No. 08-1021

IN THE

Supreme Court of the United States

GILEAD SCIENCES, INC., *et al.*,

Petitioners,

v.

TRENT ST. CLARE, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR FORMER SEC COMMISSIONERS AND OFFICIALS AND LAW AND FINANCE PROFESSORS AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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BRIEF FOR FORMER SEC COMMISSIONERS AND OFFICIALS AND LAW AND FINANCE PROFESSORS AS AMICI CURIAE IN SUPPORT OF PETITIONERS

INTEREST OF AMICI CURIAE[1]

Amici curiae are former Commissioners of the Securities and Exchange Commission (SEC) and professors of law and finance whose fields of expertise include securities regulation, class-action practice, and law and

[1] No counsel for a party authored this brief in whole or in part, and no persons or entities, other than *amici*, their members, or their counsel, made a monetary contribution to the preparation or submission of this brief. Letters from the parties consenting to the filing of this brief are on file with the Clerk.

economics. *Amici* have devoted substantial parts of their professional careers to implementing, drafting, and studying the federal securities laws, including how those laws should be interpreted to ensure protection of investors and promotion of efficiency, competition, and capital formation.

This brief reflects the consensus view of the *amici*, all of whom believe that the decision below should be reversed. Each individual *amicus* may not, however, endorse every argument presented herein. The former Commissioners and professors joining this brief as *amici*, listed alphabetically, are:

The Honorable Charles C. Cox, who served as a Commissioner of the SEC from 1983 through 1989, and as Chief Economist of the SEC from 1982 through 1983;

The Honorable Joseph A. Grundfest, who served as a Commissioner of the SEC from 1985 through 1990 and who is the William A. Franke Professor of Law and Business at Stanford Law School, Co-Director of the Rock Center on Corporate Governance at Stanford University;

Professor Allen Ferrell, who is the Greenfield Professor of Securities Law at Harvard Law School;

The Honorable Philip R. Lochner, Jr., who served as a Commissioner of the SEC from 1990 through 1991.

Simon M. Lorne, who served as General Counsel of the SEC from 1993 to 1996 and is an adjunct professor at the NYU School of Law and NYU's Stern School of Business;

Professor Larry E. Ribstein, who is the Mildred Van Voorhis Jones Chair in Law at the University of Illinois College of Law;

Professor Kenneth E. Scott, who is the Ralph M. Parsons Professor of Law and Business emeritus at Stanford Law School.

INTRODUCTION AND SUMMARY OF ARGUMENT

In this case, the Ninth Circuit set a standard for pleading loss causation that is inconsistent with the teachings of this Court and with the decisions of other circuits. Petitioners have highlighted a number of problems with that decision that independently support review, including but not limited to the split between circuits concerning the standard for alleging loss causation. *Amici* write separately to illuminate one feature of the Ninth Circuit's decision that merits this Court's particular attention: its misunderstanding of the concept of an efficient market, and how that concept bears upon loss causation.

Although there are different views about how securities markets operate and how efficient they are, the central concept *for legal purposes* is that the market price of a security swiftly incorporates all available material information (including *mis*information). This Court ruled more than 20 years ago, for example, that individual proof of reliance on an issuer's misstatement (which if required would defeat class certification) could be replaced by the rebuttable presumption that each class member relied on market price and that this price in turn reflected the misstatement. *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 248 (1988). By its very terms, that theory of reliance works only if the price incorporates the misstatement quickly, at the beginning of the class period. Similarly, if the efficient market theory is also the basis for plaintiffs' theory of loss causation, that theory works only when the market reacts (and the stock price drops) promptly in response to a statement correcting the previous misstatement. Accordingly, the "efficient market" theory can be deployed only if the market at issue is shown to incorporate material information into the price of a stock relatively quickly. Courts of appeals outside the Ninth Circuit have applied the theory in this form.

The Ninth Circuit, by contrast, has now endorsed a loss causation theory attributing a price drop in October to information disclosed in August. Its decision fundamentally misconstrues the efficient market theory, and ventures far from route taken by other circuits that see large numbers of securities cases.[2] Indeed, in *Gilead* the Ninth Circuit for the second time disclaimed the need for temporal proximity between disclosure of material information and an efficient market's reaction. Pet. App. 18a-19a. The opinion concludes that it is facially plausible that a market may be efficient yet still take months to incorporate startling new information into a stock price. *Id.* The Ninth Circuit thus upheld a complaint that, while alleging the market was efficient in order to support class treatment, nevertheless theorizes that a disclosure in August took two months to effect a drop in stock price.

