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Recommended Citation

Jonathan R. Macey, *Fraud on the Market Theory: Some Preliminary Issues*, 74 Cornell L. Rev. 923 (1989)
Available at: <http://scholarship.law.cornell.edu/clr/vol74/iss5/8>

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THE FRAUD ON THE MARKET THEORY: SOME PRELIMINARY ISSUES

Jonathan R. Macey†

Professor Fischel has been a pioneer in the application of finance theory to resolve legal disputes. When the United States Supreme Court embraced the fraud on the market theory in *Basic Inc. v. Levinson*,¹ it adopted the suggestions made by Professor Fischel on the subject in his important article, *Use of Modern Finance Theory in Security Fraud Cases Involving Actively Traded Securities*.² The article Professor Fischel presents today reflects important extensions and applications of his earlier work.

Professor Fischel has shown that the fraud on the market theory is a coherent theory for imposing liability on defendants and that the theory is firmly grounded on well proven notions in financial economics about market efficiency. Now, thanks in large part to the theories of liability suggested by Professor Fischel, plaintiffs in securities fraud cases no longer must prove that they actually relied on any alleged misstatements or omissions by the defendant in order to recover. Rather than showing reliance, such plaintiffs need only show that the market on which the securities traded was efficient. The Court has reasoned that in situations in which plaintiffs reasonably are entitled to rely on the integrity of the market price of a security, they may obtain damages for misstatements or omissions by the defendant that causes the price of that security to deviate from its "correct" level.

In addition to its conclusion that the fraud on the market theory provides a coherent basis for imposing liability on defendants, it now appears well settled that the theory is firmly grounded on well proven notions in financial economics about market efficiency, and that recovery based on the fraud on the market theory does not comprise a mere investor insurance scheme. Investors may only recover if they can allege and prove (1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4)

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¹ 108 S. Ct. 978 (1988).

² Fischel, *Use of Modern Finance Theory in Security Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982).

that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.³

But is it enough simply to demonstrate that the fraud on the market theory presents a theory of recovery that is not logically inconsistent? It does not seem to me that we can conclude that the fraud on the market theory is socially desirable merely because it is *coherent*. Just as surely as coherence is a necessary condition for imposing liability on corporate defendants; it is not a sufficient condition for doing so. Rather, it must be linked up with some underlying theory about property rights in information in order to form a complete theory of liability.⁴

An example from Professor Fischel's paper is instructive in this regard.⁵ Professor Fischel describes an American company called Waste Incorporated that announces that it has entered into a contract with the government of Saudi Arabia for the provision of waste management services and the company issues a press release announcing that it has obtained the new contract. However, the company does not disclose that the contract also contains a provision that allows the Saudis to terminate the contract at will. After the press release, the price of Waste's shares goes up because the market presumes that the company has a binding agreement. When the Saudis terminate and the price of Waste's stock declines, the people who have purchased between the time of the press release and the time of the decline in price bring suit. To what extent should these people be entitled to rely on the integrity of the market price for Waste, Inc's shares?

In this context, which Professor Fischel views as an unproblematic example of a situation in which the fraud on the market theory applies, I see several problems. A finding of liability against Waste, Inc. is tantamount to imposing a tax on Waste for the disclosure that it did make. After all, it is absolutely clear that there would have been no liability if the firm had decided to disclose nothing. Consequently, imposing liability for this sort of incomplete disclosure, particularly in the absence of a showing of reliance on any actual misstatements by the defendant, provides a strong disincentive to disclose at all. Thus, the fraud on the market theory, by penalizing those firms that choose to disclose corporate news, ultimately may make the markets less efficient.

The determination that the decision about whether to disclose

³ *Basic*, 108 S. Ct. at 992.

⁴ See Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984).

⁵ Fischel, *Efficient Capital Markets, The Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 909 (1989).

the existence of the contract in the first place is a matter of business judgment on the part of Waste's officers and directors is, in essence, an implicit declaration of the allocation of the property rights in this information. The declaration is that the information belongs to Waste's shareholders, and that it should be used for their benefit. Also implicit in this state of the world is the assumption that the shareholders have entrusted the officers and directors of Waste with the discretion to use that information to maximize the value for the firm. Thus, the ultimate test of whether liability should be imposed in this situation is whether such an imposition of liability would maximize the value of Waste Incorporated's shares.

An efficient market for a firm's stock is a valuable corporate asset. Properly applied, the fraud on the market theory would maximize firm value by improving the quality of the secondary trading market for shares in publicly traded firms. If applied too broadly however, the fraud on the market theory actually could decrease firm value by making the market for corporate stock less liquid. Again, the point is not that the fraud on the market theory should not be employed, only that it needs to be refined in significant ways before it may be said to represent a coherent theory of liability.

The fraud on the market theory also illustrates the difficulty of transporting even simple and well developed economic theories into the world of law. Specifically, it appears clear that the fraud on the market theory requires that plaintiffs may only recover if they have reasonably relied on the integrity of the market price of the stock in question. The question of whether it was reasonable for the plaintiffs to rely on the price of a security depends on whether the market for the stock is efficient.

The implication is clear. After *Basic Inc. v. Levinson*, the issue of whether a particular stock traded in an efficient market will now become an important part of every fraud on the market case. The Supreme Court finessed the issue, remarking rather carelessly that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?"⁶ In fact the opposite appears to be true. Investors who buy securities employ one of two strategies. One is to create a diversified portfolio of investments in order to eliminate firm-specific risk. The other is to attempt to locate undervalued stocks in an effort to "beat the market." In the latter category of cases investors are in essence betting that the market for the securities they are buying is in fact inefficient. It is not immediately obvi-

⁶ *Basic*, 108 S. Ct. at 991.

ous that such purchasers are relying on the efficiency of the market when they purchase stock.

In other words, all investors do not rely on the integrity of the market for the stocks they buy because all investors are not alike. Some investors rely on market integrity and others do not. And, just as all investors are not alike, all securities are not alike. It is clearly inappropriate to permit plaintiffs to reasonably rely on the integrity of the market for a security that trades in an inefficient market. But we have yet to observe a workable test for determining whether the market for a particular security is efficient. Different securities will have different efficiency characteristics. Indeed, different *types of information* may have different efficiency characteristics. Thus we must consider not only the trading characteristics of the stock in question, but the sort of information at issue, before we can conclude that a reasonable plaintiff should be entitled to rely on the integrity of the price of the stock in question.

My final point relates to Professor Fischel's distinction between trading rule efficiency and value efficiency.⁷ Trading rule efficiency is the idea that it is impossible to devise a trading rule that systematically outperforms the market. Value efficiency is the idea that a securities market is value efficient if securities prices reflect the present value of all net cash flows to a firm's assets. Professor Fischel argues that it is possible for a firm's shares to be trading rule efficient but not value efficient.

Professor Fischel is correct if the market for a firm's shares are only weak form efficient. The weak form of the efficient capital market hypothesis posits that traders cannot profit on the basis of historical price information. The prices of shares for such firms may not be "value efficient" but it still will not be possible to devise a trading strategy that systematically outperforms the market. But the gulf between trading rule efficiency and value efficiency may disappear when the discussion moves to firms whose shares trade in a market that conforms to the semi-strong version of the efficient capital market hypothesis. The prices of firms whose shares trade in a market that is efficient in the semi-strong sense will reflect all publicly available information about those firms. For such firms it does not appear that the market can be efficient in the trading sense without being efficient in the value sense because all publicly available information relating to share value will already be reflected in such firms' share prices. Thus the prices for these firms' shares must be value efficient.

⁷ Fischel, *supra* note 5, at 912-17.