

# Fraud-on-the-Market Theory After *Basic Inc. v. Levinson*

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## NOTE

### FRAUD-ON-THE-MARKET THEORY AFTER *BASIC INC. v. LEVINSON*

Over the past two decades, the fraud-on-the-market theory ("FMT") has become a powerful tool for plaintiffs in securities fraud actions.<sup>1</sup> Traditionally, to successfully maintain a securities fraud claim under Rule 10b-5,<sup>2</sup> promulgated under section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"),<sup>3</sup> a plaintiff had to

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<sup>1</sup> Commentators claim that the theory evolved as courts relaxed the individual subjective reliance requirement and began to favor an objective measure of materiality. See *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969); *Securities and Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Coates v. Securities and Exch. Comm'n*, 394 U.S. 976 (1969) (the second circuit examined the defendant's impact on the generalized impersonal market in finding a violation of Rule 10b-5); *In re Memorex Security Cases*, 61 F.R.D. 88 (N.D. Cal. 1973). The Supreme Court stimulated further development of the theory in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), and *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), by focusing on the objective materiality requirement. Finally, after *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), courts generally adopted the phrase "fraud-on-the-market." For extensive discussion of the development of the theory, see generally Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435 (1984); Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 WASH. & LEE L. REV. 861 (1982) Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982) [hereinafter Note, FMT]; Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 627 (1982) (authored by Michael A. Lynn) [hereinafter Note, *An Emerging Theory*].

<sup>2</sup> 17 C.F.R. § 240.10b-5 (1988). The Rule states:

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,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The author notes the importance of distinguishing the three alternative routes to recovery under Rule 10b-5. They are referred to as Route A, Route B, and Route C, respectively. See *infra* notes 99-100 and accompanying text.

<sup>3</sup> 15 U.S.C. § 78(j) (1982). The statute 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—

(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

establish: "(1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) on which the plaintiff reasonably relied, (5) that proximately caused his injury."<sup>4</sup> Under this analysis, an investor bringing a securities fraud claim needed to establish that the fraudulent misrepresentation or omission played a substantial role in his investment decision.<sup>5</sup> The FMT serves to establish the plaintiff's reliance requirement.<sup>6</sup> It provides the plaintiff with a rebuttable presumption of reliance on the integrity of the market.<sup>7</sup> To overcome the presumption, a defendant must sever "the link between the alleged misrepresentation" and the plaintiff's injury.<sup>8</sup>

A plurality of the United States Supreme Court recently endorsed the FMT in *Basic Inc. v. Levinson*.<sup>9</sup> The Court, however, leaves both the corporate attorney and the market investor unsure of the theory's scope of application. A comparison of *Basic* to *Shores v. Sklar*,<sup>10</sup> a 1981 fifth circuit decision, illustrates fundamental questions which *Basic* left unanswered. In forming answers to such questions, this Note will delineate the FMT's proper domain.

Part I summarizes and compares the facts of the two cases and

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.

<sup>4</sup> *Ross v. Bank South, N.A.*, 837 F.2d 980, 991 (11th Cir.), *reh'g granted*, 848 F.2d 1132 (11th Cir. 1988); *see Huddleston v. Herman & MacLean*, 640 F.2d 534, 543 (5th Cir. 1981), *aff'd in part*, 459 U.S. 375 (1983); *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Black, supra* note 1, at 435 n.2.

<sup>5</sup> *See List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811 (1965).

<sup>6</sup> As discussed *infra*, text accompanying notes 102 and 133-48, courts apply the FMT inconsistently. Yet, whenever courts use the theory, it eases the plaintiff's burden of proving reliance.

<sup>7</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 992 (1988).

<sup>8</sup> *Id.*

<sup>9</sup> 108 S. Ct. 978 (1988). Justices Blackmun, Brennan, Marshall, and Stevens comprised the plurality. Justices White and O'Connor dissented regarding the FMT. Chief Justice Rehnquist and Justices Scalia and Kennedy did not take part in the decision. The Supreme Court's endorsement followed the circuits' widespread adoption. *See Peil v. Speiser*, 806 F.2d 1154 (3rd Cir. 1986), *cert. denied sub nom. Finkel v. Docutel/Olivetti Corp.*, 108 S. Ct. 1220 (1988); *Levinson v. Basic, Inc.*, 786 F.2d 741 (6th Cir. 1986), *aff'd*, 108 S. Ct. 978 (1988); *Harris v. Union Elec.*, 787 F.2d 355 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied sub nom. Linde, Thompson, Fairchild, Longsworthy, Kohn & VanDyke v. T.J. Raney & Sons*, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated*, 459 U.S. 1027 (1982); *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

<sup>10</sup> 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983). The *Shores* litigation is ongoing. *See Shores v. Sklar*, 844 F.2d 1485 (11th Cir. 1988). This subsequent litigation is immaterial to this Note.

the routes to recovery under Rule 10b-5 that each case used. Part II analyzes the efficient market hypothesis, which underlies the FMT endorsed by a plurality of the Supreme Court in *Basic*. Part III analyzes the application of the FMT in *Shores*. Criticism of *Shores* emphasizes the fifth circuit's narrow justification for applying the FMT in an inefficient market setting. Part III also concludes that the *Shores* version of the FMT is inconsistent with *Basic*, which limits the FMT to efficient markets. *Shores* did not undertake, as *Basic* implicitly required, an analysis of the subject security market. Part IV presents a simple market test to guide lower court application of the FMT.

## I

### THE CASES

#### A. *Basic Inc. v. Levinson*

*Basic Inc.* ("Basic") and Combustion Engineering, Inc. ("Combustion") merged after Basic publicly announced its approval of Combustion's tender offer on December 20th, 1978.<sup>11</sup> As early as 1965, Combustion had expressed interest in Basic,<sup>12</sup> and in 1976 representatives of both companies first met to consider a merger.<sup>13</sup> During the next two years, heavy trading in Basic stock caused Basic to make public statements to explain the increased level of market activity. In three public statements Basic flatly denied conducting any merger negotiations, and stated that it could not account for the abnormally heavy trading of its stock.<sup>14</sup> Basic made the third state-

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<sup>11</sup> 108 S. Ct. 978, 981 (1988).

<sup>12</sup> *Id.* at 980.

<sup>13</sup> *Id.* at 981.

<sup>14</sup> *Id.* In recounting the disclosures, the Court stated:

On October 21, 1977, after heavy trading and a new high in Basic stock, the following news item appeared in the Cleveland Plain Dealer:

"[Basic] President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry."

On September 25, 1978, in reply to an inquiry from the New York Stock Exchange, Basic issued a release concerning increased activity in its stock and stated that

"management is unaware of any present or pending company development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days."

On November 6, 1978, Basic issued to its shareholders a "Nine Months Report 1978." This Report stated:

"With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."

ment in November of 1978, the month before the merger.<sup>15</sup> Basic denied any corporate developments through Friday, December 15,<sup>16</sup> but in light of Combustion's imminent tender offer, Basic asked the New York Stock Exchange to suspend trading of its stock on Monday, December 18.<sup>17</sup>

Max Levinson, along with two other Basic shareholders, brought a class action against Basic and its directors, alleging violations of section 10(b) of the 1934 Act and of Rule 10b-5.<sup>18</sup> The class<sup>19</sup> included all "shareholders who sold their stock after Basic's first public statement . . . and before the suspension of trading in December 1978."<sup>20</sup> The plaintiffs alleged that Basic's misrepresentations caused them to sell their shares at artificially depressed prices.<sup>21</sup> The district court certified the plaintiff class.<sup>22</sup> It adopted

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*Id.* at 981 n.4.

<sup>15</sup> *Id.* at 981.

<sup>16</sup> *Levinson v. Basic, Inc.*, 786 F.2d 741, 745 (6th Cir. 1986), *aff'd*, 108 S. Ct. 978 (1988). The sixth circuit's opinion describes in detail the actual extent of merger negotiations. In light of the record, Basic's denials constituted outright misrepresentations.

<sup>17</sup> *Basic*, 108 S. Ct. at 981. Exchange suspensions are common, and often occur following a news announcement which the exchange believes will significantly affect a stock's price. Likewise, it is not uncommon for a public company to request a suspension. L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 445 (2d ed. 1988).

<sup>18</sup> *Basic*, 108 S. Ct. at 981.

<sup>19</sup> With the 1966 amendments to Rule 23 of the Federal Rules of Civil Procedure, the Supreme Court increased the availability of the class action as a litigation tool. The importance of the class action to securities litigation is undisputed. See Black, *supra* note 1, at 439-41.

<sup>20</sup> *Basic*, 108 S. Ct. at 981. Courts have accepted the fraud-on-the-market theory as predominantly a class action weapon. This Note does not question this characterization. See *Levinson v. Basic, Inc.*, 786 F.2d 741, 749-50 (6th Cir. 1986). In short, "[t]he theory has revolutionized securities fraud litigation." Fischel, *Efficient Capital Markets, The Crash, and the Fraud on the Market Theory*, 74 *CORNELL L. REV.* 907 (1989) [hereinafter Fischel, *Efficient Capital Markets*].

<sup>21</sup> *Basic*, 108 S. Ct. at 981. The relationship between the misrepresentations and the depressed prices is straightforward. Mergers and takeovers benefit shareholders by allowing substantial profits through the tender offer process. Thus, the rational shareholder, with knowledge of an imminent takeover, would realize the premium value of his shares. If the company, however, fraudulently withholds such information from the shareholders, the market will not reflect the security's premium value, and the fraud will artificially depress the security's price. The fraud injures the sellers of the security who sell before the target company openly announces the takeover.

Likewise, fraudulent statements or omissions may artificially inflate a security's price. Then, the fraud injures investors who purchase [securities] in reliance on the integrity of the market price. Fischel, *Efficient Capital Markets, supra* note 20, at 909. For example, if a company fraudulently disclosed that it was involved in merger negotiations, the disclosure would injure subsequent buyers of the stock, because the fraudulent statement would artificially inflate the stock's price. If the sham merger negotiations were uncovered, the stock's price would fall, as would the value of the buyer's investment.

