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EXPERT ANALYSIS

Halliburton Fallout: Fate of the ‘Efficient Market’ Hypothesis and Event Studies in Securities Litigation

By Nicolas Morgan, Esq., and Colleen McElroy, DLA Piper, and Tiago Duarte-Silva, Charles River Associates

Reading the U.S. Supreme Court’s recent decision in *Halliburton Co. v. Erica P. John Fund*, No. 13-317, 2014 WL 2807181 (U.S. June 23, 2014), brings to mind Winston Churchill’s famous quip that democracy was the worst form of government, except all the others. Here, that phrase applies to event studies. They are the worst way to measure the impact of information on stock prices, except all the other methods that have been tried.

The Supreme Court popularized the “efficient market” hypothesis in its 1988 decision *Basic Inc. v. Levinson*, 485 U.S. 224. In short, this hypothesis posits that all publicly available information is incorporated and reflected in securities prices.

In *Basic* the court found that because securities were traded in an efficient market, the presumption that plaintiffs relied on allegedly fraudulent information when purchasing securities was justified. The court recently revisited the issue in *Halliburton* and deliberated as to whether the economic theory should continue as an integral element of securities litigation.

The plaintiffs in *Halliburton*, in accordance with the «efficient capital markets» hypothesis, claimed alleged misrepresentations regarding Halliburton’s “potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of [a] merger.”¹ They asserted the misrepresentations artificially inflated the stock price and caused a subsequent shareholder loss upon corrective disclosures.

Halliburton countered that the “robust view of market efficiency,” upon which *Basic* is premised and the plaintiffs relied, “is no longer tenable” in light of developed empirical data that reflects capital markets as not fundamentally efficient.²

THE COURT DECISION

On June 23, the court handed down a decision affirming the plaintiffs’ capacity to invoke the presumption of reliance, but allowed the defendants to enter direct evidence of a lack of price impact



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of the alleged misrepresentation at the class certification stage. The court rendered a much less decisive opinion, however, with regard to the validity of the efficient-market hypothesis. The court said *Basic* relied on a “fairly modest premise” of the efficient-market hypothesis, which posits that “market professionals generally consider most publicly announced material statements,” and Halliburton failed to pinpoint a change in economic theory substantial enough to overrule precedent.³

In reframing the issue to a more tepid support for the efficient-market hypothesis, the court’s opinion evaded direct assessment of the hypothesis’ merit. It only went so far as to say even its foremost critics “acknowledge that public information generally affects stock prices.”⁴ The concurring opinion by Justice Clarence Thomas did, however, challenge the efficient-market hypothesis in citing to various criticisms.

By avoiding evaluation of the hypothesis and leaving its role in securities litigation largely unchanged, despite being frequently debated, the court virtually ensured the efficient-market hypothesis will remain a hallmark of securities litigation. In establishing or refuting reliance on or materiality of information, litigators will continue to depend on empirical tools to determine whether information had a statistically significant impact on the price of the security.

ROLES OF EVENT STUDIES

Per *Basic*, to prove the investor class relied on the defendant’s misrepresentations, the class needs to show those misrepresentations were material and publicly known and that the security traded in an efficient market. Because these conditions imply an effect of the misrepresentation on the security price, price impact is taken to be sufficient evidence of reliance. The court decided in *Halliburton* that the presumption of reliance can be rebutted by defendants at the class certification stage if they can show the lack of a price impact, even where market efficiency has been demonstrated.

To assess all these conditions, economic experts regularly conduct event studies. These involve using statistical tools to determine whether the market reaction to a particular event extended beyond the security’s usual price fluctuations. If so, the respective misrepresentation is deemed to have had price impact. If not, this is routinely taken as evidence of no price impact.

Event studies require due care to establish the exact timing when the truth about the alleged misrepresentations was revealed. This is clearer in some situations than others, and it can be done by examining information sources, such as news articles, Securities and Exchange Commission filings, and analyst reports.⁵

Experts also control for extraneous effects on the security’s price that may confound conclusions about price impact. For example, market and industry factors are routinely included as controls in event studies.

In contrast, when there are contemporaneous news or disclosures, the security’s price movement can be due to the disclosure of the alleged misrepresentation, the other news or both. Disentangling them may involve, for example, assessing analysts’ contemporaneous views or using economic models to value competing effects on the security’s price.

