Basic Inc. v. Levinson: The Supreme Court's Analysis of Fraud on the Market and its Impact on the Reliance Requirement of SEC Rule 10b-5

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Basic Inc. v. Levinson: The Supreme Court’s Analysis of Fraud on the Market and its Impact on the Reliance Requirement of SEC Rule 10b-5

INTRODUCTION

Since 1965, the reliance requirement of SEC Rule 10b-5 has evolved into a general rule and two exceptions. The general rule states that a plaintiff must prove reliance upon a defendant’s fraudulent conduct to recover in 10b-5 actions based on material misrepresentations or omissions. The test for reliance, set out in a Second Circuit decision, List v. Fashion Park, Inc., is whether the plaintiff would have acted any differently if he or she had known the truth.

The Supreme Court articulated the first exception to the List rule in Affiliated Ute Citizens of Utah v. United States. Under this decision, plaintiffs are not required to prove reliance in 10b-5 actions involving “primarily a failure to disclose.” Lower courts have interpreted Affiliated Ute as creating a presumption of reliance that is rebuttable by the defendant.

A second exception to the List rule arose in Blackie v. Barrack. In this case, the Ninth Circuit decided to extend Affiliated Ute to situations where material misrepresentations adversely affect the price of stock traded in an efficient market. According to this

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1 17 C.F.R. § 240.10b-5 (1988). See infra note 28 for the statutory contents of the rule. Rule 10b-5 generally prohibits fraud by any person in connection with the purchase or sale of securities, and was promulgated pursuant to authority granted to the Securities Exchange Commission under § 10(b) of the Securities Exchange Act of 1934.
3 Id. at 463.
4 Id.
6 Id. at 153.
7 See infra note 128 and accompanying text.
8 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).
9 Id. at 906.
notion, known as the fraud on the market theory, a court will adopt a rebuttable presumption of the plaintiff's reliance where that plaintiff has traded in an efficient market and was injured by the market's reaction to the defendant's fraudulent misrepresentations.\textsuperscript{10} The Supreme Court recently adopted the fraud on the market theory in \textit{Basic Inc. v. Levinson}.\textsuperscript{11}

The \textit{Basic} case embraced fraudulent misrepresentations in the context of preliminary merger negotiations.\textsuperscript{12} Basic Incorporated had denied its involvement in merger negotiations at a time when it was meeting and conducting telephone conversations with Combustion Engineering concerning a merger of the two companies.\textsuperscript{13} Numerous former shareholders of Basic brought a class action against the corporation and its directors alleging "false and misleading statements in violation of Section 10(b) of the 1934 Act and Rule 10b-5."\textsuperscript{14} The shareholders claimed they lost money selling their Basic shares in the artificially depressed market created by the company's fraudulent statements.\textsuperscript{15} The Supreme Court in \textit{Basic} affirmed the district court's class certification\textsuperscript{16} by adopting the presumption of reliance supported by the fraud on the market theory.\textsuperscript{17}

The \textit{Basic} decision is significant because it addresses two important issues in securities law: first, defining the proper standard of materiality to apply under Rule 10b-5 to preliminary corporate merger discussions;\textsuperscript{18} and second, whether a presumption of reliance supported by the fraud on the market theory should be applied in situations involving material public misrepresentations.\textsuperscript{19} This Note will treat only the second issue addressed by the Supreme Court, that dealing with fraud on the market.

\textsuperscript{10} See Pell \textit{v. Speiser}, 806 F.2d 1154, 1161 (3d Cir. 1986).
\textsuperscript{12} \textit{Id.} at 980.
\textsuperscript{13} \textit{Id.} at 981.
\textsuperscript{14} \textit{Id.} The class comprised those Basic shareholders who sold their stock after the company's first public statement denying pre-merger negotiations and before the suspension of trading in December of 1978. \textit{Id.} at 987 n.5.
\textsuperscript{15} \textit{Id.}
\textsuperscript{16} One prerequisite to class certification under the Federal Rules of Civil Procedure is that "the questions of law or fact common to the members of the class predominate over any questions affecting only individual members." \textit{Fed. R. Civ. P. 23(b)(3).} The presumption of reliance in 10b-5 actions prevents individual questions of reliance from impeding class certification.
\textsuperscript{17} \textit{Basic v. Levinson}, 485 U.S. \textit{----}, 108 S. Ct. 978, 993 (1988).
\textsuperscript{18} \textit{See id.} at 982-88.
\textsuperscript{19} \textit{See id.} at 988-92.
After a brief review of the statutory and common law origins of the Rule 10b-5 implied cause of action in Part I of this Note, Part II will examine the effect of the *Basic* decision upon the *List* reliance requirement. Part III will then discuss the omissions exception to *List* as established in *Affiliated Ute* and as modified by *Basic*. Finally, Part IV of this Note considers the fraud on the market exception to the *List* rule, and the impact of *Basic* on the legal framework created by *List* and *Affiliated Ute*.

I. STATUTORY AND COMMON LAW ORIGINS OF THE 10B-5 RIGHT OF ACTION

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 allow parties to recover damages from statutory violations through private civil actions. Although no specific statutory authorization exists for a private cause of action under Section 10(b) of the Exchange Act or its counterpart, SEC Rule 10b-5, the 10b-5 private judicial remedy today is firmly entrenched...
in federal law.\textsuperscript{29}

The implied private right of action under Rule 10b-5 first appeared in \textit{Kardon v. National Gypsum},\textsuperscript{30} a 1946 federal district court opinion. The court in \textit{Kardon} based its implied right of action on the theory that the violation of a statute constitutes a tort.\textsuperscript{31} The Supreme Court finally recognized the Rule 10b-5 implied right of action in a 1971 decision, \textit{Superintendent of Insurance of New York v. Bankers Life & Casualty Co.},\textsuperscript{32} long after scores of

or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

\textit{Id.}

Courts and commentators disagree whether to distinguish between the subparagraphs of Rule 10b-5. \textit{Compare} \textit{Affiliated Ute Citizens v. United States}, 406 U.S. 128, 152-53 (1972) ("We do not read Rule 10b-5 so restrictively. To be sure, the second paragraph of the Rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted."). \textit{with 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 \S 9, 1-244 to 1-245 (1987) (footnote omitted) ("This overlap [among the subsections] matters only if courts look at the Rule as three separate provisions and glean different elements of a cause of action from each clause . . . . [T]he better approach is to require the same quantum of proof for all three clauses."). See also infra notes 117-23 and accompanying text.}

\textit{See}, \textit{e.g.}, \textit{Basic Inc. v. Levinson}, 485 U.S. \textit{____}, 108 S. Ct. 978, 983 (1988); \textit{Ernst \& Ernst v. Hochfelder}, 425 U.S. 185, 196 (1976) (citations omitted) ("Although \S 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10(b)-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established."); \textit{Blue Chip Stamps v. Manor Drug Stores}, 421 U.S. 723, 730 (1975):

Despite the contrast between the provisions of Rule 10b-5 and the numerous carefully drawn express civil remedies provided in the Acts of both 1933 and 1934, (footnote omitted) it was held in 1946 by the United States District Court of the Eastern District of Pennsylvania that there was an implied private right of action under the rule. (citation omitted). This court had no occasion to deal with the subject until 25 years later, and at the time we confirmed with virtually no discussion the overwhelming consensus of the District Courts and Courts of Appeals that such a cause of action did exist.

\textit{Id.} (citations omitted).

\textit{See also infra notes 117-23 and accompanying text.}


\textit{31} \textit{Id. at 513. See RESTATEMENT OF TORTS \S 286 (1934), which states:}

The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if; (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and (b) the interest invaded is one which the enactment is intended to protect.