By giving its blessing to this strikingly inefficient "efficient market," the Ninth Circuit reinforces its con-

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[2] A recent study shows that 25.5 percent of all securities fraud class actions since 1996 have been filed in the Ninth Circuit *See* Cornerstone, *Securities Class Action Filings 2008: A Year In Review*, Stanford Law School Securities Class Action Clearinghouse, *at* http://securities.stanford.edu/clearinghouse_research/2008_YIR/20090106_YIR08_Full_Report.pdf, fig. 21). The five other circuits addressed in Part B, *infra*, (the 1st, 2d, 5th, 6th, and 7th Circuits) account for 53.6 percent of all such actions. *See id.*

flict with other circuits and establishes a precedent for a weakened loss causation pleading requirement that is inconsistent with this Court's decision in *Dura*.

Amici are concerned that *Gilead*, by fundamentally misapplying the efficient market theory, undermines the theoretical basis for "fraud on the market" class actions, degrades the requirement of a causal link between a corrective disclosure and a stock drop, and weakens pleading standards to the point where mere speculation can sustain a class action complaint. To resolve the split between the Ninth Circuit and five other courts of appeals, preserve the integrity of the efficient market theory as recognized by this Court in *Basic*, and ensure its consistent application in nationwide securities class actions, this Court should grant the petition and reverse the decision below.

ARGUMENT

THE COURT SHOULD CORRECT THE NINTH CIRCUIT'S MISAPPLICATION OF THE EFFICIENT MARKET HYPOTHESIS AND THE RESULTING WEAKENING OF THE STANDARDS FOR PROVING LOSS CAUSATION IN THAT CIRCUIT

A. Most Circuits Accept The Presumption That An "Efficient Market" Rapidly Incorporates New Material Information Into Stock Prices

When this Court determined that class plaintiffs could rely on the efficient market theory (and therefore on the fraud on the market theory of reliance, on which modern securities class action litigation is based), the Court "did not intend conclusively to adopt any particular theory of how quickly and completely ... information is reflected in market price." *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 248 n. 28 (1988). But it did recognize that the point of the theory was to create a presumption that all persons who purchased or sold a stock within a specified period relied on certain information that was reflected in the price of that stock. *See id.* at 247. This presumption makes sense when and only when the market reacts promptly to issuer misstatements and later corrections. *See id.* (In the absence of this presumption, securities fraud cases generally could not proceed as class actions because proof of reliance on an individual basis would overwhelm any common questions of law and fact. *See id.* at 242.)

Since *Basic*, the courts of appeals have repeatedly acknowledged that an efficient market not only incorporates information into stock prices, but does so very quickly. "Evidence that unexpected corporate events or financial releases cause an ***immediate*** response in the price of a security has been considered ... 'the ***essence*** of an efficient market and the foundation for the fraud on the market theory.'" *Teamsters Local 445 Freight Division Pension Fund* v. *Bombardier, Inc.*, 546 F.3d 196, 207 (2d Cir. 2008) (citation omitted; emphasis added) (affirming denial of class certification where price did not reflect immediate reaction to adverse information). The presumption of classwide reliance does not work unless the market incorporates new information rapidly, so that every purchaser (or every seller) after a given disclosure can be presumed to have relied indirectly on the same incorporated information.

One court of appeals described an efficient market as one in which "market price responds so quickly to new information that ordinary investors cannot make trading profits on the basis of such information." *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 19 (1st Cir. 2005). Other courts have articulated the efficient market hypothesis in terms of an "immediate" or "rapid" incorporation of new information. *See, e.g.*, *Freeman* v. *Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990)

("An efficient market is one which rapidly reflects new information in price."); *West* v. *Prudential Sec. Inc.*, 282 F.3d 935, 938 (7th Cir. 2002) ("[M]arkets are efficient in the sense that they rapidly adjust to all public information ...[.] This approach has the support of financial economics as well as the imprimatur of the Justices: few propositions in economics are better established than the quick adjustment of securities prices to public information."); *Gariety* v. *Grant Thornton LLP*, 368 F.3d 356, 367 (4th Cir. 2004) ("[I]n an efficient market, 'the market price has integrity[;] ... it adjusts rapidly to reflect all new information.'" (citations omitted)); *Unger* v. *Amedisys Inc.*, 401 F.3d 316, 324 (5th Cir. 2005) ("In an efficient market, where information is nearly perfect, material misstatements alter a stock's price almost immediately."); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997) (an efficient market incorporates information "immediately"; information that did not move the market when disclosed was not actionable). Whether using the words "prompt," "immediate," or "rapid," or otherwise, the courts of appeals other than the Ninth Circuit have taken the logically correct, common-sense view that an efficient market is one that *quickly* incorporates information into stock prices.

