of the document filed with the SEC that contained the allegedly false or misleading statement, and it is insufficient to rely on information derived from the filing if the plaintiff did not himself actually read the filing at issue.<sup>180</sup> In other words, “the plaintiff must

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(dismissing § 18 claim that failed to identify any SEC filings, much less allege that a document filed with the SEC contained a material misstatement or omission). *In re Stone & Webster, Inc., Sec. Litig.*, 253 F. Supp. 2d 102, 135 (D. Mass. 2003) (dismissing § 18(a) claims that referred to portions of 10-Q not filed as a matter of law with SEC, and that failed to meet Fed. R. Civ. P. 9(b) particularity requirements), *aff’d*, 414 F.3d 187 (1<sup>st</sup> Cir. 2005); *Wachovia Bank & Trust Co., N.A. v Nat’l Student Mktg. Corp.*, 461 F.Supp.999, 1006 (D.D.C. 1978) (“The fact that statements similar to those alleged by plaintiffs were also contained in documents filed with the SEC is insufficient; absent reliance upon the filing of the statements with the Commission, s 18(a) is inapplicable.”), *rev’d on other grounds*, 650 F.2d 342 (D.C. Cir. 1980). Also, § 18(a) claims will not lie where the complaint merely alleges a failure to file a required form rather than inclusion of a misleading statement in a filing. *See Dewitt v. Am. Stock Transfer Co.*, 433 F. Supp. 994, 1005 (S.D.N.Y. 1977).

<sup>177</sup> 15 U.S.C. 78r(a) (West, Westlaw through 2013).

<sup>178</sup> *See* Part III.B., *infra*.

<sup>179</sup> *See, e.g., Cohen*, 722 F.Supp.2d at 433 (actual reliance is required under Section 18(a) (citing *Stromfeld v. Great Atlantic & Pac. Tea Co., Inc.*, 484 F. Supp. 1264, 1268-1269 (S.D.N.Y. 1980)); *see also* note 187, *infra*.

<sup>180</sup> *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968) (“Reliance on the actual 10K report is an essential prerequisite for a Section 18 action and constructive reliance is not sufficient”); *Cohen*, 722 F.Supp.2d at 434 (“Plaintiffs’ mere say-so in their Opposition that they relied on [a *Barron’s*] article or were ‘influenced’ by the Financial Institution Defendants’ conduct, without anything more, is insufficient to allege reliance”); *Cyber Media Group, Inc. v. Island Mortg. Network, Inc.*, 183 F.Supp.2d 559, 578 (E.D.N.Y. 2002) (dismissing section 18 claim because “the Court cannot find any allegation made by Plaintiffs that [defendant] made, or caused to be made, any statement, much less a false or misleading statement, in a document filed with any regulatory agency on behalf of AOP”); *Stromfeld*, 484 F. Supp. at 1268 (finding section 18 claim insufficient where “plaintiffs have not alleged anywhere in the complaint

have actual knowledge of and reliance upon the materials filed with the Commission . . . , it is not sufficient that the plaintiff saw similar information contained in other documents prepared by the issuer.”<sup>181</sup>

Plaintiffs expressly cannot rely on the fraud on the market doctrine to support a rebuttable presumption of reliance.<sup>182</sup> “Reliance based on a ‘fraud on the market’ theory may be the foundation of a remedy under Rule 10b-5, but will not satisfy Section 18(a)’s requirement.”<sup>183</sup> In addition, “cursory allegations of reliance are not sufficient to state a claim under Section 18(a).”<sup>184</sup> The Section 18(a) express private right of action thus has “a very strict reliance

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that they bought or sold securities in reliance upon any statements contained in any S.E.C. filings”); *Kennedy v. Nicastro*, 503 F.Supp. 1116, 1118 (N.D. Ill. 1980) (dismissing section 18 claim and finding defendant corporation cannot be deemed to have read and relied on its own SEC filings); *Ross v. Warner*, 480 F. Supp. 268, 272-273 (S.D.N.Y. 1979) (holding that “[a] complaint must identify the documents relied upon to state a prima facie case” under section 18); *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 525 (S.D.N.Y. 1977) (for section 18 claims, “constructive reliance will not suffice. [Citation] Plaintiff may only recover if he is able to establish reliance on the actual 10-K form.”); *Gross v. Diversified Mortg. Investors*, 431 F. Supp. 1080, 1093 (S.D.N.Y. 1977) (dismissing section 18 claim where “Plaintiffs do not allege, with the specificity required by Rule 9(b) Fed.R.Civ.P., any particular filing as having been false or that they relied upon any document filed with the SEC”), *aff’d mem.*, 636 F.2d 1201 (2<sup>nd</sup> Cir. 1980); THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.18[2] (2013) (“The section 18(a) cause of action is available to any investor who, after having read the faulty document filed, *actually relies* upon statements in the document and is therefore injured. . . the actual reliance requirement in section 18(a) means that constructive reliance will not suffice.”); Vizcarrondo, *Liabilities Under the Federal Securities Laws*, *supra* note 148, at § III.C.4., p.117 (“is not enough that the plaintiff relied on information ultimately derived from such a document if he himself did not read the document.”); Note, *Accountants’ Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1427, 1445 n. 42 (1967) (noting that because 17 C.F.R. § 249.310 (1967) does not deem annual reports submitted in connection with forms 10-K to be “filed” with the SEC, “an investor deceived by misinformation in an annual report could only recover under section 18 if he were able to show reliance on Form 10-K itself.”)

<sup>181</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.18[2] (2013) (citing *Ross v. A.H. Robins Co.*, 607 F.2d 545, 552 (2d Cir. 1979) (proof that plaintiff relied on the alleged misrepresentations in connection with the purchase or sale of stock is an essential element of a claim under section 18); *Heit*, 402 F.2d at 916 (“constructive reliance is not sufficient”); *Teachers’ Ret. Sys. of La. v. Qwest Commc’ns Int’l Inc.*, No. Civ. 04CV0782REBCBS, 2005 WL 2359311, \*11 (D. Colo. Sept. 23, 2005) (section 18(a) claim dismissed for lack of actual reliance); *Shriners Hosps. for Children v. Qwest Commc’ns Int’l Inc.*, No. 04–CV–0781, 2005 WL 2350569 (D. Colo. Sept. 23, 2005) (same); *In re Digi Int’l, Inc. Sec. Litig.*, 6 F.Supp.2d 1089, 1103-1104 (D. Minn. 1998) (failure to plead actual reliance); *Kurzweil v. Philip Morris Cos.*, Nos. 94 CIV. 2373, 94 CIV. 2546, and 94 CIV. 6399, 1995 WL 540025, \*8 (S.D.N.Y. Sept. 11, 1995) (failure to show actual reliance), *vacated on other grounds*, Nos. 94 Civ. 2373, 94 Civ. 2546, 1997 WL 167043 (S.D.N.Y. Apr. 9, 1997); *Sw. Realty, Ltd. V. Daseke*, No. CA3–89–3055, 1991 WL 83961, \*4 (N.D. Tex. Apr. 12, 1991) (sufficiently alleging reliance and stating claim under both section 18(a) and Rule 10b-5 for material omissions in Schedule 13D); *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 525 (S.D.N.Y. 1977) (“constructive reliance will not suffice”).

<sup>182</sup> See *Cohen*, 722 F.Supp.2d at 433-434 (the presumption of reliance “is not available for Section 18 claims” (citing *In re Alstrom SA*, 406 F.Supp.2d 433, 479 (S.D.N.Y. 2005) (“Section 18 requires actual, or what has sometimes been referred to as ‘eyeball,’ reliance.”) and *Heit*, 402 F.2d at 916)); see also THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.18[2] (2013) (“the fraud on the market presumption of reliance that is applicable in Rule 10b-5 cases cannot be invoke [sic] in an action under section 18(a).”).

<sup>183</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.18[2] (2013) (collecting cases).

<sup>184</sup> THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.18[2] (2013) (citing *Witriol v. Conexant Sys. Inc.*, No. 04-6219, 2006 WL 3511155, \*7 (D.N.J. Dec. 4, 2006) (dismissing section 18 claim where “the allegations of reliance are cursory and general, lacking the specificity that the Third Circuit requires to state a claim”).

requirement,”<sup>185</sup> and “[i]t is not enough that the plaintiff relied on information ultimately derived from such a document if he himself did not read the document.”<sup>186</sup> Instead, under Section 18(a) the plaintiff must demonstrate that she actually relied on the misrepresentation at issue by showing “eyeball or eardrum reliance.”<sup>187</sup>

Because Section 18(a) is the express private right of action most analogous to Section 10(b), and because the right to recover damages under Section 10(b) must be drawn from the most analogous express private right in existence in 1934,<sup>188</sup> and because the right of recovery under the implied Section 10(b) private right of action cannot be broader than the equivalent express private right, it follows that plaintiffs in implied private rights of action under Section 10(b) must also demonstrate actual eyeball reliance as a precondition to the recovery of money damages, just as they must under Section 18(a). The current practice in the lower courts, which allows recovery under the implied Section 10(b) private right of action based on a rebuttable presumption of reliance (which is, *de facto*, irrebuttable in the very large majority of instances<sup>189</sup>), is thus inconsistent with the Supreme Court’s textual approach to the interpretation of Section 10(b).

The implications of this analysis can be expressed through two distinct mechanisms of legal action. First, the actual reliance requirement can be framed as a precondition to the recovery of money damages under Section 10(b) in a manner that does not disturb *Basic*’s holding that allows for a rebuttable presumption of reliance as a means for satisfying the Section 10(b) reliance requirement. This approach avoids a conflict with *Basic* by drawing a distinction between actual reliance as a precondition to the recovery of money damages and actual reliance as the definition of the reliance element of the Section 10(b) cause of action. Second, the actual reliance requirement can serve as a basis for reversing *Basic*’s rebuttable presumption of reliance on statutory grounds. This statutory approach is independent of the complexities that would arise in a reconsideration based on evolving views of the validity of the efficient market hypothesis.<sup>190</sup> Because the Supreme Court has a cooperative advantage in the exercise of statutory interpretation over its ability to reference econometric debates regarding the validity of the efficient market hypothesis, the Court might prefer a purely statutory basis for accenting *Basic*’s presumption. In either event, the practical consequence is the same: an actual reliance requirement, whether articulated as a precondition to the recovery of damages or as a definition of the element of reliance, class certification of Section 10(b) claims will be far more difficult and the magnitude of recoveries available in Section 10(b) class actions will be far lower.

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<sup>185</sup> Vizcarrondo, *Liabilities Under the Federal Securities Laws*, *supra* note 148, at § III.C.4., p.117 (citing *Basic*, 485 U.S. at 257 (White, J., dissenting)).

<sup>186</sup> *Id.* at 117 (collecting cases).

<sup>187</sup> *Ross*, 607 F.2d at 552; *Alstom*, 406 F.Supp.2d at 479 (“Section 18 requires actual, or what has sometimes been referred to as ‘eyeball,’ reliance.”); *In re Am. Cont’l Corp./Lincoln Sav. and Loan Sec. Litig.*, 794 F.Supp. 1424, 1438 (D.Ariz.1992) (“eyeball reliance” cannot be demonstrated by the class, as the “weight of authority holds that plaintiffs must have actually read a copy of the misleading document to sustain a cause of action”).

<sup>188</sup> See Part III.A., *supra*.

<sup>189</sup> See notes 267-276, *infra*.

<sup>190</sup> For a discussion of these complexities, see Parts VI.B.2. and VI.B.3., *infra*.

## B. Legislative History

The legislative history of Section 10(b) is entirely consistent with this textual conclusion.<sup>191</sup> While explicit legislative history addresses the question of reliance as a precondition to private damage recovery under Section 18(a), there is and can be no comparable history in connection with Section 10(b) for the simple reason that Congress didn't know that it was creating a provision that would later support a judicially created right of action.<sup>192</sup> Congress thus has no reason to discuss or debate the elements of a cause of action it had no reason to suspect it had created. Instead, the legislative record establishes that Section 10(b) was intended to operate as a "catch all" provision exclusively for the benefit of the Commission's enforcement program. It was not designed to support the implication of a private right of action at all.

With regard to the purpose of Section 10(b), "[t]he most relevant exposition ... was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:" that Section 10(b) says "[t]hou shalt not devise any other cunning devices." Thus, the provision is a "catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. *The Commission should have the authority to deal with new manipulative devices.*"<sup>193</sup>

Nothing in Section 10(b)'s legislative history suggests a Congressional interest in creating a private right of action and, even when describing the provision as a "catch-all," it is a "catch-all" specifically designed to enhance the Commission's "authority to deal with new manipulative devices." It is not a "catch-all" designed to authorize private parties to bring their own causes of damages. Searching for legislative history regarding the element of reliance or the damage rule under the implied Section 10(b) private right of action is thus a fool's errand because there can be no such history.

In contrast, the legislative history of Section 18(a), an express private right of action, provides compelling support for the conclusion that, had the 73d Congress considered the question, it would not have condoned the creation of a private Section 10(b) right of action absent an affirmative demonstration of direct reliance as a pre-condition to the award of aftermarket money damages. Put another way, the adopting Congress would never have condoned the application of the fraud on the market doctrine and the rebuttable presumption of reliance to Section 10(b) actions.

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<sup>191</sup> *Central Bank*, 511 U.S. at 170-171 ("In the wake of the 1929 stock market crash and in response to reports of widespread abuses in the securities industry, the 73d Congress enacted two landmark pieces of securities legislation: the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act). 48 Stat. 74, as amended, 15 U.S.C. § 77a et seq. ...; 48 Stat. 881, as amended, 15 U.S.C. § 78a et seq. .... The 1933 Act regulates initial distributions of securities, and the 1934 Act for the most part regulates post-distribution trading.").

<sup>192</sup> *Ernst & Ernst*, 425 U.S. at 201-202 (The original version of what would develop into the 1934 Act was contained in identical bills introduced by Senator Fletcher and Representative Raybaum, S.2693, 73d Cong. 2d Sess. (1934); HR 7852, 73d Cong., 2d Sess. 1934 .... Soon after the [initial] hearings on the House bill were held, a substitute bill was introduced in both Houses ... HR 8720, 73d Cong. 2d Sess. (1934); S. 3420, 73d Cong. 2d Sess. (1934). Still a third bill was introduced and passed in the House. HR 9323, 73d Cong. 2d Sess. (1934), and the final bill is a modified version of a Senate amendment to this last House bill. *See* HR Cong. Rep. No. 1838, 73d. Cong. 2d Sess. (1934).").

<sup>193</sup> *Ernst & Ernst*, 425 U.S. at 202-203 (quoting Hearings on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce, 73d Cong. 115 (1934)) (emphasis supplied).

The initial draft of the statutory provision that evolved to become Section 18(a) allowed recovery by any plaintiff “who shall have purchased or sold a security, the price of which may have been affected by [a] misleading statement.”<sup>194</sup> that “would have permitted suits by plaintiffs based solely on the fact that the price of the securities they bought or sold was *affected* by a misrepresentation...”<sup>195</sup> and was “roundly criticized in Congressional hearings ... because it failed to include a more substantial ‘reliance’ requirement.”<sup>196</sup>

As the then-President of the New York Stock Exchange, Richard Whitney, remarked:

The really objectionable feature of this provision is that the civil penalties may be recovered by persons who have not relied upon the inaccurate or misleading statement and the amount which can be recovered will not be the actual damage which they may have suffered. If any civil penalties are deemed necessary, then they should be limited to the actual damages suffered by persons who have been misled by the false or inaccurate statement.<sup>197</sup>

The president of the Associated Stock Exchanges, Eugene Thompson, complained that “[t]he penalty provision leaves a wide open door for those who are prone to blackmail.”<sup>198</sup> Frank Hope, president of the Association of Stock Exchange Firms, worried that Section 17(a) would work to cover for bad speculation: “The broad liability imposed by the bill makes [Section 17(a)] particularly burdensome and puts tremendous advantages in the hands of a speculator to cover himself from bad speculation through endeavoring to force recovery from his broker for alleged misstatements.”<sup>199</sup>

In response to these concerns, the final version of Section 18(a) included an express reliance requirement. As explained by the then-Chairman of the House Committee, Representative Sam Rayburn:

“[t]he first provision of the bill as originally written was very much challenged on the ground that reliance should be required. This objection has been met. In other words, if a man bought a security following a prospectus that carried a false or misleading statement, he could not recover from the man who sold to him, nor could the seller be punished criminally, unless the buyer bought the security with knowledge of the statement and relied upon the statement. It seemed to us that this is as little as we could do.”<sup>200</sup>

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<sup>194</sup> See, S. 2693, 73d Cong. § 17(a) (1934).

<sup>195</sup> *Basic*, 485 U.S. at 257 (White, J., dissenting) (emphasis in original).

<sup>196</sup> *Id.* at 257; see also Stock Exchange Practices, Hearings on S. Res. 84, 56, and 97 Before the S. Comm. on Banking and Auditing, 73d Cong. 6638 (1934) (statement of Richard Whitney, President of the New York Stock Exchange); Stock Exchange Regulation, Hearing on H.R. 7852 and 8720, before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. 226 (1934) (“hereafter “Stock Exchange Regulation”) (statement of Richard Whitney).

<sup>197</sup> Stock Exchange Regulation, at 226.

<sup>198</sup> *Id.*, at 262.

<sup>199</sup> *Id.*, at 307.

<sup>200</sup> 78 Cong. Rec. 7701 (statements of Representative Sam Rayburn).

As Justice White put it, “Congress thus anticipated meaningful proof of ‘reliance’ before recovery can be had under the Securities Exchange Act.”<sup>201</sup>

### C. Narrow Construction of Section 10(b)

Separate and apart from considerations relating to the Exchange Act’s text and its legislative history, the Supreme Court has more recently enunciated a rule of narrow construction that further supports the imposition of an actual reliance requirement in Section 10(b) private litigation. The Court must be “mindful that [it] must give ‘narrow dimensions ... to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.’”<sup>202</sup> This rule of construction arises because “[c]oncerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us.”<sup>203</sup>

To be sure, the Court interprets the Section 10(b) cause of action more expansively in actions brought by the SEC because the Commission’s authority to enforce Section 10(b) is express. In those actions, the court refuses “to read the statute so narrowly, noting that it ‘must be read flexibly, not technically and restrictively.’”<sup>204</sup> The source of this distinction in interpretive approach is, however, easily ascribed to the difference between “the broad contours of the SEC’s ‘express statutory authority to enforce [Rule 10b–5],’<sup>205</sup> ... and the ‘narrow dimensions’ of the implied private right of action.”<sup>206</sup> Put another way, the remedy can be read broadly in actions brought by the Commission because the remedy is express as to the Commission, but is to be read narrowly in private actions because the remedy is implied in that context.

### D. Policy Considerations

Although Supreme Court decisions analyzing Section 10(b) have relied on policy considerations to support their conclusions,<sup>207</sup> current interpretive doctrine suggests that, policy considerations take a distant back seat to the statutory text and clear legislative history. “[I]f the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary to examine the additional considerations of ‘policy’ ... that may have influenced the lawmakers in their formulation of the statute.”<sup>208</sup> Thus, “[p]olicy considerations cannot override our interpretation of the text and structure of the [1934]

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<sup>201</sup> *Basic*, 485 U.S. at 258 (White, J., dissenting).

<sup>202</sup> *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S.Ct. 2296, 2302 (2011) (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 167 (2008)).

<sup>203</sup> *Stoneridge*, 552 U.S. at 165.

<sup>204</sup> *SEC v. Zandford*, 535 U.S. 813, 821 (2002).

<sup>205</sup> *SEC v. Tambone*, 597 F.3d 436, 455 (1<sup>st</sup> Cir. 2010) (quoting *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71, 79-81 (2006)).

<sup>206</sup> *Id.* (quoting *Stoneridge*, 552 U.S. at 167).

<sup>207</sup> *See, e.g., Blue Chip Stamps*, 421 U.S. at 737 (finding it “proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance”); *Basic*, 485 U.S. at 245 (finding “[t]he presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act.”).

<sup>208</sup> *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986) (quoting *Aaron v. SEC*, 446 U.S. 680, 695 (1980)).

Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result ‘so bizarre’ that Congress could not have intended it.”<sup>209</sup>

The modern Court thus tends to cite to policy considerations as support for conclusions it has already reached on independent grounds, typically an analysis of text or of legislative history.<sup>210</sup> The significant exception to this rule among more recent cases interpreting Section 10(b) is the plurality decision in *Basic* adopting the fraud on the market doctrine with its rebuttable presumption of reliance. As discussed below,<sup>211</sup> the plurality’s decision rests essentially on contestable policy considerations that were divorced from any reading of the statutory text and of the relevant legislative history. Those simple facts go a long way in explaining the current U.S. tension that surrounds *Basic*’s holding: *Basic* is a uniquely policy-based decision living in a textualist world.

#### IV. Subsequent Legislative Activity

The Court’s approach to subsequent Congressional activity is less than consistent. In some contexts, the Court emphasizes that the intent of the enacting Congress is “the controlling factor.”<sup>212</sup> Thus, “the interpretation given by one Congress (or a committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute.”<sup>213</sup> In other contexts, the Court indicates a willingness to consider the actions of later Congresses, and explains that “[w]hile the views of subsequent Congresses cannot override the unmistakable intent of the enacting one, such views are entitled to significant weight, and particularly so when the precise intent of the enacting Congress is obscure.”<sup>214</sup> To be sure, the precise intent of the

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<sup>209</sup> *Central Bank*, 511 U.S. at 188 (citing *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991)); see also *Pinter v. Dahl*, 486 U.S. 622, 654 (1988) (“[W]e need not entertain Pinter’s policy arguments”); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977) (language sufficiently clear to be dispositive).

