FACT OR FICTION: FLAWED APPROACHES TO EVALUATING MARKET BEHAVIOR IN SECURITIES LITIGATION

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Courts entertaining class actions brought under Section 10(b) of the Securities Exchange Act are required to make numerous factual judgments about the economic effects of the alleged misconduct. For example, they must determine whether and for how long publicly-available information has exerted an influence on security prices, and whether an alleged fraud caused economic harm to investors. Judgments on these matters dictate whether cases will proceed to summary judgment and trial, whether classes will be certified and the scope of such classes, and the damages that investors are entitled to collect.

Over the years, courts have developed a variety of common law doctrines to guide these inquiries. As this Essay will demonstrate, collectively, these doctrines operate in such an artificial manner that they no longer shed light on the underlying factual inquiry, namely, the actual effect of the alleged fraud on investors. The result is that determinations of market impact and investor loss have become, in a real sense, fictional: the size and effects of the fraud, instead, are determined based on abstract doctrine rather than any empirical assessment of market behavior. Ultimately, these stylized approaches to assessing market evidence interfere with the ability of the Section 10(b) cause of action to fulfill its modern function as a mechanism for deterring fraud.

This Essay therefore recommends that, to the extent possible, these inquiries should be replaced with alternative schemes that award damages based on some combination of statutory formulas and evidence of investors’ reliance on the fraud. These alternatives would be easier for courts to administer, and would re-align the fraud-on-the-market action with its fundamental goals.

I. INTRODUCTION

When courts recognized the fraud-on-the-market doctrine as a mechanism for bringing claims under Section 10(b) of the Exchange Act, they changed the nature of the tort. Once, Section 10(b) lawsuits were rooted in interference with the plaintiff’s decisional autonomy; today, they proscribe what can best be described as the wrongful causation of

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economic harm. That transformation was perhaps necessary to protect the integrity of securities markets, but at every stage of the process, this new type of claim requires that courts interpret market phenomena often too complex even for financial economists to explain. The evidence, after decades of litigation, is in: courts are not capable of performing these tasks. And, perhaps in recognition of their own limitations, courts have created a body of caselaw that permits them to avoid doing so. Instead, they rely on a series of doctrinal shortcuts and principles that, collectively, construct a kind of Potemkin-market that becomes the focus of judicial decision-making. Judgments about materiality, causation, and damage are predicated on this fictional construct that, while perhaps simpler to evaluate, bears little resemblance to the real markets in which frauds take place. The result is a near complete divorce of what is deemed a cognizable harm for the purposes of Section 10(b) from the actual harm that fraud inflicts.

So long as this state of affairs persists, Section 10(b) litigation cannot serve any justifiable social purpose. Securities class actions are rarely defended as compensatory devices, but to the extent that remains one of their functions, it is undermined by inaccurate calculations of damage. And to the extent deterrence is the goal, that too is ineffective, because defendants are not held liable for anything approximating the true harms they inflict. This is not to say that damages for securities fraud are systematically too high, or that they overestimate the social costs of fraud—all arguments that have been explored elsewhere in depth. My argument is that even within the confines of the action as it is defined, market evidence is misused or ignored to the point where it is impossible to tell whether damages are too high or too low; they are simply disconnected from reality.

2 Sale & Thompson, supra note 1, at 537–39.
3 My discussion will mainly be limited to claims involving common stock, as other kinds of securities may have unique idiosyncrasies. See, e.g., Michael Hartzmark et al., Fraud on the Market: Analysis of the Efficiency of the Corporate Bond Market, 2011 COLUM. BUS. L. REV. 654, 712–15; Michael L. Hartzmark & H. Nejat Seyhun, Understanding the Efficiency of the Market for Preferred Stock, 8 VA. L. & BUS. REV. 149, 160–73 (2014).
For that reason, I recommend that fraud-on-the-market actions be given a serious makeover. I believe that these actions have an important role to play in policing securities markets, but, as I demonstrate below, their evidentiary demands are too high. I therefore recommend that matters be simplified with statutory fines and other changes that will alleviate the burdens currently placed on courts and litigants, and allow Congress to tailor the remedy to the policy goals that the cause of action is intended to advance.

II. SECTION 10(b) AND FRAUD-ON-THE-MARKET

The federal securities laws and implementing regulations contain several prohibitions on fraud and misrepresentation, the broadest of which is Section 10(b) of the Securities Exchange Act. That statute prohibits the use of “any manipulative or deceptive device” in connection with the purchase or sale of a security. It applies to all domestic securities transactions, and, though it does not say so expressly, provides a private right of action to defrauded investors.

A private plaintiff bringing a claim under Section 10(b) must prove: (1) a materially manipulative or deceptive act (typically a statement); (2) in connection with a securities transaction; (3) on which the plaintiff relied; (4) accomplished with scienter; (5) economic losses; (6) caused by the fraudulent action (“loss causation”). In a traditional, face-to-face fraud action, these elements are relatively straightforward. The plaintiff will offer evidence that he or she would not have invested absent the misrepresentation, that the misrepresentation was intentionally or recklessly made, and demonstrate that her losses were in some way proximately caused by the fraud. But when the fraud occurs in the context of a modern, impersonal market, matters are more complex. Fraudsters may not deal directly with purchasers; instead, they may broadly announce false information to the market, influencing the recommendations of a variety of intermediaries—analysts, brokers, investment bankers, reporters—who pass their analysis on to traders, who then make investment decisions several steps removed from the original false statement. This process dictates the ultimate market price of the

stock,\textsuperscript{11} distorting it for everyone who trades. Investors who transact at these manipulated prices may experience real economic harm once the truth comes to light, but they will have difficulty demonstrating the precise role the false information played in their investment decision. If they invested passively, the information will have played little role at all.

In order to ensure that these investors would have a remedy—and that markets would not be left vulnerable to manipulation of this sort—federal courts came to endorse the fraud-on-the-market doctrine. As articulated by the Supreme Court in \textit{Basic Inc. v. Levinson},\textsuperscript{12} the fraud-on-the-market doctrine provides Section 10(b) plaintiffs with an alternate route for establishing reliance when their securities transactions occur in an “open and developed,” i.e., “efficient” securities market.\textsuperscript{13} These plaintiffs are granted the benefit of two rebutt able evidentiary presumptions: first that any public, material statements will have impacted the price of the subject stock, and second, that investors transacting in such a market rely on market price as an unbiased evaluation of information about that stock.\textsuperscript{14} The two presumptions, together, create a syllogism: the price is influenced by defendants’ statements, and investors rely on that price, therefore, investors rely on the defendants’ statements.

The fraud-on-the-market presumptions free investors from the burden of proving reliance on an individualized basis, and, because they smooth out the most significant differences among class members, the presumptions also facilitate the aggregation of claims into a single class action. But the presumptions also substantively change the nature of the harm alleged: in a traditional fraud action, the investor alleges that the fraud interfered with her judgment about the subject security, but in a fraud-on-the-market action, the harm is purely economic, in the form of overpayment for a security that the investor may very well have purchased even absent the fraud.\textsuperscript{15} As a result, the fraud-on-the-market context nearly eliminates any inquiry into the behavior of a specific investor.\textsuperscript{16} Instead, it requires courts to make a variety of determinations about

\textsuperscript{11} Asher v. Baxter, 377 F.3d 727, 731 (7th Cir. 2004); Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 516 (7th Cir. 1989).

\textsuperscript{12} 485 U.S. 224 (1988).

\textsuperscript{13} \textit{Id.} at 241-48.

\textsuperscript{14} \textit{Id.} at 247.

\textsuperscript{15} The investor might also allege that the fraud was designed to keep stock prices low, in which case the harm is \textit{underpayment} when the investor subsequently resells. These types of frauds are much rarer than the traditional action, in which prices are allegedly manipulated upwards.

market behavior, from assessing the impact of defendants’ statements to identifying losses attributable to the fraud. Along the way, courts have developed a variety of doctrines—sometimes called “heuristics” in the literature—to guide these inquiries. As I will demonstrate, these doctrines often have only the most tenuous connection to the underlying market behavior they purport to interpret. The accumulation of these doctrinal fictions has distorted the fraud-on-the-market cause of action to the point where it no longer offers even an approximation of the harms wrought by securities fraud.

A. Materiality

According to the Supreme Court, a fact is material if there is a “substantial likelihood” that it “would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.” Materiality is an element in every Section 10(b) action and, theoretically, is rooted in an objective understanding of a hypothetical “reasonable investor” whose qualities are uniform across investing contexts. In fact, as has been frequently observed, the market consists of many types of investors, from ordinary persons consuming news reports to sophisticated institutions relying on trading algorithms. When faced with claims outside of the fraud-on-the-market context, courts frequently—if surreptitiously—take these contexts into account, tailoring their assessments of materiality to match the investors’ circumstances.

