

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

1. *The Crash of '87*, Wall Street Journal, December 11, 1987, at 1, col. 6.

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).

5. The National Law Journal, Oct. 31, 1988, at 9, col. 1 (Drexel waits for next shoe to drop: criminal charges anticipated).

6. N.Y. Times, October 21, 1988, at 1, col. 3.

7. See *Securities and Exchange Commission Authorization Act of 1987, Securities Laws and Corporate Disclosure Regulations: Hearing Before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, House of Representatives, 97th Cong., 2nd Sess. (1982) The Securities Acts Amendments of 1975*. (Congress enacted the 1975 Amendments after the crisis of 1969 and 1970 which caused the failure of many broker-dealers, including several of the oldest and largest Wall Street firms).

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).

9. 15 U.S.C. §§ 77a - 77aa (1982).

10. 15 U.S.C. §§ 78a - 78kk (1982).

the American economy.¹¹ 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.¹² In particular, Rule 10b-5¹³ 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.¹⁴ With the *Blue Chip Stamps v. Manor Drug Stores* case,¹⁵ however, the Court began to interpret more narrowly aspects of the fraud action.¹⁶ 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.

14. Phillips, *An Essay: The Competing Currents of Rule 10b-5 Jurisprudence*, 21 IND. L. REV. 625 (1988).

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. Levinson*¹⁸. 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 misstatements 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

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.

18. 108 S. Ct. 978 (1988).

19. 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); Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982).

20. See *supra* n.19.

21. *Basic*, 108 S. Ct. 978, 990-91 (1988).

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,²⁴ to promote fair equitable practices,²⁵ and to insure fairness in securities transactions.²⁶ Principles of basic tort law were incorporated into the 1933 and 1934 Acts as means of accomplishing the Acts' ends.²⁷

The 10b-5 cause of action has been based on traditional common law fraud.²⁸ Misrepresentations, as the basis of a fraud action, had to be relied upon in order to be actionable.²⁹ 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.³⁰ The Second,³¹ Third,³² Fifth,³³ Ninth³⁴, Tenth³⁵, and Eleventh³⁶ Circuits now recognize

24. S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934). Rule 10b-5 was adopted in 1942.

25. 3 L. LOSS, *SECURITIES REGULATION* 1455-56 (2d ed. 1961). See also, *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476-77 (1977) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

26. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 804 (1980).

27. See RESTATEMENT (SECOND) OF TORTS §§ 525-530 (1977); W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 108 (4th ed. 1971).

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.*

31. *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot sub nom. Price Waterhouse v. Panzirer*, 459 U.S. 1027 (1982).

32. *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986).

33. *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied*, 103 S. Ct. 772 (1983).

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

35. *T.J. Raney & Sons v. Fort Cobb, Okla. Irr. Fuel Auth.*, 717 F.2d 1330 (10th Cir.), *cert. denied*, 104 S. Ct. 1285 (1983).

36. *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984).

that the securities market functions in response to all information fed into it whether or not investors read and use the information.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."³⁸

Some courts have distinguished between omissions and false and misleading statements,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.⁴⁰ However, a presumption of reliance is now employed in both misstatement and omission cases.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,⁴² prices are set validly,⁴³ and the market has not been manipulated.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.⁴⁵

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

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." *Id.* 647 F.2d at 468.

38. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 423 (3d ed. 1986).

39. See cases cited *infra* note 71.

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. *Id.* at 153-54.

41. See cases cited *infra* note 71.

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

43. *Id.*

44. *Id.*

45. Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982).

46. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

47. FED. R. CIV. P. 23.

48. See generally Comment, *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

Typical Representative Please Stand Up?, 36 EMORY L.J. 649 (1987); Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1159 (1982).

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

50. See generally, Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982); 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); Note, *Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend*, 29 STAN. L. REV. 1077 (1977).

51. See 8 ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 438 (R. Posner & K. Scott, eds. 1980). See also, A. BROMBERG & L. LOWENFELS, SECURITY FRAUD AND COMMODITIES FRAUD, (1982).

52. J. LORIE, P. DODD & M. KIMPTON, THE STOCK MARKET: THEORIES AND EVIDENCE 55 (1985) [hereinafter cited as J. LORIE].

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.

56. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

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.⁵⁸ Also there is the obvious paradox of investor activity.⁵⁹ 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.⁶⁰ 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."⁶¹ It has been pointed out by economists⁶² and courts⁶³ 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.⁶⁴

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*⁶⁵ 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."⁶⁶ An investor may rely on the "supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price."⁶⁷ 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 LLOYDS BANK REV. 1 (1984).

59. See J. LORIE, *supra* note 52, at 77.

60. See Black, *supra* note 19, at 455.

61. Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1035 (1977).

62. See generally *supra* notes 50-52.

63. *Basic*, 108 S. Ct. at 998 (White, J., dissenting).

64. See Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing View*, 46 MD. L. REV. 1114 (1987).

65. 806 F.2d 1154 (3d Cir. 1986).

66. *Id.* at 1160.

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

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.⁶⁸

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*⁶⁹ 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.⁷⁰

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-5.⁷¹ The Second, Ninth, and Eleventh Circuits have applied the presumption of reliance only to existing securities on developed markets,⁷² but the Fifth and Tenth Circuits have applied the theory to newly issued shares on undeveloped markets.⁷³

The first Supreme Court case to dispense with proof of actual reliance in establishing causation in non-disclosure cases was *Affiliated Ute Cit-*

68. Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1154-56 (1982).

69. 88 F.R.D. 134 (N.D. Tex. 1980).

70. *Id.* at 143 (cited with approval in *Basic*, 108 S. Ct. at 990).

71. See, *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986), *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 105 S. Ct. 814 (1985); *T.J. Raney & Sons v. Fort Cobb, Okla. Irr. Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied* 104 S. Ct. 1285 (1983); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot sub nom. Price Waterhouse v. Panzirer*, 459 U.S. 1027 (1982); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied*, 103 S. Ct. 772 (1983); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

72. *Blackie*, 524 F.2d at 895; *Panzirer*, 663 F.2d at 367-68; *Documation*, 734 F.2d at 745.

73. *Shores*, 647 F.2d at 468; *T.J. Raney*, 717 F.2d at 1333.

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 causal 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 *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 *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 *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 *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 *Panzirer* case, the presumption of reliance is nonrebuttable.

The fraud-on-the-market theory was extended to new securities on an undeveloped market in *Shores v. Sklar*.⁸⁹ The plaintiff had purchased municipal bonds but not in reliance on the offering circular. The bonds

82. *Id.* at 906. See Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435, 448 (1984).

83. *Blackie*, 524 F.2d at 908. The court in *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." *Id.*

84. *Id.* at 906.

85. See *Fausett v. American Resources Management Corp.*, 542 F. Supp. 1234 (D. Utah 1982); *Pellman v. Cinerama, Inc.*, 89 F.R.D. 386 (S.D.N.Y. 1981); *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 n.4 (N.D. Tex. 1980); *Arthur Young & Co. v. United States Dist. Ct.*, 549 F.2d 686, 694-95 (9th Cir. 1977), *cert. denied*, 434 U.S. 829 (1977).

86. 663 F.2d 365 (1981), *cert. denied*, 458 U.S. 1107 (1982).

87. *Blackie*, 524 F.2d at 906.

88. *Panzirer*, 663 F.2d at 366.

89. 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983), *rev'd sub nom.* (in part) FED. SEC. L. REP. (CCH) ¶ 92,874, *appeal dismissed*, 844 F.2d 1485, *vacated, reh'g granted*, 855 F.2d 722 (11th Cir. 1988) (*en banc*).

soon lost their value.⁹⁰ The bonds were new securities issued on an undeveloped market,⁹¹ in contrast to both *Blackie*⁹² and *Panzirer*.⁹³ In *Shores*, the Fifth Circuit found that the newly issued securities were unmarketable.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."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 *Blue Chip* case,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 *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."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.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

90. *Shores*, 647 F.2d at 463-64.

91. *Id.*

92. *Blackie*, 524 F.2d at 908.

93. *Panzirer*, 663 F.2d at 366.

94. *Shores*, 647 F.2d at 467.

95. *Id.* at 469.

96. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

97. *Id.* at 744-45.

