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Comments

The Fraud On The Market Theory: The Debate Rages On

For many years, Rule 10b-5[1] has provided the basis of a claim for plaintiffs wishing to assert a private right of action to recover damages allegedly stemming from securities fraud.[2] However, when faced with exceedingly complex cases in recent years, many courts have suggested that these private claims can be more effectively adjudicated if the typically large plaintiff class is absolved of the

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1. 15 U.S.C. § 78j of the Securities Exchange Act of 1934 (the "Act") provides in pertinent part as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device of contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Act of June 6, 1934, c. 404, Title I, section 10, 48 Stat. 891.

Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) pursuant to § 10(b) of the Securities Exchange Act of 1934, *supra*, 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 statements made, in the light of the circumstances under which they are 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.

13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951.

2. The first instance in which a federal court implied a private cause of action under Rule 10b-5 was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). The Supreme Court first affirmed this private cause of action in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 and n.9 (1971) (citing as an example of an appropriate situation in which to recognize a private right of action under Rule 10b-5 the situation wherein a party to a transaction withholds material information).

traditional tort duty of proving individual reliance upon the allegedly fraudulent activity of the defendant. The legal doctrine used by these courts to eliminate individual reliance as an element in a private 10b-5 action has been termed the "fraud on the market" theory. It corrects the perceived reliance problem by providing the plaintiffs with a rebuttable presumption of reliance.

The United States Supreme Court recently addressed the validity of the fraud on the market theory in *Basic, Incorporated v. Levinson*,[3] but the Court was unable to reach a majority consensus on the issue.[4] The purpose of this Comment is threefold: (1) to briefly describe the development of the fraud on the market theory; (2) to analyze the opposing viewpoints presented by the *Basic* Court; and (3) to suggest that an overly broad application of the fraud on the market theory to securities litigation may well yield unexpected and undesirable results.

THE DEVELOPMENT OF THE FRAUD ON THE MARKET THEORY

The private right of action developed pursuant to Rule 10b-5 is rooted in the common law of deceit,[5] one of the elements of which is reliance by the plaintiff upon the fraudulent activity of the defendant to the detriment of the plaintiff.[6] Requiring the individual plaintiff to prove his reliance was workable during the early days of securities fraud actions wherein the alleged misrepresentations occurred during direct, face-to-face negotiations.[7] However, in *SEC v. Texas Gulf Sulphur*,[8] the United States Court of Appeals for the Second Circuit expanded private Rule 10b-5 actions to encompass a cause of action premised upon an alleged misstatement in a publicly available document.[9] Thus, with the *Texas Gulf Sulphur*

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3. 108 S. Ct. 978 (1988).

4. *See infra* note 21.

5. *See, e.g.*, Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir.), *modified on other grounds*, 650 F.2d 815 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983).

6. The elements to the common law claim of deceit are: (1) misrepresentation of a material fact, (2) reliance, (3) causation, and (4) scienter. *See generally* RESTATEMENT (SECOND) OF TORTS §§ 525-548A (1976); PROSSER & KEETON, HANDBOOK OF THE LAW OF TORTS §§ 105-110 (5th ed. 1984).

7. *See* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements In Certain Open Market Transactions*, 62 N.C.L. REV. 435, 439 nn.10-12 (1984).

8. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied sub nom.*, Coates v. SEC, 394 U.S. 976 (1969).

9. *Id.* at 847-48. Judge Waterman noted that "Congress proposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, *whether conducted face-to-face, over the counter, or on exchanges.*" *Id.* (emphasis added). *See also*

decision, the private 10b-5 claim and the traditional common law deceit action first began to take on divergent characteristics.

After *Texas Gulf Sulphur*, 10b-5 plaintiffs began to assert claims that were not amenable to direct proof of reliance upon the fraudulent activity of the defendant.[10] To overcome this obstacle in cases involving an affirmative duty to disclose, the United States Supreme Court in *Affiliated Ute Citizens v. United States*[11] first approved the use of an objective standard to measure the materiality of the nondisclosure in lieu of individual proof of reliance.[12] Thereby, the Court effectively discarded the traditional subjective standard of reliance that had proven to be unworkable in the impersonal public securities market.[13]

Coincident with the expansion of Rule 10b-5 was the amendment, in 1966, of Rule 23 of the Federal Rules of Civil Procedure to expand the availability of class actions.[14] As a result of this

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

10. Often, these cases involved multiple parties, *see e.g.*, Weiss v. Tenney Corp., 47 F.R.D. 283, 291 (S.D.N.Y. 1969)(involving 3800 plaintiffs), and alleged fraudulent misstatements made over a period of time. *See, e.g.*, Ernst & Ernst v. Hockfelder, 425 U.S. 185 (1976) (involving misrepresentations made from 1946 through 1967). These cases are generally held to fall within the provisions of Rule 10b-5(b). *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-153 (1971).

11. 406 U.S. 128, 153 (1971).

12. *Id.* at 153-154. The Court specifically referred to the fraud on the market concept as being applicable to cases "involving primarily a failure to disclose. . . . [In such cases,] positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." *Id.*

13. *Id.* Justice Blackmun, writing for the majority, held that in cases "involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material. . . ." *Id.*

14. Rule 23, governing the certification and maintenance of a class action, provides in pertinent part:

> a) Prerequisites of a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impractical, (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 claims or defenses of the representative parties will fairly and adequately protect the interests of the class.
>
> (b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:. . .
>
> (3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of the members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or

amendment, many courts began to consider the class action as an appropriate judicial format with which to adjudicate claims of open market investors alleging injury as a result of securities fraud.[15]

This desire to utilize the class action was a purely natural reaction given the complexity of the typical modern securities fraud action involving numerous investor-plaintiffs.[16] In addition to the multitude of plaintiffs in the typical securities fraud case, courts were sensitive to the reality that many of the shareholders involved as plaintiffs in these cases were small investors who were otherwise economically deprived of an avenue of redress if forced to file individual suits against the defendants.[17]

Obviously, by its adoption of a revised Rule 23, the Court indicated its desire to utilize the class action as a vehicle for the efficient use of judicial resources. However, in securities fraud litigation resulting from the alleged misrepresentation by the defendant, the requirement that each individual plaintiff offer proof of reliance caused some courts to hold that these plaintiffs were unable to successfully certify a class.[18] In such cases, the courts found that the individual questions overwhelmed those issues common to the

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undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of the class action.

