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SHOULD FRAUD ON THE MARKET THEORY EXTEND TO THE CONTEXT OF NEWLY ISSUED SECURITIES?

JOSEPH DE SIMONE

INTRODUCTION

Penelope Prudent, regular reader of the *Wall Street Journal*, decided to invest some of her hard-earned money in securities. Based on the advice of her broker and her general knowledge of the securities market, Penelope purchased stock at $35 per share in Dastardly, Inc., an actively traded company on the New York Stock Exchange. She also purchased a new series of revenue bonds issued jointly by the New York Elderly Assistance Board and Do Good, Inc. to finance the construction of an affordable retirement home complex for the elderly.

One month prior to Penelope’s purchase, Dastardly, Inc.’s stock was trading at $20 per share when Dick Dastardly, Chief Executive Officer of the company, boasted in a press release and related Securities and Exchange Commission (“SEC”) disclosure documents about Dastardly Inc.’s strong showing of double digit growth for the past five quarters. In those same documents, Dastardly also predicted huge future profits based on a new product line that the corporation had perfected ahead of schedule. Penelope was not aware of Dastardly’s press release nor had she read any of Dastardly, Inc.’s disclosure documents. Those documents, in fact, contained serious misstatements. The company’s earnings and profits had been inflated through illegal accounting maneuvers, and there was no new product line. On the revenue bond side, Dick Dastardly’s distant cousin, Dan, President of Do Good, Inc., had set up a scheme to abscond with the bond proceeds. As part of that scheme, Dan made a series of false statements in connection with the financing and construction of the retirement home complex that were incorporated into the bond’s offering circular. Penelope had never read the offering circular, however.

Four months later, after Dick and Dan Dastardly had left the country, the *Wall Street Journal* reported that Dastardly, Inc. announced it was restating its earnings for the past two years to reflect the large losses it had actually incurred, and that it would finally begin to develop the promised new product line. Immediately following this announcement, Dastardly, Inc.’s stock dropped to $10 per share. At the same time, Do Good, Inc. had announced that there was insufficient funding to continue with the development of the retirement complex and that, as a result, it had defaulted on its bond payments. Contending that she had been defrauded, Penelope filed separate class actions on behalf of herself and similarly situated plaintiffs against (1) Dastardly, Inc. and its directors and officers, and (2) Do Good, Inc., its directors and officers, the underwriter for the bond issue and the bond counsel.

A common sense reading of Penelope’s predicament is that Dick and
Dan Dastardly, acting through their companies, committed securities fraud that led to Penelope's loss. The casual observer would assume, then, that Penelope should and would have a remedy through Rule 10b-5, the federal securities provision that prohibits such fraud in connection with the purchase or sale of securities. The traditional requirements of Rule 10b-5 in effect well into the 1970s, however, would deny relief to Penelope and similarly situated plaintiffs. Because Rule 10b-5 was based on the common law torts of fraud and deceit, courts traditionally required plaintiffs to have relied directly on the defendant's misrepresentations to obtain a remedy. In the example above, Penelope had not read the disclosure documents or the press release that contained the defendant's misrepresentations. Because she had not relied directly on the defendants' misrepresentations in those documents, she could not sustain a cause of action for securities fraud under the traditional interpretation of Rule 10b-5.

This traditional approach began to change in the 1970s, however, as many courts and commentators argued that it was misguided and unfair to condition relief for securities fraud on the plaintiff having read esoteric disclosure documents that provided little intelligible information to average investors. In addition, critics pointed out that the traditional reliance requirement posed burdensome evidentiary and procedural

1. Rule 10b-5, promulgated by the SEC in 1942 under its authority pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1989), provides as follows:

   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.


   3. See, e.g., Homer Kripke, The Myth of the Informed Layman, 28 Bus. Law. 631, 631-32 (1973) (stating that disclosure documents were "fairly close to worthless" to the average investor).

   4. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988) ("Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed, . . . or if the misrepresentation had not been made, . . . would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.") (citations omitted).

   5. See, e.g., id. at 242 ("[T]he presumption of reliance created by the fraud-on-the-
problems that prevented plaintiff-investors from bringing class actions. Supporters of a revised approach further contended that in litigating under an anti-fraud statute, the focus of the judicial inquiry should be on the merits of the claim that defendants committed fraud, not collateral evidentiary and procedural inquiries.

By the early 1980s, several circuits supported a theory that permitted plaintiffs who had not read or directly relied upon the defendant’s misstatements to recover under Rule 10b-5. This theory, known as fraud on the market theory, was shaped by two significant influences on securities law: the efficient capital market hypothesis and federal class action procedure. The efficient capital market hypothesis states that in open and actively traded markets, a security’s price fully reflects all available, material information relating to that security. The hypothesis assumes that efficient markets quickly absorb new information and incorporate this information into a security’s price. As a result, a plaintiff should be able to rely on the integrity of the market to price securities accurately.

In the example above, the market reacted to Dick Dastardly’s misrepresentations in the disclosure documents and press release by incorporating the positive news into the stock price, which then rose to an artificially inflated $35 per share. Then, when those misrepresentations were revealed, the stock quickly dropped to $10 per share. Fraud on the market theory uses the efficient capital market hypothesis to explain how the defendant’s misrepresentations caused a plaintiff’s loss without requiring...
a showing of direct reliance. Fraud on the market theory also furthers the goals of the Federal Rules of Civil Procedure by facilitating class actions, since it helps eliminate individual issues of reliance that tend to make securities fraud class actions impracticable. As discussed in detail below, the Supreme Court embraced the fraud on the market theory in Basic Inc. v. Levinson.

Despite the acceptance of fraud on the market theory, most courts remain faithful to Rule 10b-5's origins in tort law and retain reliance as an essential element a Rule 10b-5 claim. Courts explain fraud on the market as granting plaintiffs a presumption of reliance, establishing a prima facie case that defendants may rebut. For example, if Penelope purchased Dastardly, Inc. stock in reliance on her belief that the company was about to be taken over at a huge premium, actual knowledge of the defendant's misrepresentations in the disclosure documents would not have affected her investment decision. In this case, defendants could rebut the fraud on the market's presumption of reliance upon positive proof that the misrepresentations were irrelevant to Penelope's investment decision and that she would have bought the stock even if she had known about the misrepresentations. But critics of the theory claim that, in practice, fraud on the market effectively eliminates the reliance requirement. Instead, it establishes a recovery scheme of "pure causation," thereby creating an investor's insurance policy that conditions recovery solely on plaintiff's loss.

So far, the discussion has focused on the fraud on the market theory as it would be applied in Penelope's cause of action based on her purchase of Dastardly, Inc. stock. But Penelope also filed a suit against Do Good, Inc. based on her purchase of the new issue revenue bonds. Courts recognize a difference between these two causes of action.

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12. See id.
13. The "common questions of fact" element of Fed. R. Civ. P. 23(b)(3) requires that questions of law or fact common to all members of the class must predominate over questions affecting only individual class members for purposes of class certification. See Basic, 485 U.S. at 242; Black, supra note 5, at 440.
15. See Basic, 485 U.S. at 243. For an examination of the relationship between the reliance requirement of Rule 10b-5 and fraud on the market theory, see infra notes 62-127 and accompanying text.
16. See Basic, 485 U.S. at 243.
17. The defendants misrepresentations were the 'but for' cause but not the proximate cause of her loss.
18. See Basic, 485 U.S. at 256 & n.7 (White, J., concurring in part and dissenting in part); Ross v. Bank South, N.A., 885 F.2d 723, 733 (11th Cir. 1989) (Tjoflat, J., concurring), cert. denied, 495 U.S. 905 (1990); Shores v. Sklar, 647 F.2d 462, 486 (5th Cir. 1981) (Randall, J., dissenting), cert. denied, 459 U.S. 1102 (1983). Some commentators, however, favor the pure causation approach. See Black, supra note 8, at 926 (1988) ("An alternative explanation of fraud on the market is that it eliminates reliance as a required element and places the analytical emphasis where it belongs: on causation... [F]raud on the market is best conceptualized in terms of this pure causation approach instead of the more frequently used reliance approach.").
19. See, e.g., Freeman v. Laventhol & Horwath, 915 F.2d 193, 198-200 (6th Cir.
purchased the Dastardy, Inc. stock in a secondary market, she purchased the revenue bonds from Do Good Inc. in a "primary" or "new issues" market. Primary markets handle new issues of previously non-existent securities while secondary markets trade existing securities in an open market. The Supreme Court in Basic Inc. v. Levinson endorsed a version of the fraud on the market theory in the context of an efficient, secondary market.

Prior to the Supreme Court's decision in Basic, however, courts struggled to define the proper scope of the fraud on the market theory. It was during this period that the Fifth Circuit, in Shores v. Sklar, developed a variation of the fraud on the market theory to allow the presumption of reliance in the primary market or new issues context. Even though the plaintiffs in Shores traded on an inefficient market, the Fifth Circuit held that the plaintiff class was entitled to a presumption of reliance when they could show that the defendants issued securities that were "not entitled to be marketed" and that were part of an overall scheme to defraud investors. There exists considerable controversy as to whether the fraud on the market theory should extend to securities, such as Dan Dastardy's revenue bonds, that are issued in primary markets.

This Note explores the extension of fraud on the market theory to the context of newly issued securities. Part I of this Note examines the development and validity of the fraud on the market theory, concentrating on its relationship to two important principles that animate the theory: the efficient capital market hypothesis and the reliance requirement of Rule 10b-5. Part II examines how courts have extended fraud on the market theory to the primary market context. Part III critically reflects on arguments for and against applying the rebuttable presumption of re-

1990 (distinguishing as two distinct causes of action Basic's fraud on the market claim and Shores' fraud created the market claim).

20. Primary markets are undeveloped and inefficient. For the implications on market efficiency of the distinction between primary and secondary markets, see infra notes 27-61 and accompanying text.

21. See Basic, 485 U.S. at 243-45.

22. For a discussion of the development of fraud on the market theory in well-developed, secondary markets, see infra notes 62-127 and accompanying text. For a discussion of the development of fraud on the market in undeveloped, primary markets, see infra notes 128-206 and accompanying text.


24. See id at 468-72.

25. See id.

liance supported by fraud on the market theory to newly issued securities. Finally, the Note concludes that the fraud on the market theory's rebuttable presumption of reliance should not extend to newly issued securities.

I. BACKGROUND: FRAUD ON THE MARKET THEORY

As introduced above, there are two concepts critical to a full understanding of whether the fraud on the market theory should extend to context of newly issued securities: the efficient capital market hypothesis and the reliance requirement under Rule 10b-5. This background section examines the relationship of these two concepts to the development of fraud on the market theory.

