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Fraud Created the Market: Presuming Reliance in Rule 10(b)-5 Primary Securities Market Fraud Litigation

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FRAUD CREATED THE MARKET: PRESUMING RELIANCE IN RULE 10B-5 PRIMARY SECURITIES MARKET FRAUD LITIGATION

*Matt Silverman**

*This Note addresses the circuit split regarding the “fraud created the market” presumption of reliance in Rule 10b-5 securities fraud cases. Fraud created the market was first adopted by the U.S. Court of Appeals for the Fifth Circuit in *Shores v. Sklar*, and applies in cases where a defendant has engaged in a “scheme to defraud” the investing public in the primary securities market.*

*This Note first discusses Congress’s intent behind relevant securities laws, the effect presuming reliance has on the class certification process, and how the presumption of reliance has been applied in Rule 10b-5 actions by the U.S. Supreme Court. Next, this Note analyzes the initial acceptance of the fraud created the market theory in *Shores*, and the split between the U.S. Courts of Appeals for the Fifth, Tenth, and Eleventh Circuits, which have accepted the theory, and the U.S. Courts of Appeals for the Third and Seventh Circuits, which have rejected the theory. Finally, this Note argues that the Fifth Circuit’s unique interpretation of what constitutes a “scheme to defraud” in *Abell v. Potomac Insurance Co.* is consistent with congressional intent, urging its acceptance by the Supreme Court so that investors may have reliance presumed in the primary market.*

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INTRODUCTION

When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. . . . It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.¹

The question of how far securities law should extend to protect investors from fraud has divided courts for more than seventy years. Currently, circuit courts are struggling with whether a presumption of reliance should extend to plaintiffs who seek to recover under section 10(b)² of the Securities Exchange Act of 1934³ (Exchange Act) in Securities and Exchange Commission (SEC) Rule 10b-5 actions,⁴ when fraudulent misrepresentations or omissions were made during the process of offering the security to the public in the primary market.⁵

1. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).
2. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006).
3. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78kk (Exchange Act). *See generally* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 37–39 (4th ed. 2001) (providing overview of the Exchange Act).
4. 17 C.F.R. § 240.10b-5 (2010).
5. *See infra* Part I.A.2.

In general, the securities market can be divided into the primary and secondary markets.⁶ The primary market consists of securities, such as stocks and bonds, which enter the market for the first time through initial offerings and distributions.⁷ Once distributed, the securities enter the secondary market, where they are traded between different parties on stock exchanges and over-the-counter markets.⁸ Although the U.S. Supreme Court in *Basic Inc. v. Levinson*⁹ held that reliance under “fraud on the market” theory (FOTM) could be presumed in actions concerning securities trading in efficient secondary markets,¹⁰ the Court has not recognized a presumption for efficient or inefficient primary markets. The U.S. Courts of Appeals for the Fifth, Tenth, and Eleventh Circuits have adopted some form of “fraud created the market” theory (FCTM),¹¹ which extends the presumption of reliance to plaintiffs who were defrauded when purchasing newly issued securities.¹² *Shores v. Sklar*¹³ was the first case to adopt FCTM.¹⁴ It extended the presumption to primary market investors who relied on the “integrity of the market” to filter out fraudulent securities because “governments would not authorize, underwriters would not finance and brokers would not offer to sell bonds they knew were unmarketable.”¹⁵

Circuit courts accepting FCTM consider a security to be *unmarketable* (or “not entitled to be marketed”)¹⁶ when the defendants have engaged in a scheme to defraud the investing public¹⁷ and but for the fraud, the security could not have been sold on the market at any price.¹⁸ This scheme to

6. See 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.1[4] (5th ed. 2009).

7. See *id.*

8. See *id.*

9. 485 U.S. 224 (1988).

10. See *infra* Part I.A.6.a.

11. See *Ross v. Bank S., N.A.*, 885 F.2d 723 (11th Cir. 1989); *T.J. Raney & Sons, Inc. v. Fort Cobb, Okl. Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. May 1981).

12. See *infra* Part I.A.7. Commentators have argued that the theory is baseless because it does not rest on economic theory. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1060 n.5 (1990) (criticizing the *Shores* decision as unsupported by economic theory).

13. 647 F.2d at 469–70.

14. See Julie A. Herzog, *Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5*, 63 GEO. WASH. L. REV. 359, 374 (1995) (commenting that the U.S. Court of Appeals for the Fifth Circuit in *Shores* “set sail in new waters” by adopting this presumption of reliance).

15. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1159–60 (6th Cir. 1994); see *infra* Part I.A.7.

16. *Shores*, 647 F.2d at 469.

17. See *infra* Parts I.A.7, II.A.

18. See *infra* Part I.A.7; see also Client Alert, Chadbourne & Park LLP, “Fraud Created the Market” Securities Fraud Theory Rejected by the Third Circuit, Widening Circuit Split, 2–3 (Aug. 25, 2010), available at <http://www.chadbourne.com/files/Publication/656f9992-3826-4c25-ace3-33ede8de9f6e/Presentation/PublicationAttachment/346251ae-732d-448c-83be-38c239759986/Security%20Lit-%20Fraud%20Created%20Market%20ca.pdf>; Peter J. Dennin, Note, *Which Came First, The Fraud or the Market: Is the Fraud-Created-the-*

defraud must be “so pervasive that it goes to the very existence of the [securities] and the validity of their presence on the market.”¹⁹ If the security is found to be unmarketable then the investor must show reliance on the integrity of the market, and that the investor was injured by the fraud.²⁰ Circuit courts have diverged on whether unmarketable means “economic unmarketability” or “legal unmarketability.”²¹

Economic unmarketability focuses on whether the securities could have been sold on the market at any price “if the true risk . . . had been known.”²² The Fifth Circuit has interpreted this to mean that the security is unmarketable if the business the security is purported to support is a sham.²³ The Eleventh Circuit also uses a form of economic unmarketability. It applies FCTM when the security is patently worthless, defining this to mean that the security must have no underlying value (i.e. not backed by any assets or functioning business).²⁴ Legal unmarketability determines unmarketability by looking to see “if, absent fraud, a regulatory agency or the issuing municipality would have been required by law to prevent or forbid the issuance of the security.”²⁵ Circuits justify FCTM and these different theories of unmarketability with two main arguments.²⁶ First, FCTM allows courts to better combat fraud. Second, FCTM is consistent with the purposes of securities regulation.²⁷ Specifically, FCTM seeks to protect investors and promote open markets by punishing fraud and mandating disclosure in securities markets.²⁸

Two circuit courts have rejected FCTM.²⁹ Most recently, in *Malack v. BDO Seidman, LLP*,³⁰ the U.S. Court of Appeals for the Third Circuit summarized and expanded upon the many criticisms of FCTM.³¹ The

Market Valid Under Rule 10b-5?, 69 FORDHAM L. REV. 2611, 2612 (2001) (stating that “[u]nmarketable” securities are those issued only because of the issuer’s fraud”).

19. *Ross v. Bank S., N.A.*, 885 F.2d 723, 729 (11th Cir. 1989).

20. *See infra* Part II.A.1–II.A.3.

21. *See Dennin, supra* note 18, at 2625 (discussing the different theories of fraud created the market (“FCTM”)).

22. *Ross*, 885 F.2d at 736 (Tjoflat, J., concurring).

23. *See infra* Part II.A.1.

24. *See infra* Part II.A.2.

25. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1160 (6th Cir. 1994) (explaining the U.S. Court of Appeals for the Tenth Circuit’s legally unmarketable standard); *see infra* Part II.A.3.

26. *See infra* Parts I.A.7, II.A, III.A.

27. *See infra* Parts I.A.7, II.A, III.A.

28. *See infra* Parts I.A.1–I.A.2, I.A.7, II.A, III.A (describing the purposes of different securities regulations as promoting disclosure, preventing fraud, and limiting unnecessary liability).

29. The U.S. Courts of Appeals for the Seventh and Third Circuits have rejected FCTM. *See infra* Part II.B.1–II.B.2. Meanwhile the U.S. Courts of Appeals for the Sixth, Eighth, and Ninth Circuits have neither rejected nor accepted the theory. *See generally* *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931 (9th Cir. 2009); *In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309 (8th Cir. 1997); *Ockerman*, 27 F.3d at 1151.

30. 617 F.3d 743 (3d Cir. 2010).

31. *Id.* at 756 (concluding that FCTM was baseless, and that it does not have firm theoretical or judicial support); *see infra* Part II.B.2.

Malack court called FCTM a form of investor insurance³² inconsistent with the Private Securities Litigation Reform Act of 1995 (PSLRA),³³ contrary to the Exchange Act's purpose,³⁴ and implicitly rejected by the Supreme Court in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*³⁵

Stoneridge did not explicitly mention FCTM; however, to be consistent with the PSLRA, the opinion asserted that any expansion of Rule 10b-5 private actions, including the reliance element, should be left to Congress.³⁶ The PSLRA was passed to decrease the number of strike suits³⁷ filed against companies whose securities dropped in value, whether or not fraud was involved.³⁸ Accordingly, the *Malack* opinion stated that FCTM undermines the PSLRA³⁹ because the presumption of reliance causes defendants "to settle early and often to avoid litigation costs and the risk of getting hit with a large verdict at trial,"⁴⁰ which makes frivolous lawsuits more burdensome.⁴¹ In interpreting Congress's intent behind the PSLRA, the *Stoneridge* Court viewed the PSLRA as authorization by Congress to further narrow and limit the contours of Rule 10b-5's private action and, at

32. *Malack*, 617 F.3d at 752. Critics argue that investor insurance is created when reliance is presumed in inefficient primary markets because it makes investors believe they will be able to recover anytime they make a bad investment and, therefore, investors will not read the offering materials. See *infra* notes 218–21, 303 and accompanying text.

33. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

34. See *Malack*, 617 F.3d at 752 (commenting that Congress purposely left certain injuries without remedy and that it did not intend to regulate the merits of "various investments").

35. See *Id.* at 753–55 (stating that whether or not the action is extended should be left to Congress and "the § 10(b) private right should not be extended beyond its present boundaries" (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 165 (2008))); see also *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931, 942 (9th Cir. 2009) (finding that the U.S. Supreme Court "adopted a rather restrictive view of private suits under § 10(b)").

36. *Stoneridge*, 552 U.S. at 165–66; see *infra* II.B.2.

37. Strike suits are frivolous lawsuits filed by lawyers looking to extract a settlement from defendants who want to avoid the costs of litigation. S. REP. NO. 104-98, at 4 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 683 (describing that the purpose of the PSLRA was to prevent these types of suits); see also Michael B. Dunn, Note, *Pleading Scienter After the Private Securities Litigation Reform Act: Or, a Textualist Revenge*, 84 CORNELL L. REV. 193, 196 n.11 (1998) (stating that the PSLRA was "designed to thwart the strike suit at every stage of litigation"); *infra* notes 83, 308 and accompanying text.

38. See, e.g., 15 U.S.C. § 78u-4(a)(6) (2006) (limiting the awards of class plaintiffs' attorneys' fees to a "reasonable percentage"); H.R. REP. NO. 104-369, at 31, 37 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 730, 736 (seeking to end "manipulation by class action lawyers" and "frivolous securities class actions"); see also Evan Hill, Note, *The Rule 10b-5 Suit: Loss Causation Pleading Standards in Private Securities Fraud Claims After Dura Pharmaceuticals, Inc. v. Broudo*, 78 FORDHAM L. REV. 2659, 2671–72 (2010) (discussing the frequency with which strike suits were filed due to the low bar a plaintiff's lawyer needed to overcome in order to extract settlements).

39. See *infra* note 308 and accompanying text.

40. *Malack*, 617 F.3d at 755; see *infra* Part I.A.4.

41. *Malack*, 617 F.3d at 755 (finding that these costs "infect the function of the entire securities market" by increasing the risks and costs of bringing securities onto the market).

least, to prevent any expansion.⁴² *Malack* points out that the “[a]doption of [FCTM] would extend § 10(b) liability far beyond its current contours.”⁴³

This Note analyzes the development, application, and rejection of FCTM in the circuit courts. It focuses on whether or not the presumption is supported by Congress’s intent in passing the securities laws and if it should be incorporated into Rule 10b-5 actions dealing with newly issued securities. This Note contends that the Supreme Court should address FCTM and embrace the theory because it broadens the presumption of reliance without imposing burdensome liability on defendants who issue securities in good faith.⁴⁴ FCTM promotes disclosure by securities issuers, protects primary market investors, deters fraud, and punishes fraudsters, all of which are consistent with federal securities law.⁴⁵ Embracing the FCTM exception would lead to a more honest primary market, and would not create the type of investor insurance and frivolous lawsuits that many critics foresee as a byproduct of FCTM’s adoption.⁴⁶

Part I of this Note explains the adoption of the Securities Act of 1933 (Securities Act) and the Exchange Act, the judicial development of private causes of action under section 10(b) and Rule 10b-5, including the evolution of the presumption of reliance under *Basic* and *Affiliated Ute Citizens of Utah v. United States*,⁴⁷ and the subsequent adoption of FCTM under *Shores*. Part II addresses the circuit court split regarding FCTM, focusing on the variations adopted by the circuits and the reasons for its rejection by other circuits. Finally, Part III advocates embracing a modified version of *Shores* to promote investor protections that are consistent with the PSLRA, the Exchange Act, and common sense.

I. THE PRESUMPTION OF RELIANCE IN PRIVATE RULE 10B-5 ACTIONS

This part addresses the judicial development and importance of the presumption of reliance under Rule 10b-5 in the Supreme Court. This part first lays out the Securities Act and Exchange Act and their purpose. Next, it discusses in general why courts choose to adopt presumptions in court proceedings, and specifically how the presumption of reliance can affect the outcome of a Rule 10b-5 action during the class certification process. This Note then surveys the application of this presumption of reliance to

42. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 165 (2008) (“Congress . . . ratified the implied right of action after the [Supreme] Court moved away from a broad willingness to imply private rights of action.”); see Thomas O. Gorman, *Third Circuit Rejects “Fraud-Created-the-Market” Theory*, SEC ACTIONS, (Aug. 18, 2010, 2:47 AM), <http://www.secactions.com/?p=2496> (discussing how FCTM is “contrary to the teachings of *Stoneridge* which cautioned against expansive readings of the reliance requirement, particularly in view of the fact that the cause of action under Section 10(b) has been crafted by the courts, not Congress”).