In fraud-on-the-market cases, however, there is no single investor, or investor-archetype, for courts to consider. Courts fill the void by referencing a hypothetical investor, often sophisticated and professional, on the theory that it is the behavior of these investors that drives market pricing. This notional investor is then deployed by courts to decide—

18 Basic, 485 U.S. at 231–32 (quotations omitted).
21 See Margaret V. Sachs, Materiality and Social Change: The Case for Replacing “the Reasonable Investor” with “the Least Sophisticated Investor” in Inefficient Markets, 81 TUL. L. REV. 473, 481 (2006); see also Flannery v. SEC, 810 F.3d 1 (1st Cir. 2015) (examining what institutional investors consider when purchasing esoteric securities); U.S. v. Litvak, 808 F.3d 160 (2d Cir. 2015) (holding jury may consider evidence of same).
22 See Asher v. Baxter, 377 F.3d 727, 731 (7th Cir. 2004); Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 515 (7th Cir. 1989); see also Stefan J. Padfield, Who Should do the
frequently on the pleadings, prior to discovery and without expert analysis—that particular facts or statements are immaterial as a matter of law, and thus incapable of influencing market prices.\textsuperscript{23}

For example, courts frequently declare that certain vague, hyperbolic, or generic statements amount to “puffery,” such that they contain “no useful information upon which a reasonable investor would base a decision to invest.”\textsuperscript{24} Courts are not only famously inconsistent in how the puffery doctrine is applied,\textsuperscript{25} but they also tend to assume a level of rationality in market functioning that is rarely in evidence.\textsuperscript{26} Among


\textsuperscript{23} The Supreme Court has held that materiality determinations are usually matters for a jury, \textit{TSC Indus., Inc. v. Northway, Inc.}, 426 U.S. 438, 450 (1976), but the materiality-based dismissals at the pleading stage remain common. \textit{See, e.g.}, David A. Hoffman, \textit{The “Duty} to \textit{Be a Rational Shareholder}, 90 MINN. L. REV. 537, 542 (2006).

\textsuperscript{24} Parnes v. Gateway 2000, 122 F.3d 539, 547 (8th Cir. 1997) (quoting Seals v. Glasser, 64 F.3d 1061, 1066 (7th Cir. 1995)).

\textsuperscript{25} Stefan J. Padfield, \textit{Immaterial Lies: Condoning Deceit in the Name of Securities Regulation}, 61 CASE W. RES. L. REV. 143, 165 (2010), and David A. Hoffman, \textit{The Best Puffery Article Ever}, 91 IOWA L. REV. 1395, 1403-04 (2006). Compare the following examples of statements found \textit{not} to be puffery: Richman v. Goldman Sachs Group, Inc., 868 F. Supp. 2d 261, 277 (S.D.N.Y. 2012) (“Our clients’ interests always come first. Our experience shows that if we serve our clients well, our own success will follow.” “Integrity and honesty are at the heart of our business.” “Our reputation is one of our most important assets.”); Lapin v. Goldman Sachs Group, Inc., 506 F. Supp. 2d 221 (S.D.N.Y. 2006) (“integrity and honesty are at the heart of our business”); \textit{In re MidAtlantic S’holder Litig.}, 758 F. Supp. 226, 232 n.2 (S.D.N.Y. 2006) (bank had “an excellent record of credit quality” and had “adher[ed] to stringent credit criteria”); \textit{In re Marsh & McLennan Companies, Inc. Securities Litigation}, 501 F. Supp. 2d 452, 475 (S.D.N.Y. 2006) (“Marsh provides value to clients by developing the most cost-effective responses to the risks they face”); Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 364 (1st Cir. 1994) (company practice was to “address issues in a timely and conservative manner” and company “worked from very conservative assumptions”) to those that \textit{\textit{were} found to be puffery: Boca Raton Firefighters & Police Pension Fund v. Bahash, 506 Fed. Appx. 32 (2d Cir. 2012) (company engaged in “transparent and independent decision-making” to produce “independent and objective analysis,”); Lloyd v. CVB Financial Corp., 2012 WL 12883517, at *3 (C.D. Cal. 2012) (“[t]he overall credit quality of the loan portfolio is sound”, “strong credit culture and underwriting integrity remain paramount”); ECA & Local 134 IBEW Joint Pension Trust v. JP Morgan Chase Co., 553 F.3d 187, 205 (2d Cir. 2009) (company employs “risk management processes [that] are highly disciplined and designed to preserve the integrity of the risk management process”); City of Monroe Employees Retirement System v. Bridgestone Corp., 399 F.3d 651, 670 (6th Cir. 2005) (“rigorous testing under diverse conditions at our proving grounds around the world helps ensure reliable quality for original equipment customers”).

\textsuperscript{26} Bainbridge & Gulati, \textit{supra} note 17, at 120 (“[O]ur review of opinions invoking the puffery doctrine found little, if any, evidence that judges were looking to the financial economics literature as a basis for their assumptions.”).
other things, despite courts’ insistence that sophisticated traders are above such trivialities, numerous studies have documented the relevance of managerial “tone” to investors; as one pair of scholars put it, “[a]necdotally, it does not take much time watching investment programs on television to notice that even quite vague statements of optimism by corporate managers are considered important by the investment news media.” Nonetheless, in a striking demonstration of courts’ imperviousness to evidence on this issue, the Ninth Circuit went so far as to declare that statements deemed “puffery” by courts are in actionable even if plaintiffs can demonstrate their influence on the market.

I have previously argued that these decisions may not reflect judges’ factual determinations regarding market behavior so much as policy judgments regarding the appropriate scope of the federal securities laws. That said, the doctrine remains messy and unbounded, and it is impossible to tell how much is grounded in a considered attempt to cabin the scope of Section 10(b) versus a romanticized view of investor behavior.

Next, taking to heart Basic’s admonition that “too low a standard of materiality . . . might bring an overabundance of information within its reach, and lead management simply to bury the shareholders in an


28 Bainbridge & Gulati, supra note 17, at 120.

29 Police Ret. Sys. v. Intuitive Surgical, Inc., 759 F.3d 1051, 1060 (9th Cir. 2014).

avalanche of trivial information," courts often declare that some matters are too inconsequential to concern reasonable investors. As with puffery, these judgments may be made despite explicit market evidence to the contrary, and more generally, are difficult to reconcile with findings that such banal matters as a CFO’s golfing habits or a CEO’s use of the company jet are relevant to assessing a corporation’s financial condition. In a world where trading is frequently accomplished via high speed computers synthesizing vast quantities of data, few details can reliably be identified as beyond a reasonable investor’s interest, yet courts continue to pass judgment as a matter of law, unmoored from any empirical assessment of market behavior.

Finally, the “truth-on-the-market” doctrine features what are perhaps courts’ boldest armchair pronouncements about materiality. That doctrine holds that if fraudulent information is presumed to influence stock prices, truthful information may be presumed to do so as well, sometimes to the point of completely offsetting the original, false information. As the Eleventh Circuit put it, a plaintiff who relies on the fraud-on-the-market doctrine “must take the bitter with the sweet.”

The truth-on-the-market doctrine arises in many guises. Sometimes, it is used to establish that any misstatements were immaterial from inception because the truth was available to investors via other channels. Other times, the truth may be revealed at a later date, to little obvious market reaction, and courts interpret the lack of price movement to mean either that the original misstatement was immaterial, or that—as discussed more below—it was not responsible for investors’ losses.

31 Basic, 485 U.S. at 231.
32 See Bainbridge & Gulati, supra note 17, at 125-26; Hoffman, supra note 23, at 573.
33 See Greenhouse v. MCG Capital Corp., 392 F.3d 650 (4th Cir. 2004) (concluding an executive’s lie about his resume was immaterial despite the dramatic stock price reaction that followed disclosure of the truth).
35 David Yermack, Flights of Fancy: Corporate Jets, CEO perquisites, and inferior shareholder returns, 80 J. FIN. ECON. 211 (2005).
37 Meyer v. Greene, 710 F.3d 1189, 1199 (11th Cir. 2013).
38 The Second Circuit recently held that the “truth-on-the-market” designation should only be applied to arguments that the truth was available at the outset of the fraud, prior to the plaintiffs’ purchase, see Arkansas Teachers Retirement System v. Goldman Sachs Group, Inc., 879 F.3d 474, 485-486 (2d Cir. 2018), but did so in the curious context of a class action—where necessarily, the “outset” of the fraud is defined in different ways for different class members, depending on when they invested. For some plaintiffs, the claimed truthful disclosures came after they purchased, but for others, they almost
Whatever the context, depending on how clearly or accessibly the truth was publicized, the doctrine may invite courts to make heroic assumptions about how quickly markets can interpret and digest obscure or disaggregated information. As a result, information buried in stray sentences in long SEC filings, scattered across multiple court filings, or public real estate records, reported in niche medical journals, or even contained in nonpublic agency files available only via FOIA request, has all been assumed by courts to have completely offset even much more prominent falsehoods. Strikingly, courts presume the cleansing effects of these buried disclosures even when a second, more conspicuous, disclosure of the truth—such as a newspaper report—triggers an obvious market response. The reaction to the later disclosure would ordinarily suggest that the earlier disclosure had not fully penetrated the market, but courts remain untroubled by the contradiction.

Decisions along these lines falsely imbue markets with near mystical perfection. The more mundane reality, though, is that even efficient markets do not process information instantaneously, and stock prices may underreact to complex, difficult to find, or piecemeal data.

certainly would have been available beforehand over the course of the three-year class period. Which only demonstrates that arguments about the truth’s impact on price are more properly viewed as variations on a single theme.