A. Efficient Capital Market Hypothesis

The theoretical underpinning of fraud on the market theory is the efficient capital market hypothesis. An efficient securities market is one that rapidly reflects new information in a security’s price without bias: the more rapidly the market incorporates new information into a security’s price, the more efficient the market. In a fully efficient market, an investor cannot achieve investment returns greater than the market average through securities research. A policy of throwing darts at the New York Times stock listings and passively holding the chosen securities over time would lead to returns that are equivalent to an investment strategy based on active research and trading that seeks out undervalued securities and capitalizes on market trends.


28. See Fischel, supra note 27, at 911-12; 4 Alan A. Bromberg & Lewis D. Lowenfels, Securities Fraud & Commodities Fraud § 8.6 (1988).

29. One commentator states the following:

The paradigm of an efficient securities market is often viewed as one in which transaction costs are zero; all investors have instantaneous access to all relevant information, and all investors agree on the implications of this information. . . . [Efficient market enthusiasts believe that] conditions in actual securities markets parallel the paradigmatic conditions closely enough so that an efficient market mechanism is at work in . . . actual markets.

See Lockwood, supra note 27, at 1303-04 (footnotes omitted).

30. See Daniel R. Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Tex. L. Rev. 1, 3-4 (1978). Under this definition of the hypothesis referred to as “trading-rule efficiency,” a market is efficient if it is impossible to devise a trading rule that systematically outperforms the market absent possession of inside information. Another definition of the hypothesis, “value efficiency,” “focuses on the extent to which security prices reflect the present value of the net cash flows generated by a firm’s assets.” Fischel, supra note 27, at 913.

31. See Fischel, supra note 27, at 915. Though the hypothesis posits that securities research is unnecessary because the market is efficient, the market will remain efficient only if most market participants believe that to be false and engage in research. Marginal
The semistrong version\textsuperscript{32} of the hypothesis holds that the market price of a given security will quickly reflect all relevant, publicly available information.\textsuperscript{33} The semistrong version of the hypothesis provides a theoretically coherent and empirically tested\textsuperscript{34} mechanism to substantiate the central premise of the fraud on the market theory: when a material misrepresentation enters the stream of publicly available information, it is quickly incorporated into the security's market price, artificially inflating (or, less typically, deflating) that price.\textsuperscript{35} Thus, because markets incorporate all publicly available information into a security's price, investors should be able to reasonably rely on the market to price securities accurately.\textsuperscript{36} The hypothesis validates the fraud on the market plaintiff's claim that the defendant's misrepresentation caused the plaintiff's injury even though plaintiff did not directly rely on the misrepresentations.\textsuperscript{37} Note that the difference between traditional face-to-face exchanges of goods and transactions involving actively traded securities in efficient markets is the presence or absence of reliable market prices reflecting information possessed by diverse sets of traders and analysts.\textsuperscript{38} Where such a mechanism does not exist, as in transactions outside an efficient market, it is not reasonable to rely on the offer price as incorporating relevant information about the value of the underlying asset.\textsuperscript{39} Given the importance of the efficient market hypothesis as a foundation for fraud on the market theory,\textsuperscript{40} it is essential to determine whether profits may be attainable when markets react to new information and move toward the new equilibrium point of efficiency. See Lockwood, supra note 27, at 1304.

32. There are three versions of the hypothesis—weak, semistrong, and strong—that reflect the efficiency of the market with respect to a given set of information. The weak form of the hypothesis holds that the market incorporates past price movements into a security's present price. A trading scheme that depends on knowledge of a stock's past price movements to predict future prices, e.g., the chartists on Wall Street, cannot lead to investment returns above the market average since the information is already reflected in the stock's price. The semistrong version, discussed in the text, holds that the market price of a stock reflects all publicly available information. The strong version holds that a security's market price incorporates all information from whatever source, including inside information. The strong version predicts that an individual with inside information could not outperform average market returns because such information already is reflected in market price. The acknowledged profitability of insider trading suggests that the strong form of the theory is not correct in practice. See Fischel, supra note 27, at 911; Lockwood, supra note 27, at 1303 n.165; Cohen, supra note 8, at 735.

33. See Fischel, supra note 27, at 911.

34. Courts adopting the fraud on the market theory have alluded to empirical studies establishing the validity of the semistrong version. See Basic Inc. v. Levinson, 485 U.S. 224, 246 & n.24 (1988).

35. See Fischel, supra note 27, at 911-12.

36. See Basic Inc. v. Levinson, 485 U.S. 224, 244-47 (1988).

37. See id.; Fischel, supra note 27, at 911-12.

38. See Fischel, supra note 27, at 912.

39. See id.

40. See Freeman v. Laventhal & Horwath, 915 F.2d 193, 198 (6th Cir. 1990) ("fraud on the market theory cannot be applied logically to securities that are not traded in efficient markets"); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1121 (5th Cir. 1988) (fraud on the market theory requires "active, efficient secondary market" for subject securities),
the security at issue, in fact, traded on an efficient market. Typically, courts do not directly address the issue; instead, they casually state that securities that trade on any open, actively traded and well-developed markets are efficient. Courts and commentators have noted that “[t]hese terms are cumulative in the sense that a developed market will almost always be an open one, and an efficient market will almost invariably be a developed one.” In *Freeman v. Laventhal & Horwath*, the Sixth Circuit, the highest court to address the issue directly, identified five factors for determining market efficiency:

1. a large weekly trading volume;
2. the existence of a significant number of reports by securities analysts;
3. the existence of market makers and arbitrageurs in the security;
4. the eligibility of a company to file an S-3 Registration Statement; and
5. a history of immediate movement of the stock price caused by unexpected corporate events or financial releases.


41. “An open market is one in which anyone, or at least a large number of persons, can buy or sell.” Cammer v. Bloom, 711 F. Supp. 1264, 1276 n.17 (D.N.J. 1989) (quoting Bromberg & Lowenfels, *supra* note 28, § 8.6).

42. See infra note 47 and accompanying text.

43. “A developed market is one which has a relatively high level of activity and frequency, and for which trading information (e.g., price and volume) is widely available. It is principally a secondary market in outstanding securities. It usually, but not necessarily, has continuity and liquidity (the ability to absorb a reasonable amount of trading with relatively small price changes).” *Cammer*, 711 F. Supp. at 1276 n.17 (quoting Bromberg & Lowenfels, *supra* note 28, § 8.6).

44. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 244-47 (1988) (holding that securities trading on open, active, and well-developed markets are efficient and applying fraud on the market theory to them).


46. 915 F.2d 193 (6th Cir. 1990).

47. Evidence of a large weekly trading volume, an actively traded market for the stock, signifies substantial investor interest in the security. Investor interest and a high volume of trading suggests that the market is incorporating newly available corporate information into the stock price. *See id; Cammer*, 711 F. Supp. at 1286.

48. Investors rely on these analyst reports in deciding on whether to purchase securities. These analysts help to quickly disseminate key information throughout the investor population. *See Freeman*, 915 F.2d at 199; *Cammer*, 711 F. Supp. at 1286.

49. These entities ensure the completion of market mechanisms by reacting swiftly to newly released corporate information by purchasing stock and driving it to the equilibrium price level. *See Freeman*, 915 F.2d at 199; *Cammer*, 711 F. Supp. at 1286-87.

50. The SEC’s rationale for permitting companies to use a Form S-3 is the premise that the company’s stock trades in an efficient market. To qualify for Form S-3 registration, an issuer must meet several criteria including an aggregate market value of voting stock held by non-affiliates of at least $150 million, or at least $100 million and an annual trading volume of at least 3 million shares of such stock. *See Freeman*, 915 F.2d at 199; *Cammer*, 711 F. Supp. at 1287; Lockwood, *supra* note 27, at 1315.

51. *Freeman*, 915 F.2d at 199.
Commentators have suggested other related factors that courts should consider in determining market efficiency, including the number of traders in the security, the number of holders of the security and the number of outstanding securities.  

Traditionally, the most frequently noted factor courts considered in determining efficiency was whether the security traded on an exchange and, if so, which exchange. Courts have generally agreed that the New York Stock Exchange ("NYSE") and American Stock Exchange ("AMEX") were efficient markets. There has been less uniformity, however, as to whether securities that trade on Over-the-Counter ("OTC") markets were efficient. While most courts and commentators concurred that the OTC market was generally less efficient than the NYSE, they agreed that the inquiry to determine efficiency should concentrate on the factors, such as those described in Freeman, that indicated whether the market for a particular stock was developed and active, not simply where the stock traded. Additionally, courts have concluded that primary market (new issue) offerings of securities are not efficient markets, since prices are set by issuers or underwriters and not impersonal market forces that result from active trading.

In 1988, the Supreme Court based its approval of fraud on the market theory and the efficient capital market hypothesis in Basic v. Levinson on...
the wide acceptance of the efficient capital market hypothesis by the lower courts, commentators, and researchers.\textsuperscript{58} The efficient capital market hypothesis, however, continues to have many detractors.\textsuperscript{59} Some commentators have described the recent trend in scholarly literature as critical of the hypothesis.\textsuperscript{60} Critics point to phenomena that seem to run counter to the existence, in practice, of efficient markets, such as trading schemes that outperform the market, the 1987 stock market crash and corporate takeovers.\textsuperscript{61} Absent the Supreme Court overturning \textit{Basic}, however, courts deciding cases involving securities traded in efficient markets will continue to grant a presumption of reliance based on the fraud on the market theory and the efficient capital hypothesis.

B. Fraud on the Market Theory and Relaxing the Rule \textit{10b-5} Reliance Standard

The relationship between fraud on the market theory and Rule \textit{10b-5}'s reliance requirement is crucial to the debate regarding the validity of fraud on the market theory and its extension beyond the context of efficient markets. This Section examines the origin, purpose, and necessity of Rule \textit{10b-5}'s reliance requirement in connection with the development and acceptance of the fraud on the market theory.

