The Fraud-on-the-Market Theory: A "Basic"ally Good Idea Whose Time Has Arrived, Basic, Inc. v. Levinson

I. INTRODUCTION

The stock market has been shaken once again. Black Monday, October 19, 1987 has replaced Black Tuesday of October 1929.1 Wall Street stories of mergers and acquisitions,2 high yield junk bonds, insider trading,3 market manipulations,4 the Drexel Burnham Lambert settlement,5 and leveraged buyouts of a proportion, magnitude, and number never dreamed of just five years ago6 have filled the newspapers and news magazines.

For many years the stock market was stable in the sense that prices rose and fell with the conditions of the day. The underlying assumptions of investment risk were not seriously questioned even though efforts were made to maintain quality control.7 The nation was confident that nothing like the Great Depression and the market crash of 1929 would ever be repeated.8 Congress enacted the Securities Act of 19339 and the Securities Exchange Act of 193410 in an effort to ensure the safety of

2. N.Y. Times, October 21, 1988, at 1, col. 3 (A partnership led by the Wall Street firm of Shearson Lehman Hutton Inc. is reportedly planning to offer about $17 billion for RJR Nabisco, Inc).
3. N.Y. Times, December 19, 1987, at 1, col. 1 (Ivan F. Boesky is sentenced to three years in prison in insider trading scandal).
4. Wall Street Journal, October 14, 1987, § A, at 6, col. 1 (At least two investigations are under way into possible illegal self-dealing involving private charitable foundations funded and controlled by Drexel Burnham's junk bond chief, Michael Milken, his brother Lowell and others).
6. N.Y. Times, October 21, 1988, at 1, col. 3.
8. N.Y. Times, October 21, 1987, §IV at 15, col. 3 (Old jokes, that were formed during Great Depression, are being revived and updated during current stock market crisis). It is not suggested that the causal factors of the market decline in 1987 are the same as those present in 1929. See, The October 1987 Market Break, FED. SEC. L. REP. (CCH) No. 1271 (Feb. 9, 1988).
the American economy.  

Individuals bought and sold securities and made or lost money feeling secure that illegality or fraud had not affected the risk. Attorneys advised their clients candidly and responsibly of the client’s obligations to disclose information as required by the SEC laws. If fraud was involved in the market prices or conditions, laws were available with which to prosecute the perpetrators. In particular, Rule 10b-5 provided broad language with which to carry out the purpose of protecting market investors from the types of activities, namely fraud and manipulation, that nearly brought the country to the brink of economic disaster during the last years of the 1920’s.

Until 1975, the Supreme Court applied broadly the SEC regulations in finding a 10b-5 fraud action. With the Blue Chip Stamps v. Manor Drug Stores case, however, the Court began to interpret more narrowly aspects of the fraud action. Justice Rehnquist, writing the majority

11. See infra notes 12-13, 24-27 and accompanying text.

12. Sections 11 and 12(2) of the Securities Act of 1933, 15 U.S.C. 77k, 77l(2) (1982), provide express causes of action by defrauded or misled buyers of securities, but the remedies are limited. Section 11 of the Securities Act prohibits material misstatements and omissions in registration statements. Section 12(2) imposes liability on a seller of registered or unregistered securities for material misstatements or omissions in any communication through which the securities are offered or sold. The Securities Exchange Act of 1934 provides antifraud provisions in sections 10(b) and 16(b), 15 U.S.C. 78j(b), 78p(b) (1982). An implied cause of action for violation of section 10(b) was accepted in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). Section 10(b) applies to all securities but section 16(b) applies to equity securities of registered companies and only to directors, officers, and ten percent or more shareholders.

13. 15 U.S.C. § 78j(b), and the Rule promulgated thereunder, 17 C.F.R. 240.10b-5 states:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality or interstate commerce, or of the mails or of any facility of any nation 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.


15. 421 U.S. 723 (1975). The Court limited 10b-5 actions to actual purchasers or sellers of securities. Id. at 725.

16. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (manipulative or deceptive conduct is required for 10b-5 actions); Dirks v. SEC, 463 U.S. 646 (1983) (a tippee is not under a duty to disclose or refrain from trading unless the tip is a breach of her fiduciary duty); Chiarella v. United States, 445 U.S. 222 (1980) (no duty to disclose mere possession of nonpublic insider information); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter, i.e., intent to deceive, manipulate, or defraud, on the part of the defendant is necessary).
opinion in Blue Chip, argued that there was "widespread recognition" that the problem of vexatious litigation under Rule 10b-5 cases needed to be circumscribed.17

If, indeed, the Court has sought to refine the scope of securities fraud actions during the past 14 years, it has made a major shift toward a broader interpretation with Basic Inc. v. Levinson18. In the Basic case, the Court supported the fraud-on-the-market theory.19 Fraud-on-the-market is a theory which recognizes that a materially false statement or omission, made available to the general public, may be relied upon by stock market professionals in the process of valuing shares.20 This process of valuing the shares, affected by false statements or omissions, causes the price of the stock to deviate from what its intrinsic value should be. As a result, investors are hurt by false statements or omissions even if they do not personally value the stock on the mis-statements or omissions. Additionally, the fraud-on-the-market theory serves as an entree for plaintiff class actions because individual direct reliance need not be proven.21 The theory is used to support a presumption of reliance in Rule 10b-5 securities fraud actions.22