B. The Ninth Circuit's Application Of The Efficient Market Hypothesis Is Fundamentally Flawed And Inconsistent With The Standards Of Other Circuits

1. The Ninth Circuit has now twice disavowed any need for an efficient market to react quickly to material information

The complaint in *Gilead* (like virtually all class actions alleging violations of Rule 10b-5) invokes the fraud on the market presumption. That presumption—

that purchasers of Gilead stock relied indirectly on defendants' alleged misstatements when they relied on the market price—necessarily assumes that the market "efficiently" incorporates available material information into the price. *See e.g., Basic*, 485 U.S. at 241-242. But the Ninth Circuit ruled that even in an efficient market, "[a] limited temporal gap between the time a misrepresentation is publicly revealed [i.e., corrected] and the subsequent decline in stock value does not render a plaintiff's theory of loss causation per se implausible." *See* Pet. App. 19a. In *Gilead*, the "limited gap" was two months: a corrective disclosure of off-label marketing activity in August could have resulted in a stock decline at the end of October, or so the court held.

That cannot be right. The problem is not a matter of the *definition* of market "efficiency." Whatever the label, if there can be two months between an issuer statement and its effect on market price, then investors relying on market prices are *not* all indirectly relying on the same underlying misinformation, and reliance cannot be resolved on a classwide basis.

Gilead marks the second time that the Ninth Circuit has held that a market can be sufficiently efficient to support a presumption of reliance on stock price even when there is no evidence of swift reaction to disclosure of a material fact. Indeed, five years ago, the Ninth Circuit held that a fact could be material even if its disclosure did not result in a swift stock price reaction. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund* v. *America West Holding Corp.*, 320 F.3d 920, 934 (9th Cir. 2003). Hence, the Ninth Circuit has now applied the view that a market need not react quickly in order to be efficient in the context of both materiality and loss causation.

2. The Ninth Circuit's view is inconsistent with the operation of an efficient market and with this Court's guidance on loss causation

The Ninth Circuit's ruling in *Gilead* would cripple the efficient market hypothesis. Regardless of whether an efficient market acts "immediately," as some argue, or merely "rapidly," a multi-month delay in response to a supposedly shocking disclosure is not consistent with market efficiency under any reasonable definition, nor (more importantly) is it consistent with the legal *application* of the market efficiency concept to allow proof of reliance on a classwide basis. *Gilead*'s approach runs contrary to the basic assumptions under which class litigants seek to establish reliance and loss causation in securities cases, and thus puts the Ninth Circuit out of step with both the logic of the law and the prevailing views of other circuits.

On the most basic level, the classwide presumption of reliance cannot apply unless securities markets react rapidly to alleged material misinformation. If a stock's price does not reflect material information when that information is disclosed, putative class members cannot be presumed to have relied upon that information via the stock price. In the absence of such a presumption, individual issues of reliance will predominate over class-wide issues. *See Basic*, 485 U.S. at 242. If a stock price requires an extended period to incorporate available information, individual class members will be differently situated depending on how much of the incorporation process had been completed at the time of each purchase. By allowing that such a market could still be deemed "efficient," the Ninth Circuit holdings thus call the entire presumption of reliance into question—undermining class-wide treatment of Rule 10b-5 claims.

Built on this flawed first principle, the *Gilead* decision is inconsistent with this Court's decision in *Dura* with respect to loss causation. *Dura* requires plaintiffs to allege and ultimately prove a causal nexus between disclosure of misconduct and their loss damages, typically by showing that price declined when a corrective disclosure was made or corrective information was otherwise revealed. *See Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 342-343 (2005) (discussing factors that may cause decline in stock price); *see also, e.g., Greenberg* v. *Crossroads Sys. Inc.*, 364 F.3d 657, 666 (5th Cir. 2004) (holding that to invoke the fraud on the market theory plaintiffs must prove loss causation by showing that stock price dropped upon disclosure of alleged fraud and was not attributable to other factors). A market that reacts swiftly to corrective disclosures can demonstrate a strong causal nexus between the previously undisclosed misconduct and the distortion of market price that harmed investors. But the theory, and the possibility of showing harm, evaporate if the market is not *expected* to react swiftly to information that changes the "total mix of information" available to investors. *Basic*, 485 U.S. at 231. If there is no price reaction for two months, then the price decline cannot be tied to the corrective disclosure and the underlying misconduct, as opposed to the several other factors to which *Dura* alludes. *See* 544 U.S. at 343.[3]