FED. R. CIV. P. 23, 28 U.S.C.A. (as amended Feb. 28, 1966, effective July 1, 1966).

15. *See* Korn v. Franchard Corp., 456 F.2d 1206, 1214 (2d Cir. 1972) (holding that the Rule 23(b)(3) requirement that the class action be the superior mode of adjudication is satisfied when, in fact, no other method is available); Green v. Wolf Co., 406 F.2d 291, 298 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969) (holding that the class action is the superior method by which to adjudicate 10b-5 claims even when separate trials are required to determine the issue of individual reliance); Weiss v. Tenney Corp, 47 F.R.D. 283, 291 (S.D.N.Y. 1969)(class action is deemed appropriate when it is the only practical method of litigating complex issues involving comparatively small individual financial outlays). *But cf.* Proposed Amendments to the Rules of Civil Procedure, 39 F.R.D. 69 (1966), wherein the Advisory Committee on Rule 23 noted that "although showing some common core, a fraud case may be unsuited for treatment as a class action if there is a material variation in the representations made or in the kinds or degrees of reliance by the persons to whom they were addressed." *Id* at 103. However, as examples of fraud claims deemed to be inappropriate, the Committee cited two decisions that significantly pre-dated the era of private claims under Rule 10b-5.

16. *See, e.g.*, Green v. Wolf Co., 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

17. *See, e.g.*, *Korn*, 456 F.2d at 1214, where the court held that one of the chief goals of Rule 23 is to provide an avenue of relief for plaintiffs whose small, individual claims cannot be litigated due to economic constraints. *See also In re* Memorex Securities Cases, 61 F.R.D. 88, 98-99 (N.D. Cal. 1973) (quoting Escott v. Barchris Constr. Corp., 340 F.2d 731, 733 (2d Cir. 1965), *cert. denied sub nom.*, Drexal & Co. v. Hall, 382 U.S. 816 (1966)).

18. *See* Black, *supra* note 7, at 440 and nn.19-20.

class.[19]

In the 1970's, federal courts began to acknowledge that the notion of requiring individual plaintiffs to prove their direct reliance upon allegedly fraudulent misrepresentations by defendants no longer comports with modern securities transactions.[20] Recently, Justice Blackmun, writing for a plurality of four justices in *Basic*,[21] acknowledged the insurmountable hurdle faced by plaintiffs that are required to individually prove their reliance on the product of the fraudulent activity.[22] Justice Blackmun noted that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class [would] effectively . . . prevent[] respondents from proceeding with a class action, since individual issues then would. . .overwhelm[] the common ones."[23]

It has been suggested that the Court lacks the authority to reject reliance altogether as an element to private 10b-5 claims.[24] This argument is based on the language of the Rules Enabling Act[25] which grants the Court the authority only to prescribe rules governing the procedural aspects of federal civil litigation. Thus, the argument concludes, if the burden of proving reliance in a private Rule 10b-5 claim is considered to be a substantive element of the claim, the Court has no authority to discard that element.

This argument is without merit for two reasons. First, as noted

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19. *See, e.g.*, Cannon v. Texas Gulf Sulphur, 55 F.R.D. 306, 307 (S.D.N.Y. 1971) (declining to certify a class of shareholders where the individual plaintiffs would be required to show a causal connection between their investment activity and the allegedly fraudulent misrepresentation).

20. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), wherein then-Associate Justice Rehnquist 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." *Id* at 745.

21. Justice Blackmun delivered the opinion in which Justices Brennan, Marshall, and Stevens joined, and in Parts I, II, and III, dealing with the procedural history of the case and the materiality of preliminary merger discussions, in which Justices White and O'Connor joined. As to Part IV, wherein the fraud-on- the-market theory was endorsed, Justice White, joined by Justice O'Connor, filed a dissenting opinion. Chief Justice Rehnquist and Justices Scalia and Kennedy took no part in the consideration or decision of the case. *Basic*, 108 S. Ct. at 980.

22. *Id.* at 989.

23. *Id.*

24. *See* Black, *supra* note 7, at 440 n.21.

25. 28 U.S.C. § 2072 (1966) provides in pertinent part that:

> The Supreme Court shall have the power to prescribe by general rules, the forms of process, writs, pleadings, and motions, and the practice and procedure of the district courts and courts of appeals of the United States in civil actions. . . . Such rules shall not abridge, enlarge or modify any substantive right. . . .

Id. (as last amended Nov. 6, 1966, Pub. L. No. 89-773, § 1, 80 Stat. 1323).

by then-Associate Justice Rehnquist in *Blue Chip Stamps v. Manor Drug Stores*,[26] the private cause of action under Rule 10b-5 is based entirely upon case law and is not derived from congressional expressions.[27] Thus, the Court is free to modify that which it has created.[28] Second, in *Burlington Northern Railway Company v. Woods*,[29] the Court recently defined its rulemaking authority rather broadly. In *Burlington*, the Court held that Federal Rules of Civil Procedure that may be rationally classified as either substantive or procedural are within the purview of the Court's regulatory authority and are, therefore, constitutional.[30] Further, even those rules that undeniably affect substantive rights are constitutional so long as the interference is merely incidental and the provision is reasonably necessary to maintain the system of rules.[31] Therefore, it seems only logical to infer that the Court has the authority to modify the elements of private Rule 10b-5 actions in whatever way

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26. 421 U.S. 723 (1975).

27. *Id.* at 737. Then-Associate Justice Rehnquist noted that:

> 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. Such growth may be consistent with the congressional enactment and with the role of the federal judiciary in interpreting it . . . but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. 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.

