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The Scope of the Judicially Implied Private Right of Action under Rule 10b-5: *Shores v. Sklar*

No federal securities law has spawned more litigation than Rule 10b-5 of the Securities Exchange Act of 1934,[1] which outlaws fraud in connection with the purchase or sale of securities.[2] Although the Rule does not explicitly create a private right of action, this right has been judicially implied since 1946.[3] In such private 10b-5 actions, courts have struggled with the perceived requirement that the plaintiff rely directly on the defendant's fraudulent act.[4] Addressing this issue in *Shores v. Sklar*,[5] a closely divided Fifth Circuit sitting en banc held that under clauses (a) and (c) of Rule 10b-5 a plaintiff who had merely relied on "the integrity of the market" was entitled to assert a claim against the promoters of fraudulently marketed industrial development revenue bonds.

I. Instant Case

In 1972 Alabama Supply and Equipment Company (ASECo), acting in concert with a Tennessee underwriter, fraud-

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1. *See* A. Conard, R. Knauss & S. Siegel, Enterprise Organization 1074-75 (2d ed. 1977); Graham, *Securities*, 12 Tex. Tech L. Rev. 319, 336 (1981); Note, Malandris v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., *The Employment of Common Law Fraud in Securities Litigation*, 10 Cap. U.L. Rev. 175, 176 (1980).

2. 17 C.F.R. § 240.10b-5 (1981). Rule 10b-5 provides that:

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

3. Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976).

4. *See* 3 A. Bromberg & L. Lowenfals, Securities Fraud and Commodities Fraud §§ 8.6(1)-.6(2) (1979).

5. 647 F.2d 462 (5th Cir. 1981), *petition for cert. filed*, 50 U.S.L.W. 3377 (U.S. Nov. 2, 1981) (No. 81-839).

ulently induced Frisco City, Alabama to finance the construction of a facility for the manufacture of mobile homes. Pursuant to Alabama law,[6] Frisco City created an Industrial Development Board, which issued tax-exempt industrial development revenue bonds. The proceeds of the bonds were then used to construct the manufacturing facility, which was in turn leased to ASECo. ASECo's rental payments were calculated to amortize the interest and principal of the bonds and, because of the tax-free financing, were significantly lower than the prevailing market rate. Although ASECo's president knew that his firm lacked the financial strength to successfully manufacture mobile homes, he nevertheless induced Frisco City to issue the bonds. He was aided in this fraud by the accountant who prepared the financial statement, the bond counsel who drafted the offering circular, and the underwriting firm that bought and resold the bond issue. Unaware of the fraudulent scheme, the plaintiff, Bishop,[7] purchased four of Frisco City's bonds for a total of approximately $4,100. Bishop had not read the offering circular, nor was he aware of its existence; he acted solely on the advice of his broker, who told him that such tax-free bonds were a good investment. About two months later, ASECo ceased all operations at the plant and stopped paying rent. The lease was declared in default, the plant was sold, and the identifiable bondholders were reimbursed at about one-third the par value of the bonds.[8]

In the United States District Court for the Northern District of Alabama, Bishop brought suit against the accountant, the bond counsel, and the underwriter.[9] The complaint sought relief under the Securities Act of 1933[10] and Rule 10b-5 of the Securities Exchange Act of 1934.[11] The court dismissed all claims under the 1933 Act but twice allowed Bishop to amend his complaint in order to allege that he had relied on the offering circular. Bishop's failure to make this allegation in the amended complaints resulted in the granting of summary judgment in favor of the defendants. Bishop appealed to the United

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6. ALA. CODE §§ 11-54-80 to -96 (1975).

7. The action was brought by Shores, the executor of Bishop's estate. 647 F.2d at 462.

8. $373.33 per $1000.00 bond. *Id.* at 464 n.1.

9. Frisco City was not liable for payment of the bond obligations and enjoyed immunity from suit. *Id.* at 465. *See* Steinberg, *Municipal Issuer Liability Under the Federal Securities Laws*, 6 J. CORP. L. 277, 279-80 (1981).

10. 15 U.S.C. §§ 77a-77bbbb (1976).

11. 17 C.F.R. § 240.10b-5 (1981).