<sup>22</sup> *Basic*, 108 S. Ct. at 981. The district court applied a presumption of reliance in certifying the plaintiff class. The presumption, a direct application of fraud-on-the-market theory, allowed the court to conclude that "questions of law or fact common to the

a presumption that members of the class relied on Basic's public statements.<sup>23</sup> The presumption was vital to the class certification because it "enabled the court to conclude that common questions of fact or law predominated over particular questions pertaining to individual plaintiffs."<sup>24</sup> The district court, however, granted summary judgment for Basic.<sup>25</sup> The sixth circuit reversed on appeal.<sup>26</sup> The court of appeals upheld the district court's class certification, and explicitly endorsed the fraud-on-the-market theory.<sup>27</sup>

### B. *Shores v. Sklar*

Unlike the stock in *Basic*, the securities at issue in *Shores v. Sklar*<sup>28</sup> did not trade on a national securities market.<sup>29</sup> Rather, *Shores* involved the issuance of industrial revenue bonds, which do not require registration under the Securities Act of 1933.<sup>30</sup> The bonds were sold in an undeveloped market.<sup>31</sup>

J.C. Harrelson, a majority shareholder of Alabama Supply and Equipment Company ("ASECo"), along with an independent Tennessee underwriter,<sup>32</sup> sought financing to construct an industrial fa-

members of the class predominate over any questions affecting only individual [plaintiffs.]" FED. R. CIV. P. 23(b)(3).

<sup>23</sup> *Basic*, 108 S. Ct. at 981. Common questions of fact or law are vital to class certification. See FED. R. CIV. P. 23(b)(3).

<sup>24</sup> *Basic*, 108 S. Ct. at 981 (citation omitted). That fraud affects the class as a whole is consistent with the notion that the fraud affects the entire market. "The fraud on the market theory . . . has shifted the focus from the individual plaintiff to whether a challenged disclosure affected the market as a whole." Fischel, *Efficient Capital Markets*, *supra* note 20, at 907.

<sup>25</sup> *Basic*, 108 S. Ct. at 982.

<sup>26</sup> *Invinson v. Basic, Inc.* 786 F.2d 741 (6th Cir. 1986), *aff'd*, 108 S. Ct. 978 (1988).

<sup>27</sup> *Id.*

<sup>28</sup> 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983).

<sup>29</sup> Basic's stock traded on the New York Stock Exchange. *Basic*, 108 S. Ct. at 981 n.4.

<sup>30</sup> 15 U.S.C. § 77c(a)(2) (1982). Section 77c(a)(2) exempts municipal bonds from securities registration requirements. The Town of Frisco City, a municipality, issued the subject industrial revenue bonds. Registration statements are an obvious source of public information, information that the efficient market will reflect. See *infra* notes 49-60 and accompanying text.

<sup>31</sup> See *Ross v. Bank South, N.A.*, 837 F.2d 980, 993 (11th Cir.) (citing *Shores*, the court stated, "[t]he second . . . type of [FMT] cases involving fraud in the issuance of securities traded on an undeveloped . . . market."), *reh'g granted*, 848 F.2d 1132 (11th Cir. 1988); *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 364 (5th Cir. 1987) ("[I]t is clear that the market for the bonds in *Shores* does not represent the active, efficient market for which the [FMT] was initially conceived."), *cert. denied*, 108 S. Ct. 1220 (1988); *Peil v. Speiser*, 806 F.2d 1154, 1162 (3rd Cir. 1986) ("*Sklar*, however, involved a newly issued security rather than a security already being traded in a well-developed market."), *cert. denied sub nom. Finkel v. Docutel/Olivetti Corp.*, 108 S. Ct. 1220 (1988); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 746 (11th Cir. 1984) ("The *Shores* opinion has been criticized primarily because it extended fraud on the market to new issues in an undeveloped market.), *cert. denied*, 469 U.S. 1132 (1985).

<sup>32</sup> The Securities Act of 1933 defines "underwriter," in relevant part, as "any per-

cility in Frisco City, Alabama.<sup>33</sup> ASEC Co successfully persuaded the Town of Frisco City to establish an Industrial Development Board. By Alabama statute, the Board had the power to issue tax-exempt bonds, use the proceeds to build an industrial facility, and then lease the building.<sup>34</sup> The municipality, however, would not guarantee the bonds. Rather, revenues from the lease would secure the debt.<sup>35</sup> Thus, the financial soundness of the facility was of utmost importance "in evaluating the worth of the bonds."<sup>36</sup>

Defendant Sklar acted as counsel for the issuance of the bonds. ASEC Co and the underwriter provided Sklar with information, and Sklar drafted an offering circular<sup>37</sup> to promote the bonds' sales. Sklar, however, intentionally or recklessly omitted relevant facts concerning the financial soundness and propriety of his clients.<sup>38</sup>

The original underwriter assigned its underwriting rights to Jackson Municipals, Inc. ("JMI"). JMI was fully aware of the fraud contained in the offering circular, but failed to investigate the wrongdoing.<sup>39</sup> In December 1972, JMI began selling the bonds to securities dealers.<sup>40</sup>

Plaintiff Bishop spoke with his securities broker in January 1973 and, upon the broker's advice, purchased three bonds.<sup>41</sup> Bishop was not aware of the offering circular and admitted that he never read it.<sup>42</sup> After ASEC Co defaulted on the bonds,<sup>43</sup> Bishop brought a class action against defendants for securities fraud in violation of section 10(b) of the 1934 Act and Rule 10b-5.<sup>44</sup> The district court

son who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security or participates or has a direct or indirect participation in any such undertaking. . . ." 15 U.S.C. § 77b(11). For a general discussion of the term, see L. Loss, *supra* note 17, at 252-68.

<sup>33</sup> *Shores*, 647 F.2d at 465.

<sup>34</sup> *Id.* See ALA. CODE §§ 11-54-80—11-54-101 (1985).

<sup>35</sup> *Shores*, 647 F.2d at 465. Upon completion of the facility, the builder leases it, and the rental payments are the "sole source for the satisfaction of interest obligations and repayment of principal." *Id.*

<sup>36</sup> Rapp, *supra* note 1, at 881.

<sup>37</sup> An offering circular is similar to a prospectus. An offeror must file one with the Securities and Exchange Commission ("SEC") and distribute copies with any securities offerings. SEC rules and regulations govern its content.

<sup>38</sup> *Shores*, 647 F.2d at 465. For example, the circular failed to state that the SEC had previously commenced a civil action against the underwriters on unrelated matters. Sklar also portrayed ASEC Co as a successful and experienced contractor, and grossly misstated ASEC Co's real estate holdings. Sklar also knowingly included a materially false financial statement in the circular. *Id.* at 466.

<sup>39</sup> *Id.* JMI was also a defendant in securities litigation with the original underwriters.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at 467.

<sup>42</sup> *Id.* at 468.

<sup>43</sup> ASEC Co defaulted in April 1974. *Id.* at 467.

<sup>44</sup> The plaintiff also sought relief under the Securities Act of 1933 and an unspeci-

held that, as Bishop admittedly never read the offering circular when he originally purchased the bonds, he could not recover because "his lack of reliance [on the circular] was fatal to his claim."<sup>45</sup> On appeal, the fifth circuit reversed, holding that Bishop had a viable claim under Rule 10b-5.<sup>46</sup> Specifically, the court of appeals held that summary judgment was improper because Bishop's pleadings would support a finding of a "deliberate, manipulative scheme[] to defraud . . . ."<sup>47</sup>

### C. Factual Comparison

*Basic* and *Shores* illustrate application of the FMT to dissimilar fact patterns. Market efficiency is the crucial distinction between *Basic* and *Shores*. Efficiency "means that the *market price* of a security represents the market's consensus estimate of the value of that security."<sup>48</sup> In an efficient market, a security's price will reflect all public information regarding the economy, financial markets, and the actual issuing company.<sup>49</sup> *Basic* involved shares of stock traded on arguably the most efficient impersonal securities market—the New York Stock Exchange.<sup>50</sup> By contrast, the securities at issue in *Shores* traded on an undeveloped, inefficient market.

*Basic*'s stock traded actively among investors on an efficient secondary market<sup>51</sup> before the plaintiffs purchased their stock or ultimately sold it at artificially depressed prices.<sup>52</sup> Because the New York Stock Exchange, the largest organized exchange in the United

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fied Alabama statute. The trial court dismissed these claims, and the plaintiff did not appeal the dismissals. *Id.*

<sup>45</sup> *Id.* at 464.

<sup>46</sup> *Id.* at 469.

<sup>47</sup> *Id.* at 464.

<sup>48</sup> J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 55 (7th ed. 1986); see J. FRANCIS & S. ARCHER, PORTFOLIO ANALYSIS 193 (1971); B. MALKIEL, THE INFLATION BEATER'S INVESTMENT GUIDE: WINNING STRATEGIES FOR THE 1980'S 64 (1980); R. IBBOTSON & G. BRINSON, INVESTMENT MARKETS 45 (1987); J. WOOD & N. WOOD, FINANCIAL MARKETS 11 (1985); Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW 1, 4 (Nov. 1982) [hereinafter Fischel, *Finance Theory*].

<sup>49</sup> J. VAN HORNE, *supra* note 48, at 55. See also R. IBBOTSON & G. BRINSON, *supra* note 48, at 47 ("The efficient markets hypothesis states that the price of an asset reflects all available information.")

<sup>50</sup> J. VAN HORNE, *supra* note 48, at 56; R. IBBOTSON & G. BRINSON, *supra* note 48, at 47.

<sup>51</sup> On the New York Stock Exchange, investors typically trade, via their brokers, among themselves. Once securities are traded in a primary market, see *infra* note 55 and accompanying text, "they are then traded from investor to investor in the *secondary market*. The role of the secondary market is to provide investors with liquidity for their investments, enabling them to move quickly, and without substantial loss in market value, from security to cash and from one security to another." R. HAUGEN, MODERN INVESTMENT THEORY 22-23 (1986).

<sup>52</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 981 (1988).

States and Canada,<sup>53</sup> is presumed to be efficient, trading prices reflect publicly disseminated information, information that may be, as in *Basic*, fraudulent.<sup>54</sup>

In *Shores*, investors traded newly issued bonds<sup>55</sup> in an undeveloped, inefficient market.<sup>56</sup> The market lacked efficiency for two reasons. First, Frisco City had no industrial revenue bond market before the defendants' scheme.<sup>57</sup> Second, the structure of the bond market would not allow rapid response to new information<sup>58</sup> such as that contained in the offering circular. Not enough market participants existed<sup>59</sup> to "drive price changes about a security's 'intrinsic' value to a random walk."<sup>60</sup> The market from which the plaintiff

<sup>53</sup> R. HAUGEN, *supra* note 51, at 23.

<sup>54</sup> See *infra* notes 58-61.

<sup>55</sup> *Shores v. Sklar*, 647 F.2d 462, 466 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983). The court of appeals found that "[revenue] bonds from towns like Frisco City are not ordinarily traded in a secondary market . . ." *Id.* at 467. This supported the district court's finding that the plaintiff purchased the bonds in the primary market directly from an underwriter. *Id.* "When securities are initially offered to the public, they are said to be sold in the *primary market*." R. HAUGEN, *supra* note 51, at 22. In a primary market, the underwriter, often an investment banking firm, is the middleman between the issuing corporation and potential security buyer. *Shores*, 647 F.2d at 467. The underwriter connects businesses with investors, the sources of capital. *Id.* This connection is on a personal level, as compared to secondary market transactions which involve impersonal transactions among investors. The Fifth Circuit Court of Appeals, however, could not conclusively determine whether the plaintiff purchased securities in a primary market or from another investor in a secondary market. *Id.* As Part IV of this Note, *infra* notes I64-88 and accompanying text, explains, however, the existence of a primary or secondary market should not determine whether a court may apply the FMT.

