Volume 18 | Issue 3 Article 7

Spring 1985

Rule 10b-5 Securities Fraud: Regulating the Application of the Fraud-on-the-Market Theory of Liability, 18 J. Marshall L. Rev. 733 (1985)

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RULE 10b-5 SECURITIES FRAUD: REGULATING THE APPLICATION OF THE FRAUD-ON-THE-MARKET THEORY OF LIABILITY

Over the last decade, several federal courts of appeals[1] have recognized the "fraud-on-the-market" theory[2] of liability in private[3] Rule 10b-5[4] securities[5] fraud actions. Under this theory, the

1. The fraud-on-the-market theory has been applied in various forms by the Second, Fifth, Ninth, Tenth and Eleventh Circuits. *See, e.g.*, Lipton v. Documation, Inc., 734 F.2d 740 (11th Cir. 1984) (applying the fraud-on-the-market theory to class action alleging that the defendant's deception inflated securities prices in the open, developed market), *cert. denied*, 105 S.Ct. 814 (1985); T.J. Raney & Sons v. Irrigation Fuel Auth., 717 F.2d 1330 (10th Cir.) (bond purchaser stated adequate grounds for relief by alleging that the defendants knowingly conspired to bring unlawfully issued bonds to market with the intent to defraud), *cert. denied*, 104 S. Ct. 1285 (1983); Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981) (purchaser of stock relied on newspaper article based on a fraudulent annual report), *vacated as moot sub nom.* Price Waterhouse v. Panzirer, 459 U.S. 1027 (1982); Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc) (purchaser of revenue bonds brought successful class action against issuers to recover for default), *cert. denied*, 459 U.S. 1102 (1983); Blackie v. Barrack, 524 F.2d 891 (9th Cir.1975) (certifying a class action for persons who purchased stock of a public company after the company released misleading financial statements), *cert. denied*, 429 U.S. 816 (1976).

2. The theory is also known as the "market impact" theory. Zuckerman v. Harnischfeger Corp., 591 F. Supp. 112, 122 (S.D.N.Y. 1984).

3. The courts expanded the application of Rule 10b-5 from a public cause of action for the federal government into a private cause of action. *See, e.g.*, Superintendent of Ins. v. Bankers Life and Cas. Co., 404 U.S. 6, 13 n.9 (1971) (inferring a private cause of action under Rule 10b-5); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa 1947) (holding that Rule 10b-5 could be the basis of a private suit to rescrind a securities transaction).

In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court held that a private cause of action under Section 10b and Rule 10b-5 had to contain an allegation of "scienter." The Court defined "scienter" as a "mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12. The Court declined to consider whether reckless behavior could constitute scienter. *Id.* Several circuit courts have adopted the position that "recklessness" is a sufficient basis for 10b-5 liability. *See, e.g.*, Healey v. Catalyst Recovery of Pennsylvania, Inc., 616 F.2d 641 (3d Cir. 1980); Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1043-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

4. Rule 10b-5 was created to combine Section 17(a) of the 1933 Securities Exchange Act and Section 10(b) of the 1934 Securities Exchange Act. A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD, § 2, p. 27 (1982) [hereinafter referred to a BROMBERG & LOWENFELS]. Section 17(a) was aimed at preventing fraud in the sale of new stock issues by brokers. *Id.* at p. 16. Section 10(b) was intended to prevent fraud in existing stocks. *Id.* at p. 27. *See* 8

SEC. 1 ANN. REP. 10 (1942) (Rule 10b-5 applies to stock purchase by anyone while the prior rules applied only to purchases by brokers).

Rule 10b-5, promulgated under the 1933 and 1934 Securities Exchange Acts, states the following:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make 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 under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection . . . with the purchase or sale of any security.

17 C.F.R. & 240, 10b-5 (1983).

According to a 1942 SEC statement, the purpose of 10b-5 was to extend the prohibition against fraud in connection with the sale and purchase of securities to all investors. SEC. EXCHANGE REL. NO. 3230 (May 21, 1942). Rule 10b-5 was promulgated to prevent inequitable and unfair practices and to insure fairness in securities transactions generally. 3 L. LOSS, SECURITIES REGULATION 1455-56 (2d ed. 1961).

Over the years three other views of the Rule's purpose have been proposed: (1) to promote fairness in the market; (2) to facilitate the flow of information to the public; and (3) to prevent misappropriation of information. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 I. LEGAL STUD. 801, 804 (1980). *See* Heller, *Disclosure Requirements Under Federal Securities Regulations*, 16 BUS. LAW. 300 (1961) (purpose of 1934 Act was to enact investors to obtain information essential to investment analysis).

The fraud-on-the-market theory has been used often in class action securities suits. In Healy v. Rhoades, 99 F.R.D. 540 (N.D. Ill. 1983), the court held that plaintiffs in a fraud-on-the-market securities class action satisfied numerosity, commonality, typicality and adequacy of representation requirements for class action certification. The case involved purchase of common stock of an acquiring corporation whose stock was alleged to be artificially inflated by the defendant. Plaintiffs established that common question of fact or law predominated over individual questions, justifying certification.

Several commentators have suggested that amendments to Federal Rule of Civil Procedure 23, allowing absent members of a class to share in a favorable judgment or settlement unless they specifically requested to be excluded from the class, was one factor that led to the liberalization of Rule 10b-5 in open market transactions under the fraud-on-the-market theory. Dooley, *Liability and Investment Banking*, 58 VA. L. REV. 776, 830 (1972); *see also* Stefen, *The Private Placement Exemption: What to Do About a Fortuitous Combination in Restraint of Trade*, 30 U. CHI. L. REV. 211 (1963). These commentators suggest that the fraud-on-the-market theory was designed for procedural and efficiency concerns of class action suits. The practical applications of the theory in the cases support this view since courts have used the theory to eliminate the need for every plaintiff to demonstrate individual reliance. Without the individual reliance hurdle, the potential for more plaintiffs and larger recovery is dramatically increased. *See* Note, *The Fraud-on-the-Market*, 95 HARV. L. REV. 1143, 1159 (1982).

5. The word "securities" refers to many types of investment transactions, including but not limited to, stock, bonds, and any instrument offered to the public by any company, evidencing or representing any right to participate in the profits, earnings or distribution of assets of any business carried on for profit. BALLANTINE'S LAW DICTIONARY, 1155 (3d ed. 1969). *See* People v. McCalla, 63 Cal. App. 783, 820 (1925).

