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Securities Fraud: The Reliance Element in Initial Offerings of Securities

David W. Swartz

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I. Introduction

In 1942, the Securities Exchange Commission (SEC) promulgated rule 10b-5[1] pursuant to section 10(b) of the Securities Exchange Act of 1934.[2] Rule 10b-5 does not explicitly authorize a private cause of action to investors alleging fraudulent securities activities. Nonetheless, federal courts recognized a private remedy under the rule shortly after its inception.[3] Explicit recognition by the United States Supreme Court of a private cause of action occurred much later.[4]

The elements of a private action under rule 10b-5 derive from the common-law tort of deceit[5] although some courts have not rig-

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1. 17 C.F.R. § 240.10b-5 (1981). The rule was promulgated in SEC Securities Exchange Act Release No. 3230 (May 21, 1942). The rule provides:

> It shall be unlawful for any person, directly or indirectly, by 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 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 of any security.

2. 15 U.S.C. § 78j(b) (1976). The section provides:

> 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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> . . . .
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> (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 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.

3. Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949); Speed v. Transamerica Corp., 71 F. Supp. 457 (D. Del. 1947); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

4. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (citing 6 L. Loss, Securities Regulation 3869-73 (Supp. 1969); 3 L. Loss, Securities Regulation 1763 (2d ed. 1961)).

5. For a discussion of the relationship between rule 10b-5 and common law fraud, see Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 Case W. Res. L. Rev. 363, 366 (1973).

To maintain an action for deceit at common law, a plaintiff must establish:

idly restricted themselves to the common-law elements in fashioning remedies.[6] The common-law background has generally required that plaintiffs prove reliance[7] as an element of a civil action;[8] however, the parameters of the reliance requirement are not uniform. Rather, the requirement varies depending upon the nature of the defendant's fraudulent action and the nature of the transaction.[9]

As a general rule, federal courts require a plaintiff bringing an action under rule 10b-5 to prove reliance when the allegations concern damages sustained as a result of his misrepresentations.[10] A different standard applies when the defendant's failures to disclose or his misrepresentations affect the price of securities traded in the open market. In these latter situations, courts presume the plaintiff's reliance on the defendant's fraudulent activity and permit the defendant an opportunity to rebut the presumption.[11]

Recently, however, the Fifth Circuit Court of Appeals permitted a plaintiff to recover under rule 10b-5 in a case alleging misrepresentations contained in an offering circular,[12] without requiring proof of

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(1) A false representation made by the defendant. In the ordinary case, this representation must be one of fact.

(2) Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element is frequently labeled "scienter."

(3) An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.

(4) Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.

(5) Damage to the plaintiff, resulting from such reliance.

W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971).

6. *See* Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5, supra* note 5, at 367.

7. Courts frequently utilize the term *transaction causation* as a substitute for the term *reliance*. Transaction causation simply means that the plaintiff must show that the alleged misrepresentations or omissions caused the plaintiff to engage in the transaction in question. Schlick v. Penn-Dixie Cement Co., 507 F.2d 374, 380 (2d Cir.), *cert. denied,* 421 U.S. 976 (1975). *See also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238-40 (2d Cir. 1974); Seiffer v. Topsy's Int'l, Inc., 487 F. Supp. 653, 666 (D. Kan. 1980); Jezarian v. Csapo, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97692 (S.D.N.Y. Nov. 12, 1980); 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD, § 4.7(551), at 86 (Supp. 1973); Note, *Causation and Liability in Private-Actions for Proxy Violations,* 80 YALE L.J. 107, 123-24 (1970).

8. 6 L. LOSS, SECURITIES REGULATION 3876 (Supp. 1969). The case most often cited for the proposition that reliance is an element in rule 10b-5 civil actions is List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965).

9. *See* R. JENNINGS & H. MARSH, SECURITIES REGULATION 1063 (4th ed. 1977).

10. Vervaecke v. Chiles, Heider & Co., Inc., 578 F.2d 713, 716 (8th Cir. 1978); Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir.), *cert. denied,* 421 U.S. 976 (1975); Issen v. GSC Enterprises, 508 F. Supp. 1278, 1287 (N.D. Ill. 1981). *See also* Comment, *The Future of the Reliance Requirement in Private Actions Under SEC Rule 10b-5: A Proposal,* 9 CUM. L. REV. 721, 730 (1979); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88* HARV. L. REV. 584, 589 (1975).

11. *See* notes 37-75 and accompanying text *infra*.

12. An offering circular provides financial data, in part, to the public to provide assistance in gathering data on a security exempted from the formal registration requirements of the federal securities laws. Thus, in many respects the offering circular resembles the document

reliance on the misrepresentations.[13] The plaintiff avoided summary judgment even though the defendant established that the plaintiff had not read the offering documents. This holding, while creating a conflict among the circuit courts on this issue, constitutes a novel approach to the reliance requirement when affirmative misrepresentations occur in the sale of securities not previously traded in the open market.[14]

This comment analyzes the reliance concept in the context of affirmative misrepresentations in original distributions of securities. The focus is to ascertain whether plaintiffs who allege misrepresentation in an initial offering should be required to prove reliance on a particular misrepresentation, or whether the presumption now provided to plaintiffs in nondisclosure and market fraud cases should be extended. The analysis includes examination of the evolution of the reliance concept in rule 10b-5 actions,[15] the legislative history of section 10(b) of the Securities Exchange Act of 1934,[16] the interpretation of section 10(b) and rule 10b-5 by federal courts,[17] and various policy considerations.[18]

II. Conflict Among the Circuits on the Need to Establish Reliance upon Alleged Misrepresentations

A. *Shores v. Sklar*[19]

In *Shores v. Sklar*,[20] plaintiff brought an action under rule 10b-5 on behalf on purchasers of industrial development revenue bonds issued by a small city in Alabama. Bond proceeds were used to finance construction of an industrial facility to be occupied by a manufacturer. The manufacturer defaulted on the rent payments and the value of the bonds plummeted. Plaintiff sought recovery against a number of persons connected with the bond issue, including the manufacturer, the bond counsel, the underwriters, and the bank trustee.[21]

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utilized for the sale of registered securities, the prospectus. 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 5.12[2], at 5-51 (1978).

13. Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), *petition for cert. filed,* 50 U.S.L.W. 3474 (U.S. Nov. 2, 1981) (No. 81-839). The *Shores* court was sharply divided (12-10), with a vehement dissent.

14. *See* notes 19-35 and accompanying text *infra.*

15. *See* notes 37-75 and accompanying text *infra.*

16. *See* notes 76-78 and accompanying text *infra.*

17. *See* notes 79-144 and accompanying text *infra.*

18. *See* notes 145-179 and accompanying text *infra.*

19. 647 F.2d 462 (5th Cir. 1981) (en banc), *petition for cert. filed,* 50 U.S.L.W. 3474 (U.S. Nov. 2, 1981) (No. 81-839).

20. *Id.*

21. For the position that investors should be denied an implied right of action under the federal securities laws for fraudulent practices arising out of the purchase or sale of municipal securities, see Schwartz, *Municipal Bonds & The Securities Laws: Do Investors Have an Implied Private Remedy?,* 7 SEC. REG. L.J. 119 (1979). The author argues that investors in municipal

The district court, after twice permitting plaintiff to amend his complaint, granted summary judgment for defendants on the ground that discovery demonstrated plaintiff's lack of reliance on the offering circular.[22] The Court of Appeals of the Fifth Circuit reversed, concluding that the trial judge had erred by construing plaintiff's claim as being narrowly confined to misrepresentations or omissions under rule 10b-5(2).[23] Instead, the court held that plaintiff's complaint alleged a broader scheme to defraud. Since the offering circular was "only one step"[24] in this scheme, the court found that plaintiff's lack of reliance on the offering circular was not determinative.[25]

The court noted that the securities laws permit an investor 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."[26] Therefore, plaintiff could establish the requisite element of causation if he proved that "the scheme was intended to and did bring the Bonds onto the market fraudulently and [that] he relied on the integrity of the offerings of the securities market."[27] In this manner, plaintiff could recover under rule 10b-5 despite his failure "to read or even to seek to read the Offering Circular."[28]

B. *Vervaecke v. Chiles, Heider & Co., Inc.*[29]

In *Vervaecke v. Chiles, Heider & Co., Inc.*,[30] plaintiff had purchased eight corporate bonds authorized by a state-created authority and issued to finance hospital construction. Plaintiff brought an action under section 10(b) and rule 10b-5 when the value of the

bonds should be confined to damage actions under state Blue Sky statutes. A Blue Sky statute is the common name for state securities acts. *Id.*

22. 647 F.2d at 468.