<sup>210</sup> See, e.g., *Amgen*, 133 S. Ct. at 1199-1202 (“We have no warrant to encumber securities-fraud litigation by adopting an atextual requirement of precertification proof of materiality that Congress, despite its extensive involvement in the securities field, has not sanctioned”); *Morrison v. Nat’l Australia Bank Ltd.*, 130 S.Ct. 2869, 2881-886 (2010) (in precluding the extraterritorial application of section 10(b), the Court looked to the text of section 10(b) and then to other provisions of the Exchange Act and Securities Act before noting that an extraterritorial application of section 10(b) would interfere with foreign securities regulation); *Central Bank*, 511 U.S. at 173, 188-90 (in determining whether section 10(b) applied to aiders and abettors, the Court held that “the text of the statute controls our decision,” but later noted that “[s]econdary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets.”)

<sup>211</sup> See Part VI, *infra*.

<sup>212</sup> *Morse v. Republican Party of Va.*, 517 U.S. 186, 219, 224-25 (1996); *Central Bank*, 511 U.S. at 185-86.

<sup>213</sup> *Central Bank*, 511 U.S. at 185-86 (quoting *Public Employee Ret. Sys. of Ohio v. Betts*, 492 U.S. 158, 168 (1989), *overruled on other grounds as stated in E.E.O.C. v. Westinghouse Elec. Corp.*, 925 F.2d 619 (3<sup>rd</sup> Cir. 1991)); see also *Weinberger v. Rossi*, 456 U.S. 25, 35 (1982) (holding “*post hoc* statements of a congressional Committee” in post-enactment legislative history were “not entitled to much weight” when interpreting a statute); *Consumer Product Safety Comm’n v. GTE Sylvania, Inc.*, 447 U.S. 102, 118 (1980) (noting “the oft-repeated warning that ‘the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one.’” (quoting *United States v. Price*, 361 U.S. 304, 313 (1960))); *id.* at n. 13 (“even when it would otherwise be useful, subsequent legislative history will rarely override a reasonable interpretation of a statute that can be gleaned from its language and legislative history prior to its enactment”); *United States v. Sw. Cable Co.*, 392 U.S. 157, 170 (1968) (“In the first place, the views of one Congress as to the construction of a statute adopted many years before by another Congress have very little, if any, significance.”) (internal quotation marks omitted).

<sup>214</sup> *Stoneridge*, 552 U.S. at 163 (internal citations omitted) (quoting *Seatrains Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 596 (1980)).

enacting Congress in the case of Section 10(b) the Exchange Act was far from obscure: Congress never intended to create a private right of action under Section 10(b), and in Section 18(a), Congress expressly refused to allow for out-of-pocket aftermarket recovery absent a prior affirmative showing of reliance. A strong textualist approach would thus minimize the implications of any later Congressional activity.

But that observation alone is insufficient to demonstrate that subsequent legislative activity is irrelevant to the Court's deliberations in the context of Section 10(b) exegesis, particularly because the Court has relied on arguments based on Congressional acquiescence, and has considered the activities of subsequent Congresses as providing support for textualist-based decisions. For example, the Court has observed that a Congressional decision extensively to address the operation of the Exchange Act, and to leave intact a "well-established judicial interpretation" suggests that "Congress ratified" the Court's implication of a private right of action under Section 10(b).<sup>215</sup> Similarly, when Congress adopted the PSLRA, the Court observed that Congress "accepted the § 10(b) private cause of action as then defined but chose to extend it no further."<sup>216</sup> But, on the other hand, the Supreme Court has rejected acquiescence arguments when raised in other contexts,<sup>217</sup> and has cautioned against drawing inferences from failed legislative proposals.<sup>218</sup>

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<sup>215</sup> *Herman & MacLean*, 459 U.S. at 384-386 ("This cumulative construction of the remedies under the 1933 and 1934 Acts is also supported by the fact that, when Congress comprehensively revised the securities laws in 1975, a consistent line of judicial decisions had permitted plaintiffs to sue under Section 10(b) regardless of the availability of express remedies. . . . In light of this well-established judicial interpretation, Congress' decision to leave Section 10(b) intact suggests that Congress ratified the cumulative nature of the Section 10(b) action."); see also *Merrill Lynch*, 456 U.S. at 381-82 ("the fact that a comprehensive reexamination and significant amendment of the CEA left intact the statutory provisions under which the federal courts had implied a cause of action is itself evidence that Congress affirmatively intended to preserve that remedy."); James D. Gordon III, *Acorns and Oaks: Implied Rights of Action Under the Securities Acts*, 10 STAN. J. L. BUS. & FIN. 62, 87 (2004) ("The acquiescence argument is simple. Congress is fully aware that the federal courts have created implied remedies under the securities acts. However, Congress has not reversed any implied right of action or stopped the courts from creating them, even though Congress has amended the securities acts several times. Therefore, Congress has acquiesced in what the courts have done.").

<sup>216</sup> *Stoneridge*, 552 U.S. at 166; see also *Dura*, 544 U.S. at 346 (The PSLRA "makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss.").

<sup>217</sup> *Central Bank*, 511 U.S. at 186; *Patterson v. McLean Credit Union*, 491 U.S. 164, 175, n.1 (1989); *Aaron v. SEC*, 446 U.S. 680, 694 n. 11 (1980) ("But, since the legislative consideration of those statutes was addressed principally to matters other than that at issue here, it is our view that the failure of Congress to overturn the Commission's interpretation falls far short of providing a basis to support a construction of § 10(b) so clearly at odds with its plain meaning and legislative history."); *Helvering v. Hallock*, 309 U.S. 106, 121 (1940) (Frankfurter, J.) ("[W]e walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.").

<sup>218</sup> *Central Bank*, 511 U.S. at 187 ("[F]ailed legislative proposals are 'a particularly dangerous ground on which to rest an interpretation of a prior statute.'" (quoting *Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 650 (1990) (holding that the parties' competing arguments based on subsequent legislative developments—respondents' contentions that congressional acquiescence in their position is demonstrated by Congress' failure to enact a provision denying § 10(b) aiding and abetting liability after the lower courts began interpreting § 10(b) to include it, and petitioner's assertion that Congress' failure to pass 1957, 1958, and 1960 bills expressly creating such liability reveals an intent not to cover it—deserve little weight in the interpretive process, would not point to a definitive answer in any event, and were therefore rejected))).



Significantly, however, an analysis of subsequent legislative activity provides strong support for the textualist conclusion that plaintiffs in Section 10(b) actions must demonstrate actual reliance as a precondition to recovery. Indeed, amendments to the Securities Act and to the Exchange Act adopted since 1934 suggest that Congress has taken positions inconsistent with the efficient market theory and that it has also rejected the potentially “Draconian” implications of the out-of-pocket damage measure as applied in aftermarket trading cases. Congressional failure to adopt legislation expressly rejecting the fraud on the market hypothesis, also cannot reasonably be interpreted as acquiescence in the *status quo* as it is currently followed by the lower courts. The legislative histories of the Securities Act and Exchange Act subsequent to their adoption are thus consistent with conclusion that actual reliance is a precondition to recovery under Section 10(b).

#### A. Amendments to the Securities Act and to the Exchange Act

In the 80 years since its adoption, the Securities Act, it has been amended on at least 38 occasions.<sup>219</sup> The Exchange Act has been amended on at least 57 occasions.<sup>220</sup> The trend in legislative activity, particularly in recent years, has been toward a narrowing of the private right of action under Section 10(b) and a broadening of the Commission’s authority to pursue violators of the securities laws.<sup>221</sup> Taken together, these trends suggest a Congressional preference for public enforcement of the securities laws over private enforcement through Section 10(b) litigation or other means.<sup>222</sup>

For example, the Private Securities Litigation Reform Act of 1995<sup>223</sup> reflects Congress’ most extensive attempt to address private securities litigation practice.<sup>224</sup> That legislation is

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<sup>219</sup> See Appendix A.

<sup>220</sup> See Appendix B.

<sup>221</sup> *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 754 (3<sup>rd</sup> Cir. 2010) (“In *Stoneridge*, [552 U.S. at 157] the Supreme Court noted that, at least since *Central Bank*, Congress has approved of narrowing the scope of § 10(b) liability.”); see also *Morrison v. Nat’l Australia Bank*, 130 S. Ct. 2869, 2883 (2010) (limiting extraterritorial jurisdiction of Section 10(b)); *Stoneridge*, 552 U.S. at 158 (“The § 10(b) implied private right of action does not extend to aiders and abettors. The conduct of a secondary actor must satisfy each of the elements or preconditions for liability. . . .”); *Central Bank*, 511 U.S. at 177 (concluding “that the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation”).

<sup>222</sup> The Court has inferred that Congress is not opposed to a narrow interpretation of the implied Section 10(b) private right of action. See *Malack*, 617 F.3d at 754 (noting that the *Central Bank* decision “led to calls for Congress to create an express cause of action for aiding and abetting. . . [b]ut Congress declined to do so” and “[i]nstead, in §104 of the Private Securities Litigation Reform Act of 1995 (PSRLA), 109 Stat. 737, [Congress] directed [that] prosecution of aiders and abettors [be carried out] by the SEC” (quoting *Stoneridge*, 552 U.S. at 158)); see also *id.* (observing that “[t]he PSRLA also instituted heightened pleading and loss causation requirements for ‘any private action’ arising from the Securities Exchange Act” (quoting *Stoneridge*, 552 U.S. at 165-66)).

<sup>223</sup> Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

<sup>224</sup> See, e.g., Richard M. Phillips and Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 Bus. Law. 1009, 1009 (1996) (observing that the PSLRA “is the first comprehensive revision of the federal securities laws governing private securities litigation since their enactment as part of the New Deal”); see also *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71, 81 (2006) (noting that, among other things, the provisions of the PSLRA “limit recoverable damages and attorney’s fees, provide a ‘safe harbor’ for forward-looking statements, impose new restrictions on the selection of (and compensation awarded to) lead plaintiffs, mandate imposition of sanctions for frivolous litigation, and authorize a stay of discovery pending resolution of any motion to dismiss. See 15 U.S.C. § 78u-4.”).

widely appreciated as imposing a broad range of procedural constraints on the prosecution of private securities fraud litigation in a manner that reduces the viability of many private claims.<sup>225</sup> Further, when the Supreme Court has interpreted the securities laws in a manner that adversely affects both the Commission’s ability to enforce the securities laws and private parties’ ability to bring private actions, Congress has acted quickly to restore the Commission’s authority but has done nothing to restore private party litigants to the positions held prior to the Supreme Court’s narrowing decision. For example, when the Supreme Court in *Central Bank* eliminated aiding and abetting liability under Section 10(b), Congress acted promptly to restore the Commission’s ability to prosecute aiding and abetting violations, but did nothing to restore the right of private party litigants to bring those claims.<sup>226</sup> Similarly, when the Court in *Morrison* restricted the ability of the SEC and of private litigants to pursue violations of the Exchange Act that were unrelated to transactions occurring in the United States, Congress acted to restore the Commission’s enforcement authority but did nothing to expand the right of private party litigants to pursue claims not based on transactions in the United States.<sup>227</sup> This pattern suggests a Congressional preference for public enforcement by the SEC over private enforcement through Rule 10b-5 actions for money damages is thus apparent.

This preference for Commission enforcement action is also reflected in the Dodd-Frank Act, which provides for the payment of bounties to whistleblowers who provide the Commission with “original information” that leads to the recovery of funds in enforcement proceedings.<sup>228</sup> No

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<sup>225</sup> See, e.g., *Merrill Lynch*, 547 U.S. 71, 81 (2006) (observing that the PSLRA, by seeking “to deter or at least quickly dispose of those suits whose nuisance value outweighs their merits[,] placed special burdens on plaintiffs seeking to bring federal securities fraud class actions”); *Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 162 (2d Cir. 2010) (“The SEC also observes that private plaintiffs who bring securities claims already face significant hurdles—they must prove that the defendants knew the falsity of their statements, and as a result of the Private Securities Litigation Reform Act, must ‘state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.’ 15 U.S.C. § 78u-4(b)(2).”); Elloit J. Weiss and Janet E. Roser, *Enter Yossarian: How to Resolve the Procedural Catch-22 that the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457, 500 (1998) (utilizing a case study to demonstrate that the pleading demands are unduly burdensome on shareholders when they are denied discovery under the PSLRA); see also *Amgen*, 133 S. Ct. at 1200 (“In enacting the Private Securities Litigation Reform Act of 1995 (PSLRA), 109 Stat. 737, Congress recognized that although private securities-fraud litigation furthers important public-policy interests. . . such lawsuits have also been subject to abuse, including the ‘extract[ion]’ of ‘extortionate ‘settlements’ of frivolous claims. H.R. Conf. Rep. No. 104-369, pp. 31-32 (1995),”); noting that the PSLRA’s provisions were intended to curb this abuse); *Tellabs*, 551 U.S. at 313 (noting that “Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA), 109 Stat. 737” “[a]s a check against abusive litigation by private parties”); *Kircher v. Putnam Funds Trust*, 547 U.S. 633, 636 (2006) (noting that the PSLRA “put limits on federal securities class actions”).

<sup>226</sup> Private Securities Reform Litigation Act, Pub. L. No. 104-67, at § 104, 109 Stat. 737 (codified as amended at 15 U.S.C. § 78t(e); see *Stoneridge*, 552 U.S. at 158; *Malack*, 617 F.3d at 158.

<sup>227</sup> *Morrison v. Nat’l Australia Bank Ltd.*, \_\_\_ U.S. \_\_\_, 130 S. Ct. 2869 (2010); Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864-65 (2010) (codified at 15 U.S.C. §§ 77v(a), 78aa (Supp. IV 2010)).

<sup>228</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922(b)(1), 124 Stat. 1376, 1842 (2010) (codified as amended at 15 U.S.C. § 78u-6 (b)(1) (2006 & Supp. V 2011)). For a description of the Dodd Frank bounty provisions in a context relevant to the analysis of the Section 10(b) implied private right of action, see Amanda M. Rose, *Better Bounty Hunting: How the SEC’s New Whistleblower Program Changes the Securities Fraud Class Action Debate 2* (Vanderbilt Public Law Research Paper No. 13-34, 2013), available at SSRN: <http://ssrn.com/abstract=2305403> (suggesting that the Dodd Frank whistleblower bounty provision is the “proverbial nail in the [fraud on the market] class action coffin,” because the bounty program “promises to supplant the deterrence benefits of FOTM class actions, while simultaneously increasing their costs.”).

such inducement is offered to persons who provide information to private plaintiff counsel or to corporate compliance officials.<sup>229</sup> The Fair Funds provision of the Sarbanes Oxley Act of 2002 expands the SEC's ability to distribute its own recoveries in a manner that compensates injured investors, and thus enhances the Commission's ability to act as a substitute for the compensation fruition otherwise served by private securities fraud litigation.<sup>230</sup>

Congress has also added penalty provision to the Securities Act and to the Exchange Act in an effort to expand the Commission's ability to impose fines on violators and thereby enhance deterrence.<sup>231</sup> These penalties are unavailable to private party plaintiffs. Similarly, Congress granted the Commission's authority to impose treble damages in cases of insider trading,<sup>232</sup> but, unlike the treble damages available in private antitrust enforcement,<sup>233</sup> Congress gave no right to recover multiple damages to private parties pursuing private claims for money damages. In addition, Congress has expanded the Commission's authority to seek officer and director bars<sup>234</sup> and to seek monetary penalties through administrative proceedings rather than through civil proceedings in federal court.<sup>235</sup> Again, these rights were not extended to private parties, and the clear trend in subsequent legislative activity is to strengthen the hand of public enforcement through the SEC, and not of private enforcement through Section 10(b).

But beyond these larger trends, it deserves emphasis that the securities laws have been expressly amended through provisions that are fundamentally inconsistent with the logic of the efficient market theory which serves as the basis for the fraud on the market presumption and its

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<sup>229</sup> 15 U.S.C. § 78u-6(a)(6); *Asadi v. G.E. Energy (USA), L.L.C.*, No. 12-20522, 2013 WL 3742492, \*2 (5<sup>th</sup> Cir. July 17, 2013) (holding that “the plain language of the Dodd-Frank whistleblower protection provision creates a private cause of action only for individuals who provide information relating to a violation of the securities law to the SEC”).

<sup>230</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 §308, 116 Stat. 745 (codified at 15 U.S.C. § 7246). Prior to the enactment of Sarbanes-Oxley, “the SEC had endeavored to return profits disgorged by defendants in its enforcement actions to victimized investors. When a defendant paid a penalty, in contrast, the SEC remitted the amount to the Treasury. Sarbanes-Oxley's Fair Funds provision charges the SEC to endeavor to return penalty monies to injured investors, elevating the interests of shareholder victims over those of the public fisc.” William W. Bratton and Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 139 (2011).

<sup>231</sup> See Securities Enforcement Remedies and Penny Stock Reform Act, Public Law 101-429, 104 Stat. 931 (1990) (giving the Commission authority generally to seek civil money penalties in enforcement cases); see also Statement of the Securities and Exchange Commission Concerning Financial Penalties, Release No. 2006-4 (Jan. 4, 2006) (discussing corporate penalties).

<sup>232</sup> Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended at 15 U.S.C. § 78a, 78c, 78o, 78t, 78u, 78ff (Supp. 11 1984)) (under this legislation, the SEC has the authority to seek a maximum penalty of treble damages for insider trading violations).

<sup>233</sup> The Clayton Act, 15 U.S.C. § 15(a) (West, Westlaw through 2013) (“any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States in the district in which the defendant resides or is found or has an agent, without respect to the amount in controversy, and shall recover threefold the damages by him sustained. . .”).

<sup>234</sup> See Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, §§ 101, 201, 104 Stat. 931, 932, 935 (1990) (granting the Commission the express authority to seek officer and director bars); Sarbanes-Oxley Act of 2002, § 305(a)(1), 15 U.S.C. §78u (2002) (amending the director and officer bar statutes by changing the standard for obtaining a bar from “substantial unfitness” to mere “unfitness.”); see also Jon Carlson, *Securities Fraud, Officer & Director Bars, and the Unfitness Inquiry after Sarbanes Oxley*, 14 FORDHAM J. CORP. & FIN. L. 679, 684-87, 693-94 (2009) (discussing the history of officer and director bars in federal legislation)

<sup>235</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P, 124 Stat. 1376 (2010) (granting to the SEC broad authority to impose civil monetary penalties in administrative proceedings).

concomitant rebuttable presumption of reliance. In particular, the PSLRA added a 90-day “lookback” provision that limits the amount of recoverable damages in private actions:

“[I]n any private action arising under this Act in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate ... and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.”<sup>236</sup>

The legislative history explains that “[t]ypically, in an action involving a fraudulent misstatement or omission, the investor’s damages are presumed to be the difference between the price the investor paid for the security and the price of the security on the day the corrective information gets disseminated to the market.... [But] [c]alculating damages based on the date corrective information is disclosed may end up substantially overestimating plaintiff’s damages. The Conference Committee intends to rectify the uncertainty in calculating damages in new section 21D(e) of the 1934 Act by providing a ‘look back’ period, thereby limiting damages to those losses caused by the fraud and not by other market conditions.”<sup>237</sup> This “look-back period simply recognizes that corrective information often engenders over-corrective price declines and that, in assessing the plaintiff’s true losses, time should be allowed for the security to bounce back to a price that more accurately reflects its true value.”<sup>238</sup> The PSLRA’s 90-day lookback provision thus demonstrates a Congressional belief that stock prices can overreact to bad news and that it can take the 90 days for the market to adjust to an equilibrium appropriate for the measure of damages.

Belief in systematic over-reaction and the necessity of a 90-day period for the market to incorporate all relevant information is, however, fundamentally inconsistent with the operation of the efficient market hypothesis upon which the fraud-on-the-market doctrine rests.<sup>239</sup> The fraud on the market theory presumes that stock prices respond quickly and accurately to the release of new information.<sup>240</sup> Evidence of systematic over-reaction to the release of bad news

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<sup>236</sup> 15 U.S.C. § 78u-4(e)(1) (West, Westlaw through 2013).

<sup>237</sup> H. Conf. Rep. No. 104-369 (Nov. 28, 1995) (citing Princeton Venture Research, Inc., PVR Analysis, *Securities Law Class Actions, Damages as a Percent of Market Losses* (1993); Baruch Lev and Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic and Policy Analysis*, 47 STAN. L. REV. 7, 9–11 (1994)).

<sup>238</sup> Phillips & Miller, *The Private Securities Litigation Reform Act of 1995*, *supra* note 224, at 1060.

<sup>239</sup> See, e.g., Werner F. M. De Bondt and Richard Thaler, *Does the Stock Market Overreact?*, 40 J. FIN. 739 (1985) (if stock prices systematically overreact, then price reversals should be predictable from past return data, implying a violation of market efficiency); Narasimhan Jegadeesh and Sheridan Titman, *Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency*, 77 J. FIN. 65 (1993) (if stock prices overreact or underreact to information then profitable trading strategies will exist in violation of market efficiency). Accord Jeffrey L. Oldham, *Taking “Efficient Markets” out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U.L. REV. 995, 1027-28 (2003) (The PSLRA “noticeably rests on Congressional disbelief in the EMH as an accurate description of the current functioning of the marketplace.”); Michael Y. Scudder, *Comment, The Implications of Market-Based Damage Caps in Securities Class Actions*, 92 NW. U.L. REV. 435, 461 (1997) (noting the inconsistency between the PSLRA’s ninety-day ‘look-back’ period and the efficient market theory).

