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ARBITRATION

Forum-selection clause trumps FINRA arbitration, 9th Circuit says

By Phyllis Lipka Skupien, Esq., Managing Editor

A federal appeals court has ruled that the city of Reno, Nev., and Goldman Sachs & Co. must settle their bond dispute through the federal courts as the forum-selection clause in their agreement supersedes any obligation to arbitrate.

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REUTERS/Robert Galbraith

The city of Reno, Nev., says Goldman Sachs failed to disclose a conflict of interest concerning $211 million in municipal bonds it advised the city to issue.

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Escalating U.S.–Russia tensions lead to new sanctions, heightened money-laundering risks

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Halliburton II: The end of the fraud-on-the-market presumption?

By Lawrence T. Gresser, Esq., Mark S. Cohen, Esq., and Melanie A. Grossman, Esq.
Cohen & Gresser

The U.S. Supreme Court heard argument March 5 in *Halliburton Co. v. Erica P. John Fund Inc.*, a rare case in which the court will directly consider whether to overrule or modify its own precedent.[1] The concept at issue — the "fraud on the market" presumption — has helped shape securities fraud class actions for over 25 years. The court's decision thus has the potential to significantly alter the legal landscape.

BASIC V. LEVINSON AND THE FRAUD-ON-THE-MARKET PRESUMPTION

The fraud-on-the-market presumption was adopted by the Supreme Court in *Basic Inc. v. Levinson*[2] to address the "unrealistic evidentiary burden" imposed by the element of reliance in Rule 10b-5 securities class actions.[3]

Rule 10b-5 prohibits, among other things, misrepresentations or omissions in connection with the purchase or sale of securities. To prevail on a Rule 10b-5, claim, a plaintiff must show:

- A material misrepresentation or omission by the defendant.
- *Scienter*.
- A connection between the misrepresentation or omission and the purchase or sale of a security.
- Reliance upon the misrepresentation or omission.
- Economic loss.
- Loss causation.

In an individual fraud case, the standard way for a plaintiff to prove reliance is by showing awareness of the alleged misrepresentation and an action (or lack of action) based on that misrepresentation. The *Basic* court recognized two problems with this standard in securities class actions.

> In *Amgen*, the U.S. Supreme Court held that proof of materiality is not required to invoke the fraud-on-the-market presumption at the class certification stage.

First, many investors now trade stock in an "impersonal" market and will not have direct proof of reliance on any particular misrepresentation or omission. Second, requiring each member of a putative class to prove individual reliance on a misrepresentation would make it difficult to certify securities class actions, because individual issues of reliance would tend to predominate over issues common to the class.[4]

The majority in *Basic* adopted the fraud-on-the-market presumption as a way for plaintiffs to demonstrate reliance in the absence of direct proof. Generally, the fraud-on-the-market presumption holds that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business."[5] Because "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price," "an investor's reliance on any public material misrepresentations ... may be presumed for purposes of a Rule 10b-5 action."[6]

The court made clear in *Basic* that the presumption is rebuttable: "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."[7]

HALLIBURTON I

In 2002, a group of plaintiffs, including lead plaintiff Erica P. John Fund, Inc., filed a putative securities fraud class action against Halliburton. The plaintiffs alleged that Halliburton deliberately made various misrepresentations related to the scope of its potential liability from ongoing asbestos litigation.

In 2008 the U.S. District Court for the Northern District of Texas denied the plaintiffs' request for class certification, saying the putative class failed to prove "loss causation," or a causal connection between the misrepresentations and the plaintiffs' loss. The 5th U.S. Circuit Court of Appeals affirmed.

In a unanimous decision, the Supreme Court held that the lower courts erred by requiring proof of loss causation at the class certification stage.[8]

Halliburton conceded this point, but argued that the Supreme Court was not correctly interpreting the 5th Circuit's decision. According to Halliburton, the 5th Circuit's denial of class certification was based on EPJ Fund's failure to show "price impact" — "that is, whether the alleged misrepresentations



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affected the market price."[9] Halliburton said if a misrepresentation does not affect the market price of a security, an investor cannot be said to have relied on the misrepresentation merely because the investor purchased stock, and therefore, the Basic presumption should not apply.

The court declined to address this argument, saying, "[w]hatever Halliburton thinks the Court of Appeals meant to say, what it said was loss causation."[10]

The court vacated and remanded the case to allow the lower court to address any further arguments against class certification. In the meantime, the Supreme Court issued its opinion in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*.[11]

AMGEN SETS THE STAGE FOR *HALLIBURTON II*

In *Amgen*, the Supreme Court held that proof of materiality is not required to invoke the fraud-on-the-market presumption at the class certification stage.

