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FRAUD ON THE MARKET: A CRITICISM OF DISPENSING WITH RELIANCE REQUIREMENTS IN CERTAIN OPEN MARKET TRANSACTIONS

BARBARA BLACK†

The still-developing fraud on the market theory is the primary method by which securities fraud plaintiffs have attempted either to relax or eliminate the troubling reliance and causation requirements. Professor Black examines this emerging theory and suggests that the traditional common-law fraud concepts that focus on reliance and causation still have validity and continue, even in this context, to offer appropriate limitations on liability. The Article analyzes cases that have reduced or ignored this reliance element and explains why the legal concepts from which the fraud on the market theory evolved demand stricter adherence to reliance in certain markets but not in others. Professor Black incorporates the efficient market theory into her analysis by suggesting it as a condition which the courts should consider when determining the degree to which they will demand proof of causation and reliance in a securities fraud case.

In securities fraud litigation under rule 10b-5,1 it has become popular to invoke a theory of “fraud on the market” in order to relax, or even eliminate, the traditional tort law element of reliance. This is accomplished by emphasizing the other traditional elements of materiality and causation.2 The para-

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It shall be unlawful for any person, directly or indirectly, by the 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 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.


2. The traditional elements of deceit at common law, from which a rule 10b-5 claim is derived, are as follows: (1) Misrepresentation of a material fact, (2) reliance, (3) causation, and (4) scienter. See Restatement (Second) of Torts §§ 525-550 (1977); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971). See generally 3 L. LOSS, SECURITIES REGUL-
digim of a fraud on the market litigation is a class action brought by purchasers

**Materiality.** A fact is material if there is a substantial likelihood that the reasonable investor would consider it important in making an investment decision. See TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Although TSC articulated the standard for materiality in cases brought under rule 14a-9 of the Exchange Act, 17 C.F.R. § 240.14a-9 (1983), courts have uniformly applied this standard in rule 10b-5 cases. E.g., SEC v. MacDonald, 699 F.2d 47, 49 (1st Cir. 1983); Simpson v Southeastern Inv. Trust, 697 F.2d 1257, 1259 (5th Cir. 1983); Harmsen v. Smith, 693 F.2d 932, 946 n.11 (9th Cir. 1982); Trecker v. Seag, 679 F.2d 703, 709 (7th Cir. 1982); Austin v. Loftskaarden, 675 F.2d 168, 176 (8th Cir. 1982); Elkind v. Ligget & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980).

Reliance. Reliance involves subjectively determining whether a particular investor considered the misrepresentation a substantial factor in making his investment decision. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). In cases involving omissions, the test is met if the investor would have been influenced to act differently than he did had defendant disclosed to him the undisclosed fact. Id. at 463. Courts have required that the reliance be reasonable in affirmative misrepresentation cases, e.g., Holdsworth v. Strong, 545 F.2d 687, 695 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977), or that the investor exercise “due diligence” in making his decision, e.g., Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), cert. denied, 434 U.S. 911 (1977) (White, J., dissenting) (Justice White contended that the Supreme Court should grant certiorari to clarify the standard of care with regard to “due diligence.”).

Causation. Causation involves a determination that the harm suffered by the investor “flowed” from the misstatement. See Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975). Traditionally, causation requires a finding that the misrepresented fact was a proximate cause of the investor's loss; thus, the misrepresentation must touch upon the reasons for the stock's decline in value. “Absent the requirement of causation, Rule 10b-5 would provide no insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission.” Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir.), rehearing denied, modified on other grounds, 650 F.2d 815 (5th Cir. 1981), aff'd in part, rev'd in part on other grounds, 103 S. Ct. 683 (1983). The Second Circuit, on the other hand, takes a more relaxed view of proximate cause, permitting recovery upon a showing that the economic loss was a foreseeable consequence of the misrepresentation and not necessarily upon a showing that the loss resulted from the misrepresentation's effect on the true value of the security. E.g., Marbury Management, Inc. v. Kohn, 629 F.2d 705, 708-10 (2d Cir.), cert. denied, 449 U.S. 1011 (1980).

Many courts use the terms “transaction causation” and “loss causation” instead of reliance and causation respectively. E.g., Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975). This author agrees with Judge Frankel, in Schlick, 507 F.2d at 384 (Frankel, J., concurring), that the use of these terms does not aid analysis in this area and instead contributes to the confusion between these terms and the requisite elements of reliance and causation in rule 10b-5 cases. Therefore, this Article's analysis of causation deliberately avoids these terms. For a contrary view, see Crane, An Analysis of Causation Under Rule 10b-5, 9 Sec. Reg. L.J. 99,100 (1981) (advocating the use of these terms in analysis of rule 10b-5 claims).


**Privity.** While at common law there is no absolute requirement of privity, and thus third parties may be liable in a deceit action, plaintiff must nevertheless be "one to whom, or to influence whom, the third party made the misrepresentation." 3 L. Loss, supra, at 1628; see also Prosser, Misrepresentation and Third Persons, 19 Vand. L. Rev. 231 (1966). The insider trading cases, in which plaintiffs complain of injury because they were trading in the marketplace during a time when others were trading on the basis of undisclosed information, provide most of the judicial examination of the privity requirement under rule 10b-5. Compare Shapiro v. Merrill Lynch,
of stock alleging that over a period of time the stock prices were artificially inflated due to material misstatements contained in publicly available corporate documents. The recent rash of corporate scandals involving allegations of "cooked books" and other efforts by corporate management to improve the firm's apparent profitability certainly will give rise to many more fraud on the market suits.

The fraud on the market theory has not fully developed, and few decisions have extensively analyzed it. Its development is traceable principally to two factors. First, courts have sought to streamline securities fraud litigation to make it an appropriate vehicle for class actions. Thus, individual issues of proof, such as reliance, which would make an action inappropriate for class action certification, are minimized. Second, in recent years there has been increased judicial, administrative, and scholarly recognition of the "efficient market" thesis, which states that in free and actively traded markets, stock


3. E.g., Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976), discussed infra notes 72-100 and accompanying text.

4. In recent months, the SEC frequently has expressed its concern over the practice of "cooked books," that is, management inflating sales and earnings figures in order to satisfy their superiors' desire for increased profitability. E.g., Treadway says Pressure to Meet Goals May Cause Executives to 'Cook Books,' SEC. REG. & L. REP. (BNA) 421 (Mar. 4, 1983); SEC v. McCormick & Co., Inc., SEC. REG. & L. REP. (BNA) 21 (D.D.C. Dec. 21, 1982) (defendants consented to a permanent injunction without admitting or denying SEC's allegations); Wall St. J., July 5, 1983, at 1, col. 6 (Nucorp Energy executive accused of cooking the books); Wall St. J., Nov. 8, 1982, at 2, col. 2 (executives of foreign subsidiary of Pepsico manipulated earnings figures).


6. See infra notes 16-30 and accompanying text.


Professor Daniel R. Fischel is the leading legal scholar advocating the use of the efficient market thesis in analyzing corporate and securities law issues. See, e.g., Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L.REV. 1161 (1981); Fischel, Use of Modern Finance, supra note 5, at 1; Fischel, The Law and Economics of Dividend Policy, 67 VA L. REV. 699 (1981) [hereinafter cited as Fischel, The Law]; Fischel, Effi-
prices will fully reflect all available information about the corporation. Influenced by this theory, some courts view as outdated the traditional notion that the investor must read the documents containing the misstatement in order to be misled.

This Article traces the development of the fraud on the market theory and analyzes the leading cases in the area. It examines objections to the fraud on the market theory and discusses problems in harmonizing the theory with explicit causes of action under the federal securities laws. Finally it explores the Security and Exchange Commission’s recognition of the efficient market thesis in developing the integrated disclosure system, and its application to the fraud on the market theory.

Fraud on the market cases can be interpreted in two ways. Under one interpretation, plaintiff’s burden of establishing direct reliance is eased by according him a presumption of indirect reliance upon showing a material misstatement; reliance, in this weakened form, remains an element in rule 10b-5 cases. Under another interpretation, the reliance element is eliminated; the court is concerned only with ascertaining whether the violation caused plaintiff injury. Under this approach, a case involving a material misstatement becomes a case of stock manipulation.

This Article concludes that the latter “pure causation” theory, while

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8. Adherents of the efficient market thesis contend that the principal tool of securities analysts in predicting future stock prices—the use of fundamental or intrinsic value analysis to find undervalued or overvalued stocks—is useless, at least for the average analyst and average investor. This is so because the market has already taken into account expected events in currently pricing the stock. Accordingly, the current stock price is the best estimate of the stock’s intrinsic value, and future price movements will be random. Fama, Random Walks in Stock Market Prices, FIN. ANALYSTS J., Sept.-Oct. 1965, at 55, excerpted in ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 156, 157-62 (R. Posner & K. Scott eds. 1980).

Three forms of the efficient market thesis are generally recognized as weak, semistrong, and strong. Weak form efficient market theorists assert that past price trends in stock prices convey no information about future trends. Generally, everyone except the chartists accepts the weak form. The theory in its semistrong form is that an investor cannot analyze the publicly available information about a corporation to outpredict the market concerning its future performance. The theorists advocating the strong form contend that even those investors with access to information not generally available cannot outperform the market.

Not surprisingly, many market professionals dispute the validity of the efficient market thesis except in the weak form. See, e.g., Bernstein, In Defense of Fundamental Investment Analysis, FIN. ANALYSTS J., Jan.-Feb. 1975, at 57. Moreover, it is frequently observed that the thesis only works so long as securities analysts disbelieve it; it is their efforts to outperform the market that result in the market’s efficiency. E.g., J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 98 (1973).


seemingly attractive as a principle of law and logic, marks too radical a departure from rule 10b-5's common-law origins in deceit. On the other hand, affording plaintiff a presumption of indirect reliance is appropriate whenever there is a basis for determining that the stock is traded in an efficient market. The courts should incorporate the SEC's work on the integrated disclosure system to determine whether the market is efficient for the stock in issue and thus whether affording plaintiff a presumption of indirect reliance is appropriate. When the market is not efficient, plaintiff should bear the burden of establishing reliance. In some instances plaintiff may meet this burden by demonstrating indirect reliance, such as consulting a broker or reading an investment column. In other instances, when the securities are speculative in nature, plaintiff should be required to show direct reliance: that he actually read the disclosure document.

I. Development of the Fraud on the Market Theory

In rule 10b-5 cases, courts initially required plaintiffs to establish, in addition to materiality, both reliance and causation. These requirements were unquestionably appropriate and not particularly burdensome when the violation resembled the common-law tort of deceit, as when an individual sued on the basis of misrepresentations made to him in direct negotiations. The decision of the Second Circuit in SEC v. Texas Gulf Sulphur Co., however, expanded the rule 10b-5 remedy to include misstatements contained in publicly available documents. Thus, the rule 10b-5 claim was no longer directly analogous to the common-law tort.

Class actions, in particular, exemplified the problems resulting from plaintiff's required showing of reliance and causation. The amendment of rule 23 of the Federal Rules of Civil Procedure, intended to expand the availa-
bility of class actions, prompted many courts to view the class action as an appropriate vehicle for adjudicating the liability of defendants whose misstatements affected many open market investors. Unless a class action could be maintained, investors with small losses effectively would be precluded from redressing their injuries. Since class action status under paragraph (b)(3) of rule 23 depends on a “predominance of common issues,” defendants attempted to defeat class action certification by asserting that each plaintiff must show individual reliance on the misstatements to establish a rule 10b-5 claim. While some courts held that the requirement of individual reliance made the class action inappropriate for rule 10b-5 claims, others, unwilling to destroy the utility of the class action suit in securities fraud litigation, sought to relax or even eliminate the reliance requirement.

The court in Green v. Wolf Corp. proposed separate or bifurcated trials questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.” The amendments also greatly increase judicial power and discretion to manage and supervise class actions.