43. *Malack*, 617 F.3d at 754.

44. See *infra* Part III.A.

45. See *infra* Part III.A.

46. See *infra* Part III.A.; see also Dennin, *supra* note 18, at 2614 (stating that FCTM is both “valid and necessary” and “provides investors with a flexible mechanism for combating securities fraud”).

47. 406 U.S. 128, 153–54 (1972).

fraudulent omissions of material information under *Affiliated Ute* and *Basic*, which expanded the presumption to efficient secondary markets under FOTM when there have been material misrepresentations and omissions. Part I concludes by analyzing the *Shores* decision and the Fifth Circuit's adoption of FCTM.

A. *Private Causes of Action Under the Securities Act of 1933 and the Securities Exchange Act of 1934*

Following the Great Depression of 1929, Congress enacted the Securities Act⁴⁸ and the Exchange Act⁴⁹ to protect investors from unfair market manipulation and rid the securities market of its former philosophy of caveat emptor.⁵⁰ As President Franklin D. Roosevelt stated, the new regulatory scheme put “the burden of telling the whole truth on the seller . . . [and provided an] impetus to honest dealing” in the securities markets.⁵¹ In other words, the purpose of the Acts was, and still is, to prevent fraud and create full disclosure in the markets so investors can make informed decisions on their own.⁵² To this end, the Securities Act regulates the initial public offering (IPO) of securities⁵³ sold in the primary market.⁵⁴ The Exchange Act governs securities that have already been offered and sold to the public and are traded in secondary markets, such as stock exchanges.⁵⁵ Both Acts require that companies disclose material information regarding the security.⁵⁶ Under the Securities Act, companies make these disclosures in their securities' registration statement and

48. 15 U.S.C. §§ 77a–77aa (2006) (Securities Act).

49. 15 U.S.C. § 78j(b); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 408 (1990) (describing the process leading to its enactment).

50. S. REP. NO. 73-792, at 1–5 (1934); see *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 171 (1994); see also Hill, *supra* note 38, at 2665–66 (describing the circumstances leading to the stock market crash of 1929 and the purpose of the Acts).

51. H.R. REP. 73-85, at 2 (1933).

52. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669 (1984) (stating that securities law has “two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued and periodically thereafter”).

53. Securities are financial instruments that represent rights in something else, like a piece of a corporation or a debt. See 15 U.S.C. § 77b(a)(1) (2006). An initial public offering is when the securities are first offered for sale to the public. See HAZEN, *supra* note 6, § 1.1.

54. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (stating that the Securities Act “was designed to provide investors with full disclosure of material information concerning public offerings”); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975) (finding that the Securities Act's primary purpose was to increase disclosure in the context of “initial distributions of newly issued stock”). Under the Securities Act, issuers are responsible for registering the securities with the Securities and Exchange Commission (SEC) and disclosing material information within the registration statement and prospectus. HAZEN, *supra* note 6, § 2.0. A prospectus is any “document that describes a public offering of securities by an issuer or controlling shareholder.” *Gustafson v. Alloyd Co.*, 513 U.S. 561, 584 (1995).

55. See HAZEN, *supra* note 6, § 1.1[4].

56. *Id.* § 12.4.

offering materials (such as a prospectus),⁵⁷ which are distributed to investors during an IPO. The Exchange Act requires public companies to release information periodically in accordance with the regulatory framework.⁵⁸ To monitor compliance with these regulations and enforce the rules promulgated under the Acts, Congress created the SEC in 1934.⁵⁹ The SEC plays an active role in regulating securities sold for the first time on the primary market and traded in the secondary market.⁶⁰ Additionally, each Act provides private plaintiffs the right to bring actions against actors who fraudulently misrepresent or omit material information to investors.⁶¹ This private liability is meant to allow investors to “safely buy and sell securities upon the exchanges” and to prevent fraudulent practices that hinder “the operation of the markets.”⁶²

1. The Securities Act

The Securities Act allows private causes of action, in part, to prevent fraud in the primary market and to “promote ethical standards of honesty and fair dealing.”⁶³ In furtherance of this goal the Securities Act covers a myriad of securities and establishes a low threshold for liability under the Act.⁶⁴ Sections 11 and 12(a)(2) of the Securities Act create private remedies for negligent conduct leading to misstatements or omissions in a registration statement or prospectus.⁶⁵ This negligence standard has been interpreted to mean that liability is “virtually absolute, even for innocent misstatements” concerning the securities and parties covered by the Act.⁶⁶

57. Registration statements include disclosures made mandatory by the Securities Act and, absent an exemption, must be issued in order for a security to be legally sold. HAZEN, *supra* note 6, § 2.2[1](a); *see infra* notes 67–71 and accompanying text. Registration prospectuses generally encapsulate information that would be useful to the average investor. *Eckstein v. Balcor Film Invs.*, 58 F.3d 1162, 1168–69 (7th Cir. 1995); *see also* 15 U.S.C. § 77b(a)(10) (providing the statutory definition).

58. HAZEN, *supra* note 6, § 2.0.

59. 15 U.S.C. § 78d; *see* U.S. SEC. & EXCHANGE COMM’N, <http://www.sec.gov/about/whatwedo.shtml> (last visited Feb. 23, 2011).

60. *See* 15 U.S.C. § 78f.

61. *See, e.g.*, HAZEN, *supra* note 6, § 12.4.

62. H.R. REP. NO. 73-1383, at 11 (1934).

63. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 690 (3d Cir. 1991) (stating that Congress designed the Act to increase disclosure through requiring registration and punishing fraud (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976))).

64. *Id.* at 690–92.

65. 15 U.S.C. §§ 77k(a), 77l(a)(2). In order to have a private cause of action, section 11 requires plaintiffs to show that they purchased a registered security and that “any part of the registration statement [or prospectus] contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein.” *Id.* § 77k(a). Some courts have also interpreted section 17(a) as creating a private cause of action. *See* Thomas L. Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641, 642–43 (1978) (discussing how section 17(a) is interpreted by courts as creating a private cause of action).

66. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983); *see infra*, notes 81–82 and accompanying text (explaining that scienter, meaning knowledge or recklessness, is required under Rule 10b-5).

Although the Act is expansive, it does have limitations. First, section 3(a)(2) provides a list of securities that are exempt from the Act, including securities issued by state, local, and federal governments,⁶⁷ such as municipal⁶⁸ and industrial revenue bonds.⁶⁹ Second, certain corporate officers are exempt from liability under the Securities Act.⁷⁰ Therefore, investors who lose money due to misrepresentations in the primary industrial revenue and municipal bond markets have no recourse under the Act and must seek recovery through other channels like Rule 10b-5 of the Exchange Act.⁷¹

2. The Exchange Act

Section 10(b)⁷² is the “catchall provision” of the Exchange Act.⁷³ It provides plaintiffs with a cause of action against defendants who use manipulative or deceptive practices in regulated securities disclosures.⁷⁴ Promulgated under section 10(b), SEC Rule 10b-5⁷⁵ is the primary means for recovery in a fraud action under the Exchange Act.⁷⁶ Rule 10b-5 identifies the following unlawful manipulative and deceptive practices:

67. See 15 U.S.C. § 77c(a); HAZEN, *supra* note 6, § 4.3.

68. See 15 U.S.C. § 77c(a)(2). Municipal bonds are exempt because generally they are guaranteed by the government. HAZEN, *supra* note 6, § 4.3.[1][a] nn.4–5.

69. SEC Rule 131(b) explains this exemption, providing that an industrial revenue bond issued by a government, but payable by a private party, is exempt if the debt obligation relates to a public project. See 17 C.F.R. § 230.131(b) (2010).

70. Actions cannot be brought against certain corporate officers, lawyers, and accountants unless specifically mentioned within the statute. See 15 U.S.C. § 77k(b); see also *Herman & MacLean*, 459 U.S. at 386 n.22 (describing how plaintiffs were barred from bringing an action under the Securities Act because the defendants were exempt).

71. Many of the key cases where plaintiffs have argued for FCTM involved misrepresentations made in the offering materials of municipal and industrial revenue bonds. See, e.g., *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1151–53 (6th Cir. 1994); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1120–22 (5th Cir. 1988); *Shores v. Sklar*, 647 F.2d 462, 463–65 (5th Cir. 1981). At least one commentator has suggested that in *Shores* and similar decisions involving municipal bonds, plaintiffs “should be entitled to some minimal assurance that the market offers protection against sham investments,” but that “the best way of providing for this would be for legislative enactment of an explicit remedy for purchasers of revenue bonds comparable to section 11 of the Securities Act of 1933.” Barbara Black, *The Strange Case of Fraud on the Market: A Label in Search of a Theory*, 52 ALB. L. REV. 923, 955 (1988).

72. 15 U.S.C. § 78j(b).

73. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980) (stating that “[s]ection 10(b) is aptly described as a catchall provision, but what it catches must be fraud”).

74. See *id.*; see also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976).

75. 17 C.F.R. § 240.10b-5 (2010). In 1942, the SEC created Rule 10b-5 in accordance with section 10(b) of the Exchange Act. Since *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), the courts have created and upheld a private cause of action through a process of judicial interpretation and congressional inaction. See *Herman & MacLean*, 459 U.S. at 380 n.10, for a summary of the evolution and then recognition of the private cause of action by the Supreme Court. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (affirming that a private action had been consistently recognized).

76. See, e.g., Symposium, *Happy Birthday 10b-5: 50 Years of Antifraud Regulation*, 61 FORDHAM L. REV. S1 (1993).

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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.⁷⁷

The Supreme Court has recognized that 10b-5(b) extends to securities in the primary market context,⁷⁸ including securities that are exempt from the Securities and Exchange Acts.⁷⁹ The private cause of action for misrepresentation under Rule 10b-5(b) tracks the common law tort of deceit and misrepresentation, also known as fraud.⁸⁰ In order to recover, a plaintiff must show: (1) a material misrepresentation, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation.⁸¹ Since the 1970s, Supreme Court decisions⁸² and congressional legislation, including the PSLRA,⁸³ have limited Rule 10b-5's scope. Even as 10b-5 has been actively restricted, the presumption of reliance standard has remained unchanged since *Basic*.⁸⁴

77. 17 C.F.R. § 240.10b-5.

78. See *Herman & MacLean*, 459 U.S. at 383–84. As Judge Frank Easterbrook observed in *Eckstein*, the plaintiffs get a longer statute of limitations under Rule 10b-5 than under sections 11 and 12 of the Securities Act, but the standard for liability is higher. *Eckstein v. Balcor Film Invs.*, 8 F.3d 1121, 1123–24 (7th Cir. 1993); see also Black, *supra* note 71, at 946 (stating that courts that have adopted a *Shores* approach “transform a claim necessarily based on Rule 10b-5 into the equivalent of a section 11 claim”).

79. HAZEN, *supra* note 6, § 12.3[3], at 526; see *supra* notes 68–70 and accompanying text.

80. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

81. See *id.* Each element must be pleaded with particularity in order to move past summary judgment. FED. R. CIV. P. 9(b); HAZEN, *supra* note 6, § 12.3[3] (stating that rule 9(b) necessarily applies to Rule 10b-5 claims). Compare to sections 11 and 12(a)(2), which do not require a showing of reliance or scienter. *Herman & MacLean*, 459 U.S. at 382 (stating that all that is needed for a prima facie case is a showing that there is a material misrepresentation or omission and that “[l]iability . . . is virtually absolute, even for innocent misstatements” whereas fraud requires scienter); see *Eckstein v. Balcor Film Invs.*, 58 F.3d 1162, 1170 (7th Cir. 1995) (stating that reliance need not be shown).

82. See, e.g., *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (limiting liability to all third parties, regardless of their role in fraudulent conduct, because plaintiffs do not rely on third parties’ conduct); *Dura Pharm., Inc.*, 544 U.S. at 342 (determining that plaintiffs must show loss causation); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 185 (1994) (disallowing causes of action against people who aid and abet); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214–15 (1976) (replacing simple negligence with the element of scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754–55 (1975) (requiring a plaintiff to have either bought or sold the security affected by fraud).

83. 15 U.S.C. § 78u-4(a)(6), (b)(1)-(2) (2006)) (limiting class plaintiffs’ attorneys’ fees to a “reasonable percentage” of recoveries and adopting higher pleading standards with regards to scienter); see also Robert A. Prentice, Stoneridge, *Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611, 612 (2008) (noting that because of the Supreme Court’s interpretations since *Blue Chip* and the PSLRA’s enactment, the “Rule 10b-5 cause of action actually provides markedly less protection than investors enjoyed before 1934, rather than more [protection]”).

84. See *infra* notes 114–26 and accompanying text. Congress could have limited or eliminated the presumption, but the SEC Chairman, Arthur Levitt, testified in support of

3. The Reliance Element of a Rule 10b-5 Claim

Courts require reliance⁸⁵ because it establishes the causal connection between a defendant's fraud, the plaintiff's decision to buy the security, and the injury.⁸⁶ Thus, reliance proves actual causation.⁸⁷ To prove reliance in a Rule 10b-5 claim, a plaintiff must show that the defendant's misrepresentation or omission was material⁸⁸ and that the misrepresentation or omission was a substantial factor in the plaintiff's decision to buy, hold, or sell the security.⁸⁹ The plaintiff's reliance on the defendant's misrepresentation or omission must also be reasonable.⁹⁰ Even though reliance is a well-established element of a Rule 10b-5 action, over the years, courts have recognized that reliance is difficult to prove in class actions.⁹¹ Unlike common law fraud, where an action usually involves a few actors dealing face-to-face, a Rule 10b-5 action "literally involv[es] millions of shares changing hands daily" between many investors and therefore "Rule 10b-5's reliance requirement must encompass these differences."⁹² In order

fraud on the market (FOTM). *See Hearings Before the Subcomm. on Telecomms. and Fin. of the H. Comm. on Commerce*, 104th Cong. 13 (1995) (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission), available at <http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt> ("An actual reliance requirement of the type proposed would also make it virtually impossible for investors to assert their claims as part of a class action.").

85. Sometimes reliance is referred to as "cause in fact" or "transaction causation." *See, e.g., Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1118 (5th Cir. 1988).

86. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965) (stating that the aim of "Rule 10b-5 is to deter misconduct . . . rather than to compensate their victims" and that therefore reliance ensures that the misrepresentation actually caused the harm). The judicial requirement of reliance originated from the tort action of deceit. *See Black, supra* note 71, at 923 n.2 (describing that elements of a Rule 10b-5 action are based in the common law tort action of deceit and retain many of its characteristics). At common law, because the "great majority of [deceit] cases" involved misrepresentations between "distrustful adversaries" (or those at arm's length), the courts used reliance to prevent the creation of insurance for injured parties. *W. KEETON, PROSSER AND KEETON ON LAW OF TORTS* 726 (5th ed. 1984). Thus reliance ensured that the fraud itself caused the injury. *RESTATEMENT (SECOND) OF TORTS* § 525 (1977).

87. *See Black, supra* note 71, at 924 (stating that the reliance element establishes "causation in fact"); *see also* *RESTATEMENT (SECOND) OF TORTS* § 546 cmt. b. As one court put it, "[t]o say that a plaintiff relied [on fraud] is to say that the defendant's actions 'played a substantial part in the plaintiff's investment decision.'" *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931, 939 (9th Cir. 2009) (quoting *Rowe v. Maremont Corp.*, 850 F.2d 1226, 1233 (7th Cir. 1988)).

88. Determining the materiality of an omission or misrepresentation is a fact intensive question that requires the court to examine whether the omission or statement would have been considered by a reasonable investor deciding whether to buy or sell a security. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32, 240 (1988); *see also* *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (stating a fact is material if a reasonable investor would have considered the information important in making an investment choice).

89. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1158 (6th Cir. 1994).

90. *List*, 340 F.2d at 462.

91. *See, e.g., Basic*, 485 U.S. at 243–45 (stating that showing actual reliance during class certification is impracticable); *see also* *Dennin, supra* note 18, at 2617–18 (explaining that showing actual reliance early in litigation would be "too burdensome").

92. *Basic*, 485 U.S. at 243–44; *see* Joseph De Simone, Note, *Should Fraud on the Market Theory Extend to the Context of Newly Issued Securities?*, 61 *FORDHAM L. REV.*

to encompass these differences, the court can presume reliance so that plaintiffs do not have to make the difficult showing of actual reliance for each of the many individual class members.⁹³ This also allows judges in the early stages of litigation to focus on the underlying fraud, the intent of the actors, and the injury caused.⁹⁴ However, the presumption is rebuttable,⁹⁵ signifying that defendants can rebut the presumption at trial by showing that there was no actual reliance.⁹⁶ Even so, the presumption is still useful to plaintiff classes because they have less to prove in the early stages of litigation, including the pivotal class certification stage.⁹⁷

4. Class Certification

The importance of whether the presumption is applied cannot be understated. Application of the presumption often affects whether a class of investors is certified under Rule 23 of the Federal Rules of Civil Procedure (Rule 23).⁹⁸ In many Rule 10b-5 lawsuits, certification is outcome determinative. Settlement is more likely when classes are certified, as defendants would rather pay a settlement than risk an adverse outcome after trial.⁹⁹ Conversely, when the class is not certified, individual plaintiffs are often compelled to withdraw their claims because the litigation costs for an individual, or a class action with a small class, outweigh the probable benefits of prevailing in court.¹⁰⁰

Plaintiffs will generally seek certification¹⁰¹ under Rule 23(b)(3), which requires that “questions of law or fact common to class members

S151, S161–68 (1992) (explaining the development of the rebuttable presumption of reliance in detail).

93. See *infra* notes 115–24 and accompanying text.

94. See *infra* Part I.A.6.d.

95. See *infra* Part I.A.6.d.

96. See *infra* Part I.A.6.d.

97. See *infra* Part I.A.4.

98. FED. R. CIV. P. 23.

99. See Patricia Groot, Note, *Fraud on the Market Gets a Minitrial: Eisen through In Re IPO*, 58 DUKE L.J. 1143, 1157–58 (2009); see also *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 755 (3d Cir. 2010) (agreeing that “class certification puts pressure on defendants to settle claims, even if they are frivolous” (citing *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 310 (3d Cir. 2008))); *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 379 (5th Cir. 2007) (stating that “class certification may be the backbreaking decision that places insurmountable pressure on a defendant to settle, even where the defendant has a good chance of succeeding on the merits”) (internal quotations omitted).

100. See Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 457 (2006).

101. In order for a class to be certified it must also meet the requirements of Rule 23(a), which states that one or more members of a class may sue or be sued as representative parties on behalf of all members only if:

(1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and (4) the representative parties will fairly and adequately protect the interests of the class.

FED. R. CIV. P. 23.

predominate over any questions affecting only individual members.”¹⁰² If reliance is presumed, there is no need to show that each individual plaintiff relied on the misstatement in the same manner until after the class is certified.¹⁰³ Without the presumption, each plaintiff would have to show how his or her individual reliance was sufficiently similar to every other plaintiff’s form of reliance in order to be in compliance with Rule 23.¹⁰⁴ This makes certification nearly impossible in light of the predominance requirement because of the expense of compiling the necessary information and the inevitable differences between class members that would likely exist.¹⁰⁵ In this way, the presumption of reliance acts as a practical resolution to these difficulties, allowing for the common questions to predominate over individual ones under Rule 23(a)(2) and 23(b)(3).¹⁰⁶ Without the presumption, defendants would rigorously challenge predominance during the certification process,¹⁰⁷ which would allow courts to reject “nearly all proposed securities class actions under the reliance element.”¹⁰⁸ Therefore, presuming reliance is essential for a class action suit to proceed. In general, a court will only apply a presumption if certain criteria are met. The next section discusses these criteria and how, in common law, courts decide if a presumption should be applied.

102. *Id.*; see *Dunbar & Heller*, *supra* note 100, at 461. Rule 23(b)(3) is intended to redress monetary damages. See *Groot*, *supra* note 99, at 1147 n.28 (explaining that (b)(1) and (b)(2) were not intended to be used when the primary remedy sought is damages).

103. See *Black*, *supra* note 71, at 927–29 (finding that a presumption of reliance does not eliminate a plaintiff class proving reliance, but removes it from a court’s analysis during the class certification stage).

104. *Basic Inc. v. Levinson*, 485 U.S. 224, 242 (1988) (pointing out that in class action cases, to require “individualized” proof of reliance from each member in a proposed class might prevent an action from proceeding because “individual issues” would overwhelm “the common ones”).

105. See *Groot*, *supra* note 99, at 1152; see also *Moore v. PaineWebber, Inc.*, 306 F.3d 1247, 1252 (2d Cir. 2002) (“Class-wide issues predominate if resolution of some of the legal or factual questions that qualify each class member’s case as a genuine controversy can be achieved through generalized proof, and if these particular issues are more substantial than the issues subject only to individualized proof.”).

106. See *Basic*, 485 U.S. at 242 (arguing that the presumption created “a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Federal Rule of Civil Procedure] 23”) (internal quotations omitted).

107. *In re Healthsouth Corp. Sec. Litig.*, 261 F.R.D. 616, 621 (N.D. Ala. 2009) (stating the “strongest attack aims at the predominance requirement” regarding reliance).

108. *Id.*; see *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 747 (3d Cir. 2010) (explaining that “[p]roving reliance . . . can quickly become a cumbersome endeavor that overwhelms the ‘questions of law or fact common’ to the proposed class”); *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 394 (5th Cir. 2007) (stating that “no class may be certified in a § 10(b) case without a classwide presumption of reliance”); see also *Groot*, *supra* note 99, at 1158 n.96 (describing how Congress could have limited class certification by reversing *Basic* when it enacted the PSLRA but did not because it would make bringing a class action near impossible).

5. The Presumption of Reliance in Rule 10b-5 Actions

Presumptions of certain claims or facts play an important role in judicial review.¹⁰⁹ Courts and commentators have reasoned that allowing certain presumptions helps to realize goals of public policy, fairness, and judicial economy.¹¹⁰ Such goals are met where difficult-to-prove facts or claims are assumed, allowing an action to progress toward trial.¹¹¹ Courts may also apply presumptions if they are consistent with “congressional policy” and “common sense.”¹¹² Consistent with these goals, the Supreme Court has extended a presumption of reliance so that courts can focus attention on whether or not there was a material misrepresentation or omission, if it caused injury, and whether scienter was present.¹¹³

If a plaintiff can show that the other elements have been met,¹¹⁴ then the Supreme Court allows a rebuttable presumption that plaintiffs relied on fraudulent misrepresentations or omissions in two scenarios.¹¹⁵ First, in *Affiliated Ute*, the Court granted the presumption in cases involving the omission of information to investors, if the omitted information was shown to be material “in the sense that a reasonable investor might have considered [it] important in . . . making [the investment] decision.”¹¹⁶ In this type of case, the net effect is that “materiality and reliance . . . collapse into one.”¹¹⁷ The presumption under *Affiliated Ute* has been widely accepted and the Supreme Court has rationalized the presumption by pointing to the inherent unfairness and difficulty a plaintiff would face in having to prove the counterfactual of “how he would have acted if [the] omitted material information had been disclosed.”¹¹⁸ However, in cases that involve a mix of both misrepresentations and omissions, the *Affiliated*

109. 2 KENNETH S. BROUN ET AL, MCCORMICK ON EVIDENCE § 343 (5th ed. 1999). Presumptions are also useful devices for allocating the burdens of proof between parties. *Id.*; FED. R. EVID. 301.

110. *Basic*, 485 U.S. at 245; see BROUN, *supra* note 109, § 343 (noting that presumptions “correct an imbalance resulting from one party’s superior access to the proof”).

111. BROUN, *supra* note 109, § 343 (“Generally, however, the most important consideration . . . is probability. Most presumptions have come into existence primarily because judges have believed that proof of fact B renders the inference of the existence of fact A so probable that it is sensible and timesaving to assume the truth of fact A until the adversary disproves it.”); see *Basic*, 485 U.S. at 245 (expanding the Court’s willingness to allow a presumption because it is difficult to prove reliance).

112. *Basic*, 485 U.S. at 245–46; see *infra* notes 293–99 and accompanying text.

113. See Black, *supra* note 71, at 934; see also *supra* note 81 and accompanying text.

114. HAZEN, *supra* note 6, § 12.10[6].

115. See *infra* notes 116–21 and accompanying text.

116. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153–54 (1972). The Supreme Court found that positive proof of reliance was not the plaintiff’s burden. *Id.* Reliance is presumed if the defendant omitted information that it had a duty to disclose, and that information was material. *Id.*; see *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (explaining that the duty exists where there is a fiduciary or similar relationship of trust between the parties).

117. Jeffrey L. Oldham, Note, *Taking “Efficient Markets” Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Act*, 97 NW. U. L. REV. 995, 1005 (2003).

118. *Basic Inc. v. Levinson*, 485 U.S. 224, 245 (1988); see Oldham, *supra* note 117, at 1005.

Ute holding does not apply.¹¹⁹ In such mixed cases, the plaintiff must either show actual reliance or obtain the presumption through FOTM.¹²⁰ FOTM, as held by *Basic*, allows the presumption of reliance when material misrepresentations or omissions are disseminated into an efficient market.¹²¹ In expanding the presumption of reliance to FOTM, the *Basic* Court relied on the efficient capital market hypothesis (ECMH), an economic theory widely accepted at the time.¹²² ECMH states that in an efficient capital market, a misrepresentation or omission will be incorporated into the price of the security.¹²³ Since investors use price to formulate their investment decisions, the Court was therefore willing to presume that plaintiffs had relied on the misrepresentation.¹²⁴ Thus, in order to recover under the *Basic* standard, the plaintiffs were required to show that the market for the security they purchased was efficient.¹²⁵

6. Expanding the Presumption to Efficient Markets

a. Fraud on the Market Under Basic

In *Basic*, shareholders of Basic Inc. claimed that the company and its directors issued misleading press releases which “artificially depressed” the share price.¹²⁶ These press releases stated that the company was not engaged in merger negotiations;¹²⁷ however, shortly after their release, the directors approved the sale of Basic Inc.¹²⁸ The plaintiff class had sold their shares before the board’s endorsement of the sale and claimed to have been injured by selling at a depressed price.¹²⁹ In seeking class certification,¹³⁰ the plaintiffs argued the Court should apply FOTM to create a rebuttable presumption of reliance.¹³¹ A plurality of the Court agreed with the shareholders, and adopted FOTM, which expanded the presumption of reliance in Rule 10b-5 actions.¹³² Writing for the Court,

119. See Black, *supra* note 71, at 925. In cases that involve both misrepresentations and omissions, the plaintiff would have to either show actual reliance, or use the fraud on the market theory of reliance. *Id.*

120. *Id.*

121. *Basic*, 485 U.S. at 247 (applying the fraud on the market theory of reliance “where materially misleading statements have been disseminated into an impersonal, well-developed market for securities”); see *infra* notes 126–53.

122. See *infra* note 136; see also De Simone, *supra* note 92, at S156 (stating that “[t]he theoretical underpinning of [FOTM] is the [ECMH]”).

123. See *infra* notes 135–41 and accompanying text.

124. See *infra* notes 135–41 and accompanying text.

125. See *infra* notes 138–40 and accompanying text.

126. *Basic*, 485 U.S. at 228–29.

127. *Id.* at 227–28.

128. *Id.*

129. *Id.* at 228.

130. See *supra* Part I.A.4.

131. *Basic*, 485 U.S. at 229–30 (stating that the Court granted certiorari to resolve a split in the Courts of Appeals regarding this presumption).

132. *Id.* at 246–50. Prior to *Basic*, the Court had only recognized the presumption of reliance in Rule 10b-5 actions in pure omission cases like *Affiliated Ute*. See *supra* note 116 and accompanying text.