1. Development of the Fraud on the Market Theory

The private right of action under Rule \textit{10b-5} was based on the common law torts of fraud and deceit.\textsuperscript{62} To recover in fraud at common law, a plaintiff must establish that the misrepresentation or omission at issue is the proximate or legal cause of plaintiff's injury.\textsuperscript{63} To do this, the

\begin{itemize}
\item \textsuperscript{58} See \textit{Basic Inc. v. Levinson}, 485 U.S. 224, 245-47 (1988).
\item \textsuperscript{60} See \textit{Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors}, 58 U. Chi. L. Rev. 187, 198 (1991) ("In recent years, however, the efficient capital markets theory has become increasingly discredited, especially since the stock market crash of October 1987."); \textit{Lockwood, supra note 27}, at 1302 ("In the past decade, however, the hypothesis has come under increasing criticism based on further empirical studies and logical analysis of the processes underlying the theory.").
\item \textsuperscript{61} See Lipton & Rosenblum, \textit{supra} note 60, at 198-200; \textit{Fischel, supra} note 27, at 913; \textit{Lockwood, supra} note 27, at 1305.
\item \textsuperscript{63} See \textit{Restatement (Second) of Torts} § 525 (1976); \textit{W. Page Keeton et al., Prosser
plaintiff must establish both reliance on a misrepresentation and the loss caused by that reliance. The purpose of the reliance requirement is to establish causation in fact. That is, plaintiff must establish that the misrepresentation was the legal cause of plaintiff's loss by establishing that the loss reasonably resulted from plaintiff's reliance on the misrepresentation or omission.

In *List v. Fashion Park, Inc.*, the seminal modern case on reliance in the Rule 10b-5 context, the court held that the plaintiff established reliance when the defendant's misrepresentation was a substantial factor in determining the course of conduct that resulted in the plaintiff's loss. As in the common law fraud context, the purpose of the reliance requirement in a Rule 10b-5 action has been to provide the necessary causal nexus between the defendant's wrongful conduct and the plaintiff's injury. Subsequent to the *List* decision, courts began to develop modifications to the strict direct reliance requirement that were aimed at overcoming what would otherwise be virtually insurmountable obstacles for plaintiffs. Additionally, the Supreme Court acknowledged that impersonal and complex modern security's markets differed from the simple, direct transactions contemplated by the early fraud cases and that courts should consider those differences in applying the reliance requirement of Rule 10b-5. With this in mind, some courts began to grant

64. See Basic, 485 U.S. at 243; Restatement (Second) of Torts § 525 (1976); Prosser and Keeton, supra note 63, § 105, at 728.
65. See Restatement (Second) of Torts § 537 (1976); Prosser & Keeton, supra note 63, § 110, at 765.
66. See Restatement (Second) of Torts § 546 (1976); Prosser & Keeton, supra note 63, § 110, at 767. Causation in fact is established if the misrepresentation induced the plaintiff to enter into the transaction. See id.
67. See Restatement (Second) of Torts § 548A (1976); Prosser & Keeton, supra note 63, § 110, at 767.
70. *See List*, 340 F.2d at 462. Materiality and reliance combine to establish that the defendant's misrepresentation caused the plaintiff's loss. Materiality is the objective test of causation and depends on whether the misrepresented or omitted information would have been a substantial factor in a reasonable person's decision to buy or sell securities. Reliance, on the other hand, comprises the subjective component of causation and depends on whether the plaintiff himself considered the information in making his investment decision. See Harold S. Bloomenthal, Securities Law Handbook § 14.01, at 437 (1990).
71. *See supra* note 4 and accompanying text.
72. *See Basic Inc. v. Levinson*, 485 U.S. 224, 243-44 (1988); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983) (stating that Rule 10b-5 actions are designed in part to add to the protections provided to investors by the common law); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975) (stating that Rule 10b-5 actions are distinct from common law deceit and misrepresentation claims).
plaintiffs in special circumstances a presumption of reliance.\textsuperscript{73}

Courts initially recognized a presumption of reliance only in cases of total nondisclosure or omission of material fact.\textsuperscript{74} The plaintiff in an omissions case has a more difficult evidentiary burden to bear than a plaintiff in an affirmative misrepresentation case, since the plaintiff in the omission's case must show a speculative state of facts, i.e., how the plaintiff would have acted if defendant had disclosed the omitted information.\textsuperscript{75} Courts reasoned that it was easier to prove direct reliance on an affirmative misstatement because the plaintiff could point to the misstatement and explain how it affected the plaintiff's investment decisions.\textsuperscript{76}

\textit{Mills v. Electric Auto-Lite Co.}\textsuperscript{77} and \textit{Affiliated Ute Citizens v. United States}\textsuperscript{78} are the watershed cases in relaxing the strict standard of direct reliance.\textsuperscript{79} In Mills, defendant Auto-Lite's shareholders sued to set aside a proposed merger between Auto-Lite and Mergenthaler Linotype Company under SEC Rule 14a-9, which prohibited misrepresentations in proxy solicitations.\textsuperscript{80} The Supreme Court held that plaintiff-shareholders need not show direct reliance on defendant's misrepresentations or omissions in proxy statements if such misrepresentations were material.\textsuperscript{81} Instead, the proof of materiality of the proxy solicitation itself, rather than individual reliance\textsuperscript{82} on the defect in the solicitation materials, provided the required causal link in the transaction.\textsuperscript{83} Thus, \textit{Mills} eliminated the direct reliance requirement in actions under Rule 14a-9 concerning material misstatements or omissions in proxy materials.\textsuperscript{84}

\textsuperscript{73} See \textit{Affiliated Ute Citizens v. United States}, 406 U.S. 128, 153 (1972) (justifying presumption of reliance where defendant breaches duty to disclose material information); \textit{Mills v. Electric Auto-Lite Co.}, 396 U.S. 375, 381 (1970) (presuming reliance upon showing of materiality where proxy solicitation itself, rather than defect in the solicitation materials, served as the essential link in the transaction); \textit{Schlick v. Penn-Dixie Cement Corp.}, 507 F.2d 374, 381 (2d Cir. 1974) (presuming reliance where plaintiff is an unwilling seller of securities in a market manipulated by defendant), \textit{cert. denied}, 421 U.S. 976 (1975).

\textsuperscript{74} See \textit{Affiliated Ute}, 406 U.S. at 153-54.

\textsuperscript{75} See \textit{Basic}, 485 U.S. at 245.

\textsuperscript{76} See \textit{Affiliated Ute}, 406 U.S. at 153-54.

\textsuperscript{77} 396 U.S. 375 (1970).

\textsuperscript{78} 406 U.S. 128 (1975).


\textsuperscript{80} See \textit{Mills}, 396 U.S. at 378. Defendant Auto-Lite had sent out a proxy statement to the plaintiff-shareholders that stated that Auto-Lite's board of directors approved of the merger, but neglected to reveal that the bidder, Mergenthaler Linotype Company, was already the majority shareholder of Auto-Lite and had nominated every member of the board. \textit{See id.}

\textsuperscript{81} \textit{See id.} at 385.

\textsuperscript{82} \textit{See id.} at 382 n.5 ("Proof of actual reliance by thousands of individuals would ... not be feasible ... and reliance on the nondisclosure of a fact is a particularly difficult matter to define or prove.").

\textsuperscript{83} \textit{See id.} at 384-85.

\textsuperscript{84} \textit{See id.}
In *Affiliated Ute*, the Supreme Court applied similar reasoning regarding the direct reliance requirement in omissions cases to the Rule 10b-5 context. The defendants in *Affiliated Ute*, market makers in the stock of a company holding assets for certain native Americans and sales agents for the native Americans, had remained silent as to prevailing market prices for the stock in circumstances in which they had a duty to disclose those prices. The Supreme Court ruled that the Tenth Circuit had erred when it held that there was no violation of Rule 10b-5 unless the record disclosed evidence that the plaintiffs had directly relied on the material factual misrepresentations made by the defendants. The Court drew a distinction between misstatements and omissions under Rule 10b-5(b), which required direct reliance, and activities under Rule 10b-5(a) and (c) that constituted a "course of business" or "device, scheme, or artifice," both of which merited a presumption of reliance. Specifically, the Court held that under the circumstances of *Affiliated Ute*, in which there was a failure to disclose material facts in the face of a duty to disclose, positive proof of direct reliance was not a requirement for recovery. Later cases have interpreted the presumption of reliance recognized in *Affiliated Ute* as rebuttable.

Two years after *Affiliated Ute*, the Second Circuit addressed the reliance requirement in a different context in *Schlick v. Penn-Dixie Cement Corp.* In *Schlick*, the plaintiff did not allege fraud in his purchase of a security; instead, he alleged that a fraudulent proxy statement was one step in a scheme that led to the forced liquidation of his security. The Second Circuit reversed the district court's dismissal of the Rule 10b-5 and Rule 14a claims, emphasizing the nontypical nature of the case. Typically, recovery on a 10b-5 claim required a showing of both loss causation and transaction causation (causation and reliance, respectively). The *Schlick* court carved out a limited exception to this re-

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86. See id. at 152.
87. See id. at 152-53.
88. See id. at 153-54 ("This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.").
89. See *Basic Inc. v. Levinson*, 485 U.S. 224, 248-49 (1988); *Lipton v. Documation*, Inc. 734 F.2d 740, 742 n.3 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985); *Rifkin v. Crow*, 574 F.2d 256, 262-63 (5th Cir. 1978).
90. 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975).
91. See *Schlick*, 507 F.2d at 381.
92. See id. at 383-84.
93. "Many courts use the terms 'transaction causation' and 'loss causation' instead of reliance and causation, respectively." Black, supra note 5, at 435 n.2; accord *In re Cat- anella*, 583 F. Supp. 1388, 1414 (E.D. Pa. 1984) ("Stripped of fancy nomenclature, transaction causation is the reliance element in a section 10(b) case."); see also Robert N. Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 Wash. & Lee L. Rev. 861, 865 n.21 (1982) ("Transaction causation" turns upon a direct causal connection between the transaction complained of and the offending act. 'Loss causation' means only that nexus between the offending act and the economic harm exists."). Some commentators feel that the distinction between loss causation and transac-
requirement in cases where the plaintiff alleged a scheme to defraud that included market manipulation and a merger on preferential terms, of which the proxy documents were only one part.94 Further, in the case at hand, the defendant's misrepresentations and omissions in the proxy statement were irrelevant to the plaintiff's investment decision, since the defendant's manipulation of the market caused a forced sale by plaintiffs.95 Thus, the Schlick court specifically held that when a plaintiff alleged that a loss had resulted from a fraudulent scheme to bring about a forced sale of the plaintiff's securities, the plaintiff need not plead or prove direct reliance (transaction causation) because the plaintiff had, in fact, made no investment decision.96