17. See Korn v. Franchard Corp., 456 F.2d 1206, 1214 (2d Cir. 1972); Green v. Wolf Corp., 406 F.2d 291, 298 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969); Esplin v. Hirschi, 402 F.2d 94, 101 (10th Cir. 1968) (“[A]ny error [in class certification], if there is to be made one, should be committed in favor of allowing the class action”), cert. denied, 394 U.S. 926 (1969). Prior to the revision of rule 23, Professor Loss observed that “[t]he ultimate effectiveness of the federal remedies . . . may depend in large measure on the applicability of the class action device.” 3 L. Loss, supra note 2, at 1819.


19. The Advisory Committee on rule 23 left unresolved whether a fraud action was appropriate for class action status:

The court is required to find, as a condition of holding that a class action may be maintained under this subdivision, that the questions common to the class predominate over the questions affecting individual members. . . . [A] fraud perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action, and it may remain so despite the need, if liability is found, for separate determination of the damages suffered by individuals within the class. On the other hand, although having some common core, a fraud case may be unsuited for treatment as a class action if there was material variation in the representation made or in the kinds or degrees of reliance by the persons to whom they were addressed.

Federal Rules of Civil Procedure, 23(b)(3) advisory committee note.


In Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548 (D. Utah 1970) (Reynolds I) the trial court specifically found that each of the three plaintiffs relied on the press release in making his decision to sell, although only one actually saw the article, and one plaintiff testified that he had no recollection of how he received the information. Id. at 558-61.


as a solution to the "individual reliance-relaxed reliance" conflict. A trial is initially conducted on the common issue whether the defendants made any material misstatements.23 If there is a determination adverse to defendants, separate trials are held on the questions of liability and damages. These questions often turn on individual issues of reliance24 and causation. The Green solution of bifurcated trials, however, was correctly criticized as merely postponing the inevitable: a determination on the manageability of the class action.25

Accordingly, courts looked to another solution, a more objective theory that would make common to the class the previously subjective, individual issue of reliance. This was accomplished by equating materiality with reliance. In re Memorex Security Cases26 is an early illustrative case. The court recognized its creation of different reliance requirements for negotiated and open market transactions.27 Nevertheless, basing its decision on the desire to permit the use of class actions in securities fraud litigation,28 the court adopted an objective standard of reliance to eliminate "the overwhelming task of examining the subjective intent of each class member in his decision with respect to his stock."29

Causation also presents problems in class action certifications. Plaintiffs usually are purchasers alleging that they were harmed by purchasing stock at prices artificially inflated by reason of defendants' actions. Defendants argue that any misstatement's effect on the market price would vary over time, requiring individual determination of each plaintiff's damages and thereby making litigation unmanageable as a class action under rule 23(b)(3). Courts, however, typically downplay the significance of the damages issues.30

23. In a fraud case involving multiple defendants and misstatements made over a period of time, it is debatable whether these are indeed common questions. See supra note 19. Most courts have held that they are, and have found a "common course of conduct," reasoning that the earlier misstatements caused the later ones to fall into error, like "standing dominoes." E.g., Herbst v. Able, 47 F.R.D. 11, 19-20 (S.D.N.Y. 1969); Fischer v. Kletz, 41 F.R.D. 377, 381 (S.D.N.Y. 1966).

24. The court in Green left open the issue whether reliance was required, 406 F.2d at 301.

25. E.g., In re United States Fin. Sec. Litig., 69 F.R.D. 24, 43 (S.D. Cal. 1975); see In re Memorex Sec. Cases, 61 F.R.D. 88, 98 (N.D. Cal. 1973). Manageability is one of the factors the court must consider in determining class action certification under rule 23(b)(3). See supra note 16.


27. See id. at 99-100.

28. "It appears that reliance of the actual, subjective, individual nature necessary in the classical fraud case would unnecessarily encumber large 10b-5 actions and thereby thwart the Congressional interest in providing a means by which investors may recover against market manipulators in federal court." Id. at 99.

29. Id. at 100. Another early case, Herbst v. Able, 47 F.R.D. 11, 20 (S.D.N.Y. 1969), reasoned that "[t]he question of reliance, itself, may well be one of those claims typical of the claims of the entire class," which is one way to transform an individual issue into a common one.

30. There are few securities opinions involving open market investors that discuss damages, except theoretically; most cases are settled prior to the determination of damages. Although it only considered limited data, one study found that settlement generally occurs before the determination of class certification; even when certification is denied, a substantial number of cases are still settled. Kennedy, Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study, 14 Hous. L. Rev. 769, 797, 810-15 (1977).

Two measures of recovery are common: restitution and out of pocket loss. The former is the traditional measure of damages in rule 10b-5 cases and was approved by the Supreme Court in
Two Supreme Court decisions, Mills v. Electric Auto-Lite Co. and Affiliated Ute Citizens v. United States, furthered the demise of the subjective reliance element by emphasizing the objective materiality element. In Mills minority shareholders alleged, under section 14(a) of the Exchange Act, that shareholder approval of a merger had been obtained by means of a materially misleading proxy statement. The Seventh Circuit, while upholding the lower court's determination that the proxy statement was materially deficient, questioned whether the misstatements had caused the shareholders any harm. The court noted that in a common-law action for fraud plaintiff would have to establish reliance on the misstatement. Because "[r]eliance by thousands of individuals, as here, can scarcely be inquired into," however, the Seventh Circuit decided that the determinative issue was the fairness of the merger terms. It reasoned that if the terms were fair the shareholders suffered no

Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972), involving direct negotiations. See supra notes 44-55 and accompanying text. For open market investors, the better view is that out of pocket recovery should be used, i.e., the difference between what was paid for the stock and what it was actually worth at the time of the transaction. E.g., Huddleston v. Herman & MacLean, 640 F.2d 534, 555-56 (5th Cir.), modified on other grounds mem., 650 F.2d 815 (5th Cir. 1981), aff'd in part, rev'd in part on other grounds, 103 S. Ct. 683 (1983); Bonime v. Doyle, 416 F. Supp. 1372, 1384 (S.D.N.Y. 1976), aff'd mem., 556 F.2d 554 (2d Cir. 1977). See Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 Stan. L. Rev. 371 (1974). A variation of the out of pocket measure is that plaintiffs recover the difference between what they paid and the value of the securities at the time the fraud is or should have been discovered. E.g., Esplin v. Hirschi, 402 F.2d 94, 105 (10th Cir. 1968), cert. denied, 394 U.S. 928 (1969). Cf. Harris v. American Inv. Co., 523 F.2d 220, 226-27 (8th Cir. 1975) (plaintiffs recover the difference between what they paid and the stock's value at the time knowledge of the fraud is publicly disseminated), cert. denied, 423 U.S. 1054 (1976). When the complaint is that plaintiffs paid an inflated price for the stock, those plaintiffs who sold the stock during the period of inflated price must have their recovery reduced by the amount of recaptured inflated value. Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1345 n.6 (9th Cir. 1976) (per curium) (Sneed, J., concurring). Courts adopting the fraud on the market theory believe that the actual value of the stock over the period can be determined by expert testimony; accordingly, awarding the appropriate recovery to each plaintiff becomes mechanical. Blackkie v. Barrack, 524 F.2d 891, 909 n.25 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); see In re LTV Sec. Litig., 88 F.R.D. 134, 148-49 (N.D. Tex. 1980).

Notwithstanding the above, some courts have stated that it is within the trial court's discretion to apply a rescissionary measure of recovery, i.e., the difference between the price paid and the stock's value at a later date, usually either the date of sale of the stock or the date the suit is instituted. See, e.g., Blackkie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970) (not an open market transaction). This method promotes manageability of a class action, because it eliminates both the necessity of determining the stock's varying theoretical value over the relevant time period and the problems of class membership between class members who sold the stock and those who did not. See Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343-44 (9th Cir. 1976) (Sneed, J., concurring). The flaw in the rescissionary measure is that it permits plaintiffs to recover for all declines in the stock price, even those caused by factors unrelated to the misstatement: "Wrongdoing defendants should not be mulcted to make simple the management of a class proceeding under rule 10b-5." Id. Compare Huddleston v. Herman & MacLean, 640 F.2d 534, 555 (5th Cir.), modified on other grounds mem., 650 F.2d 815 (5th Cir. 1981), aff'd in part, rev'd in part on other grounds, 103 S. Ct. 683 (1983) (rescission measure rejected) with Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 49 (2d Cir.) (rescission measure applied, but reduced to reflect decline in general market conditions), cert. denied, 439 U.S. 1039 (1976). See Note, supra, at 386.

35. Id. at 436 n.10.
injury, because a sufficient number of them would have voted to authorize the merger even if there had been accurate disclosure.

The Supreme Court, although vacating the Seventh Circuit’s opinion, agreed that the court could not examine individual issues of reliance.\(^{36}\) It disapproved, however, of the appeals court’s alternative of reviewing the fairness of the merger terms.\(^{37}\) Instead, the Court emphasized the requirement of materiality\(^{38}\) as a substitute for proof of individual reliance. Thus, in *Mills* the Supreme Court explicitly recognized, in a section 14(a) action, the practical considerations of maintaining a class action as a rationale for eliminating proof of individual reliance.\(^{39}\)

Both section 14(a) and rule 14a-9,\(^{40}\) on the one hand, and section 10(b) and rule 10b-5, on the other, are implied remedies for false and misleading statements. *Mills*, however, is distinguishable from rule 10b-5 cases on several significant grounds. First, when shareholders bring suit based on a misleading proxy statement sent to them as part of a proxy solicitation process, reliance is more appropriately presumed because there is a greater likelihood that at least a sizeable number of those in the plaintiff class have read some portions of the document.\(^{41}\) Second, a shareholder is directly harmed, whether or not he reads the proxy statement, or even if he reads it and is not misled, if a sufficient number of shareholders are misled by the proxy statement to vote in favor of the proposed action.\(^{42}\) Third, courts tend to recognize a more direct connection between misstatement and harm in the context of a proxy solicitation.\(^{43}\) Finally, the number of plaintiffs is determinable, although it may be

\(^{36}\) *Mills*, 396 U.S. at 380.

\(^{37}\) In the Court’s view, this approach would immunize all misstatements that did not relate to the merger terms and would discourage shareholders from bringing actions to enforce the proxy rules. *Id.* at 382.

\(^{38}\) “There is no need to supplement this [materiality] requirement . . . with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury . . . .” *Id.* at 384-85.

\(^{39}\) The Court left open the questions whether there would be causation when management controlled enough votes to assure authorization of the transaction, but referred to a district court case that held there would be sufficient causation in this situation. *Id.* at 385 n.7. Lower courts in the Second Circuit have split on this issue. *See* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 378 n.7 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975), and cases cited therein.


\(^{41}\) The proxy rules are very likely the most effective disclosure device in the SEC scheme of things. The proxy literature, unlike the application for registration and the statutory reports, gets into the hands of investors. Unlike the Securities Act prospectus, it gets there in time. It is more readable than any of these other documents. And it gets to a great many people who never see a prospectus.


\(^{43}\) Because of this recognition of more direct harm, courts have found negligence the appropriate standard of culpability in § 14(a) damage claims, notwithstanding the requirement of scien-
large. Because of these significant distinctions, the Mills rationale is not sufficiently persuasive authority for abandoning the reliance requirement in rule 10b-5 actions.

The Supreme Court opinion, Affiliated Ute Citizens v. United States, addressed the reliance requirement in a rule 10b-5 case involving rather unusual facts. Plaintiffs, mixed-bloods of the Ute Indian Tribe, sued a bank and two of its employees. The bank had acted as transfer agent for stock of a corporation formed for the purpose of distributing tribal assets. Although the bank had been requested to discourage resales of the stock, its employees had actively encouraged a secondary market among non-Indians. Indeed, they had “devised a plan and induced the mixed-blood holders of [the] stock to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell.” The Supreme Court held that the appeals court had read rule 10b-5 too restrictively in requiring evidence that plaintiffs had relied on misstatements made by the employees, since “[as market makers] they possessed the affirmative duty under the Rule to disclose this fact to the mixed-blood sellers.”