Justice Harry A. Blackmun accepted the ECMH theory as a legitimate theoretical foundation for FOTM.¹³³

b. The Efficient Capital Market Hypothesis

The ECMH states that in an open¹³⁴ and well-developed market,¹³⁵ where information is available and actors are rational, the price of a security will represent its inherent value.¹³⁶ However, if misrepresentations are material, the price of the security will not match its value.¹³⁷ In accordance with the ECMH, FOTM holds that since investors rely on the price of a security in deciding whether to buy or sell, it is presumable that the plaintiffs relied on the fraudulent misrepresentation or omission because the market digested that information (or lack thereof) into the price.¹³⁸ Using this theory, the *Basic* plurality expanded the presumption of reliance to the limits recognized by the Court today.¹³⁹

c. Relying on Efficiency

In accordance with the ECMH, the *Basic* plurality stated that a presumption of reliance can be applied so long as the security trades in an

133. See *Basic*, 485 U.S. at 246–50. *But see id.* at 254 (White, J., concurring in part and dissenting in part) (stating that the Court should not underpin a presumption of reliance solely on a theory “which may or may not prove accurate upon further consideration”). The Court’s acceptance of the ECMH and application to FOTM has been widely covered and accepted by commentators. See, e.g., Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 910–12 (1989) (discussing the validity of the theory); L. Brett Lockwood, Comment, *The Fraud-on-the-Market Theory: A Contrarian View*, 38 EMORY L.J. 1269, 1269–70 (1989); De Simone, *supra* note 92, at S155–57.

134. “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).

135. “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 [and] will almost always be an open one.” *Id.*

136. See generally *Basic*, 485 U.S. at 244–47; Fischel, *supra* note 133, at 911–12. At the time of FOTM’s adoption, ECMH was widely accepted. See, e.g., Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978) (announcing that “there is no other proposition in economics which has more solid empirical evidence supporting it”). However, over the years ECMH has been criticized by behavioral finance commentators that argue, in part, that even in efficient markets price may not reflect value. See, e.g., Larry E. Ribstein, Forum Article, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 138–43 (2006) (stating that markets are “noisy” because market participants may act irrationally, choosing to buy, sell, or hold without the value of the security and its underlying assets in mind).

137. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008) (upholding the FOTM).

138. See *Basic*, 485 U.S. at 244–47; De Simone, *supra* note 92, at S157. Some courts find that the Court merely used the word reliance even though no such reliance occurred, only an effect on the price. See e.g., *Eckstein v. Balcor Film Invs.*, 8 F.3d 1121, 1129 (7th Cir. 1993).

139. See, e.g., *Stoneridge*, 552 U.S. at 159 (recognizing the ECMH and that FOTM and the *Affiliated Ute* presumption are the only times when reliance is presumed).

efficient market,¹⁴⁰ because “[t]he causal connection between the defendants’ fraud and the plaintiffs’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.”¹⁴¹ The dissent criticized this position, arguing that people trading in the market, efficient or not, do not always rely on price to make their investment decisions, and regularly trade on the belief that stocks are over or under valued.¹⁴² The dissent found that this presumption was nothing more than investor insurance,¹⁴³ and “effectively eviscerate[d]” the reliance requirement in contravention of congressional intent.¹⁴⁴ As is commonly argued by dissenting opinions regarding the expansion of the private right

140. See *Basic*, 485 U.S. at 244–47. However, *Basic* “offers little guidance for determining whether a market is efficient,” *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 368 (4th Cir. 2004), and has left each of “the circuits room to develop its own [FOTM] rules.” *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1120 (5th Cir. 1988). One of the most popular methods of determining market efficiency was established in *Cammer*, 711 F. Supp. at 1285–87. Courts apply a multifactor test, known as “*Cammer* factors” which include:

- (1) whether the security has a large weekly trading volume;
- (2) whether a significant number of securities analysts followed and reported on the company’s stock during the applicable period;
- (3) whether the stock had numerous market makers;
- (4) whether the company was entitled to file an S-3 Registration Statement in connection with public offerings; and
- (5) whether the security experienced an historical showing of immediate price response to unexpected corporate events or financial releases.

In re Healthsouth Corp. Sec. Litig., 261 F.R.D. 616, 632 (N.D. Ala. 2009) (citing *In re DVI Inc. Sec. Litig.*, 249 F.R.D. 196, 208 (E.D. Pa. 2008); *Unger v. Amedisys Inc.*, 401 F.3d 316, 323 (5th Cir. 2005)). Other courts have also considered additional factors: “[1] the company’s market capitalization; [2] the bid-ask spread; [3] the float, or issue amount outstanding excluding insider-owned securities; and [(4)] the percentage of institutional ownership.” *Id.* at 632 (citing *Unger*, 401 F.3d at 323; *Bell v. Ascendant Solutions, Inc.*, 422 F.3d 307, 313 (5th Cir. 2005); *In re Scientific-Atlanta, Inc. Sec. Litig.*, 571 F. Supp. 2d 1315, 1338 (N.D. Ga. 2007); *Krogman v. Sterritt*, 202 F.R.D. 467, 474, 478 (N.D. Tex. 2001)).

141. *Basic*, 485 U.S. at 242; see *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 175 (3d Cir. 2001) (stating that “[i]n an efficient market the misinformation directly affects the stock prices at which the investor trades and thus, through the inflated or deflated price, causes injury even in the absence of direct reliance” (internal citations and quotation marks omitted)).

142. *Basic*, 485 U.S. at 252, 256–57 (White, J., concurring in part and dissenting in part) (commenting that replacing traditional legal analysis “with economic theorization” was sure to lead to confusion). But as courts and commentators have recognized, price “is the best indicia of value” which makes truthful pricing free of distortion all the more important. See Fischel, *supra* note 133, at 920. Further, even in situations where investors do not believe price is reflective of the securities value, these same investors will still rely on comparisons “between [securities] current prices and expected future prices.” *Id.* Therefore, just like any investor who believes that price is reflective of value, these investors rely on market to be free from fraud. *Id.*

143. *Basic*, 485 U.S. at 256–57 (White, J., concurring in part and dissenting in part). FCTM has also raised the same criticism. See *infra* notes 221–23, 303 and accompanying text. But see Fischel, *supra* note 133, who argues that even if there is effectively a non-rebuttable presumption during class certification it does not create investor insurance because the presumption only reduces the burden of proof on one element. Plaintiffs must still establish that the defective disclosure affected the security price and by how much. *Id.* at 918–19.

144. *Basic*, 485 U.S. at 258 (arguing that the Exchange Act’s legislative history shows a clear intent to have reliance be part of the fraud action).

of action under Rule 10b-5, the dissent asserted that expansion should be left to Congress.¹⁴⁵ Even so, the plurality found that FOTM, “by facilitating Rule 10b-5 litigation, supports the congressional policy embodied in the [Exchange] Act” to provide for a “free and open public market.”¹⁴⁶

d. Overcoming a Basic Presumption

Importantly, even when the presumption of reliance is granted to a plaintiff class under *Basic*'s FOTM theory, a defendant can still defeat the action by positive proof of non-reliance.¹⁴⁷ This can be done in several ways. “Any showing that severs the link” between a misrepresentation and the decision to buy the security would be enough,¹⁴⁸ such as “demonstrating that a plaintiff, even had he or she known the truthful information that was not disclosed, would nevertheless still have purchased the stock at the same price.”¹⁴⁹ Circuit courts have expanded the ability to overcome the presumption by explaining that if a defendant can show that the investor “intentionally refused to investigate” a security, or if the fraud was obvious to the investor and that harm would likely follow, the presumption is overcome.¹⁵⁰ However, rebutting the presumption is rare because that would only occur at trial, which generally does not take place because either the defendants settle, the plaintiffs are not certified, or the case is dismissed.¹⁵¹

Since the *Basic* decision, FOTM has been widely applied by the federal courts in Rule 10b-5 actions at both the district and circuit court levels.¹⁵² But just as courts have willingly embraced the presumption in efficient

145. *Basic*, 485 U.S. at 256–57; *but see* Fischel, *supra* note 133, at 921 (arguing that adopting FOTM “is judicial legislation only in the sense that all interpretation of Rule 10b-5 is judicial legislation”).

146. *Basic*, 485 U.S. at 245–46 (plurality opinion) (internal citations omitted). Indeed, some have argued that FOTM is consistent with the Securities Acts’ goal of disclosure because it creates greater disincentives to commit fraud and incentives to voluntarily disclose information to “firms [who] are the lowest cost producers of information.” Fischel, *supra* note 133, at 921. Indeed, in a developed market “investors generally rely on a security’s market price.” *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1158 (6th Cir. 1994). Therefore investors indirectly rely on disclosure documents because financial professionals generally read the disclosure documents when making their decisions to buy and sell, which “affect[s] the security’s price.” *Id.*

147. *See* *Keirman v. Homeland, Inc.*, 611 F.2d 785, 788–89 (9th Cir. 1980); Black, *supra* note 71, at 925.

148. *Basic*, 485 U.S. at 248. *See* Black, *supra* note 71, at 935, for examples of how an investor could be shown not to have relied on the market’s integrity. One example would be an investor who sells a security solely to cash out to make a purchase, and does not rely on the market to make this decision (although Professor Black notes it would be difficult for a defendant to prove the motives of an individual seller). *See* Black, *supra* note 71, at 935.

149. *Ballan v. Upjohn Co.*, 159 F.R.D. 473, 481 (W.D. Mich. 1994) (citing *Basic*, 485 U.S. at 248–49); *see In re Worldcom, Inc. Sec. Litig.*, 219 F.R.D. 267, 292 (S.D.N.Y. 2003).

150. *Ockerman*, 27 F.3d at 1161.

151. *See, e.g., Oldham supra* note 117, at 1013 (stating “it is largely recognized that rebutting the presumption is, in practice, hardly ever done”); *see also supra* notes 99, 103.

152. *See supra* notes 131–41.

secondary markets, they have also been reluctant to apply the presumption in the IPO context, arguing that it is unjustified under *Basic* and securities law.¹⁵³

7. Fraud in Inefficient Markets

As much as *Basic* is the seminal case for FOTM, *Shores* is the seminal case for FCTM.¹⁵⁴ In *Shores*, plaintiff Clarence E. Bishop, Jr. sought to represent a class of municipal bondholders who had lost millions after the bond issuer defaulted on its obligations.¹⁵⁵ Bishop had not read the offering materials but sought to have reliance presumed.¹⁵⁶ The court determined that the bonds were the product of a scheme to defraud investors perpetrated by J. C. Harrelson, President of Alabama Supply and Equipment Company (ASECo), Clarence Hamilton, President of Investors Associates of America, Inc., and Jerald H. Sklar, bond counsel.¹⁵⁷ The men “determined to induce the Town of Frisco City to create an Industrial Development Board to finance ASECo’s [tax-exempt bond] facility as a scheme to defraud the investing public.”¹⁵⁸ Under a local statute, these bonds could be issued for the development of an industrial plant, which, once up and running, would capitalize the interest on the bonds.¹⁵⁹

In the application to the city and the offering circular, Sklar, as bond counsel, omitted information about SEC investigations and ongoing suits against ASECo and Investor Associates, and included financial information drastically overvaluing ASECo’s and Harrelson’s assets.¹⁶⁰ These misstatements and omissions ensured that ASECo would meet the statutory eligibility requirements to issue municipal bonds.¹⁶¹

153. See, e.g., *In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24, 43 (2d Cir. 2006) (stating “[i]t is . . . doubtful whether the *Basic* presumption can be extended, beyond its original context, to tie-in trading, underwriter compensation, and analysts’ reports” (citing *West v. Prudential Sec., Inc.*, 282 F.3d 935, 938 (7th Cir. 2002))); *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990) (stating “a primary market for newly issued [securities] is not efficient or developed under any definition of these terms”) (internal citations and quotation marks omitted); *Berwecky v. Bear, Stearns & Co.*, 197 F.R.D. 65, 68 n.5 (S.D.N.Y. 2000) (finding that the “presumption can not logically apply when plaintiffs allege fraud in connection with an IPO, because in an IPO there is no well-developed market”). But see generally Robert G. Newkirk, Note, *Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context*, 58 U. CHI. L. REV. 1393 (1991) (arguing that applying FOTM to IPOs would further the disclosure goals of securities regulation and that reliance on the market price of an IPO in many situations is reasonable under the ECMH).

154. Although the *Shores* court and many subsequent cases did not refer to the theory as “fraud created the market,” the theory was given this name in *Eckstein v. Balcors Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993), and has become widely accepted.

155. *Shores v. Sklar*, 647 F.2d 462, 463–64, 467 (5th Cir. May 1981).

156. *Id.* at 464.

157. *Id.* at 465.

158. *Id.*

159. *Id.*

160. *Id.*

161. See *id.* at 466.

Additionally, the underwriter¹⁶² was aware that these documents were misrepresentative;¹⁶³ the contractor of the plant entered a sweetheart deal with Harrelson, in which he paid Harrelson for the contract, and the trustee for the bonds failed to monitor whether or not ASECo defaulted, which it invariably did.¹⁶⁴ When the default occurred, the value of the bonds decreased, and the investors, including Bishop, lost significant funds.¹⁶⁵

Bishop alleged that he “was the victim of a pervasive scheme to defraud members of the investing public in violation of the securities laws.”¹⁶⁶ In a split decision, a narrow majority of the en banc court agreed, holding that a presumption of reliance could be made under sections (a) or (c)¹⁶⁷ of Rule 10b-5¹⁶⁸ if the fraud was an “intentional scheme[] which deceive[s] or defraud[s] purchasers of securities.”¹⁶⁹ The court remanded the case holding that Bishop would have to prove that

(1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) [he] reasonably relied on the Bonds’ availability on the market as an indication of their apparent genuineness, and (3) as a result of the scheme to defraud, he suffered a loss.¹⁷⁰

The dissent pointed out that this was a new standard that departed from past precedent and widely held conceptions of actions under Rule 10b-5.¹⁷¹ Generally, cases involving a misrepresentation or omission in offering materials would fall under clause (b),¹⁷² whereas clauses (a) and (c) were reserved for instances where the defendant’s actions constituted

162. In general, an underwriter purchases securities from the issuer and then offers to sell or distribute the security on behalf of the issuer, thereby reducing the issuer’s risk if the securities do not sell. *See HAZEN, supra* note 6, § 4.27[1]. Underwriters are commonly used because “issuers do not have the wherewithal or expertise in the financial industry to market their shares to a large number of investors” and so issuers use underwriters who have well-established distribution networks. *Id.* at § 2.1(1); *see* Securities Act of 1933 § 2(a)(11), 15 U.S.C. § 77b(a)(11) (2006) (providing the full statutory definition).

163. *Shores*, 647 F.2d at 466.

164. *Id.* at 466–67.