23. The court conceded that plaintiff's claim under 10b-5(2) could not withstand his admitted lack of reliance on the offering circular. Nevertheless, the court permitted plaintiff to proceed under 10b-5(1) and 10b-5(3). To recover, plaintiff was required to show the following: (1) the defendants had conspired to bring securities onto the market that were not entitled to be on the market; (2) plaintiff reasonably relied on the market as an indicator of the bonds' genuineness; and (3) plaintiff suffered a loss as a result of the scheme to defraud. *Id.* at 468-70.

24. *Id.* at 468.

25. *Id.* at 469.

26. *Id.* at 471. The court would only permit recovery if plaintiff could prove that the securities would never have been marketed but for the fraud. Thus, if plaintiff proved no more than that the bonds would have been offered at a lower price or at a higher rate, rather than that they never would have been issued or marketed, plaintiff could not recover. *Id.* at 470. This standard presents an inconsistency in allowing recovery when plaintiff can prove that the security should not have been marketed but for the fraud, while denying recovery when plaintiff can only prove that the security should have been offered at a drastically lower price. Often the difference between the two situations is slight. Moreover, proof problems inhere in attempts to show that a security should never have been offered on the market.

27. *Id.* at 469.

28. *Id.* at 468.

29. 578 F.2d 713 (8th Cir. 1978).

30. *Id.*

bonds declined.[31] The Court of Appeals of the Eighth Circuit affirmed the summary judgment granted defendants because plaintiff could not present a factual issue regarding his reliance on the offering documents.[32] Plaintiff could only allege that "he read the offering statement when he began to learn that there might be a problem with the bonds, but he had no specific recollection of reading it before that."[33] Thus, without expressing any opinions about which factors induced the plaintiff to purchase, the court found that plaintiff had not established any causation between the alleged fraud and plaintiff's resulting loss.[34]

C. *Summary*

Shores v. Sklar and *Vervaecke v. Chiles, Heider & Co., Inc.* illustrate cases having similar factual situations but vastly different results. Both cases concerned an initial offering of securities with alleged misrepresentations. Both trial courts also barred plaintiffs' claims under rule 10b-5(2) because plaintiffs failed to allege sufficient facts to prove reliance on the offering documents. Upon appeal, the Fifth Circuit, unlike the Eighth Circuit, viewed the complaint broadly and provided plaintiff the opportunity to recover under rule 10b-5(1) and (3), notwithstanding plaintiff's failure to rely on the offering documents. Permitting plaintiff to rely on the integrity of the market in a 10b-5 action, rather than on the actual misrepresentations in initial offering materials,[35] constitutes a change from the reliance concept as currently developed.[36] Because of this change, the Fifth Circuit's approach to the fraud on the market theory of causation deserves close scrutiny.

31. As in Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), *petition for cert. filed*, 50 U.S.L.W. 3474 (U.S. Nov. 2, 1981) (No. 81-839), plaintiff joined every party connected with the bond issue—the accountant or bond counsel, the underwriters, and the bank chosen to act as trustee for the bond proceeds.

32. The district court had concluded that plaintiff "did not even see the offering statements until after the commitment to purchase the securities had been made. Clearly, plaintiff's determination was influenced primarily by factors personal to him and unrelated to the alleged misrepresentations and omissions." 578 F.2d at 719.

33. *Id.* at 718. The court resisted plaintiff's attempt to apply the reliance rule utilized in situations of nondisclosures to this situation that alleged "material misrepresentations, and omissions in the nature of misrepresentations, in two specific documents. . . ." *Id.* at 719.

34. *Id.*

35. *But see* Jezarian v. Csapo, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97692 (S.D.N.Y. Nov. 12, 1980). In *Jezarian*, plaintiff brought a rule 10b-5 action, alleging that an offering prospectus for preferred stock contained misrepresentations. Discovery materials established that plaintiff did not examine the prospectus, but rather relied on the advice of his broker in making the purchase. Plaintiff then attempted to amend the complaint in order to state a fraud on the market theory of causation, similar to that recognized in Shores v. Sklar, thereby establishing a presumption of reliance and avoiding the necessity of proving reliance. The court rejected the attempt to amend because deposition testimony indicated that the broker's advice, not the prospectus, caused the decision to purchase; therefore, even assuming that a presumption of reliance could have been raised under a market fraud theory, this evidence effectively rebutted the presumption. *Id.*

36. *See* Note, *Securities*, 12 TEX. TECH. L. REV. 319, 344 (1981).

III. Evolution of the Reliance Concept in 10b-5 Actions

A. Nondisclosure Cases

The United States Supreme Court has recognized that requiring the plaintiff in securities fraud litigation to prove reliance often amounts to an unreasonable burden. For example, in *Affiliated Ute Citizens v. United States*,[37] a group of American Indians had formed a corporation to manage assets derived from tribal holdings. The corporation designated a local bank to act as transfer agent and requested that the bank stress the importance of retaining the stock, since the value of the shares was difficult to ascertain. Two bank employees, however, helped shareholders dispose of shares. Certain Indian shareholders brought an action under section 10(b) and rule 10b-5 because the bank employees had failed to inform the sellers of higher prices available in a resale market. The Supreme Court, in reversing the Tenth Circuit Court of Appeals,[38] held that

> [u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.[39]

Lower federal courts have interpreted *Affiliated Ute* to mean that, in cases involving nondisclosure, proof of the alleged nondisclosure's materiality can be substituted for proof of reliance.[40] *Affiliated Ute* and its progeny, however, do *not* abolish the reliance requirement in cases of nondisclosure,[41] but merely permit a pre-

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37. 406 U.S. 128 (1972).

38. The court of appeals had held that no actionable violation of the rule occurred "unless the record disclosed evidence of reliance on material fact misrepresentations" by the bank employees. *Id.* at 152. The Supreme Court considered this view of rule 10b-5 overly restrictive: "To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact. The first and third subparagraphs are not so restricted." *Id.* at 152-53. For a discussion of the Supreme Court's treatment of reliance in *Affiliated Ute, see* Comment, *Affiliated Ute Citizens v. United States—The Supreme Court Speaks on Rule 10b-5,* 1973 UTAH L. REV. 119, 131.

39. 406 U.S. at 153-54.

40. *See, e.g.,* Ross v. A.H. Robins Co., 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980); Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Issen v. GSC Enterprises, 508 F. Supp. 1278, 1287 (N.D. Ill. 1981); Seiffer v. Topsy's Int'l, Inc., 487 F. Supp. 653 (D. Kan. 1980); *but see* Allen Organ Co. v. North Am. Rockwell Corp., 363 F. Supp. 1117 (E.D. Pa. 1973) (the materiality of *misrepresentations* establishes causation). One court has held that proof of a misrepresentation *or* a nondisclosure, without more, effectively establishes causation under *Affiliated Ute.* Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975).

41. Completely discarding the concept of reliance in favor of materiality would be anomalous because the two elements prove different aspects of plaintiff's case. Materiality determines whether a reasonable man would have attached significance to the undisclosed or misrepresented information while reliance focuses on whether the fraudulent activity influenced the particular plaintiff to act differently. JACOBS, THE IMPACT OF RULE 10B-5 § 64-01,

sumption of reliance.[42]

A presumption of reliance in nondisclosure cases is necessary because requiring proof of reliance would present unreasonable evidentiary problems:[43] Plaintiffs would be required to prove reliance on a statement that did not exist. For this reason, "reliance has little if any rational role" in cases involving nondisclosure.[44] Moreover, an element of probability supports the construction of this presumption. Judges have generally recognized presumptions because proof of one fact renders proof of a second fact so probable that it is sensible and time-saving to assume the truth of the second fact until the adversary can disprove it.[45] Thus, in nondisclosure cases, proof of the materiality of the nondisclosed fact and proof of damage make it prudent to assume the fact of plaintiff's reliance.