The majority opinion, authored by Justice Ruth Bader Ginsburg and joined by Chief Justice John Roberts and Justices Stephen Breyer, Samuel Alito, Sonia Sotomayor and Elena Kagan, conceded that materiality is "indisputably" an "essential predicate" of the fraud-on-the market presumption.[12]

a failure to prove materiality at the merits stage will not force courts to examine individual questions; instead, it will end the case entirely.

Justice Alito wrote a concurring opinion. Justice Clarence Thomas, writing for the dissent, said the majority erred by focusing on the question of materiality in terms of its relevance to a 10b-5 claim, rather than its relevance to determining whether reliance is susceptible to class-wide proof.

According to the dissent, "nothing in logic or precedent justifies ignoring at certification whether reliance is susceptible to Rule 23(b)(3) class-wide proof simply because one predicate of reliance — materiality — will be resolved, if at all, much later in the litigation on an independent merits element." Justice Thomas was joined by Justice Anthony Kennedy and, in part, by Justice Antonin Scalia.

The concurring and dissenting opinions in *Amgen* did more than question the majority's holding, however; they cast a bulls-eye on *Basic*.

Justice Thomas and Justice Alito both pointed out that the court was not asked to revisit the fraud-on-the-market presumption in *Amgen*. Justice Thomas called the *Basic* decision "questionable," while Justice Alito said, "more recent evidence suggests that [the]

> During the 25 years *Basic* has been part of the court's jurisprudence, Congress has taken numerous steps to address securities fraud class actions, and yet Congress left the presumption intact.

Nevertheless, the majority held that the "pivotal inquiry" for class certification purposes was whether or not proof of materiality is necessary to insure that questions of law common to the class will predominate. The court answered this question in the negative for two reasons. First, the test for materiality is an objective one, focusing on what a "reasonable investor" would consider important. Second, the majority held that plaintiffs do not need to prove materiality at the class certification stage, because "there is no risk whatever that a failure of the common question of materiality will result in individual questions predominating."[13]

Because materiality is also an essential element of a 10b-5 claim, the court said, presumption may rest on a faulty economic premise," and "[i]n light of this development, reconsideration of the *Basic* presumption may be appropriate."[14]

Justice Scalia went as far as saying, "[t]oday'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."

HALLIBURTON MAKES ITS WAY BACK TO THE SUPREME COURT

On remand Halliburton argued that class certification was still improper in light of evidence demonstrating that the company's alleged misrepresentations did not impact the price of the securities. Halliburton said price impact, unlike materiality, is not an essential element of a Rule 10b-5 claim. Therefore, although the absence of price impact would eliminate the fraud-on-the-market presumption of reliance, it would not defeat the plaintiffs' claims entirely.

The District Court and 5th Circuit rejected this argument. They held that although a Rule 10b-5 action does not require proof of price impact, "a plaintiff must nevertheless prevail on this fact in order to establish another element on which the plaintiff does bear the burden of proof — loss causation."[15]

The 5th Circuit said that to successfully prove a lack of price impact resulting from a misrepresentation, Halliburton must demonstrate that the stock price did not increase when the misrepresentation was announced, and did not decrease after the truth was revealed. If Halliburton demonstrated at the merits stage that the price of the stock did not decrease when the truth was revealed, the plaintiffs' claims would not become individualized; they would fail.

ARGUMENTS BEFORE THE SUPREME COURT

The Supreme Court certified two questions on appeal:

- Whether the court should overrule or substantially modify the holding in *Basic* to the extent that it recognizes a presumption of class-wide reliance derived from the fraud-on-the-market theory.
- Whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price.[16]

Halliburton's arguments

Halliburton emphasizes five key points in its brief as to why the court should overrule the fraud-on-the-market presumption.[17]

First, Halliburton argues that *Basic* was wrong when it was decided. There is no express cause of action for violations of Section 10(b) in the Exchange Act. Therefore, according to Halliburton, the Supreme Court should have borrowed from the most analogous cause of

action, Section 18(a), in crafting the elements of a 10(b) claim. Section 18(a) requires proof of actual reliance.

Second, Halliburton says that although the economic principle underlying *Basic* (shares traded on a well-developed market incorporate all publicly available information) enjoyed wide support, evidence now suggests public information is often not quickly or rationally incorporated into market price. Halliburton further says that "efficiency is not a binary, yes or no question" in that a stock might trade efficiently some of the time or with respect to certain types of information, but not others.