165. *Id.* at 464.

166. *Id.*

167. These subsections make it unlawful “(a) To employ any device, scheme, or artifice to defraud” or “(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.” 17 C.F.R. § 240.10b-5 (2010).

168. *Shores*, 647 F.2d at 469.

169. *Id.* at 472. Importantly, the dissent took issue with this statement, stating that “[n]o other court has applied clause [a] or [c] of the Rule on the basis of the scale or elaborateness of the scheme to defraud.” *Id.* at 486 (Randall, J. dissenting). Rather, “clauses [a] or [c] of the Rule have been applied instead to cases in which the fraud is not covered by clause [b] of [Rule 10b-5]” like “total omissions cases, such as [*Affiliated*] *Ute*.” *Id.*

170. *Shores*, 647 F.2d at 469–70 (majority opinion).

171. *Id.* at 486 (Randall, J., dissenting).

172. *Id.*; *see Santa Fe Indus. v. Green*, 430 U.S. 462, 476–77 (1977) (stating that manipulative conduct actionable under (a) and (c) is activity that is designed to artificially affect the price of a security but does not involve misrepresentations).

manipulative acts,¹⁷³ like stealing money, rather than when the defendants induced the plaintiff to do something, like buy a security.¹⁷⁴

The basis for the majority's new interpretation of Rule 10b-5(a) and (c) was that there is a "distinction between securities that are 'entitled to be marketed'"¹⁷⁵ and securities that are not entitled to be marketed.¹⁷⁶ Under this distinction a security that is fraudulently brought to market but could still be sold, even if at a very low price, would be entitled to be marketed and would therefore not violate 10b-5(b), whereas a security that, absent the fraud, could not have been sold at any price would fall under the "not entitled to be marketed" category and thus the court would apply 10b-5 (a) or (c).¹⁷⁷ If the security falls under the latter category, then reliance is presumed if the plaintiff "can show that he reasonably relied on the integrity of the marketplace to offer him securities that were entitled to be marketed."¹⁷⁸ This theory of unmarketability is the foundation for the different variations of FCTM that exist across the circuits today.

Part I of this Note explained relevant securities law, what reliance is, when it is presumed, its importance in class actions, and how defendants can rebut the presumption. Part II examines the diverging views of *Shores's* holding in the circuit courts.

II. SCHEMES TO DEFRAUD AND CREATING LIABILITY IN THE CIRCUIT COURTS

The *Shores* version of FCTM enabled plaintiffs to gain the presumption of reliance when a newly issued security was so rife with fraud that no investor would have bought the security willingly had the fraud been disclosed.¹⁷⁹ *Shores's* novel approach expanded the presumption of reliance to schemes to defraud, under clauses (a) and (c) of Rule 10b-5. This decision departed from the widely accepted view that cases involving misrepresentations and omissions only fell under clause (b).¹⁸⁰ Today the circuit split consists of three circuits adopting and interpreting *Shores's* elemental approach and expansion of Rule 10b-5(a) and (c), two circuits rejecting FCTM, and three circuits undecided. Each circuit court's take on

173. See, e.g., *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931, 938, 941 (9th Cir. 2009) (stating clauses (a) and (c) generally apply to manipulative acts that constitute a scheme to defraud not misrepresentations or omissions).

174. *Shores*, 647 F.2d at 486 n.23 (citing R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS* 1064 (4th ed. 1977)). The dissent explained that (a) and (c) would apply if the defendant pocketed proceeds from sale, rather than inducing a plaintiff to invest more money through a misrepresentation, in which case clause (b) would apply. *Id.*

175. *Id.* at 472–73.

176. See *id.* at 486 (inferring from the majority opinion that if there is an "entitled to be marketed security," then there must be a security that is not entitled to be marketed).

177. *Id.* at 473. In other words, "but for the fraud the securities would have been unmarketable." *Eckstein v. Balcor Film Invs.*, 8 F.3d 1121, 1130 (7th Cir. 1993) (internal quotations omitted).

178. *Shores*, 647 F.2d at 473.

179. See *supra* notes 163–75 and accompanying text.

180. See *supra* notes 172–73 and accompanying text.

FCTM is discussed below in the following order: first the circuits that have accepted FCTM, then the circuits that have rejected it, and finally the undecided circuits.

A. *Redefining Unmarketability and FCTM After Shores*

The Fifth, Tenth, and Eleventh Circuits each employs its own standard for what “not entitled to be marketed” means.¹⁸¹ The Fifth Circuit uses economic unmarketability and looks to whether or not the security is patently worthless. In order for a security to be worthless, the defendants must have intended to defraud the investing public and the business underlying the security must be a sham.¹⁸² The Eleventh Circuit applies its own form of economic unmarketability. It defined “patently worthless” as when a security could not be offered at any price, meaning that the security has no resale or liquidation value because it was not backed by underlying assets.¹⁸³ Finally, the Tenth Circuit applies legal unmarketability. This standard is met when the securities would not have been issued but for the defendants’ knowing violations of the securities law.¹⁸⁴ Although the circuits use different standards of unmarketability, all three follow *Shores*’s analysis of whether the plaintiffs relied on the integrity of the market and analyze if this reliance caused injury.

1. The Fifth Circuit

The Fifth Circuit refined FCTM and what “not entitled to be marketed” means in *Abell v. Potomac Insurance Co.*¹⁸⁵ Like *Shores*, *Abell* involved municipal bonds that resulted in the loss of millions of dollars to investors.¹⁸⁶ The plaintiffs brought an action against the project’s developer and the underwriter’s counsel,¹⁸⁷ claiming that their fraudulent activities had caused the bond issuer to default.¹⁸⁸ During class certification, the plaintiff sought to have reliance presumed because prospective class members had not read the offering materials and therefore could not show actual reliance.¹⁸⁹ Relying on *Shores*, the plaintiffs argued that but for the defendants’ fraud the securities would not have been entitled to be marketed.¹⁹⁰ The defendants countered that in order for FCTM to apply under *Shores*, the securities would have to be worthless, and if they “retained any value at all” then the theory would not apply.¹⁹¹ The court

181. *See supra* note 170 and accompanying text.

182. *See infra* Part II.A.1.

183. *See infra* Part II.A.2.

184. *See infra* Part II.A.3.

185. 858 F.2d 1104 (5th Cir. 1988), *vacated on other grounds and remanded sub nom.* Fryar v. Abell, 492 U.S. 914 (1989).

186. *Id.* at 1112. As of the trial date the bondholders’ total losses were \$12,019,118. *Id.*

187. *Id.* at 1114–15 (finding that section 12 of the Securities Act did not apply because neither could be characterized as a “seller” under the Act).

188. *Id.* at 1115–16.

189. *Id.* at 1119–20.

190. *Id.* at 1121.

191. *Id.*

disagreed with the defendants' interpretation of what the *Shores* opinion meant by "worthless."¹⁹² In *Shores*, bonds had retained some value because of the underlying assets.¹⁹³ Even though the assets gave the *Shores* bonds some value, "the sham 'business' did not [provide value] because the promoters never intended to start a legitimate one."¹⁹⁴ In other words, the bonds may have had some inherent value because assets backed them but the hoax business was worthless because it could not generate the revenue to pay interest on the bonds. Therefore, the court held that FCTM only applied "where the promoters knew that the subject enterprise was worthless when the securities were issued, and successfully issued the securities only because of defendants' fraudulent scheme."¹⁹⁵ The court held that the plaintiffs could not rely on FCTM since the bonds "always had a legitimate value" because the underlying business was not a hoax or scam.¹⁹⁶ The court therefore determined that the bonds were not patently worthless¹⁹⁷ and although the defendants engaged in fraud leading to the eventual default,¹⁹⁸ there was no scheme to defraud investors by starting a sham business.¹⁹⁹ The Fifth Circuit warned that to hold otherwise would expand the presumption of reliance too far.²⁰⁰ Soon after *Abell* was decided the newly created Eleventh Circuit addressed FCTM.

2. The Eleventh Circuit

In *Ross v. Bank South, N.A.*,²⁰¹ the Eleventh Circuit addressed FCTM for the first time. Sitting en banc, a plurality upheld the *Shores* theory and extended the presumption of reliance to a group of bondholders, who had bought securities in the primary market and would not have been able to prove actual reliance.²⁰² Extending *Shores*'s three-part test,²⁰³ the court recognized that the first element was a substantial hurdle because "the

192. *Id.* at 1122.

193. *Id.* at 1121–22.

194. *Id.* at 1122.

195. *Id.* at 1122–23. This has become known as economic unmarketability. See *Ross v. Bank S., N.A.*, 885 F.2d 723, 736–37 n.10 (11th Cir. 1989) (stating that under this standard marketability does not depend on the value of the bonds but rather on the value of the subject enterprise and the promoter's knowledge of that value).

196. *Abell*, 858 F.2d at 1122 (pointing out that the bonds always had a legitimate value in the bond market, remaining near market value for several years after Westside disclosed the accurate version of its beginning and several months after this lawsuit commenced); see also *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 391 n.35 (5th Cir. 2007) (reaffirming the *Abell*'s not entitled to be marketed standard).

197. *Abell*, 858 F.2d at 1122.

198. See *id.* at 1111–12.

199. See *id.* at 1122; see also *Shores v. Sklar*, 647 F.2d 462, 469–70 (5th Cir. May 1981).

200. *Abell*, 858 F.2d at 1122.

201. 885 F.2d 723 (11th Cir. 1989); see *Newkirk supra* note 153, at 1405–06 (stating the "Fifth Circuit effectively required that a security be entirely worthless before the [presumption] would apply in the IPO context, a condition that very rarely holds true in real world situations").

202. The class of investors had bought bonds without looking at the disclosures. *Ross*, 885 F.2d at 728–29.

203. See *supra* text accompanying note 170.

defendant must have *known* the securities could not be marketed and must have brought the securities to market with the intent to defraud.”²⁰⁴ The plurality found that the plaintiffs failed to make such a showing, and were not able to show that the fraud was so pervasive as to make the bonds unmarketable.²⁰⁵ Unlike *Shores* where the “misrepresentations went to the concealment of existing factors vital to the viability of the project, [in this case] the alleged fraud center[ed] on projections of an uncertain future occurrence” and the court refused to apply the presumption.²⁰⁶

In a concurring opinion, Judge Gerald B. Tjoflat found that the fraud met the *Shores* standard, but rejected the theory because the *Shores* holding was “fundamentally flawed and should be overruled.”²⁰⁷ Perhaps the most significant part of the concurrence, though, was Judge Tjoflat’s unease with *Shores* and the plurality’s attempt to define the “elusive” concept of “unmarketable.”²⁰⁸ Judge Tjoflat explained unmarketability could either be considered “economic unmarketability” or “factual unmarketability.”²⁰⁹ Under economic unmarketability, which Judge Tjoflat stated the plurality had applied, the question a court must ask is, “[C]ould the [securities] have been brought onto the market at any combination of price and interest rate if the true risk of nonpayment had been known?”²¹⁰ Judge Tjoflat, as other courts have pointed out, noted that this standard is near impossible to meet with bonds because even the most risky bonds can still be sold at some price.²¹¹ Furthermore, even if the issuer becomes bankrupt, a bondholder can still seek to recoup some value as a creditor, because “even bonds in default have a salvage value.”²¹² In discussing the unworkability of this standard, Judge Tjoflat also referred to *Abell*, in which he stated the Fifth Circuit had abandoned the economic unmarketability test in favor of a test that evaluated whether or not the “promoter knew that the subject enterprise was worthless when the securities were issued.”²¹³ His opinion noted that this standard was equally unconvincing for two reasons. First, it would be impossible for the entities involved in issuing the security to know if it was worthless.²¹⁴ Second, it is unreasonable for an investor to rely on them because

[a]ll of the parties involved in an issuance have a significant self-interest in marketing the securities at a price greater than their true value. The

204. *See Ross*, 885 F.2d at 729–30.

205. *Id.* at 731.

206. *Id.*

207. *Id.* at 733 (Tjoflat, J., concurring). Judge Gerald Bard Tjoflat also wrote that the Fifth Circuit had “embarked on a path of confusion, and I fear that the majority today only pushes us farther down that path.” *Id.*

208. *Id.* at 735.

209. *Id.* at 735–36.

210. *Id.* at 736.

211. *Id.* at 736; *see Eckstein v. Balcor Film Invs.*, 8 F.3d 1121, 1131 (7th Cir. 1993); *see also infra* notes 267–68 and accompanying text.

212. *Ross*, 885 F.2d at 736 n.8; *see also id.* at 740 (writing that “to determine when a security is worthless is nearly, if not completely, impossible”).

213. *Id.* at 736 n.10 (emphasis omitted).

214. *Id.* at 740.

promoter/corporation and the issuer (if a separate entity) have an obvious interest in marketing the securities regardless of their true fair market value. Likewise, the bond counsel and underwriter, who are often retained under a contingency fee contract, are interested in marketing the securities at an inflated price. The underwriter in particular, who, like an insurer, can spread the risk of loss among many stock or bond subscriptions, has a reduced incentive to investigate thoroughly the true value of the securities it underwrites.²¹⁵

Turning to factual unmarketability, Judge Tjoflat found it to be the better choice of two unreasonable alternatives. Under factual unmarketability, “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.*”²¹⁶ Even if it would be reasonable for an investor to rely on regulators, overall this reliance would not be reasonable because one would expect misdealing by the self-interested actors who bring the bond to market.²¹⁷

With these deficiencies in mind, Judge Tjoflat concluded his concurrence by noting that the theory would be problematic in determining damages and would have adverse policy implications. Because the investor relies on the integrity of the market rather than the price, there would be only two options for assessing damages. The first option would be to award no damages because the investor had no price on which to rely.²¹⁸ This option clearly contradicts the purpose of allowing the presumption because damages “would be so nominal as to preclude the bringing of such suits.”²¹⁹ The alternative would be to measure damages by the purchase price, which the opinion maintains would be unreasonable and against public policy.²²⁰ It is unreasonable because the investor “had no right to rely on the issuance price,” and would result in investor insurance, creating a situation in which “an investor might rationally seek to avoid reading disclosures in order to preserve a possible claim under *Shores.*”²²¹ This disincentive runs counter to the Exchange Act’s purpose of creating disclosure.²²² Even if one argues that such damages would cause a greater level of disclosure, the opinion points to criminal liability, already in place, to do the job of deterrence.²²³

In one of four dissenting opinions, Judge Thomas Alonzo Clark found that there were triable issues of fact as to whether or not the bonds were unmarketable.²²⁴ Judge Clark found FCTM viable because *Shores*

215. *Id.* But see Newkirk, *supra* note 153, at 1407 (discussing that it may be reasonable for shareholders to rely on underwriters “and the IPO process to act as independent judges”). Further, in IPOs many of the “elements of an active market remain.” *Id.*

216. *Ross*, 885 F.2d at 736.