The Supreme Court, with the Basic decision, has renewed interest in the fraud-on-the-market theory.23 This Note examines the background and application of the fraud-on-the-market theory. An analysis of the Basic majority and dissenting opinions follows. Finally, it will be shown that the positive aspects of the Basic decision for investors, namely a presumption of reliance which functions to remove a difficult evidentiary burden and which provides for easier class action certification, should be weighed against the uncertainty that corporations and their counsel now face because of the Court's unrestricted announcement that the fraud-on-the-market theory is acceptable in Rule 10b-5 actions. The favoring of the investor by the United States Supreme Court will be

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17. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975). The Court was concerned with strike suits, that is, those cases without merit but which have a settlement value because the defendant can be forced to engage in costly discovery. Id. at 740-41.
20. See supra n.19.
22. See Black, supra note 19; Note, supra note 19.
23. Basic, 108 S. Ct. at 998. The Basic court determined the materiality standard for violation of § 10(b) of the Securities Exchange Act of 1934 in the context of corporate preliminary merger negotiations statements in addition to approving the fraud-on-the-market theory. Id. at 983.
seen by many as welcome and long overdue. However, it is not without a cost. With the *Basic* decision, the Court may have given investors the impression that they no longer must act with caution and care when dealing with stock market risk. At the same time, the Court seems ready to impose a greater burden on those who make the disclosure to those who are careless.

II. BACKGROUND

The purpose of the Securities Act of 1933 and the Securities Exchange Act of 1934, and specifically Rule 10b-5, was to protect investors against manipulation of stock prices, to promote fair equitable practices, and to insure fairness in securities transactions. Principles of basic tort law were incorporated into the 1933 and 1934 Acts as means of accomplishing the Acts' ends.

The 10b-5 cause of action has been based on traditional common law fraud. Misrepresentations, as the basis of a fraud action, had to be relied upon in order to be actionable. If applied to securities fraud cases, the plaintiffs would be required to show that they had relied on the prospectus or other publicly disclosed information, in addition to the other elements of fraud, in order to recover damages. The Second, Third, Fifth, Ninth, Tenth, and Eleventh Circuits now recognize

28. The elements for common law fraud include: a misrepresentation of a material fact, reliance, causation and intent or scienter. Restatement (Second) of Torts §§ 525-530 (1977).
29. See W. Prosser, supra note 27.
30. Id.
34. Blackie V. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).
that the securities market functions in response to all information fed into it whether or not investors read and use the information.\textsuperscript{37} The reliance element is demonstrated by showing both that the misstatements or omissions affected the market and that the purchase or sale of a security caused the plaintiff's injury. A misrepresentation is ""impounded in the market price, and the person who buys without knowledge of the prospectus is acting on false information to the same extent as those who buy with knowledge."\textsuperscript{38}

Some courts have distinguished between omissions and false and misleading statements,\textsuperscript{39} noting that proof of reliance for omissions is a particularly difficult problem because of the need to show how the plaintiff would have acted had the information been disclosed.\textsuperscript{40} However, a presumption of reliance is now employed in both misstatement and omission cases.\textsuperscript{41}

The primary purpose of the reliance presumption in a Rule 10b-5 cause of action is to allow the investor to rely on the expectation that the securities markets are fraud-free,\textsuperscript{42} prices are set validly,\textsuperscript{43} and the market has not been manipulated.\textsuperscript{44} In an open market the investor is able to assume that a security is priced accurately, that is, that the market price is in fact the equivalent of the intrinsic value.\textsuperscript{45}

A secondary, but no less important, purpose for allowing a presumption of reliance is to maintain a class action.\textsuperscript{46} The procedural concerns of class actions under the Federal Rules of Civil Procedure,\textsuperscript{47} namely, the need for each plaintiff to show individual reliance, are eliminated; therefore, the potential for more plaintiffs and larger recoveries exists.\textsuperscript{48} Additionally, as the majority in Basic pointed out, the

\textsuperscript{37} The Fifth Circuit pointed out in Shores that the Supreme Court "did not eliminate reliance as an element of a 10b-5 omission case; it merely established a presumption that made it possible for the plaintiffs to meet their burden." \textit{Id.} 647 F.2d at 468.


\textsuperscript{39} See cases cited infra note 71.

\textsuperscript{40} Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972). The Supreme Court held that in a face-to-face transaction where the defendant failed to state material facts, the plaintiff's reliance could be presumed from the materiality of the facts. The defendant would then have an opportunity to prove that the plaintiff had not relied on the material omissions. \textit{Id.} at 153-54.

\textsuperscript{41} See cases cited infra note 71.

\textsuperscript{42} Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).

\textsuperscript{43} \textit{Id.}

\textsuperscript{44} \textit{Id.}

\textsuperscript{45} Note, \textit{The Fraud-on-the-Market Theory}, 95 Harv. L. Rev. 1143 (1982).


\textsuperscript{47} Fed. R. Civ. P. 23.