\textit{Id.} Courts have adopted statutory provisions as a basis for civil liability in actions for torts other than negligence, such as trespass, deceit, nuisance, or strict liability. \textit{See RESTATEMENT (SECOND) OF TORTS \S 286 comment d (1965).}

\textit{32} 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under \S 10(b).".). \textit{Accord Ernst \& Ernst, 425 U.S. at 196; Blue Chip Stamps, 421 U.S. at 730.}
lower court decisions had already made such a recognition. The Supreme Court’s decision is believed to be based on the idea that a right of action could be implied from the Exchange Act’s general policy of protecting investors. In *Touche Ross & Co. v. Redington*, however, the Court moved away from this statutory implication theory toward a congressional intent theory to support the implied 10b-5 right of action. As a result, most courts now look to legislative intent as the principal justification for the implied right of action under 10b-5.
While the elements of a 10b-5 violation depend upon the type of abuse that is pled, most jurisdictions agree that 10b-5 actions involving misrepresentations or omissions commonly require not only a misrepresentation or an omission, but also the elements of materiality, scienter, reliance, and injury. These requirements mirror the elements of the common law tort action of deceit, upon which the 10b-5 action is based.

Just how close the 10b-5 action should be to common law deceit is unclear. Many courts view the relationship between an

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39 5 A. Jacobs, supra note 28, § 36, at j2-5. Jacobs recognizes no less than seven distinct types of 10b-5 violations:

- These abuses can be categorized as (1) misrepresentation and omission when the defendant trades, (2) misstatement and concealment when the defendant does not buy or sell, (3) mismanagement, (4) manipulation, (5) tipping important nonpublic data, (6) tender offers and exchange offers, and (7) activities of broker-dealers and other fiduciaries.

Id. While much variety in the required elements exists between the various categories, the elements of a 10b-5 action become considerably more uniform when analyzed within any of the previously mentioned categories.

40 See, e.g., Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 61 (2d Cir. 1985) (In order to state a Rule 10b claim, the plaintiff “must allege that, in connection with purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff’s reliance on defendant’s actions caused him injury.”); James v. Meinke, 778 F.2d 200, 205 (5th Cir. 1985) (citation omitted) (“Rule 10b-5 claim[s] require material misrepresentation, scienter, reliance, diligence and injury”); Lucas v. Florida Power & Light Co., 765 F.2d 1039, 1040 (11th Cir. 1985) (footnote omitted) (Stating that the elements of a Rule 10b-5 action are “(1) a misstatement or an omission; (2) of material fact; (3) made with scienter; (4) on which the class reasonably relied; (5) which proximately caused the class’ injury.”).

41 The elements of the common law action for deceit include (1) a false representation; (2) knowledge or belief by defendant of the false nature of the statement or of its lack of basis; (3) intention to induce reliance by the plaintiff; (4) plaintiff’s justifiable reliance resulting in (5) damage to the plaintiff. W. Keeton, Prosser and Keeton on the Law of Torts 728 (5th ed. 1984). See Farrar v. Churchillill, 135 U.S. 609, 615 (1890) (fraudulent misrepresentation must concern a material fact, must be false, must be relied upon by the other party, and must have been made with a reasonable belief that it was false); Stewart v. Wyoming Cattle Ranch Co., 128 U.S. 383, 388 (1888) (discussion of common law tort action of deceit); Ming v. Woolfolk, 116 U.S. 599, 602-03 (1886) (“The requisites to sustain an action for deceit ... [are] the telling of an untruth, knowing it to be an untruth, with intent to induce a man to alter his condition, and his altering his condition in consequence, whereby he sustains damage.”); Johnston v. Venturini, 294 F. 836, 838-39 (3d Cir. 1923) (citing the elements listed in Ming, supra, as necessary for an action of deceit); Pain v. Kiel, 288 F. 527, 529 (8th Cir. 1923) (elements of action for deceit are a false representation, the speaker’s knowledge of it’s falsity, an intent to induce the other party to act, actual reliance by the other party, and injury); Davis v. Louisville Trust Co., 181 F. 10, 11 (6th Cir. 1910) (statements made to induce purchase of stock were false and fraudulent and made for the purpose of inducing such purchase were sufficient to establish cause of action for deceit).

action for deceit and Rule 10b-5 as limited.43 These courts perceive the use of common law principles in the securities context as misleading.44 Their position is premised upon two considerations: 1) federal securities laws were intended in part to remedy deficiencies in the common law,45 and 2) modern securities markets "involving millions of shares changing hands daily"46 hardly resemble the face-to-face transactions typical of the common law deceit action.47 Thus, these courts believe that the elements of 10b-5 should take into account the distinctions between modern securities markets and the face-to-face transactions that were prevalent during the development of the common law.48

In light of this reasoning, an appropriate solution is to selectively apply principles from tort law to 10b-5 actions while closely adhering to the policies underlying the securities acts.49 Much of the case law interpreting Rule 10b-5 does borrow heavily from tort concepts.50 The Supreme Court's affirmation of the "scienter"51 standard in *Ernst & Ernst v. Hochfelder*52 is illustrative of this

43 See id. at 388.
44 See id.
45 See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); see also Basic, 108 S. Ct. at 990 n.22 (citation omitted) ("Actions under Rule 10b-5 are distinct from common law deceit . . . and are in part designed to add to the protections provided investors by the common law.").
46 Basic, 108 S. Ct. at 989.
47 See id.
48 See Capital Gains, 375 U.S. at 194. See also Blue Chip Stamps, 421 U.S. at 744-45 (Rule 10b-5 actions are distinct from common-law deceit).
50 Huddleston, 640 F.2d at 547 n.21, 555 (The implied cause of action under Rule 10b-5 "is essentially a tort claim" derived from the common law action of deceit.), rev'd on other grounds, 459 U.S. 375 (1983); Moody v. Bache & Co., 570 F.2d 523, 527 (5th Cir. 1978) (10b-5 action is actually a tort claim); Holdsworth v. Strong, 545 F.2d 687, 693-94 (10th Cir. 1976) (court analogizes a 10b-5 action to tort action of deceit), cert. denied, 430 U.S. 955 (1977); see G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 961 n.32 (5th Cir. 1981) (common law fraud is the interpretive source of securities law concepts); Straub v. Vaisman & Co., 590 F.2d 591 (3d Cir. 1976) (common law torts of misrepresentation and deceit are relevant in interpreting Rule 10b-5); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965) (refusing to dispose of causation requirement because causation is basic element of tort), cert. denied sub nom. List v. Lerner, 382 U.S. 811 (1965); Comment, Negligent Misrepresentations Under Rule 10b-5, 32 U. CHI. L. REV. 824, 828-33 (1965).
51 "Scienter" is a mental state requiring intent to deceive, manipulate or defraud. *Ernst & Ernst*, 425 U.S. at 193.
52 Id.
fact. Courts typically look for guidance in common law deceit principles when adjudicating 10b-5 actions that closely resemble early fraud cases. But where modern securities markets are involved, courts will modify their understanding of Rule 10b-5 in consideration of the additional complexities that arise from trading on impersonal markets.

II. FACE-TO-FACE MATERIAL MISREPRESENTATIONS AND THE LIST RULE

Under Rule 10b-5, a material misrepresentation is an untrue statement or distortion of a fact where there is a substantial likelihood that a reasonable investor would consider the fact important in making an investment decision. A material misrepresentation occurs when a corporate insider is aware of information that is likely to be regarded as important to the average investor but misrepresents that information, such as by convincing minority shareholders of a closely-held corporation to sell their stock by misrepresenting “that the company was unable and would be unable to pay dividends.” Because the Affiliated Ute and Basic exceptions have severely restricted the role of reliance in omissions and fraud on the market cases, material misrepresentations are the last group of Rule 10b-5 cases to which the List rule still applies.