Id. See also Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477 (1977), where the Court noted that:

> [A]lthough we have recognized an implied [private] cause of action under [Rule 10b-5] in some circumstances . . . we have also recognized that a private cause of action under the antifraud provisions of the [Securities and Exchange Act or 1934] should not be implied where it is 'unnecessary to ensure the fulfillment of Congress' purposes' in adopting the Act.

Id.

28. *See Blue Chip Stamps*, 421 U.S. at 749, where the Court stated that "we are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or the other unless and until Congress addresses the question." *Id.*

29. 107 S. Ct. 967 (1987).

30. *Id.* at 970.

31. *Id.* Justice Marshall, writing for a unanimous Court, noted that a broad interpretation of the scope of the Court's authority to exercise its rulemaking power is justified because:

> [T]he study and approval given each proposed Rule by the Advisory Committee, the Judicial Conference, and [the] Court, and the statutory requirement that the Rule be reported to Congress for a period of review before taking effect . . . give[s] the Rules presumptive validity under both the constitutional and statutory constraints.

Id.

is necessary to permit these cases to satisfy the requirements governing the certification of a class of plaintiffs.[32]

In order to overcome the conflict involving whether to require individual proof or to permit the certification of a class in private Rule 10b-5 actions, several circuit courts have relaxed the traditional tort law element of reliance.[33] Instead, these courts have emphasized the elements of materiality and causation[34] by affording the plaintiffs a presumption of actual reliance under a concept that has come to be termed the "fraud on the market" theory.[35] This theory is premised upon the pragmatic assumption that, in the efficient, open securities market, the market price of any particular

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32. For examples where federal courts did, indeed, discard the requirement of reliance by the plaintiff, *see* Zweig v. Hearst Corp., 594 F.2d 1261, 1268-1271 (9th Cir. 1979)(expectation of market integrity is sufficient to satisfy any requirement of reliance); Arthur Young & Co. v. United States District Court, 549 F.2d 686, 695 (9th Cir.), *cert. denied*, 434 U.S. 829 (1977)(plaintiffs have "no requirements . . . [to] prove actual reliance on the false and misleading statements alleged in order to establish the liability of any. . .defendant."); Pellman v. Cinerama, Inc., 89 F.R.D. 386, 388 (S.D.N.Y. 1981)("[T]he reliance . . . of the named plaintiffs will not be an issue in the trial of this action and cannot defeat class certification."); Sargent v. Genesco, Inc., 75 F.R.D. 79, 84-85 (M.D. Fla. 1977)(reliance is presumed after plaintiff proves that defendant's misrepresentation is material); *In re* United States Fin. Sec. Litig., 69 F.R.D. 24, 41-44 (S.D. Cal. 1975)("It is sufficient to show that there were . . . misrepresentations or omissions which were part of a common scheme to manipulate the price of the stock."); Werfel v. Kramarksy, 61 F.R.D. 674, 681 (S.D.N.Y. 1974)("We doubt that proof of actual reliance, as in a common law action for deceit, is necessary in a 10b-5 action for damages.").

33. *See supra* note 6 and accompanying text regarding the elements of the common law claim of deceit.

34. *See, e.g.*, Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), wherein the United States Court of Appeals for the Ninth Circuit held that:

> [C]ausation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of [the defendant's] misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between the defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case.

Id. at 906. *See also* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 593 (1975).

35. *See* Peil v. Speiser, 806 F.2d 1154, 1160-1161 and n.10 (3d Cir. 1986); Harris v. Union Electric Co., 787 F.2d 355, 367 (8th Cir.), *cert. denied*, 107 S. Ct. 94 (1986); Lipton v. Documentation, Inc., 734 F.2d 740, 746 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); T.J. Raney & Sons, Inc., v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330, 1332-1333 (10th Cir. 1983), *cert. denied sub nom.*, Linds, Thompson, Fairchild, Langworthy, Kohn & Van Dyke v. T.J. Raney & Sons, Inc., 465 U.S. 1026 (1984); Shores v. Sklar, 647 F.2d 462, 469 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102, (1983); Panzirer v. Wolf, 663 F.2d 365, 367-368 (2d Cir. 1981), *cert. granted sub nom.*, Price Waterhouse v. Panzirer, 458 U.S. 1105, *judgement vacated and complaint dismissed*, 459 U.S. 1027 (1982); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). *See also* Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1154-56 (1982).

stock is determined by all of the information regarding the company and its business that is made available to the investing public.[36] If this underlying assumption is accepted as being valid, then it logically must follow that any misleading statement regarding a company or its business that is made available to the market will necessarily impact the price of the stock for that company as it is traded on that market.[37]

Moreover, the fraud on the market theory also assumes that the investing public is entitled to, and in fact does, rely on the integrity of the securities market to establish market prices that are equal to the value of the securities being traded.[38] Succinctly, the principal underlying the fraud on the market theory is that all investors in the stock of a company will be defrauded by any public and material misstatement or material omission regarding that company, including those investors that do not directly rely upon the misstatement or omission.[39] Viewed in this light, the fraud on the market theory is the practical embodiment of the efficient market concept espoused by many courts and commentators.[40]

THE OPPOSING VIEWPOINTS AS PRESENTED IN *Basic*

Recently, in *Basic, Incorporated v. Levinson*,[41] the Supreme Court addressed the issue of whether reliance is a requisite element to be proven in order to successfully assert a private cause of action under Rule 10b-5.[42] The six Justices participating in the de-

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36. *See, e.g.*, Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986).

37. *Id.* at 1161. *See generally* Black, *supra* note 7, at 439-446 (detailing the development of the fraud on the market theory in the federal court system).

38. *Basic*, 108 S. Ct. at 990. *See also* Note, *The Fraud on the Market Theory: Efficient Markets and the Defenses to an Implied 10b-5 Action*, 70 IOWA L. REV. 975, 980-81 (1985).

39. *Basic*, 108 S. Ct. at 990. Justice Blackmun, quoting from *In re* LTV Securities Litigation, 98 F.R.D. 134, 143 (N.D. Tex. 1980), noted that:

> [T]he market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.

