11-2007

When Should Investor Reliance Be Presumed in Securities Class Actions

Roberta S. Karmel
Brooklyn Law School, roberta.karmel@brooklaw.edu

Recommended Citation
63 Bus. Law. 25 (2007-2008)

When Should Investor Reliance Be Presumed in Securities Class Actions?

*By Roberta S. Karmel**

Reasonable or justifiable reliance is one of the elements of a claim by a private party under section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). Section 18 of the Exchange Act has an even stricter reliance requirement, but proof of reliance is not required for a claim under section 11 of the Securities Act of 1933. This Article will discuss the basis for these discrepancies and inquire into whether traditional interpretations of the reliance requirement need to be re-examined. There are at least two possible reasons for such re-examination. First, the reliance requirement is frequently presumed in securities class actions based on the efficient capital market hypothesis ("ECMH"), but the ECMH has come to be seriously questioned in the academic literature. Second, high-powered decision makers in several recent reports have asserted that U.S. capital markets are becoming less competitive than overseas markets due, in part, to the high level of civil liability under the federal securities laws. These decision makers recommend that the uncertainties as to the elements of liability under Rule 10b-5 be resolved. Once such element, reliance, has become actively litigated with respect to the certification of class actions, and the decisions in these cases are often critical to the outcome of the litigation.

This Article argues that in developing the law of civil liability under Rule 10b-5, the courts should be guided by the doctrine that public companies impliedly represent that the statements they make in U.S. Securities and Exchange Commission ("SEC") filings and other required public utterances are truthful, and accordingly, they should be liable when materially false or misleading statements are made that cause damage to investors, whether or not investors can prove they read and relied upon such statements in purchasing or selling securities. Nevertheless, a plaintiff should be required to prove that such presumed reliance was reasonable. Such a theory of constructive reliance could be achieved through a reinterpretation of section 18 of the Exchange Act, through presumptions concerning reliance in Rule 10b-5 cases, or through legislation or possibly rulemaking by the SEC.

This Article will discuss the common law action for deceit, its inapplicability to issuer fraud in modern securities markets, and the defects of section 18 of the Exchange Act as a substitute for the common law. The development of Rule 10b-5 actions as an alternative cause of action and the requirements for reliance in Rule 10b-5 cases will also be covered. This Article then will discuss the ECMH, the theories of its supporters and detractors, as well as its use by the SEC in formulating securities disclosure policy. Finally, a revisionist view will be presented of how the fraud-on-the-market doctrine should be used in connection with proof of reliance in securities litigation.

---

* Roberta S. Karmel is Centennial Professor of Law and Co-Director of the Dennis J. Block Center for the Study of International Business Law at Brooklyn Law School. She gratefully acknowledges the research assistance of Thomas Schiera. A research stipend from Brooklyn Law School was of assistance in the preparation of this Article.

I. Introduction

Reasonable or justifiable reliance is one of the elements of a claim by a private party under section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act").[1] This provision is a general anti-fraud prohibition giving rise to suits by any person for false or misleading statements in connection with the purchase or sale of securities. The requirement of reasonable reliance by an investor on misstatements or omissions is derived from the common law, and is also required in the express civil liability provision in section 18 of the Exchange Act.[2] But proof of reliance is not required for a claim pursuant to section 11 of the Securities Act of 1933 ("Securities Act"),[3] which provides an action for rescission to purchasers in an underwriting of securities. Also, the U.S. Securities and Exchange Commission ("SEC") is not required to prove reliance in cases it brings.[4]

This Article will discuss the basis for these discrepancies and inquire into whether traditional interpretations of the reliance requirement need to be re-examined. There are at least two possible reasons for such a re-examination at this time. First, the reliance requirement is frequently presumed in securities class actions based on the efficient capital market hypothesis ("ECMH"), but the ECMH has come to be seriously questioned in the academic literature.[5] Nevertheless, since the SEC's integrated disclosure regime for public companies also is based, at least in part, on the ECMH, any re-interpretation of the reliance requirement needs to be consonant

1. Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—. . . To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2000)) [hereinafter "Exchange Act"].

2. Section 18 provides:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to [the Exchange Act] 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 caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

Exchange Act, *supra* note 1, § 18, 84 Stat. at 897 (codified as amended at 15 U.S.C. § 78r(a) (2000)).

3. Securities Act of 1933, ch. 38, § 11, 48 Stat. 74, 82 (codified as amended at 15 U.S.C. § 77k (2000)) [hereinafter "Securities Act"].

4. *See infra* note 185 and accompanying text.

5. *See infra* Part III.

with the SEC's integrated disclosure regulations and policies. Second, high-powered decision makers have asserted in several recent reports that the U.S. capital markets are becoming less competitive than overseas markets due, in part, to the high level of civil liability under the federal securities laws.[6] These report authors recommend that the uncertainties as to the elements of liability under Rule 10b-5 be resolved.[7] One such element is reliance, because the issue of reliance in the certification of class actions has become an actively litigated area and the decisions in these cases are often crucial to the outcome of the litigation. The U.S. Supreme Court is likely to address the reliance issue in connection with securities class action certifications in the near future, and such a decision could affect the future of securities class actions under section 10(b).[8]

A threshold question as to whether a case can proceed as a class action is whether reliance by the class can be presumed or reliance must be proven by individual plaintiffs or groups. I argue that reliance should be presumed when materially false or misleading statements are made by an issuer in a document required to be filed with the SEC, but that such a presumption of reliance should not end the inquiry as to whether such reliance was reasonable. But the presumption of reliance should not be accorded to statements by third parties who do not owe a duty to public investors or shareholders. A number of courts are already headed in the direction of creating more stringent standards for the reliance requirement in section 10(b) cases,[9] but this development is often criticized, as being inimical to investors.[10]

This criticism takes too narrow a view of investor and public policy concerns. In section 10(b) cases, there are two sets of investor interests at stake—the interests of purchasers of an issuer's securities in the public securities markets, and the interests of existing shareholders. Similarly there are opposing shareholder interests at the time of a section 10(b) lawsuit—the interests of investors who no longer hold the issuer's securities and the shareholders during the pendency of the lawsuit. Further, third party public company defendants who do not clearly owe a duty to public investors may owe a duty to their own shareholders. A reinterpretation of the reliance requirement could effect a better

6. *See* THE COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 5 (Nov. 2006), *available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf* [hereinafter "CAPITAL MARKETS REGULATION"]; MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 101 (Jan. 2007), *available at* http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf [hereinafter "BLOOMBERG & SCHUMER"]. *See also* U.S. CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, REPORTS AND RECOMMENDATIONS (March 2007), *available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.

7. *See* CAPITAL MARKETS REGULATION, *supra* note 6, at 80–82; BLOOMBERG & SCHUMER, *supra* note 6, at 100–04.

8. *See infra* notes 161–62.

9. *See infra* Part IV.

10. *See, e.g.*, Editorial, *Holding Accomplices Accountable*, N.Y. TIMES, May 13, 2007, at 11.

balance of these disparate interests. In addition, it should be recognized that the securities class action is a cumbersome and very expensive mechanism for obtaining recourse for investors where there has been issuer fraud. The real party in interest in these cases frequently is the plaintiffs' attorney who obtains 25–35% of the recovery.[11] Consideration of the "public interest" is stated as an alternative to "the protection of investors" in section 10(b).[12] The national economic interest may sometimes outweigh the special economic interest of a subset of investors.

When Congress enacted the Exchange Act, it established civil liability for false or misleading statements in any document filed pursuant to the Exchange Act for any person who, in reliance upon any such statement, purchased or sold a security at a price affected by the statement.[13] Before the advent of the Internet and the SEC's EDGAR system, it was difficult for investors to access documents filed with the SEC. It was also difficult for plaintiffs to prove reliance on information in filed documents. Accordingly, section 18 was rarely used as a basis for a lawsuit.[14] By contrast, section 11 of the Securities Act which provides for civil liability for false or misleading statements in a prospectus used in a registered securities offering does not require proof of reliance.[15]

In order to obtain recourse for fraud in connection with the purchase or sale of securities, other than in a registered public offering, plaintiffs persuaded federal judges to imply a claim for liability under section 10(b) of the Exchange Act[16] and Rule 10b-5 thereunder.[17] These provisions broadly prohibit the making of false or misleading statements but do not otherwise specify the elements of a fraud claim. Since claims under section 10(b) were implied by the courts, the courts were required to fill in the contours of this statutory tort, which became widely used not only by individual investors, but also by plaintiffs in securities class actions.

---

11. *See* CAPITAL MARKETS REGULATION, *supra* note 6, at 11.

12. *See* Exchange Act, *supra* note 1, § 10(b), 48 Stat. at 891 (codified as amended at 15 U.S.C. § 78j(b) (2000)).

13. *Id.*

14. According to Professors Louis Loss and Joel Seligman, the restrictive language and interpretations of section 18 gave plaintiffs suing pursuant to this section no advantage over those suing pursuant to a common law action for deceit. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 11-C-3(c) (3d ed. 1995).

15. *See* Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967).

16. Exchange Act, *supra* note 1, § 10(b), 48 Stat. at 891 (codified as amended at 15 U.S.C. § 78j(b) (2000)).

17. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (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.

17 C.F.R. § 240.10b-5 (2007). *See also* Thomas F. McInerney III, *Habermas, Proceduralism and the Private Cause of Action Under Rule 10b-5: The Implications for Democracy*, 31 CREIGHTON L. REV. 805, 806–29 (1998).

Rule 10b-5 was enacted by the SEC in a somewhat casual manner in 1942 in order to capture fraud by buyers, as well as sellers, of securities.[18] Four years later, a court found an implied private right of action in section 10(b) utilizing a statutory tort theory to interpret congressional intent.[19] The Supreme Court did not uphold such a claim for several decades, but by the early 1970s such a claim was well established.[20]

In the first three decades of interpretations under section 10(b), the courts expanded the types of cases that could be brought under this section, but beginning in 1975, the Supreme Court began a retrenchment.[21] Since then, the Supreme Court's development of the law under section 10(b) has not been consistent. Some courts have reaffirmed expansive readings of the anti-fraud provisions,[22] some have enlarged the actions cognizable under section 10(b),[23] and some have curtailed the types of cases that can be prosecuted.[24] Congress has left the development of the substantive law of Rule 10b-5 cases to the courts, although it has tinkered with remedies, making the punishment for insider trading cases more severe in the 1980s,[25] and making it more difficult to prosecute securities class actions in the 1990s.[26]

---

18. Milton Freeman, the staffer who drafted the rule, recounted its origins in *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

19. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

20. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983).

21. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739–47 (1975). *See also* Huddleston v. Herman & MacLean, 640 F.2d 534, 541 n.6 (5th Cir. 1981), *rev'd in part on other grounds*, 459 U.S. 375 (1983).

22. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 650–66 (1997) (holding that partner in law firm that represented a company in a tender offer for common shares of another company was criminally liable for misappropriation when he purchased call options in the target company and then sold them for a substantial profit).

23. *See, e.g.*, Musick, Peeler & Garrett v. Employers Ins., 508 U.S. 286, 297 (1993) (holding that insurer had a right to contribution from accountants and attorneys involved in misleading public offering); Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 594–97 (2001) (holding that an option consisting of an oral contract was enforceable, and defendant's failure to disclose its intention not to honor the option upon forming the contract amounted to actionable fraud); SEC v. Zandford, 535 U.S. 813, 819–25 (2002) (holding that stockbroker's sale of customer's securities and personal use of the proceeds without the customer's knowledge or consent constituted fraud "in connection with" the sale of a security and was therefore actionable).

24. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 198–99 (1976) (holding that negligence cannot be the basis for an action under Rule 10b-5 and the plaintiff must allege and prove scienter); Chiarella v. United States, 445 U.S. 222, 232–33 (1980) (holding that employee of a financial printer was not liable under Rule 10b-5 because he did not violate any fiduciary duty by identifying takeover targets from unpublished corporate announcements and purchasing shares in the targets which he would then sell for large profits); Central Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 175–77 (1994) (holding that a private action for aiding and abetting a fraud is not actionable under Rule 10b-5).

25. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.); Insider Trading and Securities Enforcement Act of 1988, Pub. L. No.100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

26. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter "PSLRA"]; Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter "SLUSA"].

In trying to define the parameters of a section 10(b) case, the courts have looked to the elements of the common law action for deceit. Recently, the Court has stated that a judicially implied Rule 10b-5 claim "resembles, but is not identical to, common-law tort actions for deceit and misrepresentation."[27] Looking to the common law has not necessarily been a helpful referent since the federal securities laws were passed because common law remedies for fraud on investors were inadequate in modern anonymous securities markets.[28] The use of the securities class action to vindicate Rule 10b-5 claims in an anonymous public securities market is a far different vehicle than the classic action for deceit by a buyer against a seller of securities or other goods. Further, the Supreme Court has interpreted Rule 10b-5 by "old tort law" cases rather than "modern tort law scholarship."[29]

Another problem is that there is no overriding theory as to what section 10(b) cases are supposed to accomplish other than the vague goals of fostering the public interest or protecting investors, goals which elude measurement. On the one hand, giving section 10(b) an expansive interpretation in securities class actions assists investors in the public securities markets injured by an issuer's fraud because they purchased or sold securities based on fraudulent information. On the other hand, the funds collected in such an action come from the issuer and potentially injure the issuer's shareholders, particularly long-term shareholders who held at the time of the issuer's false or misleading statements. But opponents of the existing securities litigation system have equally vague and unsatisfactory goals like curbing abusive class actions.[30] In recent years, the courts have confronted both the salutary and unsavory aspects of securities class actions by focusing on the elements of reliance and causation in securities anti-fraud cases, and testing them according to the ECMH. The result has not been coherent, in part because developments have not been based on any clearly articulated policy.

The ECMH is a theory of financial economics describing the relationship between financial disclosure and securities prices which has had a profound effect on academic literature, rule making by the SEC, and judicial decision making.[31]

27. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005). Looking to tort law to interpret Exchange Act fraud is not new. In *Moody v. Bache & Co., Inc.*, 570 F.2d 523, 527 (5th Cir. 1978), the court observed that Rule 10b-5 is "essentially a tort claim."

28. Basic Inc. v. Levinson, 485 U.S. 224, 244 n.22 (1988) (plurality opinion). Not all justices have agreed with this rationale. *See, e.g.*, Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1110 (1991) (Scalia, J., concurring in part).

29. Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877, 887 (2006).

30. *Compare* Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 742–43 (1995) (arguing that a substantial percentage of settlements of private matters are merely an effort to avoid litigation costs and that therefore the SEC must act to make meritless claims more difficult to pursue), *with* Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 448–57 (1994) (arguing against limits on private rights of action because courts are equipped to weed out nonmeritorious claims, settled claims often have more merit than studies suggest, and private rights of action provide an important police function). *See also* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991); *but see generally* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497 (1997) (arguing for the continuation of securities class actions).

31. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549–50 (1984).

The "weak" version of the ECMH asserts that securities prices are determined by currently available information rather than historical trends.[32] The "semi-strong" version of the theory asserts that securities prices reflect all publicly available information.[33] The "strong" version of the ECMH asserts that securities prices reflect all information, whether publicly available or not.[34] The ECMH has been utilized to raise a presumption of reliance for plaintiffs in securities class actions under the fraud-on-the-market doctrine. This Article will discuss the ECMH and its use in determining whether the elements of reliance and transaction causation have been satisfied in section 10(b) cases against issuers and their officers and directors, and also in cases against third parties such as research analysts and banks.[35]

I argue that in developing the law of civil liability under Rule 10b-5, the courts should be guided by the doctrine that public companies impliedly represent that the statements they make in SEC filings and other required public utterances are truthful, and accordingly, they should be liable when materially false or misleading statements are made that cause damage to investors, whether or not investors can prove they read and relied upon such statements in purchasing or selling securities. Nevertheless, a plaintiff should be required to prove that such presumed reliance was reasonable. Such a theory of constructive reliance could be achieved through a reinterpretation of section 18 of the Exchange Act or through presumptions concerning reliance in Rule 10b-5 cases, or through legislation or possibly rule making by the SEC. Since 1980, the SEC has worked toward an integration of the Securities Act and the Exchange Act, and since 2002, the SEC staff has focused on the importance of annual and periodic reports filed pursuant to the Exchange Act as these have become the building blocks for integrated disclosure. Nevertheless, the civil liability provisions for false or misleading statements in prospectuses and other documents filed with the SEC or publicly circulated by issuers have not been reconciled or integrated. The use of the ECMH by the courts has helped to bridge the gap in theories of appropriate liability for issuer false and misleading statements under the Securities Act and the Exchange Act, but current cases in which courts question the viability of the ECMH may change the law.

Part II of this Article will discuss the common law action for deceit, its inapplicability to issuer fraud in modern securities markets, and the defects of section 18 of the Exchange Act as a substitute for an action for deceit. The development of Rule 10b-5 actions as an alternative remedy and the requirements for reliance in these cases will also be covered. Part III will discuss the ECMH, and the theories of

32. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of the Theory and Empirical Work*, 25 J. FIN. 383, 388 (1970).

33. *Id.*

34. *Id.* The "weak" version of the ECMH commands nearly universal acceptance; the "semi-strong" version is generally accepted; and the "strong" version is controversial because it assumes the existence of insider trading. Even if the markets are efficient in any of these ways, stock market prices do not necessarily reflect accurate estimates of a security's intrinsic value. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 106–08 (5th ed. 2006).

35. Although section 10(b) encompasses other varieties of fraud, such as insider trading, the focus of this Article will be on false or misleading statements by issuers and cases against research analysts and other third parties.

its supporters and detractors, as well as its use by the SEC for formulating securities disclosure policy. Part IV will discuss recent cases questioning the ECMH as a tool for presuming reliance by an investor class and in cases against third parties. Part V will set forth a revisionist view of how the fraud-on-the-market doctrine should be used in connection with proof of reliance in securities litigation.

II. Section 18 of the Exchange Act and the Development of Section 10(b) as a Statutory Tort

A. The Elements of a Common Law Deceit Action

The tort of deceit or fraudulent misrepresentation is of ancient origin.[36] It can be argued that the prohibition against business fraud goes back to the principle of *lifnei iver* in the Old Testament that "[y]ou shall not . . . place a stumbling block before the blind."[37] This has been interpreted as a prohibition against giving bad advice to another person, especially when the advisor has an ulterior motive.[38] It further is a prohibition against helping or causing another to sin. Therefore, accountants and auditors who negligently issue financial statements and mislead others, such as investors or creditors, are guilty of *lifnei iver*.[39]

The common law tort of deceit is generally traced to *Pasley v. Freeman*,[40] in which the court divorced liability for fraudulent misrepresentation from contractual relationships. According to the *Restatement (Second) of Torts*, the elements of the common law action for deceit are as follows: "[o]ne who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation."[41] A simpler, alternative formulation is that at common law, the tort of deceit required "a misstatement of a material fact, made with scienter, on which the plaintiff relied, causing damages as a result."[42] This definition makes explicit that fraud requires knowing or reckless misconduct, a requirement that was embodied in the common law.[43] In *Ernst & Ernst v. Hochfelder*,[44] the Supreme Court interpreted the words "manipulative," "device" and "contrivance" in Rule 10b-5 to similarly require scienter.

The required elements of materiality, reliance, and causation can easily be, and frequently are, confused. One commenter has observed that reliance is a

36. *See* Richard A. Epstein, Torts 549 (1999).

37. *Leviticus* 19:14.

38. Hershey H. Friedman, *Placing a Stumbling Block Before the Blind Person: An In-Depth Analysis* (2002), *http://www.jlaw.com/Articles/placingstumbling.html*.

39. *Id.*

40. (1789) 100 E.R. 450, 452, 457–58 (K.B.).

41. Restatement (Second) of Torts § 525 (1977).

42. Thompson, *supra* note 29, at 879.

43. Derry v. Peek, (1889) 37 App. Cas. 337, 374 (H.L.). Yet, more recently, the common law has developed the tort of negligent misrepresentation. *See* Epstein, *supra* note 36, at 568–74.

44. 425 U.S. 185, 198–99 (1976).

corollary of materiality.[45] In part, this is because at common law the plaintiff's reliance had to be "justifiable" and this was shown by proof that the misrepresentation was material.[46] Further, causation was shown by proof that the plaintiff relied on the defendant's statements to his or her detriment.[47] What is frequently considered "transaction causation" is in fact a variant of the reliance requirement.[48]

Whether a plaintiff has demonstrated reliance at common law can turn on whether the defendant had a reasonable expectation that the plaintiff would rely upon the misrepresentation in question. For example, in a Massachusetts case in which shareholders sued an accounting firm for fraudulent misrepresentation in connection with an audit opinion, the court held that the plaintiffs did not have to show that the accounting firm's misrepresentations were made with the purpose of inducing reliance; rather, they could show that the firm had reason to expect that shareholders would rely on its audited statements.[49] By contrast, in a Texas case in which an institutional investor sued an accounting firm for fraudulent misrepresentation for confirming the financial strength of a bank in a merger, the court held that the defendant was not liable because it had no reason to expect the plaintiff to rely on its audit report in deciding to buy notes.[50]

B. Liability Under Section 18

Section 18 of the Exchange Act is in some ways as rigorous as, or even more rigorous than, the common law action for deceit, although in other ways it is more relaxed. Scienter is not required.[51] But both transaction causation and loss causation are required.[52] More relevant to this Article, there is a strict reliance requirement. The party seeking recovery must demonstrate that the plaintiff had actual knowledge of and relied upon specific misstatements in one or more documents filed

45. Thomas Lee Hazen, The Law of Securities Regulation 499 (5th ed. 2005). In a recent case, the judge remarked that "transaction causation is akin to reliance." *In re* Credit Suisse-AOL Sec. Litig., 465 F. Supp. 2d 34, 51 (D. Mass. 2006).