In Blackie v. Barrack,97 the Ninth Circuit extended the presumption of reliance recognized in omissions cases, such as Affiliated Ute, and forced seller cases, such as Schlick, to affirmative misrepresentation cases under the fraud on the market rationale.98 In Blackie, the Ninth Circuit found that the requirement of direct reliance by each shareholder in the context of a large class action proceeding was an unreasonable and unnecessary evidentiary burden.99 The court held that in the context of an impersonal stock exchange on a developed market, a prima facie case of reliance was adequately established by (1) the proof of the purchase of the security, and (2) the proof of the materiality of the defendant's misrepresentation.100 Thus, the Ninth Circuit concluded that when plaintiff met

94. See Schlick, 507 F.2d at 381.
95. See id.
96. See id. at 380-81; accord Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969) ("[W]here the success of a fraud does not require an exercise of volition by the plaintiff, but instead requires an exercise of volition by other persons, there need be no showing that the plaintiff himself relied upon the deception."); cert. denied, 400 U.S. 822 (1970); Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir.) ("Whatever need there may be to show reliance in other situations [citing List and other cases], we regard it as unnecessary in the limited instance when no volitional sale is required and the result of a forced sale is exactly that intended by the wrongdoer."); cert. denied, 389 U.S. 970 (1967).
97. 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).
98. In Blackie, the plaintiff class, consisting of thousands of stockholders that had purchased or sold Ampex Corporation stock on the NYSE, alleged that the defendants made fraudulent misrepresentations in approximately forty-five publicly released documents, including Ampex's annual and quarterly reports, press releases, and other SEC documents. The plaintiffs alleged that the market, acting efficiently, artificially inflated Ampex's stock price when it incorporated the misrepresentations and omissions over the 27 month class period. The defendants resisted class certification, however, arguing that Rule 10b-5's requirement of direct proof of subjective reliance by each class member would inevitably create sufficient conflicts between class members and the named plaintiffs that would render their representation of the class inadequate. See id. at 902-05.
99. See id. at 907; supra note 4 and accompanying text.
100. See Blackie, 524 F.2d at 906.
these criteria, it shifted the burden of disproving reliance to the defendant.\textsuperscript{101}

2. Acceptance by the Supreme Court: \textit{Basic v. Levinson}

In \textit{Basic Inc. v. Levinson},\textsuperscript{102} the Supreme Court adopted the fraud on the market theory in the context of efficient markets. Basic Inc., a publicly traded company on the NYSE, was involved in merger negotiations with a suitor, Combustion Engineering, from September 1976 through December 1978.\textsuperscript{103} Rumors of the possible takeover caused the price and trading volume of Basic stock to increase throughout this period.\textsuperscript{104} During this period, however, Basic issued three statements denying knowledge of any reason for the stock's upward activity and specifically denying the existence of the merger negotiations.\textsuperscript{105} In December 1978, Basic notified the NYSE that it had been approached concerning a merger; it approved Combustion's tender offer the next day.\textsuperscript{106} The plaintiff class consisting of stockholders who had sold their shares during the class period\textsuperscript{107} alleged that defendant Basic and its directors artificially depressed the price of Basic stock throughout the class period, thereby injuring plaintiffs who sold their stock at depressed prices.\textsuperscript{108} In its opinion, the Supreme Court addressed the issue of whether the preliminary merger discussions were material and whether the district court properly applied a presumption of reliance supported by the fraud on the market theory.

After speaking for an undivided court on the issue of materiality, Justice Blackmun could muster only a plurality for the Court's resolution of the issue of reliance and the fraud on the market theory.\textsuperscript{109} At the outset, Blackmun explained that his task was not to assess the general valid-

\textsuperscript{101} See \textit{id}. Defendants could rebut the presumption "(1) by disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; [or] (2) by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it." \textit{Id}. The court did acknowledge, however, that defendant's right to disprove causation was of limited value since it would be difficult to convince a jury that plaintiffs were indifferent to material fraud. \textit{See id}. at 906 n.22.

\textsuperscript{102} 485 U.S. 224 (1988).

\textsuperscript{103} See \textit{id}. at 227-28.

\textsuperscript{104} See \textit{id}.

\textsuperscript{105} See \textit{id}. at 227-28 & n.4.

\textsuperscript{106} See \textit{id}. at 227-28.

\textsuperscript{107} Pursuant to the strong form of the efficient capital market hypothesis, the complaint sought to certify all investors who sold stock between October 1, 1976, the day negotiations for the merger started, and December 20, 1978. The district court, however, certified only plaintiffs who sold stock after the first misleading announcement validating the semistrong form of the hypothesis. \textit{See id}. at 228 n.5.

\textsuperscript{108} See \textit{id}. at 228. It was not necessary to allege that plaintiffs lost money in absolute terms on their investment in Basic stock. In fact, since Basic's stock price was rising throughout the period, most plaintiffs made money when they sold their stock. \textit{See id}. at 260 (White, J., concurring in part and dissenting in part).

\textsuperscript{109} Chief Justice Rehnquist, Justice Scalia, and Justice Kennedy took no part in the decision. \textit{See id}. at 250.
ity of the theory, but to consider whether it was proper for the court to apply a rebuttable presumption of reliance that was supported in part by the fraud on the market theory.\textsuperscript{110}

Justice Blackmun first reiterated that reliance is an independent element of a Rule 10b-5 action, providing the causal connection between defendant's misrepresentations and plaintiff's injury.\textsuperscript{111} Citing \textit{Mills} and \textit{Affiliated Ute}, Blackmun pointed out that Supreme Court precedent indicated ways to prove causation without requiring positive proof of reliance.\textsuperscript{112} Blackmun further explained that the Court's understanding of reliance must reflect the differences between modern securities transactions and the face-to-face transactions that gave rise to the requirements of common law fraud.\textsuperscript{113} Based on considerations of fairness, public policy, probability, and judicial economy, Blackmun acknowledged that plaintiffs who allege fraud in an open and well-developed market should benefit from a rebuttable presumption of reliance.\textsuperscript{114} As further support for his position, Blackmun cited empirical studies supporting the efficient capital market hypothesis.\textsuperscript{115} The Court implicitly accepted the semi-strong version\textsuperscript{116} of efficient capital market hypothesis when it stated that the Court will presume plaintiff's reliance on any public material misrepresentation because most publicly available information was reflected in a stock's price.\textsuperscript{117} Blackmun emphasized, however, that reliance was still an element of Rule 10b-5 and that any showing that severed the link between the defendant's misrepresentation and, either the price received (or paid) by plaintiff or the plaintiff's decision to trade at a fair market price, would be sufficient to rebut the presumption.\textsuperscript{118}

In dissent, Justice White joined the plurality in rejecting those wider versions of fraud on the market embraced by lower courts that he felt equated causation with reliance and allowed recovery notwithstanding

\begin{enumerate}
\item See id. at 242.
\item See id. at 243.
\item See id.
\item See id. at 243-45 (citing Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986); Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); \textit{In re LTV Sec. Litig.}, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).
\item See \textit{Blackie}, 524 F.2d at 245-46. To invoke the rebuttable presumption of reliance, plaintiff must allege and prove the following: defendant made public, material misrepresentations that would induce a reasonable, relying investor to misjudge the value of the shares that traded on an efficient market between the time the misrepresentations were made and the time the truth was revealed. See id. at 248 n.27.
\item See id. at 246 & n.24.
\item See id. at 246 & n.24. See Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).
\item See id. at 248-49.
\end{enumerate}
positive proof of the plaintiff’s nonreliance. While the majority reiterated the importance of reliance as an element of a Rule 10b-5 claims and emphasized the rebuttable nature of the fraud on the market theory’s presumption of reliance, White argued that the chance of a defendant actually rebutting the presumption in practice was virtually impossible in all but the most extraordinary case. Consequently, the majority’s rejection of the pure causation version of the fraud on the market theory rings hollow, for it created a de facto irrebuttable presumption of reliance.

Continuing in dissent, Justice White claimed that courts lack the expertise to judge the merits of incorporating novel economic theories into Rule 10b-5 jurisprudence. He argued that Congress, with its superior resources and expertise, was far better equipped than the federal courts to determine how modern economic theory should modify the established legal norms of fraud. White further argued that courts are in no position to sanction the distinction that fraud on the market plaintiffs draw between the market price of a stock and the “integrity of the price”—the “true value” at which the stock would trade absent defendant’s misrepresentations.

Justice White also argued that an examination of congressional intent militated against adoption of the fraud on the market theory. Further, he claimed that permitting recovery to plaintiffs who made no effort to read disclosure documents was inconsistent with the congressionally adopted policy favoring disclosure as the main protective device for investors. White concluded that courts should limit their role in inter-


120. See Basic, 485 U.S. at 256 n.7 (White, J., dissenting in part and concurring in part) (citing Blackie v. Barrack, 524 F.2d 891, 906-07 n.22 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976) and In re LTV Sec Litig., 88 F.R.D. 134, 143 n.4 (N.D. Tex. 1980)).

121. See id. at 256-57 & 256 n.7. The theory acts as an investor’s insurance scheme allowing recovery based upon plaintiff’s showing that they sold stock at a lower price than what might have been. See id.

122. See id. at 253 (“with no staff economists, no experts schooled in the ‘efficient-capital-market hypothesis,’ no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.”).

123. See id. at 254.

124. See id. at 255.

125. For a more detailed discussion of this point, see infra notes 248-53 and accompanying text.

126. See 15 U.S.C. §§ 78m, 78o(d) (1988 & Supp. II 1990). Justice White cites commentators and judges favorable to this view. See Basic, 485 U.S. at 259 (citing Black, supra note 5, at 457-59 (arguing that fraud on the market is at odds with congressionally sanctioned disclosure policy); Shores v. Sklar, 647 F.2d 462, 483 (5th Cir. 1981) (Randall, J., dissenting) (same), cert. denied, 459 U.S. 1102 (1983)).
interpreting Rule 10b-5 to giving effect to the policy decisions made by Congress.\textsuperscript{127}

II. FRAUD ON THE MARKET IN THE NEW ISSUES CONTEXT

Although the Supreme Court in \textit{Basic} limited its analysis of fraud on the market to actively traded, well-developed markets, lower courts had applied and have continued to apply the fraud on the market's presumption of reliance in wider contexts—including primary markets.\textsuperscript{128} Courts and commentators dubbed the primary market's version of the theory "fraud created the market."\textsuperscript{129} As early as 1977, the Ninth Circuit recognized a presumption of reliance in a primary or new issues market.\textsuperscript{130} In \textit{Shores v. Sklar},\textsuperscript{131} the Fifth Circuit went further and expressly endorsed a version of the fraud on the market theory in a primary market for revenue bonds. The \textit{Shores} decision sparked a controversy over the nature of the fraud on the market theory between (1) those who felt fraud on the market was a specific theory depending for its validity on the efficient capital market hypothesis, and (2) those who believed fraud on the market was a more general idea that encompassed any theory that granted investors a presumption of reliance for Rule 10b-5 purposes.\textsuperscript{132} This section examines how the lower courts have extended the fraud on the market theory, analyzed in Section I, to the primary market or new issues context.

