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INTRODUCTION

The federal securities laws1 were enacted by Congress to stimulate new confidence in the nation’s capital markets through information disclosure rules and antifraud provisions.2 The disclosure rules were designed to enable investors to evaluate and compare securities, while the antifraud provisions were created to protect small investors from ingenious fraudulent schemes and manipulative practices that prevent the market forces of supply and demand from freely determining the price of a security. In order to effectuate congressional intent, the federal courts have liberally interpreted the language of the securities laws to encompass novel and imaginative frauds.3 In articulating standards of proof, however, the federal courts have failed to fully realize the two-fold purposes of the federal securities laws.4 In particular, proof of causation in rule 10b-55 actions is an area of the law in which the federal courts have exalted form over substance.

Causation is the relational link between a defendant’s act and a

2. The drafters of these acts stated that “[t]he purpose of these sections is to secure to potential buyers the means of understanding the intricacies of the transaction into which they are invited.” H.R. REP. No. 85, 73rd Cong., 1st Sess. 8 (1933). The drafters stated that the other primary purpose of the acts was:

   [T]o prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; . . .

S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933).
4. See notes 73-91 infra and accompanying text.
plaintiff's injury. The courts have developed different standards of proving causation under the federal securities laws depending upon the particular type of fraud and the form of the allegations used by the plaintiff. Thus, rule 10b-5 violations such as omissions to state material facts, misrepresentations, and fraudulent practices trigger varying standards for establishing causation. This variation is especially critical for rule 10b-5 plaintiffs seeking class action certification under rule 23 of the Federal Rules of Civil Procedure.

Recently, a new theory has evolved which suggests a single test to determine causation in open market settings regardless of the characterization of the fraud. Under this "fraud on the market" theory, the court's inquiry is directed to the substance of the fraud and its effect on the market price of the security. This variation is especially critical for rule 10b-5 plaintiffs seeking class action certification under rule 23 of the Federal Rules of Civil Procedure.

FEDERAL SECURITIES LAWS AND RULE 10b-5

The Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) were enacted by Congress after a comprehensive investigation revealed myriad stock market abuses that contributed to the stock market crash of 1929. Congress determined that extensive federal regulation of the securities markets was essential to post-Depression recovery. The primary goals of both acts were to prevent fraud and to effectuate the dissemination of material financial information to all investors. It was the intent of Congress to make the acts comprehensive in order to pro-

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6. See notes 61-91 infra and accompanying text.
7. See notes 82-91 infra and accompanying text.
8. See notes 92-133 infra and accompanying text.
hibit future ingenious fraudulent schemes involving the trading of securities.\(^\text{14}\) The 1933 Act regulates the original issuance of securities,\(^\text{18}\) while the 1934 Act regulates trading in securities already issued and outstanding.\(^\text{18}\) The 1934 Act also created the Securities and Exchange Commission (SEC) and gave it substantive rule-making authority and broad enforcement powers to effectuate Congressional intent.\(^\text{17}\)

**Rule 10b-5**

Under the authority of section 10b of the 1934 Act,\(^\text{18}\) the general securities fraud section, the SEC promulgated rule 10b-5,\(^\text{19}\) which defines more precisely the types of fraud generally prohibited in section 10b. The rule generally makes it unlawful to engage in any fraudulent activity and includes a specific prohibition against the

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15. The market involved in the original issuance of securities is called the primary market. E. Bromberg, Securities Fraud § 2.2 at 21 (Supp. 1970) [hereinafter cited as Bromberg].

16. The market in which previously issued and outstanding securities are traded is called the secondary market. E. Gadsby, Federal Securities Exchange Act § 1.01 at 1-2 (1980) [hereinafter cited as Gadsby].