<sup>56</sup> See *infra* notes 58-61 and accompanying text.

<sup>57</sup> The defendants "induce[d] the Town of Frisco City to create an Industrial Development Board to finance ASECo's facility . . ." 647 F.2d at 465. Given that the Board did not exist prior to the defendants' scheme, and that such a board must authorize municipal bonds, see ALA. CODE § 11-54-87 (1985), it follows that the defendant actually created the market for the bonds. See also *Ross v. Bank South, N.A.*, 837 F.2d 980, 995 (11th Cir.) (in correctly concluding that a defendant can rebut the FMT presumption by showing that "his fraud had no effect on the market price," the court stated, "A *Shores* defendant can make no such showing . . . because his fraud *creates* the bond itself.") (emphasis in original), *reh'g granted*, 848 F.2d 1132 (11th Cir. 1988).

<sup>58</sup> That the security's price rapidly adjusts to new information is essential to the efficient market hypothesis. See *infra* note 61; J. VAN HORNE, *supra* note 48, at 55; R. IBBOTSON & G. BRINSON, *supra* note 48, at 47; Fischel, *Finance Theory*, *supra* note 48, at 9; see also Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970), reprinted in CAPITAL MARKET EQUILIBRIUM AND EFFICIENCY 41 (J. Bicksler ed. 1974) [hereinafter Fama, *Efficient Capital Markets*] ("[a] market in which prices always 'fully reflect' available information is called efficient").

<sup>59</sup> Commentators agree that the efficient market theory requires that a sufficiently large number of market participants "promptly receive and analyze all the information that is publicly available concerning companies whose securities they follow." See J. VAN HORNE, *supra* note 48, at 56. See also, R. HAUGEN, *supra* note 51, at 467 (referring to an "army" of well-informed security analysts and traders); Fama, *Efficient Capital Markets*, *supra* note 58, at 388 ("the market may be efficient if 'sufficient numbers' of investors have ready access to available information").

<sup>60</sup> J. VAN HORNE, *supra* note 48, at 56. The random walk hypothesis asserts "that

purchased the securities was not efficient.<sup>61</sup>

*Basic* and *Shores* apply the FMT in markets with distinct characteristics. *Basic* applies the FMT in an efficient market and *Shores* applies the FMT in an inefficient market. An examination of the foundations of the FMT as applied in *Basic* reveals that courts should use the FMT only in cases involving an efficient market setting.

## II

### THE FMT AND *BASIC INC. v. LEVINSON*

#### A. FMT as a Presumption of Reliance

In *Basic*, the Supreme Court reinforced the traditional notion

one cannot use past security prices to predict future prices in such a way as to profit on average." *Id.* Thus, while new information may cause a change in the value of a security, "subsequent security price movements will follow . . . a random walk. . . ." *Id.* at 55-56. Fama presents the random walk model in detail. See generally Fama, *Efficient Capital Markets*, *supra* note 58. See also Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANALYSIS J. 55 (Sept.-Oct. 1965), reprinted in R. POSNER & K. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 156 (1980) (general discussion of the random walk model). Law review commentary on the fraud-on-the-market theory has incorporated the random walk model. See, e.g., Black, *supra* note 1, at 437-38; Note, *An Emerging Theory*, *supra* note 1, at 647-49.

<sup>61</sup> If a market is efficient, it should have the following characteristics:

1. Security prices should respond quickly and accurately to the receipt of new information that is relevant to valuation.

2. The change in security prices from one period to the next should be random in the sense that the change in price that takes place today should be unrelated to the change in price that occurred yesterday or any other day in the past.

3. It should be impossible to discriminate between profitable . . . and unprofitable investments in a future period based on any of the characteristics of these investments that can be known in the current period. It should be impossible, for example, for us to construct a trading rule that utilizes information available at time  $t$  that enables us to predict the most profitable investments of  $t + 1$ .

4. If we separate investors who are knowledgeable from those who are not, we should discover that we are unable to find a significant difference between the average investment performance of the two groups. Moreover, . . . differences in performance between groups and within groups should be due to chance, and not something systematic and permanent like differences in ability to find information not already reflected in stock prices.

R. HAUGEN, *supra* note 51, at 475-76. Haugen analyzes each of these factors. *Id.* at 476-82.

From this description of an efficient market, it follows that a "market is *inefficient* with respect to a piece of information if securities prices do not reflect that information and if an investor can earn excess returns by trading on the basis of that information." K. GARBADE, *SECURITIES MARKETS* 237 (1982). Thus, when information disseminates slowly and investors "take time in analyzing the information and reacting," characteristics of an inefficient market exist, and "prices may deviate from [actual] values. . . ." R. HAUGEN, *supra* note 51, at 466.

that reliance is an essential element of a Rule 10b-5 action.<sup>62</sup> "Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."<sup>63</sup> In *Ross v. Bank South, N.A.*,<sup>64</sup> Judge Allgood succinctly explained the relationship between reliance and causation: "Reliance . . . always revolves around the issue of causation, i.e., proving that the damaged party was induced to act by the defendant's conduct thereby establishing the causal link between the defendant's misconduct and the plaintiff's decision to buy or sell securities."<sup>65</sup>

The Supreme Court first abrogated the plaintiff's burden of proving direct reliance<sup>66</sup> in *Affiliated Ute Citizens v. United States*,<sup>67</sup> holding that the plaintiff could satisfy the reliance requirement by establishing that the defendant made material omissions.<sup>68</sup> Although *Affiliated Ute* did not expressly state that proof of materiality creates a presumption of reliance, courts, including the Supreme Court in *Basic*, have relied on this case in creating such presumptions.<sup>69</sup>

<sup>62</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 989 (1988) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)). See *supra* notes 4-8 and accompanying text.

<sup>63</sup> *Basic*, 108 S. Ct. at 989 (citing *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981)); see also *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3rd Cir. 1986) (arguing that the "causal connection" under FMT is equivalent to direct reliance causation), *cert. denied sub nom. Finkel v. Docutel/Olivetti Corp.*, 108 S. Ct. 1220 (1988); *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 715 (8th Cir. 1978) (indicating that "causal nexus" is required to limit a defendant's liability); *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975) (concluding materiality of misrepresentation may establish necessary causal link), *cert. denied*, 429 U.S. 816 (1976); Note, *The Reliance Requirement in Private Actions under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 593 (1975) (arguing that, although direct reliance is not necessary to establish causation in specific instances, reliance by some market participants is ultimately required.).

<sup>64</sup> 837 F.2d 980 (11th Cir.), *reh'g granted*, 848 F.2d 1132 (11th Cir. 1988).

<sup>65</sup> *Id.* at 1005 (Allgood, J., concurring in part and dissenting in part).

<sup>66</sup> See *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811 (1965) (burden of proving direct reliance imposed on the plaintiff).

<sup>67</sup> 406 U.S. 128 (1972).

<sup>68</sup> Omissions involve the defendant's failure to disclose; misrepresentations involve the defendant's false and misleading disclosures. The Court held that where the plaintiff bases his claim primarily on omissions,

positive proof 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 established the requisite element of causation in fact.

*Id.* at 153-54 (citations omitted). For commentary on the significance of the *Affiliated Ute* decision, see Black, *supra* note 1, at 442-45, 447-49; Rapp, *supra* note 1, at 869-70; Note, *FMT, supra* note 1, at 1145-46; Note, *An Emerging Theory, supra* note 1, at 634-35.

<sup>69</sup> See *Basic Inc. v. Levinson*, 108 S. Ct. 978, 990 (1988); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 742-43 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *Arthur Young & Co. v. United States Dist. Court*, 549 F.2d 686, 694 (9th Cir.), *cert. denied*, 434

*Blackie v. Barrack*<sup>70</sup> illustrates a lower court's first whole-hearted application of the FMT reliance presumption to a misrepresentation in an open market fraud context. The Ninth Circuit Court of Appeals stated, "We merely recognize that individual 'transactional causation' can in these circumstances be inferred from the materiality of the misrepresentation, and shift to the defendant the burden of disproving a prima facie case of causation."<sup>71</sup> Courts have consistently regarded *Blackie* as an extension of the *Affiliated Ute* presumption to misrepresentation cases.<sup>72</sup>

The ninth circuit reasoned in *Blackie* that even in a misrepresentation case, the securities purchaser relies on the assumption that the market price reflects the security's value.<sup>73</sup> By relying on the security's price, a purchaser indirectly relies on any representations. Yet, "whether he is aware of it or not, the price he pays reflects material misrepresentations."<sup>74</sup> It is unsound to defeat recovery because reliance is indirect, for the "causal chain is broken only if the purchaser would have purchased the stock even had he known of the misrepresentations."<sup>75</sup> Using this reasoning, the court concluded that the presumption is appropriate because the requirement of

U.S. 829 (1977); *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425, 1446 (S.D. Cal. 1988); *In re LTV Securities Litigation*, 88 F.R.D. 134, 142 (N.D. Tex. 1980).

<sup>70</sup> 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

<sup>71</sup> *Id.* at 906 (citations omitted). "Transaction causation" and "loss causation" have played an important role in many lower court decisions. See *Harris v. Union Elec. Co.*, 787 F.2d 355 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986); *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (2d Cir. 1981); *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part*, 459 U.S. 375 (1983); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Bastian v. Petren Resources Corp.*, 682 F. Supp. 956 (N.D. Ill. 1988). For purposes of this Note,

[t]ransaction causation is established when the plaintiff shows that the defendant's fraudulent conduct caused the plaintiff to engage in the transaction in question. This is nothing more than "but for" causation, which is merely another way of describing reliance. Loss causation, on the other hand, is the nexus between the defendant's fraudulent conduct and the plaintiff's pecuniary loss.

*Harris*, 787 F.2d at 366 (citations omitted).

The fraud-on-the-market theory, because it is directed toward the reliance requirement, applies directly to transaction causation. Thus, unless otherwise specified, when this Note discusses causation, it refers only to transaction causation. Loss causation remains an element of the 10b-5 claim; a plaintiff still must establish damages. See *Wilson*, 648 F.2d at 92; *Bastian*, 682 F. Supp. at 957; see also *Murray v. Hospital Corp. of Am.*, 682 F. Supp. 343 (M.D. Tenn. 1988) (fraud-on-the-market theory does not relieve the plaintiff of the obligation to plead and prove loss causation.).