46. *See* Restatement (Second) of Torts § 538(2) (1977).

47. *Id.* § 537.

48. *See* Currie v. Cayman Res. Corp., 835 F.2d 780, 785 (11th Cir. 1988).

49. Reisman v. KPMG Peat Marwick LLP, 787 N.E.2d 1060, 1066–68 (Mass. App. Ct.), *review denied*, 787 N.E.2d 1060 (Mass. 2003) (unpublished table decision).

50. Ernst & Young L.L.P. v. Pacific Mut. Life Ins. Co., 51 S.W.3d 573, 579–82 (Tex. 2001).

51. In this respect it is easier to prosecute a case under section 18 than under section 10(b). *See* Wachovia Bank & Trust Co., N.A. v. Nat'l Student Mktg. Corp., 650 F.2d 343, 356–58 (D.C. Cir. 1980) (noting that fraud is required for a section 10(b) claim), *cert. denied sub nom.* White & Case v. Wachovia Bank & Trust Co., N.A., 452 U.S. 954 (1981); Ross v. A.H. Robbins Co., Inc., 607 F.2d 545, 556 (2d Cir. 1979) ("A plaintiff seeking recovery under [§] 18 faces a significantly lighter burden" than a plaintiff seeking recovery under § 10), *cert. denied*, 446 U.S. 946 (1980).

52. Theresa A. Gabaldon, *Causation, Courts, and Congress: A Study of Contradiction in the Federal Securities Laws*, 31 B.C. L. Rev. 1027, 1038, 1060–64 (1990).

with the SEC containing the false or misleading statement at issue.[53] Constructive or presumed reliance is insufficient; "eyeball" reliance is necessary.[54]

Because of this reliance requirement, section 18 has proved to be a completely ineffective remedy for recovering losses caused by issuer misstatements or misleading omissions, even when such statements have been made to the SEC in documents required to be filed pursuant to the federal securities laws. By contrast, in some common law cases, and cases under federal statutes other than the federal securities laws, the reliance requirement for deceit or fraudulent misrepresentations has been relaxed where misrepresentations are made to a regulator.

For example, plaintiffs injured by bone screws implanted in their spines alleged that the manufacturer made misrepresentations to the U.S. Food and Drug Administration ("FDA") when it sought to obtain approval to market the bone screw device. The court held both that the lower court was in error in determining the plaintiffs could not establish causation, and that reliance might not be required to be proven because there was indirect reliance on the statements made to the FDA.[55] Courts also have held that a company's misrepresentation to a regulator can give rise to a class action claim under the Racketeer Influenced and Corrupt Organization Act ("RICO") by consumers injured by the regulator's reliance on the false statements. Such a theory was utilized in a case involving the presentation of fraudulent accounting statements, which overstated expenses and understated income by reason of improper expensing methods, in connection with a public service commission rate making proceeding.[56] A class action by purchasers of electricity was initially allowed to go forward under the theory that defendants violated the mail fraud statute in the utility rate making proceedings because plaintiffs satisfied the predicate for a RICO violation in alleging a loss of money—a tangible, cognizable injury.[57] In another RICO case the Court

53. *See In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 283–84 (3d Cir. 2006); *Ross*, 607 F.2d at 552; Heit v. Weitzen, 402 F.2d 909, 916 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

54. Jacobson v. Peat, Marwick, Mitchell & Co., 445 F. Supp. 518, 525 (S.D.N.Y. 1977). Fraud-on-the-market reliance is unavailable. *See In re* MDC Holdings Sec. Litig., 754 F. Supp. 785, 798 (S.D. Cal. 1990).

55. *In re* Orthopedic Bone Screw Liab. Litig., 159 F.3d 817, 826–29 (3d Cir. 1998), *rev'd sub nom. on other grounds*, Buckman Co. v. Plaintiffs' Legal Comm., 531 U.S. 341 (2001).

56. Taffet v. S. Co., 930 F.2d 847 (11th Cir. 1991), *vacated & reh'g granted*, 958 F.2d 1514 (11th Cir. 1992). This theory was utilized in *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 369 (4th Cir. 2004), in a section 10(b) case, and succeeded in the district court, but was reversed on appeal on the ground that the lower court needed to address on remand whether the defendant "made a public misrepresentation for which it may be found primarily liable." For a discussion of aiding and abetting liability, see *infra* notes 151–53 and accompanying text.

57. *Taffet*, 930 F.2d at 856–57. The court in *Taffet*, 930 F.2d at 857, reversed the district court and found that the plaintiffs alleged a cognizable claim under RICO. On rehearing, the court of appeals decided that the filed rate doctrine precluded plaintiffs' claim and upheld the district court. Taffet v. S. Co., 967 F.2d 1483, 1494 (11th Cir.), *cert. denied*, 506 U.S. 1021 (1992). For another case in which plaintiffs alleged a fraudulent misrepresentation as the basis for a RICO claim, see *Suffolk v. Long Island Lighting Co.*, 907 F.2d 1295, 1305–08, 1311–12 (2d Cir. 1990) (holding that fraudulent misrepresentation regarding building of Shoreham nuclear plant by state-regulated utility could be the basis for a RICO claim, but affirming judgment notwithstanding the verdict entered by the trial court because there was not enough of a causal connection between the fraud and plaintiffs' alleged injury).

suggested in dictum that "parking transactions" by a broker-dealer resulting in a false net capital statement to regulators could be the predicate for a mail fraud, wire fraud, or "fraud in the sale of securities claim" on behalf of customers of the broker-dealer proximately injured by these stock manipulations and false net capital computations.[58]

The very narrow interpretations of section 18 by the courts have so vitiated the usefulness of that provision that there have been no recoveries under this section.[59] The language of section 18 would not necessarily preclude the use of the indirect reliance theory espoused in these non-securities cases to grant recovery to investors injured by an issuer's false or misleading statements in filed SEC documents, but the rigidly narrow interpretation of the reliance requirement by the courts has precluded the use of such a theory. Further, section 18 could also be reinterpreted by using the ECMH to assert that investors are entitled to expect that the market price of a security is set without being affected by materially false or misleading statements emanating from the issuer. Under such a reinterpretation, investors would need not prove they "eyeballed" the false or misleading statements at issue.[60]

One of the barriers to a revisionist interpretation of section 18 is that there is legislative history suggesting that an express reliance requirement was inserted into the statute after criticism that an earlier version of section 18 would have allowed recovery to any plaintiff who could show that stock purchased or sold was affected by a false or misleading statement in a filed document.[61] Nevertheless, the cases that permit recovery to plaintiffs for indirect reliance outside of the section 18 context are consonant with the idea expressed in section 18 that companies should be liable for false or misleading statements in SEC filed documents.

C. The Development of Liability Under Rule 10b-5

From 1946, when an implied right of action was recognized in a Rule 10b-5 case, until 1975, the Supreme Court accepted few securities law cases. In 1971, the Court recognized this implied right of action in a footnote, with virtually no discussion.[62] By then, the lower courts had developed a robust body of Rule 10b-5 case law. In 1975, the Court referred to this case law as "a judicial oak which has grown from little more than a legislative acorn."[63] Despite some attempts by the Burger Court to curtail the further growth of this oak tree, and efforts by Congress to curtail securities class actions, Rule 10b-5 cases have become a veritable forest. Two doctrines of relevance to this Article were of particular importance in encouraging this growth.

58. Holmes v. Sec. Investor Prot. Corp., 503 U.S. 258, 272 n.19 (1992).

59. *See* Gabaldon, *supra* note 52, at 1061.

60. Marc I. Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 Cornell L. Rev. 557, 598–600 (1982).

61. *See Basic*, 485 U.S. at 257–58 (White, J., dissenting). It is ironic that this change was prompted by testimony by Richard Whitney, President of the New York Stock Exchange, later indicted for embezzlement.

62. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

63. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

In *SEC v. Texas Gulf Sulphur Co.*,[64] the court held that an issuer did not need to purchase or sell securities in order to be liable for false or misleading statements under Rule 10b-5. Although this case was an action by the SEC and not a private action, subsequent courts did not distinguish between government and private actions for damages. In *Herman & MacLean v. Huddleston*,[65] the Court held that a Rule 10b-5 action could be prosecuted by a private plaintiff even though Rule 10b-5 overlapped with the remedy provided by section 11 of the Securities Act. These holdings opened the door for a flood of litigation under Rule 10b-5, many of them class actions. Although Congress attempted to partially close that door in the 1990s by establishing stricter pleading requirements for securities class actions and pre-empting securities class actions in the state courts,[66] the scandals in the securities markets in the wake of the 2000–2001 market collapse led to numerous class action cases under the anti-fraud provisions against both established issuers and smaller, newer public companies. Success in prosecuting these cases depended, among other things, on the ability of plaintiffs to establish the reliance and causation requirements imported into Rule 10b-5 doctrine from tort law.[67]

Proving reliance in class actions is virtually impossible since separate trials could be necessary in order to resolve whether reliance existed for each transaction that occurred in a public securities market.[68] Similarly, proving reliance in the case of nondisclosure is problematic at best, because of the difficulty of proving a negative. In *Affiliated Ute Citizens v. United States*,[69] the Court held that in face-to-face transactions between a seller and buyer of securities, reliance can be presumed from the materiality of the facts omitted from disclosure. This holding was thereafter interpreted by lower courts as applying only in "pure" omission cases, as opposed to cases where there were both misrepresentations and omissions.[70]

Then, in *Basic Inc. v. Levinson*,[71] the Supreme Court adopted the fraud-on-the-market theory as a basis for permitting a presumption of reliance in misrepresentation cases arising from securities traded on public markets. In a plurality decision, Justice Blackman based the holding that reliance could be presumed in a

---

64. 401 F.2d 833, 860–62 (2d Cir.), *cert. denied*, 404 U.S. 1064 (1972).

65. 459 U.S. 375, 382–87 (1983).