39 Technically, most courts agree that truth-on-the-market is only appropriate to decide if the “corrective information must be conveyed to the public ‘with a degree of intensity and credibility sufficient to counter-balance effectively any misleading information created by’ the alleged misstatements, . . .”, and is almost never appropriate for determination on a motion to dismiss. Ganino v. Citizens Utils. Co., 228 F.3d 154, 167 (2d Cir. 2000) (quoting In re Apple Computer Sec. Litig., 886 F.2d 1109, 1116 (9th Cir. 1989)). Nonetheless, as with materiality more generally, many courts engage these arguments on the pleadings (or, as below, at class certification), often by simply avoiding the “truth-on-the-market” label.

40 In re Merck & Co. Sec. Litig., 432 F.3d 261, 269 (3d Cir. 2005).
43 Meyer v. Greene, 710 F.3d 1189, 1198 (11th Cir. 2013).
46 See, e.g., Meyer, 710 F.3d 1193; Merck, 432 F.3d at 265.
The presumption of market impact that plaintiffs often seek by employing the fraud-on-the-market doctrine is usually not embarrassed by acknowledging these imperfections, as the Supreme Court recently acknowledged.\textsuperscript{49}

That said, it is also not uncommon for fraud claims to be predicated, at least in part, on nominally public statements that were nonetheless thinly distributed or otherwise presented in unobtrusive fashion.\textsuperscript{50} These kinds of statements may only have an impact on the prices of securities that trade in the most well-developed of markets, and—as discussed more below—the fraud-on-the-market doctrine is ill-equipped to draw such nuanced distinctions. Given that, it is perhaps understandable that courts tend to assume an extraordinarily high level of efficiency across the board.\textsuperscript{51} Still, it must be recalled that these decisions are often made on the pleadings or in the context of a motion for class certification, without a full factual record. By doing so, courts implicitly treat these issues as abstractions and legal principles rather than factual inquiries. And though there are many courts that approach market evidence with more humility,\textsuperscript{52} there are sufficient counterexamples so as

\textsuperscript{49} Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2410 (2014) (describing the Basic presumption as “modest”).


\textsuperscript{51} See id. at 75–76.

to create a widening gulf between the hyper-idealized “market” as conceived for the purposes of litigation, and the actual, real-world markets that the parties, and the court, are purportedly investigating.

B. The Safe Harbor

In 1995, Congress passed the Private Securities Litigation Reform Act (“PSLRA”)\(^\text{53}\) with the goal of deterring plaintiffs from filing meritless “strike suits” alleging fraud based on nothing more than unfavorable or unexpected business developments.\(^\text{54}\) Among other provisions, the PSLRA contains a safe harbor that insulates, to some degree, management projections of future performance from private Section 10(b) claims. Statements covered by the safe harbor may only give rise to Section 10(b) liability if the plaintiff establishes both that the statement was made with actual knowledge of its falsity, and that the statement was unaccompanied “by meaningful cautionary statements identifying important factors that could cause actual results to differ materially. . .”.\(^\text{55}\)

The safe harbor was modeled on a common law doctrine known as “bespeaks caution.”\(^\text{56}\) That doctrine provides that “meaningful warnings and cautionary language” may counterbalance a misleading projection and thus render it “immaterial and thus nonactionable as securities fraud.”\(^\text{57}\) Unlike the bespeaks caution doctrine, however, nothing in the safe harbor requires that cautionary language completely neutralize the allegedly-fraudulent statement in order to shield it; to the contrary, the Conference Report accompanying the statute stated that “[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor.”\(^\text{58}\)

Left without any specific standard by which to evaluate cautionary language, then, courts have tended to reward lengthy, generic risk disclosures over warnings more tailored to the issuer’s unique

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\(^{56}\) Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1276 n.7 (11th Cir. 1999).

\(^{57}\) Harden v. Raffensperger, Hughes & Co., 65 F.3d 1392, 1404 (7th Cir. 1995).

circumstances\textsuperscript{59}—precisely the opposite of the types of cautions that would mitigate the effects of any misstatements. As a result, in application, the safe harbor grants issuers limited “license to defraud,”\textsuperscript{60} in the sense that forward-looking statements, made with scienter, may be immune from a shareholder lawsuit even when they are likely to influence investors.

Standing alone, that might be viewed as simply a congressional choice about the types of frauds that should be the subject of private, rather than public, enforcement actions, but the safe harbor complicates courts’ analysis of even the \textit{non}-forward-looking statements that are ostensibly outside its scope. This is because management projections are frequently paired with, or offered in close proximity with, present or historical representations that purportedly underlie and support the projection. Most courts agree that these representations are \textit{not} insulated by the safe harbor,\textsuperscript{61} but that requires courts to distinguish between “present tense” and “forward looking” in ways that may have little meaning to market participants.\textsuperscript{62}

\textit{IBEW Local 98 Pension Fund v. Best Buy Co.},\textsuperscript{63} illustrates the difficulty. Best Buy executives issued an allegedly false projection of future performance and then stated they were “on track to deliver and exceed . . .


\textsuperscript{60} In re Stone & Webster, Inc., Sec. Litig., 414 F.3d 187, 212 (1st Cir. 2005).

\textsuperscript{61} See, e.g., In re Quality Sys. Link, Inc. Sec. Litig., 865 F.3d 1130, 1141 (9th Cir. 2017); Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 705 (7th Cir. 2008); In re Stone & Webster, Inc., Sec. Litig., 414 F.3d 187, 213 (1st Cir. 2005).

\textsuperscript{62} For example, there is a split of authority as to whether a statement that the company is “on track” to meet projections is forward-looking (and thus potentially subject to safe-harbor protection), or not. \textit{Compare Wochos v Tesla}, 2018 WL 4076437, at *5–6 (N.D. Cal. 2018) (“on track” is forward-looking) \textit{with} Dahhan v. OvaScience, Inc., 2018 WL 3637969, at *8 (D. Mass. July 31, 2018) (“on track” is not forward looking). Meanwhile, representations such as “sales are still going strong,” Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 705 (7th Cir. 2008), “[W]e are not anticipating any major increase in maintenance costs or cost of oversight,” No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 933 (9th Cir. 2003), and “We’re well poised to go into [the third quarter],” Capri Optics Profit Sharing v. Digital Equip. Corp., 950 F.2d 5, 11 (1st Cir. 1991), have all been deemed to be statements of present condition rather than future projections. In truth, it is difficult to imagine that investors draw much distinction between a company’s representation that it is “on track” to meet previous EPS guidance and that sales are “still going strong”; both statements convey similar information (though perhaps with greater or lesser specificity), namely, that present conditions are consistent with achieving expectations for the future.

\textsuperscript{63} 818 F.3d 775 (8th Cir. 2016).
...” those projections on an analyst conference call a few hours later. The stock price demonstrably reacted to the original statement, but did not respond to the second, confirmatory statement. Later, Best Buy was unable to meet its projections, and investors filed a lawsuit alleging that the company had intentionally or recklessly misled the market. The district court agreed that the plaintiffs had credibly alleged fraud, but concluded that the projection was protected by the safe harbor due to Best Buy’s extensive cautionary language. The second statement, however, was deemed a description of present conditions, and was not. As a result, plaintiffs were permitted to pursue Section 10(b) claims based on the second statement, but not the first. However, on appeal from the district court’s decision to certify the class, the Eighth Circuit concluded that the second statement had not had any impact on the company’s stock price. As a result, plaintiffs could not utilize the fraud-on-the-market doctrine to establish reliance on that statement.

Was the Eighth Circuit correct? The plaintiffs’ expert conceded that the second statement had not introduced additional inflation into the stock price. And certainly, the original projection might have implicitly carried with it the representation that the company was “on track” to meet projections, such that the second representation added nothing new. The Eighth Circuit suggested as much, noting that it had not been tasked with deciding whether the “on track” statement could “meaningfully be distinguished” from the projection. On the other hand, if the company had not made such a statement during the conference call, the market might have suspected something was amiss and reacted negatively.

These distinctions that the safe harbor requires courts to draw, but there are no tools available to draw them. Thus, once again, market evidence is evaluated as a matter of theoretical possibility rather than empirical reality.

C. Loss Causation

In a fraud-on-the-market action, loss causation refers to the proximate relationship between the artificial inflation introduced into the stock by the fraud, and the economic loss ultimately experienced by investors. Like all proximate cause analyses, loss causation in the fraud-on-the-market context is a hybrid mix of the factual and the prudential: it

65 818 F.3d 775, 783.
requires courts both to make a but-for determination as to whether the defendant’s behavior contributed to the plaintiff’s injury, and a policy determination as to whether that contribution was sufficiently significant to hold the defendant legally responsible. Yet here as well, courts have invented tests and definitions that are far removed from the reality of how markets function.

It is generally agreed that, at minimum, loss causation requires that the economic loss be associated with the artificial inflation leaving the stock, either in whole or in part; otherwise, the investor could recoup her overpayment by simply reselling the stock to another investor. But even though the dissipation of artificial inflation, coupled with an economic loss, is a necessary predicate to establishing loss causation, it is not clear that it is a sufficient one. In *Dura Pharmaceuticals v. Broudo*, the Supreme Court directed courts to distinguish stock price drops that reflect “the earlier misrepresentation” from those that reflect “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events.” Given the nature of market pricing, this cryptic phrase admits multiple interpretations.

