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# The "Fraud-on-the-Market" Presumption of Reliance Revisited: Supreme Court Declines to Require Proof of Materiality at Class Certification Stage

BY SECURITIES LITIGATION AND ENFORCEMENT PRACTICE

On February 27, 2013, the Supreme Court issued its opinion in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*[1] ("*Amgen*"). The issue presented in *Amgen* was whether plaintiffs invoking the "fraud-on-the-market" presumption of reliance must establish the element of materiality before obtaining class certification in federal securities class actions. A divided Court held that the issue of materiality is a question common to the entire class in such a case, and therefore, materiality does *not* need to be proven as a prerequisite for class certification.

While the Court foreclosed direct challenges to the element of materiality at the class certification stage, the Court's opinion is noteworthy because it expressly left open the possibility that the Court would reconsider the "fraud-on-the-market" presumption of reliance altogether. The "fraud-on-the-market" presumption was established by the Court twenty-five years ago in *Basic Inc. v. Levinson*[2] ("*Basic*"). If the presumption is revisited, it could dramatically change the landscape of federal securities class actions.

## The Fraud-on-the-Market Presumption of Reliance

Under Section 10(b) of the Securities Exchange Act of 1934[3] and SEC Rule 10b-5,[4] private plaintiffs must show they relied upon material misrepresentations in buying or selling a security. The judicially created fraud-on-the-market theory posits that defendants' material misrepresentations can defraud market participants by distorting the market price of the security at issue. Thus, the fraud-on-the-market presumption essentially allows plaintiffs in these cases to establish the reliance element indirectly, and on a class-wide basis, by demonstrating that certain predicates have been satisfied, including that the security at issue traded in an efficient market ("market efficiency") and that the alleged misrepresentation was made public ("publicity"). The Supreme Court granted *certiorari* in *Amgen* to address a circuit split as to whether the class proponent must also establish materiality as a condition precedent to invoking the *Basic* presumption of reliance.

### The Supreme Court's Holding: Establishing the Element of Materiality Is Not a Prerequisite to Class Certification in a Fraud-on-the-Market Case

Writing for the majority, Justice Ginsburg explained that the key question in the case was not whether "materiality is an essential predicate of the fraud-on-the-market theory; indisputably it is. Instead, the pivotal inquiry [was] whether proof of materiality is needed to ensure that the *questions* of law or fact common to the class will predominate over any questions affecting only individual members."[5]

Materiality, the Court reasoned, is a matter of objective inquiry, meaning that it is subject to proof common to the class. Because materiality is also an essential element of a Rule 10b-5 claim, failure of proof on the issue ends the case "for one and for all,"[6] demonstrating the commonality of the question of materiality. Consequently, the Court found that, while a securities plaintiff "certainly must prove materiality to prevail on the merits, . . . such proof is not a prerequisite to class certification."[7]

The Court noted that, unlike market efficiency and publicity, materiality is an indispensable element of a Rule 10b-5 claim. For the Court, "failure of proof on the issue of materiality . . . not only precludes a plaintiff from invoking the fraud-on-the-market presumption of classwide reliance; it also establishes as a matter of law that the plaintiff cannot prevail on the merits of her Rule 10b-5 claim."[8] While failure of proof as to market efficiency or publicity might lead to individualized claims, failure of proof as to materiality "ends the case for the class and for all individuals alleged to compose the class."[9] Thus, while market efficiency and publicity must be proven at the class certification stage, the Court reasoned that the element of materiality is more appropriately addressed by way of summary judgment or trial.[10]

### Revisiting *Basic*: Justice Alito's Concurrence and the Dissents

Justice Ginsburg's opinion explicitly notes that a challenge to the validity of the *Basic* presumption was not before the Court, and that the case was "a poor vehicle for exploring [the efficacy] of the fraud on the market presumption of reliance."[11] Thus, the majority opinion leaves open the possibility that the Court would revisit *Basic* in an appropriate case in the future, if securities class action defendants challenge the fundamental validity of that decision's fraud-on-the-market presumption.