In List v. Fashion Park, Inc., the Second Circuit handed down the general rule that plaintiffs must prove reliance in 10b-5 actions. The purpose of the reliance requirement is to insure that a defendant’s conduct has in fact caused the plaintiff’s loss. Without establishing this causal nexus between the illegal conduct and the plaintiff’s loss, the liability of the defendant is potentially unlimited. For example, if plaintiffs were allowed to recover

53 See supra notes 49-52.
54 See Basic, 108 S. Ct. at 989-90.
57 See supra notes 5-17 and accompanying text.
58 340 F.2d 457 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965).
59 Id. at 462.
60 See Basic Inc. v. Levinson, 485 U.S. ———, 108 S. Ct. 978, 989 (1988) (“Reliance provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”).
without proof of causation, defendants could be liable for all losses to all investors who traded in a particular stock during the operational period of the fraud, including those investors who would have traded regardless of the misrepresentation. Thus, courts look to the List rule in order to "restrict the potentially limitless thrust of Rule 10b-5 to those situations in which there exists causation in fact between the defendant's act and the plaintiff's injury."62 Most commentators agree that because causation is an indispensable element in common law tort actions, plaintiffs simply should not recover in a 10b-5 action where a defendant's fraud has not caused the plaintiff's loss.63

According to List, the test of reliance is whether the plaintiff would have acted any differently had the defendant told the truth.64 This is to be distinguished from materiality, which asks whether there is a substantial likelihood that a "reasonable investor" would consider the fact important in making an investment decision.65 Materiality, therefore, focuses on a hypothetical reasonable investor;66 reliance focuses on the particular investor who seeks recovery.67 The overwhelming majority of Rule 10b-5 cases continue to recognize the List rule, requiring plaintiffs to prove reliance in actions involving face-to-face material misrepresentations.68

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64 List, 340 F.2d at 463.

65 See TSC Indus., 426 U.S. at 449.


67 See 5 A. Jacob, supra note 28, § 64.01[a], at 3-311

68 See Peil v. Speiser, 806 F.2d 1154, 1161-65 (3d Cir. 1986) (applying the fraud on the market theory, but noting the traditional rule that plaintiffs in a 10b-5 case must prove reliance); Madison Consultants v. FDIC, 710 F.2d 57, 62-65 (2d Cir. 1983) (plaintiff satisfied the reliance requirement by showing that, had a reasonable investor known of the defendants' misstatement, the investor would have considered these misrepresentations in deciding whether to take action to protect his investment); T.J. Raney & Sons v. Fort Cobb, Okl. Irr. Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983) (adopting a fraud on the market theory to establish the plaintiff's reliance that the bonds it purchased were lawfully issued when in fact the defendant was prohibited from issuing any bonds under state law), cert. denied, 465 U.S. 1026 (1984); Wilson, 648 F.2d 88, 93-94 (recovery denied to plaintiff who
In *Basic*, the Supreme Court reaffirmed reliance as a fundamental element of the 10b-5 cause of action. However, the Court severely narrowed the reliance element in cases of material public misrepresentations affecting stock traded on efficient markets by adopting a presumption of reliance in such instances.

Several portions of the *Basic* decision indicate that the presumption of reliance only applies to those situations where the security at issue is traded on an efficient market. *Basic* restates a fundamental principle of the fraud on the market theory: "the price of a company's stock [in an efficient market] is determined by the available material information regarding the company and its business." Additionally, the Supreme Court observed that the evidentiary difficulties associated with the presumption occur only where the plaintiff has traded on an impersonal market. Since these factors only apply where a market is efficient, the Court required that the shares in question must have been traded on an efficient market for the plaintiff to enjoy the benefit of the presumption. The Court, however, failed to give any hint of the standard by which a market will be determined to be efficient.

Because *Basic* retains reliance as an element of 10b-5, *List* still appears to apply to misrepresentation cases that occur in face-to-face transactions. These face-to-face misrepresentation cases typ-
ically involve closely held corporations,\textsuperscript{75} private placements,\textsuperscript{76} or customer-broker relations.\textsuperscript{77} Because this type of fraud occurs in personal transactions between individuals, the evidentiary difficulties associated with proving fraud in impersonal markets are not present.\textsuperscript{78} Thus, presuming reliance in face-to-face misrepresentation cases is inappropriate, absent some other proof problems.

Some of the language of \textit{Basic} could be used to further erode the \textit{List} rule in misrepresentation cases. The Court in \textit{Basic} noted that making plaintiffs prove reliance in omissions cases is unfair because plaintiffs would be forced to establish that they would have acted differently if the defendant had disclosed the omitted material information.\textsuperscript{79} In other words, the plaintiff's case would turn on speculation about how the plaintiff would have acted.\textsuperscript{80} Consequently, the Court held that placing the burden of proving reliance upon the plaintiff in situations involving misrepresentations also requires unfair speculation on the plaintiff's part, i.e., how the plaintiff would have acted "if the misrepresentation had not been made."\textsuperscript{81} While \textit{Basic} limited its presumption to impersonal

\textsuperscript{75} See Dupuy v. Dupuy, 551 F.2d 1005, 1009 (5th Cir. 1977) (Plaintiff sold stock in reliance on misrepresentations that "everything [was] ... going downhill" with regard to a hotel venture.); Holdsworth v. Strong, 545 F.2d 687, 689 (10th Cir. 1976) (plaintiffs sold stock in reliance on misrepresentations that the company was not able, and would not be able, to pay dividends), \textit{cert. denied}, 430 U.S. 955 (1977).

\textsuperscript{76} See Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518-19 (10th Cir. 1983) (Investors who bought limited partnership interests in reliance on oral misrepresentations that the investment involved "no risks" could not recover because the risks were clearly stated in the private placement memorandum.); Sharp v. Coopers & Lybrand, 649 F.2d 175, 179, 194 (3d Cir. 1981) (investors who bought limited partnership interests in reliance on misrepresentations contained in tax opinion letter issued by the defendant accounting firm were entitled to recovery), \textit{cert. denied}, 455 U.S. 938 (1982).

\textsuperscript{77} See Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1199 (8th Cir. 1978) (Investor who refrained from transferring investment account to another firm in reliance on the broker's misrepresentations that the transfer would be very costly and that the account was undermargined was entitled to recovery against the broker.).

\textsuperscript{78} See Basic, 108 S. Ct. at 990 (unfair evidentiary burden in omissions and misrepresentations cases results from burden of proving reliance in impersonal markets).

\textsuperscript{79} \textit{Id.}; see also Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981) ("The reason for shifting the burden on the reliance issue has been an assumption that the plaintiff is generally incapable of proving that he relied on a material omission."). \textit{cert. denied}, 455 U.S. 938 (1982).


\textsuperscript{81} See Basic, 108 S. Ct. at 990 (citing Sharp, 649 F.2d at 188).
market situations, the Supreme Court could easily extend this logic to face-to-face misrepresentation cases as well.

III. **Affiliated Ute and the Omissions Exception**

In *Affiliated Ute Citizens of Utah v. United States*, the Supreme Court formulated its first exception to the *List* rule. Affiliated Ute held that proof of reliance is unnecessary in suits primarily involving a failure to disclose information as long as "the facts withheld [were] material in the sense that a reasonable investor might have considered them important in the making of [the investment] decision." Materiality in nondisclosure cases does not require that investors would have altered their behavior in light of the omitted fact; it merely requires that investors would have considered the omitted fact significant to their investment decision. Under *Affiliated Ute*, once a plaintiff establishes the obligation to disclose and the withholding of a material fact, the causal link is made and the burden of disproving reliance shifts to the defendant.