Id.

40. *See Basic*, 108 S. Ct. at 991 n.24; Black, *supra* note 7, at 437 n.7.

41. 108 S. Ct. 978 (1988).

42. *Basic*, 108 S. Ct. at 988-99. The officers and directors of Basic, Inc. were engaged in preliminary discussions regarding a merger with Combustion Engineering, Inc. During the period of negotiation, the Basic officers made three public statements denying that any negotiations were being entertained. Shortly thereafter, Basic's officers requested that the New York Stock Exchange suspend trading in Basic securities and a board endorsed merger agreement between Basic and Combustion Engineering was subsequently announced. Re-

cision[43] unanimously agreed that reliance is, in fact, an indispensible element to such a claim.[44] Therefore, as to the issue of whether reliance is an element in securities fraud actions, the *Basic* decision serves as precedential authority that it is, indeed, required.[45]

Although the Justices were unanimous in their decision that the defendant in a Rule 10b-5 action must have the opportunity to rebut any showing of reliance made by the plaintiff,[46] they differed significantly as to the allocation of the burden of proving or disproving such reliance.[47] Unfortunately, the *Basic* Court failed to provide the divided circuit courts[48] with precedential guidance as to the extent of the burden on the plaintiff to initially prove his reliance upon the defendant's misrepresentation.[49] Yet, the discussion offered by Justices Blackmun and White does serve to articulate the two long-standing opposing viewpoints[50] to the burden of proof issue.

Justice Blackmun, writing for the plurality,[51] first retained the requirement of reliance as an element of a Rule 10b-5 action.[52] Next, he advocated adoption of the fraud on the market theory as the proper method by which to allocate the burden of proving this

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spondents in *Basic* were former shareholders who sold their stock after Basic's first public denial of the negotiations and before the suspension of trading pursuant to the disclosure of the merger agreement. They alleged that they suffered financial injuries as a result of trading away their Basic securities at prices that were artificially depressed by the false and misleading public statements made by the Basic officers and directors. *Id* at 980-81.

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

44. *Basic*, 108 S. Ct. at 989 and 993.

45. *See supra* note 21 and accompanying text. When a fragmented Supreme Court decides a case and no single rationale explaining the result enjoys the assent of at least five Justices, the holding of the Court may be viewed as that position taken by those members who concurred in the judgment on the narrowest grounds. *See* Marks v. United States, 430 U.S. 188 (1977).

46. *Basic*, 108 S. Ct. at 993-94 (White, J., concurring in part).

47. *Id. See also supra* notes 26 through 32 and accompanying text for the proposition that the judiciary has the authority to allocate this burden of proof in any reasonable manner.

48. *See supra* note 35 and accompanying cases for a listing of those circuits that have adopted the fraud on the market theory. *But cf.* Vervaecke v. Chiles, Heider & Co., 578 F.2d 713 (8th Cir. 1978)(rejecting the fraud on the market theory in cases involving newly issued securities).

49. *See supra* note 45 and accompanying text.

50. A theory resembling the fraud on the market theory in all but name was first espoused by the Circuit Court of Appeals for the Ninth Circuit in Blackie v. Barrack, 524 F.2d. 891, 906 (1975).

51. *Basic*, 108 S. Ct. at 980.

52. *Id.* at 989.

reliance.[53] Referencing the legislative history of the Securities Exchange Act of 1934,[54] as quoted by the Court previously in *Ernst & Ernst v. Hochfelder*,[55] Justice Blackmun held that reliance provides the causal connection between the defendant's injurious conduct and the plaintiff's financial injury.[56] However, he also acknowledged that the millions of transactions closed each day on the modern securities markets bear little resemblance to the face-to-face bargaining upon which the common law of fraud was developed.[57]

Justice Blackmun viewed the fraud on the market theory as an acceptable method by which to accommodate the unique position of the investor alleging injury as a result of open market securities fraud.[58] Thus, he accepted the Sixth Circuit's decision to do likewise in the prior proceeding of this case.[59] According to Justice Blackmun, the fraud on the market presumption is intended to preclude the plaintiff from facing the necessity of proving how he would have acted had the fraudulent activity not occurred.[60] Using this presumption, a 10b-5 plaintiff will satisfy his burden of prov-

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53. *Id.* at 990-91.

54. S. REP. No. 792, 73d Cong., 2d Sess., 6 (1934).

55. 425 U.S. 185, 205-06 (1976). Justice Powell quoted the legislative history of § 10(b) of the Securities Exchange Act of 1934 in support of his holding that § 10(b) is intended to provide for liability against:

> [A]ny person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation. . . . [Such person] shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage.

Id.

56. *Basic*, 108 S. Ct at 989 (citing, *e.g.*, Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 (2d Cir. 1981); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied sub nom*, List v. Lerner, 382 U.S. 811 (1965)).

57. *Basic*, 108 S. Ct. at 989-90. To provide background information to the development of the common law action, Justice Blackmun cited W. PROSSER AND W. KEETON, THE LAW OF TORTS § 105 at 726 (5th ed. 1984), wherein the authors note that the majority of cases leading to the development of the common law of misrepresentation involved misrepresentations made in the course of bargaining. As a result, the authors surmise that the tort action for misrepresentation has been significantly influenced by the ethics of bargaining between distrustful adversaries. *Id.*

58. *Basic*, 108 S. Ct. at 990. Justice Blackmun noted that presumptions of this type are intended to "assist [the] court . . . in managing circumstances in which direct proof . . . is rendered difficult." *Id.*

59. Levinson v. Basic, Inc., 786 F.2d 741, 750 (6th Cir. 1986).

60. *Basic*, 108 S. Ct. at 990 (citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-154 (1972); Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981), *cert denied*, 455 U.S. 938 (1982)).

ing reliance by proving "(1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; . . . and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed."[61]

