Short Sellers, Short Squeezes, and Securities Fraud

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We would like to thank participants at the National Business Law Scholars Conference at UC-Berkeley School of Law, the Corporate and Securities Litigation Conference at Boston University School of Law, Jessica Erickson, Verity Winship, Jill Fisch, A.C. Pritchard, and David Webber. We would also like to thank Austin J. Humble for dedicated research assistance.

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An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.[1]

In short, Basic's assumption that all investors rely in common on 'price integrity' is simply wrong.[2]

I. INTRODUCTION

Imagine that a products liability class action lawsuit has been filed against an automaker for a design defect that causes the automobile's brakes to fail. Under the law of products liability, owners of the implicated make and model year are potential members of a plaintiff class. One would not expect, however, that class to include the two neighbors who wagered about whether their friend's qualifying vehicle's brakes would fail. Welcome to the wacky world of modern securities fraud class action lawsuits.

In 1988, the United States Supreme Court in *Basic v. Levinson* embraced a revolutionary approach to securities fraud litigation. This approach saved the plaintiff securities fraud class action form,[3] and by extension, most private securities fraud litigation under Rule 10b-5. *Basic* did so by holding that each plaintiff in a purported class did not need to show actual reliance on a particular fraudulent statement of the issuer; instead, a class would get the presumption of reliance because they purchased the shares in a market in which the market price signals to investors all publicly available information.[4] This holding, however, affirmed by *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*")[5] is premised on the assumption that investors purchase shares in publicly-traded companies because they believe that the market price, a product of all publicly-available information, reflects the fundamental price. As Justice Thomas noted

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1. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).

2. Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 289 (2014) (Thomas, J., concurring) [hereinafter *Halliburton II*].

3. *Basic*, 485 U.S. at 243–44 ("The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences.").

4. *Id.* at 247.

5. *Halliburton II*, 573 U.S. at 284. At the time of this writing, another Supreme Court case is pounding on the gate of *Basic* reliance. *See* Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp., Inc., 955 F.3d 254 (2020) *vacated and remanded by* Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp., Inc., 141 S. Ct. 1951 (2021), *vacated by* Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp., Inc., No. 18-3667 2021 WL 3776297 (2d. Cir. 2021), *vacated and remanded* (applying price inflation maintenance theory and holding defendant did not rebut the *Basic* presumption).

in his concurrence in *Halliburton II*, this assumption is not correct.[6]

Though a typical investor at the time of *Basic* may have purchased shares in a corporation based on some signal from the market price, many investors in the 2020s do not. In fact, many investors purchase or sell shares because they believe that the market price is false and they intend to benefit from a future market correction. The atypical investor may also trade to hedge positions or trade as a result of predetermined programming. Most notably and controversially, short-sellers most definitely do not rely on the market price signal. Therefore, the concept of a short seller having a securities fraud cause of action does not seem consistent with either the assumptions of *Basic* or with theories of tort compensation generally. Short-sellers would not rely on the brakes' integrity; they would bet on the brakes to fail.

In the decades that have followed *Basic v. Levinson*, attempts to prune the "judicial oak" of private securities fraud claims "grown from little more than a legislative acorn"[7] have continued to threaten its existence. Neither Congressional overhauls[8] nor pro-defendant Supreme Court rulings,[9] however, have rationalized this odd cause of action.

Moreover, class action securities litigation plays out in an absurd plane. Each side is trying to end the game earlier or later, but neither wants to let the litigation play out until the bitter and expensive end, where the result may either be a finding with no attorney fees for the losing plaintiffs or a potentially enormous damages judgment that results in bankruptcy.

This Article explores a relatively unexamined legal fiction: the Supreme Court's continued acceptance of the assumption that most investors participate in the market in reliance on the integrity of the market prices and application of rules designed for "typical" investors to an unknown cohort of "atypical" investors, including short-sellers, options traders, algorithmic and high-speed traders, and institutional investors.

Of all the strange aspects of the class action securities fraud lawsuit, one of the most bizarre is that the courts do not know the identities or investment holdings of the

6. *Id*. at 289.

7. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.").

8. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) [hereinafter PSLRA]. The PSLRA was the product of four bills introduced in the House of Representatives and two in the Senate and was vetoed by President Bill Clinton on December 19, 1995. Both Houses of Congress overrode the veto on December 22, 1995. *See* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1009, 1019–23 (1996) (calling the PSLRA "the first comprehensive revision of the federal securities laws governing private securities litigation since their enactment as part of the New Deal").

9. *See generally* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) (holding that plaintiffs in private securities fraud lawsuits may not bring Rule 10b-5 causes of action against aiders and abettors who are not "primary actors"); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148 (2008) (holding that contract parties that knowingly participated in artificial transactions designed by the issuer to mislead investors were not "primary actors" because they did not make false statements directly to the investors); Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005) (holding that plaintiffs in securities fraud cases must plead loss causation by showing a connection not only between price movement and fraudulent statements but also between opposite price movement and disclosure of the fraud).

members of the class until a damages phase, if any, or a settlement claims process.[10] The identities and investment positions of class members can be revealed to the public in the contest to be the lead plaintiff for the class, however. Recent cases involving short sellers applying to be lead plaintiffs reveal that short sellers are probably not rare among the universe of investors in the United States capital markets.[11] Though Chief Justice John Roberts reasoned that only "the occasional investor" will be an atypical investor that does not rely on the signal of the market share price,[12] these atypical investors may in fact be the most typical investor.

Little scholarship has seriously considered how short sellers and other atypical traders fit into the existing securities fraud paradigm. In particular, the existing literature does not address whether, when, and to what extent atypical investors should be lead plaintiffs or plaintiffs at all, given the goals of the securities fraud cause of action and, more specifically, congressional and judicial attempts to rationalize securities fraud class actions. Building on an analysis of all securities fraud cases filed in federal court in 2017, this Article paints a more accurate picture of the universe of traders than the universe presumed by the Supreme Court in *Basic* and *Halliburton II*. In addition, this Article examines the most vigorous lead plaintiff contest in recent memory, arising in litigation surrounding Elon Musk's August 2018 "taking Tesla private" Twitter post; the tweet that launched a thousand lawsuits.[13] This data and the lead plaintiff fight among atypical traders in Tesla securities[14] highlights the importance both of understanding existing district court practice and of developing normative theories to help regulators and judges assess atypical investors' lead plaintiff motions going forward.

This inquiry is made even more cogent and timely by recent examples of short sellers not only being lead plaintiffs in securities fraud lawsuits,[15] but also being alleged targets and perpetrators of securities fraud and market manipulation themselves.[16] Generally, when an issuer makes false statements, its motivation is to avoid shareholder losses and maintain share price. However, securities fraud class actions have been filed

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10. Jessica Erickson, *Automating Securities Class Action Settlements*, 72 VAND. L. REV. 1817, 1820 (2019) ("[T]he only way to identify class members has been to require them to identify themselves, typically by filing a [settlement] claim and document their transactions.") [hereinafter *Automating Settlements*].

11. *See, e.g.*, Amended Complaint, Nardy v. Chipotle Mexican Grill, Inc., No. 1:17-CV-01760, 2019 WL 3297467 (D. Colo. July 20, 2017) (appointing as lead plaintiff an investor claiming over $1 million in losses from both put and call options).

12. *Halliburton II*, 573 U.S. 258, 268 (2014).

13. *See, e.g.*, Complaint, SEC v. Musk, No. 1:18-CV-8865 (S.D.N.Y. Sept. 27, 2018) (alleging violations of Rule 10b-5 for tweeting "Am considering taking Tesla private at $420. Funding secured," which he knew to be false). This civil enforcement action was settled less than a month alter by Musk paying a $20 million fine and stepping down as Chairman of the Tesla Board of Directors. *See* Consent Motion for Entry of Final Judgment, SEC v. Musk, No. 1:18-CV-8865 (S.D.N.Y. Sept. 29, 2018).

14. Isaacs v. Musk, No. 18-CV-04865, 2018 WL 6182753 (N.D. Calif. Nov. 27, 2018) (appointing as lead plaintiff in class action lawsuit against Elon Musk and Tesla, Inc. an investor who "held interests that cover most of the persons/entities likely to be in the class—i.e., long positions in common stock, long positions in options, and short positions in options— and thus can most adequately represent the class (in light of the differing damages analysis that might apply to each class of investors)").

15. *See, e.g.*, *In re* Overstock Sec. Litig., No. 2:19-CV-709, 2020 WL 5775845 at *2 (D. Utah Sept. 28, 2020) (detailing that the lead plaintiff "shorted more than 2.5 million Overstock shares" before the class period and purchased more throughout the class period).

16. *See* discussion *infra* Section VI.A. regarding "short squeezes."

against Tesla, Inc.[17] and Overstock.com[18] alleging, with evidentiary support, that the makers of false statements did so with the intent to harm traders with short positions in the stock. The enmity between issuer and short seller is well understood, but the use of securities fraud lawsuits as a remedy for the "short squeeze" tactic is not. This issue is even muddier when those traders initiating the short squeeze are not associated with the issuer, as in the recent case involving GameStop Corp.[19]

This Article contends that preventing short sellers from participating in securities fraud class actions promotes not only the public interest goals of securities fraud lawsuits, but also the efficiency goals of the Private Securities Litigation Reform Act ("PSLRA"). Making short sellers ineligible improves the manageability of a class action lawsuit and the choice of lead plaintiff. In addition, excluding damages that emanate from short positions shrinks the universe of potential damages, creating less of an incentive for defendants to settle or invest huge resources in class certification fights rather than proceed to trial. Most importantly, this Article argues that short sellers should not benefit from the *Basic* presumption; therefore, their inclusion in any prospective class of typical traders should jeopardize class certification.

Part II provides background on securities fraud class actions, and Part III explores the different types of investors in the modern securities markets. The atypical, or nontraditional, investor is then placed into existing securities fraud class action jurisprudence in Part IV to throw in stark relief some of the misalignments between atypical investors and securities fraud doctrine. Part V focuses on atypical investors acting as lead plaintiffs in securities fraud cases, including the Tesla litigation, and Part VI specifically examines short sellers in various securities fraud contexts. Part VII gives some recommendations for the future of the securities fraud class action.

II. BACKGROUND: PRIVATE SECURITIES FRAUD LITIGATION

Making a false statement of a material fact or omitting to state a material fact when under a duty to do so in connection with the purchase and sale of a security constitutes securities fraud under Section 10 and Rule 10b-5 of the Securities Exchange Act ("Exchange Act").[20] When the maker of the statements is a publicly held issuer, then any

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17. *In re* Tesla, Inc. Sec. Litig., 477 F. Supp. 3d 903 (N.D. Cal. 2020) (denying defendant's motion to dismiss in case surrounding allegedly false tweet from CEO Elon Musk after tweeting in the months prior that short sellers would be seriously harmed by upcoming news).

18. *See In re* Overstock Sec. Litig., No. 19-CV-7089, 2020 WL 5775845 (dismissing suit against issuer alleging that "Defendants engaged in a scheme to issue a locked-up dividend they knew would cause a short squeeze, artificially spike Overstock's stock price, and force short sellers of Overstock stock to cover their positions at inflated prices"). Though Judge Dale Kimball dismissed this suit in September 2020, he granted leave for the lead plaintiff, Mangrove Partners Master Fund, to amend the consolidated complaint on January 6, 2021. An amended complaint was filed on January 11, 2021. *See* Consolidated Complaint, *In re* Overstock Sec. Litig., No. 19-CV-709 (D. Utah Sept. 27, 2019).

19. *See* discussion *infra* Section VI.A. detailing the public rally against short sellers among online retail investors in January 2021.

20. *See* Securities Exchange Act, § 10(b) (making it unlawful to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance"). Rule 10b-5 further explicates "manipulative or deceptive devices" to include making "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances

material public statement or omission is deemed to be made in connection with the constant secondary trading in that security. Though both the Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ") can prosecute this fraud under Section 10 and Rule 10b-5,[21] private investors also have a cause of action for the same statements.[22] Though civil fines and criminal penalties can serve a deterrence function for managers,[23] private securities fraud litigation also serves the same goal[24] if the prospect of monetary damages alters corporate behavior to improve disclosure.[25] Theoretically, private investors can supplement the resources of the SEC by aiding in enforcement as "private attorneys general."[26] Regardless of the deterrence function of securities fraud, private litigation, as opposed to governmental prosecution, ideally serves its own purpose of compensating injured plaintiffs.[27] For private causes of action brought under Rule 10b-5, however, the plaintiff has a higher evidentiary burden than the governmental actors. A private securities fraud plaintiff must prove that the defendant made a false statement of a material fact, that the plaintiff relied on the statement in connection with the purchase or sale of the security, that the statement caused the plaintiff's loss, and that the maker of the statement had the requisite mental state when making the false statement.[28]

A. Securities Fraud and the Class Action Mechanism

Securities fraud cases against publicly traded issuers brought by investors are generally brought as class action lawsuits. Much has been written about the economics of

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under which they were made, not misleading."

21. *Id.*

22. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729–30 (1975) (describing how in 1971, though neither the statutory provision nor the rule refer to private causes of action, the Supreme Court "confirmed with virtually no discussion the overwhelming consensus of the District Courts and Courts of Appeals that such a cause of action did exist"). *See also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

23. *See* M. Todd Henderson & Adam C. Pritchard, *From Basic to Halliburton*, REGUL., at 20 (Winter 2014–2015) ("The Securities and Exchange Commission and the Department of Justice are authorized to bring suits to enforce the securities laws in general and antifraud rules specifically. Absent a system of private suits, presumably the government would pick up some of the slack.") [hereinafter *Basic to Halliburton*].

24. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (stating that "the securities statutes seek to maintain public confidence in the marketplace. They do so by deterring fraud, in part, through the availability of private securities fraud actions.").

25. *But see* Tom Baker & Sean Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officer's Liability Insurer*, 95 GEO. L.J. 1745, 1799 (2007) (finding that because of insurer practices, "securities class actions, in particular, are not fulfilling their deterrence promise").

26. *See* Bleznak v. C.G.S. Sci. Corp., 387 F. Supp. 1184, 1189 (3d Cir. 1974) ("The concept of the private attorney acting as a 'private attorney general' is vital to the continued enforcement and effectiveness of the Securities Acts.").

27. *See* Steinberg v. Carey, 470 F. Supp. 471, 478 (S.D.N.Y. 1979) (stating "it is important to note what is sometimes forgotten that these actions are presumably intended for the benefit of the small consumer or investor who otherwise would have no means of redress."). *But see* Erickson, *Automating Settlements*, *supra* note 10, at 1820 n.9 (reporting from interviews with class administrators that approximately 20–25% of eligible plaintiffs file claims after settlement).

28. *See* Securities Exchange Act § 21D(b). This provision does not mention reliance on the material statement, though reliance has long been required by courts for Rule 10b-5 cases, though plaintiffs generally benefit from the *Basic* presumption of reliance. *See* discussion *infra*, Section II.B. (discussing reliance).

the class action securities fraud lawsuit and its abuses.[29] However, currently no one has devised a superior system that would allow plaintiffs with small to moderate losses to bring a lawsuit against a large, publicly-held issuer.[30] Without a collective action mechanism and attorneys willing to take a contingency fee on behalf of the class, even with its conflicting incentives, few investor plaintiffs would bring claims, deterrence would be reduced, and fraud victims would go uncompensated.[31]

Class action attorneys are willing to expend extraordinary amounts of time and effort on contingency because the ultimate fee is based instead upon a percentage of the claims of *all* injured plaintiffs.[32] Because of this, a lawyer may be neutral as to how large the damages of the one named plaintiff are, because those damages have no bearing on the attorney's eventual contingency fee. As long as the lawyer's plaintiff can be chosen as the lead plaintiff for the class, that plaintiff's lawyers will be chosen as class counsel[33] and the lawyer's fee will be based on the ultimate damages settlement or, in rare cases, award.[34]

The proposed class in a securities fraud lawsuit includes not only shareholders who traded during a specific time period, but also security holders: holders of options and other derivatives. In addition, it includes short sellers who briefly become shareholders by purchasing shares to cover short positions, transferring ownership immediately to a lender of option holder. The potential damages, therefore, may be astronomically large.[35] Because of the threat of a large trial verdict, particularly a fraud verdict not covered by insurance,[36] defendants litigate vigorously to gain dismissal and settle only when they

29. Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1115 (2011) (discussing the "now familiar principal-agent problems between class counsel and the class itself").

30. For example, in the Household International, Inc. litigation, at least 22,000 claims were for amounts less than $250,000. *See generally* Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., No. 02-CV-5893, 2013 WL 11319836 (N.D. Ill. July 11, 2013).

31. *See* Lynn A. Baker, Michael A. Perino, & Charles Silver., *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 COLUM. L. REV. 1371, 1371 (2015) ("Every year, fee awards enable millions of people to obtain access to justice and strengthen the deterrent effect of the law by motivating lawyers to handle class actions.").

32. *But see* Stephen J. Choi, Jessica Erickson, & A.C. Pritchard, *Working Hard or Making Work? Plaintiffs' Attorney Fees in Securities Fraud Class Actions*, 17 J. EMPIRICAL LEGAL STUDS. 438, 444 (2020) (finding evidence that lead counsel firms bill more hours when there are co-lead counsels and when companies are the largest, suggesting that firms "make work" when awards are more likely to be a smaller percentage of a settlement).

33. Though the court chooses the lead plaintiff, the lead plaintiff has the right to "select and retain" class counsel. *See In re* Cendant Corp. Litig., 264 F.3d 201, 222–23 (3d Cir. 2001) (holding that the trial court could not use an auction to select lead counsel). Therefore, applications to be lead plaintiff must demonstrate that they have chosen competent class counsel with experience and skill in similar cases.

34. *See* Lynn A. Baker, Michael A. Perino, & Charles Silver, *Setting Attorneys' Fees in Securities Class Actions: An Empirical Assessment*, 66 VAND. L. REV. 1677, 1702–08 (finding from a dataset of post-PSLRA settlements that 17.9% of fee requests were decreased by the courts, with some reductions being small (from 27% of settlement to 25%) and some being quite large (from 30% of settlement to 7.6%)).

35. According to Cornerstone Research, 77 class actions were filed in 2019 with "disclosure dollar losses" each of more than $1 billion. Furthermore, 76 class actions were filed in 2019 with "maximum dollar losses" each of more than $4 billion. *See generally* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2019 YEAR IN REVIEW (2019), http://securities.stanford.edu/research-reports/1996-2019/Cornerstone-Research-Securities-Class-Action-Filings-2019-YIR.pdf [https://perma.cc/3XR3-CK2J] [hereinafter 2019 REPORT].