*Affiliated Ute* spawned many interpretive problems among the circuits. Although the Supreme Court indicated that reliance is not required in omissions cases and did not even use the word "presumption," *Affiliated Ute* has been interpreted by most lower federal courts as adopting a rebuttable presumption of reliance.

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84 *Affiliated Ute*, 406 U.S. at 153-54.
86 *Affiliated Ute*, 406 U.S. at 154; see also *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970). The existence of an obligation to disclose depends upon the particular factual circumstances. For example, an insider or one possessing insider information must either disclose the inside information or abstain from trading. See *Affiliated Ute*, 406 U.S. at 153.
88 *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), cert. denied, 459 U.S. 1102 (1983). *Ute* 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. When the *Ute* presumption attaches, the defendant may rebut it by showing that the plaintiff did not rely on the defendant's duty to disclose.

*Id.* at 468. See also *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 359 (5th Cir. 1987)
The Fifth Circuit's decision in *Rifkin v. Crow* provides a particularly descriptive summary of the operation of this presumption:

[W]here a 10b-5 action alleges defendant made positive misrepresentations of material information, proof of reliance by the plaintiff upon the misrepresentation is required. Upon an absence of proof on the issue, plaintiff loses. On the other hand, where a plaintiff alleges deception by defendant's nondisclosure of material information, the *Ute* presumption obviates the need for plaintiff to prove actual reliance on the omitted information. Upon a failure of proof on the issue, defendant loses. But this presumption of reliance in nondisclosure cases is not conclusive. If defendant can prove that plaintiff did not rely, that is, that plaintiff's decision would not have been affected even if defendant had disclosed the omitted facts, then plaintiff's recovery is barred.

Most of these cases justify the presumption on the ground that ordinarily it will be impossible for plaintiffs to prove that they relied on the absence of disclosure, i.e., something that was not said. Thus, the presumption of reliance is viewed as a rule of procedure.

Other courts treat *Affiliated Ute* as adopting an inference of reliance, finding that the element of reliance reasonably follows from a showing of materiality. This idea is known as constructive
reliance. Constructive reliance assumes that once a plaintiff shows that a "reasonable investor" would have the propensity to rely upon the fraud, the court should infer that the individual plaintiff in fact did rely on the fraud. Reliance, at that point, is a settled issue.

The language in Basic Inc. v. Levinson supports the theory that Affiliated Ute creates not a question of fact for the jury that can be presumed or inferred, but a question of law for the court. The only pertinent reference to Affiliated Ute in Basic speaks of dispensing with the reliance element, not presuming it. According to Basic, the plaintiff's demonstration of the defendant's breach of the duty to disclose material information establishes the causal connection between the defendant's fraud and the plaintiff's injury. The Court made no reference at all to any shifting of the burden of reliance to defendants in omissions cases. The Court's discussion of Affiliated Ute is, however, dicta, and may not prevent the majority of lower federal courts from applying a rebuttable presumption of reliance in nondisclosure cases.

The Supreme Court's decision in Basic also indicates a possible change of position for the Supreme Court regarding the theoretical justification for Affiliated Ute. Subsections (a) and (c) of Rule 10b-5 make unlawful a "course of business" or a "device, scheme, or artifice" that operates as a fraud or deceit. Affiliated Ute held that the defendants' conduct, in failing to inform the plaintiffs that they were market-makers, fell within at least one of these two subsections. Additionally, the Supreme Court found that because subsections (a) and (c) do not encompass material misrepresenta-

234, 239 (2d Cir. 1975) ("In cases involving non-disclosure of material facts . . . materiality rather than reliance thus becomes the decisive element of causation . . . [a]nd determination of materiality allows logically an inference of reliance.") (citing Chris-Craft Indus., 480 F.2d 341); Pellman v. Cinerama, 89 F.R.D. 386, 387 (S.D.N.Y. 1981) ("To establish causation . . . a plaintiff must prove that an omission was material; he need not prove that he relied upon the absence of the information in making his decision."); Tucker v. Arthur Andersen & Co., 67 F.R.D. 468, 479 (S.D.N.Y. 1975) ("[R]eliance will not be an individual issue since causation may be presumed if the plaintiffs can prove . . . materiality.").

93 See S. Jacobs, supra note 28, at § 64.01[b][i].
94 Id.
95 See supra note 92.
97 Id. at 989.
98 Id.
99 Id.
101 Affiliated Ute, 406 U.S. at 153.
tions or omissions as does subsection (b), subsections (a) and (c) of Rule 10b-5 operate free from any issue of reliance.\textsuperscript{102} This distinction recognized by the Court in \textit{Affiliated Ute} follows from the notion that subsections (a) and (c) expand upon traditional notions of fraud by including under 10b-5 a broad variety of conduct which may not constitute misrepresentations or omissions, but which should be characterized as fraud even though its effect upon the plaintiff's conduct cannot be firmly established.

In \textit{Basic}, however, none of the Supreme Court's references to \textit{Affiliated Ute} mention any of the various subsections of Rule 10b-5. Instead, the Supreme Court's discussion of \textit{Affiliated Ute} focuses upon two ideas. First, the Court stated that proof of reliance is not necessary where causation can be shown in other ways.\textsuperscript{103} Second, \textit{Basic} found that requiring plaintiffs to prove reliance upon a material omission in "open market situations" results in an unfair evidentiary burden on the plaintiffs.\textsuperscript{104} Neither of these ideas are found within the four corners of the \textit{Affiliated Ute} opinion. While the references in \textit{Basic} are not entirely inconsistent with the rationale of \textit{Affiliated Ute}, they do indicate a clear shift in focus away from a statutory interpretation of the subsections of Rule 10b-5 and demonstrate a new concern for evidentiary burdens and proof of causation.

\section*{IV. \textit{Basic Inc. v. Levinson}: Fraud on the Market}

In \textit{Basic Inc. v. Levinson},\textsuperscript{105} the Supreme Court endorsed a second exception to the \textit{List}\textsuperscript{106} reliance requirement: fraud on the market.\textsuperscript{107} \textit{Basic} found that the Sixth Circuit correctly applied a presumption, supported by the fraud on the market theory, that the plaintiff class relied upon the integrity of the market price when they sold their securities.\textsuperscript{108} Because only four justices formed the Court majority,\textsuperscript{109} with the five conservative justices either

\textsuperscript{102} \textit{Id.} at 152-53.
\textsuperscript{103} \textit{Basic}, 108 S. Ct. at 989.
\textsuperscript{104} \textit{Id.} at 990.
\textsuperscript{105} \textit{Basic Inc. v. Levinson}, 485 U.S. \underline{---}, 108 S. Ct. 978, 993 (1988).
\textsuperscript{107} \textit{Basic}, 108 S. Ct. at 993.
\textsuperscript{108} \textit{Id.} at 990-92.
\textsuperscript{109} Justice Blackmun delivered the opinion of the Court, joined by Justices Brennan, Marshall, and Stevens. \textit{Id.} at 978.
dissenting or not participating, the ultimate status of the fraud on the market theory may await future adjudication.

Under the fraud on the market theory, lower courts have almost uniformly adopted a rebuttable presumption of reliance in cases involving public material misrepresentations in the open market. This doctrine, which focuses on the reliance requirement of SEC Rule 10b-5 as a manifestation of the more expansive concept of causation, rests on two propositions. First, in open secondary markets, the price of stock is determined by all available material information. Second, investors rely on the integrity of market prices when making investment decisions.

110 Justice White, joined by Justice O'Connor, dissented to the relevant portions of the majority opinion discussing the fraud on the market issue. Chief Justice Rehnquist, and Justices Scalia and Kennedy did not participate in the decision. Id.