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

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

19. 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.

use of material misrepresentations or omissions in connection with the sale or purchase of a security.\textsuperscript{20} In keeping with the legislative purpose of the 1934 Act, courts generally interpret this rule broadly and flexibly.\textsuperscript{21}

Neither the 1934 Act nor rule 10b-5 specifically created a private cause of action.\textsuperscript{22} The courts, however, quickly recognized an implied private cause of action to effectuate the overall purpose of the Act: the protection of investors from securities fraud.\textsuperscript{23} The SEC administrative remedies only focused on the prevention of future violations of the securities laws.\textsuperscript{24} This judicially-created private cause of action, on the other hand, enabled victims of past fraudulent activities to be compensated for their injuries and substantially improved the effective enforcement of the 1934 Act.\textsuperscript{25} This private cause of action for rule 10b-5 violations was formally acknowledged by the Supreme Court in 1971.\textsuperscript{26}

\begin{itemize}
\item[20.] Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (1979).
\item[21.] Sup't of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6, 12 (1971).
\item[22.] Although section 10b and rule 10b-5 were drafted to "close a loop hole in the protection against fraud" by means of SEC enforcement procedures (SEC Securities Act Release No. 3230 (May 21, 1942)), the legislative history of neither the Act nor section 10b indicated any intent to create a private cause of action. 1 Bromberg, supra note 15, §2.4 at 27-28; Note, SEC Rule 10b-5: A Recent Profile, 13 WM. & MARY L. REV. 860, 865-66 (1972); Comment, Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?, 72 COLUM. L. REV. 562, 563-65 (1972). Kardon v. National Gypsum, 69 F. Supp. 512 (E.D.Pa. 1946) was the first case in which a court implied a private cause of action under Section 10 and Rule 10b-5.
\item[23.] [T]he right to recover damages arising by reason of a violation of a statute . . . is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly . . . . Where, as here, the whole statute discloses a broad purpose to regulate securities transactions of all kinds . . . in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.
\item[24.] The SEC has three potential courses of action to follow: (1) criminal prosecution, (2) civil injunctions and (3) administrative disciplinary actions. Gadsby, supra note 16, §102[1] at 1-18 to 1-19.
\item[26.] Sup't of Insurance v. Banker's Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971). In recent years, the Supreme Court has been moving away from this position of implying private causes of action where none are explicitly created by statute. In Piper v. Chris-Craft
Since the rule 10b-5 private cause of action was implied by the courts, there were no clear statutory guidelines for identifying the elements of this newly-created cause of action. The language of rule 10b-5, nonetheless, incorporates well-established common law concepts of fraud and deceit. The courts, therefore, looked to the common law tort of deceit to determine the essence of a rule 10b-5 action. The elements of common law deceit are: (1) a false representation; (2) knowledge or belief that the representation is false; (3) intent to induce action or inaction based on the misrepresentation; 4) justifiable reliance on the representation; and 5) actual damage resulting from the reliance. In order to maintain a deceit action, privity between the plaintiff and defendant also was required.
Although the tort of deceit encompassed all kinds of misrepresentations, including spoken words, written words, and actions, it traditionally did not include omissions.\textsuperscript{30} Rule 10b-5, on the other hand, extends to all types of fraud including both misrepresentations and omissions.\textsuperscript{31} Despite this limitation of deceit to affirmative misrepresentations, it still provided the courts with the initial framework to structure the elements of the private security fraud action.\textsuperscript{32} It is now well settled that in order to establish a private cause of action under rule 10b-5, a plaintiff must show: (1) a purchase or sale of securities;\textsuperscript{33} (2) scienter on the part of the def-
defendant;34 (3) a compensable injury;35 (4) a material omission, a material misrepresentation or a fraudulent act or device with regard to the securities;36 and finally, (5) causation.37 The element of

34. Scienter has been defined by the Supreme Court as an intent to defraud or to act with such recklessness that it is deemed to constitute fraud. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). A private cause of action for damages will not lie under § 10b or rule 10b-5 in the absence of an intent to deceive or defraud. Before Hochfelder, scienter of the defendant could be shown through intentional recklessness or negligent conduct. The Court, however, did not decide the case on the basis of recklessness, but recognized in a footnote that recklessness is sometimes considered a form of intentional conduct for purposes of imposing liability. Id. at 194 n.12. See Bucklo, The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977).

After Hochfelder, all cases have rejected negligence as actionable conduct under rule 10b-5. See, e.g., Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Shell v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 156 (8th Cir. 1977); Wright v. Heizer Corp., 560 F.2d 236, 251 (7th Cir. 1977); First Virginia Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977).


Decisions prior to Hochfelder