States Court of Appeals for the Fifth Circuit, which reversed and remanded.[12] The Fifth Circuit subsequently granted a petition for an en banc rehearing[13] and in a 12-10 decision vacated the lower court's summary judgment and remanded the case to allow Bishop the opportunity of proving his allegations of fraud.[14]

The majority opinion acknowledged that Bishop's lack of reliance was indeed fatal to his ability to maintain a cause of action under clause (b) of Rule 10b-5 for alleged misrepresentation or omission of material facts.[15] This allegation, however, was viewed as only one aspect of Bishop's complaint, which further alleged the perpetration of an elaborate scheme to create a bond issue that would defraud the public. Since clauses (a) and (c) of Rule 10b-5 proscribe any fraudulent acts or practices, the court decided that Bishop had properly stated a cause of action under the Rule.[16] Through their fraud the defendants had succeeded in placing unmarketable bonds on the market. The court held that under Rule 10b-5 Bishop had justifiably relied on the integrity of the market for assurance that the bonds were at least entitled to be in the marketplace. The court declared that the purposes of the securities acts and Rule 10b-5 included not only promotion of full disclosure but also investor protection from fraud and achievement of honesty in the securities market. Moreover, causation existed between defendants' fraud and Bishop's loss despite Bishop's lack of reliance on the offering circular. Hence the court held that the Rule afforded Bishop a remedy if he could prove his allegations of fraud, even though he had not read or relied on the offering circular. However, the court ruled that Bishop would have to prove that the bonds were entirely unmarketable and not merely manipulated in terms of price or rate.[17]

The dissenting opinion criticized the court's "profoundly unwise" decision as being without supporting precedent and contrary to all prior decisions of the circuit courts and the Supreme Court.[18] Attacking the majority's distinction between

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12. Shores v. Sklar, 610 F.2d 235 (5th Cir. 1980).

13. Shores v. Sklar, 617 F.2d 441 (5th Cir. 1980).

14. Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), *petition for cert. filed*, 50 U.S.L.W. 3377 (U.S. Nov. 2, 1981) (No. 81-839).

15. *Id.* at 468.

16. *Id.* at 468-69.

17. *Id.* at 470-71.

18. *Id.* at 472 (Randall, J., dissenting).

marketable securities that could be sold at some price and unmarketable securities that could not (absent fraud) be sold at any price, the dissent noted the anomalous result that direct reliance by a plaintiff would be required if the security he purchased was marketable but would not be required if the security happened to be unmarketable.[19] In a rather lengthy analysis of the element of reliance in a 10b-5 private action, the dissent contended that since Bishop had voluntarily purchased the bonds, his lack of reliance on the offering circular should preclude his recovery—his reliance on the integrity of the market was insufficient.[20] The primary purpose of the federal securities laws, the dissent maintained, is to require full disclosure, and "once full disclosure is achieved, individual investors are expected to look out for their own interests."[21] The practical effect of the majority's holding, the dissent feared, would be to convert Rule 10b-5 into a scheme of investors' insurance.

II. Analysis

The Fifth Circuit correctly decided that in a private 10b-5 action to which clauses (a) and (c) apply the plaintiff need not directly rely on the defendant's fraud in order to state a cause of action. Unfortunately, the court negated much of the holding's ameliorative effect by limiting application of the decision to unmarketable securities that have been fraudulently placed on the market. This limitation ignores the need for 10b-5 protection against fraudulent price inflation of marketable securities.

A. Rule 10b-5: Beyond Full Disclosure

The history of Rule 10b-5 indicates that its purposes include not only the promotion of full disclosure but also the eradication of fraud from the securities market. Congress passed the Securities Exchange Act of 1934 at a time of national economic crisis and pervasive fraud in the securities market.[22] The report accompanying the original version of the Act recognized that to restore confidence in the securities exchanges the law must pro-

19. *Id.* at 472-73.
20. *Id.* at 481, 487.
21. *Id.* at 482.
22. Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 Colum. L. Rev. 562, 563 (1972).

tect the investor.[23] Realizing the impossibility of specifically proscribing all potential securities abuses, Congress included in the 1934 Act a "catchall" provision, section 10(b), which conferred upon the Securities and Exchange Commission (SEC) the power to make any other rules necessary to achieve the purposes of the Act.[24] Pursuant to section 10(b), the SEC in 1942 promulgated Rule 10b-5.[25]

In addition to requiring disclosure, Rule 10b-5 outlaws any type of securities fraud. Clauses (a) and (c) of the Rule prohibit any fraudulent "device, scheme, . . . artifice [,] . . . act, practice, or course of business . . . in connection with the purchase or sale of any security."[26] The Fifth Circuit focused on this language in deciding that Rule 10b-5 demands more than full disclosure.[27]

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23. The report stated:

> If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others . . . , it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position.