Indeed, at least four Justices explicitly indicated a willingness to question that presumption. In a brief concurrence, Justice Alito acknowledged that the *Basic* presumption of reliance "may rest on a faulty economic premise," and stated that reconsideration of the presumption may be appropriate.[12] Meanwhile, Justice Thomas, joined by Justices Scalia and Kennedy, stated that "[t]he *Basic* decision itself is questionable,"[13] and seems poised to revisit the issue. Justice Thomas recognized that market efficiency may not be "a binary, yes or no question,"[14] and voiced concern about the Court's ability to interpret and implement microeconomic theory. He noted that "[t]he Court retains discretion over the contours of *Basic* unless and until Congress sees fit to alter them – a fact Congress must also have realized when it passed the Private Securities Litigation Reform Act of 1995 . . . and other legislation."[15] These statements, particularly when read with those of Justice Alito, suggest that several members of the Court are poised to revisit *Basic*'s holding – which could potentially undo the entire fraud-on-the-market presumption of reliance.

### *Amgen*'s Impact on Class Certification in Securities Fraud Actions

Reading the Court's decisions in *Halliburton, Matrixx,* and *Amgen* together,[16] it is fairly clear that to invoke the fraud-on-the-market presumption and obtain class certification under Rule 23(b)(3), a securities fraud plaintiff must adequately allege materiality, and directly *prove* that (i) a security traded in an efficient market, (ii) a defendant made a public misstatement or omission regarding the security at issue during the relevant time period, and (iii) the class representative purchased the security during the relevant time period. Whether, and to what extent, materiality and loss causation may be indirectly involved in the consideration of these three items, however, is less clear.

Securities fraud defendants faced with the *in terrorem* effects of a certified class may more stringently contest whether a security traded in an efficient market with event studies and related empirical evidence. They may also more closely examine class periods at certification. And when and if a class is certified, Justice Ginsburg's opinion indicates that summary judgment is an appropriate procedure for disposing of those class claims where it can be shown that the market price for the security did not respond to the introduction of a supposedly "material" misstatement.

The Court's split decision in *Amgen* revealed that several Justices on the Court may be willing to revisit the twenty-five-year-old *Basic* presumption of reliance and likely set the stage for a future challenge to the Court's holding in that case.[17] Contemporary economic theory has indeed cast doubt on the very concept of market efficiency, which has provided the central underlying rationale for the fraud-on-the-market doctrine. Perhaps most significantly, then, *Amgen* may portend a fundamental attack on the fraud-on-the-market doctrine altogether.

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[1] No. 11-1085, --- S. Ct. ----, 2013 WL 691001 (U.S. Feb. 27, 2013).

[2] 485 U.S. 224 (1988).

[3] 15 U.S.C. § 78j (2006 & Supp. 2010).

[4] 17 C.F.R. § 240.10b-5 (2012).

[5] *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 2013 WL 691001, at *8 (emphasis in original).

[6] *Id.* at *8. The Court termed this failure of proof "a fatal similarity." *Id.* at *9.

[7] *Id.* at *4. As a corollary to finding that direct proof of materiality is not required at the class certification stage, the Court also determined that courts need not consider rebuttal evidence proffered by the securities fraud defendant. *See id.* at *15.

[8] *Id.* at *11.

[9] *Id.*

[10] *Id.* at *9.

[11] *Id.* at *10 n.6.

[12] *Id.* at *16.

[13] *Id.* at *19 n.4 (Thomas, J., dissenting).

[14] *Id.*

[15] *Id.* at *22 n.9.

[16] The *Halliburton* decision held that plaintiffs need not show loss causation at class certification. *Erica P. John Fund Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011). *Matrixx* determined that materiality is not a bright-line rule, and returned to *Basic*'s holding that materiality is proven when there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318 (quoting *Basic*, 485 U.S. at 238).

[17] To grant certiorari, four Justices must vote in favor of hearing a particular matter. *See* Hearing on S. 2060 and S. 2061 Before a Subcomm. of the S. Comm. on the Judiciary, 68th Cong., 1st Sess., 29 (1924) (testimony of Van Devanter, J.).