HALLIBURTON AND THE INTEGRITY OF THE PUBLIC CORPORATION

JAMES J. PARK*

INTRODUCTION

When a market for a stock is efficient, the fraud-on-the-market presumption requires courts to initially assume that investors who bought the stock relied on the integrity of the market price. This presumption is critical in establishing the common reliance necessary to certify a class when such investors assert a securities fraud claim under SEC Rule 10b-5. The validity of the fraud-on-the-market presumption rests on two related propositions. The first is descriptive: a company's stock price in an efficient market will incorporate publicly released information about the company and its economic prospects; thus securities fraud will inflate the price investors pay for the stock. The second is normative: investors can reasonably rely on the integrity of public stock markets when purchasing stock.

This Article primarily assesses the second proposition. Because stock prices are often inaccurate, critics commonly argue that markets do not have integrity. Rather than resting the reasonableness of investor reliance on what I will refer to as "market price integrity," this Article argues that the integrity of public markets is best grounded in the regulatory structure governing which corporations can be publicly traded. Put another way, the fraud-on-the-market presumption is best justified not because of an expectation that stock market prices are precisely accurate, but on what I will call the "integrity of the public corporation." Even if investors cannot reasonably believe that fraud in an efficient market is uncommon, securities laws increasingly seek to create public markets in which investors can reasonably expect that severe frauds will be rare. Such

* Professor of Law, UCLA School of Law.

reliance is clearly disrupted when fraud hides information indicating that a company should be delisted or is heading towards bankruptcy.

I. TWO THEORIES OF MARKET EFFICIENCY AND INTEGRITY

In *Halliburton v. Erica P. John Fund, Inc.*,[1] the United States Supreme Court considered whether federal courts should continue to apply the fraud-on-the-market presumption to the typical securities fraud class action, which asserts claims under Rule 10b-5.[2] In the briefs contending that the presumption should be eliminated, the essence of the argument was that investors simply cannot trust market prices because history has shown they are often inflated by noise and irrational expectations.[3] Years earlier, the Supreme Court in *Basic Inc. v. Levinson*[4] had rejected this argument, concluding that an investor can rely on the integrity of stock prices in an efficient market, and the Court in *Halliburton* affirmed *Basic* on this point while providing some additional analysis to support its conclusion.[5]

This Part unpacks the concept of market price integrity discussed by the Court in both *Basic* and *Levinson*. In doing so, it argues that the descriptive and normative foundations of the efficient markets hypothesis are closely related. To the extent that markets can be described as accurate in valuing securities, the normative case for investor reliance on market prices is stronger. When resting on the weaker claim that markets react to information but do not necessarily value stocks correctly, the argument that market prices have integrity is not as persuasive.

A. Market Prices Reflect Fundamental Value

The strongest case for market price integrity is based on the belief that stock markets are fundamentally efficient. Under this view, markets not only incorporate public information about the company's stock price, they usually do so correctly.[6]

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1. 134 S. Ct. 2398 (2014).
2. 17 C.F.R. 240.10b-5 (2015).
3. *See, e.g.*, Brief for Petitioners at 17, Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014) (No. 13-317) ("Basic's presumption of reliance cannot coexist with the reality that where one would expect maximum market efficiency and rationality, markets can prove extraordinarily *in*efficient and *ir*rational.").
4. 485 U.S. 224 (1988).
5. *See Halliburton*, 134 S. Ct. at 2407 (2014).
6. For a recent discussion of the hypothesis, see Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs*, 100 VA. L.

This bold descriptive claim about the functioning of an efficient market has implications for what investors can expect when investing in that market. If a market for a stock is fundamentally efficient, an investor can believe that the price of that stock largely reflects its value. If stock prices are accurate in this way, buying stock can easily be distinguished from gambling at a casino. Rather than simply making a bet, a stock investor has bought something of real worth. It should also be futile for traders to earn significant profits by searching for misvalued stocks because market prices will tend to be correct. Securities fraud disrupts these assumptions about a fundamentally efficient market. When a company commits fraud, investors will pay a price for the security that does not reflect its actual value and suffer losses when the truth is revealed.