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934).

24. Section 10(b) of the 1934 Act makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (1976).

25. For a brief history of the promulgation of Rule 10b-5, see R. JENNINGS & H. MARSH, JR., SECURITIES REGULATION 855-56 (4th ed. 1977); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561, 565-66 (1975).

26. 17 C.F.R. § 240.10b-5 (1981).

27. 647 F.2d at 468, 471. This focus was consistent with the Supreme Court's practice of scrutinizing the language of the Rule in private 10b-5 litigation. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court held that private 10b-5 actions are to be confined to actual purchasers or sellers, thus focusing on the Rule's language which reads "in connection with the purchase or sale of any security." The Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), stated that scienter—which is inherent in the definition of fraud—is a necessary element of a 10b-5 private action; negligence will not suffice. In so holding, the Court focused on the Rule's language proscribing "fraud or deceit." (The Court implied, however, that recklessness may qualify as scienter. *Id.* at 193 n.12. Six federal circuit courts have stated that recklessness should, or probably does, satisfy *Hochfelder*. Kaler, *Scienter After* Hochfelder: *Recklessness as a Standard in Rule 10b-5 Private Damage Actions*, 6 J. CORP. L. 337, 342 (1981).) The Supreme Court in Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), specified that fraud, not merely a breach of fiduciary duty, is required to state a cause of action under Rule 10b-5. The Court again focused on the Rule's language proscribing "fraud or deceit."

In analyzing these cases the Supreme Court has followed its own guideline: "[I]n

The inadequacies of "full disclosure" demonstrate the need for a broad prohibition of securities fraud. Former SEC Chairman William J. Casey noted in 1972 that the data most pertinent to investors—such as discounted future income projections—are prohibited by the SEC from being disclosed.[28] Disclosure is thus limited to past performance, even though, as one author recently pointed out, "the investors' principal concerns have little to do with the past" save "as a basis for predictions about future economic values."[29]

Not only is relevant investment data withheld, but the information that is reported is often of questionable value.[30] One federal court has criticized the disclosure laws as having produced not "the open disclosure envisioned by the Congress," but rather "a literary art form calculated to communicate as little of the essential information as possible . . . in a morass of dull, and—to all but the sophisticates—useless financial and historical data."[31]

B. Dispensing with Reliance as a Prerequisite for Private Recovery Under Rule 10b-5

A private 10b-5 action is not confined by the principles of tort law, which require reliance as an element in the tort of deceit. However, courts have frequently applied tort principles to private 10b-5 actions because of the judicial origin of the private right of action. The Rule itself gives no hint of the right, and it

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deciding whether a complaint states a cause of action for 'fraud' under Rule 10b-5, 'we turn first to the language of § 10(b), for "[t]he starting point in every case involving construction of a statute is the language itself."'" Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977)(quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976)(quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975))).

28. H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE 6-7 (1979). Despite subsequent efforts to change the situation, disclosure of forecasted income projections is still restricted. R. STEVENSON, JR., CORPORATIONS AND INFORMATION 90-91 (1980).

29. R. STEVENSON, *supra* note 28, at 90. Furthermore, since "[a]ny management worth its salt is continually preparing and revising its own projections," such information is readily available. *Id.*

30. The results of empirical studies are in conflict as to whether mandated disclosure has improved the efficiency of the securities market. *Id.* at 86.

31. Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971). This description seems to fit the information in ASECo's offering circular. 647 F.2d at 483 n.16 (Randall, J., dissenting). After a careful and complex evaluation of the circular's financial data, the dissent declared that the disclosed information did in fact reveal ASECo's precarious financial position. *Id.* While this position may have been visible to the dissent after the fact, it is unlikely that the average investor would likewise have been able to unravel the figures and discover ASECo's actual financial state.

has been persuasively argued that Congress never intended such a right to inhere in the Rule.[32] Nevertheless, federal courts since 1946 have recognized an implied private cause of action under 10b-5,[33] which was explicitly recognized by the Supreme Court in 1971.[34] Because the rationale of the 1946 decision was based on tort law,[35] and because reliance is an essential element in the tort of deceit,[36] some courts have stated as a general principle that reliance is essential for recovery under 10b-5.[37] The *Shores* dissent also advocated such a requirement.[38]

The *Shores* court's rejection of the reliance requirement, however, is in harmony with the purposes of the federal securities laws and Rule 10b-5. Federal courts have recognized that the fraud provisions of the securities acts are not limited to circumstances that would give rise to a common law action for deceit.[39] According to Bloomenthal, the express private remedies which *are* included in the securities laws were designed to avoid some of the common law fraud requirements.[40] The Supreme Court has notably shifted away from tort law as a basis for finding implied private remedies in securities cases.[41] Thus it is that

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32. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent*?, 57 NW. U.L. REV. 627 (1963).

33. Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976).

34. Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

35. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). *See* 1 A. BROMBERG & L. LOWENFALS, *supra* note 4, § 2.4 (1)(a).

36. W. PROSSER, HANDBOOK OF THE LAW OF TORTS 685-86 (4th ed. 1971).

37. Janigan v. Taylor, 344 F.2d 781, 785-86 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); Kohler v. Kohler Co., 208 F. Supp. 808, 823 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963).

38. 647 F.2d at 481, 487 (Randall, J., dissenting). One commentator similarly disapproved of the *Shores* holding as being contrary to the legal theory surrounding 10b-5, protesting that "courts should not stretch the provisions of section 10(b) to this extreme." Graham, *supra* note 1, at 348. Graham was responding to the 1980 Fifth Circuit panel decision, the holding and reasoning of which were essentially the same as the 1981 en banc decision (even though the panel decision did not mention Bishop's reliance on "the integrity of the market"). Basing his analysis on tort law, Graham claimed that the fraud alleged in *Shores* would only come within the ambit of 10b-5 if the plaintiff had relied directly on the offering circular or if the defendants had breached a legal duty owed to the plaintiff—a duty which Graham insists did not exist. *Id.* at 346.

39. *See* Norris & Hirschberg, Inc. v. SEC, 177 F.2d 228, 233 (D.C. Cir. 1949); Hughes v. SEC, 174 F.2d 969, 975 (D.C. Cir. 1949); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); Speed v. Transamerica Corp., 99 F. Supp. 808, 831-32 (D. Del. 1951).

40. H. BLOOMENTHAL, 1980 SECURITIES LAW HANDBOOK 105 (1980).

41. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 744-45. *See* Fischel, *Sec-*

one authority insists that Rule 10b-5 "should be treated as sui generis. Its legislative and regulative histories separate it from common law remedies."[42]

Indeed, the nature of the modern securities market makes strict adherence to the common law fraud requirements obsolete. Justice Rehnquist has noted that "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable."[43] For example, the inequality of the bargaining position between buyer and seller has increased. According to Professor Loss, the antifraud provisions of the federal securities laws resulted from "a congressional determination that the public interest demanded legislation which would recognize the gross inequality of bargaining power between the professional securities firm and the average investor."[44] Additionally, increased sophistication in business transactions has caused the investor to be far removed from face-to-face dealing with the issuer or seller of the securities. Thus, securities fraud is often successfully perpetrated indirectly on the plaintiff.[45] Recognizing the injustice of requiring the plaintiff's reliance in such situations, the Second and Ninth Circuits have allowed recovery for 10b-5 plaintiffs without direct reliance when the fraud was perpetrated on the market to the plaintiffs' detriment.[46]

Reliance is likewise not essential to establish the element of causation in the *Shores* situation. "[C]ausation must be proved," declared the Second Circuit, "else defendants could be held liable to all the world."[47] Professor Bromberg considers causation

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ondary Liability Under Section 10(b) of the Securities Act of 1934, 69 CALIF. L. REV. 80, 90-92 (1981).

42. A. JACOBS, THE IMPACT OF RULE 10b-5, at § 14 (Securities Law Series, vol. 5 rev. ed. 1980).

43. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 744-45.

44. 3 L. LOSS, SECURITIES REGULATION 1435 (2d ed. 1961).

45. *See* R. JENNINGS & H. MARSH, JR., *supra* note 25, at 1066; Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 589 n.29 (1975).

46. The Second Circuit presumed reliance in a class action in which materially misleading information filed with the SEC had allegedly affected the price of stock traded on the open market. Ross v. A.H. Robins Co., 607 F.2d 545, 553 (2d Cir. 1979). The Ninth Circuit did not require subjective reliance in a class action in which repeated misrepresentations had allegedly inflated the price of an openly traded stock. Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975).