66. *See* PSLRA, *supra* note 26, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.); SLUSA, *supra* note 26, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

67. In *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341–43 (2005), the Court set forth the elements of a Rule 10b-5 case as follows: 1) a material misstatement or omission; 2) made with scienter; 3) in connection with the purchase or sale of a security; 4) on which the plaintiff relied (referred to as "transaction causation" in fraud-on-the-market cases); 5) economic loss; and 6) "loss causation," or a causal connection between the material misrepresentation or omission and the loss.

68. *See* Green v. Wolf Corp., 406 F.2d 291, 301 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969). Courts therefore have recognized that proof of direct reliance by class members would be an unreasonable burden. *See* Semerenko v. Cendant Corp., 223 F.3d 165, 178 (3d Cir. 2000), *cert. denied sub nom.* Forbes v. Semerenko, 531 U.S. 1149 (2001).

69. 406 U.S. 128, 153–54 (1972).

70. *See* Binder v. Gillespie, 184 F.3d 1059, 1063–64 (9th Cir. 1999), *cert. denied sub nom.* Binder v. Wilson, 528 U.S. 1154 (2000). Even in face-to-face transactions courts declined to utilize the presumption of reliance in a misrepresentation case. *See* Feinman v. Dean Witter Reynolds, Inc., 84 F.3d 539, 541–42 (2d Cir. 1996).

71. 485 U.S. 224, 245–47 (1988) (plurality opinion).

class action under Rule 10b-5 on the ECMH to the effect that, in an open and developed securities market, the prices of a company's securities are determined by publicly available material information regarding the company and its business.[72] In modern public securities markets, which have replaced face-to-face transactions between a buyer and a seller of securities, the market is performing a valuation function that transmits information to investors generally. Justice Blackman argued that presumptions arise out of considerations of "fairness, public policy, and probability, as well as judicial economy," and therefore are "useful devices for allocating the burdens of proof between parties."[73] This presumption of reliance is known as the fraud-on-the-market theory.[74] The issuer misstatements in *Basic* did not involve information in SEC filed documents, but rather, public denials that the issuer was engaged in merger negotiations.[75]

Justice Bryon White, in a dissent in *Basic*, argued that the fraud-on-the-market theory "suggests that stocks have some 'true value' that is measurable by a standard other than their market price."[76] But, he asserted, investors sometimes believe that the stock market prices inaccurately reflect the true value of a security, and this is their motivation for buying or selling a stock.[77] This dissent seems to miss the point of the fraud-on-the-market theory, which is that reliance on the integrity of the market price is substituted for reliance on the challenged disclosure.[78] As explained in a subsequent district court case,[79] the average investor does not personally need access to the elaborate financial disclosure mandated by the SEC because this information is sifted through financial intermediaries whose trading establishes market prices. The court stated:

> The fraud on the market theory thus shifts the inquiry from whether an individual investor was fooled to whether the market as a whole was fooled. Hence, the theory not so much eliminates the reliance requirement as subsumes it in the fraud-on-the-market analysis. In the same way, the theory also subsumes the inquiry into materiality, causation and damages. For if a misleading or fraudulent disclosure or omission could have had no effect on the security's market price, the information cannot have been material. Similarly, if a misstatement or omission had no effect on the market price (because, for example, the market already had the correct information from other sources) then there could be no causation and no damages.[80]

After *Affiliated Ute* and *Basic*, a presumption of reliance was available to plaintiffs in most Rule 10-5 class actions. Yet, in pure omission cases, as opposed to

---

72. *Id.*

73. *Id.* at 245.

74. *Id.* This holding was presaged in *Blackie v. Barrack*, 524 F.2d 891, 905–08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), and *Peil v. Speiser*, 806 F.2d 1154, 1160–63 (3d Cir. 1986).

75. *Basic*, 485 U.S. at 227–28.

76. *Id.* at 255 (White, J., dissenting).

77. *Id.* at 256.

78. *See* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907, 908 (1989).

79. *In re* Verifone Sec. Litig., 784 F. Supp. 1471, 1479 (N.D. Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir. 1993).

80. *Id.* at 1479.

misleading statement cases, if the issuer had no duty to speak, there should be no presumption of reliance. Also, a presumption of reliance does not end all inquiry as to whether reliance was reasonable. In *Dura Pharmaceuticals, Inc. v. Broudo*,[81] the Court held that a plaintiff in a securities fraud case must prove that the defendant made a materially false statement or omitted to state a material fact, the plaintiff would not have bought shares absent the misrepresentation or omission, and that the material misrepresentation or omission caused plaintiff's injury. Both loss causation and transaction causation must be proven.[82] Loss causation requires proof of economic harm; transaction causation requires proof that the defendant's violations caused the plaintiff to engage in the transactions in question. Further, the need to allege and prove causation is related to the efficiency of the market in a security, since loss causation requires a market efficient enough so that the alleged misrepresentation is incorporated into the stock price, artificially inflating or deflating it, and also requires that subsequent corrective statements dissipate such pricing corruption. These causation requirements also are related to the materiality element of a Rule 10b-5 case because if a false or misleading statement is not material it should not move the market in a security.

A common example of an issuer's false statement which may not be material is a financial restatement. In recent years thousands of companies have issued restated financials, often in response to a changed SEC accounting interpretation,[83] and a securities class action has often quickly followed. But with financial restatements becoming such a commonplace occurrence, are they necessarily material for purposes of Rule 10b-5? Does it make sense to have a system where over 5,000 companies and their shareholders and accountants in the course of a decade become subject to the liability of a securities class action suit due to financial restatements? While the number of restatements suggests a problem with the U.S. financial reporting system, class action lawsuits do not seem the appropriate mechanism for dealing with the problem. This issue can be tested by a causation analysis in a section 10(b) suit, but it can also be tested from an inquiry as to whether investor reliance was reasonable. Changes in SEC accounting interpretations resulting in accounting restatements should be within an investor's reasonable expectations.

Another example of corporate developments where the reasonableness of investor reliance should be critically examined is the announcement of regulatory action by an administrative agency. Most public corporations are subject to a variety of regulatory regimes, and depending upon the corporation's business, certain

81. *Dura Pharms., Inc.*, 544 U.S. at 341–46.

82. *Id.* at 342–46.

83. The number of accounting restatements between 1990 and 1997 averaged 49 annually. *See* Steve Liesman, *Deciphering the Black Box: Many Accounting Practices, Not Just Enron's, Are Hard To Penetrate*, WALL ST. J., Jan. 23, 2003, at C1. However, between 1997 and 2005, U.S. public companies filed 3,642 restatements to correct accounting inaccuracies. *See* Lynn E. Turner & Thomas R. Weirich, *A Closer Look at Financial Statement Restatments*, CPA J., Dec. 1, 2006, at 3. In 2006, U.S. companies issued a record of 1,420 financial restatements, although large companies issued fewer restatements than in 2005. *See* Steven Marcy, *Total Financial Restatements Increase in 2006, but Decline for Large Entities*, 39 SEC. REG. & L. REP. (BNA) 366 (Mar. 5, 2007).

regulators are especially important, e.g., the FDA for a pharmaceutical company. Is it reasonable for an investor to believe that such a company will never be subject to a product disapproval or recall or other action by the FDA when such actions are a common occurrence?[84] If a company has made false statements in an SEC filing about the prospects of FDA action, then it may be appropriate for a securities class action to be instituted based on the untruth of such statements. But many courts utilize the *Affiliated Ute* presumption of reliance in omission cases that do not arise from face-to-face transactions,[85] and then, the reasonableness of reliance on what has not been disclosed should be seriously examined.

Although federal courts have generally utilized the fraud-on-the-market theory since *Basic*, this theory has not found favor in state courts, even in states where indirect reliance is permitted for negligent misrepresentation.[86] The attitude of the state court judges seems to be that the fraud-on-the-market theory is a construct of the federal securities laws, and does not apply to common law cases. This is a bit ironic, since the federal courts have utilized the common law in interpreting section 10(b).

III. Changing Academic Views About the ECMH and Its Use by the SEC

In the mid-1980s, Professors Gilson and Kraakman were able to claim that of "all recent developments in financial economics, the [ECMH] has achieved the widest acceptance by the legal culture.... [I]t 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 [SEC]...and it has even begun to influence judicial opinions."[87] The central thesis of the ECMH is that the pricing mechanism for securities traded in the principal public securities markets is efficient in the

84. *See, e.g., In re* Cyberonics Inc. Sec. Litig., 468 F. Supp. 2d 936, 938 (S.D. Tex. 2006) (suit arising from Cyberonics's efforts to secure approval from the FDA for marketing a device for the treatment of depression); Noble Asset Mgmt. v. Allos Therapeutics, Inc., No. CIVA-04CV-1030-RPM, 2005 WL 4161977, at *1 (D. Colo. Oct. 20, 2005) (suit arising from Allos press releases which created a perception in the stock market that the FDA would likely approve a new drug); *In re* Geopharma, Inc. Sec. Litig., 399 F. Supp. 2d 432, 435 (S.D.N.Y. 2005) (claim arising out of press release that caused investors to believe that the FDA had approved a new Geopharma drug when in fact the FDA had only approved a much less lucrative medical device); *In re* Transkaryotic Therapies, Inc. Sec. Litig., 319 F. Supp. 2d 152, 155–57 (D. Mass. 2005) (suit based on misleading public statements made by Transkaryotic regarding the results of FDA clinical tests of a new drug); Anderson v. Abbott Labs., 140 F. Supp. 2d 894, 900–01 (N.D. Ill.), *aff'd sub nom.* Gallagher v. Abbott Labs., 269 F.3d 806 (7th Cir. 2001) (suit arising from Abbott's failure to disclose ongoing compliance issues with FDA regulations); *In re* Medimmune, Inc. Sec. Litig., 873 F. Supp. 953, 956–59 (D. Md. 1995) (action arising out of statements made by Medimmune regarding the effectiveness of a new drug, FDA review of the drug, and medical journal articles concerning the drug).

85. *See id.*

86. *See, e.g., Medimmune*, 873 F. Supp. at 968 (noting that most state courts have rejected "the fraud-on-the-market concept in connection with common law fraud claims"); Kaufman v. I-Stat Corp., 754 A.2d 1188, 1200–01 (N.J. 2000); Kahler v. E.F. Hutton & Co., Inc., 558 So. 2d 144, 145 (Fla. Dist. Ct. App. 1990).

