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Second Circuit Holds That Direct Evidence of Price Impact Is Not Always Necessary to Establish Market Efficiency Under the Fraud-on-the-Market Doctrine

Introduction

In *Waggoner* v. *Barclays PLC*, No. 16-1912 (2d Cir. Nov. 6, 2017), the Second Circuit held that shareholder plaintiffs seeking class certification under the presumption of reliance conferred by the fraud-on-the-market doctrine need not offer direct evidence of market efficiency so long as other indicia of market efficiency are established. This ruling will make it more difficult for public companies defending securities fraud class actions to oppose class certification unless certain indirect evidence of inefficiency is also present.[1]

Background

In June 2014, the New York Attorney General ("NYAG") filed suit against Barclays under New York's Martin Act, alleging that Barclays concealed information about the operation of its private "dark pool" trading system, LX. Following news of the lawsuit, Barclays' stock price fell 7.38 percent. Shortly thereafter, investors in Barclays' American Depository Shares ("ADS") filed a putative securities fraud class action in the Southern District of New York.

The complaint alleges that Barclays made material misrepresentations and omissions regarding LX specifically and Barclays' business practices and risk controls generally. On defendants' motion to dismiss, the district court dismissed claims based on the general statements as inactionable puffery, but let stand claims based on certain statements about LX, such as assurances that Barclays took steps to protect clients from aggressive high frequency trading, restricted predatory traders' access to clients, and eliminated traders who continued to behave in a predatory manner.[2] Adopting the "price maintenance" theory, plaintiffs argued that the alleged LX misstatements maintained preexisting inflation in Barclays' ADS price and that such inflation dissipated upon the filing of the NYAG complaint.

On plaintiffs' motion for class certification, plaintiffs argued that class-wide reliance could be established both under *Basic*'s fraud-on-the-market presumption as well as the *Affiliated Ute* presumption of reliance

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1 Paul, Weiss, Rifkind, Wharton & Garrison LLP represented the Securities Industry and Financial Markets Association as an amicus curiae in support of defendants-appellants before the Second Circuit.

2 *Strougo* v. *Barclays PLC*, 105 F. Supp. 3d 330, 338-39 (S.D.N.Y. 2015).

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for omissions.[3] In addition to submitting a purported event study, plaintiffs relied upon a number of the *Cammer/Krogman* factors that assess market efficiency based on indirect factors, such as Barclays' market capitalization, Barclays' average weekly trading volume, analyst coverage of Barclays, the presence of market makers, and Barclays' eligibility to file an S-3.[4]

In response, defendants argued that both presumptions were inapplicable. In an effort to rebut the *Basic* presumption, defendants adduced expert evidence showing that the alleged misstatements did not cause a stock price increase. Defendants argued that plaintiffs therefore could not demonstrate a cause-and-effect relationship between information and price—and thus could not satisfy the fifth *Cammer* factor ("*Cammer* 5"). Defendants also introduced an expert opinion that the filing of an NYAG enforcement action, rather than a "correction" of the LX statements, explained the back-end price decline.

The district court certified the class, finding both presumptions applicable. As to the *Basic* presumption, the district court did not rely upon plaintiffs' event study, which had been subject to substantial criticism by defendants' expert. Instead, the court concluded that, for exchange-traded companies like Barclays, "indirect evidence of market efficiency . . . will typically be sufficient to satisfy the *Basic* presumption," and thus "there is no need to demonstrate efficiency through . . . an event study." The district court also rejected defendants' rebuttal, finding that defendants had failed to "foreclose" the price maintenance theory and failed to show that the stock price drop was not caused "at least in part" by the alleged correction of the LX statements.[5]

Defendants filed a Rule 23(f) petition with the Second Circuit. The Second Circuit granted defendants leave to appeal. On appeal, defendants argued, among other things, that (1) the *Affiliated Ute* presumption did not apply because plaintiffs' claims were based on affirmative misstatements; (2) plaintiffs failed to prove the market efficiency prerequisite to the *Basic* presumption; and (3) the district court erroneously rejected defendants' rebuttal of the *Basic* presumption.

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3 *See Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988); *Affiliated Ute Citizens of the State of Utah* v. *United States*, 406 U.S. 128 (1972).