10b-5 plaintiff[6] is entitled to a rebuttable presumption of reliance on the defendant's[7] material misrepresentation or non-disclosure in the sale of securities.[8] The investor may rely on the expectation that securities markets are free from fraud,[9] that market prices are validly set,[10] and that there has been no market manipulation.[11] In essence, the fraud-on-the-market theory enables an investor to assume that a security is accurately priced on the open market.[12]

The fraud-on-the-market theory's presumption of reliance is a departure from the traditional 10b-5 cause of action,[13] where the plaintiff must prove that the plaintiff's purchase or sale of securities was affected by a device or scheme to defraud involving the defendant,[14] the defendant misrepresented or omitted facts regarding the security with an intent to deceive or with reckless disregard for the truth,[15] the misrepresentation or omission was material,[16] the

6. Plaintiffs in a fraud-on-the-market cause of action are generally individual investors who do not have any direct dealings with the issuer or underwriter.

7. Defendants in a fraud-on-the-market case are generally the issuers whose misstatements distort the securities price.

8. Shores v. Sklar, 647 F.2d 462, 468 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983). Reliance has been a traditional element of proof in a 10b-5 claim. Grossman v. Waste Management, Inc. 589 F. Supp. 395, 400 (N.D. Ill. 1984). Reliance is a subjective determination based on whether a particular investor considered the fraud a substantial factor in an investment decision. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

When reliance is presumed to exist in a 10b-5 claim, it means that the defendant bears the burden of showing that plaintiff's decision to enter into a security transaction was not dependent upon defendant's alleged fraud. Blackie v. Barrack, 524 F.2d 891, 905 (9th Cir. 1975), *cert.denied*, 429 U.S. 816 (1976).

The ALI Federal Securities Code has proposed dispensing with reliance entirely in cases involving transactions "effected in markets" and imposes liability on fraudulent sellers or buyers without proof of reliance. FED. SEC. CODE 1703(b) (Proposed Official Draft 1978). *See generally* Whalen, *Causation and Reliance in Private Actions under SEC Rule 10b-5*, 13 PAC. L.J. 1003 (1982); Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 WASH. & LEE L. REV. 861 (1982).

9. Blackie v. Barrack, 524 F.2d at 907.

10. *Id.*

11. *Id.*

12. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.) (holding that the plaintiff corporation was entitled to recovery under Section 14(e) of the 1934 Securities Exchange Act and under Rule 10b-6), *cert. denied*, 414 U.S. 910 (1973). *See also*, Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982) [hereinafter cited as *Fraud-on-the-Market Theory*].

13. *Fraud-on-the-Market Theory*, *supra* note 12, at 1153.

14. Grossman v. Waste Management, Inc. 589 F. Supp. 395, 400 (N.D. Ill. 1984) (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

15. Grossman v. Waste Management, Inc. 589 F. Supp. at 400, *citing* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). For "reckless disregard of the truth," see Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1043-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

16. Grossman v. Waste Management, Inc., 589 F. Supp. at 400, (citing TSC Industries, Inc. v. Northway, 426 U.S. 438, 440 (1976)).

plaintiff justifiably relied on the misrepresentation or omission,[17] and the plaintiff suffered economic loss as a result of the fraud.[18] Because reliance and materiality relate to the critical issue of causation in securities fraud cases, the fraud-on-the-market theory significantly effects the causation issue by creating a rebuttable presumption of reliance. The theory does not entirely eliminate proof of causation; rather, the rebuttable reliance presumption shifts the burden to the defendant to disprove reliance.[19] The plaintiff must still prove the other 10b-5 elements, including materiality.[20]

As the fraud-on-the-market theory gained acceptance, courts began to apply it to different circumstances with inconsistent results.[21] Its inconsistent application raises three questions. First,

17. Grossman v. Waste Management, Inc., 589 F. Supp. at 400.

18. *Id.*

19. Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

20. A. BROMBERG, SECURITIES LAW § 8.6 at 210-11 (1979) [hereinafter cited as BROMBERG]. Materiality has always been a required element in 10b-5 cases. *Id.* at 214. It establishes the causal link by demonstrating the significance of the misconduct in relation to the loss incurred. Courts which do not recognize a presumption of reliance use materiality to determine whether the reliance was justifiable. Holdsworth v. Strong, 545 F.2d 687, 698 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977). *See generally* BROMBERG, § 8.7, at 214; W. PROSSER, HANDBOOK OF THE LAW OF TORTS, 685-86 (4th ed. 1982); RESTATEMENT (SECOND) OF TORTS, § 525 (1962). The Supreme Court held that a fact was material if there was a substantial likelihood that a reasonable shareholder or investor would consider it important in determining a course of conduct. Affiliated Ute v. United States, 406 U.S. at 427.

Several early securities cases found adequate causation without proof of actual reliance if the defendant's deception was material. *See, e.g.*, Chris-Craft Industries v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.) (holding for plaintiffs on basis of "constructive reliance" and applying § 14(e) of the 1934 Securities and Exchange Act and Rule 10b-6, 17 C.F.R. § 240), *cert. denied*, 414 U.S. 910 (1973); Green v. Wolf Corp., 406 F.2d 291, 295 (2d Cir. 1968) (the fraud-on-the-market theory was first called the "artificially inflated market price theory"), *cert. denied*, 395 U.S. 977 (1969); SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968) (anyone with inside information must abstain from trading while such inside information remains undisclosed), *cert. denied sub. nom.* Coctes v. SEC, 394 U.S. 976 (1969).

21. *Blackie, Panzirer* and *Documation* applied the presumption of reliance to cases involving existing securities on developed markets.

Despite these dangers, the Supreme Court has reversed the trend toward broader 10b-5 recovery because of the dangers of vexatious litigation. Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (holding that Rule 10b-5 or § 10(b) extends only to conduct involving manipulation or deception). The Court recently expressed a desire to limit the increasing amount of 10b-5 litigation. *See, e.g.*, Dirks v. Securities and Exchange Commission, 103 S. Ct. 3255 (1983) (holding that unless an insider's tip amounted to a breach of his fiduciary duty, the tippee is not subjected to a duty to disclose or refrain from trading); Chiarella v. United States, 445 U.S. 222 (1980) (mere possession of nonpublic insider information does not give rise to a duty to disclose); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (limiting a 10b-5 action to actual purchasers or sellers of securities). These decisions represent the Supreme Court attempts to promote the goals of federal securities laws while simultaneously regulating should the rebuttable presumption of reliance apply to both material misrepresentation cases and non-disclosure cases? Second, should the reliance presumption apply to claims involving undeveloped as well as developed markets? Finally, should the theory apply to newly issued securities as well as securities traded on secondary markets?[22]

In exploring these three issues, this comment examines the origins of the fraud-on-the-market theory and its current application. It concludes with a discussion intended to regulate the theory's application to ensure its proper and effective use. The comment proposes that the theory's reliance presumption should apply to both material misrepresentation and non-disclosure cases. In addition, the theory should apply only to active securities traded on developed secondary markets and should not apply to newly-issued securities nor to undeveloped markets. Finally, the theory should provide a realistic standard to enable the defendant to overcome the theory's rebuttable presumption of reliance.