87. Gilson & Kraakman, *supra* note 31, at 549–50.

sense that the prices fully reflect all available information.[88] There are three different ways of interpreting the ECMH—"weak"; "semi-strong"; and "strong." The "weak" version claims only that historical price movements are irrelevant.[89] The "semi-strong" version claims that publicly released information, such as information in SEC filings, is incorporated into stock market prices.[90] The "strong" version claims that even inside information is so incorporated.[91] Although most observers accept the "semi-strong" version of the ECMH as describing the relationship between information and price fluctuations in the public securities markets, this does not mean that informationally efficient markets always accurately represent the intrinsic value of securities, because even informationally efficient markets can be irrational. Similarly, there has long been a debate as to whether and to what extent informational efficiency contributes to allocation efficiency.[92]

After the stock market bubble of the 1990s and its inevitable collapse, the ECMH came under serious criticism. Some critics argued that the ECMH is based on a model of rational market participants, when in fact many market participants are not rational and the securities markets are full of "noise" or non-rational trading strategies that make markets unruly and volatile.[93] Behavioral finance theorists in a large body of work argue that stock price movements are explained as much by socio-psychological theories as by economics or finance.[94] Also of importance to the cases discussed below questioning the *Basic* presumption of reliance, the ECMH may not explain the relationship between information and price movements for small issuers or issuers traded in the over-the-counter markets.[95]

Whether or not the ECMH is valid, it had a powerful influence on the SEC in laying a theoretical foundation for the integrated disclosure rules of the early

88. *Id.* at 554. The ECMH originated with economic theorists. *See generally* Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J. ECON. LIT. 1583 (1989).

89. Fama, *supra* note 32, at 388.

90. *Id.*

91. *Id.*

92. *See* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 640–58 (1988) (arguing that informational efficiency has little bearing on the allocation of capital among corporations since corporations rarely rely on equity issues for funding, and because stock price rarely determines the funds an issuer receives when issuing stock). For another point of view, see John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 734–37 (1984) (outlining the argument for the necessity of informational efficiency if the securities market is to be the principal allocative mechanism for investment capital).

93. *See, e.g.*, Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 857–71 (1992); Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 138–43 (2006).

94. *See, e.g.*, Steven M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1033–53 (2000); Lawrence Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546, 592–607 (1994); Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 802–07 (2000); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 659–66 (2003). The observation that markets are heavily influenced by psychological factors is of very long standing. *See* CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (Harriman House 2003) (1841).

95. *See* COX ET AL., *supra* note 34, at 109–10.

1980s. In adopting its integrated disclosure system, the SEC acknowledged that its de-regulatory policy was premised on the assumptions that "investors are protected by the market's analysis of information about certain companies which is widely available... and that such analysis is reflected in the price of the securities offered."[96] Therefore, information provided to investors in annual and periodic reports by seasoned issuers pursuant to applicable provisions of the Exchange Act did not have to be repeated in registration statements filed by such issuers under the Securities Act.[97] The market had already digested this information and it was reflected in the prices at which securities of these issuers traded. Although efforts to integrate the disclosure provisions of the Securities Act and the Exchange Act had been advocated for some time,[98] the ECMH provided a cover for any complaints that more abbreviated offering disclosure by companies would fail to provide investors with necessary information. The SEC has continued to believe that the market for the securities of well-seasoned, world class companies is informationally efficient, and its more recent offering reform rules are also based on the ECMH.[99]

When the SEC adopted its integrated disclosure system, it failed to adjust its filings review procedures to assure that Exchange Act filings were accurate and complete, in that staff review continued to be focused on Securities Act registration statements, and there was no regularized review of Exchange Act annual and periodic reports.[100] This neglect probably led to the large number of subsequent financial restatements,[101] which raise a serious question as to whether securities prices of many stocks in the late 1990s had much relation to their intrinsic market values, even in informationally efficient markets. In addition to faulty accounting statements by public companies and other false and misleading statements by issuers, the market for some stocks may have been influenced by questionable activities of securities research analysts.[102] Since the enactment of the Sarbanes-Oxley Act of 2002, the SEC has been forced to

---

96. Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6235, 45 Fed. Reg. 63693, 63698 (proposed Sept. 25, 1980) (to be codified at 17 C.F.R. pts. 230 & 239).

97. Reproposal of Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6331, 46 Fed. Reg. 41902, 41915 (proposed Aug. 18, 1991) (to be codified at 17 C.F.R. pt. 239).

98. *See* Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1342 (1966).

99. *See* Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44722, 44727–31 (proposed Aug. 3, 2005) (to be codified in scattered parts of 17 C.F.R.). Although this release does not discuss the ECMH, in making distinctions between well-known seasoned issuers ("WKSI") and other issuers, and permitting WKSIs immediate access to the capital markets, the SEC is essentially relying on the informational efficiency of the pricing mechanisms for WKSI securities.

100. *See* JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK § 9:2.2 (Practicing Law Institute 2007).

101. *See supra* note 83.

102. Former New York State Attorney General Elliot Spitzer uncovered a scandal among investment banks whereby research analysts were issuing positive recommendations regarding issuers that were clients in order to inflate stock prices. *See* Peter Martin, *Who Pays the Piper?: Offering Independent Analysis Can Be a Delicate Task When Commercial and Investment Interests Hang in the Balance*, FIN. TIMES (LONDON), May 20, 2002, at 18 (noting that in 1999 there were eight times as many "buy" recommendations as "sell," and that in 2000, stocks most highly rated by analysts fell 31% while stocks least favorably rated rose 49%).

direct its attention to cyclical review of Exchange Act filings.[103] In addition, there has been extensive reform of the practices of research analysts.[104]

The problems of fraud in the securities markets led to a massive increase in the number of securities class actions in the early years of the 21st century, as well as to a backlash against plaintiff class action lawyers.[105] All of these developments—changing academic theories about the ECMH, extensive fraud in the securities markets, the problems of handling large and complex securities class actions—have to some extent impinged upon the use of the *Basic* presumption of reliance in securities class action cases under Rule 10b-5. These developments may also require a re-evaluation of Exchange Act civil liability for false and misleading statements by issuers in SEC filings and similar documents.

IV. Rebutting the Reliance Presumption

A. The Inefficient Market Defense to Class Certification

The U.S. Court of Appeals for the Second Circuit has analyzed the fraud-on-the-market doctrine as creating "a rebuttable presumption that (1) misrepresentations by an issuer affect the price of securities traded in the open market, and (2) investors rely on the market price of securities as an accurate measure of their intrinsic value."[106] Since this is a rebuttable presumption, the issue of when and with what type of evidence the presumption can be rebutted has arisen in a number of cases. In *Cammer v. Bloom*,[107] the court enunciated a five-factor test for determining whether a market is efficient, as follows: (1) average trading volume; (2) the number of securities analysts following and reporting on a stock; (3) the presence of market makers and arbitrageurs; (4) a company's eligibility to file a Form S-3; and (5) a cause and effect relationship between unexpected news and an immediate response in stock price.[108] In another case, a judge added the company's market capitalization, the bid-ask spread for stock sales, and the company's public float.[109] The gist of the

103. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 408, 116 Stat. 745, 790 (codified at 15 U.S.C. § 7266 (Supp. IV 2004)) [hereinafter "SOX"].

104. *See, e.g.*, N.Y. Stock Exch. R. 472; Nat'l Ass'n of Sec. Dealers R. 2711; Self-Regulatory Organizations; New York Stock Exchange LLC and the National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Changes Relating to NYSE Rule 472 and NASD Rule 2711, Exchange Act Release No. 34-54616, 71 Fed. Reg. 62331 (Oct. 24, 2006).

105. In 2001 approximately 497 securities fraud class actions were filed, more than twice than in any other year from 1995 to 2000. *See* Stanford Law School Securities Class Action Clearinghouse, Index of Filings, http://securities.stanford.edu/companies.html (last visited Aug. 15, 2007). According to Committee on Capital Markets Regulation, *supra* note 6, at 75–77, although there has been a drop in the number of securities class action suits in recent years, there has been an extreme rise in the value of an average settlement.

106. Hevesi v. Citigroup Inc., 366 F.3d 70, 77 (2d Cir. 2004).

107. 711 F. Supp. 1264 (D.N.J.), *appeal dismissed*, 993 F.2d 875 (3d Cir. 1989) (unpublished table decision).

108. *Id.* at 1286–87.

109. Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc., No. 05 Civ. 1898(SAS), 2006 WL 2161887, at *5 (S.D.N.Y. Aug. 1, 2006).

inquiry is whether the market in a thinly traded security can be considered sufficiently efficient for the presumption to be applied. Also, there have been inquiries into whether a market in shares of an initial public offering can be efficient for purposes of the fraud-on-the-market doctrine.[110]

The issue of whether reliance can be presumed generally arises in motions to certify a class in a securities fraud action in federal court, frequently a motion critical to the outcome of the case since so few securities class actions go to trial.[111] In a far-reaching Second Circuit case discussing class certification in a securities fraud case, the court held that whether the fraud-on-the-market doctrine can be utilized for a presumption of reliance is an issue that must be resolved on a class certification motion, and that in making a determination on this issue, a district court judge needs to resolve factual issues.[112] The court also found that the obligation is not lessened because there may be an overlap between such factual issues and issues on the merits.[113]

One First Circuit decision where the presumption of reliance was rebutted and the court discussed questions about the efficient market theory was *In re PolyMedica Corp. Securities Litigation*,[114] in which the court adopted a definition of an efficient market as "one in which the market price of the stock *fully reflects* all publicly available information."[115] In so doing, the court reversed the finding of the district court that "market efficiency means that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices."[116] The circuit court pointed out that its definition did not mean that the stock price paid or received by a plaintiff class was correct in the "fundamental value" sense.[117] Rather, the "fraud-on-the-market theory is concerned with whether a market processes information in such a way as to justify investor reliance."[118] In a companion case to *PolyMedica*, *In re Xcelera.com Securities Litigation*,[119] the First Circuit explained that the test for an efficient market that requires that a stock "fully reflect" all publicly available information means that the market must "rapidly" reflect new information.[120]

The Second Circuit has not yet adopted a definition of an efficient market or a test for proving or disproving that a market is efficient.[121] Other circuits that have addressed the issue are generally in accord with the First Circuit's opinion

110. *In re* Initial Public Offering Sec. Litig., 471 F.3d 24, 33 (2d Cir. 2006).
111. *See* West v. Prudential Sec., Inc., 282 F.3d 935, 937 (7th Cir. 2002). In this case, the court refused to apply the fraud-on-the-market doctrine to statements purporting to convey inside information. *Id.*
112. *Initial Public Offering Sec. Litig.*, 471 F.3d at 33.
113. *Id.*
114. 432 F.3d 1 (1st Cir. 2005).
115. *Id.* at 14.
116. *Id.* at 19.
117. *Id.* at 14–16.
118. *Id.* at 16.
119. 430 F.3d 503 (1st Cir. 2005).
120. *See id.* at 508.
121. *See Teamsters Local 445*, 2006 WL 2161887, at *5.