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." *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.⁹⁹

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 class¹⁰⁰ 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.¹⁰¹ 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.¹⁰² 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.¹⁰³ 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-5,¹⁰⁴ and that they were injured by

99. FED. R. CIV. P. 23(b)(3) advisory committee note.

100. See *supra* note 31.

101. *Basic*, 108 S. Ct. at 981.

102. *Id.*

103. *Id.*

104. See *supra* note 13.

selling their shares at prices artificially depressed by those statements.¹⁰⁵

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*.¹⁰⁶ The district court determined that the misstatements were immaterial as a matter of law.¹⁰⁷ 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.¹⁰⁸ The Court of Appeals held that discussions that might not otherwise be material can become so "by virtue of the statement denying their existence."¹⁰⁹

The United States Supreme Court granted certiorari¹¹⁰ in order to "resolve the split" among the Courts of Appeal as to the materiality standard applicable to preliminary merger negotiations¹¹¹ and to determine whether the presumption of reliance used to certify the class was properly applied.¹¹²

The materiality standard of *TSC Industries, Inc. v. Northway, Inc.*¹¹³ was expressly adopted for merger negotiations under Section 10(b) and Rule 10b-5.¹¹⁴ 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.¹¹⁵

105. *Basic*, 108 S. Ct. at 981.

106. *Levinson v Basic, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 91,801 (Aug. 3, 1984).

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.

110. 479 U.S. 1083 (1987).

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.*

114. *Basic*, 108 S. Ct. at 983.

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.

123. *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D. Tex. 1980).

124. *See supra* text accompanying notes 50-55, 64-66.

125. *See*, R. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA (1982); H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979); S. PHILLIPS & J. ZECHER, THE SEC AND THE PUBLIC INTEREST (1981); Jarrell, *The Economic Effects of Federal Regulation*

dissenters in *Basic* have disagreed.¹²⁶ 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 1975,¹²⁷ the Supreme Court has taken care to limit the scope of 10b-5 actions.¹²⁸ 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.¹²⁹

The facts of the *Basic* case are atypical.¹³⁰ 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.¹³¹ 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

of the Market for New Securities Issues, 24 J. LAW & ECON. 613 (1981); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801 (1980); Wolfson, *A Critique of the Securities and Exchange Commission*, 30 EMORY L.J. 119 (1981).

126. *Basic*, 108 S. Ct. at 997-98. See also, Black, *supra* note 19.

127. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

128. See cases cited *supra* note 16.

129. See Phillips, *supra* note 14, at 662-665.

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

132. Justice O'Connor joined in the dissent to Part IV of the *Basic* decision. Both Justices White and O'Connor concurred with the materiality standard set forth in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, (1976) and specifically adopted in *Basic*. 108 S. Ct. at 993.

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.

135. *Basic*, 108 S. Ct. at 998.

136. See Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

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,"¹³⁹ 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.¹⁴⁰ 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.¹⁴¹

The Seventy-Third Congress, passing Section 18 of the 1934 Act,¹⁴² imposed an express reliance requirement.¹⁴³ 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 . . ."¹⁴⁴ 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."¹⁴⁵

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

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."¹⁴⁶ 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.¹⁴⁷ Reliance is determined by whether the misrepresentation was a substantial factor in determining the course of conduct which resulted in the plaintiff's loss.¹⁴⁸ 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.¹⁴⁹

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*¹⁵⁰ stated:

[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 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.¹⁵¹

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

146. Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99, 100 (1981).

147. RESTATEMENT (SECOND) OF TORTS §§ 546 (causation in fact), 548A (legal cause) (1977). Causation in common law fraud actions required that the plaintiff had actually relied on the defendant's misrepresentation and was injured by the reliance. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 108, at 774-75 (4th ed. 1971).

148. RESTATEMENT (SECOND) OF TORTS § 546. See generally A. BROMBERG, SECURITIES FRAUD § 8.6(1), at 209 (Supp. 1970); L. Loss, *supra* note 25, at 1430-44; Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975); Note, *Reasonable Reliance Under 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562 (1972).

149. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1970).

150. 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 103 S. Ct. 772 (1983).

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.

153. See Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); Note, *Causation in Fraud-on-the-Market Actions—Investors' Insurance in the Second Circuit?*, 49 BROOKLYN L. REV. 1291 (1983).

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

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.*

156. *Basic*, 108 S. Ct. at 994. See, Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985).