111 See, e.g., Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986) ("If plaintiffs make such a showing [of a material misrepresentation made by defendants], the court will presume that the misrepresentations occasioned an increase in the stock's value that, in turn, induced the plaintiffs to purchase the stock."); Harris v. Union Elec. Co., 787 F.2d 355, 367 n.9 (8th Cir. 1986) (court held that certain bond purchasers established reliance by proving that the defendant's misleading prospectus had inflated the open market bond prices), cert. denied, 479 U.S. 823 (1986); Lipton v. Documation, Inc., 734 F.2d 740, 748 (11th Cir. 1984) (Fraud on the market theory "simply recognizes that reliance may be presumed where securities are traded on the open market."); T.J. Raney & Sons, Inc. v. Fort Cobb, Okl. Irr. Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983) (court held that plaintiff met its burden by establishing that the defendants had placed unauthorized bonds on the market), cert. denied sub nom. Linde, Thomson, Fairchild, Laugworthy, Kohn & Van Dyke v. T.J. Raney & Sons, Inc., 465 U.S. 1026 (1984); Panzirer v. Wolf, 663 F.2d 365, 367 (2d Cir. 1981) (plaintiff enjoyed a presumption of reliance when she based her decision to buy defendant's stock on the defendant's misrepresentation that appeared in The Wall Street Journal), cert. granted sub nom. Price Waterhouse v. Panzirer, 458 U.S. 1005, judgment vacated and complaint dismissed, 459 U.S. 1027 (1982); Ross v. A.H. Robins Co., 607 F.2d 545, 553 (2d Cir. 1979) (court held that the plaintiff arguably stated a cause of action under Rule 10b-5 where the plaintiffs alleged that the defendants' misleading statements affected the market price of defendants' stock, even though plaintiffs did not allege direct reliance); Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975) ("We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance.").

112 See Basic, 108 S. Ct. at 989 ("Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury.... There is, however, more than one way to demonstrate the causal connection.").

113 See, e.g., Basic, 108 S. Ct. at 991.

114 The theory was perhaps best explained by the Third Circuit:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined
Based upon these postulates, *Basic* held that it is appropriate to allow a plaintiff to invoke a presumption of reliance in actions under Rule 10b-5 when the plaintiff has alleged and proven four elements: that the defendant made public misrepresentations; that the misrepresentations were material; that the shares in question were bought or sold on an efficient market; and that the plaintiff traded on that market between the time the misrepresentation was made and the time the truth was revealed.\footnote{115}

According to the fraud on the market theory, a plaintiff becomes injured when the market appraises the price of the plaintiff’s stock based upon the information misrepresented by the defendant.\footnote{116} Damages arise when an investor either buys stock in an artificially-inflated market or sells stock in an artificially-depressed market, thereby paying or receiving a different price for the shares than if there had been no material fraud.\footnote{117} Regardless of an investor’s knowledge of any particular statement that turns out to have been a misrepresentation, an investor presumably trades in the market generally with expectations that the market price has been fairly set and is free from manipulation.\footnote{118}

A. *The Supreme Court’s Rationale for Adopting Fraud on the Market*

Scattered throughout the *Basic* decision are three distinct arguments that support a presumption of reliance based upon the

\footnote{115} *Basic*, 108 S. Ct. at 992-93.

\footnote{116} See *In re LTV Sec. Litig.*, 88 F.R.D. 134 (N.D.Tex. 1980):

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

\footnote{id} at 143.

\footnote{117} See *T.J. Raney & Sons*, 717 F.2d at 1332 ("Material misinformation will theoretically cause the artificial inflation or deflation of the stock price.")(\footnote{118} *Blackie*, 524 F.2d at 907.
fraud on the market theory. The essence of the Court's syllogism
is that because causation can be sufficiently established without
direct proof of reliance, a presumption of reliance is especially
appropriate where the evidentiary difficulties of proving reliance
impede the certification of class actions and thereby threaten the
underlying policies of the securities acts.

1. Causation May Be Established By Means Other Than
   Reliance

The Supreme Court in Basic observed that although reliance
remains an element of the 10b-5 implied right of action,\(^\text{119}\) positive
proof of reliance may be unnecessary where causation can be
proven sufficiently by other means.\(^\text{120}\) The Supreme Court used
identical reasoning to dispense with reliance in two previous deci-
sions, Mills v. Electric Auto-Lite Co.\(^\text{121}\) and Affiliated Ute.\(^\text{122}\)

Mills dealt with an action under Rule 14a-9, which prohibits
fraud in connection with proxy solicitations and is quite similar to
Rule 10b-5.\(^\text{123}\) In that case, the plaintiffs' proof that votes necessary
for approval of a merger were obtained by way of a materially
misleading proxy solicitation also served to establish the necessary
causal connection between the defendants' wrong and the plaintiffs'
injury.\(^\text{124}\) Thus, the plaintiffs' proof of materiality was sufficient
to also establish causation.\(^\text{125}\) Mills theorized that where a reason-
able investor would have the propensity to rely upon a misleading
proxy statement, one may assume enough investors did in fact rely
on the statement to sufficiently taint the entire vote.\(^\text{126}\) An actual
inquiry into the reliance of each investor upon the defect in the
solicitation materials was not required because it was "the proxy
solicitation itself, rather than the particular defect in the solicitation
materials, [that was the] essential link in the accomplishment of
the transaction."\(^\text{127}\)

\(^\text{119}\) See supra note 69 and accompanying text.
\(^\text{120}\) Basic, 108 S. Ct. at 989.
   prohibits fraud in connection with proxy solicitations.
\(^\text{124}\) Id. at 384.
\(^\text{125}\) Id. at 385.
\(^\text{126}\) Id. at 384.
\(^\text{127}\) Id. at 385.
Similarly, *Affiliated Ute* also found that proof of reliance is unnecessary to establish causation. As stated previously, *Affiliated Ute* dispensed with proof of reliance in suits “involving primarily a failure to disclose” as long as the plaintiff could establish materiality “in the sense that a reasonable investor might have considered [the omitted facts to be] important” to his or her investment decision. Hence, causation was established by the materiality of the omission in that case rather than by reliance.

Between these two decisions, *Mills* clearly provides the stronger foundation for *Basic*. Both *Basic* and *Mills* attempt to protect the integrity of an evaluational process whereby the rights of individual investors are determined. *Mills* considered an evaluation of the fairness of certain merger terms by a shareholder vote; *Basic* considered the evaluation of a security by the open market. Both of these cases reflect an awareness that *individual reliance is irrelevant where the integrity of the evaluational process can otherwise be shown to be affected by fraud*.

The Supreme Court’s reference to *Affiliated Ute* presents theoretical difficulties. *Affiliated Ute* involved a series of face-to-face transactions where the defendants encouraged investors, with whom they had a fiduciary relationship, to sell stock for less than fair value without disclosing that the defendants were market-makers in the stock. Unlike *Mills*, the evaluational process in *Affiliated Ute* took place through individual investors judging the value of stock for themselves based upon individual transactions with the defendants. Unable to rely upon the integrity of an impersonal evaluation process, *Affiliated Ute* offers no support for its conclusion that causation is more probable when both materiality and a duty to speak are present.