The *Basic* and *Halliburton* decisions do not directly refer to fundamental value when discussing market price integrity. It is the dissent in *Basic* that raises the issue, arguing that the majority's view reflects the erroneous assumption that markets are fundamentally efficient.[7] Pointing to the majority's citation of a district court opinion asserting that investors can "rely on the price of a stock as reflection of its value," the dissent argued that the majority "implicitly suggests that stocks have some 'true value' that is measurable by a standard other than their market price."[8]

Both the *Basic* and *Halliburton* dissents criticize the idea that markets are fundamentally efficient. They do so primarily by invoking the value investor, an investor who buys stock believing it is underpriced in that it trades at a price below its actual value. The value investor does not believe that the market price has integrity in the fundamental sense, but instead tries to exploit, for profit, inefficiencies in the market.

The existence and success of value investors is a problem for the fraud-on-the-market presumption in two ways. First, the ability of such investors to earn abnormal returns undermines the descriptive point that stock markets are so efficient that such profits cannot be made. Second, the presence of value investors undermines the normative point that investors can reasonably believe that market prices reflect the value of their investment.

REV. 313 (2013).

7. *Basic*, 485 U.S. at 255.

8. *Id*.

The *Halliburton* decision responds to these arguments on two grounds. The first is that "most" investors do not fit into the category of value investors.[9] In the Court's words, the majority of investors know "they have little hope of outperforming the market in the long run;" thus they "will rely on the security's market price as an unbiased assessment of the security's value in light of all public information."[10] The second is that even value investors rely on the belief that market prices will eventually reflect fundamental value.[11]

The first response does not convincingly show that value investors are unimportant. Even taking at face value the assertion that "most" investors are not value investors, it is difficult to deny that many investors take on a value approach. It may be the case that value investors are outnumbered by passive investors, but investors who assess whether or not market prices reflect fundamental value do more to set market prices than passive investors.[12] Moreover, the question is not solely whether or not there are more value investors than passive investors; the mere existence of value investors should signal to passive investors that they cannot naively believe that market prices reflect the value of a stock.

The second argument essentially contends that even if there are inefficiencies in the market price, investors rely on the belief that market prices are eventually correct. The Court notes that for a value investing strategy to succeed, the stock must return to its fundamental value. Such an investor will calculate the extent to which the stock has diverged from such value, "and such estimates can be skewed by a market price tainted by fraud."[13]

This is a stronger argument than the first, but it is somewhat unclear what the Court means. Typically, value investors look for stocks that are underpriced by the market. Yet fraud tends to inflate the price of a stock. Perhaps there will be cases where a value investor believes a stock trading at $10 a share is worth $15 a share, but it turns out that the company is committing a fraud and the stock is only

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9. *Halliburton*, 134 S. Ct. at 11–12.

10. *Id.* at 12.

11. *Id.* ("[A]n investor implicitly relies on the fact that a stock market's price will eventually reflect material information. . . .").

12. For an argument that this price discovery is the "essential" role of the securities laws, see Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711 (2006).

13. *Halliburton*, 134 S. Ct. at 12.

worth $5 a share. The value investor suffers damages, so there is an argument that he should be able to recover the difference. On the other hand, given the value investor's belief that market prices are often incorrect, it is difficult to base the case for protecting such an investor on the theory that market prices are fundamentally correct.

B. Market Prices Are Not Distorted by Fraud

The weaker view of market price integrity would not require fundamental efficiency but only that market prices reflect public information. Even if stock prices do not accurately measure the true value of a stock, if a market is informationally efficient, stock prices will incorporate fraudulent statements. Put another way, if a fraud inflates earnings by 10 percent, that misstatement will also inflate the stock price trading in an efficient market by some amount. Even if the stock price does not accurately measure the fundamental value of the company, an investor has still paid more for the stock with the misrepresentation, and arguably should be able to recover damages. To say that markets have integrity does not mean that stock prices are usually right, but simply that investors should be able to rely on the assumption that the market price is not inflated by fraud.