THE ORIGINS OF THE FRAUD-ON-THE-MARKET THEORY

The 1934 Securities Exchange Act and Rule 10b-5 were drafted broadly to cover many types of securities fraud.[23] The deceptively

their applications. The circuit courts should attempt to do the same thing by regulating, and thereby standardizing the fraud-on-the-market theory's application. *Shores* and *T.J. Raney* have applied the theory to newly issued securities on undeveloped markets, while other courts have applied the theory only to developed, secondary markets. The circuits have created a judicial inequality by applying the theory to contrasting circumstances.

This author believes that the fraud-on-the-market theory is valid and should be accepted because it promotes market integrity by facilitating defrauded investors in the recovery of their losses. However, the theory's current inconsistent applications and results reached by the courts has created judicial inequality among the circuits. The theory's uneven application has created confusion and conflict between the competing securities policy considerations of encouraging market integrity, Blackie v. Barrack, 524 F.2d at 907, warning investors of marketplace risk, Shores v. Sklar 647, F.2d at 483 (Randall, J., dissenting), and maintaining judicial economy. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). Without proper regulation, the fraud-on-the-market theory could weaken the causal nexus between the alleged fraud and the loss suffered, thereby threatening judicial economy because an unlimited number of plaintiffs could have triable 10b-5 cause of action using the fraud-on-the-market theory of liability. For example, a stock purchasers whose stock declines in value later discovers some corporate misconduct which occurred either before or after the stock decline. The purchaser could attempt to recover for fraud on the market as a whole even if the misconduct did not actually cause the stock price to decline. If unregulated, the theory could risk opening the floodgates of litigation to an unmanageable number of plaintiffs, given the volume of investor participation in today's markets. *T.J. Raney*, 717 F.2d at 1330.

22. A secondary market is a market on which already issued securities are traded, as distinguished from newly, issued securities.

23. Senator Fletcher, one of the sponsors of the 1934 Act, indicated that Section 10(b) of the Act was intended to prevent all kinds of price manipulation

simple language of 10b-5[24] underscores the general purposes of the rule and of the Act: to protect investors and to restore confidence in the securities markets.[25] The Rule's broad language provides the courts with flexibility to shape the required elements for a 10b-5 cause of action. The change in the reliance requirement from proof of actual reliance to a reliance presumption is one example of the flexibility courts have exercised in securities fraud cases.[26]

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which would hurt investors. BROMBERG & LOWENFELS *supra* note 4, at 13 n.110. Thomas Corcoran, one of the drafters of Section 10(b), described the Act as a "catchall clause [intended] to prevent manipulative devices." *Id.* at § 2, p. 23.

Section 10(b) of the 1934 Act, the precursor of Rule 10b-5, provides in part:

> It shall be unlawful for any person, directly or indirectly . . . (b) 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, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78 (1982).

In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Supreme Court held that the Securities Acts were designed to "protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing." *Id.* at 195. *See* H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-5 (1933). Section 10(b) of the 1934 Act should be read "flexibly, not technically and restrictively." Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475 (1977), *quoted in* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 91971).

24. Rule 10b-5 provides in part that:

> It shall be unlawful for any person, directly or indirectly, . . . (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made, not misleading . . .

17 C.F.R. § 240 (1982).

25.

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secrecy of important information obstructs the operations of the markets as indices of real value.

H.R. REP. NO. 1383, 73d Cong., 2d Sess. 10 (1934). *See also* H.R. REP. No. 85, 73d Cong., 1st Sess. 3-4 (1933). *Cf.* Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Law*, 93 HARV. L. REV. 322, 334 (1979) (goals were protection of investors and market efficiency); Knauss, *Disclosure Requirements—Changing Concepts of Liability*, 24 Bus. Law. 43 (1968) (primary purpose of Acts was to protect investors from fraud); Doyle, *The Fraud on the Market Theory: A Unified Concept of Causation in Rule 10b-5 Open Market Actions*, 12 LOY. U. CHI. L.J. 727 (1981) (10b-5 enacted to instill new confidence in nation's markets).

26. The elements of the traditional 10b-5 action developed from Shores v. Sklar, 647 F.2d 462 (1981). To recover under a fraud claim at common law, a plaintiff must prove five elements: 1) a false representation, 2) of a material fact, 3) scienter or defendant's part including an intent to induce, 4) plaintiff's justifiable reliance on the inducement, and 5) the resulting damages. RESTATEMENT (SECOND OF TORTS) §§ 525-526 (1962); *see* W. PROSSER, HANDBOOK OF THE LAW OF TORTS 685-86 (4th ed. 1982). Although the elements of Rule 10b-5 developed from the common law of fraud, the Supreme Court decided that the common law only provided limited guidance for actions under 10b-5. Blue Chip

Courts had required proof of actual reliance in establishing causation in a 10b-5 case until 1972 when the United States Supreme Court decided *Affiliated Ute Citizens v. United States.*[27] In *Affiliated Ute*, the Ute Indian Tribe sued a bank which had encouraged the Indian tribes to sell their shares of stock of a corporation consisting of tribal assets without disclosing to them material facts that reasonably could have influenced their decision to sell.[28] The court held that, in cases involving non-disclosures or omissions, proof of actual reliance was not necessary and plaintiffs were entitled to a presumption of reliance.[29] The Court reasoned that proof of reliance on an undisclosed set of material facts was too high an evidentiary hurdle for the 10b-5 plaintiff to overcome.[30]

The *Affiliated Ute* holding opened the door for the development of the fraud-on-the-market theory. Prior to *Affiliated Ute*, the plaintiff had to prove that he or she actually relied on the defendant's misstatements or omissions which in turn directly caused the loss suffered.[31] After *Affiliated Ute*, proof of actual reliance in non-disclosure cases was no longer necessary. While *Affiliated Ute* established a rebuttable presumption of reliance in non-disclosure cases, the Supreme Court did not address the issue of whether reliance could be presumed in cases involving affirmative misrepresentations.[32] Some courts have interpreted *Affiliated Ute* narrowly,

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Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975) (face-to-face dealings regulated by the common law differ from anomymous trading on national markets). Courts have significantly departed from the common law elements of fraud in 10b-5 claims. In List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.) (suit for lost profits due to non-disclosure by insider purchasing stock of minority stockholder), *cert. denied*, 382 U.S. 811 (1965), the court held that the investor was no longer required to show a relationship of trust with the defendant. *Id. List*, in effect, abandoned the traditional common law requirement of privity as it applied to securities fraud cases because of the virtual elimination of face-to-face transactions. *Id.*

27. 406 U.S. 128 (1972).