<sup>240</sup> See, e.g., STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD, AND JEFFERY JAFFE, *CORPORATE FINANCE* (2010) 431-435 (information is rapidly incorporated into securities prices and, typically, an investor’s awareness of information does not present a trading opportunity because the market will already have absorbed the information into the market price); Bradford Cornell and James C. Rutten, *Market Efficiency, Crashes and Securities Litigation*, 81 TUL.

would be inconsistent with the EMH because the over-reaction should create a buying opportunity that would be arbitrated away by investors.<sup>241</sup> Further, although the Supreme Court has expressed no view as to the speed with which the markets must adjust to new information to be considered efficient,<sup>242</sup> the lower courts have looked for adjustment speeds far shorter than 90 days,<sup>243</sup> and the academic literature suggests that, in sufficiently large and liquid markets, efficiency can be achieved in a matter of seconds or minutes, and certainly does not require months.<sup>244</sup>

The notion of a market that systematically over-reacts to negative information and that requires ninety days properly to absorb the implications of new information is thus anathema to the concept of semi-strong market efficiency. Therefore, as a purely logical matter, it is difficult to interpret a 90-day look back provision of the PSLRA as anything but a direct repudiation of the logic underlying the efficient market hypothesis, and as refusal to accept the intellectual foundation on which *Basic*'s rebuttable presumption of reliance is built. The 90-day lookback provision of the PSLRA is accordingly inconsistent with any inference that Congress intends to endorse *Basic*'s rebuttable presumption of reliance, and is more consistent with Congressional disapproval of the economic theory on which the rebuttable presumption of reliance rests.

The “contemporaneous trader” provision of the Insider Trading and Securities Fraud Enforcement Act of 1988,<sup>245</sup> codified in Section 20A of the Exchange Act, is also difficult to

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L. REV. 443 (2006) (under the efficient market theory, prices fully, accurately and quickly respond to news in a manner that eliminates the opportunity to profit from the information).

<sup>241</sup> See sources cited in note 240, *supra*. See also Andrew W. Lo and A. Craig MacKinlay, *Data-Snooping Biases in Tests of Financial Asset Pricing Models*, 3 REV. FIN. STUD. 175 (1990) (Stock market overreaction suggests that contrarian portfolio strategies that rely on negative serial correlation should be profitable, in violation of the efficient market hypothesis.).

<sup>242</sup> *Basic v. Levinson*, 485 U.S. 224, 249 n.28 (1988) (“[W]e do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.”).

<sup>243</sup> See, e.g., *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 19 (1<sup>st</sup> Cir. 2005) (in order for a market to be efficient, market price must respond “so quickly to new information that ordinary investors cannot make trading profits on the basis of such information”); *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 635 (3<sup>rd</sup> Cir. 2011) (not requiring that information be absorbed “instantaneously” for a market to be efficient, but allowing a response lag of up to four days).

<sup>244</sup> See, e.g., James M. Patell and Mark A. Wolfson, *The Intraday Speed of Adjustment of Stock Prices to Earnings and Dividends Announcements*, 13 J. FIN. ECON. 223 (1984) (suggesting that markets become efficient in five to fifteen minutes); Jeffrey A. Busse and T. Clifton Green, *Market Efficiency in Real Time*, 65 J. FIN. ECON. 415 (2002) (observing that the speed of market response has changed as market technology has evolved, and that market response is measured in minutes, not days or months (at 416)); Gregory Laughlin, Anthony Aguirre, and Joseph Grundfest, *Information Transmission between Financial Markets in Chicago and New York*, \_\_\_ Fin. Rev. \_\_\_ (forthcoming, 2013) (Rock Center for Corporate Governance at Stanford University Working Paper No. 137), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2227519](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2227519) (special edition on computerized and high frequency trading) (documenting that as of 2012 prices in New York area equities markets respond to changes in Chicago futures equities with a lag in the range of 4-5 milliseconds).

<sup>245</sup> 15 U.S.C. 78t-1(a) (West, Westlaw through 2013) (granting an express right of action to any person who purchases or sells securities against any person who purchases or sells securities of the same class while in possession of material, non-public information). The House Report notes that the purpose of this provision was to reverse the holding in *Moss v. Morgan Stanley*, 719 F.2d 5 (2d. Cir. 1983) which refused to apply the misappropriation doctrine to claims brought by contemporaneous traders. H.R. Rep. 100-910, Insider Trading and Securities Fraud Enforcement Act of 1988 (Sept. 9, 1988) at 38-39. The limitation of liability to the amount of disgorgeable profits followed the recommendation of the Securities and Exchange Commission that liability be “limited to the amount of profit gained or loss avoided by the defendant as a result of the violation” and rejected

reconcile with the current private damages recovery regime under Section 10(b). Under traditional forms of insider trading litigation, plaintiffs argue that inside traders have an obligation to disclose or abstain.<sup>246</sup> Thus, every person who trades while there is a violation of the duty to disclose can assert a cause of action against the inside trader for an out-of-pocket damage award measured by the difference between the price at which the security actually traded and the price at which it would have traded, had proper disclosure been made.<sup>247</sup> Section 20A, however, creates express liability against insider traders in favor only of “contemporaneous traders.”<sup>248</sup> It also limits the defendant’s liability to “the profit gained or loss avoided” by the transaction.<sup>249</sup> The statute is thus fundamentally inconsistent with the dominant out-of-pocket measure of damages as applied to aftermarket Section 10(b) litigation – which would have allowed recovery by all traders during the period when the fraud was alive in the market (*i.e.*, the duty to disclose or abstain was being breached) – and relies instead on a measure capped by disgorgement and coupled with a privity-like requirement that is otherwise absent in the law, where the recovery potentially available to contemporaneous traders is further reduced by any recovery obtained by the Commission under Section 21(d).<sup>250</sup>

## B. The Logic of Acquiescence

The strongest argument in support of *Basic*’s rebuttable presumption of reliance rests on the notion of Congressional acquiescence. Congress has been aware of *Basic*’s holding since 1988, and in the intervening years has done nothing to reverse *Basic*’s application. This inaction stands in sharp contrast to situations in which Congress has acted quickly to reverse, in part, the implications of Supreme Court decisions, with which Congress disagrees.<sup>251</sup> Moreover, the House bill that ultimately became the PSLRA included a provision that would have expressly

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earlier versions of the bill that would have “eliminate[ed] any cap on the defendants’ liability ....” Statement of David S. Ruder, Chairman, United States Securities and Exchange Commission, Before the Subcommittee of Telecommunications and Finance of the House Committee on Energy and Commerce, Concerning Additional Methods to Deter and Prosecute Insider Trading July 11, 1988, at 20. 21. As the SEC noted, the Subcommittee’s original bill, which would have applied an out of pocket measure, “could produce arbitrary and inconsistent results in cases involving roughly equivalent violations.” *Id.* at 21. Indeed, this is only one of the many problems that arise in connection with the application of the out of pocket measure.

<sup>246</sup> See, e.g., *Dirks v. SEC*, 463 U.S. 646, 653 (1983) (discussing “the obligation to disclose or abstain”); *Chiarella v. U.S.*, 445 U.S. 222, 227 (1980) (same).

<sup>247</sup> See, e.g., *Elkind v. Liggett & Meyers*, 472 F.Supp. 123, 129 (1978) (applying a damage measure defined as “the difference between price actually paid by for Liggett stock by each member of the plaintiff classes and the price at which Liggett stock would have sold if the tipped information had been publicly disclosed”), *reversed* 635 F.2d 156, 170 (2d Cir. 1980) (criticizing the “transactional out-of-pocket measure used by the district court in this case” for, among other things, “its potential imposition of Draconian exorbitant damages, out of all proportion to the wrong committed...”); see also Part V.B., *infra*.

<sup>248</sup> 15 U.S.C. § 78t-1(a) (West, Westlaw through 2013). Neither the text nor the legislative history of Section 20A defines what is, and what is not “contemporaneous” trading. Neil V. Shah, *Section 20A and the Struggle for Coherence, Meaning and Fundamental Fairness in the Express Right of Action for Contemporaneous Insider Trading Liability*, 61 RUTGERS L. REV. 791, 813 (2009). Federal courts have tried to define the contours of the contemporaneous requirement, but with disparate results. *Id.* Accordingly, some courts have held that “[f]ive trading days is a reasonable period between the insider’s sale and the plaintiff’s purchase to be considered contemporaneous,” see *In re Oxford Health Plans, Inc.*, Securities Litigation, 187 F.R.D. 133, 144 (S.D.N.Y. 1999), while other courts require same day trading, see *In re Aldus Securities Litigation*, No. C92–885C, 1993 WL 121478.

<sup>249</sup> 15 U.S.C. § 78t-1(b)(1) (West, Westlaw through 2013).

<sup>250</sup> 15 U.S.C. § 78t-1(b)(2) (West, Westlaw through 2013).

<sup>251</sup> See notes 226 and 227, *supra*.

overturned the fraud on the market presumption by imposing an actual knowledge requirement, but that provision was strongly opposed by the Commission and was ultimately rejected. The rejected provision stated:

“Reliance.-In any action arising under Section 10(b) based upon a material misstatement or omission concerning a security, the plaintiff must prove that he or she had actual knowledge of and actually relied on such statement in connection with the purchase or sale of a security and that the misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by plaintiff.”<sup>252</sup>

The decision to reject this language is susceptible of two fundamentally irreconcilable interpretations. On the one hand, it can be viewed as Congressional acquiescence in the current state of affairs, and as tacit approval of the fraud on the market theory and the rebuttable presumption of reliance.<sup>253</sup> On the other hand, it can be viewed as lending “support to the notion that, in passing the PSLRA, Congress was not willing to pass on the fraud-on-the-market theory or the presumability of the reliance requirement. The PSLRA’s silence on the fraud-on-the-market doctrine neither validates nor undermines the existence of the doctrine.”<sup>254</sup> Put another way, the rejection of this proposed language signifies a failure to agree on the imposition of an express actual reliance requirement in the context of the compromises necessary to enact the PSLRA over a presidential veto, rather than an affirmative agreement to reject an actual reliance requirement in any context at all.

Skepticism over the persuasive force of a failed legislative provision is, however, probably the better course. As the Supreme Court has explained, “[i]t does not follow ... that Congress' failure to overturn a statutory precedent is reason for this Court to adhere to it. It is ‘impossible to assert with any degree of assurance that congressional failure to act represents affirmative congressional approval of the [courts'] statutory interpretation.... Congress may legislate, moreover, only through the passage of a bill which is approved by both Houses and signed by the President.’”<sup>255</sup> Indeed, “[a] bill can be proposed for any number of reasons, and it can be rejected for just as many others”<sup>256</sup> and “Congressional inaction lacks persuasive

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<sup>252</sup> Common Sense Legal Reform Act, H.R. 10, 104<sup>th</sup> Cong. § 204 (1995).

<sup>253</sup> See, e.g., cases cited at note 215, *supra*, where the courts treated Congressional inaction as acquiescence in judicial interpretation of statutes.

<sup>254</sup> Oldham, *Taking “Efficient Markets” Out of the Fraud-On-The-Markets Doctrine*, *supra* note 239, at 1025. For a more extensive critique of reasoning based on an acquiescence rationale, see, e.g., Lawrence C. Marshall, *Let Congress Do It: The Case for an Absolute Rule of Statutory Stare Decisis*, 88 MICH. L. REV. 177, 186-196 (1989) (outlining problems with equating Congressional failure to act with acquiescence in judicial interpretation of a statute, specifically that “congressional inaction on a given issue often means merely that some group outbid those who wanted Congress to expend energy overruling a particular judicial decision.”).

<sup>255</sup> See U.S. Const. art. I, § 7 (Congress can legislate only through the passage of a bill which is approved by both Houses and signed by the President). “Congressional inaction cannot amend a duly enacted statute.” *Patterson v. McLean Credit Union*, 491 U.S. 164, 175, n. 1 (1989) (quoting *Johnson v. Transp. Agency, Santa Clara Cty.*, 480 U.S. 616, 672 (1987) (Scalia, J., dissenting)), *superseded by statute on other grounds*, Civil Rights Act of 1991, Pub L. No. 102-166, 105 Stat. 1074.

<sup>256</sup> See *Solid Waste Agency of N. Cook County v. U.S. Army Corps of Eng’rs*, 531 U.S. 159, 170 (2001) (In interpreting the term “navigable waters” as used in § 404(a) of the Clean Water Act, the court held that “respondents have failed to make the necessary showing that the failure of the 1977 House bill [that would have defined ‘navigable waters’ narrowly] demonstrates Congress' acquiescence to the [United States Army Corps of Engineers'] regulations,” which defined “navigable waters” expansively) (quoting *Hagen v. Utah*, 510 U.S. 399, 420 (1994)).

significance because several equally tenable inferences may be drawn from such inaction....<sup>257</sup> Congressional failure to adopt a provision in the PSLRA that would have imposed an actual reliance requirement is thus a thin reed on which to rest an argument of acquiescence, particularly in light of express legislative activity that is inconsistent with the fraud on the market theory.

But perhaps the simplest and strongest reason to be skeptical of arguments based on acquiescence is the frequency with which these arguments fail in practice in the area of securities litigation. The Supreme Court has had little trouble revisiting positions long held by the lower courts under circumstances in which it could be argued that Congress had acquiesced. For example, the Court rejected aiding and abetting liability in *Central Bank*<sup>258</sup> and repudiated the conduct and effects tests in *Morrison*.<sup>259</sup> In both instances, the Court rejected doctrines that had decades' worth of support among the lower courts, and as to which it could easily have been argued that Congress had acquiesced in the lower courts' interpretation. It follows that if an acquiescence rationale failed to preserve long-standing lower court interpretations of the federal securities laws in those two instances, then the acquiescence rationale will likely also fail in a situation where the statutory text and legislative history argue even more strongly against the implication of a rebuttable presumption of reliance.

## V. The Current Approach to Section 10(b) Reliance and Damages

Lower courts currently allow for the recovery of out-of-pocket damages based on a rebuttable presumption of reliance that is, as a practical matter, irrebuttable in the vast majority of instances. This practice is inconsistent with a textualist approach to Section 10(b), and the persistence of this lower court recovery rule is readily explained as a matter of history. The Supreme Court has yet to rule on the question of aftermarket damages under Section 10(b), and has only recently called for reconsideration of *Basic*.<sup>260</sup> Because *Basic* clearly permits a rebuttable presumption of reliance, and because the Circuit Courts' approach to damages was well-established prior to the Court's clear to a textualist approach to the interpretation of Section 10(b), the district courts are simply following established Supreme Court and circuit court precedent when they allow out-of-pocket recoveries without prior showings of actual reliance. The tension between a textualist interpretation and current lower court practice is likely to be resolved, if at all, by a Supreme Court ruling that directly addresses the question of damages and reliance under Section 10(b). The invitation by four justices in *Amgen* to reconsider *Basic*'s presumption of reliance suggests that the wait for this resolution might not be long.

### A. Reliance: Is the Presumption Rebuttable?

The Supreme Court emphasizes the significance of reliance in private actions under Section 10(b). "Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action. It ensures that, for liability to arise, the 'requisite

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<sup>257</sup> Pension Benefit Guar. Corp. v. LTV Corp., 496 U.S. 633, 650 (1990) (internal quotation marks omitted).

<sup>258</sup> *Central Bank*, 511 U.S. at 191 ("hold[ing] that a private plaintiff may not maintain an aiding and abetting suit under § 10(b).").

<sup>259</sup> *Morrison*, 130 S. Ct. at 2884 (rejecting the conduct and effects tests and holding that Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities").

<sup>260</sup> See *supra* note 40.



causal connection between a defendant's misrepresentation and a plaintiff's injury' exists as a predicate for liability."<sup>261</sup> As the court itself recently explained, "[t]he traditional (and most direct) way' for a plaintiff to demonstrate reliance 'is by showing that he was aware of a company's statement and engaged in a relevant transaction ... based on that specific misrepresentation.' ... Accordingly, in *Basic* the Court endorsed the 'fraud-on-the-market' theory, which permits certain Rule 10b-5 plaintiffs to invoke a rebuttable presumption of reliance on material misrepresentations aired to the general public."<sup>262</sup>

The Court has emphasized that "[t]he presumption of reliance is just that – a presumption. It is rebuttable."<sup>263</sup> Consistent with this view, *Basic*<sup>264</sup> rejected the notion of an irrebuttable presumption that had previously been advocated by some lower court decisions,<sup>265</sup> and provided three specific examples of how the presumption might be rebutted.<sup>266</sup>

The reality of the matter, however, is that the presumption is rebuttable in theory far more than in fact.<sup>267</sup> "Apart from the 'truth on the market' defense, which refutes the materiality of the misleading disclosure by showing that other information in the marketplace ameliorated its effect,"<sup>268</sup> and thereby prevents the presumption from attaching in the first instance because the

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<sup>261</sup> *Stoneridge*, 552 U.S. at 159 (citing *Basic*, 485 U.S. at 243); *Affiliated Ute*, 406 U.S. at 154 (requiring "causation in fact" under Section 10(b)); see also *Amgen*, 133 S.Ct., at 1192-1193 (quoting *Halliburton*, 131 S.Ct. at 2184); see also *Matrixx*, 563 U.S. at 1317 (outlining the elements of a 10(b) cause of action (citing *Stoneridge*, 552 U.S. at 157)).

<sup>262</sup> *Amgen*, 133 S. Ct. at 1192 (citing *Basic*, 485 U.S. at 241-246); but c.f. Langevoort, *Basic at Twenty*, *supra* note 262, at 198 (observing that in a "better world," reliance would not be "a significant element of the [10b-5] cause of action.").

<sup>263</sup> *Amgen*, 133 S. Ct. at 1192; *Halliburton*, 131 S. Ct. at 2185.

<sup>264</sup> *Basic*, 485 U.S. at 250 ("that presumption, however, is rebuttable").

<sup>265</sup> See, e.g., *Panzirer v. Wolf*, 663 F.2d 365, 368 (2d. Cir. 1981).

<sup>266</sup> *Basic*, 485 U.S. at 248-249.

<sup>267</sup> See, e.g., Roger A. Cooper, Matthew M. Bunda, & Anthony M. Shults, *Rebutting the Presumption of Reliance in Securities Class Actions*, N.Y.L.J., June 10, 2013 (noting that "defendants have had little luck in rebutting the presumption" of reliance in section 10(b) actions); Patrick Hall, *The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit's Interpretation of Materiality In Employer-Teamster v. America West*, 2004 B.Y.U. L. REV. 863, 870-71 & n.46 (2004) ("Despite the Court's insistence that the presumption of investor reliance can be rebutted, practical experience suggests that defendants have faced a nearly impossible task in rebutting a presumption of reliance."; aside from a few "rare" exceptions, "corporate defendants have rarely prevailed in rebutting a presumption of reliance"); Oldham, *Taking "Efficient Market" Out of the Fraud-On-The-Markets Doctrine*, *supra* note 239, at 1013; Andrew R. Simmonds et al., *Dealing with Anomalies, Confusion and Contradiction in Fraud on the Market Securities Class Actions*, 81 KY. L.J. 123, 136 (1993) (noting that although there is a right to rebut the presumption of reliance in fraud-on-the-market cases, making such a showing "will be virtually impossible to make"); Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2077 (1995) (noting that the available options to rebut the presumption "represent null, or close to null, sets"); *GAMCO Investors, Inc. v. Vivendi, S.A.*, Nos. 03 Civ. 5911(SAS), 09 Civ. 7962(SAS), 2013 WL 765122, at \*8 (S.D.N.Y. Feb. 28, 2013) ("given the force of the [fraud on the market] presumption (carrying a burden of proving a purchase would have been made even if the truth were known) [,]' attempts to rebut the presumption 'would likely be futile in the vast number of cases.' *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D.Tex.1980). In part, this is because '[t]he finding of materiality by its very nature establishes that the information omitted would have been considered important by investors generally. It thus will be only the unusual case in which compatible findings of materiality and nonreliance can be made.' *duPont v. Brady*, 828 F.2d 75, 78 (2d Cir.1987).").

<sup>268</sup> Barbara Black, *Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets*, 44 LOY. U. CHI. L.J. 1493, 1498 (2013).

market is not materially misled,<sup>269</sup> “it is not clear how the fraud on the market presumption can be rebutted.”<sup>270</sup> Evidence that the market for a security is inefficient prevents the presumption from attaching and does not constitute rebuttal of the presumption. The courts are also split as to whether short sellers can ever take advantage of the presumption.<sup>271</sup> Cases refusing to apply the presumption for the benefit of short sellers in jurisdictions that refuse to recognize the presumption in the first instance, are therefore also not examples of successful rebuttal because the presumption never attaches.

Cases in which the presumption has been rebutted once it attaches are thus as rare as hen’s teeth, and there appear to be only five instances in which lower courts have held that plaintiffs have successfully rebutted the presumption.<sup>272</sup> Although this count can be criticized as

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<sup>269</sup> This operation of the “truth on the market” defense illustrates an inconsistency in *Basic*’s logic. *Basic* explains that “an investor’s reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action.” 485 U.S., at 247. Materiality is thus a precondition for the existence of the presumption, even if it need not be proved at the class certification stage. See *Amgen*, 133 S.Ct. at 1202. However, in its discussion of techniques for rebutting the presumption, the *Basic* court’s examples of market makers being “privy to the truth,” or of the truth “credibly” entering the market, are examples of materiality being rebutted, and of the presumption therefore not attaching, rather than examples of the presumption being rebutted after it attaches. For example, In *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1116 (9<sup>th</sup> Cir. 1989) the Ninth Circuit described the presumption as having been rebutted because of a showing that “corrective statements” had “credibly entered” the market. This fact pattern is, however, perhaps better interpreted as a situation in which the truth entered the market and the market “could not have been made more aware” of the risks of defendants’ strategy. *Id.* Thus, there was no initial material misrepresentation, given the “total mix” of information, available in the market, *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), and the presumption arguably should never have attached.