When a company lies about its financial condition, traders use that information to predict the corporation’s future cash flows and set an appropriate price for the stock. As newer information bearing on future cash flows comes to light, traders update their models and reprice the stock accordingly. If, due to the new information, the old, fraudulent information is rendered stale, that older information will exert less influence over the price. Any resulting stock price drop might therefore be attributed to the fraud, in the sense that more accurate information is now exerting a greater influence over the price than the false information. To offer a simple example, if a company projects it will sell 30,000 units, that information will be priced into the stock; if later it reports that it only sold 10,000 units, the market will adjust to reflect the newer, more relevant

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67 See *Palsgraf v. Long Island R. Co.*, 248 N.Y. 339 (1928); see also *Sale & Thompson*, supra note 1, at 498 (“Loss causation responds to the legal and policy concerns that the plaintiffs should not be insured against market changes. This element plays the intervening or proximate cause role that the *Palsgraf* case plays in traditional tort cases”); Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 *IOWA L. REV.* 811, 830–31 (2009).


69 Id. at 343.

70 Id.

information, and the old projection will no longer influence the stock’s price.

That said, to determine whether loss causation in the legal sense exists, courts conduct a further inquiry into the reasons why the false information became stale. In two influential cases, the Fifth and Seventh Circuits discussed a scenario in which a company lies about the qualities of a particular asset, thus inflating its stock price. Later, for reasons entirely unrelated to those qualities (such as an intervening accident), the asset loses all of its value. In this situation, the courts determined, the element of loss causation is not satisfied. Certainly, the fraud is a but-for cause of investors’ losses: the false information—the asset’s value—no longer contributes to the stock price, because the asset has become worthless. And, due to the stock price drop, investors have suffered economic losses, both in the amount they overpaid for their stock, and in the amount that represented the asset’s true value (though the latter portion is unrecoverable). Nonetheless, courts reason that the investor, though misled about the qualities of the asset, took a fully informed risk about the likelihood of its destruction via intervening event, and therefore should bear the consequence.

This, naturally, is a policy judgment. One might reasonably place responsibility on the fraudster for inducing the overpayment in the first place; nonetheless, that is not the route that courts have apparently chosen to go. We can quibble over whether the line has been drawn in the right place, but if it is the line, it requires courts to make two inquiries: first, has the artificial inflation left the stock (with a resulting price drop), and second, did it do so due to an intervening event unrelated to the fraud itself. Too often, courts do not investigate this relationship.

Courts generally agree that if the market price drops upon revelation that earlier statements were false—for example, upon the

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72 See Bastian v. Petten Res. Corp., 892 F.2d 680 (7th Cir. 1990); Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981).

73 See Bastian, 892 F.2d at 685 (“If the defendants’ oil and gas ventures failed not because of the [matters that were concealed] but because of industry-wide phenomena that destroyed all or most such ventures, then the plaintiffs, given their demonstrated desire to invest in such ventures, lost nothing by reason of the defendants’ fraud….”).

74 Prior to Dura Pharmaceuticals v. Broudo, 544 U.S. 336 (2005), the Ninth Circuit took the opposite view and placed responsibility for these losses on defendants. See Wool v. Tandem, 818 F.2d 1433, 1442 (9th Cir. 1987). In Dura, however, the Supreme Court rejected the Ninth Circuit’s interpretation and implicitly endorsed the Seventh’s. See Dura, 544 U.S. at 346.

75 Jill Fisch explains that this line of case law is more protective of defendants than the common law. See Fisch, supra note 67, at 832–33.
announcement of a restatement—those are losses “caused” by the fraud. But many cases are not quite so clear cut. For example, a company may lie about its underlying business conditions—such as its debt burden,\(^{76}\) or the functionality of a new product\(^ {77}\)—and eventually, the bill comes due when the company is forced to declare bankruptcy, or to admit to a dramatic slowdown in sales. The company’s stock price drops, even absent revelation that the company had earlier misrepresented its then-current financial condition. In these cases, the losses are attributable to the underlying problems that the fraud concealed, but the market may belatedly—or never—explicitly recognize that it had been misled.

Faced with these sorts of fact-patterns, courts have displayed dramatic inconsistency, generally recognizing that there is no requirement that the defendant company explicitly confess to fraud,\(^ {78}\) but otherwise reaching little agreement as to how close a relationship between the fraud and the disclosure that triggers the loss is required.\(^ {79}\) Many circuits have endorsed some version of the “materialization of the risk” standard, which requires that the losses be traceable to a risk concealed by the false statements.\(^ {80}\) That standard is in theory similar an analysis of intervening cause, but in application is subject to considerable variation, with courts frequently demanding some indication that market traders began to doubt the veracity of the defendants’ earlier statements.\(^ {81}\)


\(^{80}\) Lentell, 396 F.3d at 173; see also Ohio Pub. Employees Retirement Sys. v. Fed. Home Loan Mortgage Corp., 830 F.3d 376, 385 (6th Cir. 2016); In re Williams Sec. Litig. WCG Subclass, 558 F.3d 1130, 1134–135 (10th Cir. 2009).

\(^{81}\) See, e.g., Police and Fire Ret. Sys. of City of Detroit v. SafeNet, Inc., 645 F. Supp. 2d 210, 228 (S.D.N.Y. 2009) (“The February 2, 2006, disclosure did not reveal to investors that SafeNet’s statements about its accounting practices were false, and this disclosure cannot serve as a foundation to plead loss causation.”). Occasionally, courts employing the “materialization of the risk” standard adopt particularly stringent requirements for how these risks are defined. For example, in Nguyen v. New Link Genetics Corporation, 297 F. Supp. 3d 472, 500 (S.D.N.Y. 2018), the plaintiffs alleged that defendants misled the market about the characteristics of a drug study, and losses were incurred when the study produced poor results. The court rejected plaintiffs’ allegations of loss causation because the defendants “repeatedly cautioned investors about a litany of risks—the inability to achieve the trial’s primary endpoint, obtain FDA approval, or commercialize the drug.” But that elides the issue: the plaintiffs knew the trial was risky, what they did not know was that it was, allegedly, misdescribed. Cf. Pommer v. Medtest, 961 F.2d 620, 624 (7th
As I have discussed elsewhere, courts that impose such a high barrier to establishing loss causation fail to recognize the realities of how financial information is interpreted by the market. Once more current information about the company’s financial condition is disclosed, traders will no longer rely on older, outdated information to price the stock, regardless of whether they are aware that the old information was untrue. The only question, then, should be whether an intervening event broke the chain of causation between the original fraud and the company’s new status. When courts reject this reality they are, in practical effect, demanding that specific information be made available to the market—

Cir. 1992) (“It is not enough that the other party must have recognized a risk. Risks are ubiquitous. Disclosures assist investors in determining the magnitude of risks. Even savvy investors may recover when a bald lie understates the gravity of a known risk.”).

The plaintiffs further alleged that these misdescribed factors led to the study’s failure. That surely is a sufficiently tight causal chain (if proven) to justify holding defendants’ responsible for the fraud, yet the Nguyen court did not undertake this analysis.

The Nguyen court’s reasoning is not unusual; the Fourth Circuit offered a similar interpretation of the materialization of the risk standard in Katyle v. Penn Nat’l Gaming, Inc., 637 F.3d 462 (4th Cir. 2011). There, the plaintiffs alleged that the defendant company publicly maintained that it was pursuing a leveraged buyout even though it was privately negotiating to terminate the agreement. Because the LBO was no longer being pursued, the defendant company canceled scheduled meetings with state regulators, and truth began to leak out—and cause plaintiffs’ losses—upon disclosure of the agenda changes. The Fourth Circuit rejected the plaintiffs’ allegations of loss causation because the market was already aware that there were significant risks that the transaction would not close. Once again, this decision elided the actual risk to which the plaintiffs pinned their allegations—that the approvals, and the deal, would fail, not merely because of its inherent problems (of which the market was aware) because the defendant was no longer actively pursuing it, despite representing to the contrary. Once again, any ordinary chain of causation analysis would find a fairly direct relationship between the defendants’ failure to pursue the deal, and the canceled meetings (not to mention the deal’s ultimate demise).

In both Nguyen and Katyle, one might argue that the failure would have occurred anyway; the study may have failed for reasons unrelated to the design failures, the LBO may have failed for reasons other than the defendants’ lack of diligence. If proven, these intervening causes likely would break the chain of causation. But the significant point is that neither court attempted the analysis (and likely could not have done so on the pleadings).

Meanwhile, in circuits that have not adopted a materialization of the risk standard, courts may explicitly require that the market become aware that prior statements were false before the loss causation element can be met. For example, in North Port Firefighters’ Pension v. Temple-Inland, Inc., 936 F. Supp. 2d 722 (N.D. Tex. 2013), the defendant allegedly overstated the value of its mortgage-backed securities portfolio. Though it eventually disclosed that the securities’ values had declined—which caused its stock price to drop—it did not disclose that its earlier reporting had been fraudulent. As a result, the court held that the plaintiffs failed to allege loss causation.

82 Lipton, supra note 31, at 118.
often something akin to an explicit revelation of past falsity—that investors themselves do not consider necessary or relevant to value the stock. They are demanding the disclosure of *immaterial* information as a condition to investors’ recovery.