The Court in *Basic* relied in part on this absence-of-fraud form of market price integrity.[14] The majority opinion noted that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."[15] According to the Court, all investors rely on the absence of fraud because they would not invest in what was "a crooked crap game."[16]

Market price integrity as absence of fraud is easier to defend than market price integrity as fundamental value. Even if there is no knowable intrinsic value of a stock, because fraud causes a relative increase in what investors are paying, it is possible to conclude that investors would be paying less for a stock in the absence of fraud. Even a value investor, who relies on the belief that a stock is

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14. *See, e.g.*, Jill E. Fisch, *The Trouble With* Basic*: Price Distortion After* Halliburton, 90 WASH. U. L. REV. 895, 897 (2013) (noting that the Court in *Basic* "constructed a complex theory of market integrity relying on the fact that, in an efficient market, fraudulent public statements distort stock prices"). For an argument that fraudulent distortion of the market price by itself should establish class-wide reliance, see Lucian A. Bebchuk & Allen Ferrell, *Rethinking* Basic, 69 BUS. LAW. 671 (2014).

15. Basic v. Levinson, 485 U.S. 224, 246 (1988).

16. *Id*.

undervalued, would pay even less for that undervalued stock in the absence of fraud.

On the other hand, conceding that markets are not fundamentally efficient has its costs for the normative claim that market prices have integrity. If markets are unable to distinguish between fraudulent and non-fraudulent statements, investors should always expect a risk of fraud.[17] Investors can respond to such risk by discounting the price they are willing to pay for a stock. Moreover, if markets cannot distinguish between fraudulent and non-fraudulent statements, how can they distinguish between useful information and noise? If a fraud distorts a stock price by 5 percent but irrational expectations inflate the price by 100 percent, the risk of fraud is relatively trivial with respect to the overall volatility of a stock. If investors are willing to invest knowing the historical ups and downs of market cycles, they should be willing to invest even knowing that there is a modest risk of fraud.

Perhaps the problem with the absence-of-fraud approach to market price integrity is that it does not differentiate between types of frauds. Even if investors should expect minor price distortions from fraud, the complete collapse of a company's stock price in the wake of a fraud is not something that an investor should routinely expect. To fully appreciate the integrity of public markets, one must thus look beyond the accuracy of market prices to the regulatory framework that seeks to prevent substantial frauds.

II. AN ALTERNATIVE APPROACH: INTEGRITY OF THE PUBLIC CORPORATION

Rather than resting its case for the fraud-on-the-market presumption on the accuracy of stock prices, this Article looks to the legal framework governing public companies. Stock exchange rules and federal law have long required companies to meet certain standards before trading on public markets. These regulations have become more stringent in requiring public companies to verify the accuracy of their disclosures. Especially in light of these increasing expectations, investors should be able to reasonably assume that a public corporation meets basic standards of integrity.

17. *See* Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 160 ("Fraud and manipulation are predictable enough that it would be foolish for anyone simply to *assume* that a stock price has integrity.").

A. Securities Laws, the Public Corporation, and Efficient Markets

The argument that stock markets cannot be trusted unfairly dismisses the significant effort by private and public actors over the years to construct norms and law to improve the integrity of public companies. Though these mechanisms are imperfect, they attempt to distinguish between those companies in which public investment is appropriate and those in which it is not. If a company wants its stock to trade on an efficient market, it must initially meet and continue to meet the standard for being a public company.