<sup>270</sup> Black, *supra*, note 268, at 1498.

<sup>271</sup> See, e.g., Douglas A. Smith, *Fraud on the Market: Short Sellers’ Reliance on Market Price Integrity*, 47 WM. & MARY L. REV. 1003, 1006 and note 140 (2005) (“a substantial split exists among federal district courts regarding whether a short seller’s belief in overvaluation prevents the short seller from benefiting from the . . . presumption of reliance”) (also collecting examples of cases holding that short sellers can benefit from the presumption and cases holding that short sellers cannot benefit from the presumption); Samuel Francis, *Meet Two-Face: The Dualistic Rule 10b-5 and the Quandary of Offsetting Losses by Gains*, 77 FORDHAM L. REV. 3045, 3054-3055 (2009) (federal courts have “differed on whether a short seller’s belief in overvaluation prevents the short seller from benefiting from the . . . presumption of reliance”).

<sup>272</sup> These cases were identified through online searches, a review of precedents cited in the *Vivendi* litigation (see below) where defendants had strong incentives to identify all prior examples of successful rebuttal, and a review of all cases cited in the articles listed in note 267, *supra*. In *Gamco Investors, Inc. v. Vivendi, S.A.*, Nos. 03 Civ. 5911, 09 Civ. 7962, 2013 WL 765122, \*8-9 (S.D.N.Y. Feb. 13, 2013), the court concluded that defendants had rebutted the presumption by showing that the plaintiffs, who relied on an investment manager’s private market valuation that was independent of market price, had actually doubled or tripled their holdings in Vivendi stock after the fraud had been fully disclosed. The court stated, “[a] successful rebuttal of this sort will be exceedingly rare.” *Id.* at \*11. In *Stark Trading v. Falconbridge Ltd.*, 552 F.3d 568, 573 (7<sup>th</sup> Cir. 2009), the court held that sophisticated minority shareholders who tendered their shares in a merger, despite their knowledge of the fraud perpetrated by the majority shareholder, were not able to prove reliance. In *In re Safeguard Scientifics*, 216 F.R.D. 577, 582 (E.D. Pa. 2003), the court found “compelling reason to rebut the reliance presumption,” with respect to the lead plaintiff, a day trader who increased his holdings in the company’s stock after disclosure of the alleged fraud. In *Jones v. Intelli-Check, Inc.*, 274 F. Supp. 2d 615, 633 (D.N.J. 2003), the court concluded that the plaintiffs did not reasonably rely on defendant’s statements that its accounting was proper where the plaintiffs began to short sell defendant’s stock precisely because they perceived the accounting methods as misleading. Similarly, in *Moelis v. ICH Corp.*, No. 85 Civ. 6941, 1987 WL 9709, \*4 (S.D.N.Y. Apr. 16, 1987), the court held that the plaintiff, who engaged in a short sale of defendant’s stock motivated by his belief that defendant’s accounting techniques were misleading, could not prove reliance on the inflated financial statements.

over-inclusive<sup>273</sup> or under-inclusive,<sup>274</sup> even if it is low by an order of magnitude, successful rebuttals remain exceptionally rare. The Supreme Court has never cited to any instance in which any court has allowed the presumption to be rebutted once its preconditions have been satisfied. Justice White’s concern that “rebuttal is virtually impossible in all but the most extraordinary case”<sup>275</sup> seems to have been borne out by decades of experience, and even when a successful rebuttal occurs, courts warn that their findings are “sharply limited” to “unusual facts.”<sup>276</sup>

The *de facto* irrebuttable nature of the nominally rebuttable presumption of reliance also highlights a more fundamental internal contradiction in logic that is central to both *Basic* and *Amgen*. Both decisions emphasize that the presumption was adopted to facilitate class action litigation because, absent a presumption, a class would not be certifiable.<sup>277</sup> However, in the context of class action litigation, the test of whether the presumption is rebutted is applied only as against the representative plaintiff.<sup>278</sup> If the presumption is successfully rebutted against one representative plaintiff, then counsel can always substitute another class member against whom the presumption will not be rebutted, provided that the submission is timely.<sup>279</sup> Successful rebuttal of the presumption as against a proposed class representative thus constitutes a challenge to a plaintiff’s typicality for class certification purposes more than a challenge to the certifiability

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<sup>273</sup> In *Stark*, 552 F.3d 568, the plaintiffs’ knowledge of the fraud can be reframed as suggesting that they were never subject to a material misrepresentation. In *Safeguard*, 216 F.R.D. 577, as discussed in greater detail below, the plaintiff counsel could, had it acted on a more timely basis, have presented an adequate class representative and would therefore have avoided rebuttal as to the class. *Jones*, 274 F.Supp.2d 615 and *Moelis*, 1987 WL 9709 are both short seller cases, and the arguments presented against ever granting short-sellers a rebuttable presumption of reliance in the first instance could also be presented in these cases. In any event, in order to be conservative in this article’s estimate, all five cases are included in the count.

<sup>274</sup> Searching for examples of successful rebuttal is not easy. To address the possibility that there are additional examples not included in this count, I will be conducting a survey of plaintiff and defense counsel experienced in the field of securities fraud litigation inquiring as to additional examples of successful rebuttal.

<sup>275</sup> *Basic*, 485 U.S. at 256 & n. 7 (White, J., joined by O’Connor, J., concurring in part and dissenting in part).

<sup>276</sup> *Vivendi*, 2013 WL 765122, at \*9.

<sup>277</sup> See *Amgen*, 133 S.Ct. at 1192 (“requiring proof of direct reliance ‘would place an unnecessarily unrealistic evidentiary burden on [a] plaintiff who has traded on an impersonal market.’” (quoting *Basic*, 485 U.S. at 245)); *Basic*, 485 U.S. at 242 (“Requiring 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.”).

<sup>278</sup> See, e.g., *In re Safeguard Scientifics*, 216 F.R.D. 577, 582 (E.D. Pa. 2003) (the court found “compelling reason to rebut the reliance presumption,” with respect to the lead plaintiffs, and held as a result that lead plaintiffs’ claims were not typical and that lead plaintiffs were not adequate representatives; “Since no proffered class representative has satisfied Rule 23(a), we need not address the Rule 23(b)(3) requirements.”); see also *In re Pfizer Inc. Sec. Litig.*, 282 F.R.D. 38, 45-46 (S.D.N.Y. 2012) (defendants “argue that [the class representative] fails to satisfy the typicality requirement because it is subject to unique defenses.”); *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 281 (S.D.N.Y. 2003) (“The SSB Defendants contend that the claims of all of the named plaintiffs are atypical and subject to unique defenses because they did not rely, and cannot be presumed to have relied, on the market price for WorldCom securities.”); *Saddle Rock Partners v. Hiatt*, No. 96CIV.9474, 2000 WL 1182793, at \*5 (S.D.N.Y. Aug. 21, 2000) (“[E]ven a successful defense rebutting reliance [as to the class representatives] would still leave intact the basic issues of defendants’ liability for the alleged fraud. Since these are common to all class members and central to plaintiff’s claim, certification is warranted.”).

<sup>279</sup> Subsequent to the successful rebuttal of the presumption against the day-trader representative plaintiff in *Safeguard*, plaintiff counsel sought to substitute new lead plaintiffs, but the motion was denied as untimely. Had plaintiff counsel simply expanded the number of named plaintiffs, or moved more promptly to substitute new representative plaintiffs, *Safeguard* would have been an example of this phenomenon. See *Safeguard*, No. 01-CV-3208, slip. op. at 2 (E.D. Pa. Feb. 18, 2004).

of the class as a whole. Thus, as difficult as rebuttal might be in the context of individual claims, the very structure of the class action litigation process makes rebuttal essentially impossible unless plaintiff counsel fails to timely confront the challenge. The Court's insistence that the presumption be rebuttable in the class action context is thus a practical contradiction in terms: if the presumption is designed to promote class action litigation it cannot be meaningfully rebuttable and if it is to be meaningfully rebuttable then it cannot effectively promote class action litigation. The Court is trying to have it both ways when it can't.

The essentially irrebuttable nature of the presumption of reliance would thus fuel Justice White's fears that "a non-rebuttable presumption of reliance ... would effectively convert Rule 10b-5 into a scheme of investor insurance [and] [t]here is no support in the Securities Exchange Act, the Rule, or our cases for such a result."<sup>280</sup> Justice White suggested that "any extension of these laws, to approach something closer to an investor insurance scheme, should come from Congress, and not from the Courts."<sup>281</sup> This request for Congressional guidance is precisely the result that would follow from a textualist approach to the interpretation of Rule 10(b) that would impose an actual reliance requirement.<sup>282</sup>

The *de facto* irrebuttable nature of the presumption of reliance thus raises independent grounds for a challenge to *Basic*. If the plurality in *Basic* would have rejected a *de facto* irrebuttable presumption – and it is clear from the language of the opinion itself that the rebuttable nature of the presumption was critical to the Court's decision<sup>283</sup> – then it is far from clear that *Basic*'s plurality would today support its own decision given the information now available about the operation of the presumption in practice. A decision to reverse *Basic* could thus be framed as being consistent with *Basic*'s intent in light of subsequently gained information. To be sure, this logic does not suggest that the *Basic* plurality would have supported an actual reliance requirement – there is no evidence at all to support that position – but it does suggest that the plurality could not, as a practical matter, today make the same decision on the same grounds.<sup>284</sup>

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<sup>280</sup> *Basic*, 485 U.S. at 252 (White, J. dissenting) (citing *Shores v. Sklar*, 647 F.2d 462, 469 n.5 (5<sup>th</sup> Cir. 1981) (*en banc*), cert. denied, 459 U.S. 1102 (1983)).

<sup>281</sup> *Basic*, 485 U.S. at 256-257 (White, J. dissenting).

<sup>282</sup> See Part VII.B., *infra*.

<sup>283</sup> *Basic*, 485 U.S. at 242 (considering "whether it was proper for the courts below to apply a rebuttable presumption of reliance, supported in part by the fraud-on-the-market theory"); *id.* at 245 (noting that "the courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded *Basic* shares had done so in reliance on the integrity of the price set by the market"); *id.* at 248-49 ("Any 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," and providing three examples of how the presumption may be rebutted); *id.* at 250 (holding that "5. It is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory. 6. That presumption, however, is rebuttable.").

<sup>284</sup> Some commentators suggest that the Court would have been better served by eliminating the reliance requirement altogether from open market actions under Section 10(b). See, e.g., Langevoort, *Basic at Twenty*, *supra* note 262, at 198 (observing that in a "better world," reliance would not be "a significant element of the [10b-5] cause of action."). Even if this observation is analytically correct, the Court clearly rejected that approach in *Basic*, 485 U.S. at 241-47, 250, and in many subsequent decisions, see, e.g., *Amgen*, 133 S. Ct. at 1192 (endorsing the fraud on the market theory); *Stoneridge*, 552 U.S. at 159 ("We have found a rebuttable presumption of reliance in two different circumstances."); *Dura*, 544 U.S. at 341-42 (citing to *Basic* as "nonconclusively presuming that the price

## B. Damages

Although the Supreme Court has opined on many aspects of the implied Section 10(b) private right,<sup>285</sup> it has never addressed the proper measure of damages in Section 10(b) class action litigation alleging aftermarket fraud, and it expressly reserved its views on this question in *Basic*.<sup>286</sup> This decision to keep a clean slate on the question of aftermarket damages is particularly significant because the two Supreme Court cases most often cited as relevant to the definition of Section 10(b) aftermarket damages, *Affiliated Ute*<sup>287</sup> and *Randall v. Loftsgaarden*,<sup>288</sup> were both decided prior to *Basic*, thereby supporting the inference that the *Basic* plurality did not believe that these two precedents resolved the question of aftermarket damages in class action securities fraud litigation.

In *Ute*, the court allowed recovery under Section 10(b) in the amount of the difference “between the fair value” of all that the plaintiff received and the “fair value of what he would have received had there been no fraudulent conduct.”<sup>289</sup> But *Ute* is not an aftermarket trading case. Plaintiffs were defrauded in transactions involving bank employees who breached duties owed directly to those plaintiffs to inform them of higher prices that were available in other private market transactions.<sup>290</sup> The plaintiff-sellers were thus not innocent bystanders who transacted at a price that was, unbeknownst to them, affected by a fraud perpetrated by a stranger. Instead, the unfaithful bank employees either transacted directly with plaintiffs or received payments from third parties who transacted with plaintiffs at off-market prices that were available only because the bank employees had failed to disclose pricing information to the plaintiffs. In contrast, in a typical aftermarket fraud case, innocent purchasers transact with innocent sellers at prices that are affected by a third party’s fraudulent misrepresentation or omission that affects the entire market. *Ute* is therefore far more analogous to a direct fraud in which the party responsible for the misrepresentation or omission is in direct privity with the victim, and does not address the proper measure of damages in aftermarket Section 10(b) actions.

In *Randall*, plaintiff purchasers of a tax shelter vehicle brought suit against a promoter,<sup>291</sup> and the question presented to the Court was whether the measure of rescissory damages “must be reduced by any tax benefits the investor has received from the tax shelter investment.”<sup>292</sup> The Court decided that the rescissory measure need not be reduced by the tax benefit.<sup>293</sup> Here too, the fact pattern is easily distinguished in the typical aftermarket class action securities fraud litigation in which the measure of recovery is not rescission. Indeed, *Randall* is clearly not an aftermarket trading case because defendant and plaintiff are in privity.

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of a publicly traded share reflects a material misrepresentation and that plaintiffs have relied upon that misrepresentation as long as they would not have bought the share in its absence”).

<sup>285</sup> See, e.g., cases cited in note 79, *supra*.

<sup>286</sup> *Basic*, 485 U.S. at 248 n.28.

<sup>287</sup> *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972)

<sup>288</sup> *Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

<sup>289</sup> *Affiliated Ute*, 406 U.S. at 155.

<sup>290</sup> *Affiliated Ute*, 406 U.S., at 152.

<sup>291</sup> *Id.* at 650.

<sup>292</sup> *Id.* at 649.

<sup>293</sup> *Id.* at 667.

In the absence of Supreme Court guidance, the lower courts are left to their own devices in determining the appropriate measure of recovery. The dominant view among the lower courts is that an out-of-pocket recovery measure that follows *Ute*'s difference between the fair value of what plaintiff received and the "fair value of what he would have received had there been no fraudulent conduct"<sup>294</sup> is appropriate in class action aftermarket securities fraud actions, although other damage measures can also be applied in other circumstances.<sup>295</sup>

The technology for calculating aftermarket out-of-pocket losses is complex, and typically involves the testimony of battling financial experts who estimate the price at which the security at issue would have traded "but for" the alleged fraud and the intervention of a range of price-influencing factors unrelated to the alleged fraud.<sup>296</sup> Again, this entire technology governing a multi-billion dollar litigation market, in which subtle differences in econometric technique can have significant impact on plaintiff recoveries and defendant exposures, has evolved without any Supreme Court oversight.

The evolution of the lower court's approach to the calculation of damages can be traced through the decisions of the Courts of Appeal. The earliest rulings approving the out-of-pocket approach in aftermarket class action securities fraud litigation appeared in the 1960's.<sup>297</sup> By 1974, every circuit that has considered the question (eleven of the thirteen circuits) had ruled on the matter.<sup>298</sup> In contrast, the Supreme Court decisions suggesting that the elements of Section

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<sup>294</sup> *Affiliated Ute*, 406 U.S. at 155; THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.12 [2] (2013) and cases cited therein ("In Rule 10b-5 cases most courts have rejected a benefit-of-the-bargain measure of damages in lieu of an out-of-pocket measure, in large part because in most instances proof of benefit-of-the-bargain damages is speculative."); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1436-37 (9<sup>th</sup> Cir. 1987) (applying out-of-pocket measure of damages), *superseded by statute on other grounds as stated in* *Hockey v. Medhekar*, 30 F.Supp.2d 1209 (N.D. Cal. 1998); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 (8<sup>th</sup> Cir. 1986) (the proper measure of damages is the difference between the transaction price and the actual value on the date of the transaction), *cert. denied*, 479 U.S. 823 (1986); *Blackie v. Barrack*, 524 F.2d 891, 909 (9<sup>th</sup> Cir. 1975) ("While out of pocket loss is the ordinary standard in a 10b-5 suit, it is within the discretion of the district judge in appropriate circumstances to apply a rescissory measure."), *cert. denied*, 429 U.S. 816 (1976); *Hackbart v. Holmes*, 675 F.2d 1114, 1121 (10<sup>th</sup> Cir. 1982) ("The customary measure of damages in a Rule 10b-5 case is the out-of-pocket loss.").

<sup>295</sup> Other damage recoveries include rescission, benefit of the bargain, lost profits, and disgorgement. *See, e.g.*, THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION § 12.12 [2] (2013) and cases cited therein.

<sup>296</sup> For a discussion of some of the complexities that arise, *see, e.g.*, *In re Williams Sec. Litig.*, 496 F. Supp.2d 1195, 1260-61 (N.D. Okla. 2007) (addressing the difference between the constant percentage and constant dollar methodologies of calculating out-of-pocket loss); Nicholas I. Crew, Patrick G. Goshtigian, Marnie A. Moore, & Atulya Sarin, *Securities Act Violations: Estimation of Damages*, in ROMAN L. WEIL, MICHAEL J. WAGNER, AND PETER B. FRANK, LITIGATION SERVICES HANDBOOK: THE ROLE OF THE FINANCIAL EXPERT Ch.17 (3<sup>rd</sup> ed. 2001); Jeff G. Hammel & B. John Casey, *Sizing Securities Fraud Damages: 'Constant Percentage' on Way Out?*, 241 N.Y.L.J. 13, Jan. 21, 2009, at 5; Daniel; P. Lefler & Allan W. Kleidon, *Just How Much Damage Did Those Misrepresentations Actually Cause and To Whom? Damages Measurement in "Fraud on the Market" Securities Class Actions*, 1505 PLI-Corp. 285 (2005); Jon Koslow, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 FORDHAM L. REV. 811 (1991); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883 (1990).

<sup>297</sup> *See, e.g.*, *Sackett v. Beaman*, 399 F.2d 884, 891 (9<sup>th</sup> Cir. 1968); *Myzel v. Fields*, 386 F.2d 718, 745, 748-49 (8<sup>th</sup> Cir. 1967); *Janigan v. Taylor*, 344 F.2d 781, 786-87 (1<sup>st</sup> Cir. 1965); *Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10<sup>th</sup> Cir. 1962).

<sup>298</sup> *See Arber v. Essex Wire Corp.*, 490 F.2d 414, 422 (6<sup>th</sup> Cir. 1974) (The "traditional measure of damages at law" "would be the difference between what was received by appellants and the fair market value of the shares of stock at the time of the sale."); *Occidental Life Ins. Co. of North Carolina v. Pat Ryan & Assocs, Inc.*, 496 F.2d 1255, 1264-

10(b) should be inferred through reference to the express private rights of action that existed at the time of Section 10(b)'s adoption, did not issue until 1991<sup>299</sup> and were not firmly established until 1994.<sup>300</sup>

The dominant theories supporting these ruling were that the Supreme Court had blessed the out-of-pocket measure in *Ute*<sup>301</sup> and that the out-of-pocket measure was consistent with

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65 (4<sup>th</sup> Cir. 1974) (“The standard for damages applicable to Associates' counterclaim is the difference in the real value of Virginia Surety and the price paid.”); *Wolf v. Frank*, 477 F.2d 467, 478 (5th Cir. 1973), *cert. denied*, 414 U.S. 975 (1973) (“ ‘In an appropriate situation, e. g., if the securities are not worthless, a buyer can keep them and recover damages for the difference between the price paid and the real value when bought. This is an out of pocket rule not covering expected speculative profit.’” (quoting 2 A. Bromberg, *Securities Law: Fraud*, § 9.1, p. 226, at nn. 2-4 (emphasis removed) (1971))); *Swanson v. American Consumers Industries, Inc.*, 475 F.2d 516, 521 (7<sup>th</sup> Cir. 1973) (noting that in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), “plaintiff sellers who were defrauded. . . were entitled to damages measured by the difference between the fair value of what they received and the fair value of what they would have received had there been no fraudulent conduct,” and awarding to plaintiffs the fair market value of the stock they received during a reorganization); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 411-12, 417 (3d Cir. 1973) (“the clear intent of the [*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)] rule of damages, read in its entirety and in light of *Janigan [v. Taylor]*, 344 F.2d 781 (1<sup>st</sup> Cir. 1965)], is to give a defrauded seller the benefit of whichever measure of damages provides the greater recovery: either the difference between the sale price of the stock in the fraudulent transaction and its fair market value at that time or the amount of the fraudulent buyer's profit on resale.”); *Wolf v. Frank*, 477 F.2d 467, 478 (5th Cir. 1973), *cert. denied*, 414 U.S. 975 (1973) (finding out-of-pocket rule to be the appropriate measure of damages); *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971) (in 10b-5 actions, “a defrauded buyer of securities is entitled to recover only the excess of what he paid over the value of what he got”); *Sackett*, 399 F.2d at 891 (noting that plaintiff “could have commenced an action under one or both of these acts [section 17 of the Securities Act or section 10 of the Exchange Act] for damages under what may be called an out-of-pocket rule, namely, the difference between the real value of the property purchased at the date of its sale. . . and the price paid for it, together with interest and associated outlays by the purchase.”); *Myzel*, 386 F.2d at 745, 748-49 (noting that section 28(a) of the Exchange Act permits recovery of either out-of-pocket damages or disgorgement); *Janigan*, 344 F.2d at 786-87 (in the case of a defrauded buyer, “the damages are to be reckoned solely by the difference between the real value of the property at the date of its sale to the plaintiffs and the price paid for it, with interest from that date, and, in addition, such outlays as were legitimately attributable to the defendant's conduct, but not damages covering the expected fruits of an unrealized speculation.”) (internal quotation marks omitted); *Estate Counseling Service*, 303 F.2d at 533 (“ ‘Actual damages,’ under the Federal rule of damages for fraud is the ‘out of pocket rule.’”).