Third, Halliburton argues that the *Basic* standard is unworkable and has caused confusion among the lower courts.

Fourth, Halliburton says *Basic* is at odds with the court's recent class action jurisprudence, including in *Wal-Mart Stores v. Dukes*,[18] in which the court held that a putative class must "affirmatively demonstrate" compliance with Rule 23(b)(3).

Fifth, Halliburton makes a number of policy arguments in favor of overruling *Basic*, including that the fraud-on-the-market presumption forces most defendants to enter into settlements that, in the end, do not compensate investors.

Halliburton alternatively argues that the court should modify the *Basic* presumption to require plaintiffs to affirmatively demonstrate the alleged misrepresentations distorted market price, or to allow defendants to introduce price impact evidence to rebut the fraud-on-the-market presumption.

EPJ Fund's arguments

The EPJ Fund argues that *Basic* was correctly decided. Predictably, EPJ Fund devotes a substantial portion of its brief to principles of *stare decisis* and the public policy implications of eliminating the fraud-on-the-market presumption. EPJ Fund's brief says during the 25 years *Basic* has been part of the court's jurisprudence, Congress has taken numerous steps to address perceived problems associated with securities fraud class actions, and yet, Congress left the presumption intact.[19]

The EPJ Fund further argues that the court does not have to (and should not) get into the weeds of an ongoing economic debate about the validity of the efficient capital markets hypothesis. The brief says the fraud-on-the-market presumption rests on the narrower, and much less controversial, proposition that "markets generally react promptly to material public information."

Finally, EPJ Fund argues that *Basic* comports with the Supreme Court's recent class-action jurisprudence and, in fact, was discussed with approval in *Dukes* itself.

As to Halliburton's alternative argument, EPJ Fund says the 5th Circuit correctly concluded that requiring plaintiffs to show price impact — either affirmatively or in response to rebuttal evidence — would be inconsistent with the court's recent decision in *Amgen*. Furthermore, this would result in premature merits discovery and mini-trials.

PREDICTIONS AND CONCLUSION

There are at least four potential outcomes in *Halliburton*, some of which appear more likely than others.

First, the court could eliminate the fraud-on-the-market presumption entirely. It is no secret that the Supreme Court has been increasingly hostile to class actions, and it is clear from *Amgen* that at least three of the justices have serious doubts about *Basic*'s continued validity. Nevertheless, the court is unlikely to eliminate the presumption entirely, for several reasons. Most importantly, eliminating the presumption would make it almost impossible to bring a securities fraud class action. Also, overruling *Basic* could require the court to either determine that *Basic* was wrongly decided at the time or that the (hotly debated) economic literature no longer supports it, a decision the justices would be loath to make.

EPJ Fund argues that *Basic* comports with the Supreme Court's recent class-action jurisprudence and in fact was discussed with approval in *Wal-Mart* itself.

Oral argument

The court held oral argument March 5. As a general matter, the justices' questions seemed focused on Halliburton's argument that *Basic* should be modified to require plaintiffs to show, or defendants to present evidence of, price impact at the class certification stage. The justices seemed particularly focused on the practical implications of the decision before them, asking both parties for the percentages of cases in which the presumption is rebutted, cases that settle after certification and cases resolved at summary judgment.

The justices also asked both parties' counsel for their views on the cost and difficulty of demonstrating price impact at the class certification stage and how this might compare to the event studies plaintiffs already prepare to show market efficiency.

The justices debated with the parties what conclusions, if any, the court should draw from the fact that Congress did not overrule *Basic* when it enacted the Private Litigation Securities Reform Act. The court also discussed whether, as a doctrinal matter, requiring proof of price impact at the class certification stage is consistent with *Amgen*.

Second, the court could uphold the *Basic* presumption as is. This, too, seems unlikely given the questions the court certified and the number of times this issue has come before the court.

Third, the court could agree with Halliburton that plaintiffs must prove price impact at the class certification stage to justify application of the presumption. Or, fourth, the court could hold that the 5th Circuit erred in refusing to permit Halliburton to present price-impact evidence to rebut the presumption. Either of these options is possible, though the third is arguably more consistent with the court's recent class-action jurisprudence in that it places the burden on the plaintiffs in the first instance.

In either case, the court will have to tread a very fine line to ensure its decision is consistent with its more recent opinions in *Amgen* and *Halliburton I*.