In reaching this conclusion, the Court noted the distinction between paragraph (2) of rule 10b-5, on the one hand, and paragraphs (1) and (3), on the other. While the former premises liability on material misstatements, and thus is closely related to common-law fraud, the latter provisions are broader, encompassing “‘a course of business’ or a device, scheme or artifice” that operates as a fraud. Accordingly:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Despite the unique facts of Affiliated Ute, which suggest its applicability is limited to situations involving direct negotiations between purchaser and seller, it has been widely interpreted as eliminating plaintiff’s need to establish reliance in nondisclosure cases involving open market transactions. Based on Affiliated Ute, courts accord plaintiff a presumption of reliance in

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45. Id. at 153.
46. Id.
47. Id. at 152-53. For text of rule 10b-5, see supra note 1.
48. For discussion of common-law fraud elements, see supra note 2.
50. Id. at 153-54.
nondisclosure cases and, in so doing, shift the burden to defendant to prove plaintiff’s nonreliance. Some courts extend Affiliated Ute further and hold that, in open market transactions involving misrepresentations, plaintiff need prove only materiality, thus eliminating the distinction between misrepresentations and omissions.

Two significant Second Circuit opinions, Schlick v. Penn-Dixie Cement Corp. and Chris-Craft Industries v. Piper Aircraft Corp., developed the Affiliated Ute distinction between misrepresentations and fraudulent schemes. They held that victims of schemes to manipulate stock prices need only establish causation and not reliance.

In Schlick, brought under rule 10b-5, plaintiff challenged a merger between two affiliated corporations in which an exchange ratio unfair to the minority shareholders allegedly had been achieved through the majority shareholder’s stock manipulation. The district court dismissed the complaint “for want of the necessary causal connection.” The appeals court acknowledged that a plaintiff in a misrepresentations case would have to show reliance and that a plaintiff in an omissions case would have to show materiality. When, however, plaintiff alleged a fraudulent scheme involving market manipulation, of which misstatements were but one aspect, he need only show causation. Plaintiff satisfied this requirement by alleging that the minority shareholders were forced to exchange their stock on the basis of an unfair exchange ratio. Plaintiff thus established his claim upon showing that the fraudulent scheme caused his economic injury.

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56. 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975).
58. See supra text accompanying notes 48-49.
60. 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975).
61. Id. at 378. The district court also apparently did not think that the alleged violations stated a claim under federal law. Id. at 377 n.5.
62. In Vine v. Beneficial Fin. Co., 374 F.2d 627, 635 (2d Cir.), cert. denied, 389 U.S. 970 (1967), also involving a forced merger, the court regarded reliance as unnecessary in a case in which plaintiff had no choice but to relinquish his shares.
In *Chris-Craft Industries v. Piper Aircraft Corp.*, the defeated tender offeror in the struggle to obtain control of Piper Aircraft, sued Bangor Punta, the successful tender offeror, for misstatements made during the tender offer. The Second Circuit held that Chris-Craft could maintain such a claim under section 14(e) of the Exchange Act even though it had not relied on Bangor Punta's alleged misstatements, since Chris-Craft's harm did not depend "upon the exercise of volition by [it], but instead upon the exercise of volition by other persons."

The Supreme Court dismissed Chris-Craft's suit on the ground that a defeated tender offeror lacks standing to sue for damages under section 14(e). In addition, the Court noted, in dictum, that Chris-Craft would not have had standing had it brought its claim as a Piper stockholder:

As a tender offeror actively engaged in competing for Piper stock, Chris-Craft was not in the posture of a target shareholder confronted with the decision of whether to tender or retain its stock. Consequently, Chris-Craft could scarcely have alleged a need for the disclosures mandated by the Williams Act.

From this language it appears that the Court contemplated a direct reliance requirement in cases under section 14(e) involving misstatements. In another part of the opinion, however, the Court indicated that Chris-Craft would have had standing to litigate Bangor Punta's rule 10b-6 violations if Chris-Craft had alleged that it paid an inflated price for Piper stock because of Bangor Punta's fraudulent scheme: if it had sued as "a hoodwinked investor victimized by market manipulation."

The Supreme Court's *Chris-Craft* opinion thus supports the view that, unlike a plaintiff alleging injury because of misstatements, a plaintiff alleging injury because of a stock manipulation scheme need not show reliance. The former claim, essentially a common-law deceit case, is based on paragraph (2) of rule 10b-5, while the stock manipulation claim is based on paragraphs (1) and (3). The difficulty with this analysis is drawing a distinction between misstatements that affect the stock's price and other forms of stock manipulation, since any material misstatement will affect the stock's price.

65. *Chris-Craft*, 480 F.2d at 373.
67. Id. at 35.
68. Since § 14(e) was patterned after rule 10b-5, courts look to decisions interpreting § 14(e) for guidance in interpreting rule 10b-5.
69. *Chris-Craft*, 430 U.S. at 43-44. Rule 10b-6 generally prohibits a participant in a securities distribution from bidding for or purchasing securities of the same class. 17 C.F.R. § 240.10b-6 (1983). Its purpose is to prevent manipulation of the stock price to facilitate its distribution. See Proposed Amendment to Rule 10b-6, 47 Fed. Reg. 11,482, 11,483 (to be codified at 17 C.F.R. § 240.10b-6) (proposed Mar. 3, 1982).
70. *Chris-Craft*, 430 U.S. at 45.
71. See infra note 137.
II. THE FRAUD ON THE MARKET THEORY

There is no uniform fraud on the market theory; rather, the theory takes three forms, represented by three leading cases. In \textit{Blackie v. Barrack}\textsuperscript{72} plaintiffs brought a class action, seeking to represent purchasers of a corporation’s common stock over a twenty-seven month period. They alleged that some forty-five documents released publicly by the corporation contained material misstatements that artificially inflated the price of the stock. Defendants resisted class action certification by asserting, among other arguments, that direct proof of subjective reliance by each class member was necessary to establish rule 10b-5 liability. The Ninth Circuit rejected this argument, stating that subjective reliance was not a distinct element of proof in rule 10b-5 claims involving open market transactions.\textsuperscript{73}

First, the court noted that plaintiffs’ substantive claims were or could be stated in terms of omissions.\textsuperscript{74} Relying on \textit{Affiliated Ute},\textsuperscript{75} the court held that “positive proof of reliance is not a prerequisite to recovery.”\textsuperscript{76} Second, and more significantly, the court treated the claims as involving misrepresentations and relied on precedent for the following proposition:

Proof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market. . . . Proof of reliance is adduced to demonstrate the causal connection between the defendant’s wrongdoing and the plaintiff’s loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant’s conduct and plaintiff’s loss is sufficiently established to make out a prima facie case.\textsuperscript{77}

The court’s discussion of the role of reliance in a rule 10b-5 claim is subject to two interpretations. Under the prevailing view, reliance is not eliminated as an element in establishing a rule 10b-5 claim. Rather, plaintiff is afforded a rebuttable presumption of indirect reliance, necessarily easing his

\begin{itemize}
\item \textsuperscript{72} 524 F.2d 891 (9th Cir. 1975), \textit{cert. denied}, 429 U.S. 816 (1976).
\item \textsuperscript{73} \textit{Id.} at 905.
\item \textsuperscript{74} For example, the corporation’s financial statements failed to disclose the need for adequate reserves. One commentator has criticized the court of appeals’ reasoning, since in the context of a reporting corporation these so-called omissions are really failures to disclose information necessary to prevent already available information from being misleading, or half-truths, which are treated as misrepresentations. Ruder, Judicial Developments Under Rule 10b-5: Standing, Scienter, Reliance, Materiality and Implied Rights of Action, 7 INST. ON SEC. REG. 303, 325 (1976). \textit{Affiliated Ute}, however, can also be interpreted as a misrepresentation case, since the failure to disclose that higher prices were available in the secondary market was also an implied misrepresentation that the offered price was fair.
\item \textsuperscript{75} 406 U.S. 128 (1972).
\item \textsuperscript{76} 524 F.2d at 905 (quoting \textit{Affiliated Ute}, 406 U.S. at 153).
\item \textsuperscript{77} \textit{Blackie}, 524 F.2d at 906.
\end{itemize}
burden in establishing a prima facie case.78 Thus, the purchaser in open market transactions indirectly relies on the accuracy of the corporation’s public documents, since “he relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price.”79

A defendant has four defenses under the prevailing view. The first two are common to the class as a whole and relate to materiality and causation. The remaining two are specific rebuttals of an individual plaintiff’s reliance. First, defendant can disprove the materiality of the misstatement.80 If it was not material, any disparity between price and value must have been due to factors not attributable to defendant’s misconduct. Second, even if the misstatement was material, defendant can defeat plaintiff’s claim by showing that an insufficient number of traders relied on it, and that the price was not affected by it.81 This would be the case when sophisticated traders saw through the misstatement or when information from other sources discredited it.82 Third, defendant could prove that an individual plaintiff had purchased despite his knowledge of the material misstatement. Fourth, defendant could prove that an individual plaintiff would have purchased even if he had known of the falsity.83 In the latter two defenses, defendant uses plaintiff’s nonreliance to limit the chain of causation.84

Blackie also can be interpreted as a “pure causation” approach to rule 10b-5 liability. Under this view, the only purpose of reliance is to establish causation;86 when causation can be established by other means, a showing of reliance becomes unnecessary. For example, in open market transactions cau-

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78. The Blackie court characterized a requirement of direct reliance as an “unreasonable and irrelevant evidentiary burden.” Blackie, 524 F.2d at 907.
79. Id. The court in In re LTV Sec. Litig., 88 F.R.D. 134, 144 (N.D. Tex. 1980), extended the analysis by basing a presumption of indirect reliance on the efficient market thesis:
   Many investors . . . utilize the very efficiency of the market as the affirmative basis for making securities purchases. These investors rely directly on the market to evaluate information for them rather than making their independent analysis of stocks; any reliance of the market on information is thus reliance by these investors.
Id. See supra notes 7-8 and accompanying text.
80. Blackie, 524 F.2d at 906.
81. Id.
82. For studies concluding that investors are not fooled by accounting practices that cause an apparent increase in profitability, see Fischel, Use of Modern Finance Theory, supra note 5, at 6 n.19. See also Fischel, The Law, supra note 7, at 720-21.
84. Blackie, 524 F.2d at 906.
85. Professor Fischel correctly notes that allowing these defenses of nonreliance is logically inconsistent, since defendants caused these plaintiffs economic injury, and criticizes Blackie for applying the traditional tort elements to the fraud on the market theory. See Fischel, Use of Modern Finance Theory, supra note 5, at 11. Blackie’s approach, however, can be rationalized if based on judicial concern that defendants’ potential liability would otherwise be too great. See Dooley, The Effects of Civil Liability on Investment Banking and the New Issues Market, 58 VA. L. REV. 776, 819 n.203 (1972); Painter, Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5, 65 COLUM. L. REV. 1361, 1370-71 (1965). In addition, defendants should not be liable to those who knowingly assumed the risk of the investment.
sation is established by showing that the misstatement is material because a sufficient number of market traders relied on it to cause the price increase. Injury, therefore, is suffered by all who purchased the stock between the date when the material misstatement affected the price and the date when the truth was sufficiently disseminated to bring the price of the stock down to its "true" value. Thus, a material misstatement establishes plaintiff's prima facie case. The only defense is to defeat the showing of causation by either of the first two defenses discussed above. Under the pure causation approach, the remaining two defenses relating to issues of individual reliance are irrelevant.

Many courts, assuming that Blackie is an extension of Affiliated Ute's presumption of reliance, adopt the first interpretation of Blackie and state that the presumption is rebuttable. Plaintiff's nonreliance can then be raised defensively: that plaintiff did not read the report; that he did not request to see those situations in which there exists causation in fact between the defendant's act and the plaintiff's injury."