Efficient markets do not exist without actors who facilitate the valuation of the assets trading in that market. Professors Gilson and Kraakman make this point in a famous article, *The Mechanisms of Market Efficiency*.[18] They note that while financial economists have spent much time assessing whether a particular market is efficient, they have not focused much effort on explaining which factors make a market efficient.[19] Professors Gilson and Kraakman identify some of the institutions that facilitate market efficiency, such as research analysts, who process new information about a company.[20] Moreover, they conclude that law is likely to play a role in that securities laws operate to reduce the costs of processing and verifying information.[21]

More recently, financial economists have become interested in the role law plays in the development of trading markets. An extensive body of research on law and finance has posited that common law protections are associated with stronger securities markets, and presented evidence to support the hypothesis.[22] There is no consensus as to the conclusiveness of these results, and the studies in measuring the effect of law do not delve much into the details of how securities law operates in facilitating the rise of markets. However, these findings suggest that law matters in developing well-functioning markets.

There are two major mechanisms of interest by which law and private norms play a significant role in creating public markets that

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18. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

19. *Id.* at 553 ("[D]espite the substantial progress that has been made, we still lack a single, comprehensive explanation for the existence of market efficiency.").

20. *Id.* at 571–72.

21. *Id.* at 601.

22. *See, e.g.*, Rafael La Porta, et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 4 (2000); Rafael La Porta, et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

investors can trust. The first are the federal securities laws. The Securities Act of 1933[23] and Securities Exchange Act of 1934[24] set forth extensive requirements for companies that become public so that they can be traded on markets. To sell securities to the public, a company must have audited financial statements and file truthful disclosures with the SEC. As one court noted, investors rely on the "integrity of the regulatory process" and the "truth of any representations" in purchasing newly issued securities.[25] This reliance continues as the company files periodic reports with the SEC.[26] To the extent that a public company fails to maintain these obligations, the SEC has the power to "revoke the registration of a security."[27] In its initial and continuing mandates, the federal securities laws define the line between public and private companies.

The second is the private regulation set forth by stock exchanges. In particular, the exchanges have listing requirements that must be met before a company will trade on a market widely available to public investors.[28] According to the New York Stock Exchange, meeting these standards "is internationally recognized as signifying that a publicly owned corporation has achieved maturity and front-rank status in its industry."[29] As one court has noted, a stock exchange listing "carries with it implicit guarantees of trustworthiness."[30] There is an understanding that "a company must meet certain qualifications of financial stability, prestige, and fair disclosure, in order to be

23. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C.A. §§ 77a to 77aa (West 2015)).

24. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a to 78pp (West 2015)).

25. Arthur Young & Co. v. U.S. District Court, 549 F.2d 686, 695 (9th Cir. 1977); *but see* Malack v. BDO Seidman LLP, 617 F.3d 743, 750 (3d Cir. 2010) (noting that the SEC cannot be expected to prevent fraud).

26. Securities Exchange Act of 1934 § 13, 15 U.S.C.A. § 78m (West 2015).

27. *Id.* at § 12(j), 15 U.S.C.A. § 78*l* (West 2015).

28. For example, the company must show an aggregate market value of $40 million for its publicly-held shares to list on the New York Stock Exchange. New York Stock Exchange Listed Company Manual § 102.01B [hereinafter NYSE Manual]. If the average market value of a company over thirty days is less than $15 million, the Exchange will proceed to delist the company. *Id.* at § 802.01B. The exchanges arguably have significant incentives to monitor its listed companies. *See generally* A.C. Pritchard, *Markets as Monitors: A Proposal To Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 963–81 (1999).

29. NYSE Manual § 101.00; *see also* Samuel L. Rosenberry, *Listing and Delisting Securities on the New York Stock Exchange*, 45 VA. L. REV. 897, 898 (1959) ("[T]he Exchange has gradually developed listing standards which are designed to maintain a quality national and international market for securities of well established companies in which there is a broad public interest.").

30. Van Gemert v. Boeing Co., 520 F.2d 1373, 1381 (2d Cir. 1975).

accepted for that listing, which is in turn so helpful to the sale of the company's securities."[31] Thus, in setting forth listing requirements, exchanges make determinations as to which companies should trade in public markets.

B. The Rising Standard of Integrity for Public Companies

For more than a decade, the distinction between public and private companies has been growing. There is now a much greater expectation that public companies provide accurate disclosures and have good corporate governance. Whether or not the cost of these measures is justified, these efforts are designed to improve the integrity of the public corporation.