Of course, *Basic*’s adoption of fraud on the market depends upon the actual efficiency of the securities markets. By the Court’s own terms, a claim of fraud on the market cannot stand unless

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128 *Affiliated Ute*, 406 U.S. at 152-54.
129 *See supra* notes 82-86 and accompanying text.
130 *Affiliated Ute*, 406 U.S. at 153-54.
131 *Mills*, 396 U.S. at 377.
132 *See Basic*, 108 S. Ct. at 990 (quoting *LTV Sec. Litig.*, 88 F.R.D. at 143).
133 *Affiliated Ute*, 406 U.S. at 153.
134 *Id. at* 152 (“The mixed-blood sellers ‘considered these defendants to be familiar with the market for the shares of stock and relied upon them when they desired to sell their shares.’”) (quoting *Reyos v. United States*, 431 F.2d 1337, 1347 (10th Cir. 1970)).
135 *Id. at* 153-54.
the plaintiff proves the market in which the securities were traded was in fact efficient.\textsuperscript{136} "It is an article of faith" in securities laws that the market responds to all available information.\textsuperscript{137} One must wonder whether it is prudent for the Supreme Court to effectively abandon the reliance requirement in these cases\textsuperscript{138} partially based upon a theory "which may or may not prove accurate upon further consideration."\textsuperscript{139}

2. Plaintiff's Evidentiary Burden of Proving Reliance is Unreasonable

The Basic Court also supported its presumption of reliance with the notion that a plaintiff suffers an unreasonable evidentiary burden when required to prove reliance upon public misrepresentations affecting the open market.\textsuperscript{140} Basic stated that the unreasonableness of this burden results from "[r]quiring a plaintiff to show a speculative state of facts, \textit{i.e.}, how he would have acted if omitted material information had been disclosed, \ldots or if the misrepresentation had not been made," when the plaintiff has traded on an impersonal market.\textsuperscript{141}

One cannot question that the evidentiary difficulties associated with the proof of reliance in 10b-5 class actions are staggering. In Blackie v. Barrack,\textsuperscript{142} for example, shareholders brought a class action suit alleging material public misrepresentations concerning the corporate finances.\textsuperscript{143} The class' cause of action was based on a period that extended for twenty-seven months involving over 120,000 transactions in approximately 21,000,000 shares.\textsuperscript{144} The Blackie court decided to "eliminate the requirement that plaintiffs prove reliance directly in this context because the requirement imposes an unreasonable and irrelevant evidentiary burden."\textsuperscript{145}

\textsuperscript{136} Basic, 108 S. Ct. at 992 n.27.
\textsuperscript{137} Schlanger v. Four-Phase Sys., Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982).
\textsuperscript{138} See Blackie, 524 F.2d at 906 n.22 ("We doubt the right to disprove causation will substantially reduce a defendant's liability in the open market fraud context, as we doubt that a defendant would be able to prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material fraud.").
\textsuperscript{139} Basic, 108 S. Ct. at 995 (White, J., dissenting).
\textsuperscript{140} Id. at 990.
\textsuperscript{141} Id.
\textsuperscript{142} 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).
\textsuperscript{143} Blackie, 524 F.2d at 894.
\textsuperscript{144} Id. at 901.
\textsuperscript{145} Id. at 907.
Mills provides an early example of similar difficulties in the context of a Rule 14a-9 class action suit. In Mills, 317,000 votes in favor of the merger were obtained by proxy, each "necessary and indispensable to the approval of the merger." Where class actions are involved, meaning by definition that the number of plaintiffs is "so numerous that joinder of all members is impracticable," it would be impractical for each plaintiff to take the stand and testify that he or she relied upon the misrepresented facts. Thus, the Supreme Court in Mills outlined what has become the fundamental problem in fraud on the market cases: "proof of actual reliance by thousands of individuals would ... not be feasible."

The impracticability of certifying a class of purchasers or sellers required to prove reliance has become the driving force behind the fraud on the market theory. Rule 23(b)(3) of the Federal Rules of Civil Procedure provides that "questions of law or fact common to the members of the class [must] predominate over any questions affecting only individual members" in order for class certification to be proper. According to Basic, "[requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented [the plaintiffs] from proceeding with a class action, since individual issues would then have overwhelmed the common ones."

Thus, courts have applied this presumption of reliance where proof of actual reliance would be impractical or impossible. Again, Basic's reference to Affiliated Ute here seems perplexing. Basic cites Affiliated Ute for the proposition that it is unreasonable to require a plaintiff to prove reliance upon a material omission because it involves speculation. Yet the Supreme Court's decision in Affiliated Ute was based solely upon the notion that reliance is not required to prove a "course of business" or a "device, scheme, or artifice" that operates as a fraud under Rule

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146 Mills, 396 U.S. at 379.
148 Mills, 396 U.S. at 382 n.5.
151 Id.
152 Basic, 108 S. Ct. at 989.
154 Basic, 108 S. Ct. at 990.
Clearly, the Basic decision reflects the host of lower court cases\(^\text{156}\) that have interpreted and modified Affiliated Ute to stand for the proposition that the presumption of reliance in omissions cases is necessary because it is difficult to show reliance upon an omission.

### 3. Presumption of Reliance Facilitates Goals of Securities Acts

The Supreme Court in Basic also asserted that the presumption of reliance supports the congressional policies of the securities laws by facilitating 10b-5 litigation.\(^{157}\) The Court stated that Congress intended the Securities Act of 1934 to "facilitate an investor's reliance on the integrity of [securities] markets,"\(^{158}\) basing its conclusion on the notion that markets respond to all available information.\(^{159}\) This brief pronouncement by the Court is indicative of the fact that neither the goals nor the legislative history of the securities acts provide a compelling justification for use of the fraud on the market theory.\(^{160}\)

Indeed, the fraud on the market theory may actually conflict with the goals and legislative history of the securities acts. The fraud on the market theory arguably may subvert the federal securities policy of fairness\(^{161}\) by abandoning reliance, thereby allowing overinclusive recoveries.\(^{162}\) Allowing the presumption to be rebutted does not effectively prevent overinclusive plaintiff recoveries because defendants will not be able to convince a jury that the plaintiff was indifferent to a material fraud.\(^{163}\) In reality, re-
butting the presumption of reliance becomes "virtually impossible" for the defendant in the vast majority of cases.164 The presumption of reliance thus enacts a scheme of "investors' insurance"165 by essentially eliminating a defendant's ability to defend against any investor trading in the market.166 Even in Basic, "virtually every member of the [plaintiff] class made money from his or her sale of Basic stock."167 Hence, fraud on the market is an aid to recovery even to those plaintiffs who actually make money upon the sale of their securities, but claim that misrepresentations have hurt their profits. Recovery occurs regardless of whether these plaintiffs actually relied on such misrepresentations.

Additionally, the "specter of Draconian liability"168 caused by overinclusive recoveries is thought to conflict with the Court's past concerns that 10b-5 litigation gives substantial settlement values even to plaintiffs with flimsy claims.169 One can argue that the policy of fairness underlying the securities acts is not met when overinclusive recoveries can ruin a corporation that received no direct benefit from the alleged shift in market value.170 A workable theory of damages must be developed under the fraud on the market theory before courts can establish an appropriate and fair balance between enhanced plaintiff recovery and oppressive defendant liability. The Supreme Court chose not to address the issue of damages in Basic.

Commentators have also criticized the fraud on the market theory for ignoring the congressional policies of disclosure embodied in the securities acts.171 The securities acts are intended to protect the public by promoting full disclosure of information

164 See LTV Sec. Litig., 88 F.R.D. at 143 n.4.
165 See Shores v. Sklar, 647 F.2d 462, 469 n.5 (5th Cir. 1981) ("Doing away with the conventional reliance requirement in a 10b-5 case . . . could establish a scheme of investors' insurance.")], cert. denied, 459 U.S. 1102; List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965) (emphasis omitted) ("[T]he aim of [Rule 10b-5] in cases such as this is to qualify, as between insiders and outsiders, the doctrine of caveat emptor—not to establish a scheme of investors' insurance.")], cert. denied, 382 U.S. 811.
166 See Blackie, 524 F.2d at 906-07 n.22 ("We doubt the right to disprove causation will substantially reduce a defendant's liability in the open market fraud context, as we doubt that a defendant would be able to prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material fraud.").
167 108 S. Ct. at 998.
168 See Black, supra note 111, at 461.
169 See Black, supra note 111, at 460-61 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-40 (1975)).
170 See id.
171 Id. at 457-59.
necessary for the decisions of investors. The theory is that congressional disclosure policies underlying the securities acts are defeated if plaintiffs are allowed to recover under 10b-5 without having read disclosure documents. Allowing a plaintiff to recover for fraud without having read or relied upon a defendant’s public disclosures would undercut the plaintiff’s incentive to read the documents. Hence, many argue that investors’ reckless failure to inform themselves should disqualify them from recovering under Rule 10b-5.