87. The post-Blackie fraud on the market cases were brought by purchasers alleging artificial price inflation because management concealed unfavorable data. Similarly, investors who sell a stock price is artificially depressed, because management concealed favorable information would also suffer economic injury. A fraud on the market case alleging artificial depression without insider trading is unlikely, since corporate insiders have an incentive to conceal good news only long enough to purchase the stock at bargain prices. In the absence of insider trading, the corporation would be liable under rule 10b-5 only if it had a duty to disclose the favorable data.

Courts normally do not question the timing of the corporation's disclosure; instead they question the adequacy of the disclosure. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The timing of the disclosure, in the absence of inaccurate disclosure, falls within management discretion, which is protected by the business judgment rule. State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 851-52 (2d Cir. 1981); see Staffin v. Greenberg, 672 F.2d 1196, 1204 (3d Cir. 1982). But see Allen, The Disclosure Obligation of Publicly Held Corporations in the Absence of Insider Trading, 25 MERCER L. REV. 479, 496 (1974) ("There seems to be an evolving concept of a duty of full disclosure to the securities markets in general, even in the absence of insider trading."); Bauman, Rule 10b-5 and the Corporation's Affirmative Duty to Disclose, 67 GEO. L.J. 935, 988 (1979) ("Only a disclosure duty that applied irrespective of trading will fully meet the informational needs of investors.").


the report;91 that he relied on another's recommendation;92 that he made the investment decision for reasons unrelated to the misstatements;93 that he knew the falsity of the statement;94 or, that he relied on his own investigation.95

A few courts adopt the second interpretation and read *Blackie* as a pure causation case.96 They reason that there is general reliance on the market to employ all available information to set a price reflecting the actual value of the stock.97 This reliance has been found even when a plaintiff testified that she did not consider the price of the stock when she decided to buy it.98

The most extreme form of the pure causation approach is exemplified by a decision in which plaintiff sold the stock short, anticipating a price decline, and claimed injury because the price actually rose, allegedly on the basis of subsequent material misstatements.99 The district court, while doubting that fraud on the market was the law in its circuit, nevertheless permitted plaintiff to recover under the most expansive theory of fraud on the market. Clearly the plaintiff could not have relied on the misstatement in any sense, and the court permitted recovery solely on the basis of economic loss. Other courts have not clearly articulated their understanding of *Blackie*.100

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93. Kiernan v. Homeland, Inc., 611 F.2d 785 (9th Cir. 1980).
96. The Ninth Circuit, in its later opinion, Arthur Young & Co. v. United States Dist. Ct., 549 F.2d 686 (9th Cir.), cert. denied, 434 U.S. 829 (1977), was ambiguous in its interpretation of *Blackie*. The court acknowledged that *Blackie* permits defendants to introduce evidence of an individual plaintiff's nonreliance to "disprove the causal relationship between defendants' wrongful conduct and plaintiff's decision to invest." Id. at 695. Nevertheless, the court found defendants' offer of proof of nonreliance insignificant on the class certification issue. Moreover, discussion of *Blackie* in another part of the opinion suggests that this court is moving close to dispensing with reliance altogether. See id. at 694-95. In addition, since defendants' ability to defeat the presumption of reliance is largely theoretical in class actions, as a practical matter reliance is eliminated as an element.

"[T]he possibility that defendants may attempt to rebut the presumption of reliance as to each class member is not enough to defeat class action. . . . It is unrealistic . . . to now assume that because reliance would only be "presumed" the supposed common issue will unravel into thousands of unmanageable "mini-trials." This is true, given the force of the presumption (carrying a burden of proving a purchase would have been made even if the truth were known) with the resulting reality that the contest would likely be futile in the vast number of cases.

100. Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980), is often cited as an early espousal of the fraud on the market theory, but its interpretation of *Blackie*
Panzier v. Wolf shows a second form of the fraud on the market theory. Plaintiff purchased stock in a corporation that subsequently declared bankruptcy. She charged that there were material misstatements in its annual report, which she conceded she had not read. Rather, she decided to purchase the stock after reading a newspaper column reporting favorably on the corporation's prospects and after speaking to her broker. She claimed that the article would not have been so optimistic if the annual report had been accurate. The Second Circuit, reversing the trial court, held that plaintiff's theory stated a causal connection between her loss and the annual report; thus plaintiff's theory could not be dismissed on summary judgment.

While the Second Circuit saw its decision as a logical extension of Blackie, it noted a critical distinction between the two cases. The court viewed Blackie as a case of indirect reliance on the market price to reflect the worth of the stock, as determined by the publicly available information. In Wolf, however, plaintiff did not rely on the market price in making her investment decision. Nevertheless, the court found that plaintiff did rely indirectly on the annual report because she reasonably could expect that the "information heard on the street" would accurately reflect the information contained therein. Hence, plaintiff was entitled to prove that if the report were accurate, the article would not have mentioned the future prospects of the corporation favorably, and she would not have purchased the stock.

Although characterizing its decision as one involving indirect reliance, the court really dispenses altogether with the reliance requirement. While it speaks of a fraud on the market plaintiff having a "presumption of reliance," the court does not develop this concept and provides no analysis of what, if anything, would rebut this presumption. The opinion makes clear, how-

101. 663 F.2d 365 (2d Cir. 1981), vacated as moot, 103 S. Ct. 434 (1982).
103. The court observed that the attractiveness of the investment would be enhanced by a lower price. Wolf, 663 F.2d at 367 n.3.
104. Id. at 368.
105. Where the plaintiff acts upon information from those working in or reporting on the securities markets, and where that information is circulated after a material misrepresentation or omission, plaintiff has stated a sufficient claim of reliance on the misrepresentation or omission. Id. at 367. The court found that plaintiff's lack of credibility, however, made her an inadequate class representative under rule 23(a)(4). Id. at 368.
106. Referring to its earlier decision in Competitive Assoc., Inc. v. Laventhal, Krekstein, Horwath & Horwath, 516 F.2d 811 (2d Cir. 1975), the court stated that "the fact that plaintiff must trace her reliance on defendant's alleged fraud through the reactions of third parties does not
ever, that plaintiff's failure to rely on the market price does not rebut the presumption. Instead, the opinion emphasizes the chain of causation linking the alleged misstatement to plaintiff's investment decision. Thus, the Second Circuit's *Wolf* opinion can be characterized as a pure causation case.

*Shores v. Sklar*\(^{107}\) represents the third form of the fraud on the market theory. Plaintiff had purchased revenue bonds\(^{108}\) that dropped drastically in value shortly after their sale due to default by the lessee of the industrial business premises. Plaintiff admitted that he had not seen the offering circular, but bought the bonds because of his broker's recommendations. He alleged that the issuance of the bonds resulted from a fraudulent scheme "so pervasive that without it the issuer could not have issued, the dealer could not have dealt in, and the buyer would not have bought these Bonds, because they would not have been offered on the market at any price."\(^{109}\) The district court entered summary judgment for the defendants, because the plaintiff had not relied on the circular's alleged misstatements. The Fifth Circuit reversed, reasoning as follows:

The securities laws and regulations have a purpose broader than merely criticizing ever-lengthening, complex prospectuses. They cover deliberate, manipulative schemes to defraud which can annul not only the purpose of disclosure but also the market's honest function.\(^{110}\)

Accordingly, while plaintiff's failure to read the circular barred him from asserting that it contained material misstatements under rule 10b-5(2), plaintiff had stated a claim, under paragraphs (1) and (3) of the rule, based on fraud in bringing the bonds to the market.\(^{111}\) If plaintiff proved that he was willing to purchase any bonds that were "entitled to be marketed"\(^{112}\) and that he was willing to accept any marketable risk, he would establish his reliance on "the integrity of the offerings of the securities market."\(^{113}\) Causation would be established by proving defendant's scheme to defraud investors by offering bonds not entitled to be marketed.

In analyzing the distinctions between rule 10b-5 claims under paragraphs (1) and (3), on the one hand, and paragraph (2), on the other, the Fifth Circuit stated the following:

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\(^{107}\) *Shores*, 647 F.2d at 462 (5th Cir. 1981) (en banc), *cert. denied*, 103 S. Ct. 722 (1983). The judges of the Fifth Circuit were split 12-10 in this decision.

\(^{108}\) Although revenue bonds are not required to be registered under the Securities Act, 15 U.S.C. § 77c(a)(2) (1982), offers and sales of bonds are not exempt from the antifraud provisions of either that Act, *id.* § 77q(a), or the Exchange Act, *id.* § 78j(b).

\(^{109}\) *Shores*, 647 F.2d at 464 n.2.

\(^{110}\) *Id.* at 464.

\(^{111}\) *See supra* note 1 (text of rule 10b-5).

\(^{112}\) *Shores*, 647 F.2d at 471.

\(^{113}\) *Id.* at 469.
Whenever the Rule 10b-5 issue shifts from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also. . . . [R]ule 10b-5 is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents which mislead a securities buyer. The rule is recognized also to provide a basis for a federal cause of action for more elaborate, intentional schemes which deceive or defraud purchasers of securities.114

Thus, the Fifth Circuit relies on the same distinction between garden-variety misstatements and large-scale fraud, drawn in Affiliated Ute and developed in the stock manipulation cases of the Second Circuit, as a basis for its version of fraud on the market theory.115

The Shores version of the fraud on the market theory, followed in the Tenth Circuit and in a number of lower courts,116 differs from Blackie by not affording plaintiff a presumption of indirect reliance on the offering circular that would allow plaintiff to state a claim under rule 10b-5(2). Since Shores involved municipal bonds, which generally are not widely followed by analysts or heavily traded, it would have been inappropriate to extend to plaintiff the Blackie presumption of indirect reliance; the information contained in the offering circular would not be readily available in the marketplace.117 Thus, the Shores court probably was correct in dismissing the claims based on fraudulent misstatements, although the lack of evidence about the nature of the broker's recommendations and the source of his information is curious. Nevertheless, the court's distinction between facts that merely decrease the securities' value, on the one hand, and facts that make the securities valueless and hence unmarketable, on the other, is a difficult one to draw, if it is a distinction at all, since someone would always buy the securities at some price.118 In subsequent cases courts have been receptive to plaintiffs' assertions that the misstatements made the securities unmarketable.119 This expansive reading of Shores converts this version of fraud on the market into a pure causation case with respect to all forms of misstatements.

From a review of these cases, it appears that those courts that have adopted some version of the fraud on the market theory are motivated by a strong concern for protecting the open market investor. Accordingly, they reason that the requirement of reliance developed because of rule 10b-5's close resemblance to the common-law tort of deceit. They argue that even though

114. Id. at 472.
115. See supra notes 44-71 and accompanying text.
117. See infra notes 232-37 and accompanying text.
118. See supra, 647 F.2d at 486 (Randall, J., dissenting).
119. See supra note 116.
the requirement may still be appropriate in negotiated transactions, today’s rule 10b-5 claim alleging fraud on a large scale has moved light-years away from the common-law tort. Open market investors victimized by fraud, as a distinct class of litigants, should have a remedy; open market investors who bought the stock at a price substantially different from its intrinsic value certainly have been injured; to impose a direct reliance requirement, therefore, is to bar arbitrarily certain plaintiffs who suffered the same injury as those who can fortuitously establish direct reliance. Moreover, these courts believe that enforcement of the securities laws is most effectively achieved through class actions, which in turn can only be maintained if the fraud on the market theory is available to eliminate individual issues of reliance. Accordingly, courts have looked for ways of replacing proof of individual reliance with proof of a common and more objective reliance.

The argument for acceptance of the fraud on the market theory is frequently summarized in Blackie’s assertion that an investor has the right to rely on “the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price.” Hence, it is argued that if an investor establishes his reliance on the market price he has met his reliance requirement in establishing a prima facie case under rule 10b-5. Implicit in this argument is an acceptance of the efficient market thesis, which states that publicly available information affecting a corporation’s prospects is rapidly absorbed by the market, that the information has an immediate impact on the stock price, and that the marketplace reacts to both true and false data. Thus, in an attenuated way, every investor “relies” on any false information when he purchases stock at the prevailing market price.