28. *Id.* at 153.

29. *Id.* at 153-54.

30. *Id.* at 142.

31. Ordinarily, a plaintiff in a traditional 10b-5 claim had to prove as an element of causation actual reliance on the defendant's fraud. Sharp v. Coopers & Lybrand, 649 F.2d 175, 186 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). *See generally* Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir.) (discussing elements necessary for private recovery for 10b-5 violations), *cert. denied*, 434 U.S. 911 (1977); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.) (discussing the meaning of "reliance" in a case of nondisclosure under Rule 10b-5), *cert. denied*, 382 U.S. 811 (1965). In an affirmative misrepresentation case, a plaintiff could show reliance by showing that "his reliance is a substantial factor in determining the course of conduct that results in his loss." RESTATEMENT OF TORTS § 546 (1936). In a non-disclosure case, a plaintiff could prove actual reliance either by "demonstrating a subjective state of mind that conflicted with the concealed information or by showing that he consciously put his trust in the defendant's advice." *Fraud-on-the-Market Theory, supra* note 12, at 1144.

32. The United States Supreme Court has denied certiorari to all cases to date involving the issue of fraud-on-the-market.

limiting the presumption of reliance to non-disclosure cases.[33] Others have interpreted *Affiliated Ute* broadly, extending the reliance presumption to cases involving affirmative misrepresentations.[34] The Supreme Court has neither addressed the broad interpretation of *Affiliated Ute* nor the validity of the fraud-on-the-market theory and its permissible boundaries.

APPLICATION OF THE FRAUD-ON-THE-MARKET THEORY

The United States Courts of Appeals for the Second, Fifth, Ninth, Tenth, and Eleventh Circuits have applied the fraud-on-the-market theory in varying degrees and with inconsistent results.[35] The broadest application of the theory remains in the Ninth Circuit. In *Blackie v. Barrack*,[36] the court extended the presumption of reliance to material misrepresentation cases. In *Blackie*, the plaintiffs purchased Ampex Corporation securities during a twenty-seven month period between the release of the 1970 and 1972 annual reports. They claimed that Ampex had misrepresented its financial condition in the 1970 report.[37] The *Blackie* court found that the misrepresentations sufficiently influenced the market's price so that causation could be established in the impersonal stock exchange context by proof of purchase and by proof of materiality of misrepresentations, without direct proof of reliance.[38] The court

33. *See, e.g.*, Sharp v. Coopers & Lybrand, 649 F.2d 175, 186 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) (reliance is an element of plaintiff's actions under Rule 10b-5 regarding misrepresentation); Rifkin v. Crow, 574 F.2d 256 (5th Cir. 1978) (investor class action to recover for stock prices inflated by misleading statements made by corporate defendant); St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040 (8th Cir. 1977) (corporation not liable for stock loss not caused by any material omissions), *cert. denied*, 435 U.S. 925 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1040-42 (7th Cir. 1977) (record must establish plaintiff's reliance on material misrepresentations and omissions), *cert. denied*, 434 U.S. 875 (1978); Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976) (en banc) (plaintiffs required to show that sellers' reliance on buyers' misrepresentations was justifed), *cert. denied*, 430 U.S. 955 (1977); Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975) (finding of non-reliance on alleged non-disclosure of a material fact defeated plaintiffs' cause of action); Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 482 F.2d 880, 884-85 (5th Cir. 1973) (stock purchaser could not recover for non-disclosure absent proof of reliance on particular omissions).

34. *See supra* note 1 and accompanying text. *See also* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974) (holding that plaintiff need not prove reliance on misstatement or omission in order to recover), *cert. denied*, 421 U.S. 976 (1975).

35. *See supra* note 21 and accompanying text.

36. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

37. *Id.* at 894.

38. *Blackie*, 524 F.2d at 906. The court concluded that proof of purchase and proof of materiality were enough to establish a causal link between defendant's conduct and plaintiff's loss. *Id.* *See* In re Memorex Security Cases, 61 F.R.D. 88, 101 (N.D. Cal. 1973); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 593 (1975).

held that the actual reliance requirement imposed an unreasonable and unnecessary evidentiary burden on the plaintiff.[39]

Blackie also established a standard to rebut the presumption of reliance which a defendant could meet by either proving that an insufficient number of shares were traded based on the misrepresentation, or that the plaintiff, despite knowledge of the misrepresentation, still purchased the stock.[40] While a defendant could theoretically rebut the presumption of reliance, this standard proved to be a difficult burden to overcome.[41] Nevertheless, the significance of *Blackie* is that the court applied the fraud-on-the-market's rebuttable reliance presumption to a misrepresentation case. Thus, the plaintiff need not have actually known of the defendant's fraud as long as the plaintiff can establish that the fraud adversely affected the market price. The *Blackie* court did not, however, extend its holding to securities fraud on undeveloped or primary markets.[42]

The Second Circuit[43] has taken a similar approach in applying the fraud-on-the-market theory to securities fraud involving a developed, secondary market. In *Panzirer v. Wolf*,[44] the court held that the plaintiff may recover under the theory even though she never saw the misrepresentations contained in an annual report.[45] Proof of actual reliance on the misrepresentation was unnecessary.[46] The plaintiff read *The Wall Street Journal* and relied on the market's integrity to assimulate accurate information.[47] The court held that, if the plaintiff can link the loss suffered to the defendant's fraud by showing that the fraud was a substantial or significant contributing cause, then the plaintiff has established sufficient reliance to support a 10b-5 claim.[48] It is uncertain, however, whether the *Panzirer* decision is identical to *Blackie* because

39. *Blackie*, 524 F.2d at 907-08. The court rejected the requirement that a plaintiff had to prove actual reliance on an omission of a material fact because it would require proof of a speculative negative. *Id.* at 908.