217. *Id.* at 740; see *supra* note 215 and accompanying text.

218. *Ross*, 885 F.2d at 743.

219. *Id.*

220. *Id.*

221. *Id.* at 743–44.

222. *Id.*

223. *Id.* at 744 n.23.

224. *Id.* at 747 (Clark, J., dissenting).

recognized a “legitimate theory for protecting investors from fraudulently marketed securities that supplements” the Exchange Act’s policy of disclosure.²²⁵ Judge Clark’s dissent interpreted the unmarketability theory under the protections of Rule 10b-5(a) and (c) to mean that “[t]he relevant inquiry is whether there is any combination of price *and* interest rate at which the bonds would have been marketable but for the fraud.”²²⁶ Judge Clark imagined two situations in which this would occur. First, where, like the defendants in *Shores*, “a fraudulent scheme’s sole purpose from its inception was to swindle investors.”²²⁷ In this type of case the inquiry would be easy.²²⁸ However, in a case where the “project’s promoters fraudulently portray an otherwise infeasible project as financially viable in order to issue unmarketable bonds,” the inquiry is difficult.²²⁹ The dissent recognized this to be a fact intensive question and therefore would require a “restrained approach towards granting summary judgment in favor of defendants.”²³⁰

Although the Eleventh Circuit has not addressed the issue since, the U.S. District Court for the Northern District of Alabama recently relied on the doctrine in *In re HealthSouth Corp. Securities Litigation*.²³¹ The court found that the presumption of reliance could be applied in the IPO of corporate bonds because the bonds “could not have been marketed at any price without the fraud.”²³² As the dissent predicted in *Ross*, the determination of whether the bonds were unmarketable was a fact intensive question, requiring testimony of employees and economists.²³³ As one managing director of UBS testified, the bonds “would never have seen the light of day” had the fraud been disclosed.²³⁴ As the plaintiffs’ expert witness Timothy A. O’Neill²³⁵ pointed out, the underlying value of the company (negative \$529 million) would ensure that no investor would purchase a bond for this company given its credit statistics.²³⁶ Or in *Shores*’s terms, “those bonds could not have been issued at any price . . . because you actually can’t settle into a known default.”²³⁷ Thus the bonds were not entitled to be marketed because they were unmarketable.²³⁸ Since the plaintiffs also proved that they reasonably relied on the bonds’

225. *Id.* at 748.

226. *Id.* at 750.

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.* at 751.

231. 261 F.R.D. 616 (N.D. Ala. 2009).

232. *Id.* at 642.

233. *Id.* at 642–44.

234. *Id.* at 643–44 (“[Timothy A.] O’Neill found no basis in reality for the assumption that such a large new issuance of distressed company bonds with dramatically deep price discounts could have been issued to achieve an effective yield high enough to reflect the HealthSouth credit risk.”).

235. A former Senior Managing Director and former head of the Debt Syndicate Department at Bear Stearns Co. *Id.* at 630 n.13.

236. *Id.* at 644.

237. *Id.* (internal quotation marks omitted).

238. *Id.*

availability on the market as an indication of their genuineness, and that this reliance caused the plaintiffs to suffer a loss, which satisfied the last two elements of *Shores* and *Ross*,²³⁹ the court extended the presumption of reliance and the class was certified.²⁴⁰ Today the Eleventh Circuit's interpretation of FCTM, similar to the Fifth Circuit's, looks at economic unmarketability. However, the Tenth Circuit has taken an entirely different approach.

3. The Tenth Circuit

Soon after *Shores* was decided, the Tenth Circuit accepted FCTM in *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*,²⁴¹ when it upheld the certification of a class of bond investors, including members who had not relied on the offering materials.²⁴² The court affirmed that investors should be allowed "to assume that the securities were lawfully issued,"²⁴³ pointing out that FCTM did not create a scheme of investor insurance. The court reasoned that the theory was a logical extension of Rule 10b-5's protection against fraudulent schemes to "cases in which the securities were not qualified legally to be issued."²⁴⁴ This adaptation of FCTM has come to be known as legal unmarketability.²⁴⁵

In subsequent cases involving IPO claims, the Tenth Circuit has continued to uphold this standard, relying closely on *Shores* and *TJ Raney*. In *Bank of Denver v. Southeastern Capital Group*,²⁴⁶ the U.S. District Court for the District of Colorado reiterated that FCTM arises only when dealing with primary market securities if "a plaintiff shows that but for the alleged fraud the security would never have been marketed and that the plaintiff relied on the integrity of the market to produce marketable securities."²⁴⁷ The district court further explained the theory in *Alter v. DBLKM Inc.*,²⁴⁸ stating that reliance may be presumed if "the fraud is so egregious that no investor would have purchased the security if the truth were known."²⁴⁹ The key to legal unmarketability was that without the defendants' scheme to defraud, the securities would not have been lawfully issued and therefore were unmarketable.²⁵⁰

239. See *supra* notes 168–70 and accompanying text.

240. *In re HealthSouth*, 261 F.R.D. at 642–45.

241. 717 F.2d 1330, 1333 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984).

242. *Id.* at 1332–34.

243. *Id.* at 1333 (holding that the class "stated grounds for relief by alleging that the defendants knowingly conspired to bring unlawfully issued . . . bonds to market with the intent to defraud, that it reasonably relied on the availability of the bonds as indicating their lawful issuance, and that it suffered injury resulting from the purchase of the bonds").

244. *Id.*

245. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1160 (6th Cir. 1994); see *Dennin*, *supra* note 18, at 2629 (stating that legal unmarketability has not been accepted by any other circuit and is distinct from economic unmarketability).

246. 763 F. Supp. 1552 (D. Colo. 1991).

247. *Id.* at 1557.

248. 840 F. Supp. 799 (D. Colo. 1993).

249. *Id.* at 805.

250. *Id.*

The legal unmarketability standard adopted by the Tenth Circuit, similar to the versions of FCTM practiced in the Fifth and Eleventh Circuits, has rarely been applied.²⁵¹ In fact, among the three circuits only a handful of plaintiff classes have received the presumption of reliance under FCTM, yet other circuits have rejected the theory, fearing it would be against public policy and the intent of the securities laws.

B. Rejecting Shores and FCTM: Policy and Congressional Intent

Just as the circuits embracing FCTM echo the *Shores* opinion, the circuits rejecting the theory point to the *Shores* dissent and Judge Tjoflat's concurrence in *Ross*. The Third Circuit and the U.S. Court of Appeals for the Seventh Circuit have rejected FCTM in all of its manifestations, claiming that the theory lacks any theoretical underpinning, is contrary to Congress's intent for the Securities and Exchange Acts and the PSLRA, and is not supported by the Supreme Court.

1. The Seventh Circuit

In *Eckstein v. Balcor Film Investors*,²⁵² Judge Frank H. Easterbrook, writing for a unanimous Seventh Circuit, addressed whether a plaintiff class could use FCTM in a primary market context. Two sets of plaintiffs brought suit against the defendant, Balcor Film Investors (BFI), alleging that BFI fraudulently omitted facts from offering materials it had issued under the Securities Act to raise capital for a partnership.²⁵³ Using the supplement and the prospectus, BFI was able to raise \$48 million, \$13 million over the \$35 million needed to meet the partnership requirement to begin deploying the capital to make movies.²⁵⁴

The Eckstein plaintiffs had not read the prospectus or the supplement,²⁵⁵ and argued that FCTM entitled them to the presumption of reliance because without the misrepresentations and omissions in the offering materials, the \$35 million would not have been raised.²⁵⁶ The court characterized this argument as asserting a claim based on causation instead of reliance.²⁵⁷ The Seventh Circuit rejected the presumption, insisting that this theory would remove any legitimate showing of reliance—the necessary link between the injury and the fraudulent offering materials.²⁵⁸ The court held that in order for the plaintiffs to recover they would have to prove that each of the thousands of investors that purchased the securities would have acted

251. See *supra* Part II.A.

252. 8 F.3d 1121 (7th Cir. 1993).

253. *Id.* at 1125.

254. *Id.* at 1123. BFI had been formed by Balcor Entertainment Company, Ltd., to raise money to make low budget films, which would be produced and distributed by New World Entertainment, Ltd. *Id.*

255. *Id.* The other group called the Majeski Group had read the prospectus and did not need to rely on FCTM. *Id.*

256. *Id.*

257. *Id.*

258. *Id.* at 1129–31.

differently had the prospectus included the negative information and that the \$35 million dollar threshold would not have been met.²⁵⁹ It appears that this counterfactual argument—that but for the fraud, the securities would not have been sold—is not practicable when dealing with the subjective intent of thousands of investors.²⁶⁰ However, it has been argued that the opinion’s reasoning is similar to the legal unmarketability standard,²⁶¹ because what the court was really asking was: but for the fraud, would the securities have been legally issued?²⁶² However, the plaintiffs could not prove that the investors would not have bought the securities but for the fraud.²⁶³ Whatever one might call this standard, it is clearly different from legal unmarketability under *T.J. Raney* because the court refused to recognize reliance on the regulatory process.²⁶⁴ The opinion stated that it was unreasonable for an investor to rely on the regulatory process by which the bonds were brought to market because the SEC does not engage in “merit regulation” when it reviews disclosure or registration statements.²⁶⁵ Therefore a security does not reach the market because of the adequacy or truth of the disclosures.²⁶⁶

Next, the opinion criticized *Shores*’s theory of unmarketability, noting that “[s]ecurities of bankrupt corporations trade freely [and that] some markets specialize in penny stocks.”²⁶⁷ Under this viewpoint, the lack of disclosure may allow the security to be sold at a higher price than its real value would dictate. But even so, the *Shores* standard would almost never be applicable because securities almost always have some worth, even if only pennies.²⁶⁸ Yet, the court did not expressly address what would happen if it were found that the security was indeed worthless.²⁶⁹

Although the Seventh Circuit has not addressed FCTM outside of *Eckstein* and its rehearing,²⁷⁰ several district courts within the Seventh

259. *Id.* at 1131.

260. Shon Morgan, Recent Case, *Eckstein v. Balcor Film Investors*, 8 F.3d 1121 (7th Cir. 1993), 107 HARV. L. REV. 1170, 1175 (1994) (stating that this counterfactual requires subjective proof from the thousands of investors and that is “substantially less attractive to plaintiffs”).

261. See Dennin, *supra* note 18, at 2642.

262. See *Eckstein*, 8 F.3d at 1131.

263. See *id.*; see also Morgan, *supra* note 260, at 1175. The *Eckstein* case was reheard a year later by the Seventh Circuit, and again the court did not need to accept or reject the theory because the plaintiffs did not meet their burden of proof. *Eckstein v. Balcor Film Invs.*, 58 F.3d 1162, 1170–71 (7th Cir. 1995).

264. See *Eckstein*, 8 F.3d at 1130–31.

265. *Id.*; see *infra* notes 295–99 and accompanying text.

266. *Eckstein*, 8 F.3d at 1130–31; see HAZEN, *supra* note 6, § 3.7[2] (stating that the “SEC does not review the merits of the registration statement and the offering,” instead it focuses “on the adequacy and clarity of the disclosure . . . and also will conduct a ‘plain English’ review of those portions of the registration statement that are subject to the SEC’s plain English disclosure requirements”).

267. *Eckstein*, 8 F.3d at 1131.

268. *Id.*

269. See Dennin, *supra* note 18, at 2642; see *infra* notes 271–72 (discussing a district court’s interpretation of *Eckstein* to allow the presumption of reliance when the security is worthless).

270. *Eckstein v. Balcor Film Invs.*, 58 F.3d 1162 (7th Cir. 1995).

Circuit have interpreted *Eckstein*'s meaning. In *Levine v. Prudential Bache Properties, Inc.*,²⁷¹ the U.S. District Court for the Northern District of Illinois understood the *Eckstein* opinion to leave the door open to finding a presumption of reliance in a market that was not open and developed. *Levine* stated that a plaintiff would need to plead that the "securities would have been actually excluded from the market" and not just that they would be sold for less if the fraudulent activity had been disclosed.²⁷² In other words, that court adopted the economic unmarketability standard developed in *Ross*.²⁷³ Thus, only if the securities are worthless can a presumption of reliance be found in a market that is not open and well developed.²⁷⁴

The same year *Levine* was decided, the Northern District Court of Illinois further explained *Eckstein*'s holding in *Endo v. Albertine*.²⁷⁵ The *Endo* court held that a presumption could also be applied in the primary market context if the market for the security in question was "sufficiently efficient."²⁷⁶ Unlike in *Eckstein*, the market for the securities in *Endo*

was sufficiently efficient to presume plaintiffs' reliance based on a fraud-on-the-market theory . . . [because there was] 1) . . . substantial volume of securities; 2) a large number of investors; 3) the direct involvement of many underwriters in the offering; and 4) the existence of an impersonal, national trading market where the price of the [security] is much more likely to reflect the public availability of information.²⁷⁷

This holding does not rely on FCTM but rather a new application of FOTM to efficient primary markets. The factors the court used are the same as those applied in the secondary market FOTM cases.²⁷⁸

The Seventh Circuit has not addressed the *Levine* or *Endo* holdings, nor has it elaborated upon *Eckstein*. The *Levine* and *Eckstein* decisions suggest that if a security were either completely worthless or unissuable but for the fraud, then perhaps the circuit would allow the presumption of reliance in narrow circumstances.²⁷⁹ However, these possible presumptions of reliance are different than FCTM for three reasons. First, they lack the "scheme to defraud" element. Second, there is no application of clauses (a) or (c) of Rule 10b-5 to cases that involve misrepresentations and omissions. And third, there is no recognition that an investor can rely on the integrity of the market.²⁸⁰ The *Endo* court's decision also did not accept FCTM. Instead, *Endo* applied FOTM to primary markets.²⁸¹ There may be some narrow circumstances where the presumption of reliance can be applied in the IPO

271. 855 F. Supp. 924 (N.D. Ill. 1994).