An investor, however, by trading in the stock, necessarily must accept the risk that the stock’s price varies from its value. The availability of a good deal of information about a corporation provides no assurance that it is accurate information. Moreover, even if the information is factually accurate, it is subject to misinterpretation by the market. While an investor necessarily must

120. Recent Supreme Court opinions lend support to this view. See, e.g., Herman & MacLean v. Huddleston, 103 S. Ct. 683, 691 (1983) (“[T]he antifraud provisions of the securities laws are not coextensive with common law doctrines.”); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975) (“[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years from the world of commercial transactions to which Rule 10b-5 is applicable.”). For discussion of the common-law tort elements, see supra note 2.

121. See supra notes 16-30 and accompanying text. The courts believe that without effective enforcement, corporate management will not be deterred from issuing fraudulent statements.


123. Blackie v. Barrack, 524 F.2d 890, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). The phrase “fraud on the market” originated in Herbst v. Able, 47 F.R.D. 11, 16 (S.D.N.Y. 1969). In Herbst plaintiffs alleged that misstatements had caused an artificial inflation in the price of the common stock, which induced them to convert their debentures into common stock. Since a decision to convert debt into stock is based principally on the market price of the stock, in such a case there is direct reliance on the price in making the decision.

124. See supra notes 7-8.

125. Fischel, Use of Modern Finance Theory, supra note 5, at 5.

126. The large-scale frauds perpetrated on the marketplace in recent years, like those in In re
purchase or sell stock at the prevailing market price, if he wishes to trade in the stock, he does not necessarily rely on the stock's price as the best available indicator of its value, since he can have no assurance that it accurately reflects the corporation's worth. Indeed, many investors purchase or sell stock because they believe the price inaccurately reflects the corporation's worth.

In addition to asserting the right to rely on the market price, plaintiffs also have argued that they have a right to rely on the integrity of the market. While an investor must accept all normal market rises, which include the possibility that the market misinterpreted data, he need not accept abnormal risks like schemes to defraud the market. Shores reasoned that plaintiff's injury was caused by such a scheme; had there been full and accurate disclosure the bonds would have been rejected by the marketplace. The presence of a fraudulent scheme, however, should not require a private damages claim for all open market investors.

In Arthur Young & Co. v. United States District Court,127 a case involving offerings of stock registered under the Securities Act, it was argued that the investor's right to rely on the market price was based on his right to rely on the federal regulatory process to ensure the accuracy of disclosure.128 Following this rationale, it can be asserted that open market investors have a similar right to rely on the accuracy of information disclosed in reports filed under the Exchange Act. Such reliance on the regulatory process is misplaced. Even though the SEC has made strides toward improving the quality of disclosure, particularly in the Exchange Act reports, neither the agency nor the marketplace can ensure the accuracy of these documents.129

These "right to rely" arguments are not persuasive substitutes for the reliance requirement. They are much more persuasive arguments when they are used to establish causation. The shareholder's complaint is that he was injured by manipulation of the stock price by means of misstatements, and that he was harmed by the market's reaction to the misstatements; that is, that he traded in the stock at a time when the price was tainted by inaccurate information. Thus, the misstatements caused the injury. Since the essence of his claim is manipulation of the stock price, reliance is irrelevant; rather, causation is the requisite element.130 This argument, however, potentially transforms every
misstatement case into a stock manipulation case.

At common law, stock manipulation was an offense grounded on a “free and open market” theory: the public has a right to expect that the markets are free and open and reflect prices arrived at through bona fide transactions and not through manipulation.\(^\text{131}\) In *Rex v. De Berenger*,\(^\text{132}\) the earliest English stock manipulation case, defendants were convicted of conspiring to raise the price of government securities by circulating false rumors that Napoleon had been killed and peace was forthcoming. In such cases, in which the manipulation is effected through false statements, the offense resembles deceit. When, however, the manipulation is accomplished through acts such as wash sales, matched orders or fictitious bids, the wrong is better grounded on a “free market” theory. Thus, stock manipulation has roots in both deceit and “free and open market” theories.\(^\text{133}\)

The conflict between the theories is apparent in cases that consider whether a victim of stock manipulation can sue the manipulator in the absence of a contractual or fiduciary relationship. An early English case held that a plaintiff who knew the listing requirements of an exchange, and purchased stock assuming that the corporation had met those standards, could recover on a deceit theory from defendants, who obtained the listing on the basis of false statements made to the exchange.\(^\text{134}\) Later cases, both in England and the United States, generally found that plaintiffs could not recover when there was no fiduciary or contractual relationship, since under the deceit theory there was either a lack of reliance or the injury was found to be too remote.\(^\text{135}\)

If, instead of deceit principles, the “free market” theory is applied, it can be argued that plaintiff has the right to expect that the prevailing market price has been set by actual, and not rigged, transactions. When the manipulative device is, for example, fictitious quotations, plaintiff’s injury is clear, and there is no need for reliance. Professor Berle extended this theory to assert that when a misstatement created a false valuation by the entire market and the buyer relied on the state of the market, he should be able to recover damages. This must be one of the earliest expressions of a fraud on the market theory.\(^\text{136}\)

relinquish his shares, and therefore reliance became meaningless. In fraud on the market cases, however, plaintiffs do have a choice: not trading in the particular security. *Cf.* Madison Consultants v. FDIC, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,239, at 96,041 n.6 (2d Cir. 1983) (presumption of reliance amounts to presumption of causation where the plaintiff directly trades in stock in reliance on defendant’s deception, since he could have declined to enter the transaction if he knew of fraud).

132. *Id.*
135. 3 L. Loss, supra note 2, at 1534; Moore & Wiseman, supra note 133, at 65.
136. Berle, supra note 133, at 269. See also Moore & Wiseman, supra note 133, at 65.
When the misstatements are accompanied by other manipulative devices and are clearly made with a manipulative intent, allowing the purchaser to recover without showing reliance, on a "free and open market" theory, is appropriate. In the absence of classic manipulative devices, allowing a purchaser to recover, based on a finding of causation alone, marks a radical departure from rule 10b-5's traditional underpinnings in deceit law. Thus, while seemingly attractive as a principle of law and logic, such a judicial modification of rule 10b-5 is inadvisable without some sort of legislative authority.

III. OBJECTIONS TO THE FRAUD ON THE MARKET THEORY

The principal objections to the fraud on the market theory are that it contradicts the disclosure rationale of federal securities regulation, increases the likelihood of complex litigation of questionable utility, and makes the potential damages claims exorbitant. Recovery is no longer compensatory; rather, it becomes a windfall. In addition, the heavy cost of litigation is borne by the corporation and necessarily affects adversely the corporation's economic well being, while diminishing the value of shareholders' investments.

A. The Conflict Between Federal Disclosure Policy and the Fraud on the Market Theory

Since the principal purpose of the federal securities legislation is to provide disclosure to enable investors to make informed decisions, opponents of the fraud on the market theory argue that this policy is undermined by permitting recovery by investors who have not read the disclosure documents.139 They contend that an investor who fails to read at least some of the readily available public information acts recklessly and consequently should be disqualified from receiving the acts' protections.140

137. See Second Circuit stock manipulation cases supra notes 56-71 and accompanying text. Some opinions have emphasized the need for a comprehensive scheme to defraud or manipulate the stock price, and not merely material misstatements, to establish a fraud on the market claim. E.g., Blackie v. Barrack, 524 F.2d 891, 905-08 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975); Beissinger v. Rockwood Computer Corp., 529 F. Supp. 770, 785-86 (E.D. Pa. 1981); Greenspan v. Brassler, 78 F.R.D. 130, 135 (S.D.N.Y. 1978); In re Equity Funding Corp. of Am. Sec. Litig., 438 F. Supp. 1303, 1314 (C.D. Cal. 1977). These courts are struggling to establish a special category of fraud on the market cases to separate these cases from run of the mill misrepresentation cases in which plaintiffs must establish reliance. See supra notes 52-55 and accompanying text. They have not made clear, however, how plaintiff is to establish such a scheme. The nature of the misstatement, the number of occasions the misstatement or a variation of it is repeated, and the length of time over which the misstatements are made, seem to be relevant factors.

138. See Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149 (5th Cir. 1982) (rule 10b-5 stock manipulation claim inappropriate when an explicit remedy under § 9(e) of the Exchange Act is available), vacated and remanded for consideration in light of Huddleston, 103 S. Ct. 1245 (1983), rev'd on remand, 718 F.2d 725 (5th Cir. 1983). The Fifth Circuit determined that Huddleston's "broad and unrestricted analysis" compelled reversal of the earlier decision. For doubts on that view see infra notes 196-211. See also infra notes 193-213 and accompanying text.


140. Plaintiff may be denied recovery, notwithstanding defendant's rule 10b-5 violation, if
Rebutting this objection, critics of the federal disclosure system assert that there is no rational reason for a reasonable investor to read the disclosure documents. They argue that the required disclosure does not provide information useful to investment decisionmaking.141 The disclosure documents have become so complex and technical that an investor untrained in accounting and financial analysis would understand little of the contents.142 Finally, according to efficient-market theorists, the average investor cannot learn from the disclosure documents anything that would enable him to outperform the market, since the information contained therein has already been absorbed by the market and is reflected in the stock price.143 Acceptance of any of these arguments leads to the conclusion that requiring the investor to read the document to prosecute the claim is requiring him to engage in an unproductive task;144 therefore, an investor cannot be acting recklessly if he disregards the disclosure documents. It follows that those who doubt the benefits of the current disclosure system will more readily adopt a fraud on the market theory.

Resolution of the role of disclosure in investment decisions is outside the scope of this Article; nevertheless the perceived conflict between the disclosure policy and the fraud on the market theory is considerably reduced if the concept of reliance is expanded to include forms other than just "eyeball" reliance on the document itself.145 Few investors actually read and understand the disclosure documents, but this does not mean that they do not "rely" on them in making their investment decisions. Their reliance is simply not a direct reliance. Instead, investors typically rely on their brokers or other advisers, or on newspaper columns and other sources that do derive their information and recommendations from the disclosure documents. As early as 1933, Congress recognized this filtering-down process when it created a remedy for misstatements in a registration statement in the Securities Act.146 It is therefore appropriate, if not essential, for courts to recognize explicitly the existence of such forms of indirect reliance, and to acknowledge them as appropriate methods for investors to make their investment decisions.147

Requiring an investor to testify about a vaguely recalled newspaper article or conversation with his broker may well be a waste of judicial time. When


143. E.g., H. Kripke, THE SEC AND CORPORATE DISCLOSURE 86-87 (1979); see supra notes 7-8.

144. Disclosure has also been criticized on the ground that its costs outweigh its benefits. See, e.g., Benston, supra note 126.


the stock is so widely traded that information about the corporation is widely disseminated, it may be appropriate to presume indirect reliance.\textsuperscript{148}

\textbf{B. Facilitating the Use of Securities Fraud Class Actions}

The fraud on the market theory developed largely for pragmatic reasons. Since class actions provide the only effective remedy for open market investors, individual, subjective issues of proof must be minimized to enable use of the class action procedure. Thus, judicial inclination to remove obstacles from large-scale securities fraud litigation supplied the impetus to modify the traditional reliance requirement.\textsuperscript{149} Consequently, plaintiffs and their attorneys are encouraged to institute these suits and have a basis for negotiating a favorable settlement.\textsuperscript{150}

Whether encouraging class action suits in this manner is an appropriate policy\textsuperscript{151} depends on one's assessment of the benefits of private securities fraud actions. For years courts and commentators enthusiastically embraced the premise of \textit{J.I. Case Co. v. Borak},\textsuperscript{152} that private litigation aids in effective enforcement of the securities laws because private plaintiffs will prosecute violations that would go undetected due to the SEC's limited resources. Accordingly, many courts, supported by commentators,\textsuperscript{153} have viewed the scope of rule 10b-5 expansively and eased plaintiff's burdens in prosecuting claims.\textsuperscript{154}

The Supreme Court, however, has made it clear that rule 10b-5 is not the

\textsuperscript{148} Proponents of a fraud on the market theory often assert that plaintiffs need not prove reliance in nondisclosure cases and, by extension, should not be required to prove reliance in cases involving open market transactions because it is "impossible" to do so, and therefore such "impossibility" justifies dispensing with it. \textit{E.g.}, Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 93 (2d Cir. 1981); Titan Group, Inc. v. Faggen, 513 F.2d 234, 238-39 (2d Cir. 1975); Seiffer v. Topps's Int'l, Inc., 487 F. Supp. 653, 666 (D. Kan. 1980). It certainly is not impossible for plaintiff to testify that if he had been told the omitted fact he would have acted differently, and such testimony, if credible, would establish the requisite reliance. \textit{List v. Fashion Park, Inc.}, 340 F.2d 457, 463 (2d Cir.), \textit{cert. denied}, 382 U.S. 811 (1965). Courts may decide that since such testimony is self-serving and predictable, it can be dispensed with; dispensing with the testimony, however, does not necessitate elimination of the element of reliance in any fraud case. Rather, the need to establish direct reliance should be balanced against the waste of judicial time, according to the particular case.