A. Shores v. Sklar

In \textit{Shores v. Sklar}, the Fifth Circuit extended the fraud on the market theory to a primary market involving a new issue of revenue bonds. Prior to \textit{Shores}, however, the Ninth Circuit had extended the presumption of reliance to the context of a primary market for oil and gas limited partnerships. In that case, \textit{Arthur Young & Co. v. United States District Court},\textsuperscript{133} the defendant had sold limited partnership interests in oil and gas exploration ventures to members of the plaintiff class pursuant to an allegedly misleading registration statement filed with the SEC.\textsuperscript{134} The Ninth Circuit found that misrepresentations and omissions in disclosure materials in an undeveloped, primary market merited a similar presumption of reliance that the Ninth Circuit had granted to the plaintiffs in \textit{Blackie v. Barrack} in a developed market two years earlier.\textsuperscript{135} Specifi-

\textsuperscript{127} See \textit{Basic}, 485 U.S. at 259.
\textsuperscript{128} See \textit{infra} notes 134-206 and accompanying text.
\textsuperscript{129} See \textit{Freeman v. Laventhal & Horwath}, 915 F.2d 193, 199 (6th Cir. 1990); \textit{Schmidt, supra} note 8, at 495.
\textsuperscript{130} See \textit{Arthur Young & Co. v. United States District Court}, 549 F.2d 686, 694-95 (9th Cir.), \textit{cert. denied}, 434 U.S. 829 (1977).
\textsuperscript{131} 647 F.2d 462 (5th Cir. 1981), \textit{cert. denied}, 459 U.S. 1102 (1983).
\textsuperscript{132} See \textit{id.} at 474.
\textsuperscript{133} 549 F.2d 686 (9th Cir.), \textit{cert. denied}, 434 U.S. 829 (1977).
\textsuperscript{134} See \textit{id.} at 688.
\textsuperscript{135} See \textit{id.}
cally, the court substituted the primary market investor's reliance on the "integrity of the regulatory process" and the truth of any statement made to regulatory agencies during the securities' issuance for the developed market investor's reliance on the integrity of the market to price securities accurately. Thus, the court allowed the plaintiffs to proceed under the theory that the reliance requirement was satisfied by the petitioners reliance on the integrity of the regulatory process.137

In Shores, the Fifth Circuit directly addressed the application of the fraud on the market theory to a primary market. Applying novel and disputed reasoning in the fraud on the market context, a closely divided Court of Appeals, sitting en banc, distinguished between a misrepresentation claim under Rule 10b-5(b) and a more generalized scheme to defraud claim under Rule 10b-5(a) and (c).141 The Fifth Circuit affirmed the lower court's grant of defendant's motion for summary judgement as to the plaintiff's Rule 10b-5(b) affirmative misrepresentation claim based on misstatements and omissions in the offering circular, holding that Rule 10b-5(b) required plaintiffs to plead direct reliance to state a claim. The Fifth Circuit, however, reversed the district court's grant of summary judgement as to plaintiff's Rule 10b-5(a) (scheme to defraud) and (c) (fraudulent course of action) claims. The court explained that while Rule 10b-5(b) referred to misrepresentations and omissions, the language of clauses (a) and (c) was broader. Since the affirmative misrepresentations in the offering circular at issue here were part of a more general scheme to defraud investors, the lack of reliance on the offering circular, one specific part of the scheme, was not determi-

136. See id. at 689, 694-95.
137. See id. at 695 ("[T]he purchaser of an original issue security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies and the investors at the time of the original issue.").
138. In Shores, the plaintiff class of investors purchased revenue bonds issued by the Industrial Revenue Board of Frisco City, Alabama, to finance the construction of a mobile home manufacturing plant. The plaintiff class alleged that, throughout the issuance process, defendants Alabama Supply and Equipment Company ("ASECo"), Investors Associates, ASECo's underwriter, and Jerald H. Sklar, ASECo's bond counsel, made numerous misrepresentations concerning the business experience and competence of ASECo that included overstating ASECo's assets and its ability to support the project. Sklar incorporated many of the misrepresentations and omissions into the offering circular. The class plaintiff, Clarence E. Bishop, Jr., neither saw the offering circular nor knew that one existed. The district court granted summary judgement for defendants because the class plaintiff did not read the offering circular. See Shores v. Sklar, 647 F.2d 462, 463-67 (5th Cir. 1981), cert. denied, 459 U.S. 1102 (1983).
139. See id. at 472 (Randall, J., dissenting) ("The majority opinion today adopts a new theory of recovery in federal court under Rule 10b-5.").
140. See, e.g., Fischel, supra note 26, at 12 (suggesting that other courts not adopt the holding of Shores); Stanek, supra note 26, at 293 (Shores decision "indefensible").
141. See Shores, 647 F.2d at 469; supra notes 86-96 and accompanying text.
142. See Shores, 647 F.2d at 468.
143. See id. at 468-69.
144. See id. at 468-70.
Thus, the plaintiff stated a claim under Rule 10b-5(a) and (c)'s generalized anti-fraud language.

The Fifth Circuit formulated a standard for granting a plaintiff the presumption of reliance in the primary market context. It held that investors could rely on the market to preclude securities that, but for defendants' fraud, were not "entitled to be marketed." To recover, plaintiff must show the following:

(1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) [plaintiff] reasonably relied on the [b]onds' availability on the market as an indication of their apparent genuineness, and (3) as a result of the scheme to defraud, [plaintiff] suffered a loss.

Thus, if plaintiffs alleged a generalized scheme to defraud investors that was not limited to misstatements in the disclosure documents, a lack of direct reliance on those documents would not preclude recovery.

Judge Randall's dissent in Shores argued that the majority opinion was completely without supporting precedent and that it conflicted with prior decisions of the Fifth Circuit, other circuits, and analogous Supreme Court decisions. Moreover, Judge Randall believed that even if the majority was pronouncing ex cathedra, its novel holding was the product of poor legal reasoning and unwise policy. The dissent maintained that the majority took a garden variety affirmative misrepresentation case and recast it as a generalized scheme to defraud case under Rule 10b-5(a) and (c) on the basis of an alternative theory of relief in the complaint not argued at the district court level. The dissent further argued that the plaintiff's entire case should be dismissed under Rule 10b-5(b); alternatively, even if the claim proceeded under Rule 10b-5(a) and (c), it should be dismissed.

Judge Randall claimed that the only direct precedent that the majority cited for its novel proposition for relief was the sweeping and generalized anti-fraud language under Rule 10b-5(a) and (c). The dissent used the cases that the majority opinion mentioned collaterally—Affiliated Ute, Rifkin, Blackie and Schlick—to show that the majority's formu-
lation had no support in the caselaw. The dissent also argued that the majority effectively eliminated the reliance requirement, a clear break with Rule 10b-5 precedent, since positive proof of the plaintiff's nonreliance would not affect the plaintiff's recovery under the majority's reasoning.

The dissent acknowledged two lines of cases in which courts had relaxed the reliance requirement: total nondisclosure cases and fraud on the market cases. However, whereas the majority would add Shores as a third type of case in which plaintiffs merited the presumption of reliance, the dissent distinguished the Shores holding as different in kind from the other two lines of cases. In both the total nondisclosure and the fraud on the developed market contexts, positive proof of the plaintiff's nonreliance on the defendant's misrepresentations rebutted the presumption of reliance. In other words, reliance was still an element for recovery, but the burden of proof shifted to the defendant to rebut the presumption. The dissent viewed Shores as dispensing with reliance as an element altogether because proof of the plaintiff's nonreliance would not affect recovery.

The dissent also pointed out that the only factual situation in which courts have not required reliance as an element of recovery under Rule 10b-5 has been the forced sale context. As discussed earlier, when plaintiffs alleged that they had sustained a loss as the result of a fraudulent scheme to bring about a forced sale of their securities, they need not prove reliance because they had made no investment decision to participate in the transaction.

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158. Under the majority's formulation, positive proof of nonreliance on defendant's fraudulent acts would not affect recovery since it does not affect any of the elements in the test: (1) defendant's scienter, (2) bonds not entitled to be marketed, (3) availability of the market as an indication of the bonds' genuineness, and (4) plaintiff's loss. See Shores v. Sklar, 647 F.2d 462, 469-70 (5th Cir. 1981), cert. denied, 459 U.S. 1102 (1983).

159. See supra notes 74-89 and accompanying text. Circuit courts have interpreted the presumption of reliance to be rebuttable upon positive proof of plaintiff's nonreliance on the omitted facts. See Rifkin v. Crow, 574 F.2d 256, 262-63 (5th Cir. 1978).

160. See supra 97-127 and accompanying text.

161. See Shores, 647 F.2d at 481 (Randall, J., dissenting).

162. See id.

163. See id. at 474.

164. See id. at 479 (Randall, J., dissenting) (citing Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975)).

165. See id. at 480 ("[W]here the success of a fraud does not require an exercise of volition by the plaintiff, but instead requires an exercise of volition by other persons, there need be no showing that the plaintiff himself relied upon the deception."). (citing Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970)); Vine v. Beneficial Fin. Co., 374 F.2d 627, 635 (2d Cir.) ("Whatever need there may be to show reliance in other situations [citing List and other cases], we regard it as unnecessary in the limited instance when no volitional act is required and

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they need not prove reliance to recover.\textsuperscript{166} The dissent argued, however, that \textit{Shores} did not fit this fact pattern because the plaintiffs made a volitional investment decision.\textsuperscript{167}

Even if the majority's opinion in \textit{Shores} was supported by some precedent and did not conflict with established case law, the dissent presented several policy arguments against granting the presumption of reliance to plaintiffs in a primary market context. First, such a standard would introduce an ambiguous distinction between fraudulently marketed bonds that, absent fraud, can be marketed at some price and those bonds that, absent fraud, cannot be marketed at any price.\textsuperscript{168} Second, the majority opinion carried a great potential for increasing the volume of litigation by providing a federal forum to those who by their own actions would otherwise have forfeited protection of the rule and relegated themselves to state court actions for conversion.\textsuperscript{169} Finally, the majority opinion had the potential for protracting much Rule 10b-5 litigation that would otherwise have terminated at the summary judgment phase.\textsuperscript{170}

\textbf{B. Confusion in Applying the Shores Standard}

Courts interpreting the \textit{Shores} decision have disagreed over the scope and application of the Fifth Circuit's "not entitled to be marketed" standard. The result of this disagreement has been a plethora of standards and tests: (1) the "patently worthless" test; (2) the "issued in violation of applicable law" test; (3) the "economic unmarketability" test; and (4) the "factual unmarketability" test.\textsuperscript{171} Each of these tests is reviewed briefly below.