Although presumptions provide a valuable advantage to plaintiffs in nondisclosure cases, the defendant may defeat plaintiff's claim by rebutting the presumption—in other words, by disproving reliance. As stated by the Court of Appeals of the Third Circuit in *Rochez Bros. v. Rhoades*,[46]

> We do not read [*Affiliated Ute*] to say that the issue of reliance *vel non* may not be considered at all in a nondisclosure case, but only that proof of reliance is not required for recovery. If defendant is able to prove that there was clearly no reliance . . . then the nondisclosure cannot be said to have caused the subsequent loss and under ordinary principles of the law of fraud, recovery should be denied.[47]

Defendants can rebut the presumption of reliance by proving that the investor's decision would not have been affected even if the omitted fact had been disclosed.[48] One court has also stated that the pre-

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at 3-153 (1974); *see also* Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981); Chelsea v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975); Comment, *Recent Developments in Securities Law: Causes of Action Under Rule 10b-5,* 26 BUFFALO L. REV. 505, 523 (1977).

42. Ross v. A.H. Robins Co., Inc., 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980); Vervaecke v. Chiles, Heider & Co., Inc., 578 F.2d 713, 716-18 (8th Cir. 1978); Rifkin v. Crow, 574 F.2d 256, 262 (5th Cir. 1978); Issen v. GSC Enterprises, Inc., 508 F. Supp. 1278, 1287 (N.D. Ill. 1981).

43. Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 n.6 (2d Cir. 1981); Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981); Titan Group. Inc. v. Faggen, 513 F.2d 234, 238 (2d Cir.), *cert. denied,* 423 U.S. 840 (1975). *In re* Commonwealth Oil/Tesoro Petroleum Securities Litigation, 484 F. Sup. 253, 260 (W.D. Tex. 1979).

44. 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 8.6 at 209 (1967).

45. C. MCCORMICK, MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 343 (Cleary ed. 1972).

46. 491 F.2d 402 (3d Cir. 1974) *cert. denied,* 425 U.S. 993 (1976).

47. *Id.* at 410.

48. *Id. See also* Rifkin v. Crow, 574 F.2d 256, 262 (5th Cir. 1981); Clark v. Cameron-Brown Co., 72 F.R.D. 48, 58 (M.D.N.C. 1976).

In Dwoskin v. Rollins, 634 F.2d 285 (5th Cir. 1981), the presumption of reliance was effectively rebutted in a case involving conversion rights of preferred stock into common stock because plaintiff's evidence showed that the decision to convert the stock, rather than to take the cash redemption price, would not have changed even if the defendant had disclosed the omitted facts, *i.e.*, that the common stock might be restricted. *Id.* at 292.

sumption can be rebutted by showing that, taking into consideration the information available, the investor had knowledge or should have had knowledge of the omitted information.[49]

B. Fraud on the Market Cases

Courts have not restricted the utilization of presumptions of reliance solely to situations in which investors allege nondisclosure. For instance, when plaintiffs claim that misrepresentations distorted the price of a security traded in the open market, reliance on those misrepresentations will be presumed.[50] Federal courts have labeled this viewpoint the fraud on the market theory. This theory has been considered an extension of the presumption of reliance provided in nondisclosure cases to misrepresentation cases involving market transactions.[51]

The fraud on the market theory recognizes that certain elements associated exclusively with the open market[52] may provide the basis for plaintiff's decision to purchase. An individual may decide to purchase securities because of a favorable price trend, price earnings ratio, or some other consideration.[53] Plaintiffs in these situations rely generally "on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price."[54]

The central assumption of the fraud on the market approach is that the market transmits information to investors.[55] This assumption finds support in the efficient market theory, which proposes that all available, relevant information concerning a specific company

49. Hartnett v. Ryan Homes, Inc., 360 F. Supp. 878, 886 (W.D. Pa. 1973), *aff'd,* 496 F.2d 832 (3d Cir. 1974) (court of appeals ruled against plaintiff based on its finding that the omissions were not material).

50. *See, e.g.,* Ross v. A.H. Robins Co., Inc., 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980); Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 381 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975); Koenig v. Smith, 88 F.R.D. 604, 607 (E.D.N.Y. 1980); *In re* LTV Securities Litigation, 88 F.R.D. 134, 142 (N.D. Tex. 1980); Panzirer v. Wolf, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,363 (S.D.N.Y. April 21, 1980).

51. *In re* LTV Securities Litigation, 88 F.R.D. 134, 142 (N.D. Tex. 1980).

52. Open market transactions in securities differ from initial distributions. Open market transactions occur when the stock dealt in has previously been traded. Initial distributions are not preceded by trading in the offered security but consist of public offerings made on behalf of the issuer. 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW, § 6.03, at 6-4 (1978).

53. Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

54. *Id.*

55. This transmission of information results from the interposition of the market between the buyer and the seller. The market performs part of the valuation process usually performed by the investor in face-to-face transactions. "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." *In re* LTV Securities Litigation, 88 F.R.D. 134, 143 (N.D. Tex. 1980).

will be reflected in the price of securities traded in the open market.[56] The theory encompasses "widely followed securities of larger corporations"[57] existing in a "free and actively traded market."[58] Thus, in cases involving misrepresentations of actively traded securities, especially those of large corporations, reliance on the market's integrity is a viable concept because the misrepresentations will be reflected in the price.[59] Arguably, no similar result obtains in an initial offering situation because no basis exists for believing that the market has established a price that reflects all available, relevant information.[60]

Typically, fraud on the market actions are brought as class actions. To defeat class certification, defendants frequently argue that proof of reliance will vary among the proposed members of the class,[61] thereby violating the requirements for class certification procedure.[62] Courts have extended the presumption of reliance originally utilized in nondisclosure cases to class action petitions, in order to obviate the necessity of denying class certification. This extension results whether the alleged violation constitutes a nondisclosure or a misrepresentation.[63]

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56. *See* Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355, 361 (2d Cir. 1979); Comment, *Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend,* 29 STAN. L. REV. 1077, 1089-90 (1970). As stated by one author:

> Basically, efficient capital markets exist when security prices reflect all available public information about the economy, about financial markets, and about the specific company involved. Implied is that market prices of individual securities adjust very rapidly to new information. As a result, security prices are said to fluctuate about their "intrinsic" values.

J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 45 (4th ed. 1977).

57. *In re* LTV Securities Litigation, 88 F.R.D. 134, 144 (N.D. Tex. 1980).

58. Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355, 361 (2d Cir. 1979).

59. "The market price of stocks reflects all available public information—and hence necessarily, any material misrepresentations as well." *In re* LTV Securities Litigation, 88 F.R.D. 134, 144 (N.D. Tex. 1980).

60. *Cf.* Arthur Young & Co. v. United States District Court, 549 F.2d 686 (9th Cir.), *cert. denied,* 434 U.S. 829 (1977), in which the court noted that the purchaser of an original issue should be permitted to rely on the integrity of the regulatory process just as the open market purchaser relies on the integrity of the market. *Id.* at 695.

61. *See, e.g.,* Blackie v. Barrack, 524 F.2d 891, 905 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Pellman v. Cinerama, Inc., 89 F.R.D. 386, 387 (S.D.N.Y. 1981); Dura-Bilt v. Chase Manhattan Corp., 89 F.R.D. 87, 93 (S.D.N.Y. 1981).

62. Rule 23(b)(3) of the Federal Rules of Civil Procedure requires that, for a case to proceed as a class action, the "questions of law or fact common to the members of the class predominate over any questions affecting only individual members. . . ." FED. R. CIV. P. 23(b)(3).