\textsuperscript{149} See supra notes 16-30 and accompanying text.

\textsuperscript{150} Even though, under the prevailing view of \textit{Blackie}, defendants may raise a plaintiff's nonreliance defensively, see supra notes 84-85 and accompanying text, plaintiffs have in most instances won the war by obtaining class action certification, since this will virtually guarantee their prospects of a favorable settlement.

\textsuperscript{151} The Federal Rules of Civil Procedure are not intended to expand substantive law. 28 U.S.C. § 2872 (1976).

\textsuperscript{152} 377 U.S. 426 (1964). In \textit{Borak} the Court implied a private cause of action under § 14(a) of the Exchange Act, and provided the impetus for further suits to achieve the same end.


\textsuperscript{154} Thus, for instance, in some circuits, prior to Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), negligence was sufficient to establish defendant's liability. \textit{E.g.}, White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974) (applying a "flexible duty" standard); Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), \textit{cert. denied}, 390 U.S. 951 (1965) (holding negligence was sufficient to establish liability). Also, prior to Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), plaintiff need not have been a purchaser or seller to have standing. \textit{E.g.}, Eason v. General Motors Acceptance Corp., 490 F.2d 654, 661 (7th Cir. 1973), \textit{cert. denied}, 416 U.S. 960 (1974).
A principal concern of the Court was the particularly vexatious nature of rule 10b-5 litigation that gave even the flimsiest case a substantial settlement value. Respected commentators have observed that since the goals of SEC and private enforcement differ, the latter may not be an appropriate supplement to the former, but may actually hamper the purposes of the securities laws. Moreover, evidence that a sizeable number of private suits follow upon conclusion of SEC investigations casts substantial doubt on the Borak premise. These plaintiffs do not ferret out previously undiscovered violations, but rather ride on the agency’s coattails.

Even if private suits are based on violations prosecuted by the SEC, it can be argued that they provide a deterrent because of the in terrorem effect of imposing substantial liability. This argument neglects to consider that since ultimately the current or future shareholders “foot the bill” for plaintiffs’ litigation, in the form of a reduced market value for their stock, compensating the plaintiffs for past injuries inevitably causes shareholders present or future harm. Moreover, in a fraud on the market case, a corporation held liable for the artificial inflation in the stock value must compensate plaintiffs even though the premium did not directly benefit the corporation. There is no principle of equitable disgorgement of profits, as exists in the insider trading cases, to justify plaintiffs’ recovery at the expense of other shareholders in a fraud on the market case. In addition, the concern that large awards in fraud on the market cases become windfalls rather than compensatory recoveries is compounded by the difficulties in formulating damages and in excluding any loss due to factors unrelated to the misstatements. There can be little doubt that, in fraud on the market cases, computation of damages can be an incredibly complex process, with no greater assurance of reasonable accuracy. This, coupled with the fact that virtually all these cases are settled before a determination of liability, lends support to the argument that securities fraud litigations result in haphazard, arbitrary, and potentially ruinous recoveries.

Early decisions recognized a reliance requirement in rule 10b-5 cases, not only to conform the remedy to the common-law tort, but also to limit defend-

155. See, e.g., Aaron v. SEC, 446 U.S. 680 (1980) (scienter requirement extends to injunctive actions); Chiarella v. United States, 445 U.S. 222 (1980) (when the misconduct involves nondisclosure, defendant must have duty to disclose to be liable under rule 10b-5); Sante Fe Indus. v. Green, 430 U.S. 462 (1977) (plaintiff must allege a deception or misrepresentation to establish rule 10b-5 claim); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (defendant must have acted with scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (plaintiff must be purchaser or seller to have standing in 10b-5 claim). Two issues that remain open are: recklessness as establishing scienter, see supra note 2, and aider and abetter liability. Herman & MacLean v. Huddleston, 103 S. Ct. 683, 685 n.4 (1983).


159. See Frankel, supra note 157, at 579.


161. See supra note 30.
It is ironic that the first recognition of the danger of providing "investors' insurance" against bad investments was in cases involving negotiated transactions and that the reliance requirement is most rigorously adhered to today in these cases. In the open market cases, however, in which commentators have recognized the serious problem of staggering corporate liability, many courts have largely dispensed with a reliance requirement in the name of protecting the open market investor.

The insider trading cases have presented most dramatically the specter of "Draconian liability." It was the inability to limit the damage recovery that led the Sixth Circuit, in *Fridrich v. Bradford*, to find that defendants caused no injury to plaintiffs. In *Elkind v. Ligget & Meyers, Inc.* the Second Circuit attempted to solve the problem, not by refusing to find liability, but by limiting plaintiffs' recovery to the disgorgement of defendants' gains. The First Circuit, in *SEC v. MacDonald*, went further, and held that the measure of disgorgement was limited to accretions in stock value occurring up to a reasonable time after other investors received the information. Significantly, the court felt it necessary to exclude gains not causally related to the fraud even when the SEC brought the suit. These cases illustrate the judicial perception that "Draconian liability" is a serious issue when the traditional tort-law elements are relaxed.

In conclusion, while the fraud on the market theory presents an attractive approach to providing protection for open market investors, it nonetheless raises serious doubts about whether it is an appropriate judicial expansion of rule 10b-5 law. In cases in which indirect reliance cannot appropriately be presumed, the theory conflicts with federal disclosure policy; even in cases involving widely-traded securities, in which a presumption of indirect reliance is appropriate, the theory adds to the existing difficulties plaguing the typical large-scale federal securities litigation involving huge damages claims.

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168. *Id.* at 320-21. The Sixth Circuit did, however, leave open the question of liability when defendants' trading affected the market price. *Id.* at 320 n.27.
169. 635 F.2d 156 (2d Cir. 1980).
170. *Id.* at 173.
171. 699 F.2d 47 (1st Cir. 1983).
IV. THE FRAUD ON THE MARKET THEORY AND THE EXPLICIT REMEDIES

Another objection to the fraud on the market theory is that it conflicts with the Supreme Court’s efforts to harmonize the implied remedy under rule 10b-5 with the explicit remedies under the federal securities laws. Specifically, rule 10b-5, with its elimination or relaxation of the reliance element, conflicts with section 18 of the Exchange Act, which requires direct reliance.

In Herman & MacLean v. Huddleston\(^{172}\) the Supreme Court held that the plaintiff’s potential section 11 claim\(^{173}\) under the Securities Act did not preclude recovery under rule 10b-5 of the Exchange Act. While recognizing the overlap of section 11 and rule 10b-5 and, in general, the appropriateness of cumulative remedies, the Court’s opinion does not mandate cumulative remedies in all instances.\(^{174}\) Instead, the implied remedy must be harmonized with the explicit remedies.\(^{175}\) In addition, in Ernst & Ernst v. Hochfelder\(^{176}\) the Supreme Court declined to extend rule 10b-5 liability to negligent misstatements because it would “nullify the effectiveness of the carefully drawn procedural restrictions”\(^{177}\) of section 11. Therefore, the role of reliance and causation in the explicit remedy provisions must be examined in order to determine their appropriate role in rule 10b-5 claims, since the Court would refuse to dispense with a reliance requirement in rule 10b-5 if it conflicted with the congressionally designed statutory scheme.\(^{178}\)

Section 11 of the Securities Act\(^{179}\) permits anyone who acquires a security issued under a registration statement to sue the issuer and certain other specified defendants for material misstatements in the registration statement. There is no requirement that plaintiff demonstrate any reliance on the registration statement unless he acquires the security after the issuer releases an earnings statement covering a twelve-month period beginning after the effective date.

\(^{172}\) 103 S. Ct. 683 (1983).

\(^{173}\) The court of appeals noted that plaintiffs “apparently did have a Section 11 remedy,” Herman & MacLean v. Huddleston, 640 F.2d 534, 541 n.5 (1981), although the Supreme Court indicated that this conclusion may be open with respect to the accounting firm, 103 S. Ct. at 687 n.11. A commentator has suggested that the § 11 claim was apparently time-barred. Siegal, The Interplay Between the Implied Remedy under Section 10b-5 and the Express Causes of Action of the Federal Securities Laws, 62 B.U.L. Rev. 385, 391 (1982).

\(^{174}\) In Huddleston cumulative remedies under § 11 and rule 10b-5 were accepted because “the two provisions involve distinct causes of action and were intended to address different types of wrongdoing,” 103 S. Ct. at 687. Section 11 was “designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering,” id., and thus imposes liability for any material misstatement in the registration statement. Rule 10b-5, on the other hand, is a “catchall” antifraud provision requiring scienter. Id.

\(^{175}\) In Huddleston the Court determined that exempting fraudulent misstatements in registration statements from rule 10b-5 liability would “conflict with the basic purpose of the 1933 Act: to provide greater protection to purchasers of registered securities.” Id. at 688.

\(^{176}\) 425 U.S. 185 (1976).

\(^{177}\) Id. at 210.

\(^{178}\) A threshold question is whether there is, in fact, a coherent statutory scheme with respect to the explicit remedies, since a significant distinction between the two Acts is apparent. The remedies for material misstatements under the Securities Act substantially ease plaintiff’s burden of proving causation and reliance; the remedy for material misstatements under the Exchange Act requires plaintiff to prove both reliance and causation.

date of the registration statement.180 Even when reliance is required, it may be established by means other than showing that the plaintiff actually read the document.181 Moreover, plaintiff need not prove that the price of the stock was artificially inflated by reason of the misstatement;182 rather, it is defendant's burden to show that the economic loss suffered by the plaintiff resulted from factors other than the misstatement.183

Section 12(2) of the Securities Act184 permits a purchaser of a security to sue the offeror or seller for misstatements made either orally or in a prospectus.185 There is no requirement that the plaintiff establish reliance or that the misstatement cause his injury.186

In contrast, section 18 of the Exchange Act permits a purchaser or seller of a security to sue for misstatements contained in reports filed under the Exchange Act, but only when he can show that he relied directly on the statement and that the stock price was affected by the statement.187 Thus, the plaintiff must show both reliance and causation to establish a section 18 violation.