36. *See* A.C. Pritchard, *Who Cares?*, 80 WASH. UNIV. L. Q. 833, 885–86 (2002) (arguing that corporate

cannot. Should plaintiffs certify a class and survive a motion to dismiss, the probability that defendants will settle before trial becomes almost certain.[37] Though 1,849 post-PSLRA securities fraud class actions settled between 1996 and 2019,[38] only fourteen such actions were tried to a verdict between 1996 and 2019.[39]

1. The Private Securities Litigation Reform Act and the Plaintiff

Criticisms of securities fraud class action lawsuits focus somewhat on doctrine, but particularly on human opportunism and incentive structures.[40] The PSLRA was enacted to ameliorate some of these perceived abuses.[41] Though the PSLRA attempted to change various aspects of securities fraud litigation,[42] from heightened pleading requirements,[43] restricting eligibility for lead plaintiffs,[44] and delaying expensive discovery until after the motion to dismiss stage,[45] the overall intent of the amendments was to reduce the number of securities fraud class actions and the cost of those actions to defendants.[46] Though

officers are predisposed to settling securities fraud claims both to avoid enormous personal liability and to avoid wrongdoing findings that foreclose insurance coverage).

37. *See In re* Rhone-Poulenc-Rorer, Inc., 51 F.3d 1293, 1299 (7th Cir. 1995) ("We do not want to be misunderstood as saying that class actions are bad because they place pressure on defendants to settle. That pressure is a reality, but it must be balanced against the undoubted benefits of the class action that have made it an authorized procedure for employment by federal courts.").

38. *See* 2019 REPORT, *supra* note 35, at 1 (analyzing securities class action settlements).

39. ADAM T. SAVETT, SECURITIES CLASS ACTION TRIALS IN THE POST-PSLRA ERA (April 12, 2021), app.box.com/v/PSLRA-Trials (showing just twenty-five securities fraud class action trials since passage of the PSLRA, with fourteen from facts that occurred post-PSLRA and seven additional cases settling during trial or resulting in default judgment).

40. *See* Phillips & Miller, *supra* note 8, at 1009–10 (arguing that the impetus for the PSLRA was "the speculative securities class action lawsuit—a strike suit initiated not because plaintiffs or their class action lawyers had any persuasive evidence of fraudulent conduct on the part of the defendants but primarily as an in terrorem device for extracting settlements from the defendants irrespective of the merits of the underlying claims").

41. Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u (1995). *See generally* Joel Seligman, *Rethinking Private Securities Litigation*¸73 UNIV. CIN. L. REV. 95, 95–96 (2004) (summarizing the arguments for the passage of the PSLRA, including the automatic filing of stock-drop suits, the inclination of companies to settle regardless of the merits of actions, and the danger to capital formation due to "out of hand" securities litigation).

42. *See* Seligman, *supra* note 41, at 117 ("The 1995 Act is a type of "kitchen sink" legislation consisting of idea after idea piled upon one another to address an apparent problem with a disproportionate response.").

43. Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, § 21D(b)(1) ("In any private action arising under this title in which the plaintiff alleges that the defendant (A) made an untrue statement of a material fact or (B) omitted to state a material fact . . . the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information or belief, the complaint shall state with particularity all facts on which that belief is formed.").

44. *Id.* at §21A(3)(B)(i) ("In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party."); *see also* Hillary A. Sale, *Heightened Pleading & Discovery Stays: An Analysis of the Effectiveness of the PSLRA's Internal Information Standard on '33 and '34 Act Claims*, 76 WASH. UNIV. L.Q. 537, 562 (1998) (questioning whether the discovery stay, when combined with the heightened pleading standards, would result in some meritorious suits being dismissed).

45. Securities Exchange Act of 1934, 15 U.S.C. 78u-4, § 21(b)(3).

46. *See* John C. Coffee, Jr., *The Globalization of Entrepreneurial Litigation: Law, Culture, and*

cases may be dismissed at higher rates than pre-PSLRA[47] and the cases brought may be against larger issuers,[48] the number of securities fraud class action cases has not diminished.[49]

Though these reforms have not decreased the number of class action securities fraud lawsuits,[50] they have resulted in outcome-determinative legal brawls at earlier stages in litigation: the motion to dismiss and the motion to certify the class.[51] The key existential problem in securities fraud, that a successful jury verdict could theoretically result in a death penalty damages verdict,[52] one not covered by insurance,[53] still exists.[54]

Incentives, 165 UNIV. PA. L. REV. 1895, 1897, n.7 (2017) ("The Private Securities Litigation Reform Act of 1995 ("PSLRA") was intended to (and for a brief time did) curb securities litigation . . .").

47. *See* Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J. L., ECON., & ORG. 598, 617 (2007) (noting that dismissal rates for IPO litigation increased from 13.7% to 25.8% in the post-PSLRA period); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 UNIV. ILL. L. REV. 913, 937 (2005) (comparing dismissal rates of class action securities law cases before the PSLRA of between 24% and 40% with rates post-PSLRA of 60% and 65%). Overall rates for dismissals, including Rule 10b-5 claims, are much higher. *See BOX SCORES OR KEY STATISTICS FROM 1996 TO YTD*, STAN. L. SCH.: SEC. CLASS ACTION CLEARINGHOUSE, securities.stanford.edu/stats.html [https://perma.cc/TJ2V-7QNP] (showing that from 1996, 2,539 of 5,039 completed class action securities fraud cases (50.39%) ended in dismissal).

48. *See* Choi, *supra* note 47, at 623 (finding that though the PSLRA "reduced the incidence of nuisance suit litigation," it also "worked to reduce more meritorious litigation, particularly aimed at smaller companies").

49. *See* 2019 REPORT, *supra* note 35, at 5 (showing that the number of "core" securities fraud class action filings in 2019 was 268, up from 182 in 2005). According to the Securities Class Action Clearinghouse, the mean number of securities fraud class actions brought in federal court each year from 1996-2020 is just over 236. The median number is 208. *See* Stanford Law School Securities Class Action Clearinghouse, *Federal Securities Class Action Litigation 1996-YTD* (chart), http://securities.stanford.edu/charts/html (on file with author) (Detailing key statistics of securities class action suits).

50. Stephen J. Choi & Robert B. Thompson, *Securities Litigation and its Lawyers: Changes During the First Decade of the PSLRA*, 106 COLUM. L. REV. 1489, 1496 (2006) (reporting that approximately 200 class action securities fraud cases a year were filed prior to passage of the PSLRA, but in the ten years following passage, "[i]f anything, it is more likely that litigation has gone up rather than down over the entire period").

51. Following the PSLRA, various cases have asked the Supreme Court to decide exactly which elements of the securities fraud claim must be proven by the plaintiff at the motion to dismiss stage and the class certification stage. The resulting landscape is mixed. *See Halliburton II*, 573 U.S. 258, 281 (2014) (holding that plaintiffs do not need to establish loss causation at class certification, but that the defendant may use evidence of "no price impact" to rebut the presumption of class-wide reliance); Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 568 U.S. 455, 475 (2013) (holding that the plaintiff did not have the burden of proving materiality at the class certification stage because materiality is a common question to all plaintiffs); Erica P. John Fund, Inc. v. Halliburton Inc. (*Halliburton I*), 563 U.S. 804, 813 (2011) (holding that plaintiffs do not need to establish loss causation at class certification); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 326 (2007) (holding that plaintiffs must plead with particularity facts giving rise to an inference of scienter as least as strong as any opposing inference at the motion to dismiss stage). *See also* Ann M. Lipton, *Halliburton and the Dog That Didn't Bark*, 10 DUKE J. CONST. L. PUB. POL'Y 1, 24 (2015) (discussing the growing tendency of courts to not certify a class in securities fraud lawsuits due to a distrust of juries, an urge to protect defendants and an assumption that loose certification standards allow plaintiffs to "blackmail" defendants into a settlement).

52. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 641 (1996) (arguing that "greatly reducing the amount of money at stake" would rationalize incentives in class action securities fraud cases).

53. Almost all publicly held corporations purchase insurance for the benefit of corporate employees, known as "directors and officers" or "D&O" insurance. If a final judgment finds the director or officer defendant committed fraud, insurers are not obligated to pay the judgment and litigation costs under a moral hazard exclusion. However, a settlement entered into prior to judgment generally will not be considered to be a

2. Plaintiffs in a Securities Fraud Class Action

One way to reduce the cost and incidence of securities fraud class action cases is to reduce the universe of eligible plaintiffs. The year prior to passage of the PSLRA, the Supreme Court in *Central Bank v. Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[55] reduced the universe of defendants to "primary actors." The Supreme Court also ruled that Section 11 and Section 12 claims under the Securities Act specify eligible defendants in the statutory language,[56] along with a shortened one-year limitations period.[57]

However, neither the PSLRA or federal case law does much to address the number or types of plaintiffs that could be included in a class. In fact, during litigation, the parties never know the number or identities of the plaintiffs in a class, and do not narrow the class much beyond types of claims and dates of trading.[58] Courts have specified that plaintiffs must actually purchase or sell securities,[59] not just abstain from trading, and that plaintiffs must suffer an out-of-pocket loss,[60] not just a reduced gain. Beyond that, all types of securities holders are in the class, making the damages claimed by the plaintiffs extremely large.

One way to reduce the *in terrorem* effect of the class action complaint is to reduce the universe of eligible plaintiffs. As this Article argues *infra*, short sellers and others with short positions are not the type of plaintiff that Congress may have intended to protect in Section 10 and Rule 10b-5. Narrowing the universe of plaintiffs as well as defendants could help rationalize the securities fraud class action lawsuit.

Moreover, attempting to curb excessive lawsuits by defining a narrow class of plaintiffs is not unprecedented. Section 11 claims require that the shares in question be

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final adjudication of fraud, so settlements are usually covered by D&O insurance. *See* Baker & Griffith, *supra* note 25, at 1820 (explaining the moral hazard exclusion in D&O insurance).

54. The potential damages calculated from a price drop could be enormously high: the amount of the price drop multiplied by the number of shares outstanding, capped only by the full market capitalization. However, because this damage amount is rarely, if ever, in front of a jury, defendants perhaps should not include that possibility into their settlement value. *See* Charles Silver, *"We're Scared to Death: Class Certification and Blackmail*, 78 N.Y.U. L. REV. 1357, 1407 (2003) (arguing that defendants in securities fraud cases should not feel pressured into a settlement because the likelihood of an outsized jury verdict is close to zero).

55. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 179 (1994).

56. *See* Securities Act of 1933 §§ 11(a)(1-5), 12(a)(2) (providing for civil liabilities arising out of false registration statements and civil liabilities arising in connection with prospectuses and communications, respectively).

57. *See id.* at § 13 (providing that no action is liable under sections 11 and 12 unless brought within one year of the untrue statement).

58. For example, the court in *Vivendi* excluded claims by plaintiffs who purchased ordinary shares that were traded in foreign markets, unlike the ADR shares, which were listed and traded on the New York Stock Exchange. *See* In re Vivendi Universal, S.A. Sec. Litig. 765 F. Supp. 2d 512, 533 (S.D.N.Y 2011) (conforming the judgment following the decision in *Morrison v. Nat'l Australian Bank*, 561 U.S. 247 (2010)).

59. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975) (holding that Manor Drug Stores does not have standing under section 10(b) of the Exchange Act because there was no injury after the purchasing or selling of a security).

60. *See* Randall v. Loftsgaarden, 478 U.S. 647, 665–66 (1986) (holding that the damages awarded to Randall do not have to be lessened because of the tax benefits he received).

traced back to the IPO.[61] Courts have kept lawsuits claiming fraud in IPO registration statements relatively small, strictly enforcing Section 11 tracing requirements.[62]

3. *Rule 23 Requirements for Federal Class Actions*

To proceed toward settlement, federal class action securities lawsuits must first successfully move that the court certify the class of proposed plaintiffs; without class certification, the lawsuit will be dismissed.[63] Federal Rule of Civil Procedure 23(b) authorizes class actions when "the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to" other available adjudication methods.[64] The Supreme Court has interpreted Rule 23(b)(3) to require that plaintiffs in such cases demonstrate the requirements of Rule 23(a), "numerosity, commonality, typicality, and adequate representation," in order to clear the class certification bar.[65]

The numerosity requirement of Rule 23(a)(1) is met when "the class is so numerous that joinder of all members is impracticable."[66] The geographically dispersed ownership of publicly traded corporate securities by thousands of security holders usually means that prospective lead plaintiffs in securities fraud cases can easily satisfy the numerosity requirement.[67]

Commonality, typicality, and adequate representation, however, require that the overly numerous claims are sufficiently similar and that the class action can move through trial roughly as an individual lawsuit would, with the lead plaintiff's individual lawsuit being sufficiently like all of the rest. If so, then common questions of law and fact will apply to most of the elements of securities fraud for purposes of Rule 23(a)(2).[68]

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61. *See* Securities Act of 1933 § 11(a) (granting a cause of action in the case of a false statement of a material fact in a registration statement to "any person acquiring such security").

62. *See generally* Krim v. pcOrder.com, Inc., 402 F.3d 489 (5th Cir. 2005) (holding lead plaintiff in Section 11 lawsuit could not trace each of his 3000 shares back to the IPO because at the time of purchase, 0.15% of the shares in the market for purchase were not IPO shares, even though it was highly probably that he owned IPO shares).

63. *See* DONNA M. NAGY, ET AL., SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 429 (3d ed. 2012) ("The court's decision on certification carries enormous significance for all concerned. If certification is denied, most (and possibly all) members of the might-have-been class will lose the opportunity to recover because they lack the resources to sue individually.")

64. *See* FED. R. CIV. P. 23(b)(3) (providing that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy).

65. *See, e.g.*, Wal-Mart Stores, Inc. v. Dukes, 564 U.S. 338, 349 (2011) (holding that class certification is improper if there is not a common injury among every class member).

66. FED. R. CIV. P. 23(a)(1).

67. *See* Swack v. Credit Suisse First Boston, 230 F.R.D. 250, 258 (D. Mass) (drawing an inference from the average daily trading volume of over 100,000 shares of CSFB stock that the "putative class comprises hundreds, if not thousands, of geographically diverse members"); s*ee also* Jaffe Pension Plan v. Household Int'l, Inc., No. 02-C-5893, 2013 WL 11319836, at *1 (N.D. Ill. July 11, 2013) (finding that 45,231 claims had been made in response to claims cards sent post-verdict).

68. *See, e.g.*, Amchem Prod., Inc. v. Windsor, 521 U.S. 591, 615 (1997) (holding that settlement-only class certification does not need to inquire whether issues of trial management would occur and that the commonality of issues and representation were not met in this case). But our review of the dockets of securities fraud cases filed in 2017 suggests that in the rare case where the lead plaintiff determination is actually litigated, competing applicants virtually never challenge a lead plaintiff motion on commonality grounds.

B. Reliance and the Securities Fraud Class Action

The one element of securities fraud that is the most problematic for the class action structure is the element of reliance. In a class action securities fraud case, this simple element becomes quite complex and almost insurmountable if each member of the class has to provide evidence of hearing or reading the same statement in roughly the same time period prior to trading.[69] However, the *Basic* fraud-on-the-market (FOTM) presumption holds that if the securities in question traded in an efficient market, then the reliance element is presumed to be met by the class as a whole under the theory that the investors purchased or sold the stock in reliance on the fact that the stock price was sensitive to all publicly held information regarding the stock. The investors relied on the market price signal.

The economic theory that underlies *Basic* reliance is that full and complete capital markets are efficient and that stocks in an efficient market automatically incorporate all publicly available information into stock prices.[70] However, if capital markets are not efficient, then the *Basic* presumption of reliance fails.[71] The defendants, therefore, argued that the two assumptions about the U.S. capital markets underlying *Basic* do not hold and require that *Basic* be overturned.[72] First, the market for publicly-traded stock, though "well-developed," is not efficient.[73] Moreover, many investors do not trade because they believe the stock price accurately reflects true information; in fact, many investors trade because they do not believe that prices are accurate or because markets are efficient.[74] In *Halliburton II*,[75] the Supreme Court refused to hold that capital markets are not efficient for the purposes of the *Basic* presumption.

However, if most investors are purchasing and selling stocks without believing that the market is efficient and that market price signals are meaningful and are making investment decisions without regard to market prices, then the *Basic* class-wide

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69. *In re* Banc of California Sec. Litig., 326 F.R.D. 640, 648 (C.D. Cal. 2018) ("Requiring proof of individual reliance from each member of a proposed class would effectively prevent plaintiffs from proceeding with a class action under Rule 23(b)(3), since individual issues would overwhelm the common ones.").

70. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of the Theory and Empirical Work*, 25 J. FIN. 383, 387–88 (1970) (discussing the development of intersecurity tests of market efficiency).

71. To receive the benefit of the *Basic* presumption, plaintiffs must show "(1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed." *See Halliburton II*, 573 U.S. 258, 268 (2014) (holding that in order to recover in a securities fraud action it must be established that investors relied on a company's misrepresentation).

72. *Id*. at 263 ("In *Basic v. Levinson*, 485 U.S. 224 (1988), we held that investors could satisfy the reliance requirement by invoking a presumption that the price of stock traded in an efficient market reflects all public material information – including material misstatements. In such a case, we concluded, anyone who buys or sells the stock at the market price may be considered to have relied on those misstatements.").

73. Brief for Petitioners, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317, 2013 WL 6907610, at *3 (Dec. 30, 2013) ("Even in well-developed markets, stock prices do not efficiently incorporate all types of information at all times.").

74. *See id.* at *19–20 (giving as examples professional investors who "make money in the short term by exploiting their understand of the herd mentality of other, less able investors" and "computerized trading programs using complex algorithms that aim to beat the market, executing trades based on predetermined metrics, not rationally assimilating public disclosures").

75. *Halliburton II*, 573 U.S. at 272–73 (holding that the actual assumptions in *Basic* were that markets are mostly efficient, that most investors rely on the integrity of market price, and that those assumptions still hold).

presumption of reliance should fail. If investors are mostly atypical, then the argument that the *Basic* presumption of reliance makes logical sense is weakened to the point of collapse. The *Halliburton II* court conceded that the "occasional" investor was indifferent to the price signal, but what if the occasional investor was a significant part of the market?