Additionally, similar to the materiality inquiry, courts have employed bright line rules to identify types of disclosures that *cannot* cause cognizable Section 10(b) losses, because—in their view—they are, as a legal matter, devoid of informational content. For example, a number of courts have declared that announcements of investigations or lawsuits—whether instituted by the government, or internal inquiries—cannot, standing alone, cause losses for Section 10(b) purposes because an investigation or a complaint is merely an allegation rather than a confirmation of wrongdoing.\(^\text{83}\) This, of course, is a non sequitur; if a stock price represents traders’ view of the potential cash flows of the business, adjusted for risk,\(^\text{84}\) a credible possibility of fraud will cause them to reassess those risks and reprice the stock accordingly. Assuming the investigation was, in fact, caused by an underlying fraud—that is, if the plaintiffs are able to demonstrate the other elements of a Section 10(b) claim and show a causal chain between the investigation and the fraud they’ve alleged—there is no reason to treat stock price drops due to market distrust of the subject company as any less “caused” by the fraud as other kinds of price drops. An investigation is hardly an intervening event, and presumably, if there was fraud, and it is ultimately revealed—either with a full admission, or simply with disclosure of the underlying financial condition that it concealed—the stock will drop even further, to account for the fact that what was once an uncertainty has now become definite. At the same time, it is to be expected that even that drop will be smaller


\(^\text{84}\) Eisenhofer *supra* at 1421–23; see also Pommer v. Medtest, 961 F.2d 620, 623 (7th Cir. 1992) (“Probabilities determine the value of stock.”).
than it might have otherwise been, because the market’s distrust was, by now, priced in; suspicions have simply been confirmed.\footnote{In re Bradley Pharmaceuticals, Inc. Sec. Litig., 421 F. Supp. 2d 822 (D.N.J. 2006), where a court accepted loss causation allegations based on the announcement of an investigation, provides a useful example. In that case, a company’s stock price fell dramatically upon announcement of an informal SEC inquiry. At the conclusion of the investigation, the company was forced to restate previously reported sales, which resulted in a slight \textit{uptick} in its stock price, presumably reflecting the fact that the problems were not quite as dire as investors had feared. A separate question—discussed further below—is how \textit{damages} should be calculated in this scenario.}

In a twist on the truth-on-the-market concept, courts have also declared that information that is not “new,” or that represents a repackaging or reinterpretation of previously-available information, cannot trigger cognizable Section 10(b) losses.\footnote{See Meyer v. Greene, 710 F.3d 1189 (11th Cir. 2013).} For the reasons described above, these judgments may involve hypothesized market functioning that is of dubious accuracy.\footnote{See supra Part II.A.}

It might be argued that these decisions simply represent stricter policy judgments about the types of losses for which defendants should be held responsible.\footnote{Certainly, there are some transparently policy-based loss causation doctrines. Take, for example, the rule that the announcement of an investigation cannot trigger cognizable Section 10(b) losses. Courts often add a further qualification that such announcements \textit{can} trigger Section 10(b) losses if, and only if, the investigation results in a definitive finding of fraud. \textit{See} Pub. Empls. Ret. Sys. of Miss. v. Amedisys, Inc., 769 F.3d 313 (5th Cir. 2014). This makes even less sense: a disclosure of the outcome of an investigation at Time 2 cannot change how the market understood, and reacted to, an earlier disclosure at Time 1. Thus, the likely explanation for these holdings is that courts fear that if the announcement of an investigation - without a subsequent definitive revelation of wrongdoing - qualifies as loss causation, plaintiffs will find it too easy to bring meritless claims, simply based on a company’s own internal attempts to get its affairs in order. What courts ignore, however, is that it is the falsity and scienter elements of a Section 10(b) claim that are meant to protect against such a scenario.} But if that’s what courts are attempting, the approach is deeply misguided, because no serious effort is made to focus on the underlying chain of causation that led to the stock price drop beyond the particular form of \textit{announcement} that triggered it. Too often, courts’ approach to loss causation focuses on \textit{what} was disclosed to the exclusion of \textit{why} the disclosure was made and the events that led to its necessity.

Indeed, if courts are making policy judgments about remote chains of causation, they are particularly dangerous ones, because they reward defendants for “gaming” their disclosures so as to minimize
market reaction and thereby defeat a subsequent Section 10(b) claim.89 One study conducted in the wake of Dura found that firms that “bundled” disclosures of restatements with unrelated news, thereby muddying the market signal, were not only less likely to become the targets of litigation, but also had claims against them dismissed at higher rates, and settled for lower amounts.90 Managers may also seek to “walk down the stock” with unrelated negative news so as to minimize the impact of fraud-related disclosures.91 Current approaches to loss causation do nothing to discourage this behavior.

In sum, courts are not only inconsistent from case to case, but they often make no effort to identify the chain of causation that led to the loss, let alone conduct a serious policy analysis as to whether that chain should trigger liability. Absent these inquiries, judicial pronouncements regarding the presence or absence of the loss causation element bear little relationship to the real-world conditions that harmed investors.

III. CLASS CERTIFICATION

Beyond the merits inquiries that take place on a motion to dismiss (or, less commonly, in the context of summary judgment), market evidence plays a myriad of roles throughout the class certification process, and therefore is as susceptible to misinterpretation and confusion in that context as it is in the context of substantive evaluation of the plaintiffs’ claims.

As explained above, the Basic presumptions translate what would otherwise be a series of individual questions about investors’ reliance on the alleged fraud into a common question regarding the fraud’s effect on the market. That transformation is what enables plaintiffs to bring their claims as a class action.92 The class certification motion has therefore become a critical battleground to determine how the market likely responded to the alleged fraud.

89 Fisch, supra note 67, at 852.

90 See Barbara A. Bliss et al., Information Bundling and Securities Litigation, 65 J. OF ACCOUNTING & ECON. 61 (2018).

91 Fisch, supra note 67, at 852; see also Ann Morales Olazabal, Loss Causation in Fraud-on-the-Market Cases Post-Dura Pharmaceuticals, 3 BERKELEY BUS. L. J. 337, 367–68 (2006) (“A number of commentators have cautioned against sanctioning a company’s ‘walking down’ its numbers in anticipation that a fraud will be revealed, or rewarding those companies that either can obscure their fraud with its complexity or can hide their fraud the longest, by permitting them to escape liability for having thwarted plaintiffs on the element of loss causation.”).

92 See Fed. R. Civ. P. 23(b)(requiring that common questions predominate over individualized ones).
A. Establishing the Presumption of Price Impact

The essential observation of Basic is that pricing in organized markets is dictated in large part by public information, and therefore false information is likely to influence those prices. Yet not all markets—and not all frauds—are the same. There is no such thing as a perfectly efficient market; leaving aside the reality of human frailty, markets will only efficiently process information to the extent that the benefits of gathering, interpreting, and trading on new information exceed their costs. Efficiency is therefore a matter of degree; securities may trade in robust or thin markets, and respond with more or less alacrity to new information. Exceptionally well-developed markets may respond to (relative) minutiae, while even highly inefficient markets may nonetheless respond to especially significant corporate events.

At the same time, not all securities fraud claims are based on announcements of high salience. They may be predicated on boilerplate disclosures in dense documents, articles and advertisements in trade journals, or other materials of limited circulation. Some disclosures are complex and difficult to process; others may be easily understood. A single measure of market efficiency ill-suits all claims; the presumption of price impact may be more or less warranted depending on the nature of the market and the fraud alleged. In light of this reality, the fundamental policy choice is where to place the burden of uncertainty.

One solution would be to require plaintiffs to prove that each fraudulent statement influenced market prices. Such a standard would be highly protective of fraud defendants, because it would make plaintiffs bear the entire burden of uncertainty. As it turns out, though, there are few if any effective mechanisms for establishing that a statement did—or

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93 Cox, supra note 48, 1731-32; Langevoort, supra note 48, at 175.


95 Lipton, supra note 30, at 74.


did not—impact prices (a point to which I will return below). If plaintiffs bear the burden of demonstrating the effect of each statement, they will rarely succeed, and the fraud-on-the-market cause of action will be extremely limited.

Another solution would be to modulate plaintiffs’ entitlement to the presumption. Plaintiffs would bear the burden of showing that the market in which the security traded was relatively efficient for the type of information at issue and, if they met this burden, they would be entitled to a presumption that the specific false statements influenced stock prices. That, however, would be a complex (if not impossible) inquiry, especially considering that fraud claims may span numerous types of statements over a prolonged period, and certain types of information may have greater or lesser salience at different times. This entails a different policy judgment: the definition of efficiency may be over or under inclusive, depending on whether we have a greater fear of fraudsters who seek to manipulate securities markets, or plaintiffs who seek to bring nuisance lawsuits.

Until recently, courts employed very demanding standards for identifying the presence of “efficient” markets for Basic purposes, occasionally concluding that even securities trading on the NASDAQ or the NYSE were inefficient. These standards drew a considerable amount of scholarly fire, because, at least in many cases, much lower levels of efficiency would be sufficient to respond to the alleged fraud. For example, we can assume that even thinly-traded stocks will rapidly react to a sudden announcement of a “government contract that will quadruple earnings.” When courts engaged in what Donald Langevoort described as “mind-numbing investigations of adjustment variations often measured in minutes rather than weeks,” they risked no-certification.