<sup>72</sup> See *Lipton*, 734 F.2d at 743; *Rifkin v. Crow*, 574 F.2d 256, 263 (5th Cir. 1978); *LTV Securities*, 88 F.R.D. at 143 (citing *Rifkin*, 574 F.2d at 263). Cf. *Kramas v. Security Gas & Oil Inc.*, 672 F.2d 766, 769 n.2 (9th Cir.) (reserving extension of *Affiliated Ute* presumption to misrepresentations), *cert. denied*, 459 U.S. 1035 (1982).

<sup>73</sup> *Blackie*, 524 F.2d at 907.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

showing direct reliance “imposes an unreasonable and irrelevant evidentiary burden.”<sup>76</sup>

### B. FMT as Limited to Efficient Markets

The Supreme Court in *Basic* began its discussion of the fraud-on-the-market theory by defining it:

The fraud-on-the-market theory is based on the hypothesis that, in an *open end developed securities market*, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . . . The causal connection between the defendants' fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.<sup>77</sup>

Inherent in the Court's definition is the importance of an efficient, impersonal securities market. The Court concluded that the FMT presumption is “supported by common sense and probability.”<sup>78</sup> Plaintiffs rely on the integrity of an efficient market to price securities accurately.<sup>79</sup>

Justice Blackmun, writing for the plurality in *Basic*, found support for applying the FMT to modern security market transactions—as distinguished from “face-to-face transactions contemplated by

<sup>76</sup> *Id.*; see also *Peil v. Speiser*, 806 F.2d 1154, 1160 (3rd Cir. 1986), *cert. denied sub nom. Finkel v. Docutel/Olivetti Corp.*, 108 S. Ct. 1220 (1988).

<sup>77</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 988-89 (1988) (quoting *Peil*, 806 F.2d at 1160-61 (citations omitted) (emphasis supplied)). It follows from the Court's definition that “[t]he misstatements may affect the price of the stock, and thus defraud purchasers who rely on the price as an indicator of the stock's value. By artificially inflating the price of the stock, the misrepresentations defraud purchasers who rely on the price as an indication of the stock's value.” *Peil*, 806 F.2d at 1160.

<sup>78</sup> *Basic*, 108 S. Ct. at 991. The discussion of the efficient market hypothesis and the random walk model supports this conclusion. See *supra* notes 58-61 and accompanying text.

The court in *Blackie* made a similar argument in favor of the presumption of reliance. It concluded that “the same causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock. Under those circumstances we think it appropriate to eliminate the burden.” 524 F.2d at 908. (citations omitted).

<sup>79</sup> *Basic*, 108 S. Ct. at 991; see also *In re LTV Securities Litigation*, 88 F.R.D. 134, 141-46 (N.D. Tex. 1980) (indicating that reliance on the market is sufficient to establish class status in a class action).

early fraud cases"<sup>80</sup>—in *In re LTV Securities Litigation*.<sup>81</sup> Concluding that the Rule 10b-5 reliance requirement must “encompass” modern changes in the securities market structure, Justice Blackmun described the efficient market as an agent of the investor:

In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of the market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.<sup>82</sup>

The Court realized that the changes in the open securities market, and their relation to fraud under Rule 10b-5, mandated the adoption of the FMT. Open market purchasers need protection from any fraud which causes injury, even absent direct reliance on the actual misrepresentation or omission.<sup>83</sup> Section 10(b) and Rule

<sup>80</sup> *Basic*, 108 S. Ct. at 989-90. Blackmun, J., refers to traditional bargaining transactions as an example of the subject matter of early fraud cases. *Id.* at 990 n.21. A “face to face transaction” is the opposite of the open market transaction. See Fischel, *Finance Theory*, *supra* note 48, at 10. See also Fischel, *Efficient Capital Markets*, *supra* note 20, at 912 (“The critical difference between face-to-face transactions and transactions involving actively-traded securities, in sum, is the presence or absence of reliable market prices reflecting information possessed by diverse sets of traders.”).

<sup>81</sup> 88 F.R.D. 134 (N.D. Tex. 1980).

<sup>82</sup> *Basic*, 108 S. Ct. at 990 (quoting *LTV Securities*, 88 F.R.D. at 143). The court in *LTV Securities*, continued, “if the investor did not rely on such agent, there has been no reliance.” *Id.* Thus, the defendant may rebut the reliance presumption by showing that the plaintiff did not rely on the market price.

<sup>83</sup> See *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975). The dissent in *Basic* predicted that the plurality's recognition of FMT “would effectively convert Rule 10b-5 into ‘a scheme of investor's insurance.’” 108 S. Ct. at 994 (1988) (White, J., dissenting) (quoting *Shores v. Sklar*, 647 F.2d 462, 469 n.5 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983)) (the dissent in *Shores* made the same criticism, 647 F.2d at 475 (Randall, J., dissenting)). The dissent's primary contention was that because “rebuttal is virtually impossible in all but the most extraordinary case[.]” *Basic*, 108 S. Ct. at 996 n.7, the FMT protects undeserving investors. One noted commentator agrees that the presumption is nonrebuttable. See Fischel, *Efficient Capital Markets*, *supra* note 20; Fischel, *Finance Theory*, *supra* note 48, at 11. Fischel does not, however, believe that FMT creates a scheme of investor's insurance. He states:

Nevertheless, it does not follow that an effectively nonrebuttable presumption of reliance creates investor insurance. Investors' ability to claim that they relied on the integrity of the market price helps to obtain class certification but in no way establishes the merits of the underlying claim. Plaintiffs must still establish that the alleged disclosure defect artificially inflated the market price and, if so, by how much. Given the multiple alternative sources of information and the sophistication of market professionals, this task will frequently be difficult even if plaintiffs can establish that less than a model disclosure was made. Thus the fraud on

10b-5 "foster an expectation that securities markets are free from fraud" on which purchasers in a developed market should be able to rely.<sup>84</sup> Courts invoke the FMT to place "the element of reliance . . . where . . . it realistically belongs—connecting the purchaser to the market, not the specific misstatement."<sup>85</sup>

Modern finance and efficient market scholars, however, highlight the importance of limiting application of the FMT to actions alleging fraud in efficient markets.<sup>86</sup> Because the FMT presumes reliance on the market price, the underlying assumption of the theory is "that the market price reflects all publicly available information quickly and without bias."<sup>87</sup> This phenomenon occurs only in open, impersonal, and efficient markets.<sup>88</sup> As Justice Blackmun's reasoning in *Basic* shows, the Supreme Court understood that the FMT should apply only to efficient markets.

In an efficient market, a security's price responds to new information as quickly as the trading exchange can receive and process it.<sup>89</sup> This efficient market feature justifies reliance on the security's price as an accurate indication of value.<sup>90</sup> Under the efficient market hypothesis, "all publicly available information is presumed to be reflected in securities' prices. This includes information in the stock price series as well as information in the firm's accounting reports, the reports of competing firms, announced information relating to the state of the economy, and any other publicly available informa-

the market theory in no way creates an investor insurance scheme when all of the theory's implications are considered.

Fischel, *Efficient Capital Markets*, *supra* note 20, at 919. Fischel also refutes the dissent's other major criticisms, namely that the FMT is logically inconsistent and that the FMT is judicial legislation inconsistent with congressional intent. *See id.* at 920-22. For other responses to criticisms of the FMT, *see generally* Black, *supra* note 1, at 457-68; Fischel, *Finance Theory*, *supra* note 48, at 13-17.

<sup>84</sup> *Blackie*, 524 F.2d at 907.

<sup>85</sup> *LTV Securities*, 88 F.R.D. at 144.

<sup>86</sup> *See generally* Fischel, *Finance Theory*, *supra* note 48; Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373 (1984).

<sup>87</sup> Fischel, *Finance Theory*, *supra* note 48, at 9. *See supra* notes 58-61 and accompanying text.

<sup>88</sup> Fischel, *Finance Theory*, *supra* note 48, at 10. In support of this conclusion, Fischel cites *LTV Securities*. The court there noted:

Recent economic studies tend to buttress empirically the central assumption of the fraud-on-the-market theory—that the market price reflects all representations concerning the stock. Indeed, economists have now amassed sufficient empirical data to justify a present belief that widely-followed securities of larger corporations are "efficiently" priced: the market price of stocks reflects all available public information—and hence necessarily any material misrepresentation as well.

88 F.R.D. at 144. The studies which both Fischel and the court refer to are cited *supra* note 48.

<sup>89</sup> R. HAUGEN, *supra* note 51, at 476; *see supra* notes 48-49 and accompanying text.

<sup>90</sup> *See infra* notes 152-57 and accompanying text.

tion relevant to the valuation of the firm."<sup>91</sup>

Professor Fischel<sup>92</sup> concludes that courts should continue to adopt the market model of investment decision<sup>93</sup> in their application of the FMT.<sup>94</sup> This Note supports this proposition. The market model derives from the notion of efficient capital markets.<sup>95</sup> The SEC, through its adoption of an integrated disclosure system, has likewise accepted the efficient market model.<sup>96</sup> The SEC uses the

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<sup>91</sup> R. HAUGEN, *supra* note 51, at 469 (emphasis in original). The efficient market hypothesis takes three forms: the weak form, the semistrong form, and the strong form. This Note depicts the semistrong form. Under each form, different types of information are reflected in securities prices. *Id.* at 468-70. "Under the weak form . . . stock prices are assumed to reflect any information that may be contained in the *past history of the stock itself.*" *Id.* at 468-69 (emphasis in original). Seasonal stock price patterns exemplify information that a weak form efficient market would reflect. *Id.* As indicated in the accompanying text, in "the semistrong form . . . *all publicly available information* is presumed to be reflected in securities prices." *Id.* at 469 (emphasis in original). Because inside information is not public, investors who obtain inside information may profit in the semistrong efficient market by trading on it. Under the strong form, "*all information* is reflected in stock prices. This includes private, or inside, information as well as that which is publicly available." *Id.* (emphasis in original).

The Supreme Court in *Basic* did not explicitly endorse any form of the efficient market hypothesis. This Note does not attempt to formulate a conclusion in this regard, but assumes that the Court adopted the semistrong version. The Court's definition of the FMT supports this assumption by referring to "available material information." See *supra* text accompanying note 77. Fischel also concludes that the FMT adopts the semistrong version of the efficient market hypothesis. Fischel, *Efficient Capital Markets*, *supra* note 20, at 911. See generally Fama, *Efficient Capital Markets*, *supra* note 58, at 383 (Fama was the first to outline the three forms).

<sup>92</sup> Daniel R. Fischel is Professor of Law and Business at the University of Chicago and is a noted commentator on the FMT.

<sup>93</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 990 (1988).