4 *See Cammer* v. *Bloom*, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989) (establishing five factors for market efficiency: (1) the average weekly trading volume; (2) extent of analyst coverage; (3) extent market makers trade in stock; (4) issuer eligibility to file SEC registration Form S-3; and (5) the demonstration of a cause-and-effect relationship between unexpected material disclosures and changes in stock price); *Krogman* v. *Sterritt*, 202 F.R.D. 467, 474 (N.D. Tex. 2001) (adding an additional three factors: (1) the capitalization of the company; (2) the bid-ask spread of the stock; and (3) the percentage of stock not held by insiders).

5 *Strougo* v. *Barclays PLC*, 312 F.R.D. 307, 322-23, 326, 327 (S.D.N.Y. 2016).

The Second Circuit's Decision

In an opinion by Judge Droney, joined by Judges Kearse and Lohier, the Second Circuit affirmed the district court's class certification order. The court agreed with defendants' challenge to the *Affiliated Ute* presumption, but rejected defendants' challenges to the *Basic* presumption and affirmed the class certification order on that basis.

Affiliated Ute *Does Not Apply to Claims Based Primarily on Misstatements*

The Second Circuit agreed with defendants that the district court should not have given plaintiffs the benefit of the *Affiliated Ute* presumption. Adhering to two of its prior decisions, the court held that *Affiliated Ute* does not apply to claims based "primarily" on affirmative misstatements, as opposed to omissions.[6] The court noted that the alleged omissions were "simply the inverse" of the alleged misstatements.[7] The court clarified that "the *Affiliated Ute* presumption does not apply to earlier misrepresentations made more misleading by subsequent omissions, or to what has been described as 'half-truths,' nor does it apply to misstatements whose only omission is the truth that the statement misrepresents."[8] Since plaintiffs' claims concerned misstatements and not omissions, the district court improperly applied the *Affiliated Ute* presumption of reliance.

To Invoke the Basic Presumption, Plaintiffs Need Not Offer Direct Cause-and-Effect Evidence of Market Efficiency If the Other Cammer/Krogman *Factors Are Present*

The Second Circuit then turned to the district court's application of the presumption of reliance under the fraud-on-the-market doctrine. Building on its recent decision in *In re Petrobras Securities Litigation*,[9] the Second Circuit held that a plaintiff need not always offer direct event study evidence of a cause-and-effect relationship between new information and stock price movements before satisfying its burden to prove market efficiency at the class certification stage. Rather, in a case in which all of the other *Cammer/Krogman* factors weigh in plaintiff's favor, a plaintiff may generally omit such direct evidence of cause and effect.

In reaching this conclusion, the Second Circuit emphasized, "we do not imply that direct evidence of price impact under *Cammer* 5 is never important," and cited with approval its earlier rulings recognizing that *Cammer* 5 "has been considered the most important *Cammer* factor in certain cases because it assesses

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6 Slip Op. at 40.

7 *Id.* at 43-44.

8 *Id. at 44.*

9 862 F.3d 250 (2d Cir. 2017).

'the essence of an efficient market and the foundation for the fraud on the market theory.'"[10] The court held, however, that direct evidence of an efficient market may be more critical when one or more of the other *Cammer/Krogman* factors is lacking or in other (unspecified) "specific circumstances."[11]

Applying the law to the facts before it, the Second Circuit then applied a deferential standard to conclude that the district court's decision not to require direct evidence was not outside "the range of permissible decisions" and thus was not reversible.[12] In particular, the Second Circuit explained that all seven of the indirect factors considered by the district court (the first four *Cammer* factors and the three *Krogman* factors) weighed so decisively in favor of the conclusion that the market for Barclays' ADS was efficient that defendants had not even challenged these factors.[13]

Defendants' Rebuttal of the Basic Presumption Must Carry a Burden of Persuasion

The Second Circuit further rejected defendants' attempted rebuttal of the *Basic* presumption. Defendants were required to carry both a burden of production and a burden of persuasion. The court reconciled this holding with Fed. R. Evid. 301, which provides that presumptions generally do not alter the burden of persuasion, on the ground that the *Basic* presumption is a judicially created "substantive doctrine," and thus well within the rule's carve out for situations in which a federal statute "provides otherwise."[14]

Defendants had attempted to rebut the presumption with (i) plaintiffs' event study, which showed that the alleged LX misstatements did not increase Barclays' stock price and (ii) an expert report attributing Barclays' stock price decline (at least in part) to the consequences of the NYAG enforcement action, rather than the "correction" of the LX statements. As to the former, the court affirmed the district court's finding that defendants failed to meet their burden of excluding plaintiffs' theory that the alleged misstatements had maintained artificial inflation that was already in the ADS price during the class period, under the "price maintenance" theory.[15] As to the latter, the court affirmed on the basis that defendants failed to exclude the possibility that the enforcement action and alleged correction *both* contributed to the price decline, and thus that the NYAG action was, in part, a correction of earlier misstatements.