The first set of increasing requirements relates to the reliability of public company disclosures. The primary mechanism for this effort has been to mandate that public companies maintain a certain level of internal controls. These obligations were initially imposed through the Foreign Corrupt Practices Act[32] after the discovery that many companies were secretly diverting assets to pay bribes in foreign countries. Such conduct was seen as affecting the integrity of the use of company assets. After the collapse of two major public companies, Enron and WorldCom, Congress moved to address "[d]efects in procedures for monitoring financial results and controls" that were "blamed for recent corporate failures."[33] Congress then passed the Sarbanes-Oxley Act, which requires an assessment of the adequacy of a public company's internal controls by both auditors and management.[34] Commentators have noted that these provisions "produced the sharpest cleavage in terms of differentiating public companies."[35]

The second set of requirements relates to the governance of public corporations. The New York Stock Exchange has enhanced its listing rules with corporate governance requirements "aimed at maintaining appropriate standards of corporate responsibility,

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31. *Id.*
32. Foreign Corrupt Practices Act, 15 U.S.C.A. §§ 78dd-1 to 78dd-3 (West 2015).
33. S. REP. NO. 107-205, at 23 (2002).
34. *See* Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C.A. § 7262 (West 2015). Sarbanes-Oxley also makes efforts to ensure that auditors of public companies do not have conflicts of interest that would affect their integrity in auditing financial statements.
35. Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 380 (2013).

integrity and accountability to shareholders."[36] For example, exchanges now require listed companies to have boards with a majority of independent directors.[37] After Sarbanes-Oxley[38] and Dodd-Frank,[39] important board committees such as the audit and executive compensation committees must consist entirely of independent directors.[40] This move towards board independence seeks to ensure that corporate governance of public companies has integrity by removing conflicts of interest, some of which can facilitate fraud.

Public companies have not only been distinguished through greater regulation, but also through efforts that seek to reduce regulatory costs for companies that are so established that the integrity of their valuations should not be in doubt. Under certain circumstances, companies that have already offered registered securities to the public may file registration statements that are not as extensive as unseasoned companies.[41] This more lenient regulation reflects the belief that the valuation of corporations that have been public for some time is reliable enough to raise capital with fewer restrictions.[42]

While all public companies must meet certain standards, it is important to acknowledge that investors cannot expect all such companies to be equally trustworthy. Large public companies have more resources than small public companies to ensure the reliability of their disclosures. Moreover, when a significant public corporation

36. NYSE Manual § 301.00.

37. *Id.* at § 303A.01.

38. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 and 18 U.S.C.A. (West 2015)).

39. Dodd-Frank Act of 2010, Pub. L. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of U.S.C.A. (West 2015)).

40. *See* Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C.A. § 78j-1 (West 2015); 17 C.F.R. § 240.10A-3 (2015); *see also* Dodd-Frank Act of 2010 § 952, 15 U.S.C.A. § 78j-3; 17 C.F.R. § 240.10C-1(b)(1) (2015).

41. Such an issuer may SEC Form S-3, which incorporates by reference the information in periodic filings. The most commonly used test for determining whether a market is efficient considers whether the issuer is a Form S-3 filer. *See* Cammer v. Bloom, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989). Moreover, if a company meets certain size thresholds, it will be considered a Well-Known-Seasoned Issuer that can offer securities to the public with even fewer restrictions than seasoned issuers. *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Release No. 26,993, 70 Fed. Reg. 44,722, 44,726–30 (Aug. 3, 2005).

42. The timing of some of these reforms suggests that regulators are trying to offset the costs of Sarbanes-Oxley by loosening regulation of public companies in other areas. *See* James J. Park, *Two Trends in the Regulation of the Public Corporation*, 8 OHIO ST. ENTREPRENEURIAL BUS. L.J. 429 (2012).

fails in the wake of a fraud, there will be a greater social impact than when a small public corporation fails. Professors Langevoort and Thompson have thus argued that "[f]ull publicness treatment should be reserved for companies with a larger societal footprint."[43] At the same time, all public companies must meet basic regulatory mandates, and even though there will be questions as to whether the line between public and private corporations has been drawn correctly, investors should be able to reasonably expect that public companies will generally be safer investments than private companies.