Finally, fraud on the market directly contradicts the legislative history of the securities acts. During the drafting process of Section 18 of the 1934 Act, an antifraud provision similar to 10b-5, Congress expressly rejected a provision very similar to the fraud on the market theory that allowed plaintiffs to recover solely by showing the price of a security they traded was affected by a misrepresentation. By adding a substantial reliance requirement back into that section, Congress presumably intended that reliance be present before a plaintiff can recover. The comments of

172 See SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."); SEC v. Chinese Consol. Benevolent Ass’n, Inc., 120 F.2d 738, 741 (2d Cir. 1941) ("The aim . . . of the Securities Act is to protect the public by requiring that it be furnished with adequate information upon which to make investments."); Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (current version at 15 U.S.C. § 77a) ("[Goal is] to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce.").

173 See Shores, 647 F.2d at 483 (Randall, J., dissenting).

174 Id.

175 See, e.g., Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1418 (11th Cir. 1983) (reasonable diligence); Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir. 1977) (due diligence).


178 See 78 Cong. Rec. 7701 (1934) (statements of Representative Sam Rayburn) ("[The] bill as originally written was very much challenged on the ground that reliance should be required. This objection has been met.").
Representative Sam Rayburn illustrate the political compromise that took place:

The first provision of the bill as originally written was very much challenged on the ground that reliance should be required. This objection has been met. In other words, if a man bought a security following a prospectus that carried a false or misleading statement, he could not recover from the man who sold to him, nor could the seller be punished criminally, unless the buyer bought the security with knowledge of the statement and relied upon the statement.179

The legislative history of this Section 18 remains highly relevant to understanding the 10b-5 reliance requirement, by demonstrating the intent of Congress to limit the scope of damages under the antifraud provisions through the requirement that plaintiffs prove reliance upon material fraud.180

B. Defenses to Fraud on the Market

In Basic, the Supreme Court held that the presumption of reliance created by the fraud on the market theory is rebuttable.181 The Court indicated that any evidence breaking the causal connection between the misrepresentation and either the price of the security or the investor’s decision to trade can serve to rebut the presumption.182 Basic also articulated that defendants could rebut by showing that the plaintiffs did not trade in reliance upon the integrity of the market.183

As a preliminary matter, a number of courts have questioned the value of allowing this presumption to be rebutted. Justice White, writing for the Basic dissent, joined by Justice O’Connor,

179 Id.

180 This argument—that the congressional intent from § 18 demanding reliance also applies to § 10b—is supported by the Supreme Court’s practice of interpreting statutes by reference to provisions from the same or related legislation. See Securities Indus. Ass’n v. Board of Govs. of the Fed. Reserve Sys., 468 U.S. 137 (1984); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202-06 (1976), reh’g denied, 425 U.S. 986 (1976).

181 108 S. Ct. at 993.

182 Id. at 992. The court of appeals had set out essentially four defenses to the presumption of reliance under the fraud on the market theory: (1) the elements giving rise to the presumption are not satisfied; (2) the plaintiff did not rely on the integrity of the market price; (3) the defendant’s misrepresentations did not affect the price of the security; or (4) the plaintiff would have traded even with knowledge of the falseness of the statement. Basic, 786 F.2d at 750 n.6 (citing Blackie, 524 F.2d at 906).

183 Basic, 108 S. Ct. at 992.
asserted that the presumption of reliance is not rebuttable by the
defendant as a practical matter.\textsuperscript{184} The dissent believed that the
majority’s opinion operates as a theory of pure causation, creating
a nonrebuttable presumption of reliance.\textsuperscript{185} Similarly, in the case
of \textit{In re LTV Securities Litigation},\textsuperscript{186} the district court observed
that “given the force of the presumption . . . the resulting reality
[is] that [the defendant’s rebuttal] would likely be futile in the vast
number of cases.”\textsuperscript{187} Furthermore, in \textit{Blackie}, the Ninth Circuit
admitted that the right to rebut the presumption provides no real
limit on the defendant’s liability because the jury’s inquiry usually
ceases once the materiality of the defendant’s misrepresentation is
established.\textsuperscript{188} These cases indicate that attempts to limit the op-
pressive liability imposed upon defendants under the fraud on the
market theory have not been entirely successful.

1. \textit{Misrepresentations Not Causing Plaintiff’s Damage}

In \textit{Basic}, the Supreme Court recognized that a defendant could
rebut the presumption of reliance by breaking the causal connection
between the market price and the misrepresentation,\textsuperscript{189} i.e., by
showing that the fraudulent conduct did not cause the plaintiff’s
loss.

The Court first indicated that a defendant could show that
market-makers had some access to the true version of whatever
had been misrepresented by the corporation.\textsuperscript{190} In this situation,
the price of the security would not be affected by the false state-
ment because market-makers would not have bought or sold, or
rendered advice in reliance upon the misrepresentation. Alterna-
tively, \textit{Basic} stated that a defendant could establish that truth
filtered into the market itself, thereby offsetting any effects of the
fraud.\textsuperscript{191} Although the market may be efficient in these scenarios,
the price of the stock would not be affected because an insufficient
number of investors would have relied upon the misstatements.\textsuperscript{192}

\textsuperscript{184} \textit{Id}. at 996 n.7 (White, J., dissenting).
\textsuperscript{185} \textit{Id}.
\textsuperscript{186} \textit{LTV Sec. Litig.}, 88 F.R.D. 134.
\textsuperscript{187} \textit{Id}. at 143 n.4.
\textsuperscript{188} \textit{Blackie}, 524 F.2d at 906-07 n.22.
\textsuperscript{189} \textit{Basic}, 108 S. Ct. at 992.
\textsuperscript{190} \textit{Id}.
\textsuperscript{191} \textit{Id}.
\textsuperscript{192} See \textit{Black}, supra note 111, at 448.
The Court left open the possibility of developing additional methods for showing that the fraud did not cause damage to the plaintiff by finding that "any showing" breaking the causal connection is sufficient to rebut the presumption. The argument that the defendant is not liable when the conduct causes no damage to the plaintiff involves overlapping issues of rebuttable presumptions and damages. Establishing that the price differentiation suffered by the plaintiff was not caused by the defendant's fraud would likely involve the services of a special master or the testimony of an expert witness. This individual presumably could calculate damages from available data according to one of the various damages theories associated with fraud on the market.

2. Plaintiff's Decision to Trade at a Fair Price

Basic also stated that the defendant can rebut the presumption by severing the causal link between "the alleged misrepresentation and . . . his decision to trade at a fair market price." According to the Court, a defendant could sever the causal link between the misrepresentation and the plaintiff's decision to trade at a fair price by showing that the plaintiff knew the price was affected by fraud, but traded anyway for unrelated business or political reasons. In this situation, the individual plaintiff would not have relied upon the misrepresentations.

The case of Grossman v. Waste Management illustrates this defense. One of the plaintiffs traded her shares in a target corporation for shares in the acquiring corporation without knowledge of a one billion dollar liability not disclosed by the acquiring corporation.
The plaintiff admitted at trial that, even if she had known of the liability, she still would have traded because she misconstrued her rights in the transaction. This defense provides the correct result because, in the investor's mind, the other factors relevant to the investment decision had more importance than the omitted fact.