Finally, section 9(e) of the Exchange Act provides that an investor who trades in a security registered on a national securities exchange, at a price affected by certain forms of stock manipulation, may sue for damages anyone who willfully participates in the proscribed act.188 There is no requirement of reliance, but plaintiff's burden of establishing causation is onerous. It has been described as "double-barreled"; he must show that he bought or sold at a price affected by the manipulation, and his recovery is limited to damages sustained as a result of the manipulation.189

In enacting the Securities Act, Congress recognized that many investors would not be able to understand much of the contents of the registration statement and would necessarily rely on other sources of information. The information in the registration statement would affect most investors by its effect on

180. Id. § 77k(a).
181. Id.
182. Plaintiffs who sue under § 11(a) may recover the difference between the amount paid for the security (not to exceed the price at which the security was offered to the public) and (1) the value of the security on the date the suit was brought, or (2) the price at which the security was sold, if sold before the suit, or (3) the price at which the security was sold, if sold before judgment, if greater than the value on the date suit was brought. An underwriter is not liable for damages in excess of the total offering price of the securities underwritten by it. In no event shall the amount recoverable exceed the total offering price. Id. § 77k(e).
185. Unlike § 11, § 12(2) liability extends to the sale of unregistered securities. Section 12(2), however, requires privity between plaintiff and defendant, and thus is not designed as a remedy for fraud on the market. But see Croy v. Campbell, 624 F.2d 709 (5th Cir. 1980) (seller liability extends beyond strict privity; test of proximate cause used).
186. Section 12(2) provides plaintiff shall recover the price paid upon tender of the security or for damages if he no longer owns the security. Presumably this would be measured by the purchase price of the stock less the proceeds of the sale, with no allowance for the "negative causation" defense authorized in § 11(e).
188. Id. at § 78(e).
189. 3 L. Loss, supra note 2, at 1750-51.
the stock price. Therefore, Congress determined that generally purchasers
of the securities need not establish reliance on the registration statement and
need never demonstrate that they had read the registration statement.

Since Congress in 1933 clearly understood the average investor's depen-
dence on professional sources for making investment decisions, one looks to
determine the reasons Congress, in 1934, required plaintiffs to establish both
reliance and causation to state a claim under section 18 of the Exchange Act.
Legislative history provides a clear answer. As originally drafted, the provi-
dion did not contain a requirement of reliance; opposition to the Exchange
Act, led principally by the stock exchanges, resulted in the provision's revision
to its current form.

190. Thus, William O. Douglas noted that:

[Even though an investor has neither the time, money, nor intelligence to assimilate the
 mass of information in the registration statement, there will be those who can and who
 will do so, whenever there is a broad market. The judgment of those experts will be
 reflected in the price market. Through them investors who seek advice will be able to
 obtain it. And so during the early months of the life of a security the registration state-
 ment will serve as a healthy conditioner of the market. . . . The common law with its
 insistence upon the presence of an intent on the part of the seller to defraud, of a causal
 relation between the misstatement and the damage, and of a reliance by the buyer on the
 misstatement, presented almost insuperable procedural barriers to recovery.

Douglas, Protecting the Investor, 23 Yale Rev. (n.s.) 521, 524 (1933).

See also Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 176 (1933)
(During the early life of a security “the registration statement will be an important conditioner
of the market.” If plaintiff buys in the open market “he may be as much affected by misstatements as
if he had read and understood the statement.”).

191. Identical bills, which led eventually to the final legislation, were introduced by Senator
Fletcher on February 9, 1934, S. 2693, 73d Cong., 2d Sess. (1934), and by Representative Rayburn
on February 10, 1934, H.R. 7852, 73d Cong., 2d Sess. (1934). What was then § 17(a) read as
follows:

Any person who shall make or any person, including any director, officer, accountant, or
other agent of such person, who shall be responsible for the making of any statement in
any application, report, or document filed with the Commission, which statement is, in
the light of the circumstances under which it was made, false or misleading in respect of
any matter sufficiently important to influence the judgment of an average investor shall
be liable to any person (not knowing that such statement was false or misleading) who
shall have purchased or sold a security the price of which may have been affected by
such statement, and the person injured may sue in law or in equity in any court
of competent jurisdiction for the damages caused by such statement, unless the person sued
shall sustain the burden of proof that he acted in good faith and in the exercise of reason-
able care had no ground to believe that such statement was false or misleading.

During the hearings on the bills, representatives of the stock exchanges, in particular, voiced
strong objections to § 17 on several grounds, one of which was the absence of a requirement of
reliance. This was part of the stock exchanges' campaign against imposition of reporting require-
ments on listed corporations. Richard Whitney, President of the New York Stock Exchange,
stated that:

[The really objectionable feature of this provision is that the civil penalties may be re-
covered by persons who have not relied upon the inaccurate or misleading state-
ment. . . . If any civil penalties are deemed necessary, then they should be limited to
the actual damages suffered by persons who have been misled by the false or inaccurate
statement.

Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.), S. Res. 56 & S. Res. 57 Before the
Senate Banking Comm., 73d Cong., 2d Sess. 6638 (1934) [hereinafter cited as Practices Hearings];
see also Stock Exchange Regulation: Hearings on H.R. 7852 & H.R. 8720 Before the House Inter-
state & Foreign Commerce Comm., 73d Cong., 2d Sess. 726 (1934) [statement of Richard Whitney,
Pres. of the N.Y.S.E. [hereinafter cited as Regulation Hearings]; Practices Hearings, supra, Comm.
Exhibit No. 111, at 7285 (statement of Richard Whitney on § 17). Others asserted that the provi-
In light of its background, section 18 appears to be a classic product of political compromise. Realizing that all traders would be injured by a misstatement,192 Congress, to assure passage of the legislation, nevertheless gave only a small segment of investors a remedy.

The closest analogue in the explicit remedies to rule 10b-5's implied remedy of fraud on the market is section 18,193 which requires direct reliance on filed documents.194 The presence of this requirement in section 18 raises serious questions about allowing less than direct reliance as a basis for the

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193 Section 9(e) provides a private remedy for certain forms of stock manipulation, i.e., willful participation in an act or transaction prohibited under subsections (a), (b) or (c) of § 9. Section 9(a)(4) could give rise to a fraud on the market claim, since the gravamen is making misstatements for the purpose of inducing the purchase or sale of the security. The defendant, however, must be a person selling, offering to sell, purchasing or offering to purchase said security, so if the corporation were not in the market, the section would not be applicable. When applicable, there would be serious questions about allowing less than direct reliance as a basis for the


195 Section 18, 15 U.S.C. § 78r (1976), provides liability for material misstatements contained in any document filed pursuant to the Securities or Exchange Acts, or the rules and regulations thereunder. Section 13, 15 U.S.C. § 78m (1976), requires the filing of certain documents, e.g., the reports on forms 10-K, 10-Q, and 8-K, for issuers of securities registered under § 12. In general, annual reports to shareholders are not deemed to be "filed" with the SEC and are therefore not subject to the liabilities of § 18. 17 C.F.R. § 240.14a-3(c) (1983).
implied remedy. In *Huddleston*\(^{196}\) the Supreme Court accepted the cumulative remedies of section 11 and rule 10b-5, because it found that “the two provisions involve distinct causes of action and were intended to address different types of wrongdoing.”\(^{197}\) When the rule 10b-5 remedy closely resembles the express remedy in section 18 and addresses the same type of wrongdoing, *Huddleston*’s justification for cumulative remedies fails. Even so, permitting cumulative remedies works no harm if it means mere duplication. If the implied remedy relaxes a requirement of the explicit remedy, however, an unacceptable nullification of the congressional scheme results. Accordingly, the Supreme Court in *Hochfelder*\(^{198}\) sought to avoid nullification of section 11 and its procedural restrictions by interpreting rule 10b-5 to require scienter. Following the same reasoning, it would be inappropriate to imply a remedy under rule 10b-5 that expanded an express remedy, by eliminating an element required to make out the express claim. To permit this would nullify the express remedy and allow improper judicial intervention in the statutory scheme.

The forerunner of the cumulative remedies approach is the Second Circuit’s decision in *Fischman v. Raytheon Manufacturing Co.*\(^{199}\) which the Supreme Court cited with approval in *Huddleston*\(^{200}\). Both preferred and common stockholders brought suit alleging misstatements in a registration statement filed under the Securities Act with respect to the preferred stock. While only the preferred stockholders had a remedy under section 11 of the Securities Act, the court held that the common stockholders could bring a rule 10b-5 claim. It reasoned that plaintiffs who met the requirements for suing under section 11\(^{201}\) established a prima facie case by showing that the document contained material misstatements. To avoid liability, the individual defendants must prove that they exercised due diligence.\(^{202}\) Plaintiffs who did not satisfy the requirements of section 11 must establish not only the material misstatements, but also the defendant’s fraudulent intent.\(^{203}\) Thus, the court reasoned, rule 10b-5 is available for “all who are the victims of the fraud”\(^{204}\) whether or not they could bring suit under section 11. Courts subsequently extended *Fischman*’s rationale to allow rule 10b-5 claims to be brought not only by plaintiffs who never could have sued under section 11, but also by plaintiffs who theoretically might have had a section 11 claim, but had not

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\(^{196}\) 103 S. Ct. 683 (1983).

\(^{197}\) Id. at 687.

\(^{198}\) 425 U.S. 185 (1976).

\(^{199}\) 188 F.2d 783 (2d Cir. 1951).

\(^{200}\) 103 S. Ct. 683, 689 (1983).

\(^{201}\) Plaintiff must be a purchaser of the securities issued under the registration statement; he must bring suit within the statute of limitations prescribed under § 13 (generally of shorter duration than the state’s fraud statutes of limitations applicable under rule 10b-5); and the court may require him to post security for costs, § 11(e), 15 U.S.C. § 77k(e) (1976).


\(^{203}\) The Second Circuit in *Fischman* correctly anticipated the holding of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

\(^{204}\) *Fischman*, 188 F.2d at 786.
brought it.\textsuperscript{205} \textit{Huddleston} confirmed this cumulative remedies approach.

The Second Circuit, in \textit{Ross v. A.H. Robins Co.},\textsuperscript{206} applied Fischman's logic and held that a rule 10b-5 claim could be based on misstatements contained in a document filed under the Exchange Act, notwithstanding the section 18 remedy. It noted "substantial differences in the burden facing the plaintiff under the two statutes."\textsuperscript{207} Under rule 10b-5, the plaintiff must prove \textit{scienter}, while under section 18 the defendant must prove he acted in good faith and had no knowledge that the statement was false and misleading. On the other hand, section 18 required direct, "eyeball" reliance on the document, while rule 10b-5, according to the court, permitted indirect reliance. In the view of the court, the higher standard of proof imposed on the plaintiff under rule 10b-5 provided the rationale both for justifying the availability of the rule 10b-5 remedy, notwithstanding the existence of section 18, \textit{and} for relaxing section 18's direct reliance requirement under rule 10b-5.\textsuperscript{208}

The analysis in \textit{Robins} is suspect, given the rationale of \textit{Huddleston}.\textsuperscript{209} An examination of section 18(a) and rule 10b-5 leads to the conclusion that the provisions do not "address different types of wrongdoing."\textsuperscript{210} Rather, they both are concerned with fraudulent misstatements, regardless of the shift in the burden of proof. Moreover, in earlier opinions, the Supreme Court suggested that section 18 was the exclusive remedy for misstatements in filed documents.\textsuperscript{211}

On the other hand, the broad language of \textit{Huddleston} and its emphasis that rule 10b-5 fraud is light-years away from the common-law deceit remedy,\textsuperscript{212} indicate that the Court will not be inhibited by the explicit remedies in fashioning the reliance and causation elements under rule 10b-5. In addition,

\textsuperscript{205} See also Wachovia Bank & Trust Co. v. National Student Mktg. Corp., 650 F.2d 342 (D.C. Cir. 1980), \textit{cert. denied}, 452 U.S. 954 (1981), in which the District of Columbia Circuit, relying upon Fischman, held that purchasers of stock in a private placement were not limited to a remedy under § 12(2) of the Securities Act, but could bring a rule 10b-5 claim. See also Berger v. Bishop Inv. Corp., 695 F.2d 302 (8th Cir. 1982); Schaefer v. First Nat'l Bank, 509 F.2d 1287 (7th Cir. 1975), \textit{cert. denied}, 425 U.S. 943 (1976); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); \textit{In re New York City Mun. Sec. Litig.}, 507 F. Supp. 169 (S.D.N.Y. 1980).

\textsuperscript{206} 607 F.2d 545 (2d Cir. 1979), \textit{cert. denied}, 446 U.S. 946 (1980).

\textsuperscript{207} \textit{Id.} at 555.