in *PolyMedica*,[122] although the Third Circuit seems to be more in accord with the *PolyMedica* district court judge in finding that an efficient market is one in which information important to reasonable investors is incorporated into stock market prices.[123] Also, in a case in the Southern District of New York, Judge Scheindlin seemed to take issue with the First Circuit's interpretation of *Basic*, siding with the *PolyMedica* district court judge in saying that as defined in *Basic* an efficient market is one in which "market professionals generally consider *most* publicly announced material statements about companies, thereby affecting stock market prices."[124] Nevertheless, she acknowledged that other circuits had also adopted the First Circuit's broader definition.[125]

In *Xcelera.com* the First Circuit held that the district court properly applied the *Cammer* factors to find that the market in Xcelera stock was efficient.[126] In the remand of *PolyMedica*, the district court held that the market in *PolyMedica* stock was not efficient.[127] One of the important holdings of the case was that in order to find that the market for a stock is efficient, the market must react to news on the same trading day as its release.[128] In *Teamsters Local 445*, the court also held that the market in certificates issued by Bombardier was not efficient and therefore class certification was denied.[129] In all of these cases a mini trial based on a battle of experts was held.[130]

The Second Circuit has held that the market for IPO stocks is not efficient and therefore the fraud-on-the-market doctrine cannot be used to raise a presumption of reliance.[131] This case involved a motion for class certification in six securities fraud actions selected as "focus cases" out of 310 consolidated class actions claiming fraud against underwriters, issuers, and various individuals in connection with three fraudulent practices.[132] These were (1) allocating IPO shares on the condition that purchasers would purchase additional shares in the aftermarket; (2) the payment of undisclosed compensation to underwriters; and (3) the improper use of analysts in IPOs by underwriters.[133] Citing with approval a Sixth Circuit case holding that the primary market for newly issued securities is not efficient, the court held that the market for IPO shares is not efficient, and therefore

122. *See* Gariety v. Grant Thornton, LLP, 368 F.3d 356, 368 (4th Cir. 2004); Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 662 n.6 (5th Cir. 2004); Freeman v. Laventhol & Horwath, 915 F.2d 193, 198 (6th Cir. 1990); No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp., 320 F.3d 920, 947 (9th Cir.) (Tallman, J., dissenting), *cert. denied*, 540 U.S. 966 (2003); Joseph v. Wiles, 223 F.3d 1155, 1164 n.2 (10th Cir. 2000); Kowal v. MCI Commc'ns Corp., 16 F.3d 1271, 1276 n.1 (D.C. Cir. 1994).

123. *See In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997).

124. *See Teamsters Local 445*, 2006 WL 2161887, at *6.

125. *Id.*

126. *Xcelera.com*, 403 F.3d at 516.

127. *In re* Polymedica Corp. Sec. Litig., 453 F. Supp. 2d 260, 278 (D. Mass. 2006).

128. *Id.*

129. *Teamsters Local 445*, 2006 WL 2161887, at *12.

130. *See Xcelera.com*, 430 F.3d at 512; *Polymedica*, 453 F. Supp. 2d at 266, 269; *Teamsters Local 445*, 2006 WL 2161887, at *9.

131. *Initial Public Offering Sec. Litig.*, 471 F.3d at 42–43.

132. *Id.* at 27.

133. *Id.*

no presumption of reliance could be accorded to the plaintiffs and their motion for class certification failed.[134] Among other things, the court noted that analysts are not allowed to report on IPO securities for 25 days after an offering.[135]

B. The Research Analysts Cases

In December 2002, the New York Attorney General, the SEC, and other regulators reached a "global settlement" in their investigation into the investment banking practices of ten major Wall Street investment banking houses.[136] One of the primary allegations in these cases was that Wall Street securities analysts issued overly optimistic research reports in order to foster investment banking relationships between issuers and the firms at which the analysts were employed.[137] As a result of these charges, thousands of arbitration proceedings and hundreds of securities class actions were filed alleging that analyst conflicts of interest resulted in fraud on broker-dealer customers.[138] Few of these cases succeeded because it was very difficult for plaintiffs to allege and prove the necessary elements of a Rule 10b-5 claim. One of the issues on which some of the cases floundered was reliance. Other cases were dismissed because of a failure to allege sufficiently loss causation.

At the initial stages of some cases, motions to dismiss were made on the ground that the fraud-on-the-market doctrine applies only to misrepresentations by corporate insiders, not to opinions by securities research analysts. This argument was rejected on the ground that the fraud-on-the-market doctrine has no such limitation and since prices in an open market reflect supply and demand, defendants cannot defeat a motion to dismiss on the ground that that their published purchase recommendations did not affect purchasers of stock and therefore stock prices.[139] Similarly, in another case, the court held that applying the *Basic* presumption in the analyst context is a logical extension of the fraud-on-the-market doctrine because analyst reports are written "with the purpose and expectation that the market will take heed of their message. The efficient market hypothesis suggests that all relevant information—which... includes analysts reports... is immediately impacted into stock prices."[140]

---

134. *Id.* at 42–45 (citing Freeman, 915 F.2d at 199).

135. *Id.* at 43. Ironically, a similar requirement was imposed by rule after the research analysts cases, brought by the New York Attorney General and then followed up upon by the SEC, upon which this private lawsuit was based. *See* Stephen J. Hilgers, *Under the Influence: Analyzing Wall Street Research Analyst Conflicts of Interest and the Responses Designed To Induce Impartiality*, 31 Sec. Reg. L.J. 427, 475 (2003) [hereinafter "Hilgers, *Under the Influence*"].

136. *See* Press Release, Office of the New York Attorney General, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement To Reform Investment Practices: $1.4 Billion Global Settlement Includes Penalties and Funds for Investors (Dec. 20, 2002), http://www.oag.state.ny.us/press/2002/dec/dec20b_02.html.

137. *See id.*

138. *See generally* Hilgers, *Under the Influence*, *supra* note 135.

139. *See* DeMarco v. Robertson Stephens Inc., 318 F. Supp. 2d 110, 121 (S.D.N.Y. 2004); DeMarco v. Lehman Bros., Inc., 309 F. Supp. 2d 631, 636 (S.D.N.Y. 2004). *See also* Lentell v. Merrill Lynch & Co., Inc., 396 F.3d 161, 172 (2d Cir.), *cert. denied*, 126 S. Ct. 421 (2005). *But see In re* Merrill Lynch & Co., Inc., 273 F. Supp. 2d 351, 375 (S.D.N.Y. 2003) (granting defendant's motion to dismiss a class action in holding that the allegedly fraudulent research reports were not a "fraud upon the market").

140. *In re* Credit Suisse-AOL Sec. Litig., 465 F. Supp. 2d 34, 52-53 (D. Mass. 2006).

In the context of class certification, however, motions to dismiss have succeeded because courts have required a showing that analyst reports "materially and measurably impacted the market price of the security to which the [false or fraudulent] statements relate."[141] Further, a motion to certify a class was granted interlocutory review by the Second Circuit as a "novel question" but the case was settled before the Second Circuit was able to speak on the issue.[142] Nevertheless, the court expressed the view that only where publication of an analyst's report "clearly moved the market in a measurable fashion would the 'fraud on the market' doctrine seem fairly applicable."[143] Further, in a subsequent case also involving this issue, the Second Circuit held that a district court must resolve factual issues in deciding a class certification motion,[144] suggesting that a research analyst's opinion cannot be presumed to have automatic impact on the price of a security because such statements are subjective and uncertain, unlike statements emanating from an issuer which are "relatively fixed, certain, and uncontradicted."[145]

Some other cases in which the plaintiffs alleged fraud based on the conflicts between research analysts and investment bankers were dismissed on the ground that loss causation was not sufficiently alleged. In *Lentell v. Merrill Lynch & Co., Inc.*[146] the Second Circuit held that satisfying the proximate cause element in tort law was insufficient to establish loss causation in a securities case after *Dura*, and that in order to establish loss causation, a plaintiff must allege "that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security."[147] In subsequent district court cases, involving the research analyst conflict of interest scenario, the courts have dismissed complaints alleging that analyst reports were not the true opinions of the analysts when made on the ground that the relevant truth about these reports "was not disclosed, if ever, until years after plaintiffs' losses were realized."[148]

Research reports are generally directed to customers of a broker-dealer. The research analysts cases could have been decided on the ground that since analysts, unlike issuers, do not have a general duty to the marketplace,[149] the reliance requirement of Rule 10b-5 is not met unless a plaintiff can allege actual reliance on a research analyst report in purchasing or selling a security. Alternatively, where an investor did not receive or review an analyst report,[150] there is a question of whether reliance was justifiable, and therefore a presumption of reliance seems inappropriate. Where there is no evidence that a research report directly affected

141. DeMarco v. Lehman Bros., Inc., 222 F.R.D. 243, 247 (S.D.N.Y. 2004).

142. Hevesi, 366 F.3d at 81.

143. *Id.* at 80 n.7 (quoting John C. Coffee, Jr., *Security Analyst Litigation*, N.Y. L.J., Sept. 20, 2001, at 5).

144. *Initial Public Offering Sec. Litig.*, 471 F.3d at 33.

145. *Demarco v. Lehman Bros., Inc.*, 222 F.R.D. at 246.

146. *Lentell*, 396 F.3d 161.

147. *Id.* at 173.

148. Joffee v. Lehman Bros., Inc., 410 F. Supp. 2d 187, 193 (S.D.N.Y.), *aff'd*, 209 F. App'x 80 (2d Cir. 2006).

149. *See* Chiarella v. United States, 445 U.S. 222, 232–33 (1980).

150. *See In re Merrill Lynch & Co., Inc.*, 273 F. Supp. 2d at 388–89.

the price of a security, not only is there a failure of proof of causation, but it would seem anomalous to employ the fraud-on-the market doctrine to establish reliance. If research reports do not affect securities prices, the viability of the ECMH would seem to be undermined, and the viability of the fraud-on-the-market presumption would seem to be weakened.

C. Other Secondary Actor Cases

In *Central Bank, N.A. v. First Interstate Bank, N.A.*,[151] the U.S. Supreme Court held that aiding and abetting is not a basis for civil liability under Rule 10b-5. Subsequently, Congress amended the Exchange Act to provide for aiding and abetting liability in cases brought by the SEC, but not by private parties.[152] Plaintiffs have nevertheless pursued secondary actors in cases in which third parties have engaged in transactions with an issuer which resulted in false or fraudulent financial statements by the issuer. In some cases, the courts have held such third parties liable as "primary violators" and in other cases, the courts have declined to do so. These different results stem from the somewhat ambiguous dicta in the majority opinion in *Central Bank* that secondary actors are not always free from liability: "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met."[153]

In *Gariety v. Grant Thornton, LLP*,[154] the court held that in order for an accountant's misrepresentation to be actionable, the accountant must make a false or misleading public statement.[155] In addition, the court held that the requirement that the accountant made a public statement was also necessary in order to raise the presumption of reliance in a securities class action under the fraud-on-the-market theory.[156]

In *Simpson v. AOL Time Warner Inc.*,[157] the court held that "conduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b)."[158] Further, the court held that a plaintiff could utilize the presumption of reliance in such a case "if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in

151. 511 U.S. 164, 175–77 (1994).

