MARKET RISK AND EFFICIENCY

Lessons From Financial Economics

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In Basic v. Levinson the Supreme Court adopted the fraud-on-the-market theory for securities that trade in efficient markets. The Court in its holding relied in part on the research findings of financial economists who have shown that in a wide variety of situations securities prices react very quickly to the release of new information. Unfortunately, by entertaining questions of efficiency, the Court overcomplicated its inquiry.

There is disagreement among financial economists about the meaning of efficiency, how to test for it and what the results of these tests mean. It is simply too complex to determine in a securities fraud case whether the presumption of reliance on the integrity of the market price is justified on the basis of the existence of an efficient market. Fortunately, this inquiry is also unnecessary.

We have argued that courts need not consider whether a security trades in an efficient or inefficient market; rather, courts should examine whether a misstatement caused a security to trade at an artificially high or low price. The inquiry devolves then into whether and how rapidly the market responded to the alleged misstatement. Financial economists can answer this question.

As a result, courts may avoid the almost impossible task of identifying efficiency and concentrate instead on the relatively simple task of determining the stock return associated with a misstatement and whether it is statistically significant. If so, the court should conclude that the misstatement distorted the market price — that it was material — and presume reliance.

actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

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