\textsuperscript{48} See generally Comment, \textit{Class Actions, Typicality, and Rule 10b-5: Will the
fraud-on-the-market theory removes an unrealistic evidentiary burden from the plaintiff.49

III. THE EFFICIENT CAPITAL MARKET HYPOTHESIS AND THE FRAUD-ON-THE-MARKET THEORY

The notion that the investor expects the market to provide an accurate reflection of the value of a stock is based on the efficient capital market hypothesis.50 The premise of the efficient capital market hypothesis is that in pricing a stock the market anticipates events and, consequently, a stock's price is the best estimate of its intrinsic value.51 The hypothesis developed from the random walk model,52 that is, that market prices will fluctuate randomly and be independent of prior changes.53 The efficient market hypothesis, as it has evolved, suggests that the market reacts, completely and immediately, to information about the shares being traded.54 As such, the market, using all publicly available information, sets a price which reflects the actual value of the stock.55

There are three forms of the efficient capital market hypothesis: the weak form which measures whether historical price data is fully reflected; the semi-strong which measures whether all publicly available information is reflected; and the strong form which measures whether all information, including information not publicly available, is fully reflected.56 The semi-strong form of the efficient market hypothesis is the recognized basis of the fraud-on-the-market theory.57

49. Basic, 108 S. Ct. at 990.
53. Id. at 77.
54. Id. at 76.
55. Id. at 77. See also Black, Fraud-on-the-Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions, 62 N.C.L. Rev. 435, 449.
57. See J. Lorie, supra note 52, at 77.
The efficient market hypothesis has been problematic because randomness would seem to imply a lack of meaning to stock pricing. Also there is the obvious paradox of investor activity. In an efficient market when information is available, the share price will approach its intrinsic value because of investor competition. At the same time, investors trade stock because they believe stocks are under- or overvalued, that is, that the market prices do not reflect their true value. Many investors purchase or sell stocks because they believe the price reflects the corporation’s worth inaccurately. However, “[u]nder conditions of efficiency, no investor, using only information also generally available to other investors, can systematically identify and acquire undervalued (or overvalued) securities.” It has been pointed out by economists and courts that the efficient market theory has some difficulties beyond this paradox. The stock market is not only to receive information but to interpret the information and transform the information into a price. The information is supposedly factual. However, projections, conjectures, and speculations, which are of questionable sufficient factual basis, are incorporated into the mix of information to be interpreted and such “information” is filtered regularly into the market place.

The fraud-on-the-market theory, based on the efficient market hypothesis, is used to say that a buyer or seller of securities can presume an efficient market. The Third Circuit Court in Peil v. Speiser stated that “in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business.” An investor may rely on the “supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price.” It is the investor’s

58. See Wang, Some Arguments That the Stock Market Is Not Efficient, 19 U.C.D. L. Rev. 341 (1986). Wang has stated that if the “semi-strong [form of the efficient market] hypothesis were correct, one would have to conclude that the market for investment research was extremely inefficient.” Id. at 375. See also, Tobin, On the Efficiency of the Financial System, 153 Loyds Bank Rev. 1 (1984).
59. See J. Lore, supra note 52, at 77.
60. See Black, supra note 19, at 455.
62. See generally supra notes 50-52.
63. Basic, 108 S. Ct. at 998 (White, J., dissenting).
65. 806 F.2d 1154 (3d Cir. 1986).
66. Id. at 1160.
reliance on the market and not on the information disclosed by the corporation that is presumed. Therefore, reliance is still a vital part of the 10b-5 cause of action, even though the focus of the investor’s reliance has shifted to the market. Consequently, misleading statements could defraud traders in securities even if the investors did not rely directly on the misstatements. The misstatements or omissions can affect the price by either inflating or deflating it artificially, which could defraud investors who rely on the price as a reflection of the value of the share.  

A potential problem with the fraud-on-the-market theory is the conflict between the national policy of full and fair disclosure of material information to the investing public and the public’s failure to rely on that information because the market is supposedly efficient. As the district court in In re LTV Securities Litigation stated in 1980:

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

If indeed the market is functioning as an informer/agent of the investor, full disclosure to investors is not necessary and is, in fact, superfluous.  

IV. FRAUD-ON-THE-MARKET THEORY APPLIED

The various federal circuit courts have applied the fraud-on-the-market theory in securities fraud actions brought under Rule 10b-5. The Second, Ninth, and Eleventh Circuits have applied the presumption of reliance only to existing securities on developed markets, but the Fifth and Tenth Circuits have applied the theory to newly issued shares on undeveloped markets.

The first Supreme Court case to dispense with proof of actual reliance in establishing causation in non-disclosure cases was Affiliated Ute Cit-
izens v. United States. 74 In Affiliated Ute, members of a large class of shareholders alleged that they had relied, in the context of a face-to-face transaction, on the advice of two bank employees in selling their stock. 75 The bank employees failed to disclose the stock’s true value and that they were market makers in the stock. 76 The Supreme Court held:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. 77

Since 1972 and the Affiliated Ute decision, the circuits have approached the fraud-on-the-market theory with inconsistent results. 78 In Blackie v. Barrack, 79 the Ninth Circuit expanded the Affiliated Ute decision by extending the reliance presumption to a material misrepresentation case. 80 As the court noted:

Here, we eliminate the requirement that plaintiffs prove reliance directly in this context because the requirement imposes an unreasonable and irrelevant evidentiary burden. . . . Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect, despite the fact that the causational chain is broken only if the purchaser would have purchased the stock even had he known of the misrepresentation. We decline to leave such open market purchasers unprotected. 81

74. 406 U.S. 128 (1972). With Affiliated Ute the Supreme Court established a rebuttable presumption of reliance in non-disclosure cases but did not discuss whether reliance could be presumed in affirmative misrepresentation cases. Id. at 153.
75. Id.
76. Id.
77. Id. at 153-54 (citations omitted).
78. See cases cited infra notes 79-95.
79. 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).
80. The Blackie plaintiffs claimed that they purchased shares of Ampex Corporation stock between the release of two annual reports which contained misrepresentations of the corporation’s financial position. The court found that the misrepresentations had influenced the stock’s price in the market. Causation in the market place was established by proof of purchase and proof of the materiality of the misrepresentation even though there was no proof of direct reliance. Blackie, 524 F.2d at 906.
81. Id. at 907.
Consequently, the plaintiff need only establish that the fraud adversely affected the market price in order for the presumption to apply.