Justice Blackmun was careful to note that "[a]ny showing that severs the link"[62] between the defendant's misrepresentation and the plaintiff's investment activity will serve to rebut the presumption of reliance.[63] He offered, as examples, two hypothetical factual circumstances in which the burden of rebuttal would be satisfied by the defendant in a Rule 10b-5 action.[64] The first involved a situation in which the defendant was able to show that 'market makers' were privy to the truth. Here, the defendant's misrepresentation would not affect the market price because the fraud would not be transmitted into the market price in the form of investing decisions.[65] The second hypothetical situation provided by Justice Blackmun described the situation in which the defendant is able to prove that the plaintiff did not believe, and hence did not rely upon, the misrepresentation when making his investment decisions.[66] Finally, Justice Blackmun offered that the defendant can rebut the presumption of reliance by showing that the plaintiff did not rely on the integrity of the market, but instead made investment decisions on the basis of unrelated concerns.[67]

As the foundation for his adoption of the fraud on the market theory, Justice Blackmun noted that, in the modern, high-volume scenario, the market absorbs all of the available information concerning a corporation and values the corporation's stock on the basis thereof.[68] As to transactions involving such sophisticated markets, the traditional notion of face-to-face bargaining is noticeably absent. In its place, securities buyers and sellers are obliged to rely upon the securities prices to be an accurate barometer of the value

61. *Basic*, 108 S. Ct. at 992 n.27 (citing *Basic*, 786 F.2d at 750 and modifying the necessary elements as espoused by the Sixth Circuit to reflect the Court's holding regarding materiality).

62. *Basic*, 108 S. Ct. at 992.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.* (providing, *e.g.*, where market integrity is not an element in the decision to divest stock, the case where an investor sells to avoid potential antitrust actions).

68. *Id.* at 990 (quoting *In re* LTV Securities Litigation, 88 F.R.D. 134, 143 (N.D. Tex. 1980), for the proposition that "the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction.").

of the securities.[69] Therefore, Justice Blackmun noted that actions arising under Rule 10b-5 must differ from those arising under the common law tort theories of deceit and misrepresentation.[70] Further, he surmised that the Rule 10b-5 claim is intended to afford investors a greater degree of protection than does the common law tenet.[71] He found this enhanced protection to be a necessary component of the congressional policy to enhance market integrity among the investing public through the Securities Exchange Act of 1934.[72]

In addition, Justice Blackmun found the fraud on the market theory to be supported by "common sense and probability."[73] He also acknowledged recent empirical studies[74] confirming the notion that the market price of a security traded on an efficient market reflects all publicly available information regarding that security, including misrepresentations.[75] Finally, he cited support for his proposition among courts that have addressed the issue,[76] as well as among legal commentators.[77]

Justice White's opinion paints a very different picture of the desirability of using the fraud on the market theory in securities fraud litigation. He concurs with Justice Blackmun's acknowledgment that, if the fraud on the market theory is to be utilized, its presumption of reliance must be rebuttable.[78] However, he notes

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69. *Basic*, 108 S. Ct. at 990.

70. *Id.* at 990 n.22 (citing Blue Chip Stamps v. Manor Drug Stores, 471 U.S. 723, 744-45 (1975)).

71. *Basic*, 108 S. Ct. at 990 n.22 (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983)).

72. *Basic*, 108 S. Ct. at 991. Justice Blackmun, quoting from the legislative history of the 1934 Act, noted that:

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

Id.

73. *Id.*

74. *Id.* at 991 n.24 (citing *In re* LTV Securities Litigation, 88 F.R.D. 134, 144 (N.D. Tex. 1980), as citing such studies; Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 374-381 and n.1 (1984); Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 4 n.9 (1982)).

75. *Basic*, 108 S. Ct. at 991.

76. *Id.* at 991 n.25. *See also supra* note 48 and accompanying text.

77. *Id.* at 991 n.26.

78. *Id.* at 993.

that, in reality, this provision for rebuttal is all but illusory.[79] Beyond this qualified concurrence, Justice White parts company with Justice Blackmun on the applicability of the fraud on the market theory.

As the basis for his rejection of the fraud on the market theory,[80] Justice White offers two primary reasons. First, he expresses skepticism of the value of economic theory as a guiding force behind legal analysis.[81] Second, he believes that the fraud on the market theory runs counter to the congressional intent as contained in the legislative history to section 10(b) of the Securities Exchange Act of 1934.[82]

Upon addressing the value of economic theory as a guide to the development of legal doctrine, Justice White was quick to point out that law relating to section 10(b) and Rule 10b-5 has evolved thus far based on the common law principles of fraud and deceit.[83] He noted that these common law principals are ones with which the judiciary is familiar,[84] and that have served the courts to good advantage as the common law reach of Rule 10b-5 has developed.[85] Justice White would reject the adoption of economic theory to replace these tried and true common law principles because the economic theories are yet unproven.[86] In addition, he notes that jurists are without the resources with which to test and evaluate the merits of the economic theories.[87] Justice White implies that judges that are adopting these emerging economic legal theories are doing so without adequate information with which to measure their reliability. Moreover, even if the theories were validated beyond question, Justice White feels that the judiciary, in general, is

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79. *Id.* at 996 n.7. Justice White contends that the "rebuttal is virtually impossible in all but the most extraordinary case," thereby rendering the plurality's rejection of a pure causation theory virtually meaningless. *Id.* The basis for this contention is, as Justice White notes, that the Court will allow "investors to recover who can show little more than that they sold stock at a lower price than what might have been." *Id.* at 996. *See also* Blackie v. Barrack, 524 F.2d 891, 906 n.22 (9th Cir. 1975), where the Ninth Circuit opined that "we doubt that a defendant would be able to prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material fraud." *Id.*

80. *Basic*, 108 S. Ct. at 993.

81. *Id.* at 994.

82. *Id.* at 996. *See also supra* note 1 and accompanying text.

83. *Id.* at 994 (citing, *e.g.*, Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 471-477 (1977)).

84. *Basic*, 108 S. Ct. at 994.