47. Globus v. Law Research Serv. Inc., 418 F.2d 1276, 1292 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

> the trickiest of the 10b-5 elements to evaluate, both in terms of what the law is . . . and in terms of what it should be. . . . To dispense with it entirely would expose issuers, insiders, and perhaps others to immense liabilities for relatively minor misconduct. To insist that it be strictly proved would immunize them from civil liability in most instances, regardless of how major their misconduct. Some middle ground needs to be found, perhaps differing from case to case.[48]

When the plaintiff has relied directly on the defendant's misstatement, reliance obviously establishes the causal chain. But if there has been a failure to divulge, or if a deception has impersonally affected the securities market to the plaintiff's detriment, then the plaintiff's reliance is unnecessary to establish causation.[49] The Supreme Court has held that an obligation to disclose coupled with the withholding of a material fact was sufficient to establish causation in a 10b-5 action.[50] Likewise, the causal chain between defendants' fraud and Bishop's loss was not affected by Bishop's lack of reliance. The causal chain was sufficiently established by the fact that a third party, Frisco City, was fraudulently induced to market inflated bonds which Bishop purchased to his detriment.

The nature of the bonds in *Shores* illustrates how the causal chain may be established without a plaintiff's direct reliance on the defendant's fraud. Industrial development revenue bonds have been particularly prone to securities fraud,[51] not only because they are subject to less stringent registration and reporting requirements,[52] but also because of the attractive nature of these bonds to the government entity, the private firm, and the investor. By issuing such bonds to finance a new industry, the government entity stands to increase employment and boost the local economy without incurring liability for default on the bonds. Thus with practically no investment or risk, the government entity may eventually own the facilities that it builds and rents to the private firm.[53] The firm finds the situation attractive be-

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48. 3 A. BROMBERG & L. LOWENFALS, *supra* note 4, § 8.7(2).

49. W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE § 5.07, at 206-07 (1979); Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99, 107 (1981); Note, *supra* note 45, at 589.

50. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972).

51. Hellige, *Industrial Development Bonds: The Disclosure Dilemma*, 6 J. CORP. L. 291, 297 (1981).

52. *Id.* at 293; Steinberg, *supra* note 9; Graham, *supra* note 1, at 343.

53. Hellige, *supra* note 51, at 296.

cause it obtains financing at an interest rate significantly below the prevailing market rate. The investor also finds the bonds desirable because the returns are tax free and because the bonds appear to be extremely safe, having been issued in the name of the municipality. The unsophisticated investor, however, is probably not aware of the relaxed registration and reporting requirements for these bonds; nor is he likely to know that the municipality is not obligated to back the bonds.[54] The unwary investor relies simply on the name of the municipality for assurance that the bonds are marketable. In short, the kind of industrial revenue bonds purchased by Bishop are particularly susceptible to the type of fraud he alleged—that the municipality's reliance on the firm's deception has resulted in the investor's loss. It would thus be inappropriate to require Bishop to prove that he relied directly on the defendant's deception.[55]

Allowing a cause of action in the *Shores* situation also furthers the purposes of the judicially implied private right of action. When courts recognize a private right of action based on a federal regulatory statute, their purpose is "not only to compensate those injured by the violations but also to enhance the prescriptive effect of the regulation itself."[56] In the case of Rule

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54. Steinberg, *supra* note 9.

55. The dissent insisted, however, that Bishop, by his own lack of care in seeking out and relying on the circular, forfeited the protection of the Rule. 647 F.2d at 487. This assertion in essence imposes on Bishop a duty of due care premised on the notion that a plaintiff must try to protect himself before the law will afford him protection. *See* Suarez, *A Comparative Fault Approach to the Due Diligence Requirement of Rule 10b-5*, 49 FORDHAM L. REV. 561, 562 n.4; Wheeler, *supra* note 25, at 587.

Since the Supreme Court's 1976 decision in *Hochfelder*, which made scienter an essential element of an allegation in a private 10b-5 action, it is widely doubted that due dilligence by the plaintiff is a requisite for recovery. H. BLOOMENTHAL, *supra* note 40, at 130; A. JACOBS, *supra* note 42, § 64.01(b)(ii), at 3-248 to 3-252; Note, *Securities Regulation*, 12 GA. L. REV. 112, 119 (1978). When the defendant has acted with scienter, "the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated." Holdsworth v. Strong, 545 F.2d 687, 692 (10th Cir. 1976). Indeed, "the law ought not protect the wrongdoer at the expense of the injured party; rather, the reverse should be true." Comment, *Private Rule 10b-5 Recovery for Open Market Insider Trading: The Propriety of Privity and Reliance Requirements*, 15 SAN DIEGO L. REV. 751, 770 (1978).