Defendants can prove that the misstatements are immaterial. Defendants may disprove causation by showing that an insufficient number of shares were purchased or sold on the misrepresentation to affect the price or that the plaintiff knew of the misrepresentation or would have purchased the shares even though she knew of the misrepresentation.\(^{82}\) The court in \textit{Blackie} did not address the problem that the defendant's proof is the functional equivalent of the plaintiff's proof, that is, proof of a speculative negative.\(^{83}\) \textit{Blackie} also suggests that the purpose of a reliance element is to show causation.\(^{84}\) If reliance is equated with causation, the presumption is nonrebuttable. If the material misrepresentation caused the plaintiff's injury, the defendant has violated Rule 10b-5. The Ninth Circuit Court did not go this far; however, other courts have.\(^{85}\)

In \textit{Panzirer v. Wolf},\(^{86}\) the plaintiff did not rely on the market price to decide to purchase shares of a corporation. Rather, she relied on a newspaper article which was favorable to the corporation. The plaintiff's reliance was not on the integrity of the market price as it had been in \textit{Blackie}.\(^{87}\) Instead, reliance was eliminated as an element of the Rule 10b-5 action because the plaintiff could show a causal connection between the material misrepresentation in the corporation's annual report and her financial loss.\(^{88}\) Consequently, in the \textit{Panzirer} case, the presumption of reliance is nonrebuttable.

The fraud-on-the-market theory was extended to new securities on an undeveloped market in \textit{Shores v. Sklar}.\(^{89}\) The plaintiff had purchased municipal bonds but not in reliance on the offering circular. The bonds


\(^{83}\) \textit{Blackie}, 524 F.2d at 908. The court in \textit{Blackie} stated that "[d]irect proof would inevitably be somewhat proforma, and impose a difficult evidentiary burden, because addressed to a speculative possibility in an area where motivations are complex and difficult to determine." \textit{Id.}

\(^{84}\) \textit{Id.} at 906.


\(^{87}\) \textit{Blackie}, 524 F.2d at 906.

\(^{88}\) \textit{Panzirer}, 663 F.2d at 366.

soon lost their value.\textsuperscript{90} The bonds were new securities issued on an undeveloped market,\textsuperscript{91} in contrast to both \textit{Blackie}\textsuperscript{92} and \textit{Panzirer}.\textsuperscript{93} In \textit{Shores}, the Fifth Circuit found that the newly issued securities were unmarketable.\textsuperscript{94} The plaintiff, by proving that he was willing to take a marketable risk, demonstrated that he relied on the "integrity of the offerings of the securities market."\textsuperscript{95} This showing of reliance suggests that causation was shown by offering bonds which were not marketable.

The broad application of the fraud-on-the-market theory by many of the circuit courts may represent a growing consideration for investors' vulnerabilities. As early as 1975 with the \textit{Blue Chip} case,\textsuperscript{96} the Supreme Court recognized that reliance, an essential element in common law tort misrepresentation cases, was perhaps not as critical in Rule 10b-5 actions even though this was the case that began the circumscription of the scope of the fraud action. As the \textit{Blue Chip} court stated: "[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable."\textsuperscript{97} Investors willing to accept the usual risks of trading on the securities market should not be subject to schemes that are not only meant to defraud individual investors but the market in general. Material misstatements cause the market to react in a manner that causes, in turn, investors a financial harm. The courts should not neglect investors' indirect reliance on the integrity of the market place without providing an alternative solution which would redress the injury suffered.

The availability of class action certification is greatly enlarged when the burden of showing individual reliance is relaxed.\textsuperscript{98} Investors with relatively small losses would not go forward with their claims unless a class action could be maintained. Where individual reliance on the misstatements was required, class actions could be denied. The Advisory

\textsuperscript{90} \textit{Shores}, 647 F.2d at 463-64.
\textsuperscript{91} \textit{Id}.
\textsuperscript{92} \textit{Blackie}, 524 F.2d at 908.
\textsuperscript{93} \textit{Panzirer}, 663 F.2d at 366.
\textsuperscript{94} \textit{Shores}, 647 F.2d at 467.
\textsuperscript{95} \textit{Id.} at 469.
\textsuperscript{96} \textit{Blue Chip Stamps v. Manor Drug Stores}, 421 U.S. 723 (1975).
\textsuperscript{97} \textit{Id.} at 744-45.
\textsuperscript{98} FED. R. CIV. P. 23. Prerequisites for a class action include: numerosity, common questions of law or fact, typicality of claims, and fair and adequate protection of the interests of the class. In addition, one of the three subdivisions of Rule 23(b) must apply. Usually securities fraud class actions attempt to meet Rule 23(b)(3): "that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy." \textit{Id}.
Committee on Rule 23 suggests that class actions could be an appropriate vehicle for fraud actions:

Subdivision (b)(3) encompasses those cases in which a class action would achieve economies of time, effort, and expense, and promote uniformity of decision as to persons similarly situated, without sacrificing procedural fairness or bringing about other undesirable results. . . . [A] fraud perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action, and it may remain so despite the need, if liability is found, for separate determination of the damages suffered by individuals within the class. On the other hand . . . a fraud case may be unsuited for treatment as a class action if there was [sic] material variations in the representations made or in the kinds or degrees of reliance by the persons to whom they were addressed.  