63. *See, e.g.,* Ross v. A.H. Robins Co., Inc., 607 F.2d 545 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980) (misrepresentations to public regarding a company product); Seiffer v. Topsy's Int'l, Inc., 487 F. Supp. 653 (D. Kan. 1980) (misrepresentations and omissions in a prospectus for common stock and debentures); Dura-Bilt Corp. v. Chase Manhattan Corp., 89 F.R.D. 87 (S.D.N.Y. 1981) (misrepresentations in a press release); Greenspan v. Brassler, 78 F.R.D. 130 (S.D.N.Y. 1978) (misrepresentations and omissions in financial reports) (class certification denied on other grounds); Sargent v. Genesco, 75 F.R.D. 79 (M.D. Fla. 1977) (misrepresentations and omissions in prospectus and other financial media); *see also,* Rosenfeld, *The Impact of Class Actions on Corporate and Securities Laws,* 1972 DUKE L.J. 1167 (1972). Mr. Rosenfeld posits that if the complaint alleges that a misrepresentation inflates the price of stock traded on

Extending the presumption of reliance to class action litigants alleging a market fraud theory appears logical because the same considerations that support providing the presumption to an investor under a fraud on the market theory exist in an individual action or in an investors' class action.[64] Moreover, a presumption of reliance in a class setting ameliorates the problem of costly individual trials on the reliance issue.[65] The mere presence of a class action, however, should not furnish the basis for permitting a presumption of reliance. Rather, the basis lies in the fraud on the market claim itself. Therefore, absent an allegation of market fraud, proof of reliance should be required in a case involving misrepresentations.[66]

As in cases involving nondisclosures, the presumption of reliance in a market fraud case sustains from a showing of materiality.[67] Similarly, defendants in market cases are permitted to rebut the presumption of reliance.[68] Affording the defendant an opportunity to rebut follows logically from the proposition that reliance in fraud on the market cases is not eliminated, but rather is placed where it realistically belongs—connecting the purchaser to the market, not to the specific misrepresentation.[69]

A defendant can rebut the presumption of reliance in market fraud cases by two methods. First, proof that the integrity of the market and the alleged misrepresentations were not material[70] will defeat the presumption.[71] Second, the defendants can effectively rebut the presumption by proving that the investors relied primarily on

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the open market, a class action should be permitted on the theory that everyone paid the same excessive price whether or not the misstatement was read. *Id.* at 1178-79.

64. *See* notes 48-63 and accompanying text *supra*.

65. Ruder and Cross, *Limitations on Civil Liability Under Rule 10b-5,* 1972 DUKE L.J. 1125, 1135 (1972).

66. One commentator finds troublesome the suggestion that the presence of a class action in itself dispenses with the need to prove reliance. Among the reasons offered for this position is the enhanced possibility that at least some plaintiffs will recover windfall damages since, unlike the open market context, plaintiffs must ordinarily establish their individual reliance as part of the prima facie case. Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5, supra* note 10, at 597.

67. Ross v. A.H. Robins Co., Inc., 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980); Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Seiffer v. Topsy's Int'l, Inc., 487 F. Supp. 653, 666 (D. Kan. 1980); Koenig v. Smith, 88 F.R.D. 604, 607 (E.D.N.Y. 1980).

68. *See, e.g.,* Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

69. *In re* LTV Securities Litigation, 88 F.R.D. 134, 144 (N.D. Tex. 1980).

70. The United States Supreme Court provided a definition of materiality in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1975) (action brought under § 14(a) of the Securities Exchange Act of 1934). The court noted, "An omitted fact is material if there is a substantial likelihood that a reasonable investor *would* consider it important in deciding how to vote." *Id.* at 449 (emphasis supplied). *Cf.* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), in which the Court stated that facts are material if a "reasonable investor *might have* considered them important" in his decision. *Id.* at 154 (emphasis supplied).

71. Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Panzirer v. Wolf, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH)] ¶ 97363 (S.D.N.Y. April 21, 1980), citing Greenspan v. Brassler, 78 F.R.D. 130 (S.D.N.Y. 1978).

a source other than the integrity of the market in making the decision to purchase.[72]

Panzirer v. Wolf[73] illustrates a successful rebuttal of the presumption of reliânce in a market fraud case. Plaintiff brought on action under rule 10b-5 alleging that she had relied on materially misleading statements contained in the company's annual report, or, alternatively, on the integrity of the market price of the company's stock in making a purchase of five hundred shares. The court denied relief, finding that plaintiff had not relied on the market's integrity or the misrepresentations. Instead, she had relied partially on a discussion with her broker and partially on a newspaper article concerning the company.[74] Thus, defendant successfully rebutted the presumption with proof that plaintiff had relied on a source other than the integrity of the market.

In sum, the rebuttable presumption of reliance that courts have adopted under *Affiliated Ute* nondisclosure cases has evolved to include misrepresentation cases that affect the price of securities traded in the open market. This extension results from a recognition that the market itself can transmit information, including misrepresentations, upon which investors rely. Frequently, this situation arises in a class action with reliance presumed once the materiality of the misrepresentation or nondisclosure is established.[75]

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72. *Id.* The Ninth Circuit has stated this second method of disproving reliance in a slightly different manner, *i.e.*, the defendant can rebut the presumption "by proving that an individual purchased despite knowledge of the falsity of a representation, or that he would have, had he known it." Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

73. [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH)] ¶ 97363 (S.D.N.Y. April 21, 1980).

74. Neither the plaintiff nor her broker had read the company's annual report that contained the misrepresentations. *Id.* Moreover, while the broker did read to the plaintiff a portion of a "tear sheet" relating to the general category of the company's business, he did not read the information concerning the particular company. Thus, the court found that while the plaintiff had relied in part on a discussion with her broker, the discussion did not concern the company's financial statements or condition, and the presumption was effectively rebutted. *Id.*

75. Courts have held that proof of reliance is simply not an issue in certain situations. In Greenfield v. Flying Diamond Oil Corp., [1981 Transfer Binder] FED. SEC. L. REP. (CCH)] ¶ 97942 (S.D.N.Y. March 30, 1981), the court stated that reliance is a "nonissue" with respect to a forced seller in a "tender offer-short form merger" situation.

> Whatever need there may be to show reliance in other situations, we regard it as unnecessary when no volitional act is required and the result of a forced sale is that exactly intended by a wrongdoer. Since the complaint alleges that plaintiff, in effect, has been forced to divest himself of his stock and this is what defendants conspired to do, reliance by plaintiff on the claimed deception need not be shown. What must be shown is that there was deception which misled . . . stockholders and that this was in fact the cause of plaintiff's claimed injury.

Id. (quoting Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir. 1967)).

IV. Legislative History and Judicial Interpretation of Section 10(b) and Rule 10b-5

A. *Legislative History*

The legislative history of section 10(b) offers little guidance on the contours of a private action under section 10(b) and rule 10b-5. The statement most frequently encountered concerning the purposes of section 10(b) is that of Thomas G. Corcoran, a spokesman for the drafters of the 1934 Act. Mr. Corcoran remarked that section 10(b) was broadly intended as a "catch-all clause."[76] Courts frequently cite this statement as grounds for an expansive interpretation of section 10(b).[77] Interestingly, amidst the debate concerning section 10(b) and rule 10b-5, Congress has never limited the implied remedies recognized under section 10(b).[78]

B. *Judicial Interpretation*

Given the paucity of sufficient legislative statements on the subject, an analysis of the judicial perception of the policies and purposes behind the securities laws and rule 10b-5 is useful. The United States Supreme Court has stated that Congress intended the securities laws and regulations enacted for the purpose of avoiding fraud to be construed not "technically, and restrictively, but flexibly to effectuate [their] remedial purposes."[79] Recently, however, the Court qualified generalized references to the remedial purposes of the 1934 Act. In refusing to recognize an implied right of action under section 17(a) of the 1934 Act,[80] the Court noted that broad references to the remedial purposes of the securities laws will not justify reading a

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76. Mr. Corcoran noted:

> Subsection (c) says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices. [Congress enacted Subsection (c) as Section 10(b).]

Stock Exchange Regulation: Hearings on HR 7852 and HR 8720 Before the House Committee on Interstate and Foreign Commerce, 73rd Cong. 2d Sess., 115 (1934), reproduced in 8 ELLENBERGER AND MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, Item 23, at 115 (1973).

77. *See* 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 2.2(333) (1979).

78. Congress has, however, resisted attempts to give § 10(b) a more expansive reading. For example, in 1957 and in 1959 the Securities Exchange Commission urged Congress to amend § 10(b), charging its wording from "in connection with the purchase or sale of any security" to "in connection with the purchase or sale, *or any attempt to purchase or sell,* any security." 103 CONG. REC. 11636 (1957) (emphasis added); *SEC Legislation: Hearings on S. 2345 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 85th Cong., 1st Sess. (1957); *SEC Legislation: Hearing on S. 1178-82 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 86th Cong., 1st Sess., 67-68 (1959). Congress rejected the proposed change in both instances based on fears that the change would cause extended civil liability.

79. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1975); Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

80. 15 U.S.C. § 78q(a) (1976).

statutory provision more broadly than the language of the statute and the statutory scheme reasonably permit.[81]

The Court has articulated other purposes to be accommodated in construing the securities laws. These purposes include preservation of the integrity of the securities markets,[82] promotion of a high standard of business ethics in the securities industry,[83] and substitution of the philosophy of full disclosure for that of *caveat emptor*.[84] Lower federal courts describe the policies behind the securities laws either as promoting full disclosure or protecting investors from fraudulent practices.[85]

Whether the desired policy behind the securities laws is full disclosure or the protection of investors becomes important in attempting to ascertain the proper parameters of the reliance requirement in actions brought under rule 10b-5.[86] If the desired policy is full disclosure, an expansive reading of the reliance requirement, which would permit an investor to rely on the integrity of the market in an initial offering, is unjustified.[87] Permitting the investor to rely solely on the integrity of the market would emasculate the policy of full disclosure because plaintiffs could recover without any reference to the disclosure documents.[88] Conversely, if the policy is to protect

81. Touche Ross & Co. v. Redington, 442 U.S. 560, 576 (1979) (citing Securities Exchange Commission v. Sloan, 436 U.S. 103, 116 (1978)).

82. Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

83. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1975); Securities Exchange Comm'n v. Capital Gains Research, 375 U.S. 180, 186 (1963).

84. *Id.*

85. *See, e.g.,* Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981) (en banc), *petition for cert. filed,* 50 U.S.L.W. 3474 (U.S. Nov. 2, 1981) (No. 81-839) (protection of investors); O'Brien v. Continental Illinois Nat'l Bank & Trust of Chicago, 593 F.2d 54, 60 (7th Cir. 1979) (full disclosure); SEC v. International Chem. Dev. Corp., 469 F.2d 20, 26 (10th Cir. 1972) (protection of investors); Issen v. GSC Enterprises, 508 F. Supp. 1278, 1289 (N.D. Ill. 1981) (full disclosure); Rubenstein v. I.U. Corp., 506 F. Supp. 311, 315 E.D. Pa. 1980) (full disclosure).

86. The purpose of the securities laws constituted a major point of contention between the majority and the dissent in Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), *petition for cert. filed,* 50 U.S.L.W. 3474 (U.S. Nov. 2, 1981) (No. 81-839). The majority vacated the summary judgment granted defendant despite plaintiff's lack of reliance on the offering documents. The majority opinion based its decision upon its perception of the purpose behind the security laws: the promotion of free and honest securities markets with full disclosure being only one means to achieving that end. *Id.* at 470. The dissent argued that the security laws

> were not intended to create a scheme of investor's insurance or to regulate directly the underlying merits of various investments . . . the federal securities laws are based on the premise that the federal government's role is merely to ensure the free flow of complete and accurate information within the Nation's securities markets; *once full disclosure is achieved, individual investors are expected to look out for their own interests.*

Id. at 482 (emphasis supplied).

87. Statements by the Supreme Court in Santa Fe Indus. v. Green, 430 U.S. 462 (1977), support this conclusion. The Court described the "fundamental purpose" of the 1934 Act as full disclosure. "[O]nce full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." *Id.* at 477-78.

88. This result seems especially evident in a case like Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), *petition for cert. filed,* 50 U.S.L.W. 3474 (U.S. Nov. 2, 1981) (No. 81-839), in which the Court permitted plaintiff to recover even though he admitted never reading the offering documents.

investors and the integrity of the market, a more expansive approach to the reliance requirement is justified to ensure that virtually all fraudulent activities are brought within the rule's proscription.[89]

Courts, however, do not neatly categorize the policies behind section 10(b) and rule 10b-5 as either the promotion of full disclosure or the protection of investors from fraudulent activities. The acceptable approach considers the purposes of the securities laws to be both full disclosure and the protection of investors.[90] Thus, judicial pronouncements concerning the purposes of the securities laws provide conflicting guidance on the requisite reliance element in initial distributions involving misrepresentations. Recent Supreme Court decisions that restrict liability in actions brought under section 10(b) and rule 10b-5 provide a proper measure of the permissible scope of the reliance requirement.[91]

C. *Recent Supreme Court Restrictions on the Scope of Section 10(b) and Rule 10b-5*

The Supreme Court began its restrictive construction of rule 10b-5 in a series of cases beginning in 1975[92] with *Blue Chip Stamps v. Manor Drug Stores*.[93] In *Blue Chip*, plaintiff had been offered a registered stock distribution pursuant to an antitrust consent decree. Two years after this offering, plaintiff filed suit alleging that he and the class of offerees whom he was seeking to represent refrained from accepting the offer because the prospectus prepared for the issue was materially misleading in its overly pessimistic appraisal of the company's status and future prospects. The Court refused to allow plaintiff to recover.[94]

In denying recovery, the Court placed its imprimatur on the buyer-seller requirement, otherwise known as the *Birnbaum* doctrine.[95] Under the *Birnbaum* rule, only persons who have purchased

89. *See generally* note 79 *supra*.

90. For example, in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the Court stated that the purposes of the securities laws were to provide full disclosure *and* to provide a high standard of business ethics in the securities industry. *Id.* at 151 (citing Securities Exchange Comm'n v. Capital Gains Research, 375 U.S. 180, 186 (1963)).

91. Professor Bromberg has labeled this viewpoint the "Contraction Era" for 10b-5 and the other antifraud provisions. 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 2.2 (463) (1979). The Contraction Era contrasts with the expansive and liberal approach toward securities litigation undertaken by the lower federal courts from 1946 to 1975. *See* Brooks, *Rule 10b-5 in the Balance: An Analysis of the Supreme Court's Policy Perspective,* 32 HASTINGS L.J. 403, 411 (1980).

92. "Post-1974 Supreme Court decisions concerning rule 10b-5 private damages actions leave little doubt that, in the eyes of the Supreme Court, the lower federal courts have been goring the wrong ox for nearly three decades." *Id.* at 404.

93. 421 U.S. 723 (1975).

94. *Id.*

95. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), first recognized that a person must be either a purchaser or a seller of the securities in order to bring an action under § 10(b) or rule 10b-5.

or sold securities may maintain an action under section 10(b) and rule 10b-5.[96] Since plaintiff was not a purchaser of the securities in question, but rather alleged that the misleading prospectus deterred his purchase, the Court barred his recovery. Justice Rehnquist's opinion found support for this interpretation in the longstanding acceptance by the lower federal courts of *Birnbaum*'s "reasonable interpretation of the wording of § 10(b),"[97] as well as in congressional failure to reject the *Birnbaum* interpretation as developed.[98]

Restrictive attitudes concerning rule 10b-5 litigation continued in *Ernst & Ernst v. Hochfelder*,[99] in which investors victimized by a fraudulent scheme perpetrated by the president of a brokerage firm instituted an action for damages against an accounting firm that had been retained to audit the brokerage firm's books. Plaintiffs based their claim exclusively on the negligence of the accounting firm, claiming that the accountants' failure to investigate the company's internal accounting procedure caused the fraud to remain undetected. The issue presented to the court was whether section 10(b) and rule 10b-5 would support an action for merely negligent conduct.[100]

The Court concluded that a private cause of action for damages cannot be maintained under section 10(b) and rule 10b-5 absent an allegation of scienter.[101] The Court heavily emphasized the plain meaning of the words "manipulative," "device," and "contrivance" in section 10(b),[102] because the words made "unmistakable a congressional intent to proscribe a type of conduct quite different from negligence."[103] Thus, the Court added the requirement of scienter to plaintiff's prima facie case, further restricting the potential reach of rule 10b-5 litigation. Recently, the Supreme Court took a similar position on enforcement proceedings by the SEC. In *Aaron v. Securities Exchange Commission*,[104] the Court held that scienter is a necessary element in civil actions brought by the SEC to enjoin violations

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96. *See* note 95 *supra*.

97. 421 U.S. at 733.

98. *Id.* Note, however, that the Court found no specific congressional support for maintaining the *Birnbaum* rule, either. Rather, the Court stated: "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 another unless and until Congress addresses the question." *Id.* at 749.

99. 425 U.S. 185 (1975).

100. *Id.* at 197.