One well-reasoned recent proposal that takes a comparative fault approach to due diligence would grant some recovery from an intentionally misbehaving defendant even if the *plaintiff's* behavior had been reckless or intentionally culpable. Suarez, *supra*, at 575-76. In *Shores*, Bishop's failure to search out and read the circular could at most be classified as negligence, and thus even under a due diligence approach Bishop should recover against the defendants.

56. Note, *supra* note 45, at 585. In J.I. Case Co. v. Borak, 377 U.S. 426 (1964), the Supreme Court allowed an implied right of action under § 14(a) of the 1934 Act since "[p]rivate enforcement of the proxy rules provides a necessary supplement to Commis-

10b-5, the private right of action is a necessary enforcement tool since the SEC lacks the resources to prosecute the great number of 10b-5 violations that are litigated in private 10b-5 actions.[57] Eliminating reliance as a requisite to plaintiff's recovery deters potential defendants and thereby advances the objectives of the Rule.[58]

C. Price Manipulation: Part of 10b-5 Fraud

While the court correctly held that Bishop had stated a sufficient claim under 10b-5, the court's proviso that Bishop may recover only if he proves that the bonds were totally unmarketable (rather than merely price inflated) is inconsistent with the spirit of Rule 10b-5. The court apparently based this limitation on the rationale that an investor has the right "to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place"[59] —but only to that extent. The securities laws were enacted in order to restore investor confidence in the securities market by allowing investors to trade in a market that is free of fraud.[60] In this sense, investors are truly entitled to rely on the integrity of the market. But investors are not likely to place confidence in or rely on the integrity of the securities market unless they can be sure that the securities traded are not only minimally marketable but are also free from fraudulent price manipulation.

Almost any security is marketable at some price. Price is partly a function of the perceived risk of the security: the higher the perceived risk, the lower the price.[61] The relevant question is not whether the security is marketable, but whether the market price accurately reflects the risk involved. If the risk has been fraudulently concealed, as in *Shores*, then the market price is fraudulently inflated. Moreover, Rule 10b-5 draws no distinction between fraud that places inherently unmarketable securities on the market and fraud that manipulates the price of marketable

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sion action." *Id.* at 432.

57. Comment, *supra* note 55, at 761-62.

58. Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 CASE W. RES. L. REV. 363, 390 (1973). According to the Supreme Court, policy considerations are to be given great weight in private 10b-5 actions. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

59. 647 F.2d at 471.

60. *See supra* notes 22-25 and accompanying text.

61. *See* W. SHARPE, INVESTMENTS 73-76 (1978).

securities; both kinds of fraud are within the purview of the Rule. Accordingly, the Ninth Circuit in a private 10b-5 action observed that an investor in the securities market "may be assumed to be relying on an assumption that the prevailing market price on the exchange is not artificially inflated as a result of manipulation or failure to disclose material facts."[62] Consequently, the basis for recovery in an open market transaction should be that the defendant's deception has resulted in the plaintiff's loss.[63] That the security involved was artificially price-inflated rather than inherently unmarketable is immaterial. Recovery should be granted "on a showing that there was a direct causal relationship between the misrepresentation and the prevailing price."[64]

III. Conclusion

In deciding that the plaintiff stated a claim for relief under clauses (a) and (c) of Rule 10b-5, the Fifth Circuit correctly interpreted the Rule and its judicially implied private right of action. The purposes of 10b-5 include not only the promotion of full disclosure but also, in a broader sense, the eradication of fraud from the securities market. Direct reliance by a plaintiff on the defendant's deception should not be a prerequisite to maintaining a private 10b-5 cause of action since such an action is not limited by tort law principles and since the causal chain may exist—as it did in *Shores*—without direct reliance. In such a case the granting of recovery properly furthers the objectives of Rule 10b-5. The court erred, however, when it made the plaintiff's recovery contingent on his proving that the bonds he purchased were not only price-inflated but entirely unmarketable. The fraud proscribed by Rule 10b-5 is not so limited.

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62. 524 F.2d at 907.
63. Note, *supra* note 45, at 589 n.29.
64. W. Painter, *supra* note 49.