The distinctiveness of public companies goes beyond technical requirements of greater accuracy in disclosure and corporate governance. Professor Hillary Sale notes that after a period of scandal and failure to understand their obligations to the public, corporations increasingly operate in a climate of increasing government and public scrutiny with respect to their integrity as public companies.[44] Corporations that fail to meet social norms with respect to their conduct will face public backlash that can affect their business as well as their stock price. These demands for integrity require investment in compliance efforts by public companies, and the demand for such efforts is likely to grow.

III. INVESTOR RELIANCE AND THE PUBLIC CORPORATION

Shifting attention from market integrity to the integrity of the public corporation has a number of implications for the fraud-on-the-market presumption. When a stock trades on a public market, it is not reasonable for investors to believe that its price is never distorted by fraud, but it is reasonable for investors to believe that its price is not severely distorted by fraud. This reliance is consistent with the increasing expectation that public corporations trading on a stock exchange meet basic levels of integrity. To the extent that securities class actions mainly police the integrity of the public corporation, courts should shape Rule 10b-5 doctrine to focus on the most significant frauds, such as hiding the fact that a company is heading towards bankruptcy.

The normative case for the fraud-on-the-market presumption is best supported by the extensive role of the law in distinguishing

43. Langevoort & Thompson, *Publicness*, *supra* note 35, at 342.

44. Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 139 (2011).

between public and private companies. When a market for a particular stock is efficient, it is the culmination of a long process where a company goes from a private company that is difficult to value, to a public company that outsiders are comfortable valuing. Such a company will be tested by gatekeepers such as private investors, underwriters, auditors, exchanges, and research analysts before emerging on the public markets. When an investor purchases a stock on the New York Stock Exchange, he justifiably has more confidence in the value of that security than if it were trading on the penny stock market. Though fulfilling the requirements of becoming a public company is no guarantee against fraud, these standards are meant to assure investors that the most severe frauds will be rare. The investor trusts markets not because market prices are always accurate but because law and norms help screen out companies that should not be publicly traded.

Any company trading on a public market represents that it is meeting the requirements for being a public company in good faith. To the extent that there is a change in the company's condition indicating that this implicit representation is no longer true, the company should disclose such a development to investors. Even if the company's stock price does not precisely reflect its fundamental value, the fact that the company continues to trade implies that it continues to meet standards for remaining a public company.

Investors purchasing a stock that trades on an efficient market should be able to rely on the representation that the company should be trading on a public market. This reliance can be violated by a company that commits significant fraud. A severe fraud can hide the fact that a company is heading towards bankruptcy or delisting. Many securities class actions have targeted such severe frauds. As one of my earlier papers shows, about 15 percent of the securities class actions filed from 1996–2004 involved companies that filed for bankruptcy.[45] In hiding significant information from the public, a company may continue to trade on an exchange when in fact it should be in

45. James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547, 550 (2013). Securities frauds became more severe in the early part of the 2000s, as evidenced by the increasing percentage of cases where bondholders, who are typically shielded from securities fraud, recovered some part of a securities class action settlement. *See* James J. Park, *Bondholders and Securities Class Actions*, 99 MINN. L. REV. 585, 587 (2014). Nineteen of the thirty largest securities class action settlements of cases filed from 1996 to 2005 involved a bondholder recovery.

bankruptcy court or trading on the pink sheets. Investors who continue to purchase stock without knowledge of such fundamental developments can argue that their reliance on the integrity of the company as a public corporation has been disrupted.[46]

It is important to acknowledge that expectations with respect to public companies have evolved significantly since the fraud-on-the-market presumption was adopted by the Supreme Court in 1988, more than a decade before the passage of Sarbanes-Oxley. But even then, the Foreign Corrupt Practices Act had been in place since the 1970s, requiring internal controls and truthful books and records. Moreover, the fact that the severe frauds associated with Enron and WorldCom triggered the significant intervention of Sarbanes-Oxley is evidence that those frauds violated investor expectations with respect to the integrity of a public corporation. Finally, the Court in *Halliburton v. Erica P. John Fund, Inc.* affirmed the validity of the fraud-on-the-market presumption in the context of a post-Sarbanes-Oxley world that requires more of public companies.