<sup>299</sup> See *Lampf*, 501 U.S. 359 (“We can imagine no clearer indication of how Congress would have balanced the policy considerations implicit in any limitations provision than the balance struck by the same Congress in limiting similar and related protections.”).

<sup>300</sup> *Central Bank*, 511 U.S. at 178 (“When the text of § 10(b) does not resolve a particular issue, we attempt to infer ‘how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.’” (quoting *Musick, Peeler*, 508 U.S. at 294)).

<sup>301</sup> See, e.g., *Strategic Diversity, Inc. v. Alchemix Corp.*, 666 F.3d 1197, 1208-09 (9<sup>th</sup> Cir. 2012) (“The generally employed ‘out-of-pocket’ or ‘market’ measure is the difference between the fair value of what was received and the fair value of what one would have received had there been no fraudulent conduct. *Affiliated Ute Citizens*, 406 U.S. at 155, 92 S.Ct. 1456.”); *Acticon AG v. China N. E. Petroleum Holdings Ltd.*, 692 F.3d 34, 38-39 (2d Cir. 2012) (noting that “[t]he Supreme Court adopted the out-of-pocket measure of damages in *Affiliated Ute Citizens v. United States*”); *DCD Programs, Ltd. v. Leighton*, 90 F.3d 1442, 1446-47 (9<sup>th</sup> Cir. 1996) (noting “that *Affiliated Ute*'s tort-based “out-of-pocket” measure is generally the appropriate measure of damages to be applied in cases arising under sections 10(b) and 28(a).”); *Woods v. Barrett Bank of Ft. Lauderdale*, 765 F.2d 1004, 1013 (11<sup>th</sup> Cir. 1985) (“The appropriate method of computing damages in most Rule 10b-5 actions is the out-of-pocket rule. (citing *Affiliated Ute*, 406 U.S. at 155)); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190 (3d Cir. 1981) (“The Supreme Court addressed the measure of damages in rule 10b-5 actions in *Affiliated Ute*, concluding that ‘the correct measure of damages under s 28 of the Act, 15 U.S.C. s 78bb(a), is the difference between the fair value of all that the seller received and the fair value of what he would have received had there been no fraudulent conduct ’ 406 U.S. at 155,

Section 28(a)'s stricture that "no person permitted to maintain a suit for damages under the provisions of this title shall recover . . . a total amount in excess of the actual damages to that person on account of the act complained of."<sup>302</sup>

Both rationales in support of the out-of-pocket rule are, however, contestable in their own right. As previously explained, *Ute*, is easily distinguished because it is not a true aftermarket trading case.<sup>303</sup> Moreover, the Supreme Court in *Basic*, clearly reserved its view as to the proper measure of damages in aftermarket trading cases.<sup>304</sup> Circuit courts that relied on *Ute* as support for an aftermarket out-of-pocket recovery rule thus stretched the precedent to reach beyond its facts. Further, Section 28(a) is generally interpreted as a limitation on the permissible amount of recovery under the Exchange Act, and as a prohibition on the award of punitive damages.<sup>305</sup> It is not generally construed as an enabling rule or formula for calculating damages under any provision of the securities laws. Section 28(a)'s limitation of awards as to "actual damages" also raises the apparently unlitigated question of whether damages under Section 10(b) that do not result from actual reliance, as that term is used in Section 18(a), can possibly satisfy Section 28(a)'s limitation as to "actual damages." If actual reliance under Section 18(a) is a precondition to "actual damages" under Section 28(a) in a Section 10(b) action, then Section 28(a) constitutes a further, independent basis for the conclusion that an affirmative showing of actual "eyeball" reliance is a precondition to the recovery of damages under the Section 10(b) implied private right of action.

## VI. Policy Perspectives

The Supreme Court's approach to public policy argumentation in the context of Section 10(b) exegesis is, on the surface, inconsistent. The Court insists that public policy considerations

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92 S.Ct. at 1473 (citations omitted)."), *disagreed with on other grounds by In re Network Equip. Techs., Inc., Litig.*, 762 F.Supp. 1359 (N.D.Cal. 1991).

<sup>302</sup> See Section 28, 15 U.S.C. § 78bb(a) (West Westlaw through 2013) ("No person permitted to maintain a suit for damages under the provisions of this chapter shall recover. . . a total amount in excess of the actual damages to that person on account of the act complained of."); see also *DCD Programs*, 90 F.3d at 1446-47 ("In analyzing the appellants' damages claims [under section 10(b)], we necessarily begin with Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a)."); *McMahan & Co. v. Warehouse Entm't, Inc.*, 65 F.3d 1044, 1049-50 (2d Cir.1995) (citing Section 28 and noting that it "does not prescribe a particular method of calculating damages"); *Anixter v. Home-Stake Production Co.*, 977 F.2d 1549, 1553 (10<sup>th</sup> Cir. 1992) ("the more typical remedy generally limits the plaintiff's recovery to out-of-pocket losses or actual damages. § 28(a) of the Securities Exchange Act of 1934. . ."); *Pelletier v. Stuart-James Co., Inc.*, 863 F.2d 1550, 1557 (11<sup>th</sup> Cir. 1989) ("Although neither Section 10(b) of the Act nor Rule 10b-5 contains explicit provisions for determining damages, courts have applied the damages standard of Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78bb(a), to Rule 10b-5 claims."); *Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301-02 (10<sup>th</sup> Cir. 1987) (same).

<sup>303</sup> See Part V.B., *supra*.

<sup>304</sup> *Basic*, 485 U.S. at 248 n.28.

<sup>305</sup> *Randall*, 478 U.S. at 661 (noting that "§ 28(a). . . is deemed to bar *punitive* damages") (emphasis in original); *Gould v. Am.-Hawaiian Steamship Co.*, 535 F.2d 761, 784 (3d Cir.1976) (noting that "section 28 of the Act which, in addition to limiting recovery under the Act to actual, as distinguished from punitive, damages, expressly prohibits the recovery in one or more actions of a total amount in excess of the plaintiffs' actual damages."); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1286 (2d Cir. 1969) ("Section 28(a) of the 1934 Act prohibits punitive damages in actions brought under that Act."); *cert. denied*, 397 U.S. 913 (1970); *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650, 652 n.1 (2d Cir. 1979) (noting that punitive damages "are precluded under section 28(a) of the Securities Exchange Act of 1934").



cannot override the text and legislative history, particularly when the text and legislative history are clear.<sup>306</sup> Yet the Court frequently cites public policy considerations in its analysis of the Section 10(b) implied private right of action.<sup>307</sup>

There is, however, a pattern to the Supreme Court's deliberations that resolves this seeming contradiction. The modern court tends to cite to policy factors as evidence in support of a conclusion that it has already reached on textualist grounds or that is supported by legislative history.<sup>308</sup> Public policy considerations thus tend not to serve as independent bases for interpreting the statute in any particular manner, but to reinforce conclusions reached on alternative grounds. In this context, the search for policy support is, as Judge Harold Leventhal once famously observed regarding the invocation of legislative history, "the equivalent of entering a crowded cocktail party and looking over the heads of the guests for one's friends."<sup>309</sup>

Significantly, *Basic* is the only major post-1970's exception to this pattern. Policy considerations were central to the Court's analysis in *Basic*.<sup>310</sup> The statutory text played no role,<sup>311</sup> and only a snippet of legislative history that is of questionable relevance serves as

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<sup>306</sup> *Central Bank*, 511 U.S. at 188 ("policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." (quoting *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991))); *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986) ("[I]f the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary to examine the additional considerations of 'policy' ... that may have influenced the lawmakers in their formulation of the statute." (quoting *Aaron v. SEC*, 446 U.S. 680, 695 (1980))); see also *Pinter v. Dahl*, 486 U.S. 622, 654 (1988) ("[W]e need not entertain Pinter's policy arguments"); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) (language sufficiently clear to be dispositive).

<sup>307</sup> See, e.g., *Stoneridge*, 552 U.S. at 161 (in declining to extend 10(b) liability to aiders and abettors, the Court noted that "[w]ere the implied cause of action to be extended to the practices described here, however, there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees. Our precedents counsel against this extension."); *Basic*, 485 U.S. at 245 (finding "[t]he presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act."); *Ernst & Ernst*, 425 U.S. at 209 ("We think these procedural limitations [in Sections 11, 12, and 15 of the Securities Act] indicate that the judicially created private damages remedy under s 10(b) which has no comparable restrictions—cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by ss 11, 12(2), and 15 to be brought instead under s 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.").

<sup>308</sup> See, e.g., *Central Bank*, 511 U.S. at 188 (after discussing text and legislative history regarding the appropriateness of extending Section 10(b) to aiders and abettors, the court noted that "[s]econdary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets"); *Blue Chip Stamps*, 421 U.S. at 737 (finding it "proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance").

<sup>309</sup> *Conroy v. Aniskoff*, 507 U.S. 511, 519 (1993) (Scalia, J., concurring) (citing to Judge Leventhal).

<sup>310</sup> The Court relied on "considerations of fairness, public policy, and probability, as well as judicial economy," *Basic*, 485 U.S. at 245, as supporting the presumption. The Court reasoned that "by facilitating Rule 10b-5 litigation, [the presumption] supports the Congressional policy embodied in the 1934 Act." *Id.* The Court also cited to "common sense and probability," *id.* at 246, and to the efficient market theory, *id.* at n. 24.

<sup>311</sup> There is no citation in the opinion's discussion of the reliance element to any textual support that might be found in the Exchange Act, and the opinion contains no analysis of any statutory text.

support for the rebuttable presumption of reliance.<sup>312</sup> *Basic* can therefore be distinguished as an outlier plurality decision based on a policy-driven rationale that is inconsistent with the current majority's approach to Section 10(b) exegesis.<sup>313</sup> Moreover, as explained below, the policy literature provides ample support for positions that are consistent with the current presumption of reliance, as well as positions that are strongly opposed. Therefore, whichever conclusion the Court decides to reach if and when it reconsiders *Basic*, its menu of alternatives will be largely unencumbered from a policy perspective.

#### A. Support for the Current Rule

The Supreme Court has frequently observed that private enforcement actions “provide ‘a most effective weapon in the enforcement’ of the [federal] securities laws and are ‘a necessary supplement to Commission action.’”<sup>314</sup> Recent scholarship also supports the view that private class action enforcement of the federal securities laws provides a useful supplement to the Commission's own enforcement efforts.<sup>315</sup> A recent empirical study “casts doubt on the claim that SEC investigations are superior to class actions in targeting fraud and imposing sanctions on companies.”<sup>316</sup> The study documents, among other findings, that “stand-alone class actions [*i.e.*, those without parallel SEC proceedings] are more likely to produce a settlement, and settlements

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<sup>312</sup> The opinion cites to a passage at H.R. Rep. No. 1383, at 11, stating that “[n]o investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings [*sic*] about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value.” *Basic*, 485 U.S. at 246. This is, however, a highly selective reading of the legislative history because, as discussed above, *see* Part III.B., *supra*, Congress directly called for a demonstration of actual reliance under Section 18(a) as a precondition to recovery and there was (and could have been) no discussion of reliance in a private action under Section 10(b). Further, it is far from clear that the quoted passage supports the conclusion for which it is cited because it is entirely possible to accept all of the passage's premises without reaching the conclusion that a rebuttable assumption of reliance is appropriate in Section 10(b) implied private rights of action or that Congress intended such a result.

<sup>313</sup> For a detailed analysis of *Basic*'s background and evolution, *see* Langevoort, *Basic at Twenty*, *supra* note 262.

<sup>314</sup> *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co v. Borak*, 377 U.S. 426, 432 (1964)); *see also Amgen*, 133 S.Ct. at 1201 (“Congress, the Executive Branch, and this Court, moreover, have ‘recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission.’” (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007))); *Blue Chip*, 421 U.S. at 730 (same).

<sup>315</sup> *See, e.g.*, Stephen J. Choi and Adam C. Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison* (U of Michigan Law & Econ Research Paper No. 12-022, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2109739](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739) (“Our results suggest that private plaintiffs’ attorneys, if anything, provide greater deterrence against more serious securities law violations compared with the SEC.”); Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, *The Legal Penalties for Financial Misrepresentation 4* (May 1, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=933333](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=933333) (concluding “that, for the United States at least, private and public enforcement activities both are important in the control of managerial opportunism”); James D. Cox & Randall S. Thomas, *SEC Enforcement Actions for Financial Fraud and Private Litigation: An Empirical Inquiry*, 53 *Duke L. J.* 737, 777 (2003) (concluding that “[w]hen both a SEC and private action proceed for the same misconduct, private recoveries are statistically larger and settled more quickly than when there is no parallel SEC enforcement action.”).

<sup>316</sup> Choi & Pritchard, *SEC Investigations and Securities Class Actions*, *supra* note 315, at 4-5.

are bigger, relative to stand-alone SEC investigations.”<sup>317</sup> Deterrence may also be greater in private party litigation as “CEOs and CFOs are more likely to resign under circumstances related to a stand-alone class action filing as opposed to a stand-alone SEC investigation.”<sup>318</sup> Further “when a company faces both an SEC investigation and class action filing there is significantly greater loss of market confidence relative to situations in which there is only an SEC investigation or a class action filing.”<sup>319</sup>

The claim that private party securities fraud litigation is particularly “vexatious,”<sup>320</sup> and must therefore be constrained, has also been challenged as being rooted in rationales that “are now largely defunct.”<sup>321</sup> Concerns over vexatiousness are deeply rooted in the Court’s Section 10(b) analysis and are animated by the fear that unduly expansive impositions of civil liability “will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.”<sup>322</sup> More precisely, “in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.”<sup>323</sup> The ability to file these lawsuits purportedly also “permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement

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<sup>317</sup> *Id.*, at 4.

<sup>318</sup> *Id.*; see also Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, *The Legal Penalties for Financial Misrepresentation* Table 2 (May 1, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=933333](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=933333) (noting a high rate of officer and director bars and other suspensions)

<sup>319</sup> Choi & Pritchard, *SEC Investigations and Securities Class Actions*, *supra* note 315, at 3.

<sup>320</sup> The Court has relied on a “vexatiousness” rationale on at least eight occasions: See *Blue Chip Stamps*, 421 U.S. at 739; *Central Bank*, 511 U.S. at 189 (concern regarding the ability to force defendants “to expend large sums even for pretrial defense and the negotiation of settlements”); *Stoneridge*, 552 U.S. at 162-164 (concern over the potential for “plaintiffs with weak claims to extort settlements from innocent companies”); *Ernst & Ernst*, 425 U.S. at 214 n.3 (“the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good”); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (allowing a Section 10(b) claim based on a breach of fiduciary duty, about manipulation or deception poses “a ‘danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5’” (quoting *Blue Chip Stamps*, 421 U.S. at 740)); *Virginia Bankshares*, 501 U.S. at 1096 (concern that pressing liability “on psychological enquiry alone would threaten just the sort of strike suits and attrition by discovery that *Blue Chip Stamps* sought to discourage”); *Dura*, 544 U.S. at 346-347 (imposing loss causation pleading requirements because of simple allegations of price inflation “would permit a plaintiff ‘with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence’” (quoting *Blue Chip Stamps*, 421 U.S. at 741)); *Tellabs*, 551 U.S. at 323-324 (recognizing that private securities fraud claims “can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law”); see also S. Rep. No. 792, 73<sup>rd</sup> Cong., 2d Sess. p.21 (authorizing award of attorneys’ fees as protection against strike suits).

<sup>321</sup> Wendy Gerwick Couture, *The End of the Vexatiousness Rationale 2*, \_\_ Sec. Reg. L.J. \_\_ (forthcoming, 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2291147](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291147).

<sup>322</sup> *Blue Chip Stamps*, 421 U.S. at 739 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J. concurring)); see also Michael M. Boone & Patrick F. McGowen, *Standing to Sue under SEC Rule 10b-5*, 49 TEX. L. REV. 617, 648-649 (1971) (noting that “retention of the purchaser-seller requirement in private damage actions serves a good purpose—defining the class of persons to be protected by 10b-5” and that eliminating the requirement would allow “any imaginative shareholder owning a few shares of a major corporation [to] bring a derivative or class action for a considerable amount.”).

<sup>323</sup> *Blue Chip Stamps*, 421 U.S. at 740.

value, rather than a reasonably founded hope that the process will reveal relevant evidence....”<sup>324</sup> Commentators suggest that this “vexatiousness rationale” has resulted in “a thirty-five year trend of judicial constriction of the securities laws.”<sup>325</sup>

Recent scholarship suggests, however, that even if these rationales once had merit, the reforms instituted by the PSLRA render them anachronisms that exaggerate the modern consequences of class action securities fraud litigation.<sup>326</sup> Complaints that lack merit are today less likely to survive dismissal because of the PSLRA’s “strong inference” pleading requirement.<sup>327</sup> The forward-looking safe harbor also prevents actions in some cases.<sup>328</sup> The potential for discovery abuse is constrained by the PSLRA’s stay on discovery pending resolution of the motion to dismiss.<sup>329</sup> The PSLRA calls for automatic FRCP Rule 11 review in class action securities fraud litigation,<sup>330</sup> although data suggest that Rule 11 proceedings are rare and only infrequently result in sanctions against plaintiff attorneys.<sup>331</sup> Further, it can be argued that the PSLRA represents a recent Congressional effort to address these concerns over vexatiousness, and the Court should not substitute its policy judgments for Congress’ on this score.

## B. Opposition to the Current Rule

On the other side of the fence, academic critiques of the current Section 10(b) damage regime can be divided into three broad categories: (1) the observation that aftermarket out-of-pocket damages rule generates fully diversifiable wealth transfers among innocent investors, and does not measure damages as that term is generally understood by economists; (2) challenges to the validity of the efficient market hypothesis; and (3) critiques of the methodology used to test for market efficiency as a precondition to applying the rebuttable presumption of reliance. In addition, a small number of judicial opinions have raised questions about the operation of the aftermarket out-of-pocket damage rule that track some of these economic critiques.

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<sup>324</sup> *Blue Chip Stamps*, 421 U.S. at 741.

<sup>325</sup> Marc I. Steinberg and Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism*, 63 RUTGERS L. REV. 1, 55 (2010).

<sup>326</sup> Couture, *The End of the Vexatiousness Rationale*, *supra* note 321, at 1.

<sup>327</sup> See *Tellabs*, 551 U.S. at 314; see also CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2013 MID-YEAR ASSESSMENT Figure 14 (2013) (finding that dismissals are increasing over time, and that the dismissal rate for cases filed between 2008 and 2010 is in excess of 50%).

<sup>328</sup> Couture, *The End of the Vexatiousness Rationale*, *supra* note 321, at 7 (citing 15 U.S.C. § 78u-4(b)(2)(A), 15 U.S.C. § 78u-5).

<sup>329</sup> 15 U.S.C. § 78u-4(b)(3)(B).

<sup>330</sup> 15 U.S.C.A. § 78u-4(c)(1) (West, Westlaw through 2013).

<sup>331</sup> See, e.g., Michael J. Kaufman and John M. Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Fraud Litigation*, 19 CORNELL J. L. & PUB. POLICY 637, 683 (2010) (noting that the PSLRA provision that requires courts to issue findings regarding parties’ and counsel’s compliance with Rule 11 “is not currently utilized to its full capacity”); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 938 (2003) (finding that small sanctions are imposed in only a handful of cases); see also H.R. Conf. Rep. No. 104-369, at 39 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 738 (noting that prior to the PSLRA, “[e]xisting Rule 11 ha[d] not deterred abusive securities litigation.”).

## 1. Wealth Transfers, Not Damages

From a policy perspective, a large academic literature provides significant support for a rule that would narrow the scope of aftermarket damages recoverable under Section 10(b). As long ago pointed out by Judges Posner and Easterbrook, and by many other scholars,<sup>332</sup> in aftermarket trading cases, every dollar of loss by a plaintiff who unknowingly purchases (sells) a security at an inflated (deflated) price generates an equal dollar of gain for a trader who unknowingly sells (purchases) precisely the same security at precisely the same inflated (deflated) price. The “damage” measure generated by an “out of pocket” rule in the context of a pure aftermarket fraud, in which issuers and insiders never trade while the fraud is alive in the market, thus describes a wealth transfer between two sets of equally innocent and ignorant investors.<sup>333</sup> In that context, the out-of-pocket measure has nothing to do with measures of disgorgeable profits that might have been earned by wrongdoers, or with traditional notions of compensatory damages or optimal deterrence as those terms are understood by economists.<sup>334</sup>

Moreover, because aftermarket transactors are both purchasers and sellers over time, and because the probability of profiting by selling into an aftermarket fraud is the same as the probability of suffering a loss as a consequence of buying into an aftermarket fraud, the aggregate risk created by aftermarket fraud is diversifiable. Indeed, on average and over time, the risk of being harmed by an aftermarket securities fraud averages to zero for investors who

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<sup>332</sup> See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 460 (6<sup>th</sup> ed. 2003) (“People who buy the stock during [the period the fraud was alive on the market] will be hurt, but the sellers will be benefitted . . .”); Bratton and Wachter, *The Political Economy of Fraud on the Market*, *supra* note 230, at 73 (“Real-world FOTM actions proceed on an enterprise-liability theory with corporate—as opposed to individual—defendants funding the compensation; investor ‘victims’ are accordingly compensated from the pockets of other innocent investors.”); Coffee, *Reforming the Securities Class Action*, *supra* note 4, at 1558-1559 (“Often shareholders will belong to both the plaintiff class that sues and the residual shareholder class that bears the cost of the litigation. . . Thus, they are effectively making wealth transfers to themselves, in effect shifting money from one pocket to another, minus the high transaction costs of securities litigation; Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 *STAN. L. REV.* 1487, 1502 (1996) (“The chance of being on the losing or winning side of a transaction when the stock price is distorted by a securities violation can be assumed to be random”); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 *ARIZ. L. REV.* 639, 646-648 (1996) (“In any non-privity fraud case, each loser—the buyer or seller disadvantaged by the fraud—is balanced by another winner: the person on the other side of the trade.”); Frank H. Easterbrook and Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 *U. CHI. L. REV.* 611, 651 (1985) (aftermarket trading “entails offsetting gains and losses”).