101. The Court defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud," specifically leaving open the question whether this standard includes reckless behavior. *Id.* at 193 n.12. For a discussion of the various possible interpretations of the term "scienter" in rule 10b-5 actions, *see* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder,* 29 STAN. L. REV. 213, 218-27 (1977).

102. The Court utilized Webster's Dictionary to ascertain the plain meanings of the words "device" and "manipulate." *Id.* at 199.

103. *Id.*

104. 446 U.S. 680 (1980).

of section 17(a)(1) of the Securities Act of 1933,[105] section 10(b), and rule 10b-5.[106]

In *Santa Fe Industries, Inc. v. Green*,[107] the Court stated that only manipulative or deceptive practices by the defendant violate rule 10b-5. The case arose in the context of a Delaware short-form merger statute.[108] Plaintiffs, the minority stockholders of the subsidiary company, alleged that the stock of the subsidiary had been fraudulently appraised in an effort to freeze out the minority at an inadequate price. Plaintiffs rejected the appraisal remedy provided under Delaware law and brought an action under section 10(b) and rule 10b-5.[109]

The Court held that a claim of breach of fiduciary duty must be supported by allegations of manipulation or deception in order to violate either section 10(b) or rule 10b-5.[110] Defendant had effected the merger without manipulation or deception and had furnished the minority stockholders with all relevant information concerning the merger. Thus, the stockholders could choose to accept or reject the offer on the basis of that information.[111] As in *Ernst & Ernst v. Hochfelder*[112] the Court examined the language of section 10(b) and found no indication that Congress intended to prohibit conduct without manipulation or deception.[113] The Court specifically rejected the interpretation that the term "fraud" brought all breaches of fiduciary duty in connection with securities transactions within the ambit of rule 10b-5.[114]

Finally, the Court recently decided *Chiarella v. United States,*[115] which concerned the activities of a "mark up man" [116] for a New

105. 15 U.S.C. § 77q(a) (1976).

106. 446 U.S. at 681.

107. 430 U.S. 462 (1976).

108. The Delaware statute permits a parent company owning at least 90% of a subsidiary's stock to merge with the subsidiary and to make cash payments for the shares of the minority shareholders. Although the statutory provision does not require advance notice to or consent of the minority shareholders, they must be notified within ten days of the merger's effective date. Any minority shareholder dissatisfied with the offering price can petition the Delaware Court of Chancery for the payment of the fair value of his shares as determined by a court-appointed appraiser, subject to court review. DEL. CODE ANN. tit. 8, § 253(a) (1974).

109. 430 U.S. at 466-67.

110. 430 U.S. at 473-74.

111. *Id.* at 474.

112. 425 U.S. 185 (1975).

113. 430 U.S. at 473.

114. The Court stated that use of the term "fraud" to bring all breaches of fiduciary duty within the proscriptions of rule 10b-5 would, "like the interpretation rejected by the Court in *Ernst & Ernst,* 'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.'" *Id.* at 472 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. at 199).

115. 445 U.S. 222 (1980).

116. Plaintiff, as a "mark up man," selected the type fonts and page layouts for five separate takeover bids. The names of the target companies to be acquired were concealed, but plaintiff used his knowledge of securities to ascertain the names. United States v. Chiarella, 588 F.2d 1358, 1363 (2d Cir. 1978).

York financial printer. During the course of his employment, the printer handled corporate documents announcing five takeover bids, enabling him to ascertain the names of the target companies before the final printing. Based on this knowledge, he purchased target company stock for his own account without disclosing to the sellers the information he had acquired through his employment. The printer sold the shares immediately after the takeover bids were announced publicly and realized a substantial profit.[117] The Second Circuit Court of Appeals affirmed the printer's conviction on seventeen counts of violating section 10(b) and rule 10b-5.[118]

The Supreme Court reversed. The Court initially noted that the printer's use of the information would not constitute a fraud under section 10(b) unless he had an affirmative duty to disclose,[119] thus rejecting the view that anyone who regularly receives material nonpublic information must disclose the information or refrain from trading.[120] No duty existed because the printer had not been a party to any prior dealings with the sellers.[121] A duty to disclose under the antifraud provisions of the securities laws did not arise from mere possession of nonpublic information or from one's position as a market insider; rather, that duty arose from a relationship of "trust and confidence" between the parties to a securities transaction.[122]

Once again, the Court examined the language and history of section 10(b) and found no basis for expanding the concept of duty to include situations in which a relationship of trust and confidence did not bind the parties.[123] Failure by Congress and the SEC to adopt a "parity of information rule"[124] supported the court's conclu-

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117. In the course of fourteen months, the printer realized a gain of more than $30,000. 445 U.S. at 224.

118. 588 F.2d 1358 (2d Cir. 1978). This was the first criminal proceeding in which a court imposed criminal liability on a purchaser for a § 10(b) nondisclosure. For an analysis of *Chiarella, see* Cann, *A Duty to Disclose? An Analysis of Chiarella v. United States,* 85 DICK. L. REV. 249 (1981).

119. 445 U.S. at 231, "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Id.* at 235.

120. Cann, note 118, at 253.

121. Justice Powell stated:

> No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

445 U.S. at 232-33.

122. The Court noted that affirmance of petitioner's conviction would result in a general duty in the field of securities to forego *any* action based on material, nonpublic information. The Court wanted to see explicit congressional intent before formulating such a broad duty. *Id.* at 233. Normally, in a business transaction, one party is under a duty to disclose to the other "matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them. . . ." RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

123. 445 U.S. at 233.

124. *Id.* The SEC has, however, adopted a new rule in response to the *Chiarella* decision.

sion that the 1934 Act could not be read "more broadly than its language and the statutory scheme reasonably permit."[125]

These cases aptly illustrate the attitude of the Supreme Court on the permissible scope of rule 10b-5 litigation. Absent express congressional support, a case will be dismissed on the pleadings if plaintiff attempts to expand liability under rule 10b-5.[126] This restrictive interpretation buttresses the conclusion that any attempt to extend the parameters of recovery under rule 10b-5 should be pursued with caution.

The Supreme Court's restrictive attitude is also evident in the Court's disenchantment with implied rights of action in other areas of securities law. A series of recent Supreme Court cases proceeded beyond questioning the scope of various implied remedies to questioning the very existence of these remedies.[127] *Cort v. Ash,*[128] in which the Court attempted to "assemble sixty years of case law relating to the implication of private remedies into a harmonious whole,"[129] is the pivotal case in the area of implied rights of action. The *Cort* opinion established a four-part test for determining when a private remedy should be recognized under any statute that does not explicitly grant a private remedy.[130]

In two securities cases following *Cort,* the Supreme Court refused to recognize a private cause of action in favor of aggrieved investors.[131] First, in *Touche Ross & Co. v. Redington,*[132] the Court

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The rule establishes a "disclose or abstain from trading requirement" specifically relating to material, nonpublic information obtained during the course of a tender offer. The rule requires that if any person has commenced, or taken substantial steps to commence a tender offer, then any other person who has acquired material nonpublic information from the offeror shall disclose the information to the public prior to dealing or refrain from trading in the securities. 17 C.F.R. § 240.14e - 3(a) (1981).

125. 445 U.S. at 234 (quoting Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979)). The Court previously utilized this identical language in restricting the reach of remedies under the securities laws. *See, e.g.,* Aaron v. Securities Exchange Commission, 446 U.S. 680, 695 (1980).

126. *See* Brooks, *supra* note 91, at 422-23.

127. *See, e.g.*, Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979); Cort v. Ash, 422 U.S. 66 (1975).

128. 422 U.S. 66 (1975).

129. Frankel, *Implied Rights of Action,* 67 VA. L. REV. 553, 559 (1981).

130. The *Cort* test is stated as follows:

> In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant, First, is the plaintiff "one of the class for whose *especial* benefit the statute was enacted"—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of a legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

422 U.S. at 78 (emphasis supplied by the Court) (citations omitted).

131. *See* notes 132-38 and accompanying text *infra*.