\textbf{1. The Patently Worthless Test}

The Fifth Circuit refined its \textit{Shores} analysis in \textit{Abell v. Potomac Insurance Company}.\textsuperscript{172} In \textit{Abell}, the offering circular for municipal bonds contained various omissions and misstatements concerning the character and history of the project's developer.\textsuperscript{173} The plaintiff bondholder class sued, invoking \textit{Shores}' presumption of reliance in new issue bond offerings. When the defendants responded that the \textit{Shores} standard only applied when the bonds were worthless, the plaintiffs countered that the \textit{Shores} plaintiffs had received only thirty-seven percent of their investment upon liquidation of that project; thus, no showing of complete

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\textsuperscript{167} See id. at 481.

\textsuperscript{168} See id. at 472.

\textsuperscript{169} See id. at 473.

\textsuperscript{170} See id.

\textsuperscript{171} See infra notes 177-211 and accompanying text.

\textsuperscript{172} 858 F.2d 1104 (5th Cir. 1988), \textit{cert. denied}, 492 U.S. 914 (1989).

\textsuperscript{173} See id. at 1111-12.
worthlessness was necessary.\textsuperscript{174}

The Fifth Circuit sided with the defendants, explaining that even the most worthless enterprises may possess salable assets.\textsuperscript{175} In adopting this position, the court refined the \textit{Shores} standard, holding that plaintiffs can rely on the fraud on the market's rebuttable presumption of reliance only if the defendants "knew the enterprise itself was patently worthless."\textsuperscript{176} The court refused to accept the plaintiff's testimony as to the worthlessness of the bonds, reasoning that the actual performance of the bonds gave the truest assessment of their actual value.\textsuperscript{177} Since the bonds had traded at or near par value for eighteen months after the defendants had disclosed the misstatements and omissions, the bonds were not worthless.\textsuperscript{178} In other words, the \textit{Abell} court interpreted the \textit{Shores} "not entitled to be marketed" standard to apply to securities that were, in fact, patently worthless.

2. The Issued in Violation of Applicable Law Test

In \textit{T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority},\textsuperscript{179} the Tenth Circuit interpreted the \textit{Shores} standard in a different fashion. The class plaintiff, T.J. Raney & Sons, Inc., a broker-dealer of securities involved in the distribution of Series C bonds of defendant Fort Cobb, Oklahoma Irrigation Fuel Authority, alleged that the defendants commingled the bond proceeds with other funds controlled by the project sponsors and never used the funds for their intended purpose.\textsuperscript{180} Additionally, the plaintiff class argued that the Fort Cobb, Oklahoma Irrigation Fuel Authority was not a valid public trust and could not legally issue bonds under applicable state law.\textsuperscript{181}

Basing its decision on the persuasive reasoning in \textit{Shores}, the Tenth Circuit stated that federal and state regulation should permit an investor to rely on the availability of bonds on the market as indicating their lawful issuance.\textsuperscript{182} Combining the \textit{Shores} rationale with the Ninth Circuit's reasoning in \textit{Arthur Young}, the court held that the plaintiffs satisfied \textit{Shores}' "not entitled to be marketed" standard when the plaintiffs alleged that the defendants "knowingly conspired to market securities in violation of applicable state law."\textsuperscript{183} Since the lower court specifically had

\begin{itemize}
  \item \textsuperscript{174} See id. at 1121-22. In Abell, a local newspaper chronicled the developer's deceptions in a series of articles that compelled the underwriter to contact the bondholders to correct the misstatements and omissions in the offering circular. Surprisingly, from the time of disclosure until the collapse of the project eighteen months later, the bonds continued to trade at or near par value. See id. at 1112.
  \item \textsuperscript{175} See id. at 1122.
  \item \textsuperscript{176} Id.
  \item \textsuperscript{177} See id.
  \item \textsuperscript{178} See id.
  \item \textsuperscript{179} 717 F.2d 1330 (10th Cir. 1983), \textit{cert. denied}, 465 U.S. 1026 (1984).
  \item \textsuperscript{180} See id. at 1331.
  \item \textsuperscript{181} See id. at 1331, 1333.
  \item \textsuperscript{182} See id. at 1333.
  \item \textsuperscript{183} Id.
found that the bonds were issued in violation of applicable state law, the Tenth Circuit ruled that the plaintiffs stated a valid claim, and it affirmed the district court's denial of the defendants' motion to decertify the class.

3. The Economic Unmarketability Test

In *Ross v. Bank South, N.A.*, the class of plaintiff bondholders similarly invoked the fraud on the market’s presumption of reliance because they had not read the disclosure materials. The plaintiffs claimed that the defendants knew the bonds were unmarketable because the defendants had raised the price of the units far above what they had been warned was the highest price that the market could bear. Additionally, the plaintiffs alleged that the defendants engaged in sham transactions to meet the pre-sale quota and to make the project appear successful. The trial court granted the defendants' motion for summary judgment because the plaintiffs had not read the disclosure materials.

Sitting en banc, the Eleventh Circuit affirmed the judgment for the defendants, holding that the plaintiffs had not established a genuine issue of material fact regarding the marketability of the bonds. The court cited *Shores* for the proposition that securities were unmarketable only when they could not be offered for sale at any price. Additionally, the defendants must have known or recklessly disregarded the fact that the securities were worthless and placed them on the market to defraud the

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184. 885 F.2d 723 (11th Cir. 1989), cert. denied, 495 U.S. 905 (1990). In 1981, the former Fifth Circuit divided to create the present Fifth and Eleventh Circuits. The Eleventh Circuit adopted as binding precedent all Fifth Circuit decisions handed down prior to September 30, 1981. See *Bonner v. City of Prichard, Ala.*, 661 F.2d 1206, 1209 (11th Cir. 1981). As a result, the court in *Ross* was bound by the Fifth Circuit decision of *Shores*. See *Ross*, 885 F.2d at 732 n.1.

185. See *Ross*, 885 F.2d at 727. In *Ross*, Arthur Rice, a developer, entered into an agreement with the city of Vestavia Hill, Alabama, to create a municipal authority for issuing revenue bonds to finance a residential and medical facility for the elderly. The bonds were to be repaid solely through sales of the residential units. After two underwriters declined to support the project in light of sluggish market for the bonds and for similar apartment units, the board of trustees abandoned the project, citing insufficient progress in obtaining pre-sale commitments and in securing conventional financing. Rice convinced another underwriter and brokerage firm, as well as a new bond counsel and feasibility consultant, to form a joint venture to proceed with the project using significantly higher unit prices and interest rates. Under the new arrangement, Rice was required to presell 50% of the units. Faced with light demand, he dropped the deposit requirement, residency requirement, and accepted several applications from family members, friends, and employees. In addition, the official statement did not disclose the project's troubled financial history and preselling problems. The bonds defaulted three years later because the sales of residential units proved insufficient to support the project. See *id.* at 725-29.

186. See *id.* at 730.

187. See *id.*

188. See *id.* at 731.

189. See *id.* at 730.

190. See *id.* at 729.
public.\textsuperscript{191} The court found, however, that the Ross defendants did not reach this threshold level. The Eleventh Circuit distinguished the situation in Ross with the facts in Shores. The Ross plaintiffs alleged misstatements in the official statement; there were no allegations of pervasive and elaborate schemes outside of official documents as in Shores.\textsuperscript{192} Additionally, in Shores, the defendants concealed existing factors vital to the economic viability of the project.\textsuperscript{193} In Ross, the fraud centered on projections of an uncertain future occurrence: the sale of units.\textsuperscript{194}

4. The Factual Unmarketability Test

In Ross v. Bank South, N.A., Judge Tjoflat concurred in the judgment, but he called for the court to overrule Shores explicitly.\textsuperscript{195} Tjoflat viewed the court's holding as an impractical "economic unmarketability"\textsuperscript{196} test that required the plaintiffs to show that the securities could not have been sold at any price or interest rate.\textsuperscript{197} Tjoflat argued that since it was theoretically possible to market any security at some price and interest rate, a bond can never be completely worthless.\textsuperscript{198} He added that the majority had created a test that was unworkable in both theory and practice, and that the court had negated Shores' remedial effects because defendants would almost always be able to make some economic marketability showing.\textsuperscript{199}

Judge Tjoflat also argued that the economic unmarketability test was not consistent with Shores.\textsuperscript{200} He considered Shores to have established a "factual unmarketability"\textsuperscript{201} test that concentrated on the security at its actual price and interest rate.\textsuperscript{202} According to Judge Tjoflat, if all of the parties and regulatory agencies, acting in good faith and without fraud, allowed the bonds to go to market, the bonds were marketable.\textsuperscript{203} Be-

\textsuperscript{191} See id. at 729-30.
\textsuperscript{192} See id. at 731.
\textsuperscript{193} See id.
\textsuperscript{194} See id.
\textsuperscript{195} See id. at 733 (Tjoflat, J., concurring).
\textsuperscript{196} Id. at 736.
\textsuperscript{197} See id. at 735-36.
\textsuperscript{198} See id. at 736 (citing Fischel, supra note 26, at 12 ("Virtually all securities will sell for some positive price.").)
\textsuperscript{199} See id.
\textsuperscript{200} See id.
\textsuperscript{201} See id.
\textsuperscript{202} See id.
\textsuperscript{203} See id. ("[A] bond is unmarketable if, but for the fraudulent scheme, some 'regulatory' entity (whether official or unofficial) would not have allowed the bond to come onto the market at its actual price and interest rate.") (emphasis in original); cf. Arthur Young & Co. v. United States District Court, 549 F.2d 686, 695 (9th Cir. 1977) ("[T]he purchaser of an original issue security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies and the investors at the time of the original issue."); cert. denied, 434 U.S. 829 (1977). In Ross, two underwriters declined to proceed with the project. When Rice found an underwriter to proceed with the project, it was subject to conditions that Rice fraudulently disregarded. The entities—the underwriter and the city—would have prevented the issu-
cause extraordinarily risky securities or severely overvalued securities were entitled to be marketed, Tjoflat saw his formulation as the only reasonable interpretation of Shores.\(^2\)

Judge Tjoflat, who had dissented in Shores, further argued that the Ross majority should have directly overruled Shores because investors could not reasonably rely on an inefficient market to preclude unmarketable securities.\(^2\) The efficient capital market hypothesis allows courts to presume that investors can reasonably rely on the market to set accurate prices in a well-developed market.\(^2\) Judge Tjoflat argued that in an undeveloped, primary market, it was not reasonable to rely on the market's pricing mechanisms, since all the players in the issuing process had significant self-interest in marketing a security at an inflated price.\(^2\) Judge Tjoflat stated that, as a result, an investor who relied on a primary market to exclude unmarketable securities took a great and obvious risk that should not be remedied by the federal securities laws.\(^2\)

### III. ARGUMENTS FOR AND AGAINST THE EXTENSION OF THE THEORY TO NEWLY ISSUED SECURITIES

Section I examined the origin, theoretical basis, and development of the fraud on the market theory. Section II explored the extension of fraud on the market through the fraud created the market theory to the context of newly issued securities. This Section analyzes the validity of both versions\(^2\) of the presumption of reliance—fraud on the market theory as adopted by the Supreme Court in Basic Inc. v. Levinson and the fraud created the market theory enunciated by the Fifth Circuit in Shores v. Sklar—by examining whether either version of the theory is consistent with the underlying policies, goals and requirements of Rule 10b-5 in the new issues context.