\textsuperscript{210} \textit{Id.} at 556. \textit{A.H. Robins Co.} is criticized in Siegel, \textit{supra} note 173. In contrast to \textit{A.H. Robins Co.}, in Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149 (5th Cir. 1982), \textit{vacated and remanded for consideration in light of Huddleston}, 103 S. Ct. 1254 (1983), \textit{rev'd on remand}, 718 F.2d 725 (5th Cir. 1983), this nullification approach was held to bar an implied remedy under rule 10b-5 when a claim was not made out under § 9(e) of the Exchange Act, 15 U.S.C. § 78i(e) (1976). The Chemetron court reasoned that since § 9(a)(4)'s \textit{scienter}, causation, and reliance requirements are more stringent than those of rule 10b-5, allowing the implied remedy would nullify the express remedy. \textit{Cchemetron}, 682 F.2d at 1162. On remand, however, the court concluded that, after \textit{Huddleston}, a claim that contained all the elements of a rule 10b-5 offense should not be barred because of an express statutory remedy.

\textsuperscript{209} 103 S. Ct. 683 (1983).


\textsuperscript{212} 103 S. Ct. 683, 691 (1983) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975)).
Ross v. A.H. Robbins Co. is cited in Huddleston, although in the context it would be straining to read its citation as necessarily approving the result.

Liability is imposed under section 18 only with respect to misstatements in filed documents, and, notwithstanding Robins, section 18 is best viewed as the exclusive remedy. Most misstatements found in filed documents, however, are also contained in unfiled documents. Accordingly, the question becomes whether liability for misstatements in unfiled documents can be grounded under rule 10b-5 if such misstatements are also found in filed documents. The answer to this question must certainly be yes. Since SEC v. Texas Gulf Sulphur, courts have imposed liability without regard to whether misstatements are also found in filed documents. The question then becomes, since direct reliance is required for imposing liability for misstatements in filed documents under section 18, must such reliance be required for imposing liability for misstatements in unfiled documents under rule 10b-5. To answer this question negatively is not to "nullify" section 18, although its scope becomes very narrow. By this approach section 18 becomes a remedy of last resort, applicable only when the misstatement was contained in no document other than a filed one and only when the investor actually read the document. This is not inconsistent with congressional intent.

V. INTEGRATED DISCLOSURE—THE SEC'S RECOGNITION OF THE EFFICIENT-MARKET THESIS

Proponents of the fraud on the market theory rely on the efficient-market thesis to justify the theory's extended use in securities fraud cases. The SEC explicitly recognized the efficient market thesis in 1982 by its adoption of an integrated disclosure system. Therefore, it is appropriate to examine the integrated disclosure system in determining the extent of the SEC's acceptance of the efficient-market thesis to the fraud on the market theory, and its application. When the SEC has determined that information about a corporation is sufficiently widely disseminated that it need not be directly provided to the purchaser in the prospectus, the courts should likewise appropriately presume indirect reliance on the information by open market investors in fraud on the market cases.

The integrated disclosure system marked the culmination of the SEC's efforts to effect a major policy reversal: to deemphasize the Securities Act's disclosure system which mandates delivery of a prospectus to the investor

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213. Id. at 689 n.21.
214. See supra note 195.
216. While most of the fraud on the market cases involve securities purchased in trading transactions, with disclosure requirements regulated by the Exchange Act, the integrated disclosure system prescribes prospectus disclosure requirements for securities offerings registered under the Securities Act. Since the integrated disclosure system assumes an equivalency of materiality of information under the two acts, this distinction should be irrelevant.
upon the distribution of securities, and to emphasize the Exchange Act's disclosure system which mandates periodic filing of disclosure documents.217 Three levels of registrants are created. Corporations whose stocks are actively traded and widely followed in the marketplace may use form S-3. These registrants comprise the first level.218 The second level of registrants, those that have been subject to the reporting requirements of the Exchange Act for at least three years, may use form S-2. Finally, all other issuers must use form S-1.

The quantity of information required in the prospectus depends on which form the issuer is permitted to use. The SEC's creation of a "top tier" of issuers that need disseminate only a bare-bones prospectus (form S-3) is based on the efficient-market thesis. In incorporating this theory, the SEC assumes that, in the case of the most widely traded securities, information on the issuer is widely available,219 there is some assurance that it is accurate,220 and therefore it need not be directly supplied to the investor. In these instances, the prospectus need contain only new information, or information that brings up-to-date previously filed information, about the issuer, as well as information relating specifically to the offering. All other information traditionally contained in a prospectus is not set forth in the form S-3 prospectus, but is incorporated by reference to the relevant Exchange Act documents.221 In contrast, an issuer eligible to use form S-2 must either deliver to the investor copies of the Exchange Act reports or reprint the information in the prospectus. Form S-1 users must prepare a detailed disclosure document.

To be eligible to use form S-3, the issuer must have been subject to the Exchange Act reporting requirements for at least thirty-six months; it must

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220. The efficient-market theory draws no distinctions between accurate and inaccurate information. See supra notes 7-8. The SEC views the filing of the reports with the SEC, with at least the potential for SEC review, and the liabilities for misstatements, as a curb on both intentional and unintentional misstatements by management. The upgrading of the quality of the Exchange Act documents is an essential aspect of the integrated disclosure system. See generally Sec. Act Rel. No. 6383, 47 Fed. Reg. 11,380 (1982).
have filed all required reports during that period; and it must have timely filed all reports for the past twelve months. There are certain disqualifying events. Moreover, in the SEC's view, subjecting a stock to the continuous disclosure requirements for three years gives no assurance that it is sufficiently followed by the financial analysts to warrant application of the efficient-market thesis, and thus trigger eligibility for form S-3. To ensure that form S-3 is available only to such widely traded securities, the SEC imposes certain "transaction" requirements. The most significant one, in primary offerings for cash, is a "float" requirement of $150 million or, alternatively, a float of $100 million and an annual trading volume of three million shares. When the primary offering for cash is of "investment grade" nonconvertible debt and preferred securities, there is no float or trading volume requirement. In these offerings the SEC determined that investment decisions are made principally on the basis of interest rates and security ratings and not on the basis of specific information about the issuer. Moreover, any secondary offering of a qualified issuer's stock may use form S-3 as long as the securities are listed on a national securities exchange or quoted in NASDAQ, because the SEC "concluded that most secondary offerings are more in the nature of ordinary market transactions than primary offerings by the registrant, and thus, that Exchange Act reports may be relied upon to provide the marketplace the information needed respecting the registrant."

Reviewing the SEC's three releases on integrated disclosure, one sees a tightening in the criteria for form S-3 eligibility from those first proposed,
which were basically those of former S-16. 230 Apparently, the SEC became convinced that the market is not so efficient as had been popularly supposed, and that form S-16 availability included many securities not widely followed. In addition, the SEC initially proposed that secondary offerings would be subject to the same float criteria as primary offerings. Only after many commentators noted the hardships that would occur as a result, particularly for secondary offerings previously eligible under form S-16, 231 did the SEC relax the requirements for secondary offerings.

The integrated disclosure system thus supports Blackie’s232 rebuttable presumption of indirect reliance with respect to the top tier of issuers, those meeting the issuer eligibility requirements of form S-3 and one of the alternative float requirements. In addition, when the securities offered are investment grade, nonconvertible senior securities, a court may apply the Blackie presumption consistent with the premise underlying the integrated disclosure system.

It can be argued that the Blackie presumption should be extended to include all issuers that meet the registrant eligibility requirements and that have securities listed on a national securities exchange or NASDAQ. This approach is consistent with the SEC’s justification for relaxing the requirements for secondary offerings since they are more like trading transactions. 233 The SEC’s distinction between primary and secondary offerings, however, is inconsistent with the underlying premise of the integrated disclosure system—that materiality is equivalent for purposes of both Acts—and apparently was motivated by pragmatic considerations. 234

If the securities involved in a fraud on the market case do not meet the criteria of form S-3, the court should not grant plaintiffs the Blackie presumption of reliance. This refusal is consistent with the SEC’s determination that market information is not sufficiently widely disseminated to assume the market’s general familiarity with it. The requirement of reliance could be satisfied, however, in a number of ways other than eyeball reliance: discussions with a broker or investment adviser or information from an investment column. 235 Such a showing of indirect reliance is appropriate for issuers falling in the second tier—basically 3-year registrants with securities listed on an exchange or traded through NASDAQ. Corporations in this category have an established background and are followed by financial analysts and the press. An investor might appropriately make an investment decision by consulting these available sources.

If the fraud on the market case involved securities of an issuer that must

234. See supra note 231 and accompanying text.
235. See supra notes 145-48 and accompanying text.
use form S-1, the court should examine more closely the basis of plaintiff's investment decision. If plaintiff traded in stock of unseasoned firms or other speculative securities, the court should require a more direct form of reliance, perhaps including the perusal of corporate reports, to permit recovery under rule 10b-5. Without a showing of direct reliance, plaintiff's claim should be dismissed because such investor acted recklessly in failing to consult available information.\textsuperscript{236} His claim should be barred under rule 10b-5, so that the federal disclosure policy is not undermined.\textsuperscript{237}

VI. CONCLUSION

The fraud on the market theory was born out of judicial desire to provide an effective remedy for open market investors defrauded by misstatements and in particular to accommodate the rule 10b-5 remedy to the class action device. Its development, moreover, was furthered by the growing acceptance of the efficient-market theory, which calls into question the value of the average investor's direct, individual reliance on disclosure documents. Thus, fraud on the market reworks the traditional elements of a rule 10b-5 claim—materiality, reliance, and causation—to reflect the realities of open-market trading.

Fraud on the market has not yet developed into a coherent theory. In all its forms, the role of reliance is reduced by the emphasis on materiality and causation. In its most extreme form, a finding of materiality results in the conclusion that the violation caused the investor's injury: reliance is effectively eliminated as an element. Under this pure causation approach, every action for misstatement is transformed into a stock manipulation claim. This pure causation form of the fraud on the market theory is persuasive when the securities are traded in an efficient market, for if the misstatement has an impact in determining the stock price, necessarily every trader in that stock is affected by the misstatement and suffers injury as a result of it. When, on the other hand, the securities are not so widely traded that their market can be considered efficient, there is no basis for assuming that the information had an impact on the price that affects all investors. Completely eliminating the requirement of reliance, however, would mark a radical departure from rule 10b-5's traditional underpinnings and should not be undertaken by the judiciary. Moreover, it is hard to justify a cause of action that demands stricter proof in a negotiated transaction than in an open market transaction. It is particularly hard to justify such a result when part of the rationale for borrowing the requirements from common law is to limit liability under the rule.

Less radically, fraud on the market is analyzed, not as eliminating the element of reliance, but as according plaintiffs a rebuttable presumption of

\textsuperscript{236} Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), cert. denied, 434 U.S. 911 (1977), is the leading case requiring that a plaintiff in a rule 10b-5 claim establish that he used "due diligence" in making his investment decision. Under Dupuy, plaintiff's negligence will not bar his recovery; only reckless conduct establishes lack of due diligence. Other courts require that plaintiff demonstrate "reasonable" reliance. \textit{See}, e.g., Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977).

\textsuperscript{237} \textit{See supra} notes 139-48 and accompanying text.
reliance. A fraud on the market theory dispensing with a requirement that investors must actually read the disclosure documents is sound in the case of widely-traded securities. Affording plaintiff a presumption of reliance in the case of widely-traded securities follows logically from the efficient-market theory, and it is appropriate to transfer to the defendant the burden of disproving reliance. Such a relaxed view of reliance, however, is not appropriate in cases of less widely-traded securities, in which the information regarding the stock is not so readily available. Here plaintiffs should be required to demonstrate some form of reliance. In most cases, it should not be necessary to demonstrate that the plaintiff actually read the document; reliance can take whatever form is reasonable under the circumstances. When the securities at issue are speculative, however, it is appropriate for the court to require plaintiff to prove actual reliance on the disclosure documents.