Unfortunately for defendants, the identities of plaintiffs in the class beyond the lead plaintiff are unknown at class certification so defendants cannot rebut the class-wide presumption based on individual trading methods. These individualized challenges do not defeat class certification or class-wide reliance, but are reserved until after a judgment of liability[76] in the rare securities fraud cases that proceed to a judgment.[77] In almost all cases, defendants will never know if the class comprises typical investors or atypical investors.

III. WHO ARE THE INVESTORS?

Federal securities laws are designed for the "reasonable investor"[78] operating in an efficient capital market. Though this Article is not going to engage in how rational or irrational the reasonable investor is, or how efficient or inefficient the U.S. capital market is, the following describes the "typical" or traditional investor that informs debates regarding the reasonable investor vs the "atypical" investor—who may be the majority of investors trading in the U.S. capital market today.

A. Typical Investors

In the paradigmatic securities fraud scenario under Rule 10b-5, a publicly held issuer makes a false statement regarding the company, painting a rosier-than-real picture of current or future profitability. The stock price of the issuer rises after the information enters the market. An investor purchases after the statement at a price that is artificially high because of the false statement. At some point, the truth will be disclosed, and the stock price will drop. If the stock price drops to lower than our investor's purchase price, she has a cognizable cause of action. Her potential recovery and therefore value of her claim is the difference between her purchase price and the price of the stock either at the time she sells or at a date after the revelation.[79] The less common variation on this

76. *See* Swack v. Credit Suisse First Boston, 230 F.R.D. 250, 263 (D. Mass. 2005) ("During this second phase, in which the plaintiff class would be parsed in various ways based upon the precise claims of its members, the Defendants would have the opportunity to raise specific defenses against individual plaintiffs or groups of plaintiffs. In other words, although an individual plaintiff could benefit from the class having established fraud-on-the-market during phase one, in order to recover damages he would have to defeat any defenses asserted against him by Defendants in phase two.").

77. Such mini-trials have taken place or were contemplated in Jaffe Pension Plan v. Household Int'l Inc., 756 F. Supp. 2d 928 (N.D. Ill. 2010), *In re* Vivendi Universal, S.A. Sec. Litig., 284 F.R.D. 144 (S.D.N.Y. 2012), and Hsu v. Puma Biotechnology Inc., No. 15-00865, 2019 WL 4295285 (Sept. 9, 2019).

78. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (defining information as material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available").

79. *See* Securities Exchange Act, § 21D(e)(1) (limiting damages to the difference between the purchase or sale price at the artificial market price and either the "mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission . . . is

scenario occurs when a company makes false *negative* statements about the state of the company, causing the stock price to decline artificially.[80] A current shareholder, lulled into resignation by false statements of negative news, sells the shares at the artificially lower price.[81] When the positive news is disclosed, the price recovers.

For the typical investor, linking the false statement to the harm is not difficult. The investor may have heard or read something that included the false statement or may have merely noticed that the share price of a certain stock was rising. The investor alternatively may have seen that analysts were rating the stock as a "buy" because of the false statements, without hearing or reading the actual statement. The price movement carried a positive signal to the investor about the issuer.

B. Atypical Investors

Some investors today act in the stereotypical way, purchasing individual stocks because of positive news and selling individual stocks because of negative news. However, today's securities markets are dominated by investors employing various strategies that do not look like the stereotypical "buy and hold" investor. [82]

1. Cyberinvestors

For example, investors may employ program trading strategies facilitated by trading algorithms, making hundreds or thousands of trades in a single day according to a set of predetermined decisions.[83] These trades may be designed to speculate, to hedge, or to rebalance a portfolio. Algorithmic trading, including high-frequency trading, may constitute 60–70% of trading in U.S. markets. Because of the speed and lack of human analysis in trading decisions, holding periods for stocks have diminished from being measured in years at the time of *Basic* to being measured in seconds in the modern era.[84]

Linking fraudulent statements by the issuer to a particular algorithmic trade is more difficult. The software was designed prior to the statement, but it was designed to react to many different bits of information that are accessible to it. One of those inputs may be the

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disseminated to the market" or "the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security").

80. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 227–28 (1988) (describing the facts in the case, which involved Basic representatives making public statements falsely denying that it was engaged in merger negotiations to be acquired by Combustion Engineering, Inc., artificially depressing the share price).

81. Other issuers are commonly accused of "negative" securities fraud to depress stock prices prior to corporate buybacks, among other scenarios. Rule 10b-18 of the Securities Exchange Act of 1934 provides a safe harbor for issuers who engage in corporate buybacks. *See also* Jesse M. Fried, *Insider Trading Via the Corporation*, 162 UNIV. PA. L. REV. 801, 830 (2014) (discussing incentives of insider trading and impacts on public shareholders and investors).

82. *See* Tom C.W. Lin, *The New Investor*, 60 UCLA L. REV. 678, 689 (2013) (describing modern finance as "cyborg finance," which uses algorithmic trading and high frequency trading to execute most trades in the U.S. capital markets).

83. *See* Tom C.W. Lin, *The New Market Manipulation*, 66 EMORY L.J. 1253, 1271–72 (2017) ("Today, practically every significant financial institution uses some form of advanced artificial intelligence for risk analysis and investment management.").

84. *See* Lin, *New Investor*, *supra* note 82, at 688 (quoting SCOTT PATTERSON, DARK POOLS: HIGH-SPEED TRADERS, AI BANDITS, AND THE THREAT TO THE GLOBAL FINANCIAL SYSTEM 49 (2012)).

document that contains the false information, such as an annual report on Form 10-K, quarterly report on Form 10-Q, or other mandatory disclosure document. Other types of statements made to the public, for example statements on social media, may or may not be inputs into the algorithm. However, the current market price probably is an input, which may incorporate the other stray statements from the issuer. On the other hand, if the software was pre-programmed to purchase the stock regardless of price, such as software related to an index fund, then the link becomes weak again.

Damages for an algorithmic trade are more difficult to assess as well. If a high-speed trader or algorithmic trader has multiple positions in the same stock and during the same time period, and some of those quick trades are "winners" and some are "losers," then determining damages may be subject to dispute.[85] Furthermore, for these investors, establishing damages in a post-verdict phase could be expensive and contested.[86]

Courts have wrestled over the past two decades about what to do with day traders, then high-frequency traders, as a purported class of securities investors.[87] Though the only plaintiffs with revealed identities are the lead plaintiffs, courts have had to determine whether lead plaintiff candidates could be typical of the class and have common questions of law and fact predominate when the day trading lead plaintiff may face a challenge by the defendant on questions of reliance and causation.

2. Short Investors and Other Options Traders

Securities laws contemplate that the typical investor purchases stocks in companies she believes are going to increase in profitability in the future. If today's stock price theoretically represents future cash flows discounted to present value using a rate related to the probability of those continued cash flows, then an increase in the probability or magnitude of those cash flows should increase the stock price over time. However, many modern investors take positions in issuer stocks because they believe either that profitability will *decrease* in the future or that the current stock price is erroneously inflated. Investors may do this by taking various kinds of "short" positions: engaging in short sales, purchasing put options, or selling call options.

i. Short Sales

The most common short position, or at least the one that is the subject of the most

85. *See, e.g.*, Hsu v. Puma Biotechnology, Inc., 2019 WL 4295285, *5 (C.D. Cal. 2019) (determining on the "discretionary issue of whether to apply the first-in-first-out method ("FIFO") or the last-in-first-out method ("LIFO") for matching when purchased shares are sold" to use LIFO as "the more appropriate method," but not mentioning other netting or offset methods); Jaffe Pension Plan v. Household Int'l, Inc., 756 F. Supp. 2d 928, 935–36 (N.D. Ill. 2010) (holding that four federal circuit courts had held that damages are limited to "actual damages," which requires netting plaintiffs' losses against their profits, and saying that though LIFO "favors the defendants," FIFO "often gives plaintiffs a windfall").

86. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 256 F.R.D. 586, 599–600 (N.D. Ill. 2009) (admitting that "a last-in, first-out ("LIFO") analysis—without expert assistance—may be prohibitively difficult where numerous transactions are at issue" and rejecting potential lead plaintiff because whether he sustained a net loss would "consume a significant portion of the litigant's time and energy").

87. Courts have at times addressed issues surrounding "in-and-out" traders in disputes over lead plaintiff status. *See In re* McKesson HBOC, Inc. Sec. Litig., 97 F. Supp. 2d 993, 998 (N.D. Cal. 1999) (holding that including "in-and-out" profits or losses in calculation of greatest economic loss was inappropriate).

controversy, is a short sale. A short sale involves an investor selling securities at price A that the investor has borrowed (or is in the process of borrowing) from a broker-dealer. The investor is obligated to return the securities to the broker-dealer at a particular time and will pay interest proportional to the liquidity of the shares. To satisfy the obligation to return the securities, the investor will have to "cover" that original sale by purchasing identical securities at the market price on or before the due date. If the stock price has decreased between the original short sale date and the cover purchase date to (A-B), the investor realizes a profit on that transaction in the amount of B. However, if the short selling investor bets incorrectly and the stock price actually goes *up* between the sale date and the cover purchase date to (A+C), she realizes a loss of C, and that loss is not capped.[88] A "naked" short sale is one in which the short seller has not borrowed the shares or located an easy supply of these shares at the time of the sale, which may result in a "failure to deliver" the shares at settlement. Regulation SHO,[89] promulgated in 2005, prescribes time frames in which short sellers must settle the transaction.[90] Naked short sales are not illegal;[91] moreover, failures to deliver are also not necessarily violations of Regulation SHO.[92]

To observers, short selling may be described as an integral part of an efficient market, moving the share price closer to fundamental value by educated investors who are able to identify overly optimistic investor sentiment and profit from it. Short selling may also be necessary for some investors to hedge other long positions in the same security.[93] On the other hand, skeptics see short selling, particularly naked short selling, as manipulative attempts to move the market price downward for personal gain.[94]

However, the SEC has made fairly clear that short selling becomes legally problematic only when some sort of intentional manipulation or fraud is involved.[95] Exchange Act Rule 10b-21 characterizes as a "manipulative or deceptive device or contrivance" under Section 10(b):

> For any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the

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88. *See Key Points About Regulation SHO* [hereinafter *Key Points*] U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/investor/pubs/regsho.htm [https://perma.cc/GWW3-TJX4].

89. 17 C.F.R. § 242.204 (2018).

90. *See* Close-out Requirements, 17 C.F.R. § 242.204 (2009) (describing specifications for settlement).

91. *See Key Points*, *supra* note 88 ("'Naked' short selling is not necessarily a violation of the federal securities laws or the Commission's rules. Indeed, in certain circumstances, 'naked' short selling contributes to market liquidity.").

92. *Id.* ("There may be legitimate reasons for a failure to deliver.").

93. *See id.* (describing three legitimate purposes for short selling: "to profit from an unexpected downward price movement"; "to provide liquidity in response to unanticipated buyer demand"; and "to hedge the risk of a long position in the same security or related security").

94. *See* Charles F. Walker & Colin D. Forbes, *SEC Enforcement Actions and Issuer Litigation in the Context of a "Short Attack"*, 68 BUS. LAW. 687, 690–91 (2013) ("A 'short attack' on an issuer, in its most blatant form, involves massive short selling of the issuer's stock combined with the spread of negative rumors (and in many cases, the spread of misleading or outright false information) about the company in the media.").

95. *See id.* at 688, 688–89 (stating that the SEC has "deep ambivalence" regarding short selling and only gets involved when "clear evidence links short selling to demonstrably false statements that are designed to affect the market for a target issuer's securities").

> settlement date, and such person fails to deliver the security on or before the settlement date.[96]

When market participants use short selling and naked short selling to perpetuate intentional wrongdoing, then the SEC may investigate.[97] However, enforcement actions for violations of Regulation SHO are rare; successful private litigation by issuers against short sellers is even rarer.[98]

Short selling is riskier than other types of short and long investment positions because the short seller is obligated to return the relevant stocks to the lender, no matter the market price of the shares. If an investor purchases options to buy or sell securities and the market price changes so that exercising the option would create a loss for the investor (so-called "out of the money" options), then the investor merely does not exercise and loses only the premium paid for the option. If an investor purchases a security and the issuer files for a liquidating bankruptcy, then the investor's loss is capped at the purchase price of the security. A short seller's loss has no such limit.[99] If the subject security increases one thousand percent, then the short seller is obligated to purchase at that price and return the shares to the seller. Because of this, a short seller may choose to purchase the shares and return them to the lender early, if the share price begins to climb. Even if the short seller does not wish to do this, the lender may require them to do so. Suddenly climbing market prices of a stock in which the volume of short selling is significant may create a "short squeeze" that harms the short sellers.[100] As the short sellers are required to purchase shares to cover their positions, the price may rise even higher.[101]

Short selling is not an uncommon, esoteric activity in 2021. For example, short sales are tracked and reported on various websites, sometimes equaling a high percentage of the market float of a publicly traded company. For example, Nasdaq.com reports that on January 29, 2021, over 44 million shares of Microsoft Corporation were shorted.[102]

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96. *See* S.E.C., "Naked" Short Selling Antifraud Rule, 73 Fed. Reg. 61666 (2008).

97. *See, e.g.*, Options Xpress, Inc., S.E.C. Initial Decision Release No. 490 Admin. Proc. File No. 3014848 (June 7, 2013) (*vacated on other grounds by* Options Xpress, Inc., S.E.C. Release No. 3-14848 (Aug. 18, 2016)) (finding that defendants violated Regulation SHO and Rule 10b-21); Jeffrey Wolfson, S.E.C. Release No. 67451 (July 17, 2012) (accepting an offer of settlement in case in which broker-dealer violated Regulation SHO in complex transaction involving a short sale, a call option, and a sell option in which the broker-dealer without complying with closeout requirements).

98. *See* discussion *infra*, Part VI.B regarding short sellers as defendants.

99. *See Key Points*, *supra* note 88 ("Unlike a traditional long position—when risk is limited to the amount invested—shorting a stock leaves an investor open to the possibility of unlimited losses, since a stock can theoretically keep rising indefinitely.").

100. *See* discussion *infra*, Part VI.A explaining short squeezes and the events surrounding the GameStop short squeeze.

101. *See Key Points*, *supra* note 88 ("Although some short squeezes may occur naturally in the market, a scheme to manipulate the price or availability of stock in order to cause a short squeeze is illegal.").

102. *MSFT Short Interest*, NASDAQ, https://www.nasdaq.com/market-activity/stocks/msft/short-interest (last visited Oct. 14, 2021).

ii. Options Trading

Investors can purchase options as long positions or short positions.[103] Short positions are options that will increase in value as the price of a stock falls. For example, an investor may purchase (for a premium) a "put" option to sell a security at a particular exercise price A within a specified time frame.[104] If the price decreases during that time frame from A to B (A-B), then the investor may profit an amount equal to B, either by exercising the option (purchasing at price A-B and selling at A) or selling the option to another investor. If the price increases to (A+C), the investor will not exercise the option and will realize a loss in the amount of the premium.

Conversely, an investor could sell a "call" option, which would give the purchaser the option to purchase stock at price A.[105] If the stock price decreases to price A-B, then the investor will pocket the premium because the reasonable investor will not exercise the option. If the stock price increases to A+C, then the purchaser will exercise the option, forcing the investor to purchase the stock and realize a loss of C when sold to the purchaser. Like short selling, the investor's loss is not capped when selling a call option. Unlike short selling, however, this investor's only upside is the price of the premium. Investors who take short positions are likely to be program traders, high-frequency traders, or institutions.

3. Financial Institutions

Though large financial institutions do not seem at first glance to operate differently than the reasonable investor or the typical buy-and-hold investor contemplated by securities laws, recent cases have disagreed as to whether some institutional investors (in fact, the same institutional investor) make investment decisions in reliance on issuer statements and the market price of a security that incorporates those statements.[106] Sophisticated financial institutions have their own proprietary research and trading models and sometimes have access to information unavailable to retail investors.[107] In

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103. *See Investor Bulletin: An Introduction to Options*, SEC (Mar. 18, 2015) https://www.sec.gov/oiea/investor-alerts-bulletins/ib_introductionoptions.html [https://perma.cc/ZN5P-L3D9] ("Options are contracts giving the owner the right to buy or sell an underlying asset, at a fixed price, on or before a specified future date.").

104. *See id.* ("A put option is a contract that gives the buyer the right to sell shares of an underlying stock at the strike price for a specified period of time.").

105. *See id.* ("A call option is a contract that gives the buyer the right to buy shares of an underlying stock at the strike price . . . for a specified period of time. Conversely, the seller of the call option is obligated to sell those shares to the buyer of the call option who exercises his or her option to buy on or before the expiration date.").

106. *Compare In re* Vivendi Universal S.A. Sec. Litig., 183 F. Supp. 3d 458, 466 (S.D.N.Y. 2016) (holding that Capital Guardian Trust Co. was an "indifferent value investor" who ignored the market price and instead relied on its "own, carefully researched evaluation of Vivendi" and therefore could not meet the reliance element in order to recover in the successful class action) *with* Jaffe Pension Plan v. Household Int'l, Inc., No. 02 C 5893, 2012 WL 4343223 (N.D. Ill. Sept. 21, 2012) at *3 (holding that Capital Guardian Trust Co. could meet the reliance prong even if management testified that "its 'investment philosophy' suggests it is 'not true' that 'the price of a stock reflects all the information available at that time'" because management also testified that the investor would not have purchased the stock if they had known of the fraud).

107. *See* Priest v. Zayre Corp., 118 F.R.D. 552, 555 (D. Mass. 1988) (holding that lead plaintiff met the requirement of typicality because it made investment decisions based on "information readily available to other

other words, the "total mix" for institutional investors is not the same as the "total mix" for all investors, and the market price of a stock or statements from the issuer may play a lesser (or nonexistent) role in the "total mix" for a particular financial institution.

Though calculating damages for financial institutions is not difficult, particularly because they often take large, unhedged positions, linking the false statement to the decision to take a large position in an issuer is more difficult. When the investors are sophisticated and have their own research and analytic tools, then the decision to purchase the securities may be wholly unaffected by the false statement or the market price that incorporates the false statement. In many of these cases, the investor's information will suggest that the statement is false anyway or that the market price is incorrect. Knowledge of falsity breaks the link, but indifference to the falsity is more difficult to assess.

In *GAMCO Investors, Inc. v. Vivendi, S.A.*, Judge Shira Scheindlin disallowed GAMCO's claim because Vivendi rebutted the claim of reliance based on the fact that GAMCO utilized a proprietary metric that was "completely independent" of the subject of the false disclosures and the market price.[108] Though Judge Scheindlin cautioned that the ruling in this "extraordinary case" was "sharply limited to its unusual facts, and should not be taken to suggest"[109] that the options trader would not exercise the put options. Determining how much of the premium loss, if any, the false statements caused under typical loss causation analysis is problematic.