<sup>94</sup> Fischel, *Finance Theory*, *supra* note 48, at 9. Fischel carries this contention to an extreme. He maintains that the FMT, when applied in securities actions, obviates the need for separate inquiry into materiality (of the misrepresentation or omission), reliance, and damages. *Id.* at 12-13. This may be true on a theoretical level, as a nonmaterial disclosure or omission will not, under the efficient market model, affect the securities price. On a practical level, however, inquiry into materiality makes the FMT easier to understand and apply. The Supreme Court in *Basic* discussed at length the requirement of materiality and stressed its practical importance. See *Basic*, 108 S. Ct. at 983-88.

<sup>95</sup> Fischel, *Finance Theory*, *supra* note 48, at 10.

<sup>96</sup> See Black, *supra* note 1, at 468-72. Professor Black analyzes the SEC's recognition of the efficient market model: ("[T]he integrated disclosure system prescribes prospectus disclosure requirements for securities offerings," *id.* at 468 n.216, based on the degree to which "information about a corporation is sufficiently widely disseminated. . . ." *Id.* at 468. Therefore, the amount of disclosure required is a function of the efficiency of the market. See generally Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 47 Fed. Reg. 11,380 (1982); Proposal of Comprehensive Revision to System for Registration, Securities Act Release No. 33-6331, 46 Fed. Reg. 41,902 (1981); Proposed Comprehensive Revision to System for Registration, Securities Act Release No. 32-6235, 45 Fed. Reg. 63,693 (1980); Finkel v. Docutel/Olivetti Corp., 817 F.2d 356, 361 (5th Cir. 1987), *cert. denied*, 108 S. Ct. 1220 (1988); Pickholz & Horahan, *The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities*, 39 WASH. & LEE L. REV. 943 (1982).

model to determine specific prospectus requirements.<sup>97</sup> Given the acceptance of the efficient market hypothesis, courts should apply the FMT only where the plaintiff traded the subject securities in an impersonal efficient market.<sup>98</sup>

### C. *Basic* and the Scope of the FMT

Rule 10b-5 provides three routes to recovery.<sup>99</sup> Plaintiffs may recover under Routes A and C if a defendant has perpetrated a pervasive fraudulent scheme.<sup>100</sup> Plaintiffs may recover under Route B if defendants have made particular misrepresentations or omissions.<sup>101</sup> Courts disagree over whether to apply the FMT to Route B claims, particularly when the plaintiff admits that he never read the allegedly fraudulent document.<sup>102</sup> *Basic* implicitly resolves this

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<sup>97</sup> Black, *supra* note 1, at 469, observes that “[t]he SEC’s creation of a ‘top tier’ of issuers that need disseminate only a bare-bones prospectus . . . is based on the efficient-market thesis. In incorporating this theory, the SEC assumes that, in the case of the most widely traded securities, information on the issuer is widely available, there is some assurance that it is accurate, and therefore it need not be directly supplied to the investor.” (citations omitted).

<sup>98</sup> See *Basic*, 108 S. Ct. at 992. The Supreme Court adopted the findings of an impersonal, efficient market as “threshold facts” from the court of appeals below. See *Finkel*, 817 F.2d at 360; *Peil v. Speiser*, 806 F.2d 1154, 1161 (3rd Cir. 1986), *cert. denied sub nom.* *Finkel v. Docutel/Olivetti Corp.*, 108 S. Ct. 1220 (1988); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 745 (11th Cir. 1984) (“Fraud on the market theory finds its greatest justification when applied to class actions alleging fraudulent misrepresentations or omissions that affected security prices on a developed open market”), *cert. denied*, 469 U.S. 1132 (1985); *T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1332 (10th Cir. 1983), *cert. denied sub nom.* *Linde, Thompson, Fairchild, Longsworthy, Kohn & VanDyke v. T.J. Raney & Sons*, 465 U.S. 1026 (1984).

<sup>99</sup> See *supra* note 2 and accompanying text.

<sup>100</sup> See *Smith v. Ayres*, 845 F.2d 1360, 1363 (5th Cir. 1988); *Peil*, 806 F.2d at 1162. The language of the Rule itself mandates this conclusion.

<sup>101</sup> See *Smith*, 845 F.2d at 1363; *Peil*, 806 F.2d at 1162.

<sup>102</sup> In the following cases, courts concluded that the FMT does not apply to Route B claims: *Smith*, 845 F.2d at 1363; *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 362 (5th Cir. 1987), *cert. denied*, 108 S. Ct. 1220 (1988); *Shores v. Sklar*, 647 F.2d 462, 471 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. 1981), *aff’d in part*, 459 U.S. 375 (1983); *Mattoros v. Abrams*, 524 F. Supp. 254, 258 (N.D. Ill. 1981).

Most of the cases cited above originated in the fifth and eleventh circuits. Following the 1981 division of the fifth circuit into the fifth and eleventh circuits, the newly-formed eleventh circuit, in *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981), adopted decisions of the former fifth circuit rendered prior to October 1, 1981 as precedent. The fifth circuit decided *Shores* in May of 1981, five months before *Bonner*.

The following decisions expressly held that the FMT applies to Route B, and that the plaintiff need not prove a common scheme of fraudulent activity: *Peil*, 806 F.2d at 1163; *Rosenberg v. Digilog Inc.*, 648 F. Supp. 40, 43 (E.D. Pa. 1985).

The third circuit also noted in *Peil* that *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), the “seminal fraud on the market case, appear[ed] to have involved a [Route B] claim,” in that there the court “did not require a scheme in order to invoke the fraud on the market theory.” *Peil*, 806 F.2d at 1163 n.16. See also *Digilog*, 648 F. Supp. at 43 (“*Blackie* did not require proof of a common

controversy. Three arguments exist which support this proposition.

First, the Court acknowledged only Route B of Rule 10b-5 when it quoted the Rule in its opinion.<sup>103</sup> Thus, the Court apparently considered the claim a Route B claim, to which it applied the FMT.

Second, the claimed violation in *Basic* consisted of three particular fraudulent public statements.<sup>104</sup> Thus, the very acts of which the plaintiff complained fit Route B language. The case involved specific misrepresentations, not an accumulation of individual steps in furtherance of a pervasively fraudulent scheme. *Blackie v. Barrack*<sup>105</sup> involved similar facts. *Blackie*, the "seminal case"<sup>106</sup> with regard to the FMT, involved a Route B claim.<sup>107</sup>

Third, the Court relied heavily<sup>108</sup> on *Peil v. Speiser*,<sup>109</sup> in which the third circuit held that the FMT sufficiently proved causation when the plaintiffs could not show actual reliance on an inaccurate prospectus. The court in *Peil* reasoned that a single misrepresentation may affect the price of a security traded in an efficient market<sup>110</sup> and defraud those who rely on the price in their own trading.<sup>111</sup> Thus, under the efficient market hypothesis, no reason exists for excluding Route B claims from the benefits of the FMT.<sup>112</sup> Public information, whether grounded in a single misrepresentation or a fraudulent scheme, will influence a security's price.<sup>113</sup>

Lastly, the *Peil* court added that "[i]mposing such a requirement (a scheme) creates another burden which could effectively preclude

scheme."); Note, *FMT*, *supra* note 1, at 1148 n.25 ("[t]he *Blackie* reasoning makes a fraud-on-the-market theory available in a [Route B] claim as well as in claims based on [Routes A & C]").

<sup>103</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 983, n.6 (1988).

<sup>104</sup> *Id.* at 981 n.4.

<sup>105</sup> 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

<sup>106</sup> *Ross v. Bank South, N.A.*, 837 F.2d 980, 992 (11th Cir.), *reh'g granted*, 848 F.2d 1132 (11th Cir. 1988); *See also Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 361 (5th Cir. 1987), *cert. denied*, 108 S. Ct. 1220 (1988) (describing *Blackie* as the "premiere fraud on the market case").

<sup>107</sup> *See supra* note 102 and accompanying text.

<sup>108</sup> *See Basic*, 108 S. Ct. at 989, 990, 991 n.25.

<sup>109</sup> 806 F.2d 1154 (3rd Cir. 1986), *cert. denied sub nom. Finkel v. Docutel/Olivetti Corp.*, 108 S. Ct. 1220 (1988).

<sup>110</sup> *Id.* at 1163; *see supra* notes 87-91 and accompanying text.

<sup>111</sup> *Id.* at 1162. Regardless of whether a plaintiff alleges a scheme to defraud or a single fraudulent act, he must prove that the misrepresentation is material. *Id.* *See Basic*, 108 S. Ct. at 982-88, for discussion and analysis of the materiality requirement. Material misrepresentations or omissions are likely to influence the behavior of reasonable investors. *Peil*, 806 F.2d at 1162; *Basic*, 108 S. Ct. at 983 (citing *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976)).

<sup>112</sup> *Peil*, 806 F.2d at 1162. The court stated that "[n]either the district court nor defendants have explained why [Route B] claims should be exempt from the 'fraud on the market' theory." *Id.*

<sup>113</sup> *See supra* notes 87-91 and accompanying text.

the maintenance of otherwise legitimate suits under the securities laws. Securities legislation, enacted for the purposes of avoiding fraud, is intended by Congress to be construed . . . flexibly to effectuate its remedial purposes."<sup>114</sup> Given that a single misrepresentation will affect a security's price, no argument supports preventing Route B claimants from invoking the FMT in efficient market settings.

To conclude that *Basic* extends the FMT to all Rule 10b-5 claims has significant ramifications for a defendant's ability to rebut the reliance presumption. "Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance."<sup>115</sup> The defendant may rebut by proving that the misrepresentation was not material and consequently did not affect the market price,<sup>116</sup> that the plaintiff would have purchased the stock regardless of the misrepresentation,<sup>117</sup> or that the individual plaintiff purchased with knowledge of the fraud.<sup>118</sup> The defendant may no longer rebut the presumption by establishing that the plaintiff "did not rely *directly* on [the] defendant's misrepresentation[; this] fact is not relevant under the fraud on the market approach."<sup>119</sup> According to *Peil*, even if the plaintiff admits that he never read the fraudulent document, the court may invoke the FMT.<sup>120</sup> In stark contrast, *Shores v. Sklar* held

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<sup>114</sup> *Peil*, 806 F.2d at 1162 (quoting *Rosenberg v. Digilog Inc.*, 648 F. Supp. 40, 43 (E.D. Pa. 1985) (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972))).

<sup>115</sup> *Basic*, 108 S. Ct. at 992.

<sup>116</sup> *Peil*, 806 F.2d at 1163.

<sup>117</sup> *Id.* See also *Smith v. Ayres*, 845 F.2d 1360, 1363 (5th Cir. 1988) (reliance presumption rebutted because plaintiff would have taken the same course of action even with full disclosure).