In applying the fraud-on-the-market theory, misrepresentations are not made to or relied upon by individuals but rather to and by the market place. Therefore, it is appropriate to say that the market participants are an ideal class because there is no variation in representation and yet defendants may rebut the presumption where the plaintiff placed no reliance on the market in those courts where reliance is not equated with causation and is still a necessary element of Rule 10b-5 actions.  

V. THE BASIC CASE

Basic, Inc. merged with Combustion Engineering after 14 months of merger negotiations. Basic expressly made three public statements denying that merger negotiations were taking place or that it knew of corporate developments that would account for heavy trading activity in its stock. A class action was instituted against Basic and some of the directors on behalf of former Basic stockholders who sold their stock between Basic’s first denial of merger activity in October, 1977 and the suspension of trading in Basic stock just prior to the merger announcement. The former shareholders claimed that Basic’s statements had been misleading or false in violation of the Securities Exchange Act of 1934 section 10(b) and Rule 10b-5, and that they were injured by

100. See supra note 31.  
102. Id.  
103. Id.  
104. See supra note 13.
selling their shares at prices artificially depressed by those statements.  

The United States District Court for the Northern District of Ohio certified a class action but granted a summary judgment on the merits for Basic.  

The district court determined that the misstatements were immaterial as a matter of law. The United States Court of Appeals for the Sixth Circuit affirmed the class certification by agreeing that under a fraud-on-the-market theory, the former shareholders’ reliance on the company’s misrepresentations could be presumed. However, the appellate court reversed the summary judgment and remanded. The Court of Appeals held that discussions that might not otherwise be material can become so “by virtue of the statement denying their existence.”

The United States Supreme Court granted certiorari in order to “resolve the split” among the Courts of Appeal as to the materiality standard applicable to preliminary merger negotiations and to determine whether the presumption of reliance used to certify the class was properly applied.

The materiality standard of TSC Industries, Inc. v. Northway, Inc. was expressly adopted for merger negotiations under Section 10(b) and Rule 10b-5. Additionally, the Court in Basic accepted the application of the fraud-on-the-market theory as proper, not only in the fact pattern of the Basic case but seemingly in all 10b-5 class actions.

107. The district court found that there were no negotiations at the time of the first statement. Negotiations were being conducted when the second and third statements were made; however, the district court applied an agreement-in-principle test and found that the negotiations were not “destined, with reasonable certainty, to become a merger agreement in principle.” App. to Pet. for Cert. 103a.
108. 786 F.2d 741, 751 (1986). The Sixth Circuit rejected the agreement-in-principle test of materiality in merger and acquisition negotiations and held that “once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue.” Id. at 749. The court stated that statements become material “by virtue of the statement denying their existence.” Id. at 748.
109. Id. at 748.
111. Basic, 108 S. Ct. at 982.
112. Id.
113. 426 U.S. 438 (1976). “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Id. at 449. The TSC Court went on to state that “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Id.
115. Id. at 989.
The majority opinion, written by Justice Blackmun, asserted that the Court was not assessing the validity of an economic theory, 116 namely, the fraud-on-the-market theory. Rather, the majority said that the Court was attempting to ascertain whether it was, and is, proper to apply a rebuttable presumption of reliance based on the fraud-on-the-market theory.117

The Court in Basic stated that reliance continues to be an element of a Rule 10b-5 cause of action.118 Moreover, the Court reasoned that a presumption of reliance is proper in Rule 10b-5 class actions based on practical considerations consistent with the 1934 Act’s full disclosure policy and “considerations of fairness, public policy, and probability, as well as judicial economy . . . for allocating the burdens of proof between parties.” 119 The majority noted that the Congressional policy expressed in the 1934 Act is supported by the presumption device.120

Referring to the district court’s finding, that the presumption of reliance provided “a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Fed. Rule Civ. Proc.] 23,” 121 the Supreme Court concluded that a presumption of reliance removes an unrealistic evidentiary burden from the plaintiff in securities fraud cases.122

Modern securities markets differ significantly from face-to-face transactions. Where the market is performing a valuation of shares, a function ordinarily performed by the investor in private transactions, to say that the worth of the stock is equivalent to the market price, the investor looks to the securities market with the confidence usually reserved for expert appraisal, be it her own or that of other professionals based on knowledge and experience.123 The fraud-on-the-market theory is clearly reflected in this idea.124

The Court in Basic found no inconsistency with the 1934 Act’s purpose of promoting full and fair disclosure of information and the fraud-on-the-market theory even though many commentators125 and the

116. Id.
117. Id.
118. Id.
119. Id. at 990.
120. Id. at 990-91.
121. Id. at 989.
122. Id. at 990.
124. See supra text accompanying notes 50-55, 64-66.
dissentors in *Basic* have disagreed. The *Basic* majority’s underlying rationale is that even though an individual investor has not chosen to rely on the disclosed information, the market has relied on the information. The information is necessary for the market to react. It is the market which must receive material information in order to perform the task of valuation that gives rise to the buying and selling of a security at a given time.