157. *Blue Chip Stamps*, 421 U.S. 723 (1975). See *supra* notes 15-17 and accompanying text.

158. See *supra* note 72.

159. See *supra* note 73.

The majority opinion has not limited specifically application of the theory to secondary markets.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"¹⁶¹, and that the price of a security is a reflection of its intrinsic value.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.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.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 *Basic* opinion.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 *Basic* specifically did not eliminate the reliance element.¹⁶⁶ However, because the *Basic* Court did not distinguish 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.¹⁶⁷ Under a causation approach, the only question is whether the material misstatement or omission caused the plaintiff's injury.¹⁶⁸ Once a causation approach is adopted, the presumption becomes nonrebuttable.¹⁶⁹

160. *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." *Id.*

161. *Peil*, 806 F.2d 1154, 1161 n.10.

162. *Id.*

163. Wemple & Westover, *Rule 10b-5 Securities Fraud: Regulating the Application of the Fraud-on-the-Market Theory of Liability*, 18 J. MAR. L. REV. 733, 745-748 (1985).

164. *See id.*; Black, *Fraud-on-the-Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435 (1984).

165. *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983), *rev'd sub nom.* (in part) FED. SEC. L. REP. (CCH) ¶ 92,874, *appeal dismissed*, 844 F.2d 1485, *vacated, reh'g granted*, 855 F.2d 722 (11th Cir. 1988) (*en banc*).

166. *Basic*, 108 S. Ct. at 989.

167. *Id.* at 997 (White, J., dissenting).

168. *See Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot*, 463 U.S. 646 (1982).

169. *Blackie v. Barrack*, 524 F.2d 891, 906-07, n.22. Justice White notes:

[I]n 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,¹⁷⁰ 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."¹⁷¹ The measure of damages under Rule 10b-5 is beyond the scope of this Note;¹⁷² 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.¹⁷³ 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.¹⁷⁴ 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. . . . [T]he 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).

170. *Basic*, 108 S. Ct. at 995 n.5 (White, J., dissenting). Justice White quotes R. POSNER, *ECONOMIC ANALYSIS OF LAW* §15.8, 423-24 (3d ed. 1986).

171. *Basic*, 108 S. Ct. at 995 n.5.

172. Note, *The Measure of Damages Under Section 10(b) and Rule 10b-5*, 46 MD. L. REV. 1266 (1987). See generally D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* § 9.3 (1973); A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5* § 260.03 (2d ed. 1983); Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984); Recent Development, *Damages for Insider Trading in the Open Market: A New Limitation on Recovery Under Rule 10b-5*, 34 VAND. L. REV. 797 (1981).

173. Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973).

174. H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE* 86-87 (1979). See Black, *supra* note 19, at 458.

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.¹⁷⁵ 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.¹⁷⁶ Until recently, the Securities Exchange Commission prohibited the inclusion in filings of most "soft information" such as earnings projections and asset appraisals.¹⁷⁷ 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. REG. 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.

Th[e] 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: Dammed If You Do, Dammed If You Don't*, 64 HARV. BUS. REV. 34 (September-October 1986).

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

177. Hiller, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing View*, 46 MD. L. REV. 1114 (1987). The SEC's policy on soft information disclosure has undergone significant revision during the past ten years. Neither outdated policy concerns which prohibited disclosure of soft information nor concern for corporate liability can excuse misleading disclosure. Investors must receive full disclosure in order to assess risk competently. *Id.* at 1195-96. See generally *Symposium: Affirmative Disclosure Obligations Under the Securities Laws*, 46 MD. L. REV. 907 (1987).

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,¹⁷⁸ 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,¹⁷⁹ 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"¹⁸⁰ 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,"¹⁸¹ a fluid standard on the question of materiality,¹⁸² and the suggestion that class action plaintiffs will not be dismissed easily,¹⁸³ 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"¹⁸⁴ philosophy portrayed in the recent film *Wall Street*.¹⁸⁵ 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.

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178. *Basic*, 108 S. Ct. at 989.

179. *Id.* at 990.

180. *Id.* at 989.

181. *See supra* text accompanying note 177.

182. *See supra* text accompanying note 74.

183. *Basic*, 108 S. Ct. at 990-91.

184. *Wall Street*, Twentieth-Century Fox Film Corp. (1987).

185. *Id.*