132. 442 U.S. 560 (1979).

denied an implied remedy under section 17(a) of the 1934 Act.[133] Resisting appeals made to the remedial purposes of the Act, the Court based its decision on congressional failure to create a private remedy either expressly or by implication.[134] Similarly, in *Transamerica Mortgage Advisors, Inc. v. Lewis,*[135] the Court refused a private remedy to an investor under section 206 of the Investment Advisers Act of 1940,[136] a statutory provision closely resembling rule 10b-5.[137] As in *Touche Ross,* the Court's analysis began and ended with the question whether Congress intended to confer a private remedy. The Court found that Congress did not so intend.[138]

Litigants have since raised the issue whether continued recognition of an implied right of action under section 10(b) is warranted in light of the Supreme Court's stance on implied statutory remedies in other areas of securities law.[139] One author has recognized that preserving the implied private cause of action under section 10(b) conflicts with the decisions in *Touche Ross* and *Transamerica* because no congressional intent exists to authorize a private lawsuit under section 10(b).[140] The Supreme Court also has expressed dissatisfaction with the recognition of an implied private remedy under section 10(b), by noting that the decision that recognized a private right of action under section 10(b)[141] was simply an explicit acquiescence "in the 25-year-old acceptance by the lower federal courts of an implied

133. 15 U.S.C. § 78q(a) (1976).

134. 442 U.S. at 575-76.

135. 444 U.S. 11 (1979).

136. 15 U.S.C. § 80b-6 (1976).

137. Section 206 provides:

> It shall be unlawful for any investment advisor, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> . . . .
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative. . . .

Id.

138. The Court did not consider the other factors mentioned in the *Cort* analysis:

> It is true that in Cort v. Ash, the Court set forth four factors that it considered 'relevant' in determining whether a private remedy is implicit in a statute not expressly providing one. But the court did not decide that each of these factors is entitled to equal weight. The central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action. Indeed the first three factors discussed in *Cort*—the language and focus of the statute, its legislative history, and its purpose . . .—are ones traditionally relied upon in determining legislative intent.

444 U.S. 11, at 23-24 (quoting Touche Ross & Co. v. Redington, 442 U.S. at 575-76). Thus, congressional intent has become the touchstone for implying private remedies under federal statutes.

139. Wachovia Bank & Trust v. National Student Mktg., 650 F.2d 342 (D.C. Cir. 1980).

140. Frankel, *supra* note 129, at 563-64.

141. Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6 (1971).

action under § 10(b)."[142] Abrogation by the Supreme Court of the implied remedy currently recognized under section 10(b) and rule 10b-5 is unlikely. Nonetheless, the *Touche Ross* and *Transamerica* decisions express the Court's dissatisfaction with private damage actions in the context of securities regulation.[143] Accordingly, this dissatisfaction militates against expansion of private actions under section 10(b).

Thus, neither legislative history nor judicial pronouncements on the purposes of section 10(b) provide much guidance in establishing the parameters of the reliance requirement in an initial offering involving misrepresentations. One can argue, however, that current judicial attitudes on implied statutory remedies indicate that an expansive approach to the reliance requirement should not be adopted. These judicial attitudes have prompted some commentators to suggest that plaintiffs explore alternate means of seeking redress in securities litigation.[144]

V. Policy Considerations

In *Blue Chip Stamps v. Manor Drug Stores,*[145] Justice Rehnquist specifically stated that policy considerations are a proper subject of inquiry in 10b-5 litigation.[146] Difficulty inheres in the policy area, however, because competing policy considerations often surface during 10b-5 litigation. Certain considerations support a unified reliance requirement in all cases, whether the transaction included misrepresentations or nondisclosures. Other policy considerations support strict adherence to traditional reliance concepts in the context of misrepresentations in initial distributions.[147]

142. Touche Ross & Co. v. Redington, 442 U.S. at 577 n.19; Cannon v. University of Chicago, 441 U.S. 676, 690 n.13 (1979).

143. Frankel, *supra* note 129, at 563.

144. Some commentators have suggested that plaintiffs pursue litigation alternatives to rule 10b-5 either under state law or under express federal remedies. At the state level, available remedies include common law actions such as common law fraud, breach of contract, conversion, and breach of fiduciary duty. State Blue Sky statutes also provide express remedies. Express federal remedies that provide a viable alternative to rule 10b-5 litigation include: § 11 of the Securities Act of 1933, 15 U.S.C. § 77k(c) (1976), § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2) (1976), § 18 of the Securities Exchange Act of 1934, 15 U.S.C. § 78r (1976). For a discussion of these remedies, *see, e.g.,* Brooks, *supra* note 91, at 423-30.

145. 421 U.S. 723 (1975).

146. *Id.* at 737.

147. The many different suggestions advanced by the commentators on the proper role of reliance in 10b-5 actions are evidence that policies often compete. *See* Bucklo, *Scienter and Rule 10b-5,* 67 NEV. L. REV. 562, 592 (1972) ("the debate over reliance, while at present unsettled, seems likely to conclude with the elimination of that element"); Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement,* 26 S. CAR. L. REV. 653, 681-82 (1975) (in a discussion of misrepresentations occurring in face-to-face transactions, the author proposes that "plaintiff can meet his burden of proof with respect to subjective reliance and causation-in-fact by a showing of materiality. . ."); Stoll, *Reliance as an Element in 10b-5 Actions,* 53 ORE. L. REV. 169, 171 (1974) (courts should "recognize that affirmative misrepresentations to individual plaintiffs fall under the same consider-

The function of reliance in 10b-5 litigation underlies any discussion of policy. Reliance establishes causation between the defendant's wrongdoing and the plaintiff's loss.[148] Courts generally hold that reliance remains an issue in all 10b-5 cases, whether cases of misrepresentation or nondisclosure, with proof of reliance serving as a prerequisite to recovery in most misrepresentation cases and lack of reliance serving as an affirmative defense in nondisclosure cases.[149] The causal connection provided by proof of reliance functions "to qualify, as between insiders and outsiders, the doctrine of *caveat emptor*—not to establish a scheme of investor's insurance."[150] In this manner, the "potentially limitless thrust"[151] of rule 10b-5 is confined to situations in which causation in fact exists.

Policy arguments can be marshalled in favor of creating a uniform presumption of reliance for all 10b-5 actions.[152] The often indiscernible distinction between misrepresentations and nondisclosures is one consideration that supports this approach. A plaintiff's claim, either intentionally or of necessity, often contains hybrid allegations. As a result, "all actions for securities do not fit neatly into categories of misrepresentation or nondisclosure."[153] Plaintiffs commonly frame their complaints entirely in terms of nondisclosure in order to gain the advantages of the *Affiliated Ute* presumption,[154] thereby avoiding the necessity of proving reliance.[155] In one instance, purchasers of a corporation's common stock brought an action under rule 10b-5 against corporate officers and underwriters, alleging that untrue statements had been published in various financial data.[156] Defendants contended that the claims were grounded in terms of active misrepresentation, which required indi-

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ations of policy . . . as other 10b-5 cases" and move "subjective reliance from the status of a requirement of the plaintiff's prima facie case to the status of an affirmative defense."); Comment, *supra* note 10, at 748-49 ("I . . . urge the alignment of the balance of the 10b-5 actions under the same presumption of causation, thus . . . abandoning the use of reliance as an operative term."); Note, *supra* note 10, at 584 ("a presumption applicable to all cases would be inappropriate"; the author proposes a presumption applicable only to situations of nondisclosure and "fraud effected through an impersonal market.").

148. *See, e.g.,* Dwoskin v. Rollins, Inc., 634 F.2d 285, 291 n.4 (5th Cir. 1981); Vervaecke v. Chiles, Heider & Co., Inc., 578 F.2d 713, 715 (8th Cir. 1978); Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975); 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 8.7, at 213 (1979).

149. Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981). Traditionally, plaintiff assumes the burden of proving reliance in fraud actions. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 41, at 241 (4th ed. 1971).

150. List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965).

151. Dwoskin v. Rollins, Inc., 634 F.2d 285, 291 n.7 (5th Cir. 1981) (quoting Titan Group Inc. v. Faggen, 513 F.2d 234, 239 (2d Cir.), *cert. denied,* 423 U.S. 840 (1975)).

152. *See, e.g.,* Stoll, *supra* note 147, at 171; Comment, *supra* note 10, at 748-49.

153. Sargent v. Genesco, 75 F.R.D. 79, 84 (M.D. Fla. 1977).

154. *See* notes 37-49 and accompanying text *supra*.