Since 1975, the Supreme Court has taken care to limit the scope of 10b-5 actions. However, the decision in *Basic* will facilitate investors bringing class actions for securities fraud. What has prompted the Court to relax the plaintiff class burden and to place an equally unrealistic evidentiary burden on the defendant? Perhaps the conduct of the *Basic* defendants was so egregious that no other solution was plausible. Perhaps, given the shaken faith of investors in the wake of the October 1987 crash, the Court wanted to act quickly and confidently to calm the fears of investors and return to a more idealistic approach.

The facts of the *Basic* case are atypical. The plaintiffs were sellers rather than purchasers of shares, the time between the misstatements and the decision to sell the shares was eleven months, and the plaintiffs all made money on their sale of *Basic* stock. As such, this case should not have been the basis of a potentially far reaching decision and one that is tantamount to the Court’s endorsement of a complex economic theory. There is no evidence to date that the decision has had an impact

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128. See cases cited *supra* note 16.
130. Justice White in his dissent states:

None of the Court of Appeals cases the Court cites as endorsing the fraud-on-the-market theory, ante, at 991 n. 24, 99 L.Ed. 2d 218, involved seller-plaintiffs. Rather, all of these cases were brought by purchasers who bought securities in a short period following some material misstatement (or similar act) by an issuer, which was alleged to have falsely inflated a stock’s price.

Even if the fraud-on-the-market theory provides a permissible link between such a misstatement and a decision to purchase a security shortly thereafter, surely that link is far more attenuated between misstatements made in October 1977, and a decision to sell a stock the following September, 11 months later. The fact that the plaintiff-class is one of sellers, and that the class period so long, distinguish this case from any other cited in the Court’s opinion, and make it an even poorer candidate for the fraud-on-the-market presumption.

*Basic*, 108 S. Ct. at 998 n.9 (White, J., dissenting) (citation omitted).
131. *Id.* at 998-99 (White, J., dissenting).
on corporate behavior. Likewise, its effect on plaintiff class actions has yet to be observed.

VI. THE BASIC DISSENT

Justice White, writing for the dissent in Basic,132 was most concerned with the the majority's uncritical acceptance of the fraud-on-the-market theory.133 The dissent focused on the role of Congress in shaping economic policy134 and on the problem of assessing damages in this type of action.135

The fraud-on-the-market theory is a recent economic theory although the economic community and the legal system have accepted it with vigor.136 However, as the dissent pointed out, it is a theory, neither fact nor a "mature legal doctrine:"137

[W]hile the economists' theories which underpin the fraud-on-the-market presumption may have the appeal of mathematical exactitude and scientific certainty, they are — in the end—nothing more than theories which may or may not prove accurate upon further consideration. Even the most earnest advocates of economic analysis of the law recognize this.138


133. Id.

134. Basic, 108 S. Ct. at 996, 997. For an interesting analysis of the competing currents (idealism, traditionalism, economic behaviorism, paradigm case analysis, literalism, and textual structuralism) evident in recent Supreme Court decisions on securities actions, see Phillips, supra note 14.


Of all recent developments in financial economics, the efficient market hypothesis . . . has achieved the widest acceptance by the legal culture. It now commonly informs the academic literature on a variety of topics; it is addressed by major law school casebooks and textbooks on business law; it structures debate over the future of securities regulation both within and without the Securities and Exchange Commission; it has served as the intellectual premise for a major revision of the disclosure system administered by the Commission; and it has even begun to influence judicial decisions and the actual practice of law. In short, the [efficient capital market hypothesis] is now the context in which serious discussion of the regulation of financial markets takes place.

Id. at 549-550.

137. Basic, 108 S. Ct. at 993 (White, J., dissenting).

138. Id. at 995. See, e.g., Easterbrook, Afterword: Knowledge and Answers, 85 COLUM. L. REV. 1117, 1118 (1985).
Pointing out the problems associated with supplanting "traditional legal analysis . . . with economic theorization," the dissent looked to the legislative history of the Securities Exchange Act of 1934 and prudential judicial constraint in assessing the impact of the majority opinion.

As the dissent in Basic pointed out, if current economic theory concerning financial markets requires that established legal ideas of fraud be considered anew, it is Congress' role to do so. The superior resources and expertise of the Congress in enacting legislation should be given great deference by the courts. Even though there is a paucity of legislative history concerning Rule 10b-5, there is sufficient history surrounding other portions of the Securities Exchange Act to glean the intent of Congress in proposing and passing legislation which would protect investors and stabilize the economy.

The Seventy-Third Congress, passing Section 18 of the 1934 Act, imposed an express reliance requirement. Congress specifically rejected the notion that plaintiffs could have a cause of action based "solely on the fact that the price of the securities they bought or sold was affected by a misrepresentation [without reliance]: a theory closely akin to the [Basic] Court's holding . . . ." Analyzing the majority opinion, the dissent viewed the acceptance of the fraud-on-the-market theory as "eviscerat[ing] the reliance rule in actions brought under Rule 10b-5, and negat[ing] congressional intent to the contrary expressed during adoption of the 1934 Act."

The distinction between causation and reliance is blurred in the majority opinion. Causation "involves an analysis of the relationships

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139. Basic, 108 S. Ct. at 994.
140. Id. at 996-98.
141. Id. at 997. See S. 2693, 73d Cong., 2d Sess, § 17(a) (1934); 78 Cong Rec. 7701 (1934).
142. Section 18(a) of the Act provides for civil liability for misleading statements concerning securities:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages cause by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. (Emphasis added).