<sup>118</sup> *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). The court in *Blackie* also held that the defendant could rebut by proving that despite the materiality, "an insufficient number of traders relied to inflate the price." *Id.* This conclusion is unsound. It is the material fraudulent act itself that inflates or depresses the security's price. Fischel, *Finance Theory*, *supra* note 48, at 11, states: "It is a contradiction . . . for a statement to be material yet not affect enough traders to influence the market price. The meaning of materiality under the market model is that there has been an effect on the market price."

<sup>119</sup> *Peil*, 806 F.2d at 1163 (emphasis in original).

<sup>120</sup> *Id.* This conclusion troubled the dissent in *Basic*. Justice White claimed that application of the FMT in this context is "at odds with the federal policy favoring disclosure." *Basic Inc. v. Levinson*, 108 S. Ct. 978, 997 (1988) (White, J., dissenting in part). Quoting the dissent in *Shores*, Justice White continued:

[D]isclosure . . . is crucial to the way in which the federal securities laws function. . . . [T]he federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make. This system is not furthered by allowing monetary recovery to those who refuse to look out for themselves. If we say that a plaintiff may recover in some circumstances even

that under a Route B claim, a plaintiff who admits he did not read the fraudulent document may not take advantage of the reliance presumption.<sup>121</sup>

### III

#### THE FMT AND *SHORES V. SKLAR*

##### A. The *Shores* Rationale

As discussed in Part I, the subject securities in *Shores v. Sklar* were new bond issues traded on an inefficient market in Frisco City, Alabama.<sup>122</sup> "The *Shores* court was therefore faced with the difficult task of applying a doctrine developed in one context, the open market, to the not entirely analogous setting of newly issued securities."<sup>123</sup> Because the court found a general scheme to defraud<sup>124</sup> through Route A conduct,<sup>125</sup> as opposed to a single misrepresentation or omission, the *Shores* court held that the plaintiff could invoke the FMT. The court, however, limited the FMT's application to allegations that the bonds "were not entitled to be marketed. . . ."<sup>126</sup> The court focused on the absolute marketability of the bonds, not their price. Under *Shores*, therefore, a plaintiff must allege that "the fraud caused the [b]onds to be offered for sale on the market. If [the plaintiff] proves no more than that the bonds would have been offered at a lower price or a higher rate, . . . he cannot recover."<sup>127</sup>

The court's application of the FMT indicates that it failed to

though he did not read and rely on the defendant's public disclosures, then no one need pay attention to those disclosures and the method employed by Congress to achieve the objective of the 1934 Act is defeated.

*Basic*, 108 S. Ct. at 997-998 (quoting *Shores v. Sklar*, 647 F.2d 462, 483 (5th Cir. 1981) (Randall, J., dissenting), *cert. denied*, 459 U.S. 1102 (1983)).

This argument, however, "reflects a lack of understanding of the operation of [efficient] markets in transmitting information." Fischel, *Finance Theory*, *supra* note 48, at 13. It assumes, in contradiction to "theoretical and empirical evidence," that investors "can make better . . . decisions by first carefully analyzing disclosures . . ." *Id.* See *supra* notes 58-61 and accompanying text; see also *In re LTV Securities Litigation*, 88 F.R.D. 134, 145 (N.D. Tex. 1980) (describing how traditionally managed portfolios, scrutinized by managers, fare no better than randomly selected portfolios).

Fischel concludes that because the typical investor cannot understand the disclosure documents, "the rational course . . . is simply to accept the market price as given." Fischel, *Finance Theory*, *supra* note 48, at 13. This avoids imposing costs on investors "with no corresponding benefit." *Id.* at 14.

<sup>121</sup> *Shores*, 647 F.2d at 468.

<sup>122</sup> See *supra* notes 48-61 and accompanying text.

<sup>123</sup> *Lipton v. Documentation, Inc.*, 734 F.2d 740, 745 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985).

<sup>124</sup> *Shores*, 647 F.2d at 472 (the court found the existence of "fraud on a broader scale").

<sup>125</sup> See *supra* note 2 for a definition of "Route A."

<sup>126</sup> *Shores*, 647 F.2d at 469.

<sup>127</sup> *Id.* at 470.

understand efficient markets. Although *Shores* involved an inefficient market, the court appeared to rely on the efficient market model. For example, the court stated:

This theory is not that he bought inferior bonds, but that the [b]onds he bought were fraudulently marketed. The securities laws allow 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.<sup>128</sup>

The court continued:

Misrepresentation and omission cases under [Route B] which, as we do, require reliance on the document making the misrepresentation or omitting a material fact are inapposite to a case in which the buyer relied on the *integrity of the market* to furnish securities which were not the product of a fraudulent scheme.<sup>129</sup>

The court misconstrued the concepts of integrity and efficiency. The court failed to realize that market integrity is the product of market efficiency. By referring to integrity, the court meant that investors should be able to purchase securities without fear that the securities appeared on the market by virtue of a fraudulent scheme. Although this may be true, a market will have integrity, so far as FMT is concerned, only when a security's value is reflected in its price. This reflection is related to the efficiency of the market. An efficient market is one that incorporates all publicly available information into the price of a security.<sup>130</sup> Because it misconstrued these two concepts, the *Shores* court incorrectly applied the FMT in an inefficient market.

*Shores* should not have applied the FMT in an inefficient market because the theory presumes investor reliance. In an inefficient market, a security's price may not indicate its true value as determined by market analysts and investors. An inefficient market cannot accurately and quickly process the very information which is essential in determining the security's value.<sup>131</sup> For this reason, an investor cannot reasonably rely on an inefficient market to accurately reflect a security's fair price.<sup>132</sup>

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<sup>128</sup> *Id.* at 471 (emphasis added).

<sup>129</sup> *Id.* (emphasis added). The court cited *Blackie v. Barrack* for support. Because *Blackie* relied upon an efficient market in formulating the FMT, see *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976) ("We decline to leave such open market purchasers unprotected"), the *Shores* court mixed apples and oranges.

The *Shores* court also misstated the current state of the law regarding the availability of the reliance presumption for Route B claims. *Basic* indicates that the presumption is available for Route B claims. See *supra* notes 99-120 and accompanying text.

<sup>130</sup> See *supra* notes 58-61.

<sup>131</sup> See *supra* notes 58-61 and accompanying text.

<sup>132</sup> This conclusion follows because in the inefficient market, analysts do not closely follow or heavily trade the subject securities. The market does not necessarily incorpo-

## B. Circuit Court Confusion

The *Shores* opinion has created considerable confusion regarding the scope of the FMT.<sup>133</sup> *Ross v. Bank South, N.A.*,<sup>134</sup> a recent eleventh circuit<sup>135</sup> opinion, illustrates an attempt to grapple with *Shores*. *Ross* involved a new issuance of bonds which the defendant used to finance a residential/medical facility for the elderly located in Vestavia Hills, Alabama.<sup>136</sup> As in *Shores*, the city established a special board to issue the bonds.<sup>137</sup> After repeated failures to obtain an underwriter due to the calculated infeasibility of the project, defendants successfully secured Herreth, Orr & Jones to underwrite the issue.<sup>138</sup>

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rate fraudulent information in the security's price. See Black, *supra* note 1, at 453; see also *supra* notes 58-61 and accompanying text; *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 992 n.27 (1988) (reasonable reliance is an element of a Rule 10b-5 claim); *Ross v. Bank South, N.A.*, 837 F.2d 980, 995 (11th Cir.), *reh'g granted*, 848 F.2d 1132 (11th Cir. 1988) (defendant can rebut the reliance presumption by showing that plaintiff's reliance was not reasonable).

<sup>133</sup> *Lipton v. Documentation, Inc.*, 734 F.2d 740, 745 (11th Cir. 1984) *cert. denied*, 469 U.S. 1132 (1985), provides an excellent example. After acknowledging that confusion exists, *id.* at 745 n.7, the court attempts to clarify its discussion by concentrating on the facts of *Shores*: "The *Shores* holding was thus necessarily confined to the limited setting of newly issued securities traded on an undeveloped market and *did not determine* whether the fraud on the market theory should apply to the open market context. It is that question which is now before this court." *Id.* at 745 (emphasis added). This language implies that *Shores* envisions a narrow FMT. Yet, the court later stated: "We thus read *Shores* as implicitly approving of the general fraud on the market theory, although limiting its application where new securities are involved to situations where but for the fraud the securities would not have been marketable." *Id.* at 747. Because the second quotation does not limit *Shores* to new securities, the statements are inconsistent.

Furthermore, compare *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 722, *reh'g denied*, 832 F.2d 1267, (11th Cir. 1987) (interpreting *Lipton* as reading *Shores* narrowly) *cert. denied*, 108 S. Ct. 1221 (1988) and *Kennedy v. Nicastro*, 517 F. Supp. 1157, 1159 (N.D. Ill. 1981) (stating that the *Shores* court accepted only a limited version of FMT restricting its use in Rule 10b-5 actions to cases in which a seller could not have offered the bonds for sale but for the fraud) with *T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1332 (10th Cir. 1983), *cert. denied sub nom. Linde, Thompson, Fairchild, Longsworthy, Kohn & VanDyke v. T.J. Raney & Sons*, 465 U.S. 1026 (1984) (holding that *Shores* extends Rule 10b-5 protection to newly issued securities).

Commentators also disagree regarding *Shores*. See, e.g., Black, *supra* note 1, at 452 (*Shores* represents a distinct form of fraud-on-the-market theory); Brunelle, *The Shores Case—Expansion of the "Fraud-on-the-Market" Doctrine*, 9 SEC. REG. L.J. 390, 393 (1982) (*Shores* represents an advance beyond the "mainstream fraud-on-the-market cases"); Rapp, *supra* note 1, at 883 ("*Shores* extends *Blackie* and its fraud-on-the-market theory well beyond the parameters of its prior application"); Note, *FMT, supra* note 1, at 1152 (*Shores* adopted restricted view of fraud-on-the-market theory).

<sup>134</sup> 837 F.2d 980 (11th Cir.), *reh'g granted*, 848 F.2d 1132 (11th Cir. 1988).

<sup>135</sup> Recall that *Shores*, a fifth circuit case, is binding precedent in the eleventh circuit. See *supra* note 102.

<sup>136</sup> *Ross*, 837 F.2d at 987.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 988.