40. *Blackie*, 524 F.2d at 906.

41. Shores v. Sklar, 647 F.2d 462, 483 (5th Cir. 1981) (en banc) (Randall, J., dissenting).

42. *Blackie*, 524 F.2d at 907.

43. The Second Circuit has been regarded generally as the leading circuit in securities law because of its jurisdiction over the New York markets. *See, e.g.*, Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981), *cert. denied*, 458 U.S. 1107 (1982).

44. 663 F.2d 365 (2d Cir. 1981), *vacated as moot sub nom.* Price Waterhouse v. Panzirer, 459 U.S. 1027 (1982).

45. *Panzirer*, 663 F.2d at 368.

46. *Id.*

47. *Id.*

48. The court held that "[i]f plaintiff can link her injury to defendant's fraud by showing the fraud was 'substantial' or 'significant contributing cause,' plaintiff has shown sufficient reliance to support his 10b-5 claim." *Panzirer*, 663 F.2d at 367 (quoting Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 (2d Cir. 1981)).

Panzirer does not provide an explanation of how the defendant could rebut the reliance presumption.[49] It is certain, though, that the fraud-on-the-market's application to misrepresentation cases involving developed, secondary markets is not indigenous to the Ninth Circuit.

Likewise, the Fifth Circuit also has applied the theory to misrepresentation cases in *Shores v. Sklar*.[50] In *Shores*, however, the court not only extended the theory's reliance presumption to misrepresentation cases but also to new securities issued on an undeveloped market.[51] The purchasers of industrial revenue bonds sued for the purchase price after the bonds defaulted, claiming that the defendants had fabricated a materially misleading offering circular.[52] The court allowed the plaintiff to recover because the newly-issued securities were unmarketable even though the plaintiff admitted not reading the offering material containing the misrepresentations.[53] The Fifth Circuit has gone beyond *Blackie's* and

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49. *Panzirer*, 663 F.2d at 668. Despite ambiguity as to the rebuttal standards, district courts have followed *Panzirer*. *See generally* Stern v. Steans, No. 80-C-3903 (S.D.N.Y. Dec. 2, 1981) (granting class certification despite plaintiff's failure to read the false rule 13-D statement); Abrams v. Johns-Manville Corp., (Current Transfer Binder) FED. SEC. L. REP. (CCH) 98,348, at 92,152 (S.D.N.Y. Nov. 10, 1981) (plaintiff stated a fraud-on-the-market claim by assuming that market price was an accurate reflection of the stock's price); Reingold v. Deloittle, Haskins & Sells, No. 82 Civ. 5920 (GLG) slip. op. (S.D.N.Y.) Dec. 6, 1984 (applying the fraud-on-the-market theory to so-called efficient securities markets and regarding the theory as a judicially fashioned exception to the traditional requirement that the plaintiff actually rely on the defendant's deception); Friedlauder v. Barnes, No. 84 Civ. 533 (RLC) slip. op. (S.D.N.Y.) Sept. 21, 1984 (stressing that the fraud-on-the-market theory applies only to large, impersonal, actively traded markets).

50. 647 F.2d 462 (5th Cir. 1981) (en banc). The *Shores* application of the theory developed out of two prior Fifth Circuit decisions. *See, e.g.*, Rifkin v. Crow, 574 F.2d 256, 263 (5th Cir. 1978) (holding that the fraud-on-the-market theory could be broader than articulated in Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 482 F.2d 880, 884 (5th Cir. 1973), which held that lack of reliance on a stockholder's misrepresentation foreclosed recovery.

51. *Shores*, 647 F.2d at 467-68. The court held in a 12-10 en banc opinion that a 10b-5(2) claim would not work because the plaintiff failed to read the circular. Nevertheless, the court allowed recovery under the broader language of 10b-5(1) or 10b-5(3) because the bonds would not have been marketed but for the elaborate fraudulent scheme. *Id.* at 469-70.

52. *Id.* at 464.

53. *Id.* at 470. The plaintiff had to prove that, but for the fraud, the securities were unmarketable. *Id.* at 484 (Randall, J., dissenting). The Tenth Circuit found *Shores* to be persuasive in T.J. Raney & Sons, Inc. v. Irrigation Fuel Auth., 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 104 S. Ct. 1285 (1984). Concluding that federal securities laws should, at a minimum, permit a purchaser to assume that new securities were lawfully issued, the court held that "the plaintiff has stated adequate grounds for relief by alleging that the defendants knowingly conspired to bring new unlawfully issued Series C bonds to market with the intent to defraud, that [the plaintiff] reasonably relied on the availability of the bond's as indicating their lawful issuance, and that [the plaintiff] suffered injury resulting from the purchase of the bonds." *Id.* at 1333. The court ex-

Panzirer's already broad interpretation of the theory by applying it to cases involving purchases of newly issued securities on undeveloped markets.

Although the Eleventh Circuit has also recognized the fraud-on-the-market theory, it has limited its application to securities traded on secondary markets. In *Lipton v. Documation, Inc.*,[54] the court applied the theory's presumption of reliance to fraud affecting securities already issued and traded on open, developed markets.[55] The plaintiffs alleged that the defendants disseminated financial reports containing information of substantial earnings and revenue when, in fact, the defendants knew that the company had suffered a significant net loss.[56] The *Lipton* court held that the plaintiffs could not recover where the only claim of reliance was that documents which the plaintiffs did not rely upon contained the misrepresentations.[57] The plaintiffs could only recover where the allegation is fraud "on a broader scale" which affects the developed market price so that it would not have availed the plaintiffs to have read the misleading documents.[58] Both *Shores* and *Lipton* applied the reliance presumption to misrepresentation cases, but, unlike *Shores*, *Lipton* limited the presumption to the secondary markets.

The Seventh Circuit has also limited the fraud-on-the-market theory by holding that a plaintiff must demonstrate a minimum awareness of the documents which omit material facts or contain misrepresentations, even if proof of actual reliance is not required.[59] Until recently, the district courts within the Seventh Circuit have required proof of actual reliance in 10b-5 claims involving

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tended the fraud-on-the-market theory to cases in which securities were not legally qualified to be issued when there was a scheme to defraud.