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10 Slip Op. at 48 (citing *Teamsters Local 445 Freight Div. Pension Fund* v. *Bombardier Inc.*, 546 F.3d 196, 207 (2d Cir. 2008)).

11 *Id*. at 54 n.29.

12 Slip Op. at 51.

13 *Id*.

14 Slip Op. at 65–68.

15 Slip Op. at 70 (citing *In re Vivendi Sec. Litig.*, 838 F.3d 223 (2d Cir. 2016)).

Analysis

Together with the Second Circuit's recent decision in *Petrobras* (client alert here), the *Barclays* decision serves to lower the obstacles a shareholder plaintiff must overcome to obtain class certification. The indirect *Cammer/Krogman* factors are often easily satisfied in cases against exchange-traded issuers. While the Second Circuit denied that it was establishing a *per se* rule that the "securities of large publicly traded companies always trade in an efficient market,"[16] it left open the question of what circumstances (other than the absence of the other *Cammer/Krogman* factors) would require a plaintiff to meet *Cammer* 5 by offering direct price impact evidence. A petition for certiorari raising a similar issue is currently pending in *Petrobras*,[17] and the *Barclays* defendants may well seek further review too.

The Second Circuit's decision in *Barclays* appears to create a circuit split with the Eighth Circuit's decision in *IBEW Local 98 Pension Fund* v. *Best Buy Co.*[18] While the Second Circuit attempted to distinguish *Best Buy* on the ground that the case involved "overwhelming evidence" of no price impact,[19] that "overwhelming evidence" was the same evidence that the Second Circuit rejected here: that the stock price did not increase after the misstatements at issue (*i.e.*, on the "front end"). *Best Buy* held that such a front-end showing was sufficient to rebut a speculative claim of price maintenance.

The *Barclays* decision also raises questions about the viability of the price maintenance theory and the extent of its applicability. The Second Circuit's previous encounters with the theory have included caveats as to its general applicability.[20] Yet, *Barclays* tersely describes the price maintenance theory as a theory "we have previously accepted."[21] In cases where plaintiffs can invoke the price maintenance theory, it will be more challenging under *Barclays* to rebut the presumption of reliance at the class certification stage

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16 Slip Op. at 54 n.29.

17 *In re Petrobras Sec. Litig.*, No. 17-664 (U.S.) (docketed Nov. 3, 2017). The *Petrobras* petition for certiorari also raises another issue: whether Rule 23 and due process require that class membership be ascertainable through administratively feasible means.

18 818 F.3d 775 (8th Cir. 2016).

19 Slip Op. at 68 n.36.

20 *See Vivendi*, 838 F.3d at 256–60 & n.20 (holding that the district court did not err by admitting expert report that was relevant to the issue of total inflation but providing the caveat that: "[W]e do not address whether there may be other reasons, not raised by Vivendi here, why some statements unassociated with an increase in inflation do not affect a company's stock price"); *In re Pfizer Inc. Sec. Litig.*, 819 F.3d 642, 661 (2d Cir. 2016) (holding that the district court erred by excluding expert testimony based on "inflation-maintenance" theory, while also stating: "To be clear, we do not decide in this appeal that Plaintiffs' theory is either legally or factually sustainable. It might be that Plaintiffs' inflation-maintenance theory is deficient under Rule 10b-5 . . . .").

21 Slip Op. at 70 (citing *Vivendi*, 838 F.3d at 256).

because it obviates the need for plaintiffs to establish any front-end price impact. Where, as here, the back-end price impact was caused by mixed news, defendants face yet an additional obstacle.

Although the Second Circuit has made it more difficult for defendants to raise these types of issues at the class certification stage, its decision does not foreclose defendants from raising similar arguments—potentially based on the same expert evidence—at the merits stage. At that stage, unlike at class certification, plaintiffs will have the burden of proving materiality, loss causation, and damages.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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