Plaintiffs purchased bonds in 1981 and, after the issue went into default in 1984, sued alleging violations of section 10(b) and Rule 10b-5.<sup>139</sup> The district court granted summary judgment in favor of the defendants on all claims.<sup>140</sup> The court of appeals reversed, stating that the defendants had failed to rebut the reliance presumption.<sup>141</sup>

The court of appeals recognized two distinct fraud-on-the-market scenarios. The first involves the traditional open market *Blackie v. Barrack* fact pattern and rationale.<sup>142</sup> “The second (and far less common) type of fraud-on-the-market cases involves fraud in the *issuance* of securities traded on an undeveloped (primary) market.”<sup>143</sup> The court cited *Shores* as the leading case for this latter type of fraud.<sup>144</sup>

Though the court properly distinguished *Shores* from true fraud-on-the-market cases, its ultimate decision was unsound.<sup>145</sup> Relying “‘on the bonds’ availability on the market as an indication of their apparent genuineness,”<sup>146</sup> the court assumed that the market is a good indicator of value and that it reflects available information—essentially that the market is efficient.<sup>147</sup> Because the court conceded, however, that the market in *Ross* was inefficient,<sup>148</sup> the

<sup>139</sup> *Id.* at 989. The fraudulent conduct consisted of an alleged scheme by the defendants which involved sham transactions. The defendants allegedly pre-sold units in the facility to salespeople, friends, and relatives (who had no intention of actually buying the units), in order to enhance the attractiveness of the units to outsiders. Likewise, as defendants “sold” more and more units, the facility became more attractive to bond investors. *Id.*

<sup>140</sup> *Id.* at 990.

<sup>141</sup> *Id.* at 1004. Although the court of appeals affirmed the district court’s dismissal of the facility’s trustees as defendants, that portion of the opinion is inconsequential to this analysis.

<sup>142</sup> *Id.* at 992. The court stated:

The first type involves a claim by a plaintiff who purchases a security traded on a developed and open market . . . . Whether or not the plaintiff in such a case relied on a specific misrepresentation or omission, she may be entitled to relief because she relied “generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price. . . .”

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

<sup>143</sup> *Id.* at 993 (emphasis in original).

<sup>144</sup> *Id.*

<sup>145</sup> The *Ross* court’s reasoning parallels that in *Shores*. See *supra* notes 128-29 and accompanying text.

<sup>146</sup> *Ross*, 837 F.2d at 995 (quoting *Shores v. Sklar*, 647 F.2d 462, 470 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983)).

<sup>147</sup> See *supra* notes 48-60 and 87-91 and accompanying text. Simply stated, “This presumption of reliance derives from the concept of an efficient market . . . .” *McNichols v. Loeb Rhoades & Co.*, 97 F.R.D. 331, 337 (N.D. Ill. 1982).

<sup>148</sup> *Ross*, 837 F.2d at 993. The court stated that *Shores* is the leading case in which a

court applied the FMT outside its proper domain.

This new, undeveloped market version of the FMT, created in *Shores* and endorsed in *Ross*, presents a troublesome issue. While the undeveloped market version is limited to the absolute marketability of bonds,<sup>149</sup> it creates a presumption of reliance that is even harder to rebut than in the typical fraud-on-the-market case.<sup>150</sup> One commentator states that *Shores*, as interpreted by other courts, converts "fraud on the market theory into a pure causation" recovery scheme.<sup>151</sup> The reliance mandate of *Basic*<sup>152</sup> thus becomes strict "but for" causation liability.<sup>153</sup>

In this context, a reliance presumption based on the FMT effectively eliminates the plaintiff's reliance requirement. This "is an unnecessary and unjustified expansion of the fraud on the market doctrine . . . ."<sup>154</sup> Reliance on inefficient market prices does not justify the FMT presumption. Nothing supports the belief that the price indicates the security's actual value.<sup>155</sup> Only applying the FMT in efficient market settings preserves the reliance requirement which *Basic* mandates.<sup>156</sup> "The fraud on the market theory can be interpreted as defining whether an individual's reliance was reasonable under the ultimate objective standard—whether investors as a whole were fooled."<sup>157</sup> In contrast to inefficient markets, material misrepresentation or omissions in well developed markets will affect the market price. Thus, proof of materiality satisfies, though indi-

court applied the FMT in an undeveloped market. The *Ross* court continued that the case before it "require[d] our court to examine for the first time the nature of the reliance requirement in a case brought under *Shores*." *Id.* at 994.

<sup>149</sup> See *Shores v. Sklar*, 647 F.2d 462, 470 (5th Cir. 1981) (if the plaintiff proves only that the price of the bonds would have been different, he cannot recover), *cert. denied*, 459 U.S. 1102 (1983).

<sup>150</sup> *Ross*, 837 F.2d at 995. The court stated:

The rebuttal of this presumption is more difficult under *Shores* than under *Blackie*. In a *Blackie* type case, the defendant can show that his fraud had no effect on the market price. This defense severs the causal link between the fraud and the plaintiff's loss. A *Shores* defendant can make no such showing, however, because his fraud *creates* the bond itself. Without the fraud, the plaintiff could not have purchased the bond.

*Id.* (citations omitted) (emphasis in original).

<sup>151</sup> Black, *supra* note 1, at 453.

<sup>152</sup> See *Basic Inc. v. Levinson*, 108 S. Ct. 978, 989 (1988).

<sup>153</sup> See *Ross*, 837 F.2d at 994; *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 722 *reh'g denied*, 832 F.2d 1267 (11th Cir. 1987) *cert. denied*, 108 S. Ct. 1221 (1988); *T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1333 (10th Cir. 1983), *cert. denied sub nom. Linde, Thompson, Fairchild, Longsworthy, Kohn & VanDyke v. T.J. Raney & Sons*, 465 U.S. 1026 (1984).

<sup>154</sup> *Ross*, 837 F.2d at 1007 (Allgood, J., dissenting in part).

<sup>155</sup> See *supra* notes 58-61 and accompanying text.

<sup>156</sup> See *supra* note 62 and accompanying text.

<sup>157</sup> Fischel, *Efficient Capital Markets*, *supra* note 20, at 908.

rectly, the plaintiff's burden of proof.<sup>158</sup>

*Ross* opens Rule 10b-5 defendants to striking liability.<sup>159</sup> The court conceded that investors must "take the risk of default into account when making their purchases,"<sup>160</sup> but did not acknowledge that fraud is one such risk. Rather, the court concluded that even in an undeveloped, inefficient market, investors only bear risks in the "absence of fraud . . ."<sup>161</sup>

This Note does not contend that courts should leave defrauded investors without remedy. Rather, it argues that investors must prove every element of their claim in order to recover under Rule 10b-5. Because one cannot reasonably rely on pricing in an inefficient market,<sup>162</sup> courts should not give plaintiffs the benefit of a presumption of reliance in inefficient market settings. Therefore, in an inefficient market setting the plaintiff should bear the burden of proving direct reliance on the defendant's misrepresentations.<sup>163</sup>

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<sup>158</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 992 (1988). The Supreme Court stated: "The Court of Appeals found that petitioners 'made public, material misrepresentations and [respondents] sold Basic stock in an impersonal, efficient market. Thus the class . . . has established the threshold facts for proving their loss.'" *Id.* (quoting *Levinson v. Basic, Inc.* 786 F.2d 741, 751 (6th Cir. 1986)).

The court in *Peil v. Speiser* succinctly set forth the plaintiff's burden: "[P]laintiffs who purchase in an open and developed market need not prove direct reliance on defendant misrepresentations, but can satisfy their burden of proof on the element of causation by showing that the defendants made material misrepresentations." 806 F.2d 1154, 1161 (3rd Cir. 1986), *cert. denied sub nom.* *Finkel v. Docutel/Olivetti Corp.*, 108 S. Ct. 1220 (1988).

<sup>159</sup> The *Ross* court concluded that "[i]f this result resembles insurer liability, it is only because the defendant's fraud affected the entire class of purchasers. *Shores* stands for the simple proposition that fraud on a broader scale that permeates the very issuance of the bonds gives rise to liability on a broader scale." *Ross*, 837 F.2d at 996.

<sup>160</sup> *Id.* Investing in undeveloped markets is inherently risky. It is not surprising that the bonds in *Ross* returned interest at a rate of 15.5% to 17% tax free. *Id.* at 989.

<sup>161</sup> *Id.* at 996.

<sup>162</sup> See *supra* notes 87-91 and accompanying text.

<sup>163</sup> Although one can argue that this rule would preclude class actions in inefficient market settings, this is not necessarily the case. The eleventh circuit recently addressed this issue in *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, *reh'g denied*, 832 F.2d 1267 (11th Cir. 1987) *cert. denied*, 108 S. Ct. 1221 (1988). The action centered on limited partnership shares issued in an undeveloped market. Holding, as did *Shores*, that the plaintiff in a Route B claim must prove direct reliance on the misleading information, the court specifically held that "[i]n view of the overwhelming number of common factual and legal issues . . . the mere presence of the factual issue of individual reliance could not render the claims unsuitable for class treatment." *Id.* at 724. Extending *Kirkpatrick* to all three Routes under Rule 10b-5 is simple and fully warranted. Of course, the plaintiffs must find an adequate class representative. See *Epstein v. American Reserve Corp.*, No. 79 C 4767 (N.D. Ill. Apr. 21, 1988) (LEXIS, Genfed library, Dist file) (class certification denied because proposed representative inadequate); *Masri v. Wakefield*, 106 F.R.D. 322 (D. Colo. 1984) (class certification denied because representative inadequate); *Seiler v. E.F. Hutton & Co.*, 102 F.R.D. 880 (D.N.J. 1984) (class certification denied in securities fraud suit because proposed representative inadequate); *McNichols v. Loeb Rhoades & Co.*, 97 F.R.D. 331 (N.D. Ill. 1982) (class action based on

## IV

## NEW ISSUES AND THE EFFICIENT MARKET MODEL

*Shores* and *Ross* are “‘bad’ law”<sup>164</sup> because they misconstrue an economic theory and apply it in an improper setting. The proper domain of the FMT is the efficient market. As presented in Part II, the Court in *Basic Inc. v. Levinson* endorsed this conclusion.<sup>165</sup> *Basic* did not, however, decide whether a plaintiff may apply the FMT to new issues offered in efficient markets. Courts should adopt this use of the FMT to clarify its application.<sup>166</sup> Security prices in an efficient market reflect publicly available information,<sup>167</sup> so the market will incorporate fraudulent information in a new issue’s offering price. Courts should therefore limit the FMT to efficient markets, but should not restrict its application within them.

A simple market test follows naturally from *Basic*.<sup>168</sup> If the

fraud-on-the-market theory denied because class representative subject to unique defense).