When the statements were made, the options were already "underwater" or below the strike price and not exercisable. If the truth is disclosed before the exercise date, the price could decrease to below the strike price, and then the options could be valuable. However, if the truth is not disclosed until after the exercise date, then the options are worthless. The options trader was out-of-pocket at the time of purchase the same amount that she is out-of-pocket following the fraud. Generally, securities law does not compensate traders with the amounts they believe they would have made if the fraud had not occurred, just the amounts they actually lost because of the fraud. Proving that without the false statements that the price would have declined before the exercise date requires several counterfactual steps.

Even a purchaser of a call option poses problems for causation. If the purchaser sees that the price has increased from $100 to $110 and buys call options for $115, the purchaser is making an investment based on their own opinion or guess that the price will continue to rise. If the fraud is disclosed and the price resolves to $100, then the holder of the call option will not exercise but will have a loss in the amount of the premium for the option. However, that option purchaser would not have exercised the option unless the price rose above $115, so claiming that the fraud or disclosure of the fraud caused the loss is problematic.

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investors and were not based on the type of knowledge available only to an institutional investor, or one who had direct contact with corporate officers"). By extension, the court seems to indicate that a lead plaintiff would not be typical if the lead plaintiff was an institutional investor with private knowledge.

108. 927 F. Supp. 2d 88, 101–02 (S.D.N.Y. 2013).

109. *Id.*

C. Atypical Investors and Damages

The same problems with reliance and causation continue in determining the extent of damages, even if some loss was caused by the false statements. Determining how much an atypical trader has been damaged has its own issues, and for some with short positions, damages could far exceed the investor's outlay. In fact, the total damages for a class with thousands of traders with short positions could far exceed traditional damages calculations.

For example, a typical investor's damages are capped at the price that the investor paid for the shares. If the investor bought shares at $110 after a false statement is made, but after disclosure of the truth the price falls to $100, then the investor is harmed $10. The share price cannot fall below zero because of limited shareholder liability, so the amount of the harm is capped at a worst-case scenario of $110 per share. However, the losses incurred by short sellers and options traders may not have any connection to the market price or the market capitalization.

1. Short Sellers

Short sellers calculate their losses by matching the earlier sale of the borrowed securities to the later purchase of shares at a higher price to return to the lender of the securities.[110] This reverse calculation may make sense contractually; in borrowing the shares with an obligation to return them in kind, the short seller is entering into a contract based on the market price of the shares. However, for securities fraud, the connection of the later purchase with the earlier sale of borrowed securities seems to stretch the goals of private securities litigation.[111]

2. Options Traders

If Investor A sold a call option at $92 per share when the price of Stock X was $100 (instead of purchasing a put option), then the trader will have to sell a fixed number of shares to the call option holder regardless of how high the share price rises due to the false statements. Though unlikely, the price could rise from $100 to $200, and the option seller will have staggering out-of-pocket costs. If the price continues to rise before the exercise price, the amount of potential loss is uncapped. If Company X had to compensate an unlimited number of options traders (the amount of options outstanding based on Company X shares is not limited to the number of Company X shares in the public float), then the damages calculation may bear no relation to the inherent damage in the fraudulent statement. Furthermore, the riskier the traders' original trade, the more damages they may claim. A trader that sells a call option at $92 per share would have greater out-of-pocket losses than a more conservative trader that sells a call option at

110. *See, e.g.*, Rocker Mgmt., L.L.C. v. Lernout & Hauspie Speech Prods. N.V., No. Civ.A 00-5965, 2005 WL 1366025 at *7 (D. N.J. June 7, 2005) ("In the short selling context, losses caused by artificially inflated stock prices are incurred at the time of cover.").

111. *In re* Diamond Foods, Inc., Sec. Litig., 295 F.R.D. 240, 258 (N.D. Cal. 2013) ("The parties do not dispute the requirement that class members must demonstrate damages in order to state a claim and that short sellers should be excluded from the class. Plaintiff argues that its proposed class definition explicitly requires that a class member be an investor who purchased Diamond shares during the class period and was harmed thereby. Therefore, short sellers are definitionally excluded from the class.").

$100, even if the probability of the first option ever being profitable to the trader is less. The issuer cannot be taken to suggest that sophisticated institutional investors or value-based investors are not entitled to the fraud-on-the-market presumption in general."[112] The court went on to exclude two other institutional investors from recovering, including an investor who held over 45% of the securities in question.[113]

IV. ATYPICAL INVESTORS AND THE SECURITIES FRAUD CLASS ACTION

If the typical investor is not the only type of trader (or even the most common type of trader in the market) then courts will have to develop a theory of how atypical traders can or cannot participate in securities fraud litigation. Many kinds of atypical investors, if not all, will have technical standing to bring securities fraud claims. However, allowing all atypical investors to bring securities fraud causes of action and to participate in a class action may not be consistent with the goals of securities fraud enforcement or with the remedial nature of the PSLRA.

A. Atypical Investors and Standing

To be sure, the relevant statutory and regulatory texts allow all kinds of atypical investors to sue for alleged securities fraud violations. Rule 10b-5 permits investors to bring causes of action based on "any untrue statement of a material fact" or omission of "a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" if the statement or omission is made in "connection with the purchase or sale of any *security*."[114] The term "security" is defined in both Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Exchange Act, and both definitions include both "stock" and "put, call, straddle, option, or privilege on any security." Read together, Rule 10b-5 seems to anticipate securities fraud lawsuits from investors who purchased and sold options, even if the investor neither purchased nor sold actual stock. Short sellers purchase and sell securities, though in reverse order. Program traders and institutional investors also purchase securities. Courts have uniformly assumed that atypical investors have standing to bring suits under federal securities laws.[115]

B. Atypical Investors and Reliance

Though the fraud on the market (FOTM) presumption embraced by the Supreme Court in *Basic* and *Halliburton II* arguably remains viable as a compromise shortcut to an individual reliance finding in the class certification context, the doctrine is quite wobbly

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112. *Id.*

113. *See In re* Vivendi Universal, S.A. Sec. Litig., 183 F. Supp.3d 458 (S.D.N.Y. 2016); *see also In re* Vivendi Universal, S.A. Sec. Litig., 123 F. Supp. 3d 424, 428 (S.D.N.Y. 2015) (holding that Vivendi rebutted the presumption of reliance with respect to Southeastern Asset Management, which made its own valuation of Vivendi before purchasing more than 45% of its ADRs).

114. 17 C.F.R. § 240.10b-5 (2021) (emphasis added).

115. *See* Wilamowsky v. Take-Two Interactive Software, Inc., 818 F. Supp. 2d 744, 753 (S.D. N.Y. 2011) ("[T]here is no question that a short seller can allege an actionable economic loss by making covering purchases following a corrective disclosure, although the nature of the misstatement, the corrective disclosure, and the corresponding movement of stock prices would all be inverted from the standard long-investor model.").

when closely examined in the context of atypical investor. The Court expressly pitched the compromises inherent in *Basic* and *Halliburton II* at the level of the alleged fraud as a whole. That is, the FOTM presumption applies not to any particular individual plaintiff, but rather depends upon the Court's supposition that atypical traders ultimately represent only a minority of the investors affected by an alleged securities fraud.[116]

However, just because the Supreme Court chooses to ignore at class certification the probable composition of the class does not mean that atypical traders can prove each element of a Rule 10b-5 claim. Unfortunately, courts are rarely given a chance to thoroughly analyze this because of dismissals and settlements. Upon close analysis, atypical investors, particularly short sellers, should not be able to benefit from the *Basic* presumption of reliance and may not be able to prove individual reliance in most cases. Courts, however, have not uniformly decided either way.[117]

1. Short Sellers

Investor A wishes to short Stock X, perhaps because she believes that Stock X is overpriced. She thus shorts 100 shares of stock (currently trading at $100/share), borrowing them from a broker, subject to A's promise to return the same shares in 30 days, plus interest. Assume Company X made false statements about its financial condition prior to Investor A's short sale, but the truth is disclosed before Investor A has to return the shares to the broker, driving the price downward. Investor A is able to purchase the shares on the open market for less than she sold them, pocketing the difference.

In this commonplace short sale, Investor A does not believe the signal of the market price of a security. If the test for whether a plaintiff is *not* relying on the market price signal is whether "plaintiffs would have purchased [the] securities in the same transaction and at the same prices . . . had they known that [management was] engaging in an ongoing fraud"[118] then short-sellers most definitely do *not* rely on the market price signal.[119] Investor A would have engaged in more short selling had she known that

116. *Halliburton II*, 573 U.S. 258, 273–74 (2014). The opinion quotes with apparent approval an amicus brief's description of "day traders, volatility arbitragers [*sic*], and value investors" and their trading strategies. *See also* Levy v. Gutierrez, 448 F. Supp. 3d 46, 52 (D. N.H. 2019) (holding that atypical lead plaintiffs could invoke the FOTM presumption because *Halliburton II* "affirmed that although value investors may have divergent motivations and beliefs about markets as compared to traditional investors, these investors still presumably rely on the fact that a stock's market price will eventually reflect material information.").

117. *In re* Vivendi Universal, S.A. Sec. Litig., 765 F. Supp. 2d 512 n. 65 (S.D.N.Y. 2011) ("The Court notes that whether short sellers can benefit from the FOTM presumption is unsettled."). *Compare* Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010) (rejecting the argument that short sellers cannot rely on the fraud-on-the-market presumption because the semi-strong version of the efficient capital market hypothesis requires only that false statements affect the price, not that parties believe the price to be strictly accurate) *with* Jones v. Intelli-Check, Inc., 274 F.Supp.2d 615, 632–33 (D.N.J. 2003) (holding that short sellers are not entitled to the presumption of reliance provided by the FOTM theory). *See also* Fields v. Biomatrix, Inc., 198 F.R.D. 451 (D. N.J. 2000) (holding that even though short seller was not entitled to the FOTM presumption, short seller may be able to prove individual reliance); Zlotnick v. TIE Commc'ns, 836 F.2d 818, 823 (3d Cir. 1988) (holding short sellers are not entitled to FOTM presumption).

118. Gamco Inv., Inc. v. Vivendi, S.A., 927 F. Supp. 2d 88, 103 (S.D.N.Y. 2013) (applying the test to whether Vivendi successfully rebutted the *Basic* presumption with respect to an institutional investor which utilized a proprietary metric that differed from market price).

119. *But see* Schleicher, 618 F.3d at 684 ("A person buys stock (goes long) because he thinks the current

management was engaging in fraud, with the hopes that the fraud would inevitably be disclosed, causing the stock price to decline.

On the other hand, Investor A could be shorting Stock X because she has a long position in Stock X and wants to hedge downside risk. If Investor A is purchasing short positions to hedge a different position, then the Investor A's purchasing decision is probably not affected by the market price of the security because she has contradictory and opposite positions.[120]

Whether Investor A relies on the integrity of the market price at (1) the sale of the borrowed shares or (2) the purchase of the shares that are immediately surrendered is also an interesting point. Investor A seemed to not relay on price integrity at the sale of the borrowed securities. Investor A either believes the price to be inaccurate (in a speculative short sale) or is indifferent to the price signal because she is hedging an opposite position.

On the other hand, Investor A definitely did not rely on price integrity at the later purchase of the shares to return them to the lender. Investor A is purchasing to fulfill a contract obligation and must purchase before the contract date, regardless of the price. The price signal is irrelevant. However, in a securities fraud class action, the theory of recovery must be that fraudulent statements made the price artificially increase between the sale of the borrowed securities and the purchase of the covering securities. In other words, the affected trade is the purchase of the shares to return to the lender. The purchaser in that case does not rely on the price signal in fulfilling the contract obligation to return the shares.

2. Other Options Traders

Purchasers of call options are not betting on the downfall of a company, but they are also not relying on price integrity. If Stock X is trading at $100 per share, and Investor A purchases call options exercisable at $105, then Investor A believes the market price is not accurately predicting the near future. If Investor A can prove reliance, can Investor B who purchases call options exercisable at $107? $115? If the call option is out of the money at the time of purchase, then Investor A loses money if the market price is fundamentally sound. Investor A should not be able to benefit from the *Basic* presumption of reliance.[121]

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price too low and expects it to rise; a person sells short . . . because he thinks the price too high and expects it to fall . . . If a long can participate in a class, so can a short.").

120. *But see* Argent Classic Convertible Arbitrage Fund, L.P. v. Rite Aid Corp., 315 F. Supp. 2d 666, 676 (E.D. Pa. 2004) (holding that because investor sold stock short to hedge its holdings, it was entitled to the FOTM presumption of reliance).

121. In the Tesla litigation, discussed *infra*, at § V.C., Judge Chen discussed this problem when choosing one lead plaintiff with atypical holdings over one who claimed more than $1 million in losses from purchasing call options following CEO Elon Musk's tweet that he had secured funding to purchase Tesla for $420 a share. Bridgestone purchased over $2 million in call options with an exercise price of $450. Had Musk followed through on his declaration, the options would have been worthless, so arguably Bridgestone did not rely on the tweet. *See* District Court's Response Re Petition for Writ of Mandamus, *In re* Bridgestone Inv. Corp. Ltd., 18-cv-04865-EMC, at 4 (N.D. Calif. April 2, 2019) ("Missing from Bridgestone's submission to this Court was any direct evidence that, in making the purchase of the $450 option, Bridgestone relied on Mr. Musk's tweet.").

C. Atypical Investors and Loss Causation

For many securities fraud plaintiffs, proving loss causation, or presenting sufficient evidence of loss causation to survive a motion to dismiss, can be challenging. Securities fraud plaintiffs must connect their loss, usually a drop in the value of a share bought at an artificially high price, with the disclosure of the truth.[122] Because many variables combine to create price fluctuations in the market as a whole, in particular industries, and even in a particular stock, separating out the power of the deceptive statement and the ultimate disclosure of the truth is far from easy.[123] If the defendant can convince the court that the no price drop is associated with the disclosure of the truth, then the case may be dismissed for lack of loss causation.[124]

Atypical investors, particularly short sellers and options traders, have an even more complex challenge,[125] though this particular challenge is usually not addressed in a class action until after a case is settled or (rarely) a case proceeds to a jury verdict. Courts have not uniformly concluded whether short sellers can prove loss causation.[126] Even then, the causation issue may be overshadowed by the questions of how to calculate damages for an atypical trader, but the question merits more consideration.

1. Short Sellers

For example, if Investor A believes that Stock X is overvalued at $100 per share and believes the correct price is under $90, then Investor A may enter into a short sale for $100, borrowing the shares. If the share price falls to $88, then the position yields $12 a share for the short sale, after expenses. However, if the price increases to $110 following falsely rosy statements by Company X, then the short sale would have to be closed out, booking a $10 per share loss, plus expenses. The interesting question is how much of that loss, if any, did the false statements cause under typical loss causation analysis.

The short seller's loss is not caused by disclosure of the fraud; the short seller's loss is caused by the rosy statements.[127] A long purchaser transferring the shares simultaneously would not suffer a loss at all. The short seller's loss is caused by the short

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122. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342–43 (2005).

123. *See* Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 174–76 (2009) (using *In re Merck & Co., Inc. Sec. Litig.* as example of problems connecting stock price drops to releases of information).

124. *See, e.g.*, *In re* Omnicom Grp. Inc. Sec. Litig., 597 F.3d 501, 514 (2d Cir. 2010) (affirming summary judgment because the appellant "failed to raise a material issue of fact that would support a finding of loss causation"); Gordon Partners v. Blumenthal, 293 F. App'x. 815, 817 (2d Cir. 2008) (affirming dismissal of claims based on appellant's failure to prove loss causation).

125. *In re* Cooper Cos. Sec. Litig., 254 F.R.D. 628, 641 (C.D. Cal. 2009) (holding that "short sellers, in-and-out traders and index holders" are entitled to the FOTM presumption even if they ultimately can't prove loss causation").

126. *In re* Lendingclub Sec. Litig., 282 F. Supp. 3d 1171, 1188 (N.D. Cal. 2017) ("Given the practical difficulties of tracing the shortseller's loss to any alleged fraud, excluding short sellers who incurred losses from short sales during the class period is a sensible limitation that is hereby incorporated into the class definition.").

127. Willamowsky v. Take-Two Interactive Software, Inc., 818 F. Supp. 2d 744, 753 (S.D.N.Y. 2011) (opining that a successful claim by short sellers would involve a false statement depressing the stock price before the short sale, then truth being disclosed before cover); Collier v. Aksys Ltd., 2005 WL 1949868 (D. Conn. Aug. 15, 2005), *aff'd*, 179 F. App'x. 770 (2d Cir. 2006).

sale prior to the fraud,[128] not the purchase and transfer. Courts have been quite explicit that the loss for typical investors does not occur until after the corrective disclosure, so allowing short investors to have any easier path to recovery does not make sense.

The causation problem for short sellers is entangled with the reliance question. When the short seller sold the borrowed shares at $100, she believed that the market price was wrong and was taking a position opposite to the theory that the market price incorporates all available information about the issuer. Her anticipation of a market correction may have been frustrated by the securities fraud, but her anticipation may have also been incorrect.

2. Options Traders

If Investor A believes that Stock X is overvalued at $100 per share and believes the correct price is under $90, then Investor A may purchase a put option to sell the shares sometime in the future for $92. If the share price falls to $88, then the position yields $4 per share under the option, after expenses. However, if the price increases to $110 following falsely rosy statements by Company X, then the position would yield a potential loss of $18 per share, so the cause of the option seller's loss, who was selling an extremely risky option that would have resulted in a loss without the fraud.

In other words, the trader with a short position is harmed partly by the false statement and partly by their risk-seeking position. Finally, many atypical traders will have hundreds of offsetting positions; allowing traders to be insured for half those positions seems contrary to both compensation theory and the reality of a limited pool of funds available for recovery. Because so few cases litigate the damages question for the class of plaintiffs, questions remain about how damages for atypical traders would be netted or calculated.

D. Atypical Investors as Members of a Class Action

As the above discussion suggests, when taken individually, atypical investors have challenges, some insurmountable, to proving each element of a Rule 10b-5 claim. Because of the class action mechanism, with analysis of only the lead plaintiff's holdings and ignorance of the other class members' holdings, these challenges are ignored until and unless the case goes to trial. Investors who purchase after a false statement and sell after disclosure are unhappy in the same way; courts can determine damages from the dates of the class period. However, short sellers and options traders are unhappy in different ways; the differences in exercise prices and dates will be different, the prices of premiums will be different, and the costs to borrow shorted shares will be different.