ASSESSMENTS OF MARKET EFFICIENCY

Per *Basic*, the investor class satisfies the presumption of reliance by proving “publicity, materiality, market efficiency and market timing.”⁶ Experts regularly assess market efficiency through event studies that comprise various occurrences during the alleged class period. The purpose is to evaluate whether the security’s price reacts swiftly to news and use that as evidence that the security traded in an efficient market. This kind of event study is considered by most finance academics to be the best available test of market efficiency, although it still has shortcomings.⁷

The concurring opinion by Justice Thomas, which suggests that the role of the efficient-market hypothesis in securities litigation is on shakier grounds, may bear particular significance for the future of event studies and their utility in securities litigation. If securities are not, in fact, trading in an efficient market, then an event study might not provide a reliable measure as to the relationship between the security’s trading price and the information that was allegedly misrepresented and then disclosed. If so, price impact may not be the appropriate measuring stick to establish or rebut *Basic*’s central presumption of reliance.

In his opinion, Justice Thomas attacked this presumption’s assumption that “‘in a well-developed market,’ public statements are generally ‘reflected’ in the market price of securities,” grounded on the efficient capital markets hypothesis. His criticisms essentially concern the speed (“not all public information will be impounded in a security’s price with ... the same quickness”) and the accuracy (e.g., “market swings in the absence of new information and prolonged deviations from underlying asset values”) with which information is incorporated into prices.⁸

It is well known that the speed of incorporation of information into prices varies across securities and occasions. For example, a security’s price may react faster to news of a stock split that is well publicized and quicker to understand than to complex financial disclosures. Efficiency, however, is a matter of degree, as *Basic* acknowledges.

In contrast, tagging slowly adjusting security prices to be inefficient would treat the efficient-market hypothesis as if it were a binary statement. When examining slowly reacting prices, economic experts performing event studies ordinarily stretch the time window where price impact is measured and make the necessary statistical adjustments. In any case, a longer window implies a requirement of greater care in filtering potentially confounding information.

Justice Thomas also took issue with whether security prices reflect information accurately. Challenges to the efficient-market hypothesis form a sizeable academic finance literature, listing innumerable ways in which stocks with certain characteristics earn persistently high or low returns.

Assessing whether a security’s price reflects all information (that is, whether it trades in an efficient market) requires solid knowledge of how securities are valued. It follows that the valuation model of security prices is of critical importance when evaluating market efficiency. The aforementioned event studies may be the closest one can get to testing it.

The court decided that the presumption of reliance can be rebutted by defendants at the class certification stage if they can show the lack of a price impact.

CONCLUSION

Arguments against the use of event studies and their reliance on market efficiency will surely surface in securities cases, perhaps more so after Justice Thomas' concurring opinion. The alternatives to event studies, though, look no more compelling as a means of proving or disproving price impact or efficient markets. Subjective expert opinion or, to borrow Justice Thomas' phrase, "naked intuitions about investment behavior," may be alternative, non-empirical approaches, but event studies will likely remain the predominant means of determining the impact of information on securities after *Halliburton*.⁹

NOTES

¹ *Halliburton Co. et al. v. Erica P. John Fund Inc.*, No. 13-317, 2014 WL 2807181 at 2 (U.S. June 23, 2014).

² *Id.* at 9.

³ *Id.* at 10.

⁴ *Id.*

⁵ Gradual disclosure into the public domain may spread the price impact across several days, thus dividing the price impact across them, each possibly smaller than the threshold of the security's usual price fluctuations. In such situations, economic experts might test the cumulative impact over the various partial disclosures.

⁶ *Halliburton*, 2014 WL 2807181 at 14.

⁷ To borrow Nobel laureate Eugene Fama's words, short-window "[e]vent studies are the cleanest evidence we have on efficiency." Eugene Fama, *Efficient Capital Markets: II*, 46 J. FIN.1575 (December 1991).

⁸ *Halliburton*, 2014 WL 2807181 at 7-8 (Thomas, J., concurring in judgment).

⁹ *Id.* at 2.



Nicolas Morgan (L) is the West Coast chair of the securities enforcement practice at DLA Piper in Los Angeles, where **Colleen McElroy** (not shown) is a summer associate. **Tiago Duarte-Silva** (R) is financial economist with **Charles River Associates** in Boston.