Not all securities frauds would disrupt investor reliance on the integrity of the public corporation. It is unrealistic to believe that internal controls and listing requirements will stop all frauds, but they should prevent the most severe frauds absent extraordinary efforts to evade regulatory requirements. Shifting the normative focus of fraud-on-the-market suits to protection of the integrity of the public corporation might support efforts to dismiss cases involving minor stock price fluctuations. If investors do not believe that stock prices are exactly accurate, the case for allowing recovery for a temporary decline in a company's stock price is weaker.

Because the reliance interest of investors is narrower under an integrity of the public corporation approach, an argument can be made that the doctrine governing securities class actions should also be narrowed to focus on the most significant frauds. For example, the test for determining whether a misstatement is material enough to support securities fraud liability could be refined in light of this Article's analysis. If the reasonable investor relies on the integrity of the public corporation rather than the accuracy of a particular market

46. Even when a stock does not trade in an efficient market, some courts have found that an investor's reliance interest can be affected by significant violations of market integrity. When a company sells a security that is essentially unmarketable, investors can argue that they "relied on the integrity of the offerings" in purchasing the security. Shores v. Sklar, 647 F.2d 462, 469 (5th Cir. 1981).

price, there will be a stronger case that a narrower range of misstatements will be material to that investor. To be material, a fraud must do more than affect stock prices—it must hide a fundamental change that would lead to questions about whether a company should be public.[47] Such a materiality standard would reduce the costs of defending suits without merit by making it more likely that such cases will be dismissed at an early stage.[48]

An objection to this approach is that smaller frauds can be significant as well. Larger frauds may often be the culmination of multiple decisions to manipulate disclosures in what seem to be minor ways. Even if private class actions are not as viable for such cases, the SEC could fill the gap. Such smaller frauds may be well-suited for a bureaucracy with the resources to pursue cases even when they may not be economically viable for private firms.

CONCLUSION

In affirming *Basic Inc. v. Levinson*'s assumption that investors rely on the integrity of efficient markets, the decision of the Court in *Halliburton v. Erica P. John Fund, Inc.* rests on an uneasy foundation. It is difficult to argue that investors believe market prices are rarely distorted by fraud. Professor Langevoort has thus described the fraud-on-the-market presumption as one of juristic grace,[49] and *Halliburton* does not provide a reason to change his conclusion. This Article seeks to provide a firmer normative foundation for the presumption of reliance that makes securities class actions under Rule 10b-5 possible. The reliance is not on market prices, but in the extensive law and norms that have defined the public corporation for many years. These efforts strive to eliminate severe frauds from public markets. Even if investors cannot rely on the integrity of market

47. As I have argued elsewhere, materiality should be narrowed to focus on fraud that significantly distorts the fundamentals of the company. *See* James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513 (2009).

48. Defendants may object that a stronger materiality standard is not of much help to them because it is difficult to win a materiality argument on a motion to dismiss. But it is unclear why public corporations could not make an effort to select cases that are weak on materiality to go to trial. In doing so, they would create more law on the issue, making it easier to dismiss cases in the future, as well as deter plaintiffs from bringing strike suits in the future.

49. Langevoort, Basic *at Twenty*, *supra* note 17, at 195; *see also* Barbara Black, *Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets*, 44 LOY. U. CHI. L. J. 1493, 1502 (2013) ("At its core, however, *Basic* is a pragmatic, not a theoretical opinion based on the purposes of the federal securities laws, including the protection of investors and the enhancement of investor confidence.").

prices, they should be able to rely on the integrity of the public corporation.