<sup>333</sup> In addition, the stock price may decline in anticipation of the recovery, which could “create[] a feedback loop that exacerbates the price declines used as an input for determining settlements,” thereby increasing the size of the transfer. See Judson Caskey, *The Pricing Effects of Securities Class Action Lawsuits and Litigation Insurance 2*, \_\_ *J. LAW, ECON. & ORGANIZATION* \_\_ (forthcoming, 2013), available at <http://jleo.oxfordjournals.org/content/early/2013/01/16/jleo.ews048.full.pdf+html>; see also Amar Gande and Craig M. Lewis, *Shareholder-Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Spillovers*, 44 *J. FIN. & QUANTITATIVE ANALYSIS* 823, 825-26 (2009) (documenting that shareholders anticipate losses from class action lawsuits and capitalize part of the losses in advance of the lawsuit’s filing).

<sup>334</sup> This is not to argue that aftermarket securities frauds are harmless. Even a pure aftermarket fraud can distort prices in a manner that causes the misallocation of capital and that induces unwarranted and non-diversifiable reliance in transactions outside the securities markets. For example, employees can join a company in the false belief that the firm has a bright future. Banks can extend loans on the false belief that they are likely to be repaid. New companies can be formed because of the false belief that a purportedly successful firm represents an exciting market opportunity. These are real harms that cause real damages. But these damages are not even remotely approximated by an out-of-pocket rule that measures fully diversifiable transfers within a pool of investors.

purchase and sell with equal frequency.<sup>335</sup> Further, to the extent that these damages are covered by directors and officers insurance, they are mutualized across all publicly traded firms that purchase this form of coverage, and are thus borne by all investors in those firms.<sup>336</sup> Finally, to the extent that these damages are not covered by insurance,<sup>337</sup> but are paid by the corporation, all stockholders of the defendant corporation wind up bearing the cost of the settlement.<sup>338</sup> It is only in the exceptionally rare instance when an executive or director reaches into his or her own pocket to fund a portion of a recovery out of their personal assets<sup>339</sup> that the Section 10(b) private litigation process does not simply result in a wealth transfer among different categories of investors, net, of course, of the transactions costs generated by plaintiff and defense counsel and associated litigation frictions. The Court will be able to cite to this extensive economic literature to support the policy conclusion that, “[a]s presently constituted, securities class actions produce wealth transfers among shareholders that neither compensate nor deter.”<sup>340</sup>

## 2. Challenges to the Efficient Market Hypothesis

*Basic* was decided at a time when confidence in the efficient market hypothesis was at its historic peak.<sup>341</sup> Since then, a large literature challenging the efficient market hypothesis has

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<sup>335</sup> See, e.g., Richard A. Booth, *The Future of Securities Litigation*, 4 J. BUS. & TECH. L. 129, 139 (2009) (observing that for diversified investors, “gains and losses wash out over time. In other words, a diversified investor is likely to gain from the timely sale of an overpriced stock about as often as she loses from the untimely purchase of an overpriced stock.”).

<sup>336</sup> For a detailed examination of the market for directors’ and officers’ insurance, see TOM BAKER AND SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION (2010); see also Langevoort, *Capping Damages*, *supra* note 332, at 648-649.

<sup>337</sup> Michael Klausner, Jason Hegland and Matthew Goforth, *How Protective is D&O Insurance in Securities Class Actions? An Update*, 26 PLUS JOURNAL 1 (May 2013) (finding that, in a sample of securities class actions filed between 2006 and 2010 and settled between 2006 and 2012, “[i]n 58% of cases, the insurer paid the full settlement, in 28% the insurer paid some of the settlement, and in 15% of cases the insurer paid nothing”).

<sup>338</sup> This is the “pocket shifting” critique of securities fraud class action settlements. See, e.g., Alexander, *Rethinking Damages in Securities Class Actions*, *supra* note 332, at 1503-1504; Coffee, *Reforming Securities Class Actions*, *supra* note 4, at 1558. In addition, the stock price may decline in anticipation of the litigation itself, which would “create[] a feedback loop that exacerbates the price declines used as an input for determining settlements.” See Caskey, *The Pricing Effects of Securities Class Action Lawsuits*, *supra* note 333, at 2; see also Gande and Lewis, *Shareholder-Initiated Class Action Lawsuits*, *supra* note 333, at 825-26 (documenting that shareholders anticipate losses from class action lawsuits and capitalize part of the losses in advance of the lawsuit’s filing).

<sup>339</sup> Coffee, *Reforming the Securities Class Actions*, *supra* note 4, at 1551-1553, reviews the rare instances in which individual defendants are held responsible for corporate wrongdoing in class action securities fraud litigation, and observes that they typically involve “special facts” such as the corporate defendant is judgment proof, the individual defendant faces potential criminal liability, or directors’ and officers’ insurance is, for any reason, unavailable.

<sup>340</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 4, at 1535-1536; see also Bratton & Wachner, *The Political Economy of Fraud on the Market*, *supra* note 230, at 100.

<sup>341</sup> Gilson and Kraakman describe the evolution of the efficient market hypothesis as “itself the subject of a bubble, where its refraction from theory to policy through the prism of politics inflated its claims far beyond what the original academic theory could support.” Ronald J. Gilson and Reinier Kraakman, *Market Efficiency after the Financial Crisis: It’s Still a Matter of Information Costs*, \_\_ U. VA. L. REV. \_\_ (forthcoming, 2013) (on file with author). The Supreme Court’s reliance on the theory as a foundation for its ruling in *Basic* can be viewed as one example of this inflation. See also Langevoort, *Basic at Twenty*, *supra* note 262, at 197 (“In the mid-1980s, when *Basic* was decided, market efficiency claims (and market stories generally) were appealing and persuasive across a fairly wide spectrum of intellectual opinion.”); Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. Econ. Perspectives 59, 59 (2003) (observing that “[a] generation ago, the efficient market hypothesis was widely accepted by academic financial economists”); Daniel R. Fischel, *Efficient Capital Markets, the Crash, and*

emerged, but that literature has spawned an equally vigorous defense. The debate over market efficiency is nuanced and complex, and it implicates fine points of econometrics and finance theory.<sup>342</sup> It splits leading scholars.<sup>343</sup>

The most germane question for present purposes is not whether the markets are or are not efficient by any measure. It is, instead, whether the Supreme Court is well situated to referee this debate. As Justice White noted in dissent in *Basic*, the federal courts have “no staff economists, no experts schooled in the ‘efficient-capital-market hypothesis,’ [and] no ability to test the validity of empirical market studies.”<sup>344</sup> Those same limitations applied to the decision to rely on the efficient market hypothesis are equally applicable to any decision to abandon the efficient market hypothesis.<sup>345</sup> Accordingly, the Court may be better served if it cabins its consideration to matters of statutory interpretation as to which the Court has a comparative advantage, rather than rest its analysis on its perception of the current state of the art in efficient market theory which, in any event, may be historically contingent and unnecessary to the analysis.<sup>346</sup>

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*the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 907 (1989) (referring to “the academic support for the efficient markets hypothesis”); see also Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383, 383 (1970) (concluding that “with but a few exceptions, the efficient markets model stands up well.”).

<sup>342</sup> For an overview of the debate, see, e.g., Malkiel, *The Efficient Market Hypothesis and Its Critics*, *supra* note 341; Burton G. Malkiel, *The Efficient-Market Hypothesis and the Financial Crisis*, in RETHINKING THE FINANCIAL CRISIS (Alan Blinder, Andrew Lo and Robert Solow eds. 2012); Ronald J. Gilson and Reinier Kraakman, *Market Efficiency After the Fall: Where Do We Stand Following the Financial Crisis?*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Claire A. Hill and Brett H. McDonell eds., 2012); Gilson and Kraakman, *Market Efficiency After the Financial Crisis*, *supra* note 341; Bradford Cornell and James C. Rutten, *Market Efficiency, Crashes, and Securities Litigation*, 81 TUL. L. REV. 443 (2006-2007). For a popular critique of the efficient market theory, see JUSTIN FOX, *THE MYTH OF THE RATIONAL MARKET* (2009).

<sup>343</sup> See, e.g., Malkiel, *The Efficient Market Hypothesis and Its Critics*, *supra* note 341, for a discussion of the point and counterpoint that has developed among scholars involved in this debate. See also Oldham, *Taking “Efficient Markets” Out of the Fraud-On-the-Market Doctrine*, *supra* note 239, at 1033 (citing Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 VA. L. REV. 1017, 1018 (1991)); Victor L. Bernard, Christine Botosan, and Gregory D. Phillips, *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of the Fraud on the Market Theory*, 73 NEB. REV. 781, 786 (1994) (There is “substantial disagreement ... among financial economists about what conclusions empirical tests of market efficiency support.”). For an example of the legal literature that relies on the dispute over the efficient market hypothesis as a basis for challenging *Basic*, see, e.g., Paul A. Ferrillo, et al., *The “Less Than” Efficient Capital Markets Hypothesis: Requiring More Proof From Plaintiffs in Fraud-On-The-Market Cases*, 78 ST. JOHN’S L. REV. 81 (2004).

<sup>344</sup> *Basic*, 485 U.S. at 253.

<sup>345</sup> Justice Scalia, in his concurrence in *Ass’n for Molecular Pathology v. Myriad Genetics, Inc.*, 133 S.Ct. 2107 (2013), observed that regarding portions of the opinion “going into fine details of molecular biology,” he was “unable to affirm those details on my own knowledge or even my own belief.” *Id.* at 2120. If the Supreme Court is called upon to opine with regard to the correctness of the efficient market hypothesis as a foundation for a rebuttable presumption of reliance, it will have to address “fine details” of econometrics and finance. It will be questionable as to whether any Justice will be able to affirm that level of technical understanding as a matter of the Justice’s own knowledge or belief.

<sup>346</sup> Some legal scholars also argue that efficiency should not be interpreted as a precondition to establishing a presumption of reliance. See, e.g., Brief of Law Professors as Amici Curiae in Support of Petitioners 7-8, *Amgen*, No. 11-1085 (Aug. 2012) (“Proving that a market is generally highly efficient, and thus tends to incorporate all information quickly, is unnecessary to demonstrating that there has been a fraud on the market as to a specific statement. As long as a market functions well enough that a specific representation at issue was incorporated into a security’s price, [citation], a showing of general efficiency is unnecessary.” (citing Fischel, *Efficient Capital*

Indeed, one need not take any position regarding the validity of the efficient market hypothesis in order to appreciate the complexity of the questions raised. For example, a fundamental problem with any test of the efficient market hypothesis is that the test of efficiency requires the simultaneous specification of a model that describes how an asset's price is formed. Economists commonly use factor models that adjust for overall market returns, industry returns, company size, price-to-book ratio, momentum, and other factors.<sup>347</sup> However, any test of market efficiency that relies on any of these models is, by construction, a joint test of both the efficient market hypothesis and of the pricing model used to test the hypothesis.<sup>348</sup> If the pricing model is inaccurate then the statistical test can falsely conclude either that the market is either efficient or that it is inefficient, all as an artifact of the erroneously specified pricing model. Therefore, at the most fundamental level, because there is no certainty over the proper specification of asset pricing models, it is impossible affirmatively to establish the efficiency of any financial market without some meaningful degree of qualification.

Stepping back from this nihilistic ledge, however, the literature is replete with sophisticated, carefully performed studies of the efficient market hypothesis in its various forms, and many of these analyses have spawned a vigorous debate. For example, some studies examine the volatility of returns to investing in stocks relative to the volatility of stock prices themselves and claim to find patterns that are inconsistent with market efficiency.<sup>349</sup> Other studies, however, challenge the statistical methodology applied<sup>350</sup> or explain that managers act to smooth dividend payments in a manner that can cause these variance-bounds tests falsely to reject the hypothesis of market efficiency.<sup>351</sup>

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*Markets*, *supra* note 341, at 911; Macey, *Lessons from Financial Economics*, *supra* note 343, at 1021; Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumption of Market Efficiency*, 65 U. CHI. L. REV. 879, 904 (1998)). However, the case law is strongly to the contrary. See Brief of Law Processors, *supra* note 346, at 6, 10 (*Basic* expressed the conclusion that “the market price of shares traded on well-developed markets reflects all publicly available information,” and “[c]onversely, it was understood that if a market were *not* completely efficient, the fraud on the market presumption would be inappropriate.” (collecting citations and cases)).

<sup>347</sup> The commonly used models are the Fama-French three factor model, see Eugene F. Fama and Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 J. FIN. ECON. 3 (1993); Eugene F. Fama and Kenneth R. French, *The Cross-Section of Expected Stock Returns*, 47 J. FIN. 427 (1992); Eugene F. Fama and Kenneth R. French, *Size and Book-to-Market Factors in Earnings and Returns*, 50 J. FIN. 131 (1997); Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57 (1997).

<sup>348</sup> See, e.g., Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1579 (1991) (explaining that market efficiency itself is not *per se* testable because it requires a joint test with an asset pricing model. Thus, if a test shows anomalous returns that are inconsistent with a finding of market efficiency, the extent to which the anomaly is properly attributable to a mis-specification of the asset pricing model as opposed to a rejection of the efficient market hypothesis is entirely unclear.)

<sup>349</sup> See, e.g., Stephen F. LeRoy and Richard D. Porter, *The Present-Value Relation: Tests Based on Implied Variance Bounds*, 49 ECONOMETRICA 555 (1981); Robert J. Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?*, 71 AMER. ECON. REV. 421 (1981).

<sup>350</sup> See, e.g., Allan W. Kleidon, *Variance Bounds Tests and Stock Price Valuation Models*, 94 J. POLIT. ECON. 953 (1986); Terry A. Marsh and Robert C. Merton, *Dividend Variability and Variance Bounds Tests for the Rationality of Stock Market Prices*, 76 AMER. ECON. REV. 483 (1986).

<sup>351</sup> Malkiel, *The Efficient-Market Hypothesis and the Financial Crisis*, *supra* note 342, at 86.



Many studies also claim to find “anomalies” in stock price returns: patterns that suggest predictable regularities that should be inconsistent with the efficient market hypothesis.<sup>352</sup> In response, other studies suggest that anomalies can be statistical artifacts<sup>353</sup> or that they fail to refute the efficient market hypothesis because they simply reveal another market “factor” that can be incorporated into asset pricing models.<sup>354</sup> Even more intriguing, perhaps, is the finding that publication of information about an anomaly can result in a post-publication decline in the incidence and significance of that anomaly.<sup>355</sup> This pattern is arguably consistent with the efficient market hypothesis to the extent that publication reveals potentially profitable trading opportunities that the market then proceeds to arbitrage away. This thesis does not, however, refute the initial incidence of these anomalies or the possibility that the anomalies reflect a set of inefficiencies that are, in fact, present, but not broadly understood. On a note more directly relevant to securities fraud litigation, some studies claim to find systematic over-reaction or “drift” in response to certain news disclosures – a finding that appears to have influenced Congress’ decision to adopt a 90-day lookback rule in the PSLRA – whereas other studies reject those findings.<sup>356</sup> It is far from clear that the Supreme Court would want to have to resolve these academic disputes as a central part of the exercise of determining the appropriate rule for recovery under the Section 10(b) implied private right of action.<sup>357</sup>

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<sup>352</sup> For a study of 82 purported anomalies reported in peer-reviewed academic journals, see David R. McLean and Jeffrey E. Pontiff, *Does Academic Research Destroy Stock Return Predictability?* (AFFI/EUROFIDAI, Paris December 2012 Finance Meetings Paper, 2013), available at <http://ssrn.com/abstract=2156623> or <http://dx.doi.org/10.2139/ssrn.2156623>.

<sup>353</sup> See, e.g., EDWARD E. LEAMER, SPECIFICATION SEARCHES: AD HOC INFERENCE WITH NONEXPERIMENTAL DATA (1978) (explaining anomalies as the result of specification search biases that occur when the choice of the model is influenced by the model’s search); Andrew W. Lo and A. Craig MacKinlay, *Data-Snooping Biases in Tests of Financial Asset Pricing Models*, 3 REV. FIN. STUDIES 431 (1990); James J. Heckman, *Sample Selection Bias as a Specification Error*, 47 ECONOMETRICA 153 (1979) (sample construction is influenced by the result of the test); Fama, *Efficient Capital Markets: II*, *supra* note 348, at 1585 (“[w]ith many clever researchers, on both sides of the efficiency fence, rummaging for forecasting variables, we are sure to find instances of ‘reliable’ return predictability that are in fact spurious.”).

<sup>354</sup> Malkiel, *The Efficient-Market Hypothesis and the Financial Crisis*, *supra* note 342, at 83-84 (explaining that if an anomaly reflects a deficiency in the specification of the asset pricing model used to test for efficiency then by adding a factor to the pricing model that adjusts for the purportedly anomaly, the model can support a finding of efficiency); Fama and French, *The Cross-Section of Expected Stock Returns*, *supra* note 347 (proposing that size and value factors be added to the standard capital asset pricing model in part as a response to findings of anomalous returns related to size and value factors). In contrast, Josef Lakonishok, Andrei Shleifer, and Robert W. Vishny, *Contrarian Investment, Extrapolation, and Risk*, 49 J. FIN. 1541 (1994), suggests that these anomalous patterns are indeed evidence of inefficiency.

<sup>355</sup> See generally McLean and Pontiff, *Does Academic Research Destroy Stock Return Predictability?*, *supra* note 352.

<sup>356</sup> Post-announcement drift in stock price response to earnings announcements has been well-established in the literature, see, e.g., Caitlin Ann Greatrex, *The Credit Default Swap Market’s Reaction to Earnings Announcement 4* (Fordham University Department of Economics Discussion Paper No. 2008-06, 2008), available at <http://ssrn.com/abstract=1104888> (collecting studies). Other studies suggest that over-reaction is as common as under-reaction. See, e.g., Victor L. Bernard and Jacob K. Thomas, *Evidence that Stock Prices Do Not Fully Reflect the Implications of Current Earnings for Future Earnings*, 13 J. ACCTNG & ECON. 305 (1990).

<sup>357</sup> Additional examples of alleged inefficiencies are cited in Brief of Law Professors, *supra* note 346, at 19 n.7 (citing Langevoort, *Basic at Twenty*, *supra* note 262, at 175 (stating that “the contemporaneous literature suggests that even for widely traded stocks, substantial deviations from the efficiency ideal are quite possible.”); Marlene A. Plumlee, *The Effect of Information Complexity on Analysts’ Use of That Information*, 78 ACCT. REV. 275, 293 (2003) (concluding that analysts fail to incorporate complex information in forecasts); Gur Huberman & Tomer

### 3. Defining Efficiency

Even if the Supreme Court accepts that the efficient market hypothesis is accurate, the lower courts then face the practical problem of determining whether a market for a specified security over a defined time period is sufficiently efficient to support application of the fraud on the market presumption. As the *Amgen* court recognized, the question of efficiency is not a “binary yes-no”<sup>358</sup> characterization. The methodology applied by the lower courts in assessing efficiency has, however, been roundly criticized by scholars.<sup>359</sup>

The five-factor *Cammer* test is the dominant technique applied by the courts to determine whether a market is efficient for purposes of supporting the fraud on the market presumption. That test considers trading volume, analyst coverage, the number of market makers and arbitrageurs, the issuer’s ability to file on Form S-3, and the responsiveness of the market price to new information.<sup>360</sup>

More advanced perspectives as to the definition of market efficiency suggest that the *Cammer* factors are profoundly flawed and are likely biased to finding a higher degree of efficiency that actually exists.<sup>361</sup> For example, separate and apart from the *Cammer* factors, courts might want to test whether “the Law of One Price – the most basic market efficiency condition”<sup>362</sup> is satisfied. Data suggest that the *Cammer* factors can be satisfied even though Law of One Price is violated for extended periods.<sup>363</sup> Economists also rely on tests of serial correlation to examine the efficiency of any given market, and reason that if serial correlation in a stock’s returns is found to be “large enough to cover the size of transaction costs” then the data “invalidate” the conclusion that the market is efficient.<sup>364</sup> Studies also demonstrate that several

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Regev, *Contagious Speculation and a Cure for Cancer: A Nonevent that Made Stock Prices Soar*, 56 J. FIN. 387 (2001) (noting significant market effect of prominent news item concerning information that had been public for months); Peter Klibanoff et al., *Investor Reaction to Salient News in Closed-End Country Funds*, 53 J. FIN. 673 (1998) (concluding that well-publicized news items were more likely to move the market than redundant information found elsewhere, and that well-publicized news events created short periods in which the relevant markets reacted more quickly to changes); Thomas S.Y. Ho & Roni Michaely, *Information Quality and Market Efficiency*, 23 J. FIN. & QUANTITATIVE ANALYSIS 53 (1988) (finding market effect from repudiation already available information)).