54. 734 F.2d 740 (11th Cir. 1984).

55. *Id.* at 745-76. The court clarified the holding in *Shores* that the fraud-on-the-market theory should apply to new securities issued on undeveloped markets. *Id.* at 745.

56. *Id.* at 741-42.

57. *Lipton*, 734 F.2d at 747.

58. *Id.* at 747. The court found that the fraud-on-the-market was not against congressional intent because it did not eliminate reliance. *Id.* The theory simply recognized that reliance may be presumed under certain circumstances. *Id.* at 748. The theory promoted the Congressional intent of enabling a buyer to rely on an expectation that markets are free from fraud. *Id.*

59. Panter v. Marshall Field & Co., 646 F.2d 271, 284 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1978).

The remainder of the circuits have not ruled on the validity of the fraud-on-the-markets' presumption of reliance. Sharp v. Coopers & Lybrand, 643 F.2d 175, 186 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). In Vervaecke v. Chiles, Heider & Co., Inc., 578 F.2d 713 (8th Cir. 1978), the court held that the plaintiff had to prove actual reliance to recover in 10b-5 misrepresentation cases, but kept open the possibility of a reliance presumption in a non-disclosure case. *Id.* at 717. Nevertheless, a district court in the Eighth Circuit recently recognized the theory's reliance presumption as an exception to the actual reliance require-misrepresentation,[60] and generally have only permitted a reliance presumption in non-disclosure cases.[61] In 1984, however, the United States District Court for the Northern District of Illinois in *Grossman v. Waste Management, Inc.*,[62] persuaded by the court's rationale in *Blackie*,[63] applied the fraud-on-the-market theory to a situation involving both material misrepresentations and non-disclosures.[64] The plaintiffs alleged that Waste Management, Inc. misrepresented and withheld information concerning its compliance with environmental regulations, disputes with regulatory authorities, and a shareholder prospectus issued in connection with a proposed merger.[65] The court held that a plaintiff is entitled to a rebuttable presumption of reliance in both instances.[66] To rebut the presumption, the defendant must establish that the plaintiff's decision to buy or sell a security was based on factors "wholly extraneous to the market."[67] This rebuttal standard may be established either by disproving materiality by showing that an insufficient number of traders relied on the fraud to inflate the price, or proving that the plaintiff bought or sold the securities despite knowledge of the fraud, or that the plaintiff would have purchased even if he had known of the fraud.[68]

The future of the fraud-on-the-market theory in the Seventh Circuit will benefit from the lessons learned from the courts applying the theory in other circuits. If an appropriate case comes up for review, the Seventh Circuit will have the opportunity to adopt the theory to cases involving either misrepresentation or non-disclosure or both while limiting the theory to workable circumstances. It should apply the rebuttable presumption of reliance only to cases involving securities actively traded on developed, secondary markets and prohibit the theory's use in cases involving either newly issued securities or securities traded on undeveloped markets. The

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ment in a securities misrepresentation claim. *In re* McDonnell Douglas Corp. Securities Litig., 587 F. Supp. 625, 627-28 (E.D. Mo. 1983).

60. *See, e.g.*, Kennedy v. Nicastro, 517 F. Supp. 1157, 1161 (N.D. Ill. 1981).

61. *See, e.g.*, McNichols v. Loeb Rhoades & Co., 97 F.R.D. 331, 336-37 (N.D. Ill. 1982) (class action certification); HSL, Inc. v. Daniels, (1983 Transfer Binder), FED. SEC. (CCH) § 99,557 (Aug. 25, 1983).

62. 589 F. Supp. 395 (N.D. Ill. 1984). Plaintiffs bought stock in February, 1983 on advice from a investment service based on the 1981 annual report and on a 1982 prospectus concerning a proposed merger, both of which contained misrepresentations and omissions. *Id.* at 399.

63. *Id.* at 402-03. "That *Blackie* may tend to put more of a premium on full disclosure by an issuer does not make it antithetical to the goals of the securities laws." *Id.* at 403.

64. *Id.* at 401.

65. *Id.* at 399.

66. *Id.* at 403-06.

67. *Id.* at 406.

68. *Id.* at 404.

Seventh Circuit should also properly limit the theory by establishing a realistic rebuttal standard such as the one described in *Grossman*.

THE PURPOSE OF RULE 10b-5 AND THE FRAUD-ON-THE-MARKET THEORY

Rule 10b-5 was promulgated under the 1933 and 1934 Securities Exchange Acts to prevent inequitable and unfair practices in securities market transactions.[69] It was intended to allow the securities investor to rely on the expectation that markets are free from fraud.[70] The fraud-on-the-market theory fulfills this goal because it embodies the spirit of the 1933 and 1934 Acts and Rule 10b-5. The theory enhances market integrity and encourages investor confidence with its rebuttable presumption of reliance by protecting open market purchasers on developed, secondary markets against fraudulent activities which defraud the market as a whole and which thereby indirectly defraud individual purchasers.[71] The theory's rebuttable presumption of reliance also fills a dangerous hole created in federal securities law with the advent of impersonal, indirect, market transactions involving high-tech communications which have replaced face-to-face transactions.[72] The reliance presumption provides open market investors a remedy against a defendant who has manipulated stock prices by defrauding the market, but has avoided directly defrauding individual investors.[73]

The fraud-on-the-market theory is based on the economic assumption that a developed, secondary marketplace reflects all public business information.[74] An open, developed, secondary market

69. *See supra* notes 66-68 and accompanying text.

70. *See supra* note 4 and accompanying text.

71. *See supra* note 4 and accompanying text.

72. Blackie v. Barrack, 524 F.2d at 907.

73. *In re* LTV Sec. Litig., 88 F.R.D. 134, 144 (N.D. Tex. 1980).