85. *Id.*

86. *Id.* at 995 (citing Easterbrook, *Afterward: Knowledge and Answers*, 85 COLUM. L. REV. 1117, 1118 (1985), as proof that not all economic theories are eventually substantiated).

87. *Basic*, 108 S. Ct. at 994.

lacking a sufficient familiarity with economic theory to accurately translate it into legal rules.[88] To fortify his claim that judges are not well equipped to embrace economic theory as a tool of statutory interpretation, Justice White obliquely refers to decisions by the courts of appeals and the district courts that he feels the wisdom of time has proven to be imprudent.[89]

Justice White also rejects the adoption of economic theory as an unwarranted intrusion by the judiciary into the legislative process. Thus, if the reliance requirements contained in Rule 10b-5 must be relaxed in order to successfully cope with the environment in today's open securities market, Justice White would prefer that the change come in the form of a congressional amendment to section 10(b).[90]

The most fundamental difference between Justice White and the plurality on the applicability of the fraud on the market theory revolves around whether investors actually rely on market integrity; that is, whether investors rely on the market to provide prices that are equal to the true value of the securities.[91] The plurality asserted that investors, as a matter of course, rely on this market integrity when making investment decisions.[92] Hence, this notion is the basis of the plurality holding that investors must be granted a presumption that they relied on these prices to their detriment as a result of the defendant's allegedly fraudulent activity.[93]

In contrast, Justice White suggests that securities actually have no reliable measure of worth other than their market price.[94] How-

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88. *Id.* Justice White notes that the "efficient-capital-market hypothesis" incorporated into the fraud on the market theory cannot be sufficiently tested without staff economists. *Id.*

89. *Id.* at 995. Justice White referred to "wrong turns" made by lower courts, but he declined to provide specific examples. One can presume he was referring to examples such as Shores v. Sklar, 610 F.2d 235 (5th Cir. 1980), *aff'd en banc*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983). This opinion has been criticized for applying the fraud on the market theory to a situation involving newly issued bonds that had not developed a reliable trading history. *See generally* Note, *The Fraud on the Market Theory, supra* note 35.

90. *Basic*, 108 S. Ct. at 995. Justice White acknowledges that Congress has the resources and expertise to evaluate modern economic theory and the ramifications of its application to civil liability. *Id.*

91. *Id.* at 990. Justice Blackmun discusses the typical investor's reliance upon the integrity of the market to establish and maintain fair securities prices. *Id.*

92. *Id.*

93. *Id.*

94. *Id.* at 996. Justice White notes that "[e]ven if securities had some 'value'—knowable and distinct from the market price of a stock—investors do not always share the Court's presumption that a stock's price is a 'reflection of [this] value.'" *Id.*

ever, even if there were some separate and distinct method by which securities might be accurately valued, Justice White believes that the market actually is driven by the opposite of investor reliance upon such prices. Instead, he surmises that investment decisions are routinely made by investors who are betting that the market price is, in fact, an *inaccurate* measure of a security's worth.[95] Therefore, not all losing investors have necessarily fallen prey to fraudulent activity;[96] many have simply lost their wager. By protecting all investors with the fraud on the market presumption of reliance, Justice White likens the plurality's approach to investor insurance.[97] If such investor protection is deemed necessary, Justice White believes that it should emanate from Congress.[98]

Upon examining the legislative history of section 10(b) of the Act, Justice White believes that Congress is unlikely to embrace the fraud on the market theory.[99] Because the available history of section 10(b) is meager,[100] Justice White turns to the legislative history of an analogous section of the Act, section 18, which provides for a private cause of action in certain cases involving misrepresentation.[101] The initial draft of this section provided for civil liability without proof of reliance upon the misrepresentation.[102] However, Justice White noted that this provision was strongly criticized in congressional hearings because it failed to require a sufficient degree of reliance by the plaintiff in such actions.[103] The resultant provision passed by Congress was perceived as correcting this deficiency.[104]

A concern was also expressed by Justice White that the application of the fraud on the market theory will thwart the very purpose of the congressional policy favoring public disclosure of material information concerning securities.[105] He agreed with Justice Black-

95. *Id.* (citing Black, *supra* note 7, at 455).

96. *Basic*, 108 S. Ct. at 996 (citing Dirks v. SEC, 463 U.S. 646, 667 n.27 (1983)).

97. *Basic*, 108 S. Ct. at 996.

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* at 997 (citing 15 U.S.C. § 78r(a) of the Securities and Exchange Act of 1934).

102. *Basic*, 108 S. Ct. at 997. The provision as initially drafted would have provided for civil liability by plaintiffs who alleged only that the price of the security in which they invested was affected by the misrepresentation.

103. *Id.*

104. *Id.* (quoting the then-Chairman of the House Committee, Sam Rayburn, 78 CONG. REC. 7701 (1934)).

105. *Basic*, 108 S. Ct. at 992-993. Justice Blackmun in *Basic* held that the standard of

mun that this congressional intent is properly applicable to the judicially-created private 10b-5 claim on the basis of *stare decisis*.[106] The underlying principal at stake is the stringent congressional disclosure policy intended to enable investors to protect themselves by relying upon mandated disclosures.[107]

Justice White fears that by affording the investor a blanket protection from securities fraud via application of the fraud on the market presumption, the investor is no longer required to evaluate the required disclosures when making investment decisions.[108] Therefore, Justice White believes that the fraud on the market theory cannot be co-existent with the extensive federal disclosure policy.[109] Given that the federal courts must make a choice between encouraging disclosure or adopting the fraud on the market theory, Justice White contends that Congress' clear preference, a preference that should be honored by the courts, favors the encouragement of disclosure.[110]

Recommended Limitations to the Application of the Fraud on the Market Theory

Undoubtedly, the Supreme Court will squarely tackle the fraud on the market issue again in the future. As it currently stands, four Justices advocate its adoption, two reject it, and three have not yet spoken.[111] Thus, the three justices that did not participate in *Basic* possess the controlling votes that will eventually spell life or death for the fraud on the market theory.[112]

In the event that a majority of the Justices eventually endorse

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materiality as determined in TSC Industries, Inc. v. Northway, 426 U.S. 438 (1976), was the proper standard by which to measure the requirements of materiality in securities fraud litigation. In *TSC Industries*, the Court, determining the materiality of information contained in proxy- solicitation material, held that information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." 426 U.S. at 449. *See generally* Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 Md. L. Rev. 1114 (1987).