272. *Id.* at 933.

273. *See supra* Part II.A.2.

274. *Levine*, 855 F. Supp. at 933.

275. 863 F. Supp. 708, 726-27 (N.D. Ill. 1994).

276. *Id.* (stating that in *Eckstein* the price of the security was determined solely by the issuer and the underwriter based on perceived demand).

277. *Id.* at 726.

278. *See supra* Part I.A.6.b.

279. *See supra* notes 259-74 and accompanying text.

280. *See supra* notes 167-70, 199, 227 and accompanying text.

281. *See supra* notes 275-78 and accompanying text.

context within the Seventh Circuit but these presumptions do not rely on FCTM. Similar to the lower courts in the Seventh Circuit, district courts within the Third Circuit also displayed a willingness to expand the presumption into primary markets.²⁸² However in *Malack v. BDO Seidman, LLP* the Third Circuit rejected any application to primary markets when dealing with misrepresentation and omission cases.²⁸³

2. The Third Circuit

In *Malack*, the Third Circuit became the most recent court to reject FCTM.²⁸⁴ The plaintiffs sought class certification after losing substantial investments from notes²⁸⁵ issued by American Business Financial Services, Inc. (American).²⁸⁶ The American notes were tied to American's subprime mortgage business, and became worthless after the housing market collapse.²⁸⁷ American was forced to enter into bankruptcy and was subsequently liquidated.²⁸⁸ Malack and the co-plaintiffs alleged that BDO Seidman, LLP (BDO), an accounting firm that issued clean audit opinions for American, enabled the notes to be brought to market and meet the SEC's registration requirements through fraud.²⁸⁹ Malack based his reliance claim on *T.J. Raney's* legal unmarketability standard, arguing that but for the fraud, BDO would not have legally been able to issue the securities²⁹⁰—without the fraud the securities would not have gained SEC approval and reached the market.²⁹¹ The court rejected FCTM, and even stated that Malack did not meet the FCTM standard anyway.²⁹²

The Third Circuit was unwilling to accept FCTM for several reasons. First, the court denied that a presumption of reliance in the primary market context was justified, referring to the traditional reasons for using a presumption: “common sense and probability.”²⁹³ The court stated that common sense “calls for rejecting . . . that a security's availability on the market [indicates] its genuineness and is worthy of an investor's reliance.”²⁹⁴ In order to think otherwise there would need to be “some entity involved in the process of taking the security to market that acts as a

282. See, e.g., *Gruber v. Price Waterhouse*, 776 F. Supp. 1044, 1052 (E.D. Pa. 1991) (stating FCTM could apply “where the underlying business is an absolute sham”); see also *Dennin*, *supra* note 18, at 2635–36 (interpreting several district court holdings within the Third Circuit to support the Eleventh Circuit's economic unmarketability form of FCTM).

283. 617 F.3d 743, 756 (3d Cir. 2010).

284. *Id.* at 745. This was a departure from past district court cases within the Third Circuit, which had accepted FCTM. See *supra* note 282 and accompanying text.

285. A note, similar to a bond, is a debt security, which promises to pay a certain rate to the holder. See *HAZEN*, *supra* note 6, §1.6[14].

286. See 617 F.3d at 744.

287. *Id.*

288. *Id.* at 745.

289. *Id.*

290. *Id.*

291. *Id.* at 748–49.

292. *Id.* at 756.

293. *Id.* at 749–52; see *supra* notes 109–12 and accompanying text.

294. *Malack*, 617 F.3d at 749.

bulwark against fraud” and that no such bulwark exists because the SEC “cannot be reasonably relied upon to prevent fraud because it does not conduct merit regulation.”²⁹⁵ The SEC only seeks to ensure that the disclosures are clear and detailed.²⁹⁶ Echoing Judge Tjoflat’s concurring opinion in *Ross*, the court also found it against common sense for an investor to rely on the self-interested parties responsible for bringing the bonds to market.²⁹⁷ Thus, filing a registration statement or other regulated disclosure “with the SEC does not lend any more credibility or veracity” to the security or its issuer.²⁹⁸ Therefore, it makes no sense to rely on the integrity of the market, or that the market is free from fraud.²⁹⁹

Next, the court rejected probability as a justification for extending the presumption because the likelihood of a security being legally issued is greater than being fraudulently issued.³⁰⁰ Although the court could have ruled only on the unavailability of FCTM to Malack, Judge D. Brooks Smith, writing for a unanimous court, chose to reject the theory in its entirety.³⁰¹

The opinion also made several more arguments against FCTM, stating that unlike FOTM, which is supported by economic theory, FCTM has no such quantitative or theoretical underpinning.³⁰² Allowing an investor to rely on the integrity of the market and assume that financial products are free from fraud would create investor insurance,³⁰³ undermine the Exchange Act’s philosophy of disclosure,³⁰⁴ and render the *Affiliated Ute*

295. *Id.* at 749–50 (internal quotation marks omitted); see *Joseph v. Wiles*, 223 F.3d 1155, 1165–66 (10th Cir. 2000) (stating that the “SEC does not read all of the publicly available information about an offering and then determine the legitimate price for the security. Nor does [it] endorse any of the documents involved in the issuance of securities”); *supra* notes 265–66 and accompanying text.

296. *Malack*, 617 F.3d at 750 (citing *HAZEN*, *supra* note 6, § 3.7[2]); see *supra* notes 265–66, 295 and accompanying text.

297. *Malack*, 617 F.3d at 748–50.

298. *Id.* at 751 (internal quotation marks omitted) (citing *Joseph*, 223 F.3d at 1166).

299. *Id.* at 748–49. The judge also rejected that issuers would act to ensure the reliability of their information in order to establish a reputation as an honest dealer because recent history shows that “[m]any entities . . . forgo the long term benefits of accurate disclosures for the prospect of short terms gain.” *Id.* at 750 n.7 (quoting Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 782 (2006)).

300. *Malack*, 617 F.3d at 748–52. The court stated that “almost all marketed securities are, in fact, legally marketable.” *Id.* at 752.

301. *Id.* at 756 (“The [FCTM] lacks a basis in common sense, probability, or any of the other reasons commonly provided for the creation of a presumption.”).

302. *Id.* at 751 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 246–47 (1988)).

303. *Id.* at 751. Quoting the dissent in *Shores* and Judge Tjoflat’s concurrence in *Ross*, the opinion stated that FCTM would allow recovery to investors who do not watch out for themselves, and the end result would be damages in the amount of the purchase price. *Id.* at 753; see *supra* text accompanying notes 219–21.

304. The result of FCTM, the court posited, would be to discourage investors from reading disclosures and run “contrary to Congress’s goal of empowering investors with the information they need to make educated, prudent investment decisions.” *Id.* at 753; see *supra* text accompanying notes 221–23.

and *Basic* theories of reliance meaningless.³⁰⁵ Citing *Shores*, Malack argued that FCTM would “serve Congress’s goals of promoting honesty and fair dealings in the securities markets.”³⁰⁶ This argument did not sway the Third Circuit, which rejected the notion that section 10(b) could be expanded “whenever possible to prevent fraud” because securities laws are not a “catchall for any fraudulent activity committed in connection with a securities offering.”³⁰⁷ In support of this argument, the Third Circuit found that the expansion of reliance would be inconsistent with recent Supreme Court jurisprudence and the intent of Congress in passing the PSLRA.³⁰⁸

The Supreme Court pointed to *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*³⁰⁹ and the Court’s most recent reliance analysis in *Stoneridge*.³¹⁰ In *Stoneridge* the Supreme Court noted that Congress could have expanded Rule 10b-5 actions when it passed the PSLRA but instead “instituted heightened pleading and loss causation requirements for ‘any private action’ arising from the Securities Exchange Act.”³¹¹ The *Malack* Court therefore interpreted Congress’s actions as seeking to limit section 10(b).³¹² In the Third Circuit’s view, even though *Stoneridge* did not specifically rule on FCTM, it foreclosed the issue. Just after describing the two accepted presumptions of reliance set forth in *Affiliated Ute* and *Basic*, the *Stoneridge* Court stated that the section “10(b) private right should not be extended beyond its present boundaries.”³¹³ Therefore, accepting FCTM would expand the cause of action under section 10(b) and conflict with both *Stoneridge* and Congressional intent.³¹⁴

The Third Circuit next contended that expansion of the presumption of reliance would increase the number of frivolous lawsuits before the courts, which it concluded was squarely against good policy.³¹⁵ Expanding reliance would make IPO’s less attractive to issuers because of the potential high costs of litigation and the prevalence of strike suits.³¹⁶ Finally, the

305. *Malack*, 617 F.3d at 751 n.9 (finding that the FCTM then “could be invoked in any instance where a security has made it to market,” which would make the *Affiliated Ute* and *Basic* presumptions redundant).

306. *Id.* at 753.

307. *Id.*

308. *Id.* at 753–55; *see supra* notes 81–83 and accompanying text.

309. 511 U.S. 164, 191 (1994) (holding that a plaintiff is precluded from bringing an action in aiding and abetting under section 10(b)).

310. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

311. *Malack*, 617 F.3d at 754 (quoting *Stoneridge*, 552 U.S. at 165–66).

312. *Id.*

313. *Stoneridge*, 552 U.S. at 165.

314. *Malack*, 617 F.3d at 752–54; *see Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931, 942 (9th Cir. 2009) (quoting *Stoneridge* for the proposition that presumptions in Rule 10b-5 suits should not be applied under new theories).

315. *Malack*, 617 F.3d at 754–55.

316. *Id.* at 755 (“[T]hese costs infect the function of the entire securities market, harming professionals (lawyers, accountants, etc.), the companies they serve, and investors.”); *see supra* notes 37–38, 83, 308 and accompanying text.

court noted that this presumption would lead to further settlements of frivolous class actions.³¹⁷

The *Malack* opinion is the most resounding rejection of FCTM by a circuit court. However, other circuits, like the U.S. Court of Appeals for the Sixth Circuit have criticized the theory without specifically rejecting it.³¹⁸

3. The Sixth Circuit

In *Ockerman v. May Zima & Co*³¹⁹ the defendants sold municipal bonds, which had been approved by the City of Bowling Green, Kentucky, for the purpose of constructing a retirement village.³²⁰ The revenue generated from this project would pay the bond interest, but not a single habitation was ever rented or sold.³²¹ The defendant, Zima, was responsible for a financial study that was included in the offering materials detailing the potential profitability of the retirement community.³²² Zima had reason to believe the project might fail for various reasons but did not include this information in the report.³²³ Meanwhile, the promoters of the project, Thomas Hunter and Bryson Hill, also had reason to believe the project would not succeed.³²⁴ In furtherance of their effort to gain municipality approval, Hill, who marketed himself as the “money man,” misrepresented his own financials and projections for the success of the retirement community.³²⁵ After the bond issuance, Hill filed for bankruptcy and the bonds were declared in default.³²⁶ The plaintiff, who had read the bond offering materials moved to certify a class, and urged the court to accept FCTM so that the other plaintiffs who had not relied on Zima’s fraud could be included.³²⁷

Ruling for the defendants, the court rejected the claim that FCTM was applicable in this case. After reviewing the principles of economic unmarketability³²⁸ and legal unmarketability,³²⁹ the court held that the plaintiffs could prove neither that the bonds were worthless³³⁰ nor that “had

317. *Malack*, 617 F.3d at 754–55 (opining that “[r]ewarding frivolous actions with settlements is clearly undesirable”).

318. See *infra* Part II.B.3; see also Herzog, *supra* note 14, at 383 (“The Sixth Circuit declined to state affirmatively whether it would adopt or reject [FCTM]. . . .”).

319. 27 F.3d 1151 (6th Cir. 1994).

320. *Id.*

321. *Id.* at 1153.

322. *Id.*

323. *Id.*

324. *Id.* at 1153–54.

325. *Id.* For instance the circular stated that the retirement community would be equipped with kitchens and a full time nurse, which the defendants were aware was impossible for various reasons. *Id.* at 1154.

326. *Id.*

327. *Id.* at 1154–55.

328. See *supra* notes 195, 208–17 and accompanying text.

329. See *supra* text accompanying notes 217–23.

330. *Ockerman*, 27 F.3d at 1160 (stating that the retirement community “was developed and later sold, although at a substantial loss”).

full disclosure been made, the governmental entity would have been required by law to deny the bonds' issuance."³³¹

The Sixth Circuit determined that the district court's finding that Rule 10b-5(a) and (c)³³² could "permit the court to presume that a purchaser relied on the integrity of [the] defendants' scheme or course of business in issuing the securities" was erroneous.³³³ The Sixth Circuit did not address section (c),³³⁴ but did discuss section (a). Since the plaintiff could not point to "any devise, scheme or artifice to defraud" other than the offering circular, the court held that subsection "(a) [did] not appear to contribute anything not contained in subsection (b)."³³⁵ The court emphasized that to apply section (a), as the district court and *Shores* had done, in a fraud case that only includes misrepresentations, would create a form of investor insurance, which would contravene the Exchange Act policy to promote full disclosure.³³⁶ The court reasoned that to interpret section (a) differently would run contrary to *Basic* and Congress's intent, effectively eliminating the reliance requirement and creating "a new implied cause of action which amounts to investor's insurance."³³⁷ In concluding its discussion of the theory, the court chose to neither reject nor accept the theory because it was inapplicable.³³⁸

The circuit split surrounding FCTM has continued to develop since *Shores* first put forward the theory over thirty years ago.³³⁹ As it now stands, there are three circuits that have acknowledged versions of the theory, and two circuits that reject FCTM. Interestingly, all sides of the split claim to advance a position they find best fits with public policy and congressional intent regarding the primary securities market. Part III of this Note focuses on the validity of the varied reasons underlying the different courts' positions. Furthermore, it argues that the Fifth Circuit's position in *Abell* best embodies Congress's intent and furthers public policy.

331. *Id.*

332. *See supra* note text accompanying 77.

333. *Ockerman*, 27 F.3d at 1161–62.

334. Presumably the court did not address section (c) because the defendants did not create the business to steal from public, as the defendants in *Shores* had.