152. Exchange Act, *supra* note 1, § 20, 48 Stat. at 899 (codified as amended at 15 U.S.C. § 78t (2000)).

153. 511 U.S. at 191.

154. 368 F.3d 356 (4th Cir. 2004).

155. *Id.* at 369. *Accord* Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999).

156. *Gariety*, 368 F.3d at 369.

157. 452 F.3d 1040 (9th Cir. 2006).

158. *Id.* at 1052.

the market price."[159] Similarly, some district courts which have allowed scheme liability under Rule 10b-5 have taken the position that reliance on a misstatement by a secondary actor is not required under Rule 10b-5(a) and (c); rather, where banks engaged in transactions with an issuer knowing that the purpose of the transactions was to allow the issuer to make misrepresentations, the conduct of the banks was a significant contributing cause of the plaintiff's injury and this satisfied the reliance requirement.[160] This reasoning, however, seems to confuse reliance and transaction causation.

By contrast, in *In re Charter Communications, Inc., Securities Litigation*[161] and *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*[162] the Eighth and Fifth Circuits determined that the inclusion of secondary actors who assisted an issuer in a transaction which resulted in an accounting misstatement were at most guilty of aiding and abetting and could not be held liable under section 10(b). The issue in these cases was whether plaintiffs can be presumed to have relied on activities of third parties, such as investment banks who entered into allegedly fraudulent accounting transactions with an issuer, in situations where plaintiffs had no knowledge of what such third parties were doing or who they were. In a brief filed in the Fifth Circuit case against Credit Suisse and other banks by a group of state attorneys general, the argument was made that investors can presume that all actors in a securities market are behaving legally.[163] But this is a somewhat circular argument because if these third parties had no duty to the plaintiffs under Rule 10b-5, their conduct was not necessarily illegal. The Fifth Circuit took the position that the bank's actions were not "misrepresentations" on which an efficient market may be presumed to rely, nor were they stock manipulation activities.[164] The district court had viewed the transactions by the banks as "deceptive devices" under Rule 10b-5, but the Fifth Circuit held that without plaintiffs proving that "they individually relied on the banks' omissions," the banks could not be guilty of engaging in a deceptive device unless the transactions in which they engaged involved breach of some duty of disclosure.[165] This case came to the court on a motion for certification of a class. The court's view was that the plaintiffs had no expectation that the banks would provide them with information, and therefore they were not relying on the bank's candor.[166] This interpretation of Rule 10b-5 is similar to the interpretation of the Supreme Court in *Chiarella v. United States* in which the court held that a duty to disclose to a purchaser or seller of securities is required in order for an omission to violate section 10(b).[167]

159. *Id.*

160. *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 509–10 (S.D.N.Y. 2005). *See also In re* Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161, 173–74 (D. Mass. 2003).

161. 443 F.3d 987, 991–93 (8th Cir. 2006), *cert. granted sub nom.* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 127 S. Ct. 1973 (2007).

162. 482 F.3d 372, 390 (5th Cir. 2007), *petition for cert. filed*, 75 U.S.L.W. 3557 (U.S. Mar. 5, 2007) (No. 06-1341).

163. See *State AGs Contend Enron Suit Properly Certified as Class Action*, SEC. REG. & L. REP. (BNA) 102 (Jan. 22, 2007).

164. *Regents of the Univ. of Cal.*, 482 F.3d at 390–92.

165. *Id.* at 385.

166. *Id.*

167. *Chiarella*, 445 U.S. at 229.

V. A Revisionist View of the Fraud-on-the-Market Doctrine

Let me begin this part with a personal anecdote. A number of years ago I had the honor of being introduced to Justice Blackman, the author of the *Basic Inc. v. Levinson* opinion, as a "securities law guru." He immediately asked me, "What did you think of my decision in *Basic Inc. v. Levinson?* Many people think it's wrong." I told him my honest opinion which was that it seemed to me to be a sound decision, and I did not think informational efficiency was the same as other types of market efficiencies, as argued by the dissent. My positive reaction was partly based on my understanding that the SEC had utilized the ECMH in some of its most important rule making in integrating the Securities Act and the Exchange Act in the early 1980s, an initiative that began when I was an SEC Commissioner. This integration was predicated on the assumption that the securities markets are generally informationally efficient, and that information disclosed in a corporation's annual reports and other filings becomes incorporated into the price of a company's securities. Therefore, it is not necessary for an issuer to repeat prior disclosures in an Exchange Act filing that it made in a Securities Act registration statement. But if issuers are not in compliance with their disclosure obligations because they have issued false or misleading statements, the market for their stock does not have the integrity reasonably expected by investors who are entitled to assume that companies are in compliance with SEC requirements.

More recent academic skepticism about the ECMH, the cases involving inefficient markets, including IPO markets, and the cases involving research analysts and other third parties would seem to require a rethinking of the fraud-on-the-market doctrine to establish reliance. It is illogical and bad policy for investors to be able to hold seasoned issuers to the statements they make or fail to make in SEC filings and similar documents, but not to be able to sue unseasoned issuers for fraud in the statements they make in SEC filings or other deliberate utterances. Why should investors not be able to rely upon the truth of statements by issuers, and why should such statements not be presumed to be reflected in securities prices if they are material? Yet, extending the fraud-on-the-market doctrine to statements by third parties, who are not required to speak by SEC regulations and do not owe a duty to investors or shareholders, seems to encourage too much questionable litigation.[168]

The heart of this conundrum is that section 18 of the Exchange Act is useless as a civil remedy. It has essentially been read out of the statute and replaced by suits under Rule 10b-5, which have been developed by the courts in a common

168. It has long been the law that when a broker-dealer makes a recommendation to buy or sell a security, the recommendation must have a reasonable basis. Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969). But this law developed under the shingle theory to protect broker-dealers' customers from overreaching, not to protect all investors in the public securities markets from unwarranted recommendations. While the advent of the star research analyst who regularly appears on television to tout stocks may have magnified the effect of analyst recommendations on stock market prices, these recommendations seem to be just part of the general "noise" in the public securities markets. However, the SEC and banking regulators should be able to sanction banks that engage in questionable financial transactions designed to falsify issuer financial statements, and accountants who improperly fail to uncover, or even assist, such fraud.

law fashion. By contrast, the comparable civil liability provisions in the Securities Act, which provide for civil liability for false and misleading statements in offering documents, were more carefully crafted, and have provided a balance between imposing liability on issuers and insiders, and their accountants and bankers, in appropriate situations, and guarding against excessive litigation.[169] Section 11(a) of the Securities Act provides a civil action, essentially for rescission, to purchasers of securities pursuant to a registration statement that, when declared effective by the SEC, "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[170] Such an action may be brought against signers of the registration statement, directors, consenting accountants and other experts, and "every underwriter with respect to such security."[171] But this imposition of liability on directors and underwriters is not absolute. They are given two defenses in section 11(b) of the Securities Act. First, with regard to any part of the registration statement that is "expertised," a director or underwriter can prove that "he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."[172] Financial statements certified by a consenting accountant are "expertised" for purposes of this provision.[173] However, an accountant's report on unaudited interim financial statements is not an "expertised" report.[174] Second, with respect to any part of the registration statement not made on the authority of an expert, a director or underwriter can prove that he or she had "after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[175] This is commonly called the "due diligence defense."

There are not many courts interpreting these statutory provisions and rules and suggesting that section 11 of the Securities Act is a better formulation for civil liability than either section 18 or section 10(b) of the Exchange Act, particularly since the cases that have been decided have had far-reaching effects on the conduct of IPOs.[176] The Securities Act also contains express civil liability provisions in section 12,

169. Securities Act, *supra* note 3, § 11(a), 48 Stat. at 82 (codified as amended at 15 U.S.C. § 77k(a) (2000)).

170. *Id.*

171. *Id.*

172. Securities Act, *supra* note 3, § 11(b)(3)(C), 48 Stat. at 82 (codified as amended at 15 U.S.C. § 77k(b)(3)(C) (2000)).

173. *See id.*

174. Rule 436, 17 C.F.R. § 230.436 (2007).

175. Securities Act, *supra* note 3, § 11(b)(3)(A), 48 Stat. at 82 (codified as amended at 15 U.S.C. § 77k(b)(3)(A) (2000)).

176. Whether the added costs of due diligence are worth the benefits of more efficient allocation of resources in raising capital is a question for another article. *See* Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 145–84 (1984); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1005–42 (1992). The cases that exist can be divided into three rough groups: (1) the classic cases in which

but these provisions apply only to sellers in public offerings.[177] Since section 18 of the Exchange Act seems to have been crafted and interpreted to eliminate any likelihood of civil liability for issuers and insiders who commit fraud in their SEC filings, and Rule 10b-5 has led to a litigation explosion that some now claim is threatening the competitiveness of the United States capital markets,[178] a sensible re-articulation of Exchange Act liability by the courts, the Congress, or the SEC would seem to be in order. When an issuer is conducting an IPO, there is less of a policy need to balance the interests of shareholders against the interests of investors since the company's shareholders are primarily insiders. Further, the production of a prospectus in an IPO is a more deliberative process than ongoing disclosure. In secondary offerings, involving the integrated disclosure regime, there is a greater need to balance competing shareholder and investor interests, although both types of offerings can give rise to liability under section 11.

Reliance is presumed in section 11 cases until an earnings statement which covers a period of at least twelve months after the effective date of the registration statement becomes available.[179] In a recent circuit court case, the presumption of reliance was held not available where the purchasers made their investment decision before a defective registration statement was issued.[180] The court noted that the reason Congress drafted section 11 to provide for a presumption of reliance is that, even if a purchaser may not read and rely on the registration statement, any misstatements or omissions can be "reasonably assumed to affect the market price and impel the purchase."[181] Although this logic is somewhat at odds with the holding of the Second Circuit that IPO markets are not efficient for purposes of a presumption of reliance under section 10(b)(5),[182] the Second Circuit case did not involve issuer fraud, but rather wrongdoing by underwriters. Despite flaws in the ECMH, it seems more realistic to argue that issuer statements affect the pricing of an issuer's securities, so that reliance on such statements can be presumed, than to argue that statements or actions by third parties directly and necessarily affect the pricing of securities.