74. *Id.* Even a broad interpretation of Rule 10b-5, like the kind embraced by the fraud-on-the-market theory, cannot eliminate all of the investment risks inherent in securities markets. Investors should act prudently by reading securities offering materials and by investigating all possible risks. Investors should not rely on Rule 10b-5 and the fraud-on-the-market theory to guarantee the accuracy of the market. Shores v. Sklar, 647 F.2d at 483 (Randall, J., dissenting). Investors should be aware that they are assuming considerable risk of loss in any transaction because the price of the security and its trading volume may fluctuate for business reasons unrelated to any fraud or misconduct. *Id.* Hence, the fraud-on-the-market theory should not mislead investors into a false sense of security. An over-extended application of the theory would wrongly create "a scheme of investor insurance" to protect investors against the risks inherent in market transactions. *Id.* at 485. To protect against possible investment risk, investors should study a company's registration statements, offering circulars, and annual reports. Unfortunately, a recent commentary reported that most of these documents are not read by investors and "can be used effectively only by professionals." *Fraud-on-the-Market Theory*, *supra* note 12, at

is considered economically efficient because the securities prices reflect all information made public concerning a particular security.[75] Modern economic studies, known as the efficient market hypothesis, support this assumption.[76]

Following this hypothesis, the securities price on an efficient market will reflect all material public information, including any fraudulent information, regardless of whether the particular investor actually knew or relied on the fraudulent information. To protect an individual investor against fraud on efficient markets, the fraud-on-the-market theory does not require proof of actual reliance. Such a requirement would actually impede the purpose of securities laws to encourage market integrity.[77] It follows, however,

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1159, *quoting* H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE 14 (1979). This conclusion is a good reason why investors should be strongly encouraged, but not required, to read these documents concerning existing securities traded on developed markets.

75. *Fraud-on-the-Market Theory, supra* note 12, at 1153-55. The fundamental premise of the fraud-on-the-market theory is that "the market price of a security accurately reflects all publicly available information quickly and without bias." Fischel, *Modern Finance Theory in Securities Fraud Cases*, 38 BUS. LAW. 9 (1982). *See supra* note 8 and accompanying text. *See also* Note , *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 627 (1982) (concluding that modern economic theory confirms that, in an efficient market, securities prices reflect all available relevant information).

76. E. FAMA, FOUNDATION OF FINANCE 133-41 (1976). An efficient market is "[a] market having prices that fully reflect all available, relevant information." Note, *Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend*, 29 STAN. L. REV. 1077, 1089 (1977). Efficient markets have extensive self-regulatory mechanisms to insure prompt disclosure of all available public business information. *Timely Disclosure of Material Corporate Developments*, SEC. REL. NO. 8995, 35 FED. REG. 16733 (October 15, 1970). *See infra* notes 101-11 and accompanying text. *See, e.g.*, Seaboard World Airlines, Inc. v. Tiger Int'l Inc., 600 F.2d 355, 361-62 (2d Cir. 1979) (using the efficient market hypothesis to hold that the market price was a true measure of asset value in a corporate merger); *In re* LTV Sec. Litig., 88 F.R.D. 134, 144 (N.D. Tex. 1980) (an efficient market price reflects all available public information and any material fraud).

77. BROMBERG, *supra* note 20, at 210-11. *See also* Pickholz & Horahan, *The SEC's Version of the Efficient Market Theory and its Impact on Securities Law Liabilities*, 39 WASH. & LEE L. REV. 943 (1982).

For a detailed legal discussion of the efficient market hypothesis, see Note, *Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend*, 29 STAN. L. REV. 1077 (1977). The author states, in part:

> A market having prices that fully reflect all available, relevant information is an efficient market. The efficient capital market hypothesis asserts that all available, relevant information about a company's financial prospects is fully and virtually instantaneously reflected in the market price of the company's securities.

Id. at 1089-90.

For detailed economic discussions which show that available empirical evidence suggests that large, developed markets are efficient, *See, e.g.*, R. BREALEY & S. MYER, PRINCIPLES OF CORPORATE FINANCE, 260-65 (1981); J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE, 96-97 (2d ed. 1981).

that because the fraud-on-the-market theory is predicated on the efficient market hypothesis, the theory's reliance presumption should only be available to plaintiffs in cases when the fraud occurred on a developed, secondary, efficient market.[78] Conversely, the theory's reliance presumption should not apply to cases involving fraud on undeveloped securities markets because it is unreasonable to assume that the efficient market hypothesis applies to undeveloped markets.

Courts should, therefore, require plaintiffs to present sufficient evidence that the market in question is efficient so that the court can apply the fraud-on-the-market theory as a matter of law. To determine whether a particular market is efficient should be a question of fact. The most significant criterion for determining an efficient market is the market's requirement of prompt disclosure of significant corporate developments.[79] The New York Stock Exchange (NYSE) is the best example of an efficient market which requires timely and adequate disclosure of corporate news.[80] To determine whether a market is efficient should also depend on whether the market has an internal regulatory mechanism for self-policing. The NYSE uses an internal regulatory mechanism to maintain a continuous market surveillance program through its Division of Regulation and Surveillance.[81] This division sets standards for areas such as the internal handling of confidential corporate matters, an immediate press release policy, and the monitoring of rumors of unusual market activity.[82] In addition, the se-

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Economists determine the efficiency of a market by directly measuring the extent to which securities prices react to key financial events. *Id.* at 648 n.125 (citing *Report to the Advisory Committee on Corporate Disclosure to the Securities Exchange Commission*, 95th CONG. 1ST SESS. 646 (Comm. Print 1977) (*The Nature of Mandated Disclosure*, prepared by W. Beaver)).

78. *Blackie*, 524 F.2d at 906.

79. Reingold v. Deloite, Haskins & Sells, No. 82 Civ. 5920 (GLG) Slip. Op., (S.D.N.Y. December 6, 1984).

A sign that a market may be undeveloped is if it is a thinly traded market. Thinly traded markets are markets with low trading volume, usually accompanied by inefficient information systems. In thinly traded markets, the ability to gather, digest, and disseminate all relevant publicly available information is usually absent. Thus, the thinly traded markets are inappropriate contexts to apply the fraud-on-the-market theory because it is impossible to accurately discriminate between the effects of true information and misleading information on the price of securities. The converse of thinly traded markets—that high volume markets are therefore efficient—is not necessarily true. The Denver Penny Market exchange was a classic example of an inefficient market despite high volume trading. *Fraud-on-the-Market Theory, supra* note 12, at 1153 n.5. There, the regulatory mechanisms of the market were inadequate to establish efficient market conditions. *Id.* Hence, the main focus of whether a market is efficient should be the nature of the market's self-regulatory mechanisms. T.J. Raney v. Irrigation Fuel Auth., 717 F.2d 1330, 1332 (10th Cir. 1982).

80. SEC REL. NO. 8995, 35 FED. REG. 16733 (October 15, 1970).

81. THE NEW YORK STOCK EXCHANGE COMPANY MANUAL, A-18-23.

82. *Id.*

curities traded on a market should generally represent companies with adequate capital. A market in which securities of thinly capitalized companies are traded is not an efficient market. Courts should use these factors and the NYSE approach as guidelines to determine the factual question of whether a market is efficient.