335. *Ockerman*, 27 F.3d at 1161.

336. *Id.* at 1161–62.

337. *Id.* at 1162; *see* Dennin, *supra* note 18, at 2639 (stating that the court was concerned that following the district court would result in removing reliance completely from Rule 10b-5(a) and (c) actions).

338. *Ockerman*, 27 F.3d at 1161 ("[W]e neither adopt nor reject that theory since to do so would be advisory.").

339. The Eighth and Ninth Circuits have also declined to adopt or reject the theory. *See* Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931, 942 (9th Cir. 2009) (stating that if the theory was viable it did not apply to the facts of the case); *In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309, 322 (8th Cir. 1997) (writing that "even if this [c]ourt were to accept the [FCTM], the plaintiffs do not allege [sufficient] facts").

III. FRAUD CREATED THE MARKET SHOULD BE ACCEPTED IN THE PRIMARY SECURITIES MARKET

Several circuit courts have embraced FCTM because it allows investors to rely on U.S. markets to produce securities that are not intended to defraud the investing public. The Tenth Circuit applies the legal unmarketability standard, while the Fifth and Eleventh Circuits have adopted some form of economic unmarketability.³⁴⁰ The Sixth Circuit and U.S. Courts of Appeals for the Eighth and Ninth Circuits are still undecided.³⁴¹ The Seventh Circuit has refused to adopt FCTM, but in narrow situations it allows the presumption of reliance in the new issue context.³⁴² Finally, the Third Circuit has completely rejected any presumption of reliance in the new issue context (except in pure omission cases).³⁴³ The Third Circuit's firm rejection of FCTM has widened the split further, making this issue ripe for the Supreme Court to address. The Supreme Court should adopt the economic unmarketability standard established in *Abell*, because it is supported by congressional intent, and reject both the Eleventh Circuit's adaptation in *Ross* and the Tenth Circuit's legal unmarketability standard.

A. The Correct Interpretation: The Abell v. Potomac Version of FCTM Should Be Adopted

The Supreme Court should adopt the Fifth Circuit's version of FCTM as articulated in *Abell*. *Abell*'s holding proffers the best form of the theory because it expands the presumption of reliance consistent with congressional intent, public policy, common sense, and probability. This version of FCTM allows courts to punish defendants who have engaged in schemes to defraud, while limiting plaintiff recovery to instances when the fraud is so egregious that no investor would have willingly purchased the security had all the information been available.³⁴⁴

In order for the court to apply the presumption under *Abell*'s theory of economic unmarketability, a proposed plaintiff class must show that the business underlying the security is a sham.³⁴⁵ As illustrated by the Fifth Circuit's decision, this presumption is difficult to obtain because the fraud must be knowingly perpetrated to an extensive degree.³⁴⁶ Many of the parties involved in issuing the securities in *Abell* made misrepresentations, broke state laws, and generally conspired to defraud the local government and potential investors.³⁴⁷ However, the court would not extend the

340. See *supra* Part II.A.1–II.A.3.

341. See *supra* Part II.B.3.

342. See *supra* Part II.B.1.

343. See *supra* Part II.B.2.

344. See *supra* notes 194–99 and accompanying text; see also Dennin, *supra* note 18, at 2644–45 (arguing that *Abell* is the best standard because it focuses on the issuer's intent and whether the issuer intended to “perpetrate a complete sham”).

345. See *supra* notes 194–99 and accompanying text.

346. See *supra* text accompanying note 194.

347. See *supra* notes 186–99 and accompanying text.

presumption of reliance because the issuers planned to create a functioning business rather than a sham.³⁴⁸ By allowing investors to recover only in cases involving a hoax business, *Abell's* version of FCTM punishes an egregious form of securities fraud while protecting issuers from meritless suits.³⁴⁹

These inherent limitations on FCTM's application are also consistent with federal securities laws. Both the Securities and Exchange Acts were passed in order to protect investors and increase disclosure so that the securities markets could be free of fraud.³⁵⁰ *Abell's* version of FCTM is consistent with these goals because it provides investors in the primary market—who otherwise would have no cause of action under the Securities or Exchange Act—a chance to recover when fraud has been committed.³⁵¹ Without an opportunity to have reliance presumed, albeit narrow, investors who purchased exempted securities on the primary market cannot bring an action without actual reliance, an almost insurmountable barrier to certification.³⁵² Furthermore, FCTM's presumption does not conflict with Congress's intent concerning the reliance element. Legislators who passed the Securities and Exchange Acts “did not have a pervasive intent to require plaintiffs under the securities laws to read or rely specifically on a prospectus or circular.”³⁵³ Additionally, section 10(b) of the Exchange Act was meant to be read flexibly in order to restrict deceptive practices in securities markets, just as it was read when the Court first recognized a presumption of reliance in *Affiliated Ute* and expanded the presumption to FOTM in *Basic*.³⁵⁴

Importantly, there does not appear to be any evidence that FCTM is inconsistent with the PSLRA. The PSLRA was passed to insulate defendants from strike suits in order to keep frivolous litigation costs to a minimum.³⁵⁵ To meet this goal, Congress increased the pleading standards

348. See *supra* notes 195–200 and accompanying text.

349. See *supra* notes 195–200 and accompanying text.

350. See *supra* notes 50–52, 72–80, 146 and accompanying text.

351. See *supra* notes 67–71 and accompanying text.

352. See *supra* notes 91–93, 98–108 and accompanying text.

353. *Shores v. Sklar*, 647 F.2d 462, 470 n.7 (5th Cir. May 1981) (stating that section 11 of the Securities Act “allows recovery for [omissions and misrepresentations] in [a] registration statement without proof of reliance”). Since the Securities Act and Exchange Acts were passed with the same goals in mind, section 11 indicates that the reliance element is not set in stone. *Gustafson v. Alloyd Co.*, 513 U.S. 561, 578 (1995) (stating that “[i]t is understandable that Congress would provide buyers with a right to rescind, without proof of fraud or reliance, as to misstatements . . . in the context of a public offering by an issuer or its controlling shareholders”); *Shores*, 647 F.2d at 470 n.7. Interestingly, at least one commentator has suggested that Congress could expand the remedies of section 11 so that it would encompass securities or participants exempted by the Securities Act, thereby eliminating the need for FCTM. See Black, *supra* note 71, at 955.

354. See *supra* notes 73, 113–21 and accompanying text; see also *Santa Fe Indus. v. Green*, 430 U.S. 462, 475–76 (1977) (stating that section “10(b) must be read flexibly, not technically and restrictively” so that plaintiffs who suffer injury as a result of securities fraud can recover) (citation omitted).

355. See *supra* notes 33–38 and accompanying text.

for scienter.³⁵⁶ Congress could have reversed the *Affiliated Ute* or *Basic* presumptions of reliance but it did not. In fact, an earlier version of the Act included a provision seeking elimination of *Basic*'s presumption but it was rejected.³⁵⁷ This suggests that Congress supports presumptions of reliance because they are necessary to Rule 10b-5. Further, FCTM is consistent with the PSLRA's intention to prevent unnecessary litigation costs because attorneys would only bring an action under FCTM in very limited circumstances, where the security is exempt from the Securities Act *and* the fraud is so extensive it meets *Abell*'s standard.³⁵⁸

One could argue that there is no need for FCTM because issuers "benefit when [they] develop[] a reputation for disclosing accurate information to investors."³⁵⁹ Yet it has become clear in recent history that firms do not act as honestly as once thought, and increasing liability may be necessary in order to protect markets from fraud.³⁶⁰ Indeed, the FCTM presumption is consistent with the view that securities markets should be free from heavy regulation because it would rarely be applicable.

This version of FCTM should be accepted because it meets both common sense and probability. FCTM is supported by common sense because it is reasonable for an investor to expect that, regardless of its profitability, newly issued securities' offering documents are not one long laundry list of misrepresentations written with the intent of stealing from the public. The *Malack* court contended that reliance on the integrity of the market did not meet the common sense requirement because there is no regulatory agency or actor that operates as a bulwark against fraud.³⁶¹ Although the *Malack* decision is correct that no such agency exists and that actors bringing a security onto the market are self-interested, the Third Circuit too quickly dismissed the honesty of the financial industry as well as the immensity and type of fraud required by *Abell*. An investor may reasonably expect that a limited degree of misrepresentation will occur during the IPO process. However, it is unreasonable to expect that financial professionals will either negligently or knowingly overlook an entirely bogus enterprise.³⁶² Therefore, common sense is a question of degree and it is reasonable for investors to expect that sham businesses will not be capitalized and sold on the market.

356. See *supra* text accompanying note 311.

357. See *supra* note 84 and accompanying text.

358. This is because a plaintiff would bring an action under the Securities Act if possible because the standard is negligence, a far lower burden of proof than Rule 10b-5's scienter requirement. See *supra* notes 65–66, 81 and accompanying text.

359. See Prentice, *supra* note 299, at 781; see *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 750 n.7 (3d Cir. 2010) (mentioning that the long term benefits of honest disclosure prevents fraud).

360. *Malack*, 617 F.3d at 750 n.7 (stating that many issuers after short term gain forego the long term benefits of honest disclosure); see, e.g., John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 269–72 (2004).

361. See *supra* notes 265–68, 295–96 and accompanying text.

362. Most securities are issued without fraud. See *Malack*, 617 F.3d at 748–49, 752.

Additionally, FCTM is justified by probability. The likelihood of fraud being uncovered under Rule 10b-5 claims through use of FCTM is high, even if the security turns out to be marketable. In most of the decisions analyzed in Part II, there was some type of fraudulent misrepresentation.³⁶³ This high rate of fraud was, in part, a product of the high burden imposed by FCTM. Without a convincing argument that fraud occurred, it would be foolish to bother litigating a claim on FCTM. The *Malack* opinion rejected the argument that probability justifies FCTM, contending that there is a higher probability that a security will be issued legally than not.³⁶⁴ This argument misses the point. The pertinent question is what percentage of FCTM claims are actually a product of fraud. *Abell*'s high burden of proof alleviates this concern because it ensures a high probability that fraud was committed.³⁶⁵

Although imposing FCTM could lead to a higher number of successful class certifications, it will not create investor insurance. The combination of the PSLRA's higher pleading standards and the unmarketability element established in *Abell* make pleading a prima facie case of FCTM highly burdensome.³⁶⁶ Even if the number of classes receiving certification were to increase, FCTM is justified as a means to preserve the intent of securities laws. Though some innocent defendants may choose to settle or may incur extraneous legal costs, on the whole, the law will promote disclosure and investor protection, and only *Abell*'s iteration of FCTM can meet these ends.³⁶⁷

B. The Tenth and Eleventh Circuits' Interpretation of FCTM Should Be Rejected

The forms of FCTM that have been accepted by the Tenth and Eleventh Circuits should not be adopted. The Tenth Circuit's legal unmarketability standard should be rejected because it is unreasonable for investors to rely solely on the SEC, which does not engage in merit regulation, to prevent fraudulent misrepresentations in IPOs.³⁶⁸ When a security is issued, the SEC reviews the offering documents to ensure that the disclosures meet various regulations.³⁶⁹ However, it does not investigate whether these

363. See *supra* Part II.

364. See *supra* note 300 and accompanying text.

365. See *supra* text accompanying note 363. The Securities Act contributes to this likelihood because any case that is not exempt will likely result in an action under section 11, which has the lower negligence hurdle as compared to scienter under Rule 10b-5. See *supra* notes 64–66 and accompanying text.

366. Further, investor insurance is an exaggerated critique of FCTM because the presumption is rebuttable. The defendants only have to show at trial that the plaintiff class did not actually rely on the fraud in the offering materials. In cases where the defendants are innocent, they will always have a chance to prevail.

367. See *Dennin*, *supra* note 18, at 2642–47 (explaining that the Fifth Circuit's application of FCTM should be accepted because it is in accord with the Exchange Act's purpose and does not create investor insurance).

368. See *supra* notes 265–66, 295–96 and accompanying text.

369. See *supra* notes 265–66, 295–96 and accompanying text.

disclosures are true.³⁷⁰ Therefore, it does not meet the common sense requirement for an investor to rely on the SEC to prevent misrepresentations and omissions in the offering documents.³⁷¹ In addition, legal unmarketability is too expansive and would result in investor insurance.³⁷² Unlike *Abell*, the *T.J. Raney* standard of unmarketability would encourage investors to bring a strike suit anytime a misrepresentation was made knowingly. Thus, this standard is contrary to the PSLRA's intent and should not be adopted. Similarly, the Court should reject the *Ross* standard of economic unmarketability because it inappropriately relies on the value of the security.³⁷³ Since the purpose of FCTM is to prevent fraud and protect investors, it makes more sense to analyze the fraud rather than the security's value. Further, *Ross*'s standard of unmarketability is too narrow, because even the most worthless securities have some resale value.³⁷⁴ Therefore, in a situation like *Shores* where every actor involved in the IPO knowingly engaged in illegal activity, FCTM would not apply because the *Shores* bonds had scant underlying assets.³⁷⁵ The *Ross* standard may prevent unnecessary litigation successfully, as mandated by the PSLRA, but it is under inclusive to the point of protecting the perpetrators of fraud rather than its victims.

CONCLUSION

The application of FCTM has been a controversial method of presuming reliance in Rule 10b-5 actions since *Shores* first announced it over thirty years ago. In that time, the Fifth, Tenth, and Eleventh Circuits have adopted various approaches, including legal unmarketability and two distinct versions of economic unmarketability. Most recently, the Third Circuit joined the Seventh Circuit in rejecting the theory. Of these interpretations, the Fifth Circuit's position in *Abell* is the most compelling. Its application of FCTM provides investors with a much-needed avenue of redress without needlessly expanding the presumption of reliance. With this in mind, the Supreme Court should adopt the *Abell* standard and give investors protection against flagrant forms of fraud.

370. See *supra* notes 265–66, 295–96 and accompanying text.

371. See HAZEN, *supra* note 6, § 3.7[2] (stating that “[t]he SEC does not review the merits of the registration statement and the offering” rather it looks for “sufficient detail and with sufficient clarity” in the materials).

372. See *supra* note 303 and accompanying text.

373. See *supra* Part II.A.2.

374. See *supra* notes 211–12 and accompanying text.

375. See *supra* notes 211–12 and accompanying text.