Furthermore, placing the burden of proving direct reliance on the plaintiff precludes an unwarranted scheme of investors’ insurance. The dissents in *Basic*, *Ross*, and *Shores* point out that it is particularly important, given an inefficient market, to look out for oneself when making investment decisions. *Basic*, 108 S. Ct. at 997 (White, J., dissenting in part) (quoting *Shores v. Sklar*, 647 F.2d 462, 483 (5th Cir. 1981) (Randall, J., dissenting), cert. denied, 459 U.S. 1102 (1983)); *Ross*, 837 F.2d at 1005 (Allgood, J., concurring in part and dissenting in part) (quoting *Shores*, 647 F.2d at 483 (Randall, J., dissenting)). In the inefficient market context, mandating proof of direct reliance does further the disclosure policies of the securities laws. See *Ross*, 837 F.2d at 1005 (Allgood, J., concurring in part and dissenting in part). Recall that this Note reaches the opposite conclusion with regard to efficient markets. See *supra* note 120 and accompanying text.

<sup>164</sup> *Ross*, 837 F.2d at 1009 (Fay, J., concurring).

<sup>165</sup> See *supra* notes 77-91 and accompanying text.

<sup>166</sup> The crux of this analysis is the market itself and not the security. Not only is this test consistent with the efficient market hypothesis, but it simplifies the application of the FMT. For an illustrative example, consider *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978). In *Vervaecke*, the court refused to apply the FMT to a new issue of Hospital Authority bonds. *Id.* at 714. Many courts and commentators have interpreted *Vervaecke* as standing for the proposition that the FMT does not apply to new issues, and thus have concluded that the decision opposes *Shores*. See *Lipton v. Documentation, Inc.*, 734 F.2d 740, 743 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985); *T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1333 (10th Cir. 1983), cert. denied *sub nom.* *Linde, Thompson, Fairchild, Longsworthy, Kohn & VanDyke v. T.J. Raney & Sons*, 465 U.S. 1026 (1984); Note, *FMT, supra* note 1, at 1152. The eighth circuit, however, was not willing to extend the reliance presumption from *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), from omissions to misrepresentations. *Vervaecke*, 578 F.2d at 718. See *supra* notes 69-72 and accompanying text. Because *Vervaecke* involved misrepresentations, the court dismissed the fraud-on-the-market allegations.

Under the proposed market test, the *Vervaecke* plaintiff’s fraud-on-the-market claim would likewise fail, but for another reason. Had the court found that investors purchased the Hospital Authority bonds in an inefficient market, it would then conclude that the FMT did not apply. The court would not need to reach the issue of whether the bonds were a new issue.

<sup>167</sup> See *supra* notes 48-49 and 58-61 and accompanying text.

<sup>168</sup> The test is simple conceptually; however, calculating whether or not a given mar-

court defines a market as efficient, then the plaintiff should be able to invoke the FMT. The type of security traded—whether an existing or new issue—is irrelevant.

Courts may easily apply this market test. *Lubin v. Sybedon Corp.*<sup>169</sup> and *Epstein v. American Reserve Corp.*<sup>170</sup> present good examples. In *Lubin*, the defendants issued limited partnership interests in a hotel project.<sup>171</sup> Prudential-Bache Properties, one of the defendants, marketed the limited partnerships nationally from January through April 1985.<sup>172</sup> After the defendants sought Chapter 11 status,<sup>173</sup> plaintiff brought suit alleging, among other claims, violations of section 10(b) and Rule 10b-5.<sup>174</sup> Specifically, the plaintiff claimed that the defendants issued three offering documents which contained fraudulent misstatements.<sup>175</sup> The documents grossly overvalued the project and induced plaintiff to invest.<sup>176</sup>

Plaintiff sought to invoke the FMT and, consequently, did not plead direct reliance on the offering documents.<sup>177</sup> The court dismissed plaintiff's claim under *Basic* and *Blackie v. Barrack*.<sup>178</sup> The court recognized that the FMT does not apply to securities traded in inefficient markets,<sup>179</sup> and concluded that *Basic's* reliance presump-

ket is efficient may be quite difficult. See *supra* notes 58-61 and accompanying text for relevant criteria in determining whether a market is efficient. Professor Fischel addresses the problem as follows:

The most that can be said is that the more rapidly prices reflect publicly-available information, the more sensible it is to apply the theory. Factors which will be relevant in analyzing how rapidly prices reflect information include whether the security is listed on a national exchange, whether it is actively traded, and whether it is followed by analysts and other market professionals. In addition, the speed of price adjustments to new information can be tested directly by use of widely accepted statistical techniques. Nevertheless, there will inevitably be some marginal cases where the applicability of the fraud on the market theory is unclear.

Fischel, *Efficient Capital Markets*, *supra* note 20, at 912 (footnote omitted).

<sup>169</sup> 688 F. Supp. 1425 (S.D. Cal. 1988).

<sup>170</sup> No. 79 C 4767 (N.D. Ill. Apr. 21, 1988) (LEXIS, Genfed library, Dist. file).

<sup>171</sup> *Lubin*, 688 F. Supp. at 1432.

<sup>172</sup> *Id.*

<sup>173</sup> Federal bankruptcy law provides for reorganization of bankrupt businesses. See 11 U.S.C. §§ 1101-1174 (1982).

<sup>174</sup> *Lubin*, 688 F. Supp. at 1433.

<sup>175</sup> *Id.* ("According to *Lubin*, neither the Hotel's renovation history nor its later cost overruns were disclosed in the documents which were drafted to solicit investors for the limited partnership. It is these omissions (and corresponding misstatements) which lie at the heart of *Lubin's* complaint.")

<sup>176</sup> *Id.*

<sup>177</sup> *Id.* at 1447-48.

<sup>178</sup> *Id.* at 1445-46.

<sup>179</sup> *Id.* at 1445. Prudential-Bache Properties did nationally market the subject limited partnerships, but did not do so on a "free, efficient and national securities exchange." *Id.* Rather, Prudential-Bache privately placed the securities in the primary market. *Id.* "[A]ccording to Prudential-Bache, the Confidential Private Placement Memorandum prominently declared that the offering price was determined solely by the

tion was inappropriate given these facts.<sup>180</sup> The court stated that "a strict fraud-on-the-market reliance presumption does not apply where, as here, securities have not been purchased on an impersonal market."<sup>181</sup>

Likewise, in *Epstein v. American Reserve Corp.*,<sup>182</sup> the court used the market test approach. After the plaintiffs purchased securities,<sup>183</sup> they initiated a securities fraud suit alleging that the defendant corporations induced them to buy at artificially high prices. The plaintiffs claimed that the defendants' financial statements inflated the securities' prices by failing to disclose that one of the primary subsidiaries of the defendant corporation was insolvent.<sup>184</sup> The court held that "a plaintiff may invoke the rebuttable presumption of reliance afforded under a 'fraud-on-the-market' theory only if he can allege and prove . . . that the stock at issue was traded on an

General Partner, and did not necessarily reflect the value of the property." *Id.* at 1446. These facts fully explain the court's conclusion that the FMT was inappropriate in the given context. *See supra* notes 58-61 and accompanying text; *see also supra* notes 51-55 and accompanying text for discussion of primary and secondary markets; *see* R. HAUGEN, *supra* note 51, at 22-23 for discussion of private placement.

<sup>180</sup> *Lubin*, 688 F. Supp. at 1445. Investors seeking Rule 10b-5 recovery should take note of the court's pleading lesson: plead direct reliance as an alternative to the FMT reliance presumption.

<sup>181</sup> *Id.* The court could have concisely ended its analysis, but instead it continued, analyzing other possible fraud-on-the-market claims. A unique variation of the theory which the court held inapplicable, *see id.* at 1446, is found in *Arthur Young & Co. v. United States Dist. Court*, 549 F.2d 686 (9th Cir.), *cert. denied*, 434 U.S. 829 (1977). Though *Arthur Young* involved new securities issues that were not traded on the open market, the court there held that:

Just as the open market purchaser relies on the integrity of the market and the price of the security traded . . . to reflect the true value of securities in which he invests, so the purchaser of an original issue security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies and the investors. . . .

*Id.* at 695. The *Lubin* court distinguished *Arthur Young* because in the latter, the defendant had filed registration statements and prospectuses with the SEC prior to sale of the partnership interests, and had shown or sent standardized statements to every investor. In *Lubin*, no such reliance on the regulatory process was conceivable as the limited partnerships were not registered with or approved by the SEC. *Lubin*, 688 F. Supp. at 1446.

Compliance with the regulatory scheme does not create efficient markets; rather, it provides more valuable information for an efficient market to process. Thus, regulatory compliance provides no basis for application of the FMT. *See* Black, *supra* note 1, at 455. Perhaps sensing their unsound analysis, the *Lubin* court refused to conclusively endorse either *Arthur Young* or *Shores*, and refused to depart from the theory presented in *Blackie* and *Basic*. *Lubin*, 688 F. Supp. at 1446. *See supra* notes 99-121 and accompanying text. Concededly, the court's reluctance may have been based in part on the plaintiff's faulty pleading.

<sup>182</sup> No. 79 C 4767 (N.D. Ill. Apr. 21, 1988) (LEXIS, Genfed library, Dist. file).

<sup>183</sup> The securities purchased were in the form of stock or debentures. *Id.* at 2.

<sup>184</sup> *Id.* Plaintiffs also alleged that defendants took numerous actions to conceal the insolvency.

impersonal, well-developed, efficient market.”<sup>185</sup> The court relied explicitly on *Basic* and concluded that the FMT was unavailable for lack of an efficient market.<sup>186</sup>

“The link between the . . . efficient capital market[] and the fraud on the market theory is clear.”<sup>187</sup> The prices of actively traded new issues should reflect publicly available information, and consequently “it is rational for . . . investors to accept the market price as given.”<sup>188</sup> Reliance on offering prices is reasonable, and therefore plaintiffs complaining of fraudulently marketed new issues should have the right to invoke the FMT. The focal point is the type of market and not the type of security.

#### CONCLUSION

The simplicity of the market test is attractive. The different applications of the fraud-on-the-market theory have led to confusion among the courts, confusion which requires swift and pragmatic resolution. Strict adherence to an efficient market test, as proposed, would assure that courts will apply the FMT in its proper domain. *Basic Inc. v. Levinson*, though lacking a completely thorough analysis, provides the framework for this recommended guidance.

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<sup>185</sup> *Id.* at 6.

<sup>186</sup> *Id.* The court concluded that the over-the-counter market was not impersonal, well-developed, or efficient, and thus it could not meet the requirements of *Basic*. *Id.* See also *In Re Data Access Systems*, 103 F.R.D. 130, 138 (D.N.J. 1984)(trading on the over-the-counter market may not constitute an “active and substantial” market necessary to apply the FMT).

The court also denied class certification because the proposed class representative was inadequate. *Epstein*, at 6; see also *supra* note 163 for cases in which courts denied class certification because the class representative was inadequate.

<sup>187</sup> Fischel, *Efficient Capital Markets*, *supra* note 20, at 911.

<sup>188</sup> *Id.*