155. *See, e.g.,* Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981); Dura-Bilt Corp. v. Chase Manhattan Corp., 89 F.R.D. 87 (S.D.N.Y. 1981).

156. Sargent v. Genesco, 75 F.R.D. 79 (M.D. Fla. 1977) (motion for class certification).

vidual proof of reliance. Plaintiffs contended that nondisclosures characterized the complaint and that individual proof of reliance was not necessary.[157] The court accepted plaintiffs' position and reasoned that since the claims could not be characterized as either misrepresentation or nondisclosure, the remedies of the Securities Exchange Act should be viewed flexibly to achieve a high standard of integrity in the securities industry.[158]

A similar situation that causes conceptual difficulty arises when a complaint intentionally alleges both nondisclosure and misrepresentation. The Third Circuit recently recognized this problem in *Sharp v. Coopers & Lybrand.*[159] The purchaser of a limited partnership interest brought an action on behalf of himself and others against an accounting firm that prepared an opinion letter regarding the tax treatment of an investment. On appeal, the accounting firm argued that the trial court erred by allowing a presumption of reliance on the misrepresentations and nondisclosures in the opinion letter.[160]

The court initially concluded that the case involved both misrepresentations and nondisclosures, and then noted that strict adherence to the misrepresentation-nondisclosure distinction would require a dual jury instruction. The jury would have to be instructed to search for proof of reliance for the misrepresentations and for proof of nonreliance for the omissions.[161] The court found this approach confusing and unacceptable, but recognized that "a steadfast rule requiring defendant to refute a presumption of reliance would be neither equitable nor logical."[162] Accordingly, the appellate court adopted a flexible approach, holding that cases involving both misrepresentations and nondisclosures require the trial court to analyze the plaintiff's allegations in light of the likely proof at trial, to determine the most reasonable placement of the burden of proof.[163] Thus, the burden of proving reliance in the Third Circuit may rest on either party, depending upon the facts of a particular case.

Cases in which it is difficult to characterize a defendant's action as either a misrepresentation or a nondisclosure, or cases in which

157. The plaintiffs asserted that the defendants were guilty of "one big omission." *Id.* at 84. The alleged omission was the defendants' failure to include an accurate statement of the depleted financial condition of the corporation in the prospectus and other financial media that contained the misrepresentations and omissions. *Id.*

158. The court analogized its position to a fraud on the market claim, but it did not specifically adopt the fraud on the market theory. Arguably, plaintiffs could have utilized this theory since they claimed that the value of the stock had been artificially inflated in an open market setting. *Id.* at 81.

159. 649 F.2d 175 (3d Cir. 1981).

160. *Id.* at 180.

161. *Id.* at 188.

162. *Id.* *See generally* Stoll, *supra* note 147, at 171; Comment, *supra* note 10, at 748-49.

163. 649 F.2d at 188.

both misrepresentations and nondisclosures constitute the alleged fraudulent activity support arguments in favor of a uniform treatment of the reliance requirement. This uniform treatment could be providing plaintiffs a presumption of reliance in all situations, including misrepresentations in initial offerings.[164] Other policy considerations, however, counsel in favor of requiring plaintiffs to prove reliance in initial distributions with alleged misrepresentations.[165]

In recent cases restricting the reach of rule 10b-5 in securities litigation, the Supreme Court emphasized policy considerations to support its decisions, with one major concern being settlement value.[166] Specifically, the Court noted that even a complaint with little objective chance of success at trial has settlement value to the plaintiff provided the plaintiff can prevent dismissal or summary judgment.[167] The very "pendency of the lawsuit may frustrate or delay normal business activity of the defendant,"[168] causing the defendant to accept a settlement offer even when the plaintiff's case lacks merit.[169] Thus, the defendant often chooses to reach an agreement with the plaintiff rather than assume the risk of an adverse judgment or incur the costs of preparation for litigation.[170]

Furthermore, in discussing an implied right of action under rule 10b-5, one commentator noted that costs created by the enforcement of private liability extend beyond the immediate defendant.[171] Judgment costs to a corporation translate into increased capital costs. "In that event, not only do shareholders sustain a loss, but the productivity of the firm may decline—at some cost to society."[172] Thus, expansive concepts of private enforcement may hinder investment by deterring the issuance of securities.[173]

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164. Additioinal policy arguments support providing plaintiffs with a presumption of reliance in initial offerings. For example, one commentator suggests that "the in terrorem effect of deleting reliance may result in fewer misleading statements being made." Campbell, *supra* note 147, at 680. Also, it seems appropriate to provide plaintiffs with all means that might facilitate recovery so as to preclude the chance that the wrongdoer may escape liability after engaging in fraudulent activity.

165. *See* notes 166-178 and accompanying text *infra*.

166. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 740.

167. *Id.*

168. *Id.*

169. Judicial concerns regarding "vexatious litigation" exist concomitantly with concerns for settlement value. *See, e.g.,* Santa Fe Indus. v. Green, 430 U.S. at 478-79.

170. For example, one recent study examined specific settlements and judgments in the context of shareholder derivative and class action lawsuits. The author concluded:

> [W]hen stockholders press their cases, their chances of obtaining some measure of relief are quite good; over 75% of such cases resulted in either settlements, accommodation by the defendants, or a judgment in favor of the plaintiffs. *Of these three modes of termination, settlements accounted for the vast majority (94%),* accommodation for 5% and judgments for only 1%.

Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits,* 60 B.U.L. REV. 542, 567 (1980) (emphasis supplied).

171. Frankel, *supra* note 129, at 577-78.

172. *Id.*

173. *Id.*

Another consideration supporting the viewpoint that plaintiffs should be required to prove reliance on the particular misrepresentations in initial offerings is the cost of mandatory corporate disclosure documents. One recent study conservatively estimated the cost of SEC new issue disclosures at $193 million for 1975.[174] This high cost and the concomitant policy that investors be encouraged to examine disclosure materials illustrate the importance of these documents. In *Shores v. Sklar,*[175] however, the court permitted plaintiff to plead market fraud despite his admitted lack of reliance on the offering materials.[176] Permitting a plaintiff to recover based on the integrity of the market in an initial offering seemingly lessens the importance of the requirement that issuers furnish investors with disclosure documents.

Deciding whether plaintiffs alleging misrepresentations in initial offerings should be required to prove reliance on the misrepresentations requires balancing competing policy concerns. The occasional difficulty in distinguishing between misrepresentations and nondisclosures, the desire to deter misrepresentations, and the policy of punishing wrongdoers support a more relaxed reliance requirement. The Fifth Circuit adopted this approach by analogizing an initial offering situation to the fraud on the market theory developed in the context of securities traded in the open market.[177] Other considerations, however, mandate adherence to the requirement that plaintiff prove reliance on the alleged misrepresentations. These considerations include the need to establish causation between the defendant's act and the plaintiff's injury, the adverse effects of settlement value on defendants, and the emasculation of mandatory disclosure procedures.[178]

VI. Conclusion

The reliance requirement in securities litigation has evolved to accommodate plaintiffs in circumstances in which the reliance requirement previously would have barred their recovery. When the defendant has simply failed to disclose or when misrepresentations have affected the price of stock traded in the open market, courts do not and should not require plaintiffs to prove reliance on the fraudulent activity. Rather, courts provide plaintiffs with a presumption of reliance.

The reasons supporting this presumption fail, however, if the

174. S. Phillips & P. Zecher, The SEC and the Public Interest 51 (1981).

175. 647 F.2d 462 (5th Cir. 1981) (en banc), *petition for cert. filed,* 50 U.S.L.W. 3474 (U.S. Nov. 2, 1981) (No. 81-839).

176. *Id.* at 468.

177. *Id.* at 468-69.

178. *See* note 146 *supra.*

alleged misrepresentations occur in initial distributions. In these situations plaintiffs face no unreasonable evidentiary burden in proving reliance. Moreover, plaintiffs should not be permitted to rely on the integrity of the market since no basis exists for assuming that the market has set an accurate price reflecting all information. Therefore, plaintiffs bringing actions under section 10(b) and rule 10b-5 in initial offerings should be required to prove reliance on the misrepresentations. The Supreme Court's current restrictive attitude toward section 10(b) and rule 10b-5 litigation, as well as its position on implied rights of action, especially compel this result.

DAVID W. SWARTZ