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100 For example, allegations that a company concealed sexual harassment by a high-level executive would likely be more relevant to investors today than it would have been even a few years ago. (Credit to Jill Fisch for the suggestion).


102 E.g., Cox, supra note 48, at 1726; Langevoort, supra note 48, at 168–78.

103 Cox, supra note 48, at 1732.

104 Id.

105 Langevoort, supra note 48, at 172.
decisions untethered to any policy rationale, or, at least, none that they articulated.

In *Halliburton Co. v. Erica P. John Fund, Inc.* (“Halliburton II”), the Supreme Court potentially changed the game. The Court affirmed the framework whereby plaintiffs initially establish that the market was efficient (and thus their entitlement to *Basic’s* presumptions), but relaxed the standard, describing efficiency as a “matter of degree,” and the *Basic* presumption as a “modest” one. Cognizant of the concern that not all markets are efficient enough to absorb all statements, the Court hand-waved the issue, explaining that “*Basic*’s presumption of reliance thus does not rest on a ‘binary’ view of market efficiency. Indeed, in making the presumption rebuttable, *Basic* recognized that market efficiency is a matter of degree and accordingly made it a matter of proof.” Accordingly, the Court held, defendants “may seek to defeat the *Basic* presumption [of price impact] at [the class certification] stage through direct as well as indirect price impact evidence.”

The problem with this reasoning is the poor fit between the diagnosis and the cure. It would be one thing if the Court simply decided that it would be better to grant the presumption in cases where it is not warranted than to deny it in cases where it is, and therefore the test of efficiency should not be a stringent one. But instead, the Court apparently believed it could avoid that choice altogether by first permitting plaintiffs a presumption of price impact, and then allowing defendants to rebut that presumption on a statement by statement basis. Yet the Court’s framework continues to require an on/off approach to the assessment of whether the market was efficient in the first place, without regard to whether it was efficient for *this kind of information*; the Court simply shifted the trigger point on the scale.

As we shall see, the prospect of rebuttal is not adequate to the weight the Court placed on it. Given the limited tools available for such a demonstration, courts have displayed extraordinary confusion over what rebuttal means or how it is to be shown. Worse, because these determinations are made on class certification—without consideration of a full record—courts’ evaluations are artificially truncated. The result is that courts conduct a series of tests and empirical assessments that, though held up as significant, in fact have little bearing on the question of the fraud’s effect on prices.

107 Id. at 2410; Langevoort, *Judgment Day*, at 52.
108 134 S. Ct. at 2417.
Since *Halliburton II*, at least some, though not all, courts have responded to the shift in tone and adjusted their standards for evaluating efficiency. 109 Still, courts are left without any clear standard as to how efficient is efficient enough, and none (so far) have suggested that this initial question should be answered by reference to the type of statements that form the basis for the claim. 110

**B. Rebutting the Presumption of Price Impact**

After plaintiffs establish the presence of an efficient market—and thus their entitlement to the presumption that defendants’ false statements impacted prices—defendants have the right to rebut that presumption. However, because it is a class certification motion and not a full-blown trial, there are limits to the matters courts may consider. Courts cannot consider whether the statements were material, because materiality is an element under Section 10(b) even outside the class action context; its presence or absence creates no individualized issues. 111 Loss causation is similarly off-limits: as the Supreme Court put it, “[t]he fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory.” 112

With both materiality and loss causation off the table, the *Halliburton II* Court assumed that defendants would use econometric

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111 Amgen Inc. v. Connecticut Ret. Plans and Trust Funds, 568 U.S. 455, 474 (2013). As described above, this conclusion is subject to challenge given courts’ sub rosa practice of modulating their assessment of materiality in non-fraud-on-the-market cases. See supra Part II.A.

studies to establish the lack of price impact.\textsuperscript{113} The problem here, however, is that the Court overestimated the efficacy of the tools we have to conduct such investigations, rendering the line between permitted price impact inquiries, and prohibited inquiries into loss causation and materiality, gossamer thin.

The standard mechanism for assessing whether particular information had an effect on stock prices is known as an “event study.” But, as numerous scholars have now documented, event studies are quite limited and unreliable when used in the context of securities litigation.\textsuperscript{114} These studies purport to detect when a stock’s price moves in response to news or a corporate disclosure—i.e., a particular “event,” such as the original fraudulent statement. But when multiple pieces of news are issued simultaneously, they cannot distinguish between news that moves the stock and news that has no effect.\textsuperscript{115} They are also relatively insensitive, meaning that they will only detect effects for particularly extreme stock price reactions, and the more volatile the stock ordinarily, the less effective the event study is likely to be.\textsuperscript{116} As a result, events that move the stock less dramatically (or that are confounded with events that exert pressure in the other direction) will yield a “null” result, meaning that the study will not be able to rule out the possibility that the event had no effect on prices. Thus, event studies cannot, even as a theoretical matter, offer very reliable evidence that an event did not affect stock prices, which is precisely what the Supreme Court expected they would be used to do.

Compounding the problem is that in many, if not most, cases of fraud, the plaintiff does not allege that the fraud moved the stock price upward; the more common allegation is that the fraud was used to conceal internal problems. These kinds of frauds are designed to confirm existing market expectations, and thus keep stock prices from falling;\textsuperscript{117} the fraud causes no price movement for an event study to detect.\textsuperscript{118} The same problem attaches when plaintiffs allege that the defendants disclosed

\textsuperscript{113} Halliburton II, 134 S. Ct. at 2415; see also Jill E. Fisch, The Future of Price Distortion in Federal Securities Fraud Litigation, 10 DUKE J. CONST. L. & PUB. POL’Y 87 (2015).


\textsuperscript{115} Fisch, supra note 113, at 97–98.

\textsuperscript{116} Id. at 97.

\textsuperscript{117} FindWhat Inv’t Grp. v. FindWhat.com, 658 F.3d 1282, 1290–91 (11th Cir. 2011); see, e.g. In re Vivendi, S.A. Sec. Litig., 838 F.3d 223, 232 (2d Cir. 2016).

\textsuperscript{118} Merritt B. Fox, Halliburton II: It All Depends on What Defendants Need to Show to Establish No Impact on Price, 70 BUS. LAW. 437, 441 (2015).
problems but fraudulently minimized their scope;\(^\text{119}\) in such cases, the effect of the fraud is to keep the stock price from falling as far as it would have had the truth been known, and once again, there is nothing for an event study to test.

Typically, then, defendants try to demonstrate a lack of market movement when the truth is disclosed, akin to the analysis conducted in the context of materiality. The argument is that if the market fails to respond to a revelation of the truth, the original fraud is unlikely to have moved prices either.\(^\text{120}\) Courts since \emph{Halliburton II} have accepted this logic, typically declaring that the presumption of price impact will be rebutted if defendants demonstrate \emph{both} that the market failed to respond to the initial fraud, \emph{and} that the market failed to respond to disclosure of the truth.\(^\text{121}\) But even leaving aside the weaknesses in the mechanisms used to detect such a price drop,\(^\text{122}\) the inquiry itself is orthogonal to the matter ostensibly under consideration, namely, whether the fraud distorted market prices initially. As the Supreme Court made clear, the \emph{lack} of a price drop upon disclosure of the truth does not, in fact, establish that there was no price inflation to begin with. Intervening events may have already deflated the stock to the point where the new information is no longer relevant; information about the problems may leak out over time in undetectable ways so that by the time the truth is disclosed, the market has already anticipated and priced in that information.\(^\text{123}\) Even if defendants prove the point, they will in many cases have established little of relevance.

That said, there is almost certain to be a price drop somewhere, because plaintiffs will not bring a case otherwise.\(^\text{124}\) Economic losses are a necessary element of a \emph{Section 10(b)} action, and after \emph{Dura}, it is obvious...
they must be at least plausibly connected to the underlying fraud. But even if a price drop does occur, it may not shed any light on the question whether the original statement impacted the market. This is because—as described in the context of loss causation—many “disclosures” are not so much revelations of an earlier fraud as negative business developments that would be expected to cause a market price drop regardless of the effect of any earlier lies.125 For example, in *Ludlow v. BP, P.L.C.*, the plaintiffs alleged that BP lied about the adequacy of the safety protocols on its oil rigs, and that losses were incurred (and the truth was revealed) when the Deepwater Horizon exploded—spewing 62,000 barrels of oil per day into the ocean.126 Naturally, this disaster caused BP’s stock price to plummet, but that fact hardly tells us anything about the impact of the earlier misstatements.127

Cases like BP are commonplace,128 and thus many class certification disputes do not turn on whether there was a market reaction to a disclosure, but on whether disclosure itself was, in fact, corrective or otherwise revealed the fraud.129 Frequently, the argument is paired with the claim that the fraud was actually revealed at an earlier time than the plaintiffs contend, and the lack of price movement in response to that disclosure establishes that the original fraud did not move the price either.130 But these inquiries are often indistinguishable from prohibited inquiries into materiality and loss causation. As a result, many courts either refuse to entertain them131 or work themselves into contortions to

126 800 F.3d 674, 678 (5th Cir. 2015).
127 Lipton, supra note 50, at 79.
128 For example, in *Halliburton* itself, the plaintiffs alleged that the defendants lied about their exposure to tort liability and the truth was revealed when they lost their trials. Halliburton Co., 309 F.R.D. at 255. Naturally, these negative events would be expected to impact Halliburton’s price regardless of any earlier statements. Other cases might involve regulatory enforcement actions, which again would unquestionably cause price drops even if the original misstatements had no effect at all. See, e.g., City of Roseville Emps.’ Ret. Sys. v. Horizon Lines, Inc., 686 F. Supp. 2d 404, 408 (D. Del. 2009) (price drop upon announcement of antitrust investigation).
131 Aranaz, 302 F.R.D. at 671 (truth-on-the-market is prohibited materiality inquiry); Thorpe, 2016 U.S. Dist. LEXIS 33637, at *44 (court is “unable to decouple” arguments that disclosures did not correct prior misstatements “from a materiality inquiry”). But see Ark. Teachers Ret. Sys., 879 F.3d at 485 (holding that arguments regarding the lack of price
distinguish the permissible from the impermissible.\textsuperscript{132} Moreover, given the nature of truth-on-the-market arguments,\textsuperscript{133} they may be nearly as impossible to parse in the class certification context as they are on the motion to dismiss.

