Securities Regulation Daily Wrap Up, SUPREME COURT NEWS—U.S.: Who has the burden of persuasion when invoking fraud-on-the-market?, (Mar. 5, 2018)

Securities Regulation Daily Wrap Up

By Rodney F. Tonkovic, J.D.

A petition for certiorari asks the Supreme Court to consider key recurring questions posed by the invocation of the fraud-on-the-market presumption of reliance under Basic Inc. v. Levinson. The first question posed by the petition asks which party has the burden of persuasion when a defendant tries to rebut the presumption. The second question asks what evidence must be put forth by a plaintiff seeking to rebut the presumption (Barclays PLC v. Waggoner, February 28, 2018).

Dark pools. Petitioner Barclays PLC operates an alternative trading system known as the Barclays Liquidity Cross (LX). LX operates as a “dark pool,” and Barclays said that LX was a haven from practices engaged in by high-frequency traders. Investors, however, alleged that Barclays allowed predatory high-frequency traders to operate within LX and even gave them information that was not available to other traders. As a result, the price of Barclays' ADS was inflated until the New York Attorney General’s Office brought a lawsuit against Barclays, alleging that the representations about the protections LX afforded its customers from high-frequency traders were false and misleading.

Barclays moved to dismiss the suit, stating, among other arguments, that the alleged misstatements were not material given the relatively small amount of revenue involved. The district court granted class certification for certain purchasers of Barclays’ ADS, concluding that, since omissions were at the heart of the case, the Affiliate Ute presumption of reliance applied. In the alternative, the Basic presumption also applied because there was an efficient market and direct evidence of price impact was thus not necessary. The court then found that Barclays failed to rebut the Basic presumption because it failed to demonstrate that the allegedly fraudulent statements did not impact the ADS price.

Affirmed. On appeal, the Second Circuit panel agreed with Barclays' argument that Affiliated Ute did not apply because the complaint was based mainly on allegations of affirmative misrepresentations, not omissions. The Basic presumption of reliance, however, did apply, and the panel concluded that direct evidence of price impact under Cammer is not always necessary, and was not required here at the class certification stage. In this case, the district court's decision not to rely on direct evidence was permissible because all of the seven indirect factors weighed clearly in favor of finding an efficient market.

The panel then affirmed that Barclays failed to rebut the Basic presumption and that it was not erroneous to require that this be shown by a preponderance of the evidence. Supreme Court guidance plus prior Second Circuit decisions, the panel said, indicate that defendants seeking to rebut the presumption must demonstrate a lack of price impact by a preponderance of the evidence at the class certification stage. The panel then agreed that the district court was within its discretion to conclude that the lack of price movement on the dates of the alleged misrepresentations did not rebut the presumption.

Burden of persuasion. Barclays says that the lower courts are in express disagreement as to the first question presented in the petition: whether a defendant seeking to rebut the fraud-on-the-market presumption of reliance under Basic has a burden of production or a burden of persuasion. In its decision, the Second Circuit expressly disagreed with an Eighth Circuit ruling that, based on Federal Rule of Evidence 301, defendants only have a burden of production when rebutting the Basic presumption. Rule 301 provides that the party against whom a presumption is directed has the burden of producing evidence to rebut it, while the burden of persuasion
remains with the party who had it originally, unless a federal statute provides otherwise. The Second Circuit reasoned that the Supreme Court adopted the Basic presumption pursuant to the securities laws, so the burden of persuasion was thereby shifted to the defendants.

In so holding, the Second Circuit acknowledged the Eighth Circuit's reasoning, but dismissed its holding as dictum because of evidence that the alleged misrepresentation had no impact on the price. The petition argues to the contrary that the Eighth Circuit resolved a question to which the parties had devoted substantial attention and established a legal rule that will govern future decisions in that circuit. In addition, the Second Circuit did not follow Rule 301 when it found a sufficient link between the federal securities laws and the Basic presumption to trigger Rule 301’s exception. There is no statute in the securities laws, the petition states, that allocates the burdens of proof or even established the fraud-on-the-market presumption. This square conflict, the petition says, warrants the Court's review.

Direct evidence. The petition also asks whether plaintiffs may invoke the fraud-on-the-market presumption without direct evidence that the price of the security responded to new, material information during the class period. While several other courts require event studies showing a cause-and-effect relationship, the Second Circuit held that direct evidence of market efficiency is not required where indirect factors suggest that the market is efficient; the Eleventh Circuit has reached a similar conclusion. This, the petition suggests, has created a need for guidance among lower courts confused as to whether and when indirect indicators can substitute for direct evidence. Moreover, the Second Circuit's decision is simply incorrect because it eliminates the need for a plaintiff to prove that the market promptly incorporated new, material information, which many other courts have understood to be the essence of the fraud-on-the-market presumption.

The petition argues that the Second Circuit's decision creates an express circuit conflict on the first question and muddies the waters on the other. As a practical matter, the ruling lowers the bar for plaintiffs to establish the Basic presumption and raises the bar for defendants to rebut it. According to the petition, class certification will be "inevitable" in the Second Circuit, creating "in terrorem pressure" on large, publicly-traded companies to settle.

Read the docket. This case, and others pending before the Court, can be referenced in the latest version of the Supreme Court Docket. Cases are listed separately, along with a brief summary of the questions raised and the status of the appeal.

The petition is No. 17-1209.

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Companies: Barclays PLC