73d Congress, Session 2, Ch. 404 June 6, 1934 at 897, 898.
143. Id.
144. Basic, 108 S. Ct. at 997 (White, J., dissenting).
145. Id.
between individuals and the impact of their actions on each other and third parties." The defendant’s conduct was a “cause in fact” of the injury, and thus it should be recognized as a legal cause on policy grounds. Reliance is determined by whether the misrepresentation was a substantial factor in determining the course of conduct which resulted in the plaintiff’s loss. A plaintiff must do more than show that the defendant violated the rule; she must establish causation, and, according to the dissent, should also be required to show reliance in establishing causation. However, materiality can establish causation, at least in certain circumstances.

Additionally, Congress’ policy of full and fair disclosure is compromised when the disclosure is not directed to the purchaser or seller of a security. In 1981, the dissent of Shores v. Sklar stated:

[Disclosure ... 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 though he did not read and rely on the defendants’ 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.

As the dissent in Basic noted, by removing individual reliance as an element in Rule 10b-5 actions, the Court is approaching an “investor

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151. Id. at 483 (Randall, J., dissenting) (quoted in Basic, 108 S. Ct. at 997-98 (White, J., dissenting)).
insurance scheme."152 The Court should not overprotect investors from the ordinary risks involved in market transactions.153

It would be a mischaracterization of the majority opinion to say that it was providing investor insurance. Rather, the majority wanted to accomplish its goal of facilitating Rule 10b-5 litigation154 in marked contrast with the post-1975 Supreme Court decisions in this area.155 The Court in Basic did so with its acceptance of the idea of investor access to all information even when not relied upon directly, with its recognition that the public should be protected from material misrepresentations and with its appreciation for the deterrence factor in prosecution.

According to Justice White's dissent in Basic, the common law elements of fraud and deceit should remain in Rule 10b-5 actions: "[T]he case law developed in this Court with respect to § 10(b) and Rule 10b-5 has been based on doctrines which we, as judges, are familiar: common-law doctrines of fraud and deceit."156 In approaching the Rule 10b-5 action from this perspective, the dissent is attempting to restrain the scope of the action much as the Court had done in 1975 with the Blue Chip case and subsequent cases until the Basic decision.157

VII. Effects of the Basic Case

Prior to the Basic decision, the circuit courts were divided in their application of the fraud-on-the-market theory158 to secondary markets and/or to newly issued securities on undeveloped markets.159 This situation has not been remedied by the decision in Basic.

152. Basic, 108 S. Ct. at 996.
155. Justice Blackmun has written several dissents expressing his view on the Court's post 1975 decisions. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (Blackmun, J., dissenting), Justice Blackmun stated: "[T]he Court exhibits a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping, it seems to me, with our own traditions and the intent of the securities laws." Id. In his dissent to Dirks v. SEC, 463 U.S. 646 (1983), Justice Blackmun remarked that "[t]he Court today takes still another step to limit the protections provided investors by § 10(b) of the Securities Exchange Act of 1934." Id.
158. See supra note 72.
159. See supra note 73.
The majority opinion has not limited specifically application of the theory to secondary markets.\textsuperscript{160} Lower courts have noted that the fraud-on-the-market theory is based on the idea that there is a "nearly perfect market in information,"\textsuperscript{161} and that the price of a security is a reflection of its intrinsic value.\textsuperscript{162} This assumption of a "perfect market in information" may not be applicable to newly issued stock on undeveloped markets. The "efficiency" of these markets must be determined before the fraud-on-the-market presumption is applied.\textsuperscript{163} Therefore, the fraud-on-the-market theory should be limited to secondary market transactions or those cases where the undeveloped market has been proven to be efficient.\textsuperscript{164} Where the market is inefficient, the plaintiff should have to prove reliance on material misrepresentations. However, at least one court has applied the fraud-on-the-market theory to newly issued securities since the \textit{Basic} opinion.\textsuperscript{165}

Additionally, once a material misrepresentation is proven, the reliance issue can be viewed in at least two ways, either as a complete elimination of the reliance element or as a reduction in the plaintiff's burden of establishing direct reliance by providing a presumption of indirect reliance. The Court in \textit{Basic} specifically did not eliminate the reliance element.\textsuperscript{166} However, because the \textit{Basic} Court did not distinguished the fraud-on-the-market theory of reliance from a causation theory, the dissent is correct when it states that the majority has moved dangerously close to removing the reliance element altogether.\textsuperscript{167} Under a causation approach, the only question is whether the material misstatement or omission caused the plaintiff's injury.\textsuperscript{168} Once a causation approach is adopted, the presumption becomes nonrebuttable.\textsuperscript{169}

\textsuperscript{160} \textit{Basic}, 108 S. Ct. at 991. "Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs of the integrity of the market price may be presumed." \textit{Id.}

\textsuperscript{161} \textit{Id.}

\textsuperscript{162} \textit{Id.}


\textsuperscript{166} \textit{Basic}, 108 S. Ct. at 989.

\textsuperscript{167} \textit{Id.} at 997 (White, J., dissenting).


\textsuperscript{169} Blackie v. Barrack, 524 F.2d 891, 906-07, n.22. Justice White notes: [In practice the Court must realize, as other courts applying the fraud-on-the-
The Court in Basic did not address the computation of damages in a Rule 10b-5 cause of action, but as Justice White noted, "the proper measure of damages in a fraud-on-the-market case [is] essential for proper implementation of the fraud-on-the-market presumption." The measure of damages under Rule 10b-5 is beyond the scope of this Note; however, until the Court or Congress speaks to this issue, uncertainty and a diversity of decisions will continue.