106. *Basic*, 108 S. Ct. at 996 (citing, *e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 204-06 (1976)). *See also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), for a discussion of the origin of the private cause of action pursuant to Rule 10b-5 of the Act.

107. *Basic*, 108 S. Ct. at 997-98 (citing Shores v. Sklar, 647 F.2d 462, 483 (5th Cir. 1981) (Randall, J., dissenting)).

108. *Basic*, 108 S. Ct. at 997.

109. *Id.*

110. *Id.*

111. *See supra* note 21.

112. *See supra* note 45.

the application of the fraud on the market theory, they would be prudent to impose two very clear and very significant limitations upon its application. One limitation that should be clearly specified is that the fraud on the market theory can only be justified when it is applied to mature, stable securities that are being traded on well-developed and impersonal markets.[113] Justice Blackmun alluded to such a limitation in *Basic*,[114] but neither specifically limited the application of the fraud on the market to such situations nor supplied the lower courts with definitional guidance by which to classify markets as "well-developed" or "efficient." If the fraud on the market theory is permitted to become law without such delimitation, future occurrences of inconsistent and indefensible decisions such as that resulting in *Shores v. Sklar*[115] are nearly certain.

The other and more significant limitation that should be imposed upon the application of the fraud on the market theory goes to the very heart of the defendant's allegedly fraudulent activity. This limitation would prohibit the application of the fraud on the market theory in cases involving alleged misstatement by the defendant. Rather, the presumption of reliance granted the plaintiff by the fraud on the market theory should be available only to plaintiffs alleging that the defendant failed to disclose material information. This limitation simply acknowledges that a plaintiff who is alleging injury as a result of the defendant's misstatement is in a diametrically opposing position from the plaintiff alleging nondisclosure of a material fact. In the case of a misstatement, the plaintiff will likely have little difficulty in proving his reliance upon the misstatement. Imposing such a burden of proof upon individ-

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113. *See supra* note 35.

114. *Basic*, 108 S. Ct. at 991. Justice Blackmun noted that "the market price of shares traded on *well-developed markets* reflects all publicly available information. *Id.* (emphasis added).

115. 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102 (1983)(investor recovery possible in case of new issue if investor proves that securities were totally unmarketable). For criticism of this case, *see* Note, *The Fraud on the Market Theory*, *supra* note 35, at 1157-61, wherein the author notes that:

> [B]ecause most empirical studies of efficient markets have taken place in 'developed' markets, it is uncertain whether the efficient market hypothesis is available as support for applying the fraud on the market theory to 'undeveloped' markets such as new offerings, thin markets, and restricted resale markets. Intuition alone certainly does not suggest that prices would fully reflect all publicly available information in such markets. . . . Because it is at best uncertain whether undeveloped markets are efficient, the fraud on the market theory should not be applied to them in any form.

Id.

ual plaintiffs will not prevent the certification of a class of plaintiffs in order to try those issues common to the class.[116] In contrast, a plaintiff alleging that the defendant failed to disclose material information would face a nearly insurmountable hurdle if required to prove that he acted as he did only because of the absence of the information at issue, a speculative endeavor at best.[117]

It is noteworthy that neither Justice Blackmun nor Justice White made mention of the fundamental difference between cases involving misstatements and those involving nondisclosure.[118] Moreover, *Basic* involved a factual background centered around misstatements by corporate directors.[119] Thus, as Justice White derisively rejects the fraud on the market theory as unsubstantiated and refers to it as a "mere babe" among legal doctrines,[120] Justice Blackmun and the plurality are poised to extend its applicability to its furthest reaches in one fell swoop. Justice White is understandably reticent to jump on this judicial steamroller that, as he notes, is likely to have "many adverse, unintended effects as it is applied and interpreted in the years to come."[121] If, one day, a majority of the Court finds it necessary to substantially depart from the traditional notions of tort liability to adjudicate private 10b-5 actions, a cautious route of departure is certainly in order.[122]

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116. The issue of individual reliance may be tried separately without defeating the certification of a class to adjudicate those issues common to the class. Bifurcated trials have also been proposed to determine individual damages. *Cf.* Green v. Wolf Corp., 406 F.2d 291, 301 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

117. *Basic*, 108 S. Ct. at 990. Justice Blackmun recognized the difficulty in the latter situation. However, he also found a corresponding difficulty in requiring the plaintiff to prove reliance upon a misstatement. However, in so doing, Justice Blackmun considered that the plaintiff in such a situation would attempt to prove how he would have acted in the absence of the misstatement. In reality, the plaintiff would simply prove that he relied upon the misstatement, a relatively simple, affirmative offer of proof that might well be satisfied by simply showing that the plaintiff was aware of the statement's existence when he made his investment decisions. *Id. See also* Shores V. Sklar, 647 F.2d 462, 477 (5th Cir. 1981)(Randall, J., dissenting), where Judge Randall noted the "almost insurmountable burden [imposed upon a plaintiff] if he is required to present affirmative evidence that he relied specifically on the defendant's silence with regard to a material fact." *Id. But cf.* Black, *supra* note 7, at 459 n.148, wherein Black suggests that a plaintiff can credibly testify that he would have acted differently if he had been told the omitted fact.

118. *See supra* notes 41 through 110 and accompanying text.

119. *See supra* note 42 for a factual summary of the *Basic* case.

120. *Basic*, 108 S. Ct. at 993.