#### A. Basic's Version of Fraud on the Market Extended to Primary Markets

In Basic Inc. v. Levinson, the Supreme Court adopted the rebuttable presumption of reliance supported by fraud on the market theory in open, actively traded and well-developed markets.\(^1\) Under Basic's version of the fraud on the market theory, the existence of an efficient market was an essential element for recovery.\(^2\) In contrast, Shores

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\(^2\) See Ross, 885 F.2d at 733-34, 736-37 (Tjoflat, J., concurring).

\(^2\) See Ross, 885 F.2d at 736.

\(^2\) See id. at 738-40.

\(^2\) See supra notes 27-39 and accompanying text.

\(^2\) See Ross, 885 F.2d at 739-40.

\(^2\) See id.

\(^1\) See supra note 19 and accompanying text.

\(^1\) See Basic Inc. v. Levinson, 485 U.S. 224, 244-47 (1988).

\(^2\) See id. at 245-47; Freeman v. Laventhol & Horwath, 915 F.2d 193, 197 (6th Cir. 1990); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1119-20 (5th Cir. 1988), cert. denied,
extended the fraud on the market theory to primary markets. Courts have consistently held that primary markets are not efficient. Thus, there exists considerable consensus among courts that Basic's version of fraud on the market theory should not extend to the new issues context.

Proponents of extending Basic's version of fraud on the market to the new issues context could argue, however, that primary markets can act efficiently. This argument posits that the entities issuing new securities can act as a surrogate for market forces by incorporating all material, publicly available information into the offering price of the new security. This argument assumes that the entities involved in the issuing process—developers, underwriters, bond counsels, accounting firms, municipal authorities, etc.—all have strong incentive to position a security at an accurate price and yield that reflects all material information, so that potential investors will have sufficient confidence in that price to purchase the security. Thus, the securities are issued at efficient prices and yields.

The argument will probably fail because, as discussed above, many courts have not endorsed the idea that primary markets can function as efficient markets. Additionally, critics are skeptical as to whether the self-interested players involved in the issuing process have an incentive to price securities accurately. They argue that, instead, these entities have an incentive to act inefficiently and overprice securities.

B. Validity of Shores' Fraud Created the Market Theory

Courts and commentators who oppose the fraud created the market theory developed in Shores emphasize the novelty of the Shores decision in their attempt to distance fraud created the market from the theories of relaxed reliance that the Supreme Court adopted in Basic, Mills, and Ute. Proponents of the Shores approach, on the other hand, emphasize that, although the fraud created the market theory employs a different underlying mechanism to account for the effect of defendant's fraudulent acts, the theory fits under the more general rubric of the fraud


213. See supra note 57 and accompanying text.

214. See supra note 40 and accompanying text.

215. Cf supra notes 47-52 and accompanying text (describing factors necessary for market efficiency).

216. See infra note 57 and accompanying text.


218. See Ross, 885 F.2d at 740 (Tjoflat, J., concurring).

on the market theory: a theory in which plaintiff-investors may establish indirect reliance on defendant's misrepresentations as a means of fulfilling Rule 10b-5's reliance requirement. The subsections that follow examine arguments assessing the validity of the fraud created the market theory.

1. Shores' Marketability Standard

Circuit courts cannot agree on how to interpret Shores' ambiguous "not entitled to be marketed" standard. In addition, some judges argue that the formulation creates needless complications and distinctions and is inherently flawed. These opponents of the fraud created the market theory contend that it is unfair and unwise to base a theory of Rule 10b-5 recovery on a mysterious and unclear standard, especially considering the huge potential liability involved and resources committed by defendants in securities class actions. That is, compared to the clear standard in Basic, the unclear marketability standard in Shores should not provide a remedy for plaintiffs.

Proponents of the fraud created the market theory could counter that legal rules are often unclear and applied differently by circuit courts until the Supreme Court addresses and resolves the issue. Critics of the fraud created the market theory convincingly respond to these proponents by arguing that, even if the Supreme Court defined a more precise marketability standard, any judicial attempt at measuring a given security's marketability but for an alleged fraudulent scheme is a highly speculative and precarious undertaking. Additionally, fraud created the market theory, with its emphasis on courts somehow determining marketability but for fraud, is a poor substitute for the empirically based, precise pricing mechanism of the efficient capital market hypothesis in Basic. Further, courts have noted that the Shores test could have the inequitable and incongruous result that the victim of a truly fraudulent scheme, exactly the kind of plaintiff that the relaxed reliance requirement is supposed to remedy, would not receive the presumption of reliance because

220. See Shores, 647 F.2d at 468-72; see also Cohen, supra note 8, at 758-61 (including fraud created the market as a context in which the presumption of reliance supported by the fraud on the market theory is valid).
221. See supra notes 172-208 and accompanying text.
223. See Ross, 885 F.2d at 733 (Tjoflat, J., concurring); Shores, 647 F.2d at 472-73, 486-87 (Randall, J., dissenting).
224. Compare Basic Inc. v. Levinson, 485 U.S. 224, 245-48 (1988) (stating clearly the requirements necessary for the presumption of reliance) with Shores, 647 F.2d at 465 (setting out the confusing not entitled to be marketed standard).
226. See supra notes 27-57 and accompanying text.
the securities were marketable in the absolute sense, i.e., they were not worthless.227

2. Pure Causation

Courts and commentators criticize the fraud created the market theory for eliminating the Rule 10b-5 reliance requirement and embodying a doctrine of pure causation that exposes defendants to unlimited liability.228 In Basic, the Supreme Court rejected a pure causation approach when it explicitly retained the reliance requirement as an element of a Rule 10b-5 action by allowing the defendant the opportunity to rebut the presumption of reliance.229 The ease with which a court allows defendants to rebut the presumption indicates how closely the court adheres to a traditional showing of direct reliance—the easier the rebuttal, the closer the court is to the traditional showing of direct reliance.230

In a fraud on the market claim based on trading in an efficient market, defendants may rebut the presumption of reliance by attacking either the objective or subjective components of causation (materiality and reliance, respectively).231 In his dissent in Basic, Justice White warned against a policy of pure causation that would exist where the plaintiff established liability solely upon a showing of materiality, the objective component of causation.232 In his majority opinion, Justice Blackmun directly addressed White's concern by emphasizing that if the defendant could rebut the subjective component of causation, reliance, the defendant would escape liability.233 In the case of fraud created the market, plaintiffs can rebut the objective component by establishing that the security was in fact marketable.234 Because fraud created the market theory focuses on a generalized scheme to defraud, however, a defendant who successfully rebuts the subjective component of causation (plaintiff's reliance on the defendant's misrepresentation in a disclosure document)—a showing that would rebut the presumption and negate liability under a Basic approach—would not defeat a cause of action brought under the fraud created the market theory.235 In other words, because a defendant cannot

227. See Shores, 647 F.2d at 473 (Randall, J., dissenting).
228. See id. at 484-87 (Randall, J., dissenting); Black, supra note 8, at 932.
230. See Black, supra note 8, at 934.
231. To rebut the objective component, the defendant must show that the misstatements or omissions at issue were not material, or that an insufficient number of traders relied on the misrepresentations to affect the market price. A defendant may attack the subjective component of reliance by showing that the plaintiff either knew the truth or would have nonetheless traded had he known all the relevant facts. See Basic, 485 U.S. at 248-49.
232. See id. at 255 (White, J., concurring in part, dissenting in part).
233. See id. at 248-49.
234. See, e.g., Shores v. Sklar, 647 F.2d 462, 468-72 (5th Cir. 1981) (holding that defendant can rebut the presumption of reliance upon a showing that the securities at issue were marketable), cert. denied, 439 U.S. 1102 (1983).
235. Compare Basic, 485 U.S. at 248-49 (describing ways a defendant can rebut the
rebut the subjective component, causation and reliance are based solely on a showing of marketability, i.e., pure causation. Opponents of fraud created the market theory can point to this distinction to explain why the Shores theory is a doctrine of pure causation while grudgingly accepting the validity of the theory in Basic.

The proponent of the fraud created the market theory could respond by arguing in favor of a pure causation approach to Rule 10b-5 litigation.236 Courts have consistently rejected such an argument, however.237 Alternatively, proponents of the fraud created the market theory could attempt to argue that once the plaintiff has established that the securities were not marketable, a defendant would still be able to rebut the presumption by proving that the plaintiff knew about the fraudulent scheme when the plaintiff bought the securities, or that the plaintiff would have bought the securities even if the plaintiff had known about the fraudulent scheme.238

Critics of fraud created the market theory respond that this is not a reasonable means for the defendant to rebut the presumption because no reasonable plaintiff knowingly would buy worthless bonds that a defendant fraudulently marketed.239 In contrast, it was reasonable to assume that, in the Basic context, the plaintiff may have bought the stock knowing that the defendants made misrepresentations in a disclosure document.240 The plaintiff may believe, for example, that despite the misrepresentation the security was worth buying because the company in question was an inviting takeover target, or that the stock might experience an industry wide upward movement due to extrinsic factors.241 This rationale does not transfer to a new issue of securities that a plaintiff knew was worthless and the product of a general, ongoing scheme to defraud investors.