<sup>358</sup> *Amgen*, 133 S.Ct. at 1197 n.6 (quoting Langevoort, *Basic at Twenty*, *supra* note 262, at 167).

<sup>359</sup> See, e.g., Mukesh Bajaj and Sumon C. Mazumdar, *Assessing Market Efficiency for Reliance on the Fraud-on-the-Market Doctrine after Wal-Mart and Amgen 2* (July 29, 2013), available at <http://ssrn.com/abstract=2302734> (“well-accepted empirical tests of market efficiency, rather than *ad hoc* *Cammer* factor tests, should be used to rigorously analyze plaintiffs’ reliance claims”); see also Brad K. Barber, et al., *The Fraud on the Market Theory and the Indicators of Common Stocks’ Efficiency*, 19 J. CORP. L. 285, 285-86 (1994); Victor L. Bernard, Christine Botosan, and Gregory D. Phillips, *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of Fraud-on-The-Market Theory*, 73 NEB. L. REV. 781, 796 (1994); Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in Cammer v. Bloom and Its Progeny*, 10 U. MIAMI BUS. L. REV. 303 (2002).

<sup>360</sup> *Cammer v. Bloom*, 711 F. Supp. 1264, 1286-1287 (D.N.J. 1989). Courts have added additional factors to the *Cammer* test. See, e.g., *Krogman v. Sterritt*, 202 F.R.D. 467, 474 (N.D. Tex. 2001) (considering market capitalization, bid-ask spread, and percentage of outstanding shares not held by insiders (the float)).

<sup>361</sup> The *Cammer* factors are “largely descriptive, and not protective,” and cannot “be used directly to predict efficiency.” Rapp, *Proving Markets Inefficient*, *supra* note 359, at 319.

<sup>362</sup> Bajaj and Mazumdar, *Assessing Market Efficiency*, *supra* note 359, at 8.

<sup>363</sup> *Id.* at 8.

<sup>364</sup> *Id.* at 12.

securities at issue in class action securities fraud litigation passed the *Cammer* factor test even though their prices displayed serial correlation inconsistent with efficiency.<sup>365</sup> In addition, debate arises as to the proper interpretation of event studies that are commonly used to test whether a security's price responds promptly to the disclosure of material information.<sup>366</sup> In particular, parties will litigate over the percentage of days on which material news is disclosed that must display statistically significant price reactions in order for the market to be considered efficient.<sup>367</sup>

Scholars therefore complain that the *Cammer* factors “have little ability to detect market inefficiency,”<sup>368</sup> and that the tests applied by the lower courts may be biased in favor of a finding of efficiency when the market is in fact inefficient. If this critique is correct, then the current securities fraud litigation regime may be susceptible of a double bias: (1) a bias toward finding that markets for securities are efficient when they are not, thereby applying the rebuttable presumption of reliance in situations where the presumption should never apply; and (2) a bias towards making the presumption of reliance irrebuttable when the *Basic* court contemplated that the presumption would be rebuttable. Either bias alone would expand the scope of private liability under Section 10(b) beyond its intended reach, and taken together the effect is compounded.

#### 4. Judicial Critiques of the Current Rule

The decision in *Elkind v. Liggett & Myers*,<sup>369</sup> is a rare example of a judicial opinion that appreciates the potential for disproportionate and irrational damage awards when the out-of-pocket rule is applied in the aftermarket context. In *Elkind*, the plaintiff class alleged a failure to disclose material earnings and operations information and that management illegally tipped inside information to persons who then sold Liggett & Myers shares on the open market. The trial court exonerated Liggett & Myers of the failure to disclose allegations but found that the company had illegally tipped analysts. It awarded damages in the amount of \$740,000,<sup>370</sup> calculated by multiplying the difference “between the plaintiff class members’ purchase prices ... [and] the price of the stock eight trading days after disclosure”<sup>371</sup> by the total volume of transactions during a seven calendar day period representing the span between the two illegal

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<sup>365</sup> Grigori Erenburg, Janet Kiholm Smith, and Richard L. Smith, *The Paradox of “Fraud-on-the-Market Theory”*: *Who Relies on the Efficiency of Market Prices?* 8 J. EMPIR. LEG. STUD. 260 (2011).

<sup>366</sup> Bajaj and Mazumdar, *Assessing Market Efficiency*, *supra* note 359, at 14-18.

<sup>367</sup> Bajaj and Mazumdar, *Assessing Market Efficiency*, *supra* note 359, at 16-17 (citing *In re PolyMedica Corp. Sec. Litig.*, 453 F. Supp. 2d 260, 270 (2006) (“a mere listing of five days on which news was released and which exhibited large price fluctuations proves nothing”); *In re Fed. Home Loan Mortgage Corp. (Freddie Mac) Sec. Litig.*, 281 F.R.D. 174, 180-81 (2012) (plaintiff’s expert testifies that there was a statistically significant response to 28% of the material news days considered but the court rejects a finding of efficiency because plaintiffs “must show that the market price responds to most new, material news”); *Nancy George v. China Automotive Sys., Inc.*, No. 11 Civ. 7533, 2013 WL 3357170, at \*12 (S.D.N.Y. Jul. 3, 2013) (court refuses to find efficiency when statistically significant results are found on only seven of sixteen dates on which material information was allegedly disclosed to the market)).

<sup>368</sup> Bajaj and Mazumdar, *Assessing Market Efficiency*, *supra* note 359, at 8.

<sup>369</sup> 635 F.2d 156 (2d Cir. 1980).

<sup>370</sup> *Id.* at 162.

<sup>371</sup> *Id.* (the court reasoned that eight days was a reasonable period for the market to absorb the relevant information).

tips. This is, in effect, the out-of-pocket damage rule applied in an aftermarket trading context with no actual reliance requirement.

The Second Circuit strongly objected to this approach to damage calculation because of “its potential for imposition of Draconian, exorbitant damages, out of all proportion to the wrong committed, lining the pockets of all interim investors and their counsel at the expense of innocent corporate stockholders.”<sup>372</sup> The court instead limited plaintiffs’ recovery to the profits earned by the tippees,<sup>373</sup> thereby effectively limiting recovery to a disgorgement measure.

The Second Circuit in *Elkind* thus seems to have intuited many of the issues that later came to the fore in the academic critique of aftermarket securities fraud litigation.<sup>374</sup> Indeed, *Elkind*’s critique is perfectly applicable to any Section 10(b) litigation in which the corporate or insider defendants trade no stock while the fraud is alive in the market, or where their trading is small relative to the volume of trading observed in the market as a whole. In either event, the application of the out-of-pocket damage rule, with no actual reliance requirement, will generate “Draconian” damages that can be “out of proportion to the wrong committed.”

## VII. Practical Implications and Potential Legislative Responses

The practical implications of adopting an actual reliance requirement are potentially profound: class actions would be far more difficult to certify and the size of any certifiable class would likely be greatly diminished. A significant decline in the incidence and magnitude of class action claims under Section 10(b) would likely result. This decline will likely stimulate calls for a legislative overhaul of the securities litigation process. The simplest and most direct call for a legislative response would, of course, be to amend Section 10(b) to allow for some form of a presumption of reliance, rebuttable or not, and to articulate a specific formula for recovery in aftermarket transaction. The legislative debate will not, however, be so easily cabined. Opponents of class action Section 10(b) litigation will likely oppose any reform that expands the private right of action and will likely lobby for any of a wide range of restrictions on private rights of recovery. The academic literature is also replete with suggestions for reform of the private securities fraud litigation process. The outcome of any such legislative debate is impossible to predict.

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<sup>372</sup> *Id.* at 170.

<sup>373</sup> *Id.* at 172.

<sup>374</sup> See, e.g., Booth, *The Future of Securities Litigation*, *supra* note 335, at 148-49 (Observing that “one of the major problems with SFCAs [securities fraud class actions] is that the potential damages far exceed what is needed for effective deterrence” (citing *Elkind*, 635 F.2d at 170)); Langevoort, *Capping Damages*, *supra* note 332, at 639 (“Practitioners and academics have known for some time that the standard measure of liability in open-market securities fraud cases can be excessive. The effort to award all affected marketplace traders their ‘out-of-pocket’ damages creates the potential for recovery grossly disproportionate to the nature of the underlying violation. ‘Draconian’ is the word often used.” (citing *Elkind*, 635 F.2d at 170)); see also Alexander, *Rethinking Damages in Securities Class Actions*, *supra* note 332, at 1496 (“When securities violations occur, wealth is redistributed among investors but the net effect is a transfer from one group of investors to another. The net social cost, as measured solely by trading gains and losses, arguably is zero.”); Coffee, *Reforming the Securities Class Action*, *supra* note 4, at 1535-36 (“As presently constituted, securities class actions produce wealth transfers among shareholders that neither compensate nor deter.”).

## A. Practical Implications

An actual reliance requirement under Section 10(b), whether articulated as a precondition to recovery of money damages, or expressed as a reversal of *Basic*'s rebuttable presumption of reliance, will make certification of a class difficult if not impossible in a large number of situations because plaintiffs will be unable to establish commonality pursuant to Rule 23.<sup>375</sup> This point is not lost on the Supreme Court, which has twice observed that the presumption of reliance is, in effect, necessary in order to support class certification in aftermarket securities fraud actions under Section 10(b).<sup>376</sup>

A dramatic decline in the incidence of Section 10(b) class action litigation does not, however, augur the end of securities fraud litigation. Class action litigation asserting violations of Sections 11 and 12 of the Securities Act, and Section 14 of the Exchange Act, as well as many other provisions of the federal securities laws, would continue unaffected. This is no small point, inasmuch as many of the largest recoveries in class action securities fraud history arise from Section 11 claims.<sup>377</sup>

Section 10(b) claims will also likely be pursued by large, sophisticated investors who can demonstrate that they follow active management strategies and that they reviewed documents containing the alleged misrepresentations or omissions. These investors will be able to demonstrate actual reliance and, if they suffer sufficiently large losses, will have the resources and incentives to pursue individual claims for recovery.

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<sup>375</sup> *China Automotive Sys.*, 2013 WL 3357170, at \*8 (“In the absence of this presumption of reliance on a market that absorbs the alleged material misstatements and omissions, questions as to whether any particular investor in fact relied on any particular misstatement or omission come to the fore and may overwhelm the common questions. In such a situation, resolution through representative class action is neither feasible nor a superior means of adjudication.”); *Fed. Home Loan Mortg. Corp. Sec. Litig.*, 281 F.R.D. at 177 (“Class certification is available only if plaintiff can establish a class-wide presumption of reliance through the ‘fraud on the market’ theory. . . Without this presumption, individual questions about investor reliance on misrepresentations would predominate over common questions, and a class action would not be a superior mechanism for resolving the dispute.” (citing *Basic*, 485 U.S. at 241-42)).

<sup>376</sup> *Amgen*, 133 S. Ct. at 1193 (“Absent the fraud-on-the-market theory, the requirement that Rule 10b-5 plaintiffs establish reliance would ordinarily preclude certification of a class action seeking money damages because individual reliance issues would overwhelm questions common to the class.”); *Basic*, 485 U.S. at 242 (“Requiring 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.”).

<sup>377</sup> CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS, 2012 REVIEW AND ANALYSIS Figure 11 (2012) (the median settlement value for cases involving both Section 10b-5 claims and Section 11 and/or Section 12(a)(2) claims is \$11 million, whereas the median settlement value for cases alleging Section 10b-5 claims only is \$6.8 million); *The WorldCom and Enron Directors’ Settlements* (Jan. 2005), [http://www.shearman.com/files/Publication/f2f2aa3c-5427-4cb3-88ad-4b10b5452794/Presentation/PublicationAttachment/8a1a25d2-a83a-4b77-b149-7b4511325b9e/LIT\\_012005.pdf](http://www.shearman.com/files/Publication/f2f2aa3c-5427-4cb3-88ad-4b10b5452794/Presentation/PublicationAttachment/8a1a25d2-a83a-4b77-b149-7b4511325b9e/LIT_012005.pdf) (discussing \$54 million WorldCom settlement and \$168 million Enron settlement; both cases alleged Section 11 violations); Stipulation and Agreement of Settlement 7, 14, *In re* Initial Public Offering Sec. Litig., No. 21 MC 92 (S.D.N.Y. Apr. 1, 2009), available at <http://iposecuritieslitigation.com/stipofsettlement3.09.pdf> (the Initial Public Offering Securities Litigation, involving 309 different class actions lawsuits, included Section 11 claims and settled for \$586 million).

This litigation market would, in many ways, resemble the opt-out litigation market that currently arises in the largest class action securities fraud lawsuits. Until recently, opt out litigation was relatively rare because most securities litigators believed that opt-out actions were not worth the time, effort and expense.<sup>378</sup> Large institutional investors have, however, begun opting out of large securities fraud actions in increasing numbers in order to pursue individual claims and settlements.<sup>379</sup> Sixty-five investors opted out of the \$6.1 billion WorldCom class settlement approved in 2005; more than 100 opted out of the \$2.65 billion AOL Time Warner securities class settlement approved in 2006; and more than 288 opted out of the \$3.2 billion Tyco International settlement approved in December 2007.<sup>380</sup> In some cases, institutions opted out together and litigated as a group, engaging the same counsel to pursue their claims but without forming a class.<sup>381</sup>

The decision to opt-out of a securities fraud class action is typically motivated by a range of factors. The opportunity for increased recovery plays a critical role, and data suggest that some investors who pursued individual claims earned significantly larger recoveries than they would have received had they remained members of the class, though this assertion is vigorously challenged by plaintiff class action counsel.<sup>382</sup> For example, a group of five New York City pension funds that opted out of the WorldCom litigation claims to have recovered three times more than they would have recovered had remained in the class.<sup>383</sup> Several institutional investors that opted out of the AOL Time Warner litigation appear to have recovered significantly more than they would have as class members, with one opt-out investor claiming to have settled for 50 times more than it would have recovered as a member of the class.<sup>384</sup> Institutional investors that opted out of the Qwest Communications case announced settlement proceeds between 30 and 45 times larger than the recoveries they would have received had they remained in the class.<sup>385</sup> Professor John Coffee estimates that institutional investors can recover 20% to 40% of their out-

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<sup>378</sup> Joshua H. Vinik, Andrei Rado and John R.S. McFarlane, *Why Institutional Investors Are Opting Out of Class-Action Litigation*, PENSIONS & INVESTMENTS, July 25, 2011, <http://www.pionline.com/article/20110725/PRINTSUB/307259985>.

<sup>379</sup> *Id.*; see also Kevin LaCroix, *Securities Class Action Opt-Outs: Back with a Vengeance?*, D&O DIARY, Nov. 19, 2012, <http://www.dandodiary.com/articles/optouts/>; Julie Triedman, *Heavy-Hitters Hit Pfizer with New Securities Suit, Highlighting Opt-Out Trend*, AM LAW LITIGATION DAILY, Nov. 15, 2012 (“the trend is towards more opting out” (quoting Professor John Coffee)).

<sup>380</sup> Vinik, et al., *Why Institutional Investors are Opting Out*, *supra* note 378.

<sup>381</sup> Vinik, et al., *Why Institutional Investors are Opting Out*, *supra* note 378.

<sup>382</sup> Blair A. Nicholas and Ian D. Berg, *Why Institutional Investors Opt Out of Securities Fraud Class Actions and Pursue Direct Individual Actions* 1, P.L.I. Publication, 2009, available at [http://www.blbglaw.com/news/media\\_mentions/00104/\\_res/id=sa\\_File1/PLIreprint7\\_22\\_09](http://www.blbglaw.com/news/media_mentions/00104/_res/id=sa_File1/PLIreprint7_22_09) (noting that “Institutional investors . . . have achieved significant premiums on their recovery of losses caused by securities fraud by selectively and strategically opting-out of certain securities class actions.”).

<sup>383</sup> John C. Coffee, *Accountability and Competition in Securities Class Actions: Why ‘Exit’ Works Better than ‘Voice’* 29 (Columbia L. & Econ. Working Paper No. 329, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1113845](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1113845).

<sup>384</sup> *Id.* at 29-30.

<sup>385</sup> *Id.* at 31. Several institutional investors also opted out of the Countrywide securities fraud settlement and filed their own collective action against Countrywide and certain of its directors and officers. Counsel for the opt-out plaintiffs stated that the opt out litigants’ losses were “far greater than what they would have received in the proposed settlement’ and that they were unwilling to settle for just ‘pennies on the dollar.’” Kevin LaCroix, *Are Securities Class Action Opt-Out Actions Back?*, D&O DIARY, Aug. 1, 2011, <http://www.dandodiary.com/2011/08/articles/optouts/are-securities-class-action-optout-actions-back/>.

of-pocket losses in an individual action, while class members typically recover an average of only 2% to 3% of their out-of-pocket losses.<sup>386</sup> Individual litigants can also receive settlement proceeds within 30 days of the settlement date, whereas, the proceeds from a class settlement, which are subject to a settlement approval process and claims administration, can be delayed for one to two years.<sup>387</sup>

Opt-out litigants also escape the need to litigate lengthy and complex issues surrounding class certification and administration,<sup>388</sup> and may also have the option of pursuing their claims in state court<sup>389</sup> – a venue typically unavailable to class actions because of the Securities Litigation Uniform Standards Act.<sup>390</sup> State court litigation might also provide plaintiffs a “home court” advantage and offer relief from the procedural hurdles that apply to federal class actions.<sup>391</sup> Opt-out litigants can also pursue state law or other claims that might be unavailable to a class and that have lower standards of proof than their federal counterparts.<sup>392</sup> Direct actions also provide opt-out litigants with complete control over the prosecution of the action, settlement, and the selection of legal counsel.<sup>393</sup> All of these benefits of opt-out litigation can be captured by large investors with losses sufficiently large to support the pursuit of individual claims, whether under federal or state law.

## B. Potential Legislative Responses

If the Supreme Court adopts an actual reliance requirement, then a battle over securities litigation reform is likely to erupt in Congress.<sup>394</sup> At the simplest level, the debate will likely

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<sup>386</sup> Coffee, *Accountability and Competition*, *supra* note 383, at 48.

<sup>387</sup> Nicholas & Berg, *Why Institutional Investors Opt Out of Securities Fraud Class Actions*, *supra* note 382, at 6; Triedman, *Heavy-Hitters Hit Pfizer*, *supra* note 379 (quoting out-opt counsel for several large institutional investors, who claims that the firm’s clients “are generally paid within 30 to 45 days of a settlement as we have no settlement approval or claims administration process; we just dismiss our case, and it's done”).

<sup>388</sup> Vinik, et al., *Why Institutional Investors Are Opting Out of Class-Action Litigation*, *supra* note 378.

<sup>389</sup> *Id.*; Nicholas & Berg, *Why Institutional Investors Opt Out of Securities Fraud Class Actions*, *supra* note 382, at 3-4.

<sup>390</sup> Securities Litigation Uniform Standards Act, Pub. L. 105-353, 112 Stat. 3227 (1998) (amending § 16 of the Securities Act of 1933 (15 U.S.C. §77p) and §28 of the Securities Exchange Act of 1934 (15 U.S.C. § 78bb), to provide that any “covered class action” involving a “covered security” that is filed in state court is preempted, and “shall be removed” to the federal court for the district in which the action is pending).

<sup>391</sup> Coffee, *Accountability and Competition*, *supra* note 383, at 34-36; *see also* Nicholas & Berg, *Why Institutional Investors Opt Out of Securities Fraud Class Actions*, *supra* note 382, at 1 (“In a direct state court action, an investor may potentially assert broader and more expansive liability and damages claims against corporate wrongdoers ... while avoiding the litigation hurdles, limitations and delays imposed by the federal securities laws ....”).

<sup>392</sup> Nicholas & Berg, *Why Institutional Investors Opt Out of Securities Fraud Class Actions*, *supra* note 382, at 3-4; Vinik, et al., *Why Institutional Investors are Opting Out*, *supra* note 378.

<sup>393</sup> Coffee, *Accountability and Competition*, *supra* note 383, at 37-38 (noting that “each opt out selects its own counsel and can monitor it closely, demanding at least as good a settlement as the other opt outs receive”); Nicholas & Berg, *Why Institutional Investors Opt Out of Securities Fraud Class Actions*, *supra* note 382, at 1 (“By opting-out, an institutional investor has complete control over the prosecution of its own unique claims.”).

<sup>394</sup> Calls for a legislative response followed the Supreme Courts’ decisions in each of *Central Bank*, *Stoneridge*, and *Morrison*. In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), the Supreme Court held that Section 10(b) and Rule 10b-5 do not create an implied private cause of action for aiding and abetting securities fraud. *Id.* at 191-92. Congress responded by adopting the Private Securities Litigation Reform Act (the “PSLRA”). The PSLRA reaffirmed the SEC’s express authority to seek civil enforcement against aiders and abettors of securities fraud but did not restore the rights of private parties to sue for aiding and abetting. *See* PSLRA § 104, 15 U.S.C.A. § 78t(e) (West Supp. 1996).

focus on whether Congress should amend the federal securities laws to undo the effects of any Supreme Court decision that imposes an actual reliance requirement on Section 10(b) private rights of action.<sup>395</sup> But even this simple suggestion raises complex drafting questions. Would Congress adopt the current rebuttable presumption of reliance even in the face of evidence that the presumption is *de facto* irrebuttable in all but the most unusual instances? If some other presumption is to be applied, how is it to be structured? If efficiency is to be a precondition for establishing any presumption, by what standard is efficiency to be demonstrated? Or, more boldly, would Congress simply eliminate reliance as an element of the Section 10(b) cause of action, as some commentators have suggested would have been a cleaner analysis in *Basic*?<sup>396</sup>

But if questions of this sort are raised before Congress, the debate can easily morph into a much larger controversy over the optimal structure of a securities litigation enforcement regime. And, once this larger question is put to Congress, the proposals for reform – just from the academic literature – are legion.<sup>397</sup>

One set of proposals would eliminate or sharply reduce private rights of action and instead rely more substantially on federal enforcement of the securities laws, assuming that the

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In *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008), the Supreme Court reaffirmed its holding in *Central Bank* that liability under section 10(b) does not extend to aiders and abettors, and held that, to be actionable, “[t]he conduct of a secondary actor must” itself “satisfy each of the elements or preconditions for liability” under Section 10(b) and Rule 10b-5, including proof of reliance upon a material misrepresentation or omission by the defendant. *Id.* at 158. Certain members of Congress fought to include in the Dodd Frank Wall Street Reform and Consumer Protection Act a provision that would have overturned *Stoneridge*. While that provision did not appear in the final version of the Act, the Act did expand the SEC’s enforcement authority first by extending express aiding and abetting liability to the Securities Act, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, and second by clarifying that the SEC’s aiding and abetting authority extended to “reckless” as well as “knowing” conduct. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 929M(a), § 929M(b), § 929N (2010). In addition, section 929Z of the Dodd-Frank Act required the comptroller general of the United States to “conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws.” *Id.* at § 929Z.