One implication of the Basic case is that an investor might be well advised not to read disclosure documents corporations provide. This is an interesting turn of events because providing disclosures to the public to enable investors to make reasonable and informed decisions concerning the risk they are undertaking is at the heart of the securities regulations. As a result of no longer requiring proof of direct reliance, the protection of the securities regulations is afforded to those who have acted irresponsibly for failing to inform themselves with readily available information. However, it must be noted that because of their complexity, few investors, even those with a relatively high level of sophistication, read disclosure statements. In addition, if the efficient market hypothesis is correct, anything that has been disclosed publicly will have affected the market place fully and instantaneously thereby precluding the individual investor from outperforming the market. An investor should not have to rely directly on disclosure documents that are not useful. The investor has relied on the disclosure, albeit indirectly, by looking to the market to perform the function of interpreting and accurately pricing the securities based on the disclosures. Therefore, the apparent inconsistency between the policy of full disclosure and investor

market theory have, that such rebuttal is virtually impossible in all but the most extraordinary case. . . [The majority's implicit rejection of the 'pure causation' fraud-on-the-market theory rings hollow. In most cases, the Court's theory will operate just as the causation theory would, creating a non-rebuttable presumption of 'reliance' in future 10b-5 actions.}

Basic, 108 S. Ct. at 996 n.7 (White, J., dissenting).
171. Basic, 108 S. Ct. at 995 n.5.
failure to read investment information is not as great as it may at first appear.

The decision in Basic will have a great impact potentially on corporations and their counsel. The issue of corporate disclosure of information is perceived to be fraught with difficulties. Corporations must provide sufficient disclosure so that the market can set a value to the corporate securities, that is, price shares at their intrinsic worth, and yet not jeopardize shareholders’ best interests. Until recently, the Securities Exchange Commission prohibited the inclusion in filings of most “soft information” such as earnings projections and asset appraisals. As the SEC broadens its policy to include this type of information as part of disclosure requirements and as the courts renew efforts to protect investors and deter corporate behavior characterized as unethical, if not fraudulent, counsel must consider carefully the ramifications of any corporate statement. Attorneys in the corporate legal community will perceive this responsibility as beyond the traditional prudent standard of care required of them.

VIII. Conclusion

The Supreme Court, with the Basic case, had the opportunity to establish the limits of the fraud-on-the-market theory. For example, the

175. See Bagby & Ruhnka, The Predictability of Materiality in Merger Negotiations Following Basic, 16 SEC. REP. L.J. 245 (1988) [hereinafter cited as Predictability]. In addition to the fraud-on-the-market theory, the Basic Court determined the materiality standard to be applied to preliminary merger or acquisition negotiations.

The disclosure dilemma is complicated by several conflicting public policy and private policy interests. On the one hand, the SEC usually urges ‘prompt’ disclosure . . . to enhance the market’s efficiency. . . . By contrast, corporate managers have long argued that ‘premature’ announcement of merger or acquisition negotiations will cause a run up in the target company’s stock price, possibly jeopardizing negotiations to the detriment of shareholders. . . . This duty and the regulatory trend in disclosure toward ‘stopwatch jurisprudence’ can present conflicting legal obligations that produce a ‘damned if you do—damned if you don’t’ potential for liability. Predictability, at 246.

See Ruhnka & Bagby, Disclosure: Damned If You Do, Damned If You Don’t, 64 HARV. BUS. REV. 34 (September-October 1986).

176. See Predictability, supra note 176, at 246.

fraud-on-the-market theory, dependent as it is on the efficient market hypothesis, should be applied only to those situations where the market is developed or proven to be efficient. Instead, the Court approved the fraud-on-the-market theory without limitation.

Furthermore, the Court in Basic had the opportunity to analyze the distinction between reliance and causation. Even though the Court states that reliance is not eliminated as an element in a Rule 10b-5 action, the practical effect of the Court’s decision is to create a reliance-causation equivalency. In doing so, the presumption becomes non-rebuttable. Although the Court gives examples of how the presumption of reliance can be rebutted, the defendant is put in the position of proving a speculative negative, for instance that the plaintiff disbelieved corporate misstatements or would have traded despite knowing the statements were untrue. The Court has shifted the “unnecessarily unrealistic evidentiary burden” from plaintiff to defendant. However, this allocation of the burden of proof between the parties may be reasonable in light of the plaintiff’s required showing of a material misrepresentation by the defendant.

Because of inroads on the requirement of disclosure of seemingly “soft information,” a fluid standard on the question of materiality, and the suggestion that class action plaintiffs will not be dismissed easily, corporate counsel may want to devise new strategies for advising disclosure practices among clients.

There is general discontent mixed with great interest in the “greed is good - greed works” philosophy portrayed in the recent film Wall Street. The local newspapers, as well as the national business journals, will continue to cover the various million and billion dollar insider trading, leveraged buyout, and junk bond stories. The investing public may feel some measure of vindication in knowing that they may successfully bring a Rule 10b-5 class action more easily after Basic even if their dollar figure is significantly smaller than the stories making the headlines. Perhaps that is all the Court wanted to accomplish.

Rosemary J. Thomas

179. Id. at 990.
180. Id. at 989.
181. See supra text accompanying note 177.
182. See supra text accompanying note 74.
184. Wall Street, Twentieth-Century Fox Film Corp. (1987).
185. Id.