[3] The *Gilead* opinion also suffers from a basic internal inconsistency by endorsing respondents' allegations that the underlying market was efficient *and* that it did not respond to material information for a period of months. It is hard to see how a case with such inherent contradictions could be permitted to proceed on a classwide basis.

If *Gilead* were accepted and incorporated uncritically by district courts, there would be few limits on the kinds of harm that a securities plaintiff could predicate on any given corrective disclosure. As long as a stock's price drops at some point after disclosure of alleged misconduct—no matter how many independent events have occurred between the disclosure and the stock drop—the case could still proceed past the pleading stage based on allegations of a delayed reaction.

The Court should correct the Ninth Circuit's fundamentally incorrect view of the law on such a basic concept. The Ninth Circuit has been and is certain to continue to be a major securities litigation venue, and a source of some of the most important decisions in the field.[4] Given the level of securities activity in the circuit, *Gilead*'s standard could fundamentally shift the playing field for parties, waste judicial resources on analysis unbound by law or logic, and spell the end of the efficient market hypothesis, in theory as well as practice.

C. A Complaint Cannot Establish Loss Causation By Asserting A Connection Between A Material Disclosure And A Facially Unrelated Disclosure Several Months Later

Perhaps recognizing the difficulties with its implementation of the efficient market theory, the court of appeals notes in *Gilead* that the stock declined immediately after the October earnings announcement, which

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[4] *See, e.g.*, Cornerstone, *Securities Class Action Filings 2008: A Year In Review*, Stanford Law School Securities Class Action Clearinghouse, *at* http://securities.stanford.edu/clearinghouse_research/2008_YIR/20090106_YIR08_Full_Report.pdf, at 20 (comparing class filings by circuit).

respondents allege "reflected" the impact of previously disclosed off-label marketing practices. *See* Pet. App. 19a. It is not clear why the Ninth Circuit saw a need to address this point at all given its holding that "[a] limited temporal gap" between a disclosure and a stock drop "does not render a plaintiff's theory of loss causation per se implausible." *See id.* However, to the extent the Ninth Circuit intended to buttress its ultimate holding by endorsing respondents' late-raised theory that it was the October announcement and not the August announcement that "corrected" this alleged misinformation, the opinion runs squarely counter to this Court's guidance in *Dura* and *Twombly*. *See Dura*, 544 U.S. at 343; *Bell Atlantic Corp.* v. *Twombly*, 127 S. Ct. 1955, 1965 (2007).

This Court has explained that "something beyond the mere possibility of loss causation must be alleged, lest a plaintiff with a largely groundless claim be allowed to take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value." *Twombly*, 127 S. Ct. at 1966 (internal quotation marks omitted). To that end, *Dura* requires plaintiffs to connect a stock decline to revelation of an alleged fraud, rather than to a different factor. *See* 544 U.S. at 343. Loss causation thus requires evidence that the market became aware of alleged misinformation, and that the stock price fell in response. *See id.* at 342-343.[5] This, in a securities-fraud

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[5] *See also, e.g.*, Ferrell & Saha, *The Loss Causation Requirement for 10b-5 Causes of Action: The Implications of* Dura Pharmaceuticals v. Broudo, 63 Bus. Lawyer 163, 173 (2007) ("[W]ithout a concrete reason to link the negative stock market reaction associated with [a disclosure] ... to the removal of the inflation in the stock price caused by the actionable misconduct[,] ... loss causation

context, is a component of the general requirements of *Twombly* that "factual allegations must be enough to raise a right to relief above the speculative level," *Twombly*, 127 S. Ct. at 1965, and that plaintiffs provide "enough facts to state a claim to relief that is plausible on its face," *id.* at 1974.