3. Does Market Integrity Imply Market Efficiency?

Under the fraud created the market theory, plaintiffs rely on the integrity of the market or the integrity of the regulatory process to prevent the

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presumption of reliance) with Shores, 647 F.2d at 468-72 (limiting defendant's ability to rebut the presumption to proving the bonds were marketable). See also Lockwood, supra note 27, at 1315-18 (explaining the Shores presumption as purely objective so that proof of subjective nonreliance was virtually impossible).
236. See Black, supra note 8, at 926.
237. See Basic, 485 U.S. at 245-47. For the development of the reliance requirement, see supra notes 68-127 and accompanying text.
238. Cf. Basic, 485 U.S. at 245-47 (holding that defendant may rebut presumption of reliance if plaintiff knew about the misrepresentation, or plaintiff would have acted regardless of the knowledge of the misrepresentation).
240. See Basic, 485 U.S. at 248-49.
241. In Basic, Justice Blackmun provided other situations in which the defendant may rebut the presumption, e.g., the plaintiff may have wanted to buy (or sell) the stock for political reasons. See id.
marketing of fraudulent bonds. Opponents of the fraud created the market theory maintain that when reliance on market integrity is divorced from the concept of market efficiency, reliance on the integrity of the market becomes hopelessly general and meaningless. Market integrity, absent an underlying theory to explain the causal mechanism and limit potential plaintiffs, exposes defendants to limitless liability. These critics envision a “slippery slope,” contending that if the general expectation that markets are free from fraud is to serve as a basis for dispensing with subjective reliance in the Shores type primary market context, there is probably no principled reason for requiring subjective reliance in any fraud context.

Proponents of the fraud created the market theory counter that integrity of the market does not have to imply market efficiency. Instead, integrity could simply refer to an expectation that a market is free from fraud. To these observers, an investor’s expectation that securities markets are free from fraud is understandable and reasonable. In addition, since this expectation encourages investment, it is something worth protecting. Further, the slippery slope argument fails to recognize that courts routinely draw lines, often arbitrarily, in many legal contexts. Moreover, the fraud created the market theory contains an explicit check on liability: defendants may rebut the presumption.

The proponent of fraud created the market’s argument fails, however, because reliance on a general expectation that market’s are free from fraud in a primary market context leads to unlimited liability without some underlying theory to impose limits on the concept of market integrity. Further, it bypasses the checks on unlimited liability established in Basic. In addition, some critics argue that a plaintiff’s reliance on integrity of the market or the regulatory process is not reasonable since the entities involved in the issuing process stand to gain financially from the

243. See id. at 483-87 (Randall, J., dissenting); cf. Basic, 485 U.S. at 246-47 (“[I]t is hard to imagine that there is ever a buyer or seller who does not rely on market integrity.”) (citations omitted).
244. See Shores, 647 F.2d at 473-75; id. at 483-87 (Randall, J., dissenting); Ross v. Bank South, N.A., 885 F.2d 723, 738-40 (11th Cir. 1989) (Tjoflat, J., concurring), cert. denied, 495 U.S. 905 (1990); Lockwood, supra note 27, 1315-18.
245. See Shores, 647 F.2d at 483-87; Lockwood, supra note 27, 1315-18.
246. See Basic, 485 U.S. at 246-47 (“[I]t is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?”) (citations omitted); Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975) (“The statute and rule are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely.”), cert. denied, 429 U.S. 816 (1976).
247. See Basic, 485 U.S. at 247; Blackie, 524 F.2d at 907.
248. See, e.g., Abell v. Potomac Ins. Co., 838 F.2d 1104, 1121-22 (5th Cir. 1988) (holding that presumption was rebuttable upon a showing of marketability), cert. denied, 492 U.S. 914 (1989).
249. See supra notes 239-41 and accompanying text.
sale of securities at inflated prices.\(^\text{250}\)

4. Congressional Intent

In *Basic*, Justice White argued by analogy with section 18 of the Securities Exchange Act that Congress' intent when enacting section 10 of the 1934 Act was to require plaintiffs to prove direct reliance to proceed with a private cause of action.\(^\text{251}\) Rule 10b-5, as originally promulgated by the SEC, had no private cause of action; it was judicially conferred.\(^\text{252}\) The scant legislative history of section 10(b) has led the Court to look at Congress' intent in adopting other portions of the Securities Exchange Act to discern the limits of private causes of action under Rule 10b-5.\(^\text{253}\) For example, Congress flatly rejected a proposition analogous to the fraud on the market theory in adopting a civil liability provision of the 1934 Act.\(^\text{254}\) Section 18, one of the few provisions of the Act that provided for a private cause of action and that was adopted at the same time as section 10(b), expressly required that the plaintiff prove that a misrepresentation in a report filed with the SEC both affected the price of the security and was relied upon by plaintiff.\(^\text{255}\) Significantly, the original version of section 18 did not contain a direct reliance requirement, and Congress amended the original version to include a reliance requirement due to criticism over its omission.\(^\text{256}\) When confronted with the issue then, Congress appeared to favor the direct reliance requirement. This argument applies with equal force to the fraud created the market theory, since it similarly contradicts Congress' intention to condition plaintiff's recovery on direct reliance on defendant's misstatements.

Proponents of fraud created the market theory counter that section 18's legislative history is not dispositive for section 10(b) purposes. The legislative intent behind section 10(b) is ambiguous.\(^\text{257}\) Changed circumstances in the securities markets and considerations of policy, particularly the policy in favor of facilitating class actions, have led courts to liberalize their initial restrictive interpretations of reliance under section 10(b).\(^\text{258}\) Further, the reliance requirement in the Rule 10b-5 context is a judge-made standard. It is properly within the discretion of the courts to relax the requirement that they had established previously. In addition, Congress did not move to amend Rule 10b-5 to require direct reliance

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\(^{251}\) See *supra* notes 120-33 and accompanying text.


\(^{253}\) See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 204-06 (1976).


\(^{255}\) See *id.* at 257; *Bloomenthal, supra* note 70, § 2.04, at 2-10.

\(^{256}\) See *Basic*, 485 U.S. at 258 (quoting 78 Cong. Rec. 7701 (1934) (Chairman Rayburn) ("[T]he bill as originally written was very much challenged on the ground that reliance should be required.").

\(^{257}\) See *id.* at 257 (White, J., concurring in part and dissenting in part).

\(^{258}\) See *id.* at 243-44.
after Basic. Instead, Congress appears content to leave the resolution of this issue to the courts.

5. Disclosure Policy of the Securities Laws

Critics of the fraud created the market theory point out that, traditionally, the Supreme Court has held that Rule 10b-5 and the securities laws in general have a "'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.'"259 The Court has held that the method that Congress has chosen to promote the ultimate goal of a high standard of business ethics in the securities markets is to require full disclosure of material information to investors.260 While it is clear that the ultimate goal of section 10 of the Securities Exchange Act and Rule 10b-5 is to prevent fraud in the purchase and sale of securities, courts and commentators are divided on whether the means to achieving this goal should follow the narrower, traditional emphasis on full disclosure of material information or the more expansive focus on preventing fraud generally.261 Opponents of fraud created the market theory contend that the theory improperly presumes the expansive interpretation. Additionally, critics of the fraud created the market theory emphasize that the availability of the theory further emasculates the policy of full disclosure by encouraging plaintiffs to disregard disclosure documents because plaintiffs can state a claim for relief without having actually read and acted on the affirmative misstatements contained therein.262

Proponents of fraud created the market theory attempt to counter by arguing that the expansive interpretation flows from the express language of Rule 10b-5, which reads like a general anti-fraud provision.263 In addition, they try to argue that the theory is consistent with the traditional full disclosure rationale. One commentator argues that since the Shores and Ross analysis extends only to securities that are worthless, not merely overvalued, purchasers of securities still have strong incentive to

260. See id.; see also Santa Fe Indus. v. Green, 430 U.S. 462, 477-78 (1977) ("[T]he Court repeatedly has described the 'fundamental purpose' of the [1934] Act as implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute.").
261. Compare Santa Fe, 430 U.S. at 477-78 (full disclosure) with Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981) ("[T]he purposes of the securities acts and Rule 10b-5 are far broader than merely providing full disclosure or fostering informed investment decisions."); cert. denied, 459 U.S. 1102 (1983).
262. See Basic Inc. v. Levinson, 485 U.S. 224, 258-59 (1988) (White, J., concurring in part and dissenting in part); Shores, 647 F.2d at 483 (Randall, J., dissenting); see also Black, supra note 5, at 457-59 (stating that the presumption of reliance encourages plaintiffs to disregard disclosure documents).
read disclosure materials to make sure they do not receive an overvalued but not worthless security. Critics of the fraud created the market theory could respond that distinguishing an overvalued from a worthless security through examining disclosure documents is not reasonable given the complexity of the document and unsophisticated nature of the investor. Additionally, some versions of the fraud created the market theory allow recovery on securities that are underpriced, not worthless. More importantly, when courts condition recovery on a plaintiff's reading and relying on disclosure documents, it enforces the congressionally mandated policy of full disclosure of information by strongly encouraging investors to read disclosure documents.

**CONCLUSION**

Courts should not apply a presumption of reliance in primary markets based on either the *Basic* or the *Shores* version of the fraud on the market theory. The fraud on the market theory adopted by the Supreme Court in *Basic* cannot extend to primary markets because it is valid only in efficient markets. Courts and commentators are in agreement that primary markets do not act efficiently.

Courts should also not recognize the fraud created the market theory as a valid theory of recovery because the undefinable and ambiguous nature of the *Shores* standard detracts from the theory's validity. More importantly, the fraud created the market theory does not have the theoretical and empirical basis that the efficient capital market hypothesis provides to the fraud on the market theory in *Basic*. That is, there is no coherent mechanism to provide the causal nexus between defendant's fraud and plaintiff's investment decision. The reliance requirement, therefore, becomes purely objective. This virtual elimination of subjective reliance—a policy of pure causation—is at odds with the Supreme Court's explicit recognition that reliance is an essential element of a Rule 10b-5 claim. As long as Rule 10b-5 continues to require reliance as an essential element of the cause of action, fraud created the market cannot serve as a coherent theory of recovery. Finally, there are strong policy arguments against the fraud created the market theory that, when added to the lack of theoretical and empirical basis for the theory, militate strongly against its acceptance as a valid theory of recovery in primary markets.

264. See *Shores*, 647 F.2d at 470; Schmidt, *supra* note 8, at 520-21.
266. See *supra* notes 179-83 and accompanying text.