The fraud-on-the-market theory should also apply only to securities already issued and traded on efficient, secondary markets for essentially two reasons. First, newly issued securities generally are not instantly efficiently priced. It is unreasonable to assume that the efficient market hypothesis applies to newly issued securities. The new security has not yet established a trading pattern or a price range.[83] It may take many days of trading for a newly issued security's price to accurately reflect all available public information about that security.[84] A period of initial price adjustment and correction usually accompanies a newly issued security and the initial offering price may not accurately reflect all available public information regarding that security.[85]

Second, there is no need to extend the fraud-on-the-market theory to newly issued securities. The 1933 Act's registration filing requirements adequately ensure that new securities are lawfully issued.[86] The 1933 Act was designed to protect investors against fraud that may occur during the formative stages of a security.[87] For these two important reasons, the fraud-on-the-market theory should be applied only to cases involving fraud affecting existing securities traded on developed markets. Hence, the application of the fraud-on-the-market by the Fifth and Tenth Circuits[88] should neither be expanded nor adopted.

In accordance with the anti-fraud purposes of securities law, courts should not distinguish between non-disclosure and misrepresentation claims when applying the fraud-on-the-market theory. The current case law no longer draws this distinction.[89] Because non-disclosure and misrepresentation are not distinguished in common law fraud cases,[90] they should not be considered differently in federal securities fraud. By definition, they both constitute fraud: misrepresentation by false information and non-disclosure by omis-

83. *Id.*

84. *See supra* notes 75-77 and accompanying text.

85. *See supra* notes 75-77 and accompanying text.

86. *See supra* notes 75-77 and accompanying text.

87. Section 11 of the 1933 Securities Act sets forth in great detail civil liabilities to purchasers with respect to any material misstatements or omissions. *See generally* Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

88. *See supra* note 4.

89. Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102 (1983); T.J. Raney & Sons v. Fort Cobb, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 104 S. Ct. 1285 (1984).

90. *See supra* note 1 and accompanying text.

sion of relevant information. Material non-disclosure and misrepresentation have the same dishonest effect; both elements cause deception and result in fraud.[91] In addition, many securities cases involve a hybrid of non-disclosure and misrepresentation in the alleged fraud.[92] To distinguish between these two kinds of fraud would be artificial and unjust. It would be unfair for a defendant to skirt the burden of rebutting the reliance presumption by simply arguing that the alleged fraud was a misrepresentation, and consequently that the plaintiff must prove actual reliance on the fraud.

A realistic and uniform standard for rebutting the presumption of reliance should be a vital part of the fraud-on-the-market theory. The most effective means to defeat a fraud-on-the-market reliance presumption is by disproving materiality.[93] Although this does not directly rebut the reliance presumption, both materiality and reliance relate to the same issue of causation.

A defendant should be allowed to rebut the reliance presumption in several ways. A defendant may rebut the presumption by proving that an insufficient number of traders relied upon the fraud to inflate the market price.[94] In doing so, the defendant may offer evidence concerning the percentage of investors who relied on the recommendations of analysts, advisors, or brokers in purchasing the particular security as well as evidence showing the number of traders whose actions were based on the fraud. Although this method may allow the defendant to overcome the presumption of reliance, it may be hard to ascertain, thereby making this method of rebuttal difficult to use.

A defendant may also rebut the reliance presumption by showing that the plaintiff purchased the stock despite knowledge of the fraud, or even if the plaintiff would have known of the fraud, the plaintiff would have purchased the stock anyway.[95] This method of rebuttal is also difficult to use because a defendant may have to prove a speculative negative by showing that the plaintiff would have entered the transaction even with the knowledge of the fraud at the time of the transaction. The plaintiff may defeat this rebuttal effort by merely asserting that knowledge of the fraud would have changed plaintiff's cause of action.

Courts should broaden the method of rebutting the reliance presumption. The defendant should be permitted to rebut the presumption by establishing that the plaintiff relied on non-market

91. W. PROSSER, HANDBOOK OF THE LAW OF TORTS 685-86 (4th ed. 1982).

92. *Id.*

93. *In re* McDonnell Douglas Corp. Sec. Litig., 587 F. Supp. 625 (E.D. Mo. 1983) (*citing* Austin v. Loftsgaarden, 675 F.2d 168, 178 (8th Cir. 1982)).

94. *Grossman*, 589 F. Supp. at 404.

95. *See supra* notes 19 and 20 and accompanying text.

factors in making a particular purchase.[96] The presumption can be rebutted by showing that the plaintiff relied "upon factors extraneous to the market."[97] This would shift the focus of the rebuttal to the third party on whom the plaintiff relied[98] and upon other non-market factors that played the primary role in the plaintiff's decision to purchase the securities.[99] For instance, the defendant may show that a particular plaintiff always follows his broker's recommendation in purchasing securities, no matter which security is involved.[100] Another example would be where the plaintiff had entered into a contract to purchase stock whose contractual obligations were wholly unrelated to the market price and unaffected by the fraud. In addition, the presumption could be rebutted if the defendant could prove that the plaintiff never read or knew of the publication in which the fraud occurred, and that the plaintiff was not in the practice of reading such publications.[101] It should not be sufficient to rebut the reliance presumption by establishing that a plaintiff relied on a broker's recommendation unless it can be shown that the decision to purchase was based on factors "wholly extraneous to the market."[102]

CONCLUSION

The fraud-on-the-market theory's rebuttable presumption of reliance should apply to uniform circumstances in all courts. Courts should regulate the theory by applying it only to developed, secondary markets which are considered efficient. The theory should not apply to newly issued securities or to undeveloped markets. Courts should apply the theory equally to cases involving either non-disclosure or misrepresentation, or both. Finally, courts should allow defendants to rebut the reliance presumption by a showing of factors "wholly extraneous to the market."[103] By regulating the application of the fraud-on-the-market theory, courts would remove the existing inequities resulting from the theory's inconsistent application, and at the same time, promote the legislative purpose of safeguarding market integrity.

Peter H. Wemple

96. *Blackie*, 524 F.2d at 906.
97. *Id.*
98. *Grossman*, 589 F. Supp. at 404.
99. *Id.*
100. *Id.* at 405.
101. *Id.* at 404-05.
102. *Id.* at 404.
103. *Grossman*, 589 F. Supp. at 405-06.