The transmogrification of arguments about the effect of the fraud into arguments about the effect of corrective disclosures creates additional confusion when the evidence is equivocal. A fraud may last for a prolonged period, with numerous ostensible disclosures issued over time.\textsuperscript{134} Courts may find that some, but not all, of these disclosures impacted the stock’s price, and \textit{Halliburton II} offers no guidance as to how this evidence should be interpreted. Courts have, on occasion, reached the remarkable conclusion that all who traded over a defined class period should be certified as a class, excluding the mid-period dates when partial disclosures had no effect.\textsuperscript{135} Such reasoning is facially incoherent: disclosure dates are meant to provide evidence that the price was inflated before that point—to certify a class while excluding specified \textit{days} in the middle is to suggest that somehow, the inflation spontaneously moved out and then back into the stock unprompted.\textsuperscript{136}

\begin{footnotesize}
\textsuperscript{132} For example, on remand from the Supreme Court, the district court in \textit{Halliburton} held that evaluating the “corrective” nature of a disclosure would stray too far into forbidden loss causation territory. 309 F.R.D. at 260–61. However, the court ultimately concluded that two alleged disclosures were not corrective because they revealed no new information to the market. \textit{Id.} at 271–74. In \textit{West Virginia Pipe Trades Health \& Welfare Fund v. Medtronic, Inc.}, 325 F.R.D. 280, 293–94 (D. Minn. 2018), the court held that prohibitions on assessing materiality and loss causation were no barrier to determining whether a proposed end-of-class-period disclosure added new information to the market.

\textsuperscript{133} See \textit{supra} Part II.A.

\textsuperscript{134} See, e.g., Glickenhaus \& Co. v. Household Int’l, Inc., 787 F.3d 408, 416 (7th Cir. 2015).

\textsuperscript{135} \textit{In re Am. Int’l Grp. Sec. Litig.}, 265 F.R.D. 157, 188 (S.D.N.Y. 2010); Ann M. Lipton, Halliburton and the Dog that Didn’t Bark, 10 DUKE J. CONST. L. \& PUB. POL’Y 1, 20 n.72 (2015). \textit{AIG} was decided prior to \textit{Halliburton II}, but the court conducted a price impact analysis similar to those conducted since.

\textsuperscript{136} In another example of courts getting lost in the reasoning of corrective disclosures, the court in \textit{In re Moody’s Corporation Securities Litigation}, 274 F.R.D. 480, 493 (S.D.N.Y. 2011), refused to certify a class because the plaintiffs identified corrective disclosure dates, with associated market reactions, that occurred after the end of their chosen class period. But if the market’s reaction to a corrective disclosure is only relevant to show that the price was inflated prior to that point, it should hardly have mattered that the plaintiffs had artificially truncated their class; either way, they had shown that the market price was inflated during the relevant period.
\end{footnotesize}
In re American International Group Securities Litigation\textsuperscript{137} illustrates how these highly stylized disputes can cause courts to miss the forest for the trees. In that case, AIG was alleged to have committed a massive accounting fraud combined with multiple illegal business transactions. Disclosure of the truth trickled out over several months through reports of federal and state investigations and, ultimately, a restatement of AIG’s finances. Nonetheless, the court examined stock price movements on each of the corrective disclosure dates to determine if defendants had rebutted the presumption that AIG’s fraud had impacted the price of its stock—a ludicrous question, given that AIG was a household name trading on the New York Stock Exchange that had misstated its earnings by nearly $4 billion over a multi-year class period.

The net result is that \textit{Halliburton II} commands courts to make findings similar to the merits-based determinations that already bedevil them on motions to dismiss, only they are expected to do so with their hands tied behind their backs. It perhaps unsurprising, then, that these disputes stray into territory far removed from the actual matter under consideration—namely, whether it is appropriate to try the case on a classwide basis.

One might counter by pointing out that this is simply the class certification motion; any error in plaintiffs’ favor, at least, can be revisited at summary judgment or trial when a more fulsome record can be considered.\textsuperscript{138} But that is too glib a response, because expectations for how class certification motions will be litigated drive everything from decisions about which cases will be filed to how they will be settled—and perhaps even how defendants reveal negative information to the market at the outset.\textsuperscript{139} And the \textit{denial} of class certification may, in practical effect, sound the death knell for the case as a whole.\textsuperscript{140} For that reason, the near-arbitrary gauntlet that parties must run at the class certification stage matters for the legitimacy of the entire enterprise.

To be sure, we can attempt some limited solutions.\textsuperscript{141} We can clarify what types of evidence rebuts the presumption of price impact. We can improve the use of event studies. We can alter burdens of proof

\textsuperscript{137} 265 F.R.D. 157 (S.D.N.Y. 2010).


\textsuperscript{139} See supra text accompanying notes 88-92.

\textsuperscript{140} This is particularly true given that, by the time class certification is denied, investors may be time-barred from bringing individual claims. See Cal. Pub. Emps.’ Ret. Sys. v. ANZ Sec., Inc., 137 S. Ct. 2042, 2052 (2017).

\textsuperscript{141} I have previously questioned whether class certification should involve an assessment of market efficiency or price impact at all. Lipton, supra note 135, at 21–25.
so that, once the Basic presumptions attach, defendants only need meet a burden of production before courts have flexibility to consider the evidence holistically. But the problem is more deeply rooted: the limits of what economists can prove, coupled with courts’ instinctive preference for precedent over complexity, doom any changes from the outset.

IV. DAMAGES

There are few modern judicial decisions on damages calculations because securities class actions rarely proceed through trial. Nonetheless, issues surrounding damages are significant because they inform how cases are litigated and the amounts for which they settle, so I will briefly discuss some of the challenges.

It is generally agreed that the proper measure of damages in a fraud-on-the-market action is the amount by which the stock price was inflated past its unmanipulated price, offset by any amounts the plaintiff recouped by selling before the inflation fully dissipated. That simple statement, however, hides a raft of complexity.

The unmanipulated price of the stock is typically identified by looking to its market value after the full truth has been disclosed, segmenting out any drops in value that are attributable to intervening events. Plaintiffs then work backwards from that figure to identify the stock’s unmanipulated value, and the amount of artificial inflation, at various points throughout the class period, taking into account any unrelated disclosures as well as any disclosures that bear upon the fraud itself. Necessarily, these calculations depend heavily on event studies, which—as described above—are plagued with inherent weaknesses.

Beyond this limitation, however, lies the fact that the damages to which plaintiffs are entitled—and methodologies for calculating them—are still largely undefined. To begin, the final disclosures that cause plaintiffs’ losses typically reveal not only the fact of the fraud, but also its


145 Lipton, supra note 30, at 119.

146 Id.

147 Baker, supra note 114, at 1226.
various collateral consequences. The BP case described above illustrates the problem: had the deficient safety protocols been immediately disclosed, the company’s stock price would have reacted, but not nearly as much as it plummeted in the wake of the Deepwater Horizon disaster.\textsuperscript{148} Similarly, a revelation of accounting fraud might be accompanied by associated regulatory penalties that drive the stock price down further than it would have gone if the company had simply confessed its true financial condition prior to any fraudulent action.\textsuperscript{149} Disclosures of the corporation’s true condition might also be accompanied by management upheaval, civil lawsuits by affected parties—both securities related and non—all of which contribute to the stock price drop that forms the basis of the investors’ losses.

It is a matter of continuing controversy whether and to what extent these additional damages should be collectible by plaintiffs,\textsuperscript{150} and there may be few reliable methods of segmenting them out.\textsuperscript{151} Academics have also debated whether the reputational hit that companies take as a result of a fraud should or should not count towards Section 10(b) damages,\textsuperscript{152} but if it does not, it presents another knotty—perhaps impossible—evidentiary problem.

There are also likely to be a host of other kinds of confounding factors that are nearly impossible to tease apart. Companies may make projections of future performance that are of a piece with other fraudulent statements but are protected by the safe harbor; they may issue false statements that, judges conclude, were not made with scienter and are thus inactionable. Attempts to distinguish among these statements may be entirely speculative—especially given the poor standards that govern in other phases of the action—and provide further reason to doubt the entire enterprise of assessing the harm wrought by the fraud.