In combination, these decisions dictate that securities plaintiffs cannot simply pick a disclosure at some point before a price drop and ask the court to assume that this disclosure had something to do with that price drop, no matter how facially unrelated the two may be, because the price drop was allegedly a "realization" of the impact of the earlier disclosure. *See, e.g., Metzler Inc. GmbH* v. *Corinthian Coll., Inc.*, 540 F.3d 1049, 1064 (9th Cir. 2008) (dismissing claim that, *inter alia*, did not allege facts showing that announcement precipitating stock drop had disclosed the alleged fraud and rejecting fact-free assertions that earnings announcement caused market "realization" of the impact of a previously announced problem). As the Ninth Circuit itself recognized:

> So long as there is a drop in a stock's price, a plaintiff will always be able to contend that the market "understood" a defendant's statement precipitating a loss as a coded message revealing the fraud. Enabling a plaintiff to proceed

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is lacking."); Ribstein, *Fraud on a Noisy Market*, 10 Lewis & Clark L. Rev. 137, 160-161 (2006) ("[A] corrective disclosure arguably demonstrates how much the truth affects the price, enabling the court to determine by 'backward induction' how the company would have performed ... if the market had known the truth.... [T]here is no evidence [of causation] as reliable as the backward induction method.").

> on such a theory would effectively resurrect what *Dura* discredited—that loss causation is established through an allegation that a stock was purchased at an inflated price."

Id. at 1064.

That is exactly what happened here. In *Gilead,* the statement that triggered a stock price decline (the October announcement) was an earnings release that, *inter alia,* revised wholesaler inventory estimates. The Ninth Circuit accepts respondents' attenuated claim that this announcement was actually a coded but dramatic revelation of the impact of off-label marketing that had been disclosed months before—and that the stock drop was due to a sudden realization by the market of the allegedly high fraction of sales due to off-label marketing, rather than to concerns regarding wholesaler inventories. *See* Pet. App. 16a-17a; Pet. 9-10. But the opinion does not identify any statement disclosing the fraction of Company revenue attributable to off-label marketing—the key allegedly material fact that was allegedly undisclosed. *Compare, e.g., In re Williams Sec. Litig.-WCG Subclass,* --- F.3d ----, 2009 WL 388048, at *8 (10th Cir. 2009) (true "corrective" disclosure must relate to alleged misrepresentation rather than other negative information). Nor does it identify any fact suggesting that the market understood the announcement related to off-label marketing. Instead, the opinion assumes that the October announcement was a tacit acknowledgment of the impact of off-label marketing, and finds that because respondents' theory to that effect is "not per se implausible," it is sufficient to plead loss causation. Pet. App. 19a.

Gilead conflicts sharply with the teachings of *Dura* and *Twombly.* By endorsing respondents' theory despite the lack of factual allegations that substantiate that theory, *Gilead* allows pleading by speculation—precisely what *Twombly* forbids. *See Twombly*, 127 S. Ct. at 1964-1965. This hollow standard "would permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence"—the exact situation that *Dura* rejected. *See Dura*, 544 U.S. at 347 (internal quotation marks omitted). In keeping with *Dura* and *Twombly*, other circuits have refused to accept speculation of this kind to salvage otherwise deficient allegations. *See* Pet. 3-4 (citing authority). *Amici* respectfully submit that this Court should not permit one Circuit—particularly a circuit with as active a securities docket as the Ninth—to apply such an anomalous standard to loss causation pleadings.

D. This Court Should Take This Opportunity To Clarify The Efficient Market Theory's Operation And Effect On Loss Causation Pleadings

There is no reason for any court to entertain a Rule 10b-5 complaint that relies on the efficient market hypothesis for purposes of pleading elements of class certification but cannot identify a stock price decline proximately following disclosure of the alleged fraud. If a disclosure causes a decline in an efficient market, it will do so promptly. If an allegedly "corrective" disclosure does not promptly cause a price decline, then there is no reason to believe that there was material misinformation in the "total mix" of information available to investors. The Court thus should use this case to confirm that efficient markets, by definition and by the assumptions inherent in the fraud on the market theory, react promptly to new material information.

This case further provides an example of speculative pleading tactics that highlight, rather than conceal, the weaknesses in a lawsuit. It is not be difficult for a plaintiff with a legitimate claim to identify a corrective statement that swiftly precipitates a price decline. In the current market, virtually any issuer can be victimized by a suit based on summary claims that current stock declines reflect a market "realization" of the impact of previously disclosed problems, even if the disclosure were months in the past. The Court should not countenance such a result.

CONCLUSION

This case presents an ideal opportunity for the Court to confirm the implications an efficient market carries for loss causation allegations, and to guide lower courts in analyzing such allegations. The Court therefore should grant the petition.

Respectfully submitted.

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