Even a minor modification of *Basic* has the potential to significantly alter the way securities class actions are litigated at the class certification stage and could help trigger a critical shift in the Supreme Court's class-action jurisprudence. WJ

NOTES

[1] No. 13-317.

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

[3] *Id.* at 245.

[4] *Id.* at 243-246. Federal Rule of Civil Procedure 23 requires a party seeking class certification to prove that "questions of law or fact common to class members predominate over any questions affecting only individual members." Fed. R. Civ. Proc. 23(b)(3).

[5] *Id.* at 240 (internal citation omitted).

[6] *Id.* at 247.

[7] *Id.* at 248.

[8] *Erica P. John Fund Inc. v. Halliburton,* 131 S. Ct. 2179 (2011).

[9] *Id.* at 2187.

[10] *Id.*

[11] 133 S. Ct. 1184 (2013).

[12] *Id.* at 1195.

[13] *Id.* at 1196.

[14] *Id.* at 1204.

[15] *Erica P. John Fund Inc. v. Halliburton Co.,* 718 F.3d 423 (5th Cir. 2013).

[16] *Id.* at 434.

[17] Brief for petitioners, No. 13-317, 2013 WL 6907610 (Dec. 30, 2013).

[18] 131 S. Ct. 2541 (2011).

[19] Brief for respondent, No. 13-317, 2014 WL 356636 (Jan. 29, 2014).

NEWS IN BRIEF

DERIVATIVES CROSS-BORDER REPORT PROVIDED TO G-20 LEADERS

Leaders of the world's 20 largest economies received a report detailing cross-border derivatives issues from an international group of regulators, the Commodity Futures Trading Commission announced March 31. The report was prepared for the G-20 by the Over-the-Counter Derivatives Regulators Group, an association of government officials who regulate markets in Australia, Brazil, the European Union, Hong Kong, Japan, Canada, Singapore, Switzerland and the United States . It is the first in a series of reports that will be issued by the group in 2014, the CFTC said in a statement. The initial report discusses implementation issues facing the regulators' reform of the global derivatives market, including the synchronization of regulatory frameworks between nations. The regulators are working on mandating margin requirements, accessing data repositories and compliance issues. The report is available at http://1.usa.gov/1qiZwRO.

CFTC SEEKS PUBLIC COMMENTS ON SWAP DATA RULES

The Commodity Futures Trading Commission announced March 19 that it is seeking public comment on its swaps data record-keeping and reporting requirements. The CFTC implemented the requirements in December 2011, and they require the submission of swap transaction data to swap data repositories electronically. The CFTC created data repositories to collect the data from swap market participants for the purposes of risk monitoring and increased market transparency. Swaps are financial instruments used to hedge against markets risks like default risk using credit default swaps and interest rate risk using interest rate swaps. CFTC Commissioner Scott D. O'Malia said in a statement that the comment period is a "critical step" in improving the commission's data record keeping, and he urged market participants to "carefully review" the questions and submit comments. He also asked that market participants report any issues not addressed in the regulatory agency's questions.

2 CALIFORNIA MEN CHARGED WITH INSIDER TRADING BASED ON WIVES' INFO

The Securities and Exchange Commission has charged Tyrone Hawk of Los Gatos, Calif., with trading ahead of Oracle Corp.'s acquisition of Acme Packet Inc. based on confidential information learned from his wife, a finance manager at Oracle. The SEC asserts Hawk overheard work calls made by his wife, and she confirmed the pending acquisition. Hawk then bought shares in Acme Packet before the acquisition was announced in February 2013 and made about $150,000 in illegal insider-trading profits, the SEC said. Without admitting or denying the charges, Hawk agreed to pay more than $300,000 to settle the charges. In an unrelated matter, the SEC charged Ching Hwa Chen of San Jose, Calif., of insider trading in Informatica Corp. stock based on business calls by his wife that he overheard. According to the SEC's complaint, he learned that the company would miss its earning targets for the first time in 31 consecutive quarters, the agency said. Chen then established stock positions that allowed him to profit when the stock price dropped and realized more than $140,000 in insider-trading profits, the SEC said. Without admitting or denying the charges, Chen agreed to pay about $280,000 to settle the SEC's charges.

Securities and Exchange Commission v. Hawk, No. 14-1466, complaint filed (N.D. Cal. Mar. 31, 2014).

Securities and Exchange Commission v. Chen, No. 14-1467, complaint filed (N.D. Cal. Mar. 31, 2014).