In *Morrison v. Nat’l Austl. Bank Ltd.*, — U.S. —, 130 S.Ct. 2869 (2010), the Supreme Court limited the extraterritorial reach of section 10(b) to “securities listed on domestic exchanges[ ] and domestic transactions in other securities.” *Id.* at 2884. Congress responded with Section 929P(b) of the Dodd-Frank Act, which amends Section 22 of the Securities Act of 1933 (15 U.S.C. 77v(c)), Section 27 of the Exchange Act (15 U.S.C. 78aa(b)), and Section 214 of the Investment Advisers Act of 1940 (15 U.S.C. 80b– 14(b)) to provide the district courts with jurisdiction over SEC claims involving: “(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.” Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 929P(b) (2010). The Dodd Frank Act also ordered the SEC to solicit comments and conduct a study to determine the extent to which the antifraud provisions of the Exchange Act should be extended extraterritorially in the context of private rights of action. *See* § 929Y, 124 Stat. at 1871.

<sup>395</sup> For an example of arguments in defense of the current *status quo*, see, e.g., Roberta Karmel, *In Defense of the Presumption of Reliance: Thoughts on ‘Amgen’*, N.Y.L.J., Apr. 18, 2013.

<sup>396</sup> Langevoort, *Basic at Twenty*, *supra* note 262, at 198 (“There are good reasons for fraud-on-the-market lawsuits, in terms of both compensation and, more likely, deterrence, but also good reasons to worry about indeterminacy and disproportion. Reliance and loss causation have never been the right subjects for dealing with this, and one can imagine a better world in which neither is a significant element of the cause of action.”).

<sup>397</sup> The academic literature is replete with proposals for reforming the securities fraud enforcement regime generally and Section 10(b) specifically.



Securities and Exchange Commission was properly funded.<sup>398</sup> Greater reliance on federal enforcement could also be coupled with an expanded SEC ability to impose fines and penalties on violators,<sup>399</sup> as well as with an expanded ability to distribute recoveries to investors harmed by an alleged fraud.

Another set of proposals would allow private securities fraud litigation to continue but would subject that private litigation to the SEC's authority to "oversee and manage private litigation efforts."<sup>400</sup> Others suggest that the SEC might "be given the power to evaluate private lawsuits on a case-by-case basis, blocking bad cases, aiding good ones, and otherwise husbanding private enforcement capacity in ways that conserve scarce public enforcement resources for other uses."<sup>401</sup>

Several commentators observe that a major flaw of the current public and private securities fraud litigation system is that the individuals responsible for securities frauds generally escape responsibility for their actions because settlements are most frequently paid out of corporate funds or insurance policies. They suggest a variety of reforms designed to increase the potential liability of individuals responsible for corporate wrongdoing.<sup>402</sup>

Other commentators focus on the irrationality of the out-of-pocket damage rule and suggest damage caps<sup>403</sup> or propose the application of alternative damage rules that would

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<sup>398</sup> See, e.g., Bratton and Wachter, *The Political Economy of the Fraud on the Market Presumption*, *supra* note 230, at 72 (proposing greater resources for increased SEC enforcement in return for the elimination of the fraud on the market presumption).

<sup>399</sup> See, e.g., Alexander, *Rethinking Damages in Securities Class Actions*, *supra* note 332 (proposing that a system of civil penalties replace aftermarket damage awards). In a bipartisan effort, two senators have recently proposed increasing the maximum civil penalty that the SEC can impose and would link those penalties to measures of investor harm. See *The Stronger Enforcement of Civil Penalties Act (SEC Penalties Act)*, S. 3416, 112th Congress (2012). See also Shahien Nasiripour, *Bipartisan Bid to Give More Clout to SEC*, *FIN. TIMES*, July 23, 2012, at 14.

<sup>400</sup> David Freeman Engstrom, *Agencies as Litigation Gatekeepers* 3 & n. 4, 123 *YALE L. J.* \_\_\_\_ (forthcoming 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2290843](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290843) (citing *inter alia*, Tamar Frankel, *Let the Securities and Exchange Commission Outsource Enforcement by Litigation: A Proposal*, 11 *J. BUS. & SEC. L.* 111 (2010) (proposing an auction license model for coordinating public and private enforcement); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 *U. CHI. L. REV.* 1, 115 (1991) (advancing an auction proposal); Grundfest, *Disimplying Private Rights of Action*, *supra* note 71, at 977-78 (observing that the SEC has the delegated authority to craft Rule 10b-5, and there is no obligation that the Rule extend to the maximum extent of the Congressionally delegated authority. Thus, the Commission can administratively carve back on the scope of the implied private right)).

<sup>401</sup> Engstrom, *Agencies as Litigation Gatekeepers*, *supra* note 400, at 3 & n.6 (citing *inter alia*, Jennifer Arlen, *Public Versus Private Enforcement of Securities Fraud* 46 (2007); Alexander, *Rethinking Damages in Securities Class Actions*, *supra* note 332; Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 *LAW & CONTEMP. PROBS.* 167 (1997); Geoffrey Christopher Rapp, *False Claims, Not Securities Fraud: Towards Corporate Governance by Whistleblowers*, 15 *NEXUS: CHAPMAN'S J. L. & SOC. POL'Y* 55 (2009); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 *COLUM. L. REV.* 1301 (2008)).

<sup>402</sup> See, e.g., Coffee, *Reforming the Securities Class Action*, *supra* note 4, at 1538 (suggesting that individuals responsible for wrongdoing bear increased liability in fraud on the market lawsuits).

<sup>403</sup> See, e.g., Langevoort, *Capping Damages*, *supra* note 332, at 641 (proposing a damage cap in Rule 10b-5 aftermarket litigation); Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 *COLUM. L. REV.* 237, 287 (2009).

modulate exposure depending on whether the plaintiff can demonstrate actual reliance,<sup>404</sup> or on a variety of other factors. “Loser pay” models of attorney fee awards have also been suggested as means of addressing the incentive to file speculative securities fraud claims.<sup>405</sup>

The list of potential alternatives is far longer than this summary suggests, but this abbreviated menu is more than sufficient to demonstrate that a decision to adopt an actual reliance requirement as a precondition to Section 10(b) recovery has the potential to set off a broad-ranging legislative reconsideration of the securities fraud enforcement regime. This reconsideration could well rival the debate that accompanied adoption of the PSLRA in 1995, and could presage a fundamental reconsideration of the operation of the nation’s securities law enforcement regime with the capacity to rival the scope of the PSLRA reforms.

### VIII. Conclusion

A textualist interpretation of Section 10(b) concludes that out of pocket damages cannot be awarded in aftermarket trading cases unless the plaintiff affirmatively demonstrates actual reliance. The legislative history of the Exchange Act is consistent with this conclusion, as is the Supreme Court’s more recently enunciated rule that interprets the implied private right of action under Section 10(b) in the narrowest possible manner precisely because it is an implied private right.

The post-1934 history of the Exchange Act also confirms a strong preference for agency enforcement over private enforcement. The Act has been amended in a manner that is inconsistent with the semi-strong form of the efficient market hypothesis that serves as the foundation for *Basic*’s rebuttable presumption of reliance. Another amendment rejects the disproportionate damages that can result from application of the out-of-pocket damage rule to frauds that affect aftermarket trading. The public policy literature provides further support for an interpretation of Section 10(b) that would dramatically reduce the scope of recoverable damages in aftermarket trading cases. To be sure, the same literature also provides support for an aggressive private enforcement mechanism that acts as a valuable supplement to Commission enforcement activity, but recent history suggests that the Court tends to rely on policy arguments to buttress conclusions it reaches on other grounds, and the Court tends not to rely on policy arguments as an independent basis upon which to support any particular result.

Further, *Basic*’s presumption of reliance is described by the Court as “rebuttable.” Experience teaches, however, that once the presumption attaches it is exceedingly difficult to rebut. Indeed, there appears to be only five instances in the twenty-five years since *Basic* has been adopted in which the presumption has been successfully rebutted, and that number might be an over-count. Rebutting the presumption in the context of class action litigation is particularly

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<sup>404</sup> Adam C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2007-8 CATO SUP. CT. REV. 217, 247-55 (2008) (proposing that plaintiffs who rely on the fraud-on-the-market presumption recover only disgorgement damages, while out of pocket damages be recoverable only by plaintiffs who prove actual reliance).

<sup>405</sup> See, e.g., Edward A. Fallone, *Section 10(B) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71, 81 (1997) (noting that “the original draft of the House bill [for the Private Securities Litigation Reform Act] contained a ‘loser pays’ provision that would have required unsuccessful parties to reimburse the attorneys’ fees of prevailing parties”).

difficult because a successful rebuttal is easily reframed as a challenge to the lead plaintiffs' typicality, rather than as a basis for denial of class certification. Indeed, of the five identified instances of potential rebuttal, only one arguably relates to a class action claim. To place this datum in context, at least 3,020 federal securities fraud class actions have been filed since 1996. *Basic*'s rebuttable presumption of reliance thus appears to be rebuttable in theory far more than in fact, and it is an open question as to whether *Basic*'s plurality would have adopted the presumption had they understood that the presumption would become *de facto* irrebuttable. This observation provides an independent ground for challenging *Basic*.

The conclusion that actual reliance is a precondition to recovery under Section 10(b) can be framed as having two analytically distinct implications. First, the actual reliance requirement can be described as a precondition to the award of aftermarket Section 10(b) damages in a manner that allows the Supreme Court to impose an actual reliance requirement without formally overturning *Basic*. Alternatively, the actual reliance requirement can be described as a textualist basis for reversing *Basic* in a manner that avoids complex and contestable questions over the definition and viability of the efficient market hypothesis. Because the Court lacks a comparative advantage in refereeing complex econometric disputes, a decision reversing *Basic* might rest on stronger grounds if it relied exclusively on principles of statutory construction as to which the court has a comparative advantage.

The implications of an actual reliance requirement as a pre-requisite for the recovery of aftermarket damages under Section 10(b) are profound. Section 10(b) class actions would then become difficult, if not impossible to certify, and the size of the remaining classes, if any, would shrink to a great degree. Securities fraud litigation would then be dominated by Section 11 class actions, which would be unaffected by changes to the Section 10(b) private right to recovery, and by a scrum of individual actions brought by larger investors with significant damage claims in major cases.

Such a dramatic shift in the litigation landscape would almost certainly spark calls for legislative reform. Proponents of private rights of action would likely call for reinstatement of *Basic*'s presumption of reliance. But the battle over securities litigation reform will not be easily cabined to a debate over reliance and its predicates. Instead, the debate would likely expand to consider a broad range of securities litigation reform initiatives, including alternative mechanisms for coordinating federal and private enforcement, strategies for increasing the liability of individuals responsible for fraud, methods of imposing caps on exposure for aftermarket frauds, and techniques for creating a new system of penalties that might fund compensation to investors, among a host of other alternatives. The outcome of this legislative process is impossible to predict, and could presage a fundamental reform in the operation of the nation's securities law enforcement regime.

## Appendix A

### Amendments to the Securities Act

*See* Jumpstart Our Business Startups Act, Pub. L. 112-106, 126 STAT. 306 (2012); Investor Protection and Securities Reform Act of 2010, part of the Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1822 (2010); 2004 Amendments to the Securities Act of 1933, Pub. L. 108-359, 118 Stat. 1666 (2004); Investor and Capital Markets Fee Relief Act, Pub. L. 107-123, 115 Stat. 2390 (2002); Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002); Consolidated Appropriations Act, Pub. L. 106-554, 114 STAT. 2763 (2000); Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999); Securities Litigation Uniform Standards Act, Pub. L. 105-353, 112 Stat. 3227 (1998); National Securities Markets Improvement Act, Pub. L. 104-290, 110 Stat. 3416 (1996); Securities and Exchange Commission Authorization Act of 1996, Pub. L. 104-290, 110 Stat. 3441 (1996); Private Securities Litigation Reform Act of 1995, Pub.L. 104-67, 109 Stat. 737 (1995); Philanthropy Protection Act of 1995, Pub. L. 104-62, 109 Stat. 682 (1995); Small Business Loan Securitization and Secondary Market Enhancement Act of 1994, Pub. L. 103-325, 108 Stat. 2198 (1994); Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429, 104 Stat. 931 (1990); Securities and Exchange Commission Authorization Act of 1987, Pub. L. 100-181, 101 Stat. 1249 (1987); 1982 Amendments to the Securities Act of 1933, Pub. L. 97-303, 96 Stat. 1409 (1982); Bus Regulatory Reform Act of 1982, Pub. L. 97-261, 96 Stat. 1102 (1982); Small Business Investment Incentive Act of 1980, Pub. L. 96-477, 94 Stat. 2275 (1980); Securities Investor Protection Act Amendments of 1978, Pub. L. 95-283, 92 Stat. 249 (1978); Act on the Subject of Bankruptcy, Pub. L. 95-598, 92 Stat. 2549 (1978); Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. 94-210, 90 Stat. 56 (1976); Securities Act Amendments of 1975, Pub. L. 94-29, 89 Stat. 163 (1975); 1970 Amendments to the Securities Act of 1933, Pub. L. 91-567, 84 Stat. 1498 (1970); 1970 Amendments to the Securities Act of 1933, Pub. L. 91-565, 84 Stat. 1480 (1970); Investment Company Amendments Act of 1970, Pub. L. 91-547, 84 Stat. 1424 (1970); Employment Security Amendments of 1970, Pub. L. 91-373, 84 Stat. 718 (1970); 1965 Amendments to the Securities Act of 1933, Pub. L. 89-289, 79 Stat. 1051 (1965); Securities Act Amendments of 1964, Pub. L. 88-467, 78 Stat. 580 (1964); 1962 Amendments to the Securities Act of 1933, Pub. L. 87-592, 76 Stat. 394 (1962); Hawaii Omnibus Act, Pub. L. 86-624, 74 Stat. 413 (1960); Alaska Omnibus Act, Pub. L. 86-70, 73 Stat. 146 (1959); 1958 Amendments to the Securities Act of 1933, Pub. L. 85-791, 72 Stat. 945 (1958); Small Business Investment Act of 1958, Pub. L. 85-699, 72 Stat. 694 (1958); 1954 Amendments to the Securities Act of 1933, Pub. L. 83-577, 68 Stat. 683 (1954); 1945 Amendments to the Securities Act of 1933, Pub. L. 79-55, 59 Stat. 167 (1945); Investment Advisors Act of 1940, Pub. L. 76-768, 54 Stat. 857 (1940); Motor Carrier Act of 1935, Pub. L. 74-255, 49 Stat. 557 (1935); Securities Exchange Act of 1934, Pub. L. 73-291, 48 Stat. 881 (1934).

## Appendix B

### Amendments to the Exchange Act

*See* Jumpstart Our Business Startups Act, Pub. L. 112-106, 126 Stat. 306 (2012); Investor Protection and Securities Reform Act of 2010, part of the Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1822 (2010); Credit Rating Agency Reform Act of 2006, Pub. L. 109-291, 120 Stat. 1327 (2006); Financial Services Regulatory Relief Act of 2006, Pub. L. 109-351, 120 STAT. 1966 (2006); Emergency Securities Response Act of 2004, part of the Intelligence Reform and Terrorism Prevention Act Of 2004, Pub. L. 108-458, 118 Stat. 3862 (2004); 2004 Amendments to the Securities Exchange Act of 1934, Pub. L. 108-359, 118 Stat. 1666 (2004); Sarbanes-Oxley Act of 2002, Pub. L 107-204, 116 Stat. 745 (2002); Investor and Capital Markets Fee Relief Act, Pub. L. 107-123, 115 Stat. 2390 (2002); Consolidated Appropriations Act, Pub. L. 106-554, 114 STAT. 2763 (2000); Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999); International Anti-Bribery and Fair Competition Act of 1998, Pub. L. 105-366, 112 Stat. 3302 (1998); Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227 (1998); National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996); Securities and Exchange Commission Authorization Act of 1996, Pub. L. 104-290, 110 Stat. 3441 (1996); Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (1995); Philanthropy Protection Act of 1995, Pub. L. 104-62, 109 Stat. 682 (1995); Unlisted Trading Privileges Act of 1994, Pub. L. 103-389, 108 Stat. 4081 (1994); Small Business Loan Securitization and Secondary Market Enhancement Act of 1994, Pub. L. 103-325, 108 Stat. 2198 (1994); Government Securities Act Amendments of 1993, Pub. L. 103-202, 107 Stat. 2344 (1993); Securities Act Amendments of 1990, Pub. L. 101-550, 104 Stat. 2713 (1990); Market Reform Act of 1990, Pub. L. 191-432, 104 Stat. 963 (1990); Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429, 104 Stat. 931 (1990); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. 100-704, 102 Stat. 4677 (1988); Securities and Exchange Commission Authorization Act of 1987, Pub. L. 100-181, 101 Stat. 1249 (1987); Government Securities Act of 1986, Pub. L. 99-571, 100 Stat. 3208 (1986); Shareholder Communications Act of 1985, Pub. L. 99-222, 99 Stat. 1737 (1985); Secondary Mortgage Market Enhancement Act of 1984, Pub. L. 98-440, 98 Stat. 1689 (1984); Insider Trading Sanctions Act of 1984, Pub. L. 98-376, 98 Stat. 1264 (1984); 1983 Amendments to the Securities Exchange Act of 1934, Pub. L. 98-38, 97 Stat. 205 (1983); 1982 Amendments to the Securities Exchange Act of 1934, Pub. L. 97-303, 96 Stat. 1409 (1982); Small Business Investment Incentive Act of 1980, Pub. L. 96-477, 94 Stat. 2275 (1980); 1980 Amendments to the Securities Exchange Act of 1934, Pub. L. 96-433, 94 Stat. 1855 (1980); Securities Investor Protection Act Amendments of 1978, Pub. L. 95-283, 92 Stat. 249 (1978); Foreign Corrupt Practices Act, Pub. L. 95-213, 91 Stat. 1494 (1977); Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. 94-210, 90 Stat. 57 (1976); Securities Act Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975); 1974 Amendments to the Securities Exchange Act of 1934, Pub. L. 93-495, 88 Stat. 1503 (1974); Securities Investor Protection Act of 1970, Pub. L. 91-598, 84 Stat. 1653 (1970); 1970 Amendments to the Securities Exchange Act of 1934, Pub. L. 91-567, 84 Stat. 1497 (1970); Investment Company Amendments Act of 1970, Pub. L. 91-547, 84 Stat. 1435 (1970); 1970 Amendments to the Securities Exchange Act of 1934, Pub. L. 91-508, 84 Stat. 1124 (1970); 1970 Amendments to the Securities Exchange Act of 1934, Pub. L. 91-410, 84 Stat. 862 (1970);

Employment Security Amendments of 1970, Pub. L. 91-373, 84 Stat. 718 (1970); 1969  
Amendments to the Securities Exchange Act of 1934, Pub. L. 91-94, 83 Stat. 141 (1969); 1968  
Amendments to the Securities Exchange Act of 1934, Pub. L. 90-439, 82 Stat. 454 (1968); 1968  
Amendments to the Securities Exchange Act of 1934, Pub. L. 90-438, 82 Stat. 453 (1968); 1968  
Amendments to the Securities Exchange Act of 1934, Pub. L. 90-437, 82 Stat. 452 (1968);  
Securities Act Amendments of 1964, Pub. L. 88-467, 78 Stat. 565 (1964); August 1962  
Amendments to the Securities Exchange Act of 1934, Pub. L. 87-592, 76 Stat. 394 (1962); July  
1962 Amendments to the Securities Exchange Act of 1934, Pub. L. 87-561, 76 Stat. 247 (1962);  
1961 Amendments to the Securities Exchange Act of 1934, Pub. L. 87-196, 75 Stat. 465 (1961);  
1960 Amendments to the Securities Exchange Act of 1934, Pub. L. 86-619, 74 Stat. 408 (1960);  
1960 Amendments to the Securities Exchange Act of 1934, Pub. L. 86-771, 74 Stat. 913 (1960);  
1954 Amendments to the Securities Exchange Act of 1934, Pub. L. 83-577, 68 Stat. 683 (1954);  
1944 Amendments to the Securities Exchange Act of 1934, Pub. L. 78-258, 58 Stat. 117 (1944);  
1938 Amendments to the Securities Exchange Act of 1934, Pub. L. 75-719, 52 Stat. 1070 (1938);  
1936 Amendments to the Securities Exchange Act of 1934, Pub. L. 74-621, 49 Stat. 1375 (1936).