The ALI Federal Securities Code, which would have achieved integration of the Securities Act and the Exchange Act by going to a system of company regis-

courts discuss underwriter liability prior to integrated disclosure, especially *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 692–97 (S.D.N.Y. 1968), and *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 581–83 (E.D.N.Y. 1971); (2) more recent cases in which courts find, on motions for summary judgment, that underwriters have fulfilled their due diligence responsibilities, especially *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407, 1414–21 (9th Cir. 1994), *cert. denied sub nom. Miller v. Pezzani*, 516 U.S. 868 (1995), and *In re Software Toolworks, Inc. Securities Litigation*, (9th Cir. 1994), *cert. denied sub nom. Montgomery Securities v. Dannenberg*, 516 U.S. 907 (1995); and (3) the post-2000 cases, following the bursting of the technology bubble in which courts again set high standards for due diligence, especially *In re Enron Corp. Securities Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 596–613 (S.D. Tex. 2002), and *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 656–59, 678–81 (S.D.N.Y. 2004).

177. *See* Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 583 (1995).

178. *See* REGULATION OF CAPITAL MARKETS, *supra* note 6, at 5; BLOOMBERG & SCHUMER, *supra* note 6, at 101.

179. See Securities Act, *supra* note 3, § 11(a), 48 Stat. at 82 (codified as amended at 15 U.S.C. § 77k(a) (2000)).

180. APA Excelsior III L.P. v. Premiere Techs., Inc., 476 F.3d 1261, 1273–74 (11th Cir. 2007).

181. *Id.* at 1274.

182. *See In re* Initial Public Offering Sec. Litig., 471 F.3d 24, 42–43 (2d Cir. 2006).

tration,[183] attempted to revise the civil liability provisions of the two statutes by: (1) imposing section 11 type liability on issuers, and an issuer's principal executive officers and directors, consenting named persons, and consenting directors and underwriters for fraud in registration statements, documents incorporated by reference in registration statements, and an issuer's annual report on Form 10K filed with the SEC; and (2) imposing Rule 10b-5 type liability on issuers, agents, aiders and abettors, and controlling persons for fraud in all other reports to security holders.[184] The basic difference between these two sections had to do with the burden and standard of proof and the persons liable. While time has passed the Federal Securities Code by, the notion that integrated disclosure should lead to an integration of the civil liability provisions of the Securities Act and the Exchange Act for fraud in documents filed with the SEC remains sound.

A further current anomaly in the imposition of liability under Rule 10b-5 is that the SEC is not required to prove reliance in an enforcement action for anti-fraud violations because the reliance requirement is not contained in section 10(b), but rather has been developed by the courts in private implied actions.[185] Yet, the SEC can use civil monetary penalties and enforcement settlements to establish a "FAIR" Fund for the benefit of victims of securities law violations.[186] This remedy dates back only to 2002, but by April 2005 the SEC had authorized FAIR Funds in over 100 cases with a total value of $5.2 billion.[187] Although the SEC has expressed the view that private litigation is a better mechanism than SEC enforcement for investor recovery of losses,[188] if class actions for issuer fraud in filed documents and similar communications are curtailed because markets are inefficient or investors are unable to otherwise prove that they relied upon false statements, SEC enforcement actions may become a preferable route to recover losses for investors. Further, there is a serious question as to whether private securities litigation should be able to proceed side by side with SEC actions establishing FAIR Funds.[189]

While the fraud-on-the-market doctrine may have outlived its utility, its rejection by the courts should not lead to the regulatory result that shareholders and investors cannot rely upon the truth of an issuer's statements in SEC filings and similar documents. The SEC's mandatory disclosure system depends upon fair and accurate financial disclosure by issuers. They should not be let off the hook because the market for their securities is inefficient. It may be inefficient, in part, because of their poor disclosures.

183. John C. Coffee, Jr. & Joel Seligman, Securities Regulation: Cases and Materials 285–87 (9th ed. 2003).

184. American Law Institute, Federal Securities Code §§ 1703, 1704 (1980).

185. *See* SEC v. Alliance Leasing Corp., 28 F. App'x. 648, 652 (9th Cir. 2002); SEC v. Rana Research, Inc., 8 F.3d 1358, 1364 (9th Cir. 1993).

186. The Federal Account for Investor Restitution ("FAIR") provision is contained in section 308 of SOX. *See* SOX, *supra* note 103, § 308, 116 Stat. at 784 (codified at 15 U.S.C. § 7246 (Supp. IV 2004)).

187. *See* William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Testimony Concerning the Impact of the Sarbanes-Oxley Act Before the House Committee on Financial Services (Apr. 21, 2005), *available at* www.sec.gov/news/testimony/ts042105whd.htm.

188. U.S. Securities and Exchange Commission, Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002 18–21 (Jan. 24, 2003), *available at* www.sec.gov/news/studies/sox308creport.pdf.

189. *See* Capital Markets Regulation, *supra* note 6, at 82.

Whether research analysts should be held liable to investors generally for statements in their reports to the same extent as issuers is another question, as imposing general fraud liability upon them could unduly chill analysts' insights and recommendations. Further, investor reliance on such reports seems more tenuous than investor reliance on SEC mandated disclosure by issuers. This does not mean that analysts should not be held accountable for errant behavior, but as persons associated with broker-dealers, there are other mechanisms, such as disciplinary proceedings, to hold them accountable. Similarly, banks can be sued as aiders and abettors by the SEC. Further, where research reports are transmitted to a customer, or banks engage in questionable transactions, the liability regime should be different from class action suits that include customers who never saw or read such research reports or relied on the banks which engaged in questionable transactions.

If the antipathy developing against plaintiff class action suits becomes sufficiently robust, it is likely that the courts will whittle away at Rule 10b-5 cases, and among other tools, question the presumption of reliance based on the ECMH. But a more global solution would be preferable, in which investors could hold issuers to their statements made in Exchange Act reports, in much the same fashion that section 11 of the Securities Act operates to hold issuers and others responsible for statements made in registration statements. Unfortunately, such a solution would seem to require congressional action and Congress has been notoriously irresponsible in attending to the problems engendered by the development of Rule 10b-5 litigation in a common law type of fashion. Instead of remedying the defects of section 18 of the Exchange Act, Congress has enlarged the scope of Exchange Act remedies when such an enlargement seemed popular in response to scandals, and restricted the scope of Exchange Act remedies at other times, without specifying the elements of a Rule 10b-5 action, the appropriate measure of damages, or who are the proper plaintiffs and proper defendants in such cases. One can always hope that future Congresses will be more attentive to such matters, but in the meantime, the courts and the SEC will have to attempt to reconcile the contradictory cases in this area of the law.[190]

One solution, recommended by me, is to apply the presumption of reliance narrowly to false or misleading statements in filed documents made by issuers on the theory that investors should be able to reasonably expect that issuers comply with their disclosure requirements in a truthful fashion and that such statements affect securities prices. Whether officers and directors should be similarly liable is a more complicated question. Since the CEO and CFO are now required to certify an issuer's financial statements, it would not seem a leap to hold them to similar liability. Directors perhaps should have defenses similar to the due diligence and reliance on experts defenses of section 11 of the Securities Act, but under Rule 10b-5 this notion probably becomes subsumed by the scienter requirement. Whether accountants should be liable to investors for false financial statements in

190. The latest example of how Congress deals with these problems is that Barney Frank, now the Democratic Chairman of the House Financial Services Committee, is pressuring the SEC to file a brief on behalf of the plaintiffs in the *Credit Suisse* case, but the plaintiffs are represented by William Lerach who may be indicted for improper behavior in class action lawsuits. *See* Kara Scannell, *SEC's Allegiances Are Put to Test*, WALL ST. J., May 29, 2007, at A2. Furthermore, at least one of the institutional investors,

SEC filed documents is a complicated issue, which would deserve serious attention in any redrafting of the civil liability provisions of the Securities Act and the Exchange Act. In the absence of any such legislation, accountants are generally only aiders and abettors who escape liability under *Central Bank*.

With regard to issuer statements not contained in filed documents, or statements by third parties, however, it would seem that plaintiffs should not be entitled to utilize the presumption of reliance in order to certify a class action, at least in omission cases. Rather, they should be required to prove that any false or misleading statements defied reasonable investor expectations and actually affected the price of the issuer's securities. Such a formulation, after *Dura*, would be consistent with the reasoning of the Second Circuit's decision that district courts need to resolve relevant factual issues before approving a class in a certification motion.[191] Further, it is hard to see how certifications by accountants are not considered statements to investors under *Central Bank*, but transactions by third parties could so qualify. Although reform of the reliance requirement could be initiated by the courts, it would be better for a comprehensive redrafting of Exchange Act civil liability to be accomplished through legislation.

Such legislation should integrate the liability provisions of the Securities Act and the Exchange Act in the context of modern securities markets, and place the onus for any liability on issuers and their CEOs and CFOs, without unduly favoring investors over shareholders. It should be noted that in today's institutional markets, many pension and other funds are both investors in a plaintiff class and shareholders of the defendant issuer in a securities class action. This does not make much sense except for the plaintiff's and defendant's lawyers enjoying the fees from such litigation. These transaction costs could be diminished if the parameters of section 10(b) claims were less open to changing judicial interpretations. Although a common law method generally is a useful tool for articulating fiduciary responsibilities, in the case of securities class actions under section 10(b), courts have run amuck by certifying enormous classes utilizing a presumption of reliance based on the ECMH theory in which many no longer believe.

In my view, in an appropriate case, the Court could discard the fraud-on-the-market theory, but a flat-out rejection of *Basic* would have unfortunate implications for the SEC's disclosure regime. In order for the SEC's integrated disclosure system to function, issuers need to be held accountable if their statements in SEC filed documents are not truthful. Private damage actions have a role as such an accountability mechanism, but they need to be kept within bounds so that they do not impair capital formation and the vitality of the public securities markets. The reliance requirement has been a mechanism for greatly expanding the types of cases qualifying as securities class actions, and a readjustment of the reliance requirement could be utilized to narrow the scope of these cases. Yet, such a readjustment should be targeted, and not completely gut section 10(b) and Rule 10b-5 as an accountability device for issuer fraud.

California Public Employees' Retirement System, lost money in Enron's stock investing in off balance sheet Enron deals, in some respects similar to the deals at issue in this case. *See* Richard A. Oppel, Jr., *Employees' Retirement Plan Is a Victim as Enron Tumbles*, N.Y. TIMES, Nov. 23, 2001, at A1.

191. *Initial Public Offering Sec. Litig.*, 471 F.3d at 33.