\textsuperscript{148} Lipton, supra note 30, at 119–20.


\textsuperscript{150} James Spindler argues that some or all of these collateral consequences should result in recoverable damages. See James C. Spindler, Optimal Deterrence When Shareholders Desire Fraud, Geo L.J. (forthcoming); James C. Spindler, We Have a Consensus on Fraud on the Market—and It’s Wrong, 7 HARV. BUS. L. REV. 67, 98-99 (2017).

\textsuperscript{151} This problem plagued the BP plaintiffs, who apparently had difficulty developing a model that proved the amount of inflation in the stock solely due to misleading statements about safety. Ludlow v. BP, P.L.C., 800 F.3d 674, 688–89 (5th Cir. 2015).

V. **Is There a Solution?**

If the previous analysis is correct, judicial evaluations of market impact are hopelessly muddled. The common law doctrines have diverged so far from the underlying reality of how markets function as to border on complete legal fiction. Parties joust over issues like puffery, materialization of the risk, and definitions of market efficiency in a judicial pantomime that barely pretends to assess the actual effects of fraud. As a result, there is no assurance that the damages, if any, to which the plaintiff may be legally entitled bear any resemblance to the actual harms inflicted by the defendants.

It is not that these problems are novel; it has long been understood that any judicial assessment of markets will necessarily offer only a rough justice. 153 Standards of greater or lesser stringency may not be attributable to judicial misapprehension so much as a calculated preference as to where to allocate the burden of uncertainty for an inquiry—the market effects of a fraud—that is inherently uncertain. 154 But if that is the motivation, it is ill-served by current practice: courts’ “ham-fisted” mechanisms for distinguishing meritorious cases from frivolous ones are likely to insulate even “dastardly” frauds so long as defendants can manipulate their disclosures sufficiently to match doctrinal rigidities. 155

At this point, judicial evaluation of market evidence has become so artificial that we may question the value of the private Section 10(b) action at all, or fraud-on-the-market actions, or actions based on open-market purchases. Over the years, reformers have offered various permutations on proposals that these frauds be prosecuted largely or exclusively by the government actors, 156 arguing that public officials are better positioned than private litigants to gauge when the benefits of enforcement outweigh its costs. A full exploration of these arguments is

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153 Langevoort, *supra* note 48, at 158 (noting the decision was more grounded in civil procedure than economic theory).


beyond the scope of this Essay, but for present purposes suffice to say that I continue to believe private enforcement plays an important role. The SEC does not have—and is unlikely to have—sufficient resources to police markets on its own, and, as James Park has explained, public and private enforcers may focus on different types of rule-breaking and thus together cover a fuller spectrum of misconduct. I also believe that the private class action today plays an expressive role, in that it is a visible mechanism for public accountability of large corporations to those who they have injured.

At the same time, it has long been recognized that securities class actions minimally, if at all, compensate defrauded investors; their chief value lies in their capacity to deter misconduct and thus inspire confidence in securities markets generally. But to be effective and appropriate for that purpose, there must be a rational relationship between the wrongfulness of the misconduct, the size of the harm, and the penalty imposed. Given the cavernous distance between judicial measures of harm and the underlying reality, that relationship is currently absent. Therefore, I believe that courts should be relieved from the burden of assessing market evidence or—as much as possible—determining the hypothetical significance of corporate information to investors.

How might this be achieved? To begin, it seems that either the reliance element of a Section 10(b) action, or the materiality element might be eliminated, but not both. As I have explained elsewhere, securities fraud actions are often predicated on vague or boilerplate misstatements that bear only a glancing relationship to the underlying conduct that actually caused the investors’ losses; these actions seem more like claims about corporate governance than fraud, and, at least given our current division of labor between state and federal law, are not viewed as the proper subject of a Section 10(b) action. Thus, there must be some

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160 *Id.* at 1265; Sale & Thompson, *supra* note 1, at 537–39.
161 Cf. Langevoort, *supra* note 5, at 651–62 (arguing that securities damages are not calibrated for deterrence or to remedy societal harms, and proposing a statutory cap); Langevoort, *supra* note 97, at 58 (recognizing that the questions raised by *Basic* are too extensive to be addressed via common law; a legislative solution may be required).
162 Lipton, *supra* note 30, at 110–12. It might be argued that the scienter element of Section 10(b) can be used to draw the appropriate distinctions, but that too is unsatisfying, given that scienter to deceive investors may be indistinguishable from
screening mechanism available to courts to gauge whether the misstatement was, in fact, likely to have deceived investors.

That said, one could easily imagine eliminating the reliance requirement entirely, and leaving courts only to assess materiality. We currently do this for claims brought under Sections 11 of the Securities Act,\(^{163}\) which prohibits misleading registration statements on the assumption that these documents necessarily influence the trading price of the relevant security.\(^{164}\) We might adopt a similar assumption for all public statements made about a publicly traded—or even just exchange traded—stock. To avoid the necessity of calculating loss causation or damages, we might simply impose statutory fines paid to all investors who experience an economic loss during the fraud period. This system is far from perfect: courts would still be required to gauge what would be important to a hypothetical investor, which would continue to create opportunities for judicial mischief, and investors might be overcompensated to the extent they are paid for losses unrelated to the fraudulent conduct.\(^{165}\) Still, market evidence would presumably play less of a role, and fines could be calibrated based on a legislative assessment of harm—perhaps tied to the size of the fraud relative to the issuer’s business rather than to market reaction, with a view toward deterring future misbehavior. And by redefining the cause of action in this manner, it could be expanded to securities where the demands of “market efficiency” have previously acted as an insurmountable barrier to class litigation. Indeed, it is precisely these markets, often thinly traded with little analyst attention, that may be most vulnerable to fraud. Moreover, to the extent some of the judicial decisionmaking in this area springs from a perceived need to fill gaps left by Congress, a more precise legislative articulation of appropriate penalties would alleviate these concerns.

Alternatively, as I have suggested elsewhere, we might focus on reliance.\(^{166}\) Instead of presuming price impact, we could grant a remedy to those investors who show that the misstatement factored, even minimally, into their investment decision or algorithm, without the need for judicial evaluation of materiality. This relatively light burden might be scienter to remain silent about behavior that is not, per se, the subject of the securities laws. Lipton, supra note 50, at 74–75.

\(^{163}\) Claims brought under Section 12 of the Securities Act similarly require no proof of reliance, although, due to limiting constructions of the statute, they are unlikely to arise in the context of open-market trading. See Gustafson v. Alloyd Co., 513 U.S. 561, 569-71 (1995); Pinter v. Dahl, 486 U.S. 622, 644 n.21 (1988).

\(^{164}\) APA Excelsior III L.P. v. Premiere Techs. Inc., 476 F.3d 1261, 1273-74 (11th Cir. 2007).

\(^{165}\) Fisch, supra note 67, at 867.

\(^{166}\) Lipton, supra note 30, at 136-45.
enough to weed out claims based on every jot and tittle, while still being practical for plaintiffs to pursue. Nor would it necessarily exclude all “passive” investors; many ostensibly indexed funds in fact create their own indices (or use ones created by affiliates) that rely on idiosyncratic criteria; occasionally the inclusion or weighting of a particular security may be influenced by fraudulent statements. To be sure, these cases could not be brought as class actions (though perhaps they could be certified as issue classes under Rule 23(e)), but they might still be feasible if statutory damage awards are large enough.

But if remedies are available only to those traders who establish reliance (however much their burden is eased), huge swaths of investors will be unable to recover at all. These investors might experience their exclusion as injustice, even if (or perhaps especially if) statutory awards to the remaining investors are set at a high enough level to deter future misconduct. To prevent the disparity from diminishing the expressive value of a Section 10(b) action, the best solution may be a hybrid system, whereby investors who establish reliance receive a larger award—perhaps treble the ordinary statutory figure—and investors who rely only on the materiality of the misstatement receive a lesser amount. That way, in appropriate cases, investors who can prove reliance could join with larger class actions and share some of the expenses.

VI. CONCLUSION

Securities class actions have attracted hostility from judges, politicians, and commenters for decades; that hostility, surely, has contributed to the development of doctrines that narrow the scope of permissible claims and contribute to the action’s complexity. Matters are not helped by the PSLRA, which — by barring discovery in the early stages of litigation while imposing heightened pleading requirements—front-loads securities actions and forces courts to make complex judgments on very limited records.

Still, the problems identified in this Essay have much deeper roots and call into question the very capacity of courts to make the determinations that securities class actions demand of them. Certainly, in any litigation, there is a risk of error, and courts will always need to make difficult factual judgments under conditions of uncertainty. But

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167 Adriana Z. Robertson, Passive in Name Only: Delegated Management and “Index” Investing, YALE J. ON REG. (forthcoming).
169 Lipton, supra note 30, at 139.
policymakers must also determine when the cost of efforts to ensure accuracy outweigh their benefits. It is time to recognize that as currently constituted, procedures associated with fraud-on-the-market actions barely aspire to accuracy, and the costs associated with improving them are likely to far exceed their incremental value. A redefinition of the cause of action, with damages expressly calibrated to advance its goals, would ultimately be of more benefit to litigants, courts, and markets.