The Third Circuit's recent opinion in *Zlotnick v. Tie Communications* adds an interesting twist to this defense. In *Zlotnick*, an investor sold stock short on the belief, based upon his analysis of the company's earnings and projections, that the price was overvalued and would fall. Due to fraudulent press releases to the public, however, the price of the stock rose dramatically, forcing Zlotnick to minimize his losses by covering his short sale. The Third Circuit held that, although Zlotnick lost nearly $35,000 in the transaction, presumptions of reliance under the fraud on the market theory do not apply to short sellers because short sellers do not rely on the integrity of the market. Thus, *Zlotnick* established the rule that short sellers must show actual reliance upon the defendant's representations.

The Third Circuit's analysis fails to properly apply the fraud on the market standard. Denying use of the fraud on the market theory to anyone who thought the price of a security was too high or too low would effectively limit the doctrine to unsophisticated investors. Because most investors buy or sell securities with some

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201 *Id.* at 412.
202 *Zlotnick*, 836 F.2d 818.
203 Where the traditional investor seeks to profit by trading a stock the value of which he expects to rise, a short seller seeks to profit by trading stocks which he expects to decline in value.

Short selling is accomplished by selling stock which the investor does not yet own; normally this is done by borrowing shares from a broker at an agreed upon fee or rate of interest. At this point the investor's commitment to the buyer of the stock is complete; the buyer has his shares and the short seller [i.e., the investor] has his purchase price. The short seller is obligated ... to buy an equivalent number of shares in order to return the borrowed shares. ... Herein lies the short seller's potential for profit: if the price of the stock declines after the short sale, he does not need all the funds to make his covering purchase; the short seller then pockets the difference. ... [I]f the price of the stock rises, so too does the short seller's loss.

*Id.* at 820.
204 *Id.* at 819.
205 *Id.* at 823-24.
206 *Id.* at 823.
sort of opinion regarding how the price of the stock will change,\textsuperscript{207} only investors with minimal awareness of a company's financial situation could recover under the Zlotnick approach. An investor with an opinion regarding whether the market has incorrectly determined the price of a stock still relies on the fact that there has been no fraudulent manipulation of that stock. An investor who sells short may simply disagree with the market concerning future events affecting the company, or whether the company will remain solvent, while still relying that no hidden factors are influencing the market. Thus, an investor's determination that a security is improperly priced remains a decision to trade at a fair and representative market price. Under the fraud on the market theory as applied to short sellers, the presumption of reliance should be denied only when the short seller's disagreement with the market arises from an awareness of facts that have been misrepresented.

3. Plaintiff's Reliance on Integrity of the Market

Finally, Basic held that the presumption of reliance could be rebutted by showing that the plaintiffs traded their shares without relying upon the integrity of the market.\textsuperscript{208} The idea that an investor relies on the integrity of the market was first set out in Blackie.\textsuperscript{209} According to Blackie, the investor "relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price."\textsuperscript{210}

It is not clear how a defendant shows that a particular plaintiff did not rely on the integrity of the market. Basic asserted that a plaintiff who knows the stock price is affected by fraud but who sells the shares anyway for independent reasons does not rely upon the integrity of the market.\textsuperscript{211} The issue that arises is whether the plaintiff must be aware of the falsity of the statements in question for the defendant to rebut on these grounds.

A significant body of cases allows the defendant to show that the plaintiff did not rely on the integrity of the market even though

\textsuperscript{207} See Black, supra note 111, at 455 ("[M]any investors purchase or sell stock because they believe the price inaccurately reflects the corporations worth.").

\textsuperscript{208} Basic, 108 S. Ct. at 992.

\textsuperscript{209} Blackie, 524 F.2d at 907.

\textsuperscript{210} Id.

\textsuperscript{211} Basic, 108 S. Ct. at 992.
the plaintiff had no knowledge of the fraud.\textsuperscript{212} In such situations, the presumption is rebutted when a defendant can show that the investor relied “upon factors extraneous to the market.”\textsuperscript{213} Such extraneous factors usually involve trading securities on the advice of a third party.\textsuperscript{214}

The courts should not, however, overemphasize the importance of the plaintiff’s reliance on factors extraneous to the market. Just because a plaintiff relies on the advice of a third party does not mean he or she is indifferent to fraudulent pricing. The investor and the advisor both still may assume that the price of the stock has not been manipulated through fraud. Such extraneous factors only have relevance when they serve to establish that the plaintiff would have traded in the security even if the plaintiff had known the truth.

**CONCLUSION**

According to Basic, a court may apply a rebuttable presumption of reliance where a plaintiff has purchased securities in an efficient market that has been affected by a defendant’s material misrepresentation or omission. Following the rationale of Mills, the fraud on the market theory is an attempt to establish causation by deducing that once the materiality of the defendant’s fraud has been established and the court has concluded that a reasonable investor would have the propensity to rely upon such fraud, the probability is great enough to presume that the plaintiffs did in fact so rely and to shift the burden of proof to the defendants to show otherwise.

Fraud on the market arose to facilitate the certification of plaintiffs’ class action suits under Rule 10b-5, which have otherwise been impeded because issues of individual plaintiff’s reliance often predominate over questions of law or fact common to the class. Yet, the fraud on the market theory may ultimately prove inadequate to facilitate 10b-5 class action recovery if the efficient market hypothesis is itself incorrect. Having studied the causes and effects


\textsuperscript{213} LTV Sec. Litig., 88 F.R.D. at 143-44.

\textsuperscript{214} See Beissinger, 529 F. Supp. at 786-87 (relying on recommendation of the employee of a client).
of Black Monday, many economists and academicians believe that the efficient market hypothesis is flawed and that the markets are not entirely efficient.\textsuperscript{215}

There still exist theoretical and practical difficulties with the legal framework established by \textit{Affiliated Ute} and \textit{Basic}. Distinctions between omissions and misrepresentations lack any theoretical basis in either Section 10(b) or Rule 10b-5, and the evidentiary difficulties associated with proving reliance do not exist where face-to-face transactions are involved. Additionally, distinctions between omissions and misrepresentations appear to impede judicial efficiency because of the difficulty courts have had applying \textit{Affiliated Ute}.\textsuperscript{216} Finally, \textit{Basic} remains difficult to apply because the decision failed to establish any standard by which a market may be determined to be efficient.

Because only four justices joined in the \textit{Basic} decision, the Supreme Court may ultimately modify or abandon the fraud on the market theory. There certainly are other alternatives to a presumption of reliance, such as resolving the reliance issue along with that of damages in a bifurcated class action. This procedure would promote the same purposes as fraud on the market while shielding defendants from the oppressive and draconian liability that results from the settlement value of even a frivolous claim under fraud on the market. While courts should continue to facilitate plaintiff recovery under the securities laws, such recovery must not take place to the detriment of traditional concepts of fairness and equity.

\textit{R. Douglas Martin}


\textsuperscript{216} See, e.g., Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981); Blackie v. Barrack, 524 F.2d 891, 905 (9th Cir. 1975) ("The class members' substantive claims either are, or can be, cast in omission or nondisclosure terms ... "); Mottoros v. Abrams, 524 F. Supp. 254, 258 (N.D. Ill. 1981) ("[T]he claims of plaintiff Mottoros are basically hybrid in nature. They are neither wholly misrepresentations, nor wholly omissions."); Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 93 (2d Cir. 1981) ("In many instances, an omission to state a material fact relates back to an earlier statement, and if it is reasonable to think that that prior statement still stands, then the omission may also be termed a misrepresentation. The labels by themselves, therefore, are of little help."); Zuckerman v. Harnischfeger Corp., 592 F. Supp. 112, 121 (1984) (following \textit{Wilson}).