121. *Id.*

122. Indeed, an example of just such an approach can be found in one of the earliest Supreme Court cases dealing with the presumption of reliance by the plaintiff. In Affiliated Ute Citizens v. United States, 406 U.S. 128 (1971), the Court specifically referred to the fraud on the market concept as being applicable to cases "involving primarily a failure to disclose . . . ." *Id.* at 153. *See also* Rifkin v. Crow, 574 F.2d 256, 262-63 (5th Cir. 1978),

Moreover, the application of the fraud on the market theory to cases involving misrepresentation cannot be reconciled with the congressional purpose underlying securities legislation. These statutory provisions were enacted by Congress to promote the public disclosure of information in order that investors might rely on publicly available information when making investment decisions.[123] In cases involving nondisclosure, the application of the fraud on the market theory will arguably mesh with this congressional policy. In these cases, a judicial policy of granting plaintiffs a presumption of reliance will serve to place defendants at a disadvantage and will likely encourage them to disclose material information.

In contrast, the application of the fraud on the market theory runs directly counter to the congressional policy favoring full disclosure when it is applied to cases involving misrepresentation. In these cases, the presumption of reliance absolves investors of any duty to read and rely upon the defendant's disclosures.[124] The investor protected by this blanket presumption is completely shielded from loss resulting from careless investing so long as the defendant misrepresented any material fact.[125] As such, the fraud on the market theory takes on the characteristics of investor insurance and will, in fact, dissuade investors from critically analyzing publicly available information. In addition to protecting careless investors, the elimination of the investors' duty to examine may well serve to discourage the revelation of fraud by inquisitive investors.

Commentators have suggested two reasons for the application of the fraud on the market theory to cases involving misrepresentation. First, it has been argued that the average investor is unable to comprehend the publicly available information.[126] Second, it has been suggested that the market so rapidly absorbs the misinforma-

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where the Fifth Circuit noted that:

> [A] general pattern seems to have emerged: where a 10b-5 action alleges defendant made positive misrepresentations of material information, proof of reliance by the plaintiff upon the misrepresentation is required. Upon an absence of proof on the issue, plaintiff loses. On the other hand, where a plaintiff alleges deception by defendant's nondisclosure of material information, the *Ute* presumption obviates the need for plaintiff to prove actual reliance on the omitted information.

Id.

123. *Basic*, 108 S. Ct. at 997.

124. *Id.*

125. *See supra* note 79 and accompanying text.

126. *See generally* Note, *The Fraud on the Market Theory*, *supra* note 35. *See also* Black, *supra* note 7, at 458.

tion that it is incorporated into the stock price before the average investor can make an investment decision.[127] Neither of these arguments can withstand closer scrutiny.

The plaintiffs in *Basic* were surely able to comprehend the public statements made by the defendants wherein the defendants disavowed the existence of ongoing merger negotiations that were, in fact, underway.[128] If the lack of comprehension argument is to be accepted as the impetus behind the requirement to grant the plaintiff a presumption of reliance, it cannot be squared with cases exhibiting a factual situation similar to *Basic*. Additionally, the suggestion that the average investor cannot digest available public information implies that the congressional policy of full disclosure is without purpose. Congress was careful to assure the availability of such information to all investors that they might protect themselves by making informed investment decisions.[129] Thus, Congress must have presumed that the availability of the information would be of some benefit to all investors. Even if it is proven that many "average investors" are truly unable to comprehend the available information, many of these investors make investment decisions with the assistance and advice of securities brokers. If a broker is aware of the publicly available information and relies on it when developing recommendations for his clients, then the client-investor can successfully prove his own reliance, albeit indirectly, on the fraudulent misrepresentation.[130]

The second argument for the application of the presumption of reliance in cases involving misrepresentation contains an even greater flaw. This argument proposes that the average investor need not rely upon publicly available information because the market has already digested any misrepresentation and incorporated it into the stock price. Yet, it has been noted that the bargaining in-

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127. *See* Black, *supra* note 7, at 458.

128. *See supra* note 42.

129. *Basic*, 108 S. Ct. at 997. Justice White cites, with approval, Shores v. Sklar, 647 F.2d 462, 483 (Randall, J., dissenting), for the proposition that "the federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make. This system is not furthered by allowing monetary recovery to those who refuse to look out for themselves." *Id.*

130. *See* Black, *supra* note 7, at 458. After acknowledging that such indirect reliance is possible, Black suggests that:

> [R]equiring an investor to testify about a vaguely recalled newspaper article or conversation with his broker may well be a waste of judicial time. When the stock is so widely traded that information about the corporation is widely disseminated, it may be appropriate to presume indirect reliance.

Id. at 458-59.

teraction between the buyers and the sellers, collectively, serves to force the market to stabilize at fair prices.[131] The advocates of the fraud on the market theory propose to retain this bargaining notion while disengorging it of any participation by the average investor. Extrapolating this notion, these same advocates must also be impliedly suggesting that investment activity by uninformed average investors cannot, of itself, impact security prices. It is difficult, if not impossible, to conceive of such a complex and balanced interaction that can render true prices regardless of the investment activity of a major market segment such as the "average investor."

The advocates of the fraud on the market theory hope to ensure punishment of all parties that engage in securities fraud, whether that fraud results from intentional misstatements or the nondisclosure of material information. However, it certainly is not the intent of these advocates to encourage slipshod, opportunistic investment activity. Yet, as Justice White aptly noted in *Basic*, many of the successful plaintiffs invested in Basic stock only after the first of a series of misstatements by the corporate officers.[132] These incautious speculators actually profited handsomely from their investment, but yet were awarded damages; damages borne by innocent shareholders.[133]

Thus, the incautious and overly exuberant embrace of the fraud on the market theory seems likely to prove itself to be as problematic as the situation it is intended to correct. Courts in the future should recognize the potential problems presented by this novel theory. They should move cautiously when attempting to utilize it to correct perceived problems in securities litigation lest they ruefully discover that they have merely traded one set of problems for another.

Martin J. Stanek

131. *Basic*, 108 S. Ct. at 991 (citing Lipton v. Documation, Inc., 734 F.2d 740, 748 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985)).
132. *Basic*, 108 S. Ct. at 999.
133. *Id.*