However, if courts assumed correctly that the class was made up of many atypical investors, then courts would recognize that individual questions of fact may predominate over common ones, precluding class certification.

One solution would be to create two class actions: one for typical investors and one for atypical investors; however, many investors have a combination of long positions,

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128. *Take-Two Interactive*, 818 F. Supp. 2d at 755 (holding that plaintiff "cannot plausibly articulate why those losses [from covering a short sale] are attributable to defendant's misstatements and omissions, which would not be revealed to the market for more than a year").

short positions, and options.[129] In addition, even if the class of atypical investors erroneously received the *Basic* presumption of reliance, the plaintiffs could not survive a motion to dismiss on loss causation.

V. LESSONS FROM LEAD PLAINTIFF CONTESTS: ATYPICAL INVESTORS IN THE SPOTLIGHT

The only class action plaintiffs that are visible to the defendant, the court, and even lead plaintiffs' counsel are the plaintiffs that ask the court to appoint them as lead plaintiffs. Occasionally, lead plaintiff contests become competitive and important information about those specific plaintiffs is revealed. Analyzing characteristics of lead plaintiffs can give a glimpse into that opaque world. Lead plaintiffs are, by definition, supposed to be typical of the class, so judging the class by the lead plaintiffs should be appropriate. To this end, this Article analyzes a group of 177 Rule 10b-5 cases filed in 2017 and the lead plaintiffs in those cases to determine how prevalent atypical investors are in securities fraud class actions.[130]

A. PSLRA and Lead Plaintiffs

The PSLRA did not change which investors could be part of a securities fraud class action, but it attempted to rationalize which investors could be lead plaintiffs.[131] In policing the selection of lead plaintiffs, Congress was not attempting to decrease the size of the class but rather to limit the number of frivolous claims[132] manufactured between an attorney and an affiliate of the attorney with a very small claim.[133] By creating a presumption that the court would appoint the lead plaintiff with the "largest financial interest" among the movants, Congress intended to encourage institutional investors like

129. *See Collier*, 2005 WL 1949868, at *17 (holding that the complaint of the class composed solely of short sellers was dismissed for failure to adequately plead loss causation).

130. According to Cornerstone Research, 412 securities fraud cases were filed in federal court in 2017. *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS—2017 YEAR IN REVIEW (2017), http://securities.stanford.edu/research-reports/1996-2017/Cornerstone-Research-Securities-Class-Action-Filings-2017-YIR.pdf [https://perma.cc/EH4E-HYBN]. Out of those 412 cases, 189 of them contain only 10b-5 claims. Eleven of those claims were dismissed prior to a lead plaintiff determination. One case had not yet made a determination at the time of data collection. Accordingly, this Article focuses on those 177 cases.

131. Securities Exchange Act, § 15 U.S.C. § 78u-4(a)(2)-(3).

132. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 317 ("The PSLRA's twin goals: to 'curb frivolous, lawyer' driven litigation, while preserving the investors' ability to recover on meritorious claims.").

133. *See* 15 U.S.C. § 78u-4(a)(2)(A) (requiring plaintiffs to certify that they "did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action" and disclose previous stints as lead plaintiff within the past three years); 15 U.S. § 78u-4(a)(3)(B)(vi) (prohibiting persons from being a "lead plaintiff, or an officer, director, or fiduciary of a lead plaintiff, in no more than five securities class actions during any three-year period" absent court approval). Courts have routinely approved large institutional investors as lead plaintiff, though they are frequently involved in class actions, such as public pension plans. *See* Brday v. Frontier Commc'ns Corp., 2018 WL 525485 at *1 (D. Conn. Jan. 18, 2018) (appointing public pension plan as co-lead plaintiff in face of objection that pension plan was a "professional plaintiff" because the statute "aims to protect against lawyer-drive class action litigation" and the lead plaintiff could effectively manage the litigation).

pension funds, mutual funds, and hedge funds to seek lead plaintiff status.[134] In theory, the PSLRA's lead plaintiff reforms would thus encourage sophisticated investors with large damages claims to serve, thereby providing an effective counterweight to what legislators then saw as excessive lawyer control over the plaintiffs' side of the securities litigation docket.[135]

The PSLRA requires that the court appoint a lead plaintiff "most capable of adequately representing the interests of the class members."[136] The PSLRA also creates a rebuttable presumption that the most adequate plaintiff is the person or group of persons that satisfies the requirements of Rule 23[137] and that "in the determination of the court, has the largest financial interest in the relief sought by the class."[138] Though the PSLRA lead plaintiff requirements may have changed the profile of lead plaintiffs, the new lead plaintiffs are not usually institutional investors[139] or those with large financial losses.[140]

To date, several important empirical and theoretical studies have examined the ways in which characteristics of lead plaintiffs themselves might support or conflict with congressional intent or affect litigation outcomes.[141] Among other things, commentators have (1) explored the extent to which the PSLRA has actually accomplished its stated goal of increasing participation by institutional lead plaintiffs in place of individual

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134. *See* H.R. REP. NO. 104-369, at 34 (1995) (Conf. Rep.) ("The Conference committee believes that class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions."); *see also* Stephen J. Choi, Jill E. Fisch, & A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. UNIV. L.Q. 869, 869–70 (2005) (Congress's purpose in enacting lead plaintiff provision was to "encourage institutional investors—pension funds, mutual funds, hedge funds, etc.").

135. *In re* Cendant Corp. Litig, 264 F.3d 201, 263 (3d Cir. 2001) (stating that the PSLRA was "designed to infuse lead plaintiffs with the responsibility (and motivation) to drive a hard bargain with prospective lead counsel"); Stephen J. Choi & Adam C. Pritchard, *Lead Plaintiffs and Their Lawyers: Mission Accomplished, or More to Be Done?*, *in* RESEARCH HANDBOOK ON SHAREHOLDER LITIGATION 271 (Sean Griffith, Jessica Erickson, David H. Webber & Verity Winship, eds. 2018).

136. 15 U.S.C. § 78u-4(a)(3)(B)(i).

137. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(cc).

138. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb).

139. *See* Burch, *supra* note 29, at 1121 (noting that traditional institutional investors such as banks, mutual funds, and insurance companies maintain commercial relationships with defendants or defendant's customers and are therefore loath to be lead plaintiffs in a class action against them); s*ee also infra* note 155 (discussing data from 2017 on lead plaintiffs).

140. In our dataset of claims filed in 2017, the median loss claimed by a lead plaintiff was $161,101 and the average loss was $1,350,989.44. The smallest loss claimed was $162.81 and the largest loss claimed was $46,378,080. *See* Appendix A (on file with author) (showing that in 2017, out of 177 lead plaintiffs, 11.6% claimed losses less than $10,000; 26.7% claimed losses less than $50,000; 41.3% claimed losses less than $100,000; and 58.7% claimed losses less than $250,000). *See, e.g.*, Reilly v. U.S. Physical Therapy, Inc., Memorandum of Law in Support of Motion of Sean Reilly to (1) Appoint Lead Plaintiff and (2) Approve Lead Plaintiff's Selection of Counsel, No. 1:17-cv-02347-NRB (S.D.N.Y. May 30, 2017) (alleging losses of $162.81); Memorandum Opinion and Order, Shenk v. Mallinckrodt PLC, 17-cv-00145 (DLF) (D.D.C. Mar. 9, 2018) (appointing State Teachers Ret. Sys. of Ohio as lead plaintiff with stated losses twenty times larger than opponent).

141. *See generally* Choi, Fisch, & Pritchard, *supra* note 134; David H. Webber, *Is "Pay-to-Play" Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031 (2010) (discussing the potential conflicts caused by lead plaintiffs by data analysis); James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. Rev. 1587 (2006).

natural persons,[142] (2) examined both the frequency and character of the courts' designation of lead plaintiff *groups* instead of single individuals or entities,[143] (3) analyzed the dynamics influencing larger institutional investors to eschew lead plaintiff status,[144] and (4) argued for an increased role for certain types of plaintiff groups using group dynamics theories borrowed from other social science disciplines.[145] This Article aims to start the conversation surrounding atypical plaintiffs as lead plaintiffs with a brief empirical analysis of Rule 10b-5 cases filed in 2017 and a discussion of cases that engage with whether atypical investors should be lead plaintiffs.

1. Lead Plaintiff Contests

In most class action securities fraud cases, multiple plaintiffs will file complaints alleging the same causes of action, which can be consolidated into a class action.[146] Then, the court must choose between those candidates who have filed a motion to be appointed lead plaintiff in the consolidated action. However, many times the court has only one lead plaintiff movant in front of them.[147] Other times, several plaintiffs will make motions to be appointed lead plaintiff, but all but one candidate will withdraw their motions without argument, and the remaining candidates agree to be a lead plaintiff group, or a combination.[148]

Lead plaintiff contests are common,[149] and fortunately for this analysis, movants will need to describe their trades during the proposed class period and provide evidence of losses.[150] Following these disclosures, other plaintiff movants may argue that another

142. *See* David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 NW. UNIV. L. REV. 157, 159–60 (2012) (acknowledging benefits of post-PSLRA increased appointment of institutional investors but focusing on conflicts of interest between individual and institutional investors) [hereinafter *Plight*].

143. *See* Stephen J. Choi, Jessica Erickson, & A.C. Pritchard, *Coalitions Among Plaintiff's Attorneys in Securities Class Actions* (N.Y.U. L. & Econ. Working Paper No. 20-42, 2020), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3596289 [https://perma.cc/67V9-R9YW] (finding that groups tend to form based on relationships between plaintiff counsel and between institutional investors) [hereinafter *Coalitions*].

144. *See* Charles Silver & Sam Dinkin, *Incentivizing Institutional Investors to Serve as Lead Plaintiffs in Securities Fraud Class Actions*, 57 DEPAUL L. REV. 471, 478 (2008) ("Given the alternatives an institutional investor's equilibrium strategy is to free-ride on a class action led by another investor or to file a conventional lawsuit.").

145. *See* Burch, *supra* note 29, at 1155 ("A richly representative group could alleviate adequate representation problems without jeopardizing class certification, hence the counterintuitive remedy: Appoint a diverse lead plaintiff group and link diversity to members' heterogeneous preferences.").

146. In our dataset, 113 out of 177 cases filed in 2017 had multiple complaints filed.

147. *See, e.g.*, Fields v. Biomatrix, Inc., 198 F.R.D. 451, 453 (D.N.J. 2000) ("There are no class members competing to be lead plaintiff.").

148. In our dataset of 177 cases, we determined that an almost equal number of cases involved just one motion to appoint a lead plaintiff (57 cases, 32.2%), a combination of withdrawn motions and consolidations leading to one unopposed motion (56 cases, 31.6%), and a lead plaintiff contest determined by a judge (57 cases, 32.2%). *See also* Stephen J. Choi, *Motions for Lead Plaintiff in Securities Class Actions*, 40 J. LEGAL STUD. 205, 211 (2011) (describing the phenomenon of movants to be appointed as lead plaintiff withdrawing or combining without a contest, possibly because of "side deals" between competing class counsel candidates).

149. In our dataset, lead plaintiff contests occurred in approximately one-third of filed Rule 10b-5 cases in 2017 (57 cases, 33.5%).

150. *See* Securities Exchange Act § 21D(a)(2)(A)(iv); 15 U.S.C.A § 78u-4 (requiring a sworn certification

candidate is not typical or adequate because of that investor's trading strategies or practices. The defendant can also bring these issues to the court's attention,[151] or the court could address them sua sponte. Courts have wrestled with the typicality and adequacy of various types of investors, including not only short sellers,[152] but also day traders and high frequency traders,[153] derivatives traders,[154] institutional investors,[155] and hedge funds.[156]

As stated above, the court benefits in its decision from a rebuttable presumption that the movant with the largest financial interest that meets the requirements of Rule 23 should be appointed as lead plaintiff. Therefore, courts focus on both the amount of losses of the movants and whether the movants are typical of the class and will provide adequate representation for the class.

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from each plaintiff seeking to serve as lead plaintiff that "sets forth all of the transactions of the plaintiff in the security that is the subject of the complaint during the class period").

151. Though unclear, courts have held that defendants do not have standing to oppose the lead plaintiff, but the courts then address the issues raised by the defendant anyway. *See, e.g.*, Blake Partners Inc. v. Orbcomm Inc., No. 07-4517, 2008 WL 2277117, at *1, *3 (D.N.J. June 2, 2008) ("Courts are split as to whether the defendant has standing to challenge the adequacy of a lead partner and his chosen counsel."); Fields v. Biomatrix, Inc., 198 F.R.D. 451, 454 (D. N.J. 2000) (noting that though courts disagree as to defendant's standing to oppose lead plaintiff determination, defendant could not take discovery on the issue). An interesting question is why a defendant would oppose a lead plaintiff. If there is only one lead plaintiff candidate, then the defendant has an interest in prolonging litigation or perhaps preventing class certification. However, in a lead plaintiff contest, the defendant probably has no interest in one over the other, unless the defendant has an opinion about the efficacy of the respective candidates' class counsel choices.

152. *See, e.g.*, Levy v. Gutierrez, 448 F. Supp. 3d 46, 68 (D.N.H. 2019) (holding that short sellers were typical for purposes of Rule 23 even though subject to unique defenses).

153. *See* Sklar v. Amarin Corp. PLC, No. 13-cv-06663, 2014 WL 3748248 (D.N.J. July 29, 2014) (appointing as lead plaintiff a movant who averaged 117 transactions in the stock per day and 4,565 purchases in the class period because "although a few courts have held that the presumption of "most adequate plaintiff" is rebutted as to a plaintiff who could be characterized as a day trader, most other courts have found this not to be true"). *See also* Prefontaine v. Rsch. In Motion Ltd., No. 11 Civ. 4068, 2012 WL 104770 (S.D.N.Y. Jan. 5, 2012) (holding that absent evidence to the contrary, day traders and momentum traders are not subject to unique defenses and the lead plaintiff presumption is not defeated). *But see* Bang v. Acura Pharm. Inc., No. 10 C 5757, 2011 WL 91099 (N.D. Ill. Jan. 11, 2011) (appointing investor group over individual movant with less of a financial loss in part because the volume and frequency of his trading might raise challenges to typicality and raise a unique defense regarding lack of reliance on material misstatements and omissions); Applestein v. Medivation, Inc., No. C 10-00998, 2010 WL 3749406 (N.D. Cal. Sept. 20, 2010) (holding that presumption in favor of movant was rebutted where trading raised "serious concerns" about movant's typicality); *In re* Safeguard Scis., 216 F.R.D. 577 (E.D. Pa. 2003) ("Lead Plaintiff Adal's employment as a day trader (or "position trader") who typically focuses on technical price movements rather than price, we find that even under a fraud-on-the-market theory, Defendants have presented compelling reason to rebut the reliance presumption.").

154. Andrada v. Atherogenics, Inc., 2005 WL 912359 (S.D.N.Y. April 19, 2005) (rejecting lead plaintiff whose only trades in issuer were the purchase of call options); Moskowitz v. Lopp, 128 F.R.D. 624, 631 (E.D. Pa. 1989).

155. *See Plight*, *supra* note 141, at 188 (describing how institutional investors may not be typical of the class or adequate representatives for individual investors in the class).

156. *See* City of Ann Arbor Emp.'s Ret. Sys. v. ICG, Inc., No. C-06-7453, 2007 WL 9718299 (D. W. Va. July 18, 2007) (approving hedge fund as co-lead plaintiff); *In re* Host Am. Corp. Sec. Litig., 236 F.R.D. 102 (D. Conn. 2006) (holding that hedge fund that traded in the subject stock 900 times in one day could adequately represent the class because false statements communicated to the public injure "all types of plaintiffs").

2. Largest Financial Interest

In determining which movant in a lead plaintiff contest has the largest financial interest, courts may consider "(1) the number of shares that the movant purchased during the putative class period; (2) the total net funds expended by the plaintiffs during the class period; and (3) the approximate losses suffered by the plaintiffs."[157] Unrelated plaintiffs may join together as an investor group, thus combining their losses. Though courts are skeptical of artificially formed groups,[158] they are often selected as lead plaintiffs.[159] Though this requirement should lead to more institutional lead plaintiffs, individual plaintiffs are the most common type of lead plaintiff in the 2017 Dataset.[160]

Would-be lead plaintiffs must certify as to the nature of their financial interests, but opposing plaintiffs may also seek discovery to force more financial disclosure.[161] However, questions arise as to whether plaintiffs disclose all of their trades, including options trading that may have hedged losses that they are claiming.[162] A related concern in calculating largest financial interest for atypical traders with numerous positions or off-setting positions is whether to net losses and gains and whether to match purchases and sales on a first in, first out (FIFO) or last in, last out (LILO) basis.[163] During these preliminary stages of litigation, courts are likely to postpone exact calculations until trial, which usually means postponing indefinitely.

3. Typicality and Representativeness

Typicality and representativeness refer to the suitability of the lead plaintiff to reflect the characteristics of the typical class plaintiff and to represent the entire class. However, potential differences in the types of potential lead plaintiffs themselves, their holdings, their trading strategies, and their individual trading histories[164] can produce

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157. *In re* Cendant Corp. Litig., 264 F.3d 201, 262 (3rd Cir. 2001).

158. *See* Burch, *supra* note 29, at 1135 (noting that courts have embraced smaller groups in securities class actions).

159. In the 2017 Dataset, in 177 cases, seventy-six lead plaintiffs (42.9%) of those were groups.

160. In the 2017 Dataset, in 177 cases, individual plaintiffs were lead plaintiffs in 108 cases (61.02%). Of the 63 (35.59%) institutional investor lead plaintiffs, forty-seven were pension-oriented institutional investors and fourteen were private institutional investors. Six (3.39%) lead plaintiffs in the 177 cases were groups composed of a combination of institutional and individual investors.

161. Securities Exchange Act, § 21D (a)(3)(iv); 15 U.S.C. § 78(a) ("[D]iscovery relating to whether a member or members of the purported plaintiff class is the most adequate plaintiff may be conducted by a plaintiff only if the plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class.").

162. *See In re* Grupo Televisa Sec. Litig., 2020 WL 3050550, at *8 (S.D.N.Y. June 8, 2020) (denying certification of class in case in which the lead plaintiff, Colleges of Applied Arts & Technology Pension Plan, did not disclose its share of a short position held by an investment fund that was much larger than its loss on a long position). In denying class certification, the trial court held that CAAT was not typical of the class because "[a]s an economic reality, the price drop which injured the other class members enriched CAAT thrice what it cost CAAT." *Id.* at *8; *cf. In re* Grupo Televisa Sec. Litig., 2021 WL 2000005, at *3 (S.D.N.Y. May 19, 2021) (removing CAAT's chosen lead counsel for certifying CAAT's losses in an act of fraud).

163. Jaffe Pension Plan v. Household Intern., Inc., 756 F. Supp. 2d 928, 936 (N.D. Ill. 2010) (acknowledging that "each method, however, clearly favors one party over the other").

164. For example, a trader with a long and sordid history of involvement with the SEC or other regulatory agency may face claims that their background would preclude them from adequately representing the class as lead plaintiff.

tension with respect to these two requirements. Atypical lead plaintiffs whose individual securities fraud claims give rise to defenses not shared by the class may not be considered to have typical claims and defenses under Rule 23(a)(3),[165] and atypical lead plaintiffs who may have conflicts with the class because litigating those particular defenses may not be able to "fairly and adequately protect the interests of the class" under Rule 23(a)(4).[166] Therefore, assessing whether a particular lead plaintiff is typical of the class seems more problematic than court decisions would lead a reader to believe.[167] However, courts tend to forgive atypical lead plaintiffs who may have "unique defenses" if common questions of law predominate under Rule 23(b)(3),[168] leaving those issues to a post-verdict damages phase. In almost all cases, this means that defendants will never challenge the atypical lead plaintiffs on these issues.

B. 2017 Dataset: How Typical are Atypical Lead Plaintiffs?

The intense competition among multiple lead plaintiff candidates in the *Tesla* litigation, almost all with various types of short and long positions, prompts the following questions: (1) how common it is that securities fraud cases have lead plaintiffs with short positions and (2) whether courts have focused on the complications of having atypical investors in a class for purposes of ultimate recoveries or class certification.

This paper reports results from a study of all federal 10b-5 securities fraud cases filed in U.S. District Courts during calendar year 2017, including 178 cases in which a lead plaintiff was appointed. Although the data do not suggest the atypical plaintiff situation evidenced in the Tesla litigation is rapidly becoming the norm, federal district courts designated investors with atypical holdings as lead plaintiffs in fifteen of the 178 cases (8.4%). In addition, investors with atypical holdings were asked to be appointed in thirteen additional cases but were not chosen (6.2%), sometimes because the ultimate lead plaintiff had a larger economic loss. Moreover, and more troubling, the *Tesla* case seems to be the exception rather than the rule with respect to courts' awareness of or engagement with the issues raised by atypical lead plaintiff movants' holdings. Specifically, competing traditional movants in the atypical investor lead plaintiff cases from our sample only rarely raise the "typicality" arguments that other movants' atypical holdings would seem to invite. When these arguments are raised by other plaintiffs, they are usually abandoned by sudden withdrawals by competing plaintiffs.[169] This suggests

165. *See* Grace v. Perception Tech. Corp., 128 F.R.D. 165, 169 (D. Mass. 1989) (rejecting as a lead plaintiff as "atypical" an insider and friend of an insider because they may have relied on non-market information and personal representations, rather than the integrity of the market, subjecting them to "unique defenses" at trial).

166. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 256 F.R.D. 586, 600 (N.D. Ill. 2009) (rejecting prospective lead plaintiff with possible net gains would have a standing defense that would consume much of his time, creating a conflict with a duty to represent the class).

167. *See Plight*, *supra* note 142, at 164 (noting that the cure for the conflicting incentives of lead plaintiffs and class members is to add individual investors to institutional investor groups); Burch, *supra* note 29, at 1111 ("The prescription is thus to select lead plaintiffs whose diverse preferences and motivations mirror those of the class.").

168. *See* Swack v. Credit Suisse First Bos., 230 F.R.D. 250, 264 (D. Mass. 2005) (holding that even though a lead plaintiff may face specific defenses to reliance, the class can nevertheless be adequately represented by lead plaintiff).

169. *See Coalitions*, *supra* note 143.

that traditional economic incentives may be skewed in some way by the specific dynamics of private securities fraud litigation. One possibility: because repeat player law firms do not want to limit their opportunities in the future, they rarely complain about atypical lead plaintiffs in the case in front of them. If a law firm were to win a lead plaintiff contest because of an argument against a short-selling lead plaintiff, then that firm would not be able to represent short-selling lead plaintiffs in the future.

In the thirteen cases filed in 2017 that ultimately were led by a plaintiff with atypical holdings, few lead plaintiff candidates vigorously debated whether those plaintiffs were typical and adequate representatives.[170] In one case, *In re Barrick Gold Corporation*, one of four plaintiffs vying to be appointed as lead plaintiff, BKW Living Trust, launched a robust attack against the applicant with the largest stated economic loss, Ashwini Malhrotra, prompting the court to grant discovery into whether Malhrota's trading activities precluded him from adequately representing the class:

> Malhotra has the largest financial interest in the relief sought by the class. However, BKW challenges Malhotra's ability to serve as lead plaintiff for two reasons. First, BKW argues that because Malhotra engaged in short selling during the Class Period, he must have "believed the stock price did not accurately reflect Barrick's value at the time of his short sales but rather that the stock price was inflated and would later decline." Second, BKW argues that Malhotra's in-and-out day trading suggests that he was speculating rather than relying upon Barrick's representations in his trading decisions.
>
> We recognize that short sellers and day traders are not automatically disqualified from serving as lead plaintiffs. Nonetheless, there exists a potential that Malhotra is in a unique position that would defeat typicality and adequacy.[171]

However, BKW Living Trust later withdrew its challenge, so the court appointed Malhotra without opposition.[172] In another case, *In re Kandi Technologies Group, Inc.*, one lead plaintiff candidate opposed the appointment of another candidate because the timing of his options trading precluded recoverable losses; however, the two plaintiffs eventually successfully asked to be named co-lead plaintiffs.[173] In *Rodriguez v. Gigamon*

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170. For example, in Raul v. Alcobra, Ltd., the lead plaintiff group, members of which traded call options, were appointed with no opposition. The case later was dismissed without prejudice on request of the parties. Joint Stipulation of Voluntary Dismissal Without Prejudice at 2, Raul v. Alcobra, Ltd. (S.D.N.Y. Oct. 19, 2017), (No. 17-CV-01233). In another case that was ultimately dismissed, a lead plaintiff with over $1 million in losses from both put and call options was briefly opposed before the other movant withdrew the same day based on smaller losses. Nardy v. Chipotle Mexican Grill, Inc., No. 17-CV-01760, 2019 WL 3297467, at *1, *7 (D. Colo. Mar. 29, 2019). In another case that has been dismissed with prejudice, the named plaintiff group claims losses from options contracts, but lead plaintiff contest was solely on economic loss. *In re* Galena Biopharma, Inc. Sec. Litig., No. 17-929, 2021 WL 50227, at *1, *4 (D.N.J. Jan. 5, 2021) (dismissing Second Amended Complaint on grounds that loss causation was not adequately pled).

171. Broadfoot v. Barrick Gold Corp., No. 17 CIV. 3507, 2017 WL 373844, at *1, *1 (S.D.N.Y. Aug. 9, 2017).

172. *In re* Barrick Gold Corp. Sec. Litig., No. 17 CIV. 3507, 2017 WL 4862779, at *1, *1 (S.D.N.Y. Oct. 4, 2017). This case was dismissed the next year for failure to plead scienter and garden-variety loss causation. *In re* Barrick Gold Corp. Sec. Litig., 341 F. Supp. 3d 358, 381 (S.D.N.Y. 2018).

173. *See* Stipulation & Order, Cashen v. Kandi Tech. Grp., Inc., 1:17-cv-03049-ER (S.D.N.Y. May 29, 2018). This case was ultimately dismissed on grounds that plaintiffs did not adequately plead falsity and

Inc., one party strenuously opposed the appointment of a group as lead plaintiff due to the fact that the largest losses were suffered by a group member who owned solely call options, "subjecting him to unique defenses and making him an atypical investor."[174] The investor group argued that the group member was necessary "to pursue claims for options" and better represent the class.[175] The court summarily appointed the group as lead plaintiff without discussion.[176]

Finally, in one of the eight cases, the defendants argued in a motion to dismiss that the lead plaintiff's options and the timing of the exercise or expiration precluded a finding of loss causation; however, that case was settled for $80 million prior a court ruling.[177]

How many atypical traders ultimately become lead plaintiffs is an important question, but as important is whether atypical traders are being excluded from being lead plaintiffs by the courts. In one case in our dataset, the court chose a typical plaintiff over an atypical plaintiff to be class representative, adopting arguments that the options trader would not meet the requirements of Rule 23 because all of its trading was in buying and not exercising call options, not purchasing shares, and he would be subject to individual questions of fact surrounding strike price, exercise dates, and premiums.[178] Thirteen cases in our dataset involved an atypical trader vying to be lead plaintiff unsuccessfully.

From our dataset and research in cases from other years, there is no judicial consensus about whether atypical traders can be successful plaintiffs in Rule 10b-5 cases, much less adequate class representatives in class actions. Whether atypical traders fit into the securities fraud paradigm is a question at the heart of whether atypical traders should be eligible to be lead plaintiffs in securities fraud class actions. The following discussion of a high-profile lead plaintiff contest in 2018 gives additional insight into the discussions surrounding atypical investors in these lead plaintiff contests.

C. In re Tesla, Inc.

One ongoing high-profile dispute involving multiple lead plaintiff candidates with various trading profiles highlights the importance of acknowledging the tension between

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scienter. *In re* Kandi Tech. Grp., Inc. Sec. Litig., 2019 WL 4918649 at *1, *9 (S.D.N.Y. Oct. 14, 2019) (notably, the first line of the opinion ignores co-lead plaintiff Gerald W. Klein's holdings of solely call options, saying "[c]o-Lead Plaintiffs purchased [] common stock throughout the class period"). In another case, a plaintiff opposed the motion of a plaintiff group to be lead plaintiff based on options trading and the artificial nature of the group, but later joined the group. Gallagher v. Ocular Therapeutix, Inc., 2018 WL 1371446 (D. Mass. Mar. 9, 2018).

174. Movant Babak Roushanee's Memorandum of Points and Authorities in Opposition to All Competing Motions for Appointment as Lead Plaintiff, Rodriguez v. Gigamon, Inc., at 6, 5:17-cv-00434-EJD (Apr. 11, 2017).

175. The McGowan, Kreling, and Salinas Group's Memorandum of Points and Authorities in Opposition to All Competing Motions for Appointment as Lead Plaintiff, Rodriguez v. Gigamon, Inc., at 5–6, 5:17-cv-00434-EJD (N.D. Cal. Apr. 11, 2017).

176. Order Granting McGowan, Kreling, and Salinas Group's Motion for Appointment as Lead Plaintiff, Rodriguez v. Gigamon, Inc., 5:17-cv-00434-EJD (Aug. 3, 2017).

177. *See generally In re* Yahoo! Inc. Sec. Litig., 2018 WL 4283377 (N.D. Cal. Sept. 7, 2018).

178. Reply Memorandum of Law in Further Support of Sheet Metal Workers' Pension Plan of Southern California, Arizona and Nevada's Motion for Consolidation of Related Actions, Appointment as Lead Plaintiff and Approval of Selection of Lead Counsel, 2017 WL 10403521, 17-cv-1758-UA (Apr. 3, 2017).

classical securities fraud compensation theories and the atypical trader plaintiff. On August 7, 2018, then-Tesla, Inc. Chairman of the Board and Chief Executive Officer (and current CEO) Elon Musk tweeted that he had secured financing to take the publicly-traded company private at a specific price, well above the market price.[179] He continued to post to Twitter that day about this possibility, confirming the $420 share price target and "investor support."[180] Ten days later, the *New York Times* published an article summarizing an "hourlong interview" Musk had granted the newspaper, in which the *Times* reported that the funding to which Musk's Twitter posting referred "was far from secure."[181] Tesla's share price fell substantially when the *Times* article went live,[182] and numerous putative class action securities fraud claims followed in short order. The Securities and Exchange Commission began investigating the initial tweet on August 9, 2018 and Tesla and Musk settled with the SEC on September 29, 2018.[183]

1. The Lead Plaintiff Contest

Nine plaintiffs and plaintiff groups applied to be lead plaintiffs in the consolidated Tesla securities fraud case, and only two withdrew prior to a determination.[184] For a case to attract such a large number of plaintiffs that do not subsequently withdraw is uncommonly high,[185] but what is more interesting is the variety of trading strategies employed by the plaintiffs. Because the plaintiffs had to detail their financial interests to be considered as lead plaintiffs, the contest gives a rare glimpse into the holdings of the parties. The interesting profile of these plaintiffs may be a product of one of the theories of recovery in the case: that traders with short positions were intentionally harmed by Musk when the Tesla share price rose on August 7, 2018.[186] Plaintiffs also alleged that traders with long positions were harmed by purchasing on August 7 and then having their position decline on August 17. However, plaintiffs pointed to the particular animus Elon Musk directed at Tesla short sellers during the summer of 2018 to demonstrate that Musk

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179. "Am considering taking Tesla private at $420. Funding secured." James B. Stewart, *Did Elon Musk Violate Securities Laws with Tweet About Taking Tesla Private?*, N.Y. TIMES, Aug. 9, 2018, at B1, https://www.nytimes.com/2018/08/08/business/elon-musk-tesla-sec.html [https://perma.cc/XZT4-WSKV] (calling Musk's tweet "one of the most unorthodox takeover bids ever").

180. "Investor support is confirmed. Only reason why this is not certain is that it's contingent on a shareholder vote." Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018, 2:36 PM), https://twitter.com/elonmusk/status/1026914941004001280 [https://perma.cc/BMB9-JHPW].

181. *See* David Gelles et al., *Elon Musk Details "Excruciating" Year of Sleepless Nights and Turmoil*, N.Y. TIMES (Aug. 16, 2018), https://www.nytimes.com/2018/08/16/business/elon-musk-interview-tesla.html [https://perma.cc/9PGE-CCRQ].

182. The Tesla share price closed on August 7 at $379.59, up 10% from $343.84. Following the publication of the New York Times interview on August 17, the share price closed at $305.50.

183. Press Release, U.S. Sec. and Exch. Comm'n, Elon Musk Settles SEC Fraud Charges: Tesla Charged With and Resolves Securities Law Charge (Sept. 29, 2018), sec.gov/news/press-release/2018-226 [https://perma.cc/5B3D-CNK4] (imposing a $20 million fine against Musk and the board of directors separately and requiring Musk to resign as Chairman of the Board).

184. Isaacs v. Musk, 18-cv-04865-EMC, 2018 WL 6182753, at *1 (N.D. Cal. Nov. 27, 2018).

185. Usually, as lead plaintiff candidates see other complaints filed with higher stated losses, those initial candidates withdraw their application to be lead plaintiffs.

186. For example, on June 17, 2018 Musk tweeted, "[the shorts] have about three weeks before their short position explodes." *In re* Tesla, Inc., Sec. Litig., No. 18-cv-04865-EMC, 2020, at *4 (N.D. Cal. Apr. 15, 2020). On the day of Musk's takeover announcement, he tweeted, "Ends Negative propaganda from shorts." *Id.* at *6.

intentionally increased the share price with false statements.[187]

After an unusually intense initial briefing schedule, Judge Chen of the Northern District of California named an individual, Glen Littleton as lead plaintiff. Judge Chen explicitly chose Littleton over other applicants with allegedly larger financial interests, at least in part because Littleton "held interests that cover most of the persons/entities likely to be in the class—*i.e.*, long positions in common stock, long positions in options, and short positions in options—and thus can most adequately represent the class . . ."[188] In determining which party to appoint as lead plaintiff, the court seemed to suggest that having a short position was necessary to be typical in the modern trading environment.

2. Can Only Typical Investors Be Lead Plaintiffs Now?

Shortly after the court issued its initial lead plaintiff decision, two unsuccessful lead plaintiff movants filed motions to reconsider, but the court denied the motions.[189] One aggressive movant focused on Judge Chen's apparent statement that the lead plaintiff's short positions, in combination with other positions, made him more typical and representative than plaintiffs with no short positions, *i.e.*, a typical plaintiff.[190] Several unsuccessful movants then sought the extraordinary remedy of a writ of mandamus from the Ninth Circuit Court of Appeals,[191] and that court gave the district court leave to address the petition if it so chose.

Judge Chen denied the petition, reasoning that an institutional investor with a larger stated financial interest was more problematic because part of the losses came from call options purchased after Musk's $420 tweet at a price higher than $420.[192] Because there is a strong argument that those options were not purchased in reliance on the integrity of the $420 statement, the court would have been required "to adjudicate, at a very early stage of the case, key substantive elements of reliance and loss."[193]

More specifically, Judge Chen confirmed that a lead plaintiff with both long and short positions would have an incentive to represent both types of traders, but a plaintiff with only long positions would not.[194] The short seller's loss is caused by the artificially

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187. *Id*. at 13 (quoting the Wall Street Journal, which reported that "the SEC was investigating whether Mr. Musk misled investors intentionally with his tweet in order to hurt short sellers").

188. *Isaacs*, 2018 WL 6182753 at *4.

189. Order Denying Motions to Reconsider, *In re* Tesla, Inc. Sec. Litig., 18-cv-04865-EMC (N.D. Cal. Dec. 17, 2018).

190. Bridgestone Inv. Corp. Ltd.'s Motion for Reconsideration, *In re* Tesla, Inc. Sec. Litig., 18-cv-04865-EMC (N.D. Cal. Dec. 3, 2018) ("While Bridgestone is aware of cases that hold that exclusive short sellers are atypical, it is aware of none holding that long investors with the largest loss should not be appointed as lead plaintiffs.").

191. One might wonder why a plaintiff would be so invested in being the lead plaintiff in this case. Lead plaintiffs generally receive no more in compensation than other plaintiffs, but the lead plaintiff attorneys assigned to the case will receive a fee award paid by defendants should there be a settlement. Attorneys for class members do not get attorney fees paid by the defendant in these cases. The contest is driven by the attorneys.

192. District Court's Response Re: Petition for Writ of Mandamus, Bridgestone Investment Corp. Ltd. v. United States District Court for the Northern District of California, San Francisco, at *4, 3:18-cv-04865-EMC (N.D. Cal. April 12, 2019) ("missing from Bridgestone's submission to this Court was any direct evidence that, in making the purchase of the $450 option, Bridgestone relied on Mr. Musk's tweet.").

193. *Id.* at *4.

194. *See id.* at *5–6.

high price, but the long purchaser's loss is closed by the disclosure of the fraud and subsequent stock drop.[195] Ironically, this conflict between short and long investors also arises, according to Judge Chen, because the defendants will have defenses against short sellers based on reliance.[196] If short sellers purchase shares to cover, they may not be purchasing in reliance on the fraudulent statements. This argument may go too far: Judge Chen's arguments for why lead plaintiffs may need to have short positions is also an argument for excluding them from securities fraud class actions completely.

3. Showdown at Trial?

The issues raised by Judge Chen are not issues exclusively for the selection of the lead plaintiff. These issues are important ones for determining the composition of the class, the appropriateness of the *Basic* presumption, and the proving of other elements of a Rule 10b-5 cause of action, such as loss causation. However, these issues will probably not be litigated in the *Tesla* litigation. Not only did the defendants' unsuccessful motion to dismiss not raise the "unique defenses" Judge Chen hinted toward regarding reliance and loss causation,[197] the parties stipulated as to certification of the class.[198] Should this case go to trial, which is highly unlikely, these issues will probably not be raised.

The Tesla lead plaintiff litigation highlights the general importance of two discrete, underexplored scholarly inquiries. First, it demonstrates the importance of assessing the extent to which modern stock and derivatives trading techniques and strategies raise *traditional* concerns about lead plaintiff selection that Congress nonetheless could not have anticipated in 1995. In other words, it suggests that we should ask whether new practices raise old problems. Second, it suggests that careful review of the dynamics inherent in the lead plaintiff determination are warranted, insofar as changes to the ways in which investors trade might also produce a *new* set of perverse effects militating in favor of a revised approach to the problem Congress attempted to address a quarter-century ago with its 1995 reforms.

VI. SHORT SELLERS AS SECURITIES FRAUD VICTIMS

The usual legal conversation around short sellers is whether short sellers are manipulating the stock price of a particular stock.[199] These types of trading strategies,

195. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 346 (2005) (finding that a plaintiff could satisfy the loss causation requirement by alleging that a security's price at the time of purchase was inflated due to misrepresentation).

196. *See* District Court's Response, *supra* note 192, at *6 (noting that Bridgestone's call options would subject it to the claim at class certification that the plaintiff was not representative of the class).

197. *See* Notice of Motion and Motion to Dismiss Consolidated Complaint for Defendant, *In re* Tesla, Inc. Sec. Litig., 3:18-cv-04865-EMC, No. 227 (N.D. Cal. Aug. 10, 2018).

198. *See generally* Stipulation and [Proposed] Order for Class Certification at 2, *In re* Tesla, Inc. Sec. Litig., 3:18-cv-04865-EMC (N.D. Cal. Aug. 10, 2018) ("WHEREAS, for purposes of class certification only, Defendants stipulate that Tesla, Inc. common stock, options, and other securities traded in an efficient market at all relevant times and do not seek to rebut the presumption of reliance.").

199. *See, e.g.*, Sharette v. Credit Suisse Int'l, 127 F. Supp. 3d 60 (S.D.N.Y. 2015); Cohen v. Stevanovich, 722 F. Supp. 2d 416, 424 (S.D.N.Y. 2010) ("Plaintiffs' broad and conclusory allegations of naked short selling do not state a claim for market manipulation" under Section 10(b) or 9(a)); ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87 (2d Cir. 2007).

whether real or perceived, are at the heart of CEOs' ire against "the shorts."[200] If Las Vegas gamblers bet against a particular team in the Super Bowl, the effect on the team's performance is negligible. Generally, more bets with the same opinion generally do not move reality to match the opinion. However, short selling reflects an opinion about market value, and heavy short selling can influence market value. The possibility that short sellers could intentionally influence market value is real and a more common concern than long purchasers intentionally influencing the market value in the same way.[201] However, as discussed below, January 2021 gave us some examples of long purchasers being accused of influencing market value to the detriment of short sellers.

No discussion of how short sellers fit into the securities fraud regime can ignore these notable developments. Short sellers could theoretically be market victims of three types of securities regulation violations: cases involving a fraudulent misstatement made by the issuer or its agents that affects long investors as well as short investors under Rule 10b-5. Cases involving a fraudulent misstatement by the issuer or its agents seemingly designed to affect short investors in a deliberate manner as in the Tesla lawsuit and a similar suit against Overstock.com, Inc.[202] and cases involving nonissuer market participants acting alone or in concert with the deliberate intent to manipulate market prices in a way that harms short sellers.

A. Market Manipulation Against Short Sellers

Recently, events involving retail investors communicating with one another via social media have shown that ordinary investors with small stakes may be able to manipulate a market in a publicly-held stock with the same effect as issuer misstatements. Most examples of "pump and dump" schemes in which promotors extol the virtues of an issuer to increase the price of the stock and sell at the top of the market involve thinly traded, over-the-counter stocks with small market capitalization.[203] The low price of

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200. The most vocal opponent of short selling is Patrick Byrne, former CEO of Overstock.com, Inc., who has not hesitated to file lawsuits against short sellers. *See, e.g*, Overstock.com, Inc. v. Gradient Analytics, Inc., 151 Cal. App. 4th 688 (2007); Christine Hurt, *Overstock.com v. Gradient (and the Rest of the World)*, CONGLOMERATE (July 16, 2007), http://theconglomerate.org/2007/07/overstock-v-html [https://perma.cc/M2SD-PE5E]. Byrne also created a website, Deep Capture, to investigate naked short selling and other conspiracies perhaps ignored by traditional media. *See* Sheelah Kolhatkar, *A Tycoon's Deep-State Conspiracy Dive*, NEW YORKER (Dec. 7, 2020), newyorker.com/magazine/2020/12/14/a-tycoons-deep-state-conspiracy-dive [https://perma.cc/2CNY-WPSW] (profiling of Byrne and discussing how concerns about naked short selling figure into his tightly wound and increasingly skeptical theory of the world).

201. Sharette, 127 F. Supp. 3d at 78 (finding that plaintiffs had pleaded facts that gave rise to a strong inference of scienter under Section 10(b) and 9(a)(2)).

202. *See also* Class Action Complaint for Violations of Fed. Sec. L., Ha v. Overstock.com, Inc., No. 2:19-cv-00709 (D. Utah Sept. 27, 2019). This class action lawsuit was brought against Overstock investors, including a short seller lead plaintiff, surrounding Overstock's announcement in 2019 that it would pay a stock dividend on September 23 as a digital token that could not be sold for six months under Rule 144. *See* Overstock.com, Inc., Current Report (Form 8-K) (July 27, 2019). Because the digital token belonged to the owner of the shares that short sellers had borrowed, they were forced to cover early, as the price was rising in reaction to the dividend announcement, to return shorted sales. Days before the record date, Overstock postponed the dividend and announced the new digital token would be registered and freely transferable. Press Release, Overstock.com, Inc., Overstock.com to Distribute Freely Tradable Series A-1 Preferred Shares in Upcoming Dividend (Sept. 18, 2019), http://investors.overstock.com/node/18976/pdf [https://perma.cc/Q5HJ-HLMU].

203. *See, e.g.*, Complaint, SEC v. Nielsen, No. 5:20-cv-03788, 2020 WL 3067104, at ¶ 1–2 (N.D. Cal.

these "penny stocks" can change wildly with a moderate number of trades and statements to investors.[204] The emergence of internet communication boards in the past few decades have increased the ease with which bad actors, who may be affiliates of the company or merely market participants, can manipulate the markets in this way. However, to duplicate such a pump and dump scheme in a publicly-traded stock would take intentional coordination among significant numbers of investors making substantial purchases. Enter the internet.

1. Reddit, WallStreetBets, and the GameStop Short Squeeze

Aided by easy communication on Reddit's WallStreetBets site and commission-free trades on Robinhood and other online broker apps,[205] retail investors flexed their market muscles the last week of January 2021, driving the stock price of GameStop, AMC Entertainment theaters, and others.[206] Posts encouraging others to buy shares in these "meme stocks"[207] drove their prices sky-high. In the case of GameStop, a company

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June 9, 2020) ("Defendant Nielsen, an individual investor who owned approximately 10% of the common stock of Arrayit posted numerous false and misleading statements on an internet forum that were designed to encourage other investors to buy Arrayit stock and, thereby, drive up the price of the stock. Nielsen then sold his shares of Arrayit stock at the artificially—inflated price and reaped the profit."); Salvani v. ADVFN PLC, 50 F. Supp. 3d 459, 472 (S.D.N.Y. 2014), *aff'd*, 628 Fed. Appx. 784 (2d 2015) (holding that issuer and shareholder did not have 9(b) or Rule 10b-5 claims based on false statements by "brkylnrusso" on InvestorHub because plaintiffs did not rely on statements they knew were false").

204. Press Release, U.S. Sec. and Exch. Comm'n, Investor Alert: Fraudulent Stock Promotions (July 29, 2015), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-35 [https://perma.cc/B23R-ML3Y] ("Microcap stocks (low-priced stocks issued by the smallest of companies), including penny stocks (the very lowest priced stocks), are more susceptible to stock price manipulation. Publicly-available information about microcap companies often is scarce, making it easier for fraudsters to spread false information.").

205. *See* Nathaniel Popper & Kellen Browning, *How a Guy in His Basement Helped Fuel the GameStop Frenzy*, N.Y. TIMES, Jan. 30, 2021, at A1, https://www.nytimes.com/2021/01/29/technology/roaring-kitty-reddit-gamestop-markets.html [https://perma.cc/4U9B-HUP8] (focusing on Keith Gill, who began the GameStop rally by posting as "Roaring Kitty" on Reddit and YouTube, first because he thought Wall Street did not understand gaming, then out of anger at short sellers, and then just to keep the huge profits coming). Though Gill claimed he had no investment clients, he worked for a registered securities broker-dealer firm, MML Investment Services, LLC. MML terminated his employment but paid $4 million to settle claims brought by the Massachusetts Secretary of the Commonwealth arising from failure to supervise Gill's excessive trading and social media usage. *See* Dean Seal, *'Roaring Kitty' Ex-Employee Fined $4 Million Over GameStop Posts*, LAW360.COM (Sept. 16, 2021, 2:12 PM), https://www.law360.com/articles/1422451 [https://perma.cc/M8HV-2N79].

206. *See* Matt Phillips & Taylor Lorenz, *'Dumb Money' Is on GameStop, and It's Beating Wall Street at Its Own Game*, N.Y. TIMES (Jan. 27, 2021), https://www.nytimes.com/2021/01/27/business/gamestop-wall-street-bets.html?searchResultPosition=3 [] (reporting on calls on WallStreetBets for investors to "coordinate their collective buying power on targets that are most likely to amplify price pops"). Much of the discussion on WallStreetBets takes the form of memes, screenshots of losses ("loss porn"), and personal analysis from day traders. *See* Matt Phillips, *4 Things to Know About the GameStop Insanity*, N.Y. TIMES (Jan. 28, 2021), https://www.nytimes.com/2021/01/28/business/gamestop-stock-market.html?searchResultPosition=1 [https://perma.cc/Y47L-U4P2] (reporting that in 2020, day trading has surged, perhaps because of pandemic boredom or the shut down of professional sports and sports gambling).

207. Like internet memes, "meme stocks" become extremely popular for a short period of time. *See* Taylor Lorenz & Mike Isaac, *The Misfits Shaking Wall Street*, N.Y. TIMES, Jan. 31, 2021, at BU1, https://www.nytimes.com/2021/01/29/technology/stock-traders-reddit-tiktok-youtube.html

struggling to avoid bankruptcy, its share price increased from $20 per share to $483 at the height of the rally.[208] This huge investor demand was stoked not by new positive information, however, but by WallStreetBets community members, who dared one another to keep buying in an attempt to exact revenge on Wall Street and on wealthy hedge funds with large short positions.[209] Though started by retail investors, professional investors rode the wave of optimism to profits as well.[210]

Though some day traders surely lost money by joining at the top of the wave and selling too slowly, the investors most visibly harmed were those with short positions in the meme stocks. These short sellers either sold call options with exercise prices in the future or borrowed shares from a broker-dealer and sold them, with an obligation to return the shares at a future date when the stock price is lower, thus generating a profit. In either case, the short seller will have to purchase the stock at future prices to cover their obligations. As the price rises, the seller's obligation grows, and this potential loss is unlimited. As sellers begin to purchase at increasing prices to cap their losses, the purchases make the price go even higher, squeezing the short sellers.[211] Short squeezes can happen naturally due to new positive information in the market or because shareholders with large positions purchase sizeable blocks in the open market.[212] At the end of January 2021, some prominent short sellers with large positions in GameStop stock were forced to cover their positions, resulting in huge losses.[213]

In the midst of the trading frenzy, Robinhood and some other no-fee trading platforms stopped allowing some trading in the meme stocks, resulting in very unhappy investors. Investors opening the mobile apps the morning of January 28 saw that the purchase feature had been disabled.[214] The New York Stock Exchange and the Nasdaq

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[https://perma.cc/3WZF-E49J] (quoting Zaid Admani, 29, as saying [y]ou know how we have memes that become super popular and everyone uses them for a while, then they crash? Those stocks are like that.").

208. *See* Dave Michaels, *GameStop Mania Is Focus of Federal Probes Into Possible Manipulation*, WALL ST. J. (Feb. 11, 2021), https://www.wsj.com/articles/gamestop-mania-is-focus-of-federal-probes-into-possible-manipulation-11613066950 [https://perma.cc/7YSH-FD8C] (focusing on the investigation into potential misconduct in the surge of GameStop stocks in early 2020).

209. *See id.* (focusing on claims that WallStreetBets traders used a "pump and dump" scheme to manipulate the market, which have yet to receive verification).

210. *See id.* (quoting Michael Friedman, head of trading at LEX Markets, as saying "[i]t sounds like retail guys were a smokescreen for real professionals doing the professional hardball warfare that has always existed, and the only difference this time is there was a retail smokescreen in front of them").

211. *See* Lou Whiteman, *3 Things Investors Need to Know About Short Squeezes*, MOTLEY FOOL (Jan. 25, 2021, 8:31 AM), https://www.fool.com/investing/2021/01/25/3-things-investors-need-to-know-about-short-squeez/ [https://perma.cc/V6RH-NWU5] (providing investors with background knowledge on reasons to tread lightly around short-selling).

212. Ironically, 2020 was a year-long short squeeze for short sellers of Tesla from natural causes. *See* Dana Hull & Esha Dey, *Tesla's Short Sellers Lost $38 Billion in 2020 as Stock Surged*, BLOOMBERG (Dec. 31, 2020, 6:07 AM), https://www.bloomberg.com/news/articles/2020-12-31/tesla-shorts-sellers-lost-38-billion-in-2020-as-stock-surged [HTTPS://PERMA.CC/U3YS-3GQF] (ascribing robustness in market price to "adamant long shareholders").

213. Kevin Roose, *The GameStop Reckoning Was a Long Time Coming*, N.Y. TIMES (Jan. 28, 2021), https://www.nytimes.com/2021/01/28/technology/gamestop-stock.html [https://perma.cc/S62F-EJGH] ("One of the hedge funds that had shorted GameStock, Melvin Capital, had to get a $2.75 billion bailout from two other investors after it was hammered with huge losses.").

214. *See* Catherine Thorbecke, *Robinhood Abruptly Restricts Transactions for GameStop Stock*, ABC NEWS (Jan. 28, 2021, 4:30 PM), https://abcnews.go.com/Business/robinhood-abruptly-restricts-transactions-

Stock Market have occasionally halted trading of a stock for a short period during the trading day or delay the trading in the stock at the opening bell because of an expected company announcement. The SEC also has authority to suspend trading for up to ten days in a stock because of worries about the issuer or about market manipulation. In 2020, the SEC suspended trading in 113 stocks.[215] However, a brokerage generally does not halt or suspend trading in its own corner of the market. Robinhood's stated reasoning was that Depositary Trading & Clearing Corporation, which clears trades for brokerage firms before the trade is settled by the parties, required more capital for Robinhood as security due to the large volume of purchases from its customers.[216] By not allowing customers to purchase the most popular stocks, Robinhood delayed having to raise more funds to meet the deposit requirements. However, other platforms also prohibited trading at the same time. For example, on the platform Stash, users were not able to view the stock price of the relevant meme stocks on January 28.

Depending on the point of view, the question of who the victims were in this activity is debatable.[217] The enthusiastic purchasers of GameStop and the other stocks cynically might argue that they have historically been victims of short sellers who manipulate the market as an investment strategy.[218] To them, the short sellers at best hit companies when they are down and at worst drive prices artificially downward with naked short positions that result in more shares being shorted than are in the public float. On the one hand, "squeezing the shorts" may just restore the stock price to fundamental value or may just beat them at their own game. The final insult to the retail investors was that Robinhood and other trading platforms restricted purchases in these stocks, stopping the game just when they were winning.

The short sellers would argue that the short squeeze unfairly targeted them and their information-driven trading strategy. Short selling provides information into the market price and can move prices to fundamental value. Because the trading was specifically for

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gamestop-stock/story?id=75537922 [https://perma.cc/DNM6-9BWZ] (discussing Robinhood's decision to not only restrict GameStop purchases, but to "also restrict [] certain transactions for other stock[s] touted by the sub-Reddit page r/wallstreetbets").

215. The SEC maintains a list of trading suspensions by year on its website. *See* SEC, Trading Suspensions –Archive 2020, https://www.sec.gov/litigation/suspensions/suspensionsarchive/susparch2020.htm [https://perma.cc/Q5KF-9N96] (listing stocks in 113 companies for which trading was suspended in 2020).

216. *See* Nikhilesh De, *What Really Happened When Robinhood Suspended GameStop Trading*, COINDESK.COM (Feb. 16, 2021, 7:03 AM), www.coindesk.com/what-really-happened-when-robinhood-suspended-gamestop-trading [https ://perma.cc/C6WH-G87F] (Explaining that Robinhood may have suspended trade in certain securities due to clearing firm costs).

217. Gary Gensler, Chairman of the SEC, testified to Congress in May 2021 on the need to update regulations in response to the "gamification" of stock investing through mobile apps, which use "points, rewards, leaderboards, bonuses, and competitions" and other behavioral prompts to entice traders to engage in trading activities on these apps. *See GameStop Short Selling/Market Volatility (Part III): Hearing Before H. Comm. on Fin. Svcs.*, 116th Cong. (May 6, 2021) (statement of Gary Gensler, Chairman of the Securities and Exchange Commission).

218. *See* Lorenz & Isaac, *supra* note 206 ("Many young users on the WallStreetBets forums have complained that no matter what they do, the deck is always stacked against them. Many say they seek to expose the entire financial system for the game that it is."). S*ee also* Matt Taibbi, *Suck it, Wall Street*, TAIBBI.SUBSTACK.COM (Jan. 28, 2021), https://taibbi.substack.com/p/suck-it-wall-street [https://perma.cc/NGL3-H2KE] (calling the GameStop fiasco an "updated and superior version of Occupy Wall Street").

the purpose of creating huge losses for short sellers, those harmed investors may argue that the traders intentionally distorted the market.

Here, the issuers were not harmed by rising share prices, though a meme stock frenzy in the other direction ("let's all short the stock to show the private equity!") could destroy a company's value as collateral damage. In the case of GameStop, the rally may have staved off bankruptcy.

2. Short Sellers as Plaintiffs

Short sellers may be harmed by short squeezes designed to force short sellers to suffer losses from their positions as the price of the stock increases. However, short squeezes themselves are not illegal unless there is an additional intent to distort the market for the security or the short squeeze is effectuated by fraudulent misstatements into the market.[219] For example, if one large investor felt that Company A stock was underpriced because of large-scale short selling, that investor could purchase large blocks of Company A stock. This activity might be large enough to increase the market price to the level of the fundamental value and would effectuate a short squeeze at the same time; however, the investors actions, even if in concert with other like-minded investors or investment funds, would not violate securities laws. If the investor just thinks it would be enjoyable to squeeze the short sellers and is indifferent to profiting from it, then this is probably also not actionable.

However, if the investor did not believe that Company A stock was underpriced but engaged in a deceptive scheme to increase the price for her own gain, this can be a violation of Section 10 of the Securities Exchange Act and Rule 10b-5. An example would be giving the impression of trades or sales that weren't occurring, such as "spoofing." If the person making positive statements about the stock to increase the price is being compensated by the issuer, and the person does not disclose the relationship, the statements may be considered illegal "touting."[220] If the investor makes fraudulent statements to increase the price, those statements violate Rule 10b-5.[221] Though this resembles an allegation in a pump and dump scheme, the statements must be specific enough to be actionable and not just mere "puffery."

In the Reddit/GameStop rally, investors with short positions are beginning to file lawsuits against the online bull rally leaders.[222] Short sellers, and possibly the SEC, will

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219. *See* Bruce Brumberg, *Investigations Into GameStop Trading and Reddit: Former SEC Enforcement Chief Provides Insights*, FORBES (Feb. 9, 2021), https://www.forbes.com/sites/brucebrumberg/2021/02/09/investigations-into-gamestop-trading-and-reddit-former-sec-enforcement-chief-reveals-insights/?sh=2093529e5efe [https://perma.cc/WY4G-FNBH] (quoting former Chief of the Office of Internet Enforcement at the SEC, John Reed Stark, as saying "a short squeeze is not an illegal market manipulation so long as there is no intent to artificially distort the market for a security").

220. Securities Act of 1933 § 17(b).

221. *See, e.g.*, Class Action Complaint, SEC v. O'Rourke, 19-CV-4137 (E.D.N.Y. July 17, 2019) (alleging violations of, among other things, Section 10 of the Securities Exchange Act and Rule 10b-5 in connection with scheme in which defendants cold called elderly investors and made fraudulent statements to encourage them to purchase the stock, driving the price up and then selling their own shares to the investors at the higher prices). This action has settled as to one defendant, with disgorgement of over $5 million as part of the remedy. SEC v. O'Rourke, 2020 WL 656125 (E.D.N.Y. Nov. 9, 2020).

222. *See* Class Action Complaint, Iovin v. Gill, 3:21-cv-10264-MGM (D. Mass. Feb. 16, 2021) (alleging that "Roaring Kitty" (Gill) violated Sections 9(a)(2), 9(a)(3), and 9(a)(4), as well as Rule 10b-5). Plaintiff Iovin

have to be able to identify the Reddit users and their statements, and then prove that the statements were both material and false. The statements that have appeared in the press seem either to be nonfactual opinions or expressive of nondeceptive intent. For example, "GME IS THE HOLY GRAIL . . . WE ARE STILL GOING TO THE MOON . . . IT IS NOT TOO LATE TO BUY"[223] does not seem like a misstatement of material fact. One popular post just read, "GME!!!" with emojis.[224] Some participants in these really treat the stock market as a game of chicken, with those brave enough to hold onto stocks during volatility as having "diamond hands," while those who fold have "paper hands," with postings merely egging traders on.[225] Other statements were not about the value of GameStop but about the excitement of watching the price increase to the detriment of the short sellers: "THIS IS PROOF OF OUR STRATEGY. BUY SHARES. BLEED THE SHORTS. F— THE INSTITUTIONS. HOLD THE LINE."[226]

These are not false statements about the state of the issuer, GameStop; moreover, whether a "reasonable investor" would consider these types of statements as important given the total mix of information about an issuer is doubtful. A Rule 10b-5 claim would be hard to support without different types of statements.[227] At this time, however, federal regulators including the SEC, Department of Justice, and CFTC are investigating these transactions. To date, no short sellers have filed lawsuits against Reddit users as plaintiffs. To do so would require these large, prominent short sellers to disclose their positions and possibly open themselves up to regulatory scrutiny under Regulation SHO.[228]

B. Market Manipulation by Short Sellers

On the other hand, between January 28, 2021 and February 18, 2021, plaintiffs have filed over ninety separate lawsuits stemming from the events in January involving the stock of GameStop, American Airlines, Nokia, and Bed, Bath, and Beyond.[229] However, none of these lawsuits were filed by the short sellers that were squeezed, such as Citadel or Melvin Capital. Instead, these lawsuits were filed by investors using the Robinhood app or other online brokerage app to buy and sell securities. The lawsuits named Robinhood and an array of other brokerage houses, clearinghouses, and institutional investors as defendants. The causes of action also differ among these filings; some

sold 2000 call options on GameStop stock at $100 share, requiring him to cover at $300 per share. *Id.* at 20.

223. Chris Prentice & Pete Schroeder, *EXPLAINER: Why Regulators May Scrutinize GameStop's Reddit-driven Retail Stock Surge*, REUTERS (Jan. 27, 2021, 2:53 PM), https://www.reuters.com/business/why-regulators-may-scrutinize-gamestops-reddit-driven-retail-stock-surge-2021-01-27/ [https://perma.cc/Y2GE-VJLR].

224. Cecilia D'Anastasio, *A Fight Over GameStop's Soaring Stock Turns Ugly*, WIRED (Jan. 22, 2021, 8:31 PM), https://www.wired.com/story/gamestop-stock-wall-street-bets-short-squeeze/ [https://perma.cc/Y4VP-TQKQ].

225. *Id.*

226. *Id.*

227. *See* Brumberg, *supra* note 219 ("Trying to build a successful enforcement case amid the litany of Reddit user discussion, puffery, rhetoric, and overall chaos is like chasing fruit flies in a tornado.")

228. *See* 17 C.F.R. § 240.200 et seq (defining "short sale" and marking requirements).

229. *See, e.g.*, Clapp v. Ally Fin., Complaint, 3:21-cv-00896 (N.D. Cal. Feb. 4, 2021); Cobos v. Robinhood Financial LLC, 2:21-cv-00843 (C.D. Cal. Jan. 29, 2021); Ross v. Robinhood Financial LLC, 4:21-cv-00292 (Jan. 29, 2021) (exemplifying short sale litigation).

complaints allege breach of contract, breach of the implied duty of good faith and fair dealing, breach of fiduciary duty, negligence, violations of the Sherman Act, and fraud. Some of the complaints allege violations of various provisions of the Securities Exchange Act of 1934.

In approximately twelve of these complaints, short sellers appear as co-conspirator defendants of the brokerage defendants. For example, in *Clapp v. Ally Financial*, plaintiffs allege that

> The Brokerage Defendants, Fund Defendants and Clearinghouse Defendants (together the "Defendants") conspired to prevent the Retail Investors from buying any further stock and forcing Retail Investors to sell their Relevant Securities to artificially suppress stock prices of the Relevant Securities . . . Defendants and their co-conspirators conspired to prevent the Retail investors from buying further stock in order to mitigate the Fund Defendants' exposure in their short positions.[230]

Other plaintiffs pointed out that institutional investors, such as short selling hedge funds, were allowed to continue trading on these platforms.[231]

Whether these actions are successful remains to be seen and depends upon the various theories of recovery. One cause of action alleging violations of Section 9 and 10 of the Securities Exchange Act regarding market manipulation,[232] was denied a temporary restraining order[233] because the judge found that it was not more likely than not that the plaintiffs would have standing under Section 9(a)(2) and failed to show intent under Section 9(d).[234] Market manipulation under either Rule 10b-5 or Section 9 requires more than just evidence of short selling; the short sales must be used as part of an intentionally deceitful scheme.[235] However, many of the lawsuits allege violations of

230. Clapp Complaint, *supra* note 229, at 2–3 (naming as "Fund Defendants" Citadel Enterprise Americas LLC, Citadel Securities LLC, Melvin Capital Management LP, "and other unnamed co-conspirators"); Complaint, Moody v. Robinhood Financial, LLC, 3:21-cv-00861 (C.D. Cal. Feb. 3, 2021) (naming as defendants Citadel Enterprise and Citadel Securities).

231. *See* Complaint, Dechirico v. Ally Fin.l Inc., 1:21-cv-00677 (S.D.N.Y. Feb. 8, 2021) (naming as "Fund Defendants" Citadel Enterprise, Citadel Securities, Melvin Capital, and Sequoia Capital Operations LLC).

232. Market manipulation under Rule 10b-5(c) requires both misrepresentations or omissions and "wash sales, matched orders, rigged prices, or some other manipulative act intended to mislead investors by artificially affecting market activity"). Sharette v. Credit Suisse Int'l, 127 F. Supp. 3d 60, 77 (S.D.N.Y. 2015). Section 9(a)(2) requires a showing of "(1) a series of transactions in a security creating actual or apparent trading in that security or raising or depressing the price of that security; (2) carried out with scienter and (3) for the purpose of inducing the security's sale or purchase by others." *Id.* at 78.

233. *See* Minute Order Denying Plaintiffs Ex Parte Application for a Temporary Restraining Order and Order to Show Cause Re: Preliminary Injunction, Cobos v. Robinhood Fin. LLC, 2:21-cv-00843 (Feb. 10, 2021) (discussing the denial of the temporary restraining order).

234. Section 9(a)(2) of the Exchange Act prohibits persons from effecting transactions that create actual or apparent active trading in a security, or raise or depress the price of such security, for the purpose of inducing the purchase or sale of such security by others. To have standing the plaintiff would have to show that they bought or sold a security at a price which was affected by such act or transaction. In other words, merely being prevented from purchasing a security, or selling for a gain, would not provide standing in that action. Section 9(d) prohibits effecting a "manipulative short sale."

235. ATSI Commc'ns, Inc. v. Shaar Fund, 493 F.3d 87, 101 (2d Cir. 2007) ("To be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security.").

federal antitrust law and state laws regarding antitrust, securities laws, trade practices, contract, and tort. Those causes of action may be more fruitful.

VII. SAVING SECURITIES FRAUD LITIGATION

The private securities fraud class action is viable only because of assumptions about investors and the market that do not withstand close scrutiny. Though Justice Roberts saved the class action for another day by reasoning that because most investors are typical investors, the *Basic* presumption of reliance remains sound, whether even that qualified assumption is true is questionable. Maintaining that claim over time will become more difficult as courts see more atypical investors as lead plaintiff candidates. This Article, however, does not recommend that the private cause of action be legislatively abolished.[236] Instead, to preserve private securities litigation under Rule 10b-5 as norms shift, Congress could make statutory changes to ensure that the certified class contains only typical investors, and that only those net losses caused by the false statement in question are calculated as damages.

A. Amend the Definition of "Security" for Purposes of Section 10 of the Exchange Act

All sorts of atypical investors have standing under Rule 10b-5 because of the broad definition of "security" in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, which encompasses various derivatives, including puts, calls, and options. For purposes of private lawsuits under Rule 10b-5, Congress could create a separate definition of "security," or specify which securities could form the basis of a lawsuit. Excluding derivatives from the definition could serve to narrow the universe of potential plaintiffs.

The PSLRA was an attempt to create a more administrable model of private securities litigation than 10b-5 had become in the mid-1990s. If the stereotypical securities fraud victim is the buy-and-hold plaintiff relying on the integrity of the market, then perhaps restricting the universe of purported plaintiffs could achieve that goal. Section 11 and Section 12 claims have a smaller universe of potential plaintiffs and specifically limit plaintiffs to those who did not know the false statement was false. Limiting the universe of 10b-5 claimants to certain types of typical investors could serve the same purpose.

Although this would exclude purchasers of options that do not exercise the option, it would not exclude those who exercise options and purchase or sell shares in the class period or those who sold options in therefore were obligated to sell or to purchase shares. The definition could, however, exclude shares purchased pursuant to option obligations. In addition, the definition could exclude shares purchased to cover short sale obligations to lenders of securities.

Administratively, such a rule may be hard to follow. Many plaintiffs have multiple positions, some common stock holdings, and some atypical holdings. A plaintiff may be able to allege losses from typical holdings, but should gains from atypical holdings offset

236. Some scholars and industry participants have proposed a mandatory arbitration scheme for securities fraud. *See* Henderson & Pritchard, *supra* note 23, at 26 (discussing such mandatory arbitration scheme).

them?

B. Adopt Shareholder Holding Periods

In other areas, the law requires shareholders to hold shares for a certain amount of time to enjoy certain rights. If the shareholder securities law wants to protect is the long-term investor in common equity of a firm, then Rule 10b-5 claims brought by holders of shares could impose a holding requirement. This sort of rule would exclude high-speed traders, short sellers who purchase merely to return borrowed shares, and options traders who purchase to satisfy an obligation under an option. The holding period would need to be long enough, however, to exclude those traders, and long enough so that typical investors who purchase shares with investment intent have a cause of action if a fraud is disclosed shortly after purchase.

C. Change Calculation of Damages

Any reform that excludes types of investors or types of holdings will not have an effect unless class certification and the *Basic* presumptions is changed. The only investors that the court sees are lead plaintiff candidates, not the whole class. The class can be defined as only particular kinds of investors who would be eligible under reforms, but that new definition might not change settlement behavior. Even with a narrower set of class members, damages may remain astronomical and too uncertain for defendants to push for a trial.

Congress could amend Section 21D of the Exchange Act to require plaintiffs to calculate damages in a realistic, practical way.[237] Claims involving certain types of issuers could have damage caps,[238] similar to state law caps for some types of torts claims. Here, the damage cap could be tailored to the size of the market cap of the issuer, average daily volume, and other objective metrics.

D. Codify a Reality-Based Rule for Reliance

The court in *Halliburton II* was given an unpleasant choice: uphold the FOTM theory of reliance espoused by *Basic* or eliminate private securities fraud litigation. Faced with the choice, one cannot fault the majority for choosing the former. Congress should give securities traders, issuers, and courts a "medium place."[239]

Acknowledging that the judicial creation of class-wide reliance rests on shaky ground, Congress should amend Section 21D of the Exchange Act to allow for class-wide reliance regardless of the efficiency of the U.S. capital markets. Reliance on market prices is at best a legal fiction, and a statutory provision could eliminate the adherence to an outdated presumption.

237. *See id.* at 26 (suggesting a compromise of allowing companies to amend their charters to waive FOTM in exchange for unjust enrichment damages, which would be considerably lower than shareholder loss damages).

238. *See* Langevoort, *supra* note 52, at 660 (opining that a "floating standard" as a percentage of a measure such as "market capitalization, net assets or gross income" would be workable).

239. *The Good Place: Mindy St. Claire* (NBC television broadcast Jan. 19, 2017) (revealing a "Medium Place" that is not the Good Place or the Bad Place, but in between, which will later become the inspiration for designing a new afterlife).

Instead, Section 21D could merely not require a showing of reliance by certain types of investors in certain types of cases. Admittedly, securities fraud is a tort, and reliance has long been an element of fraudulent misrepresentation for individual frauds.[240] Reliance, however, is not an element of an SEC enforcement action,[241] a Section 11 claim,[242] or a Section 12(a)(2) claim.[243] Policy reasons and alternative safeguards substitute for reliance in those claims, and Congress could fashion something similar with respect to Rule 10b-5 claims. Otherwise, the private securities fraud class action lawsuit seems like it might have an existential crisis again twenty-five years after *Halliburton II*.

VIII. CONCLUSION

In 1988, the Supreme Court reasoned that "[t]he modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences."[244] Over thirty years later, the modern securities markets are just as different from the 1988 markets as they were from the earlier days Justice Blackmun had in mind. Similarly, our understanding of reliance must change to encompass those differences.

The FOTM presumption is a legal fiction. Just as there are no fertile octogenarians or precocious toddlers, there may be fewer and fewer investors who purchase stock in reliance on the price integrity of the market price. Institutional investors armed with software and research, short sellers and options traders, and high-speed traders are not occasional tourists to the markets, but important daily market participants. Securities regulation should acknowledge this, not just with broker-dealer regulation, but also with reforming private securities class action litigation. If the private securities fraud lawsuit depends on the continued application of the legal fiction of the *Basic* presumption, then it will eventually disintegrate. These lawsuits have a role to play in the U.S. enforcement ecosystem. Efforts to codify class-wide reliance, perhaps in a compromise with damage caps or other reforms, would ensure its continued existence.

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240. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 9 Fraud ("One who fraudulently makes a material misrepresentation of fact, opinion, intention, or law, for the purpose of inducing another to act or refrain from acting, is subject to liability for economic loss caused by the other's justifiable reliance on the misrepresentation.").

241. SEC v. Aprizzo, 689 F.3d 204, 213 (2d Cir. 2012) ("Thus, while a plaintiff must prove reliance (a concept closely akin to causation) in a private securities fraud suit. . . , there is no such requirement in an SEC enforcement action." *Id.* (citing Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 341–42 (2005); SEC v. KPMG LLP, 412 F. Supp. 2d 349, 375 (S.D.N.Y. 2006)).

242. Securities Act of 1933 § 11(a) (allowing "any person acquiring such security" to sue if the registration statement "contained an untrue statement of a material fact").

243. *Id.* § 12(a)(2) (creating liability for "any person who offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact" to the purchaser).

244. Basic Inc. v. Levinson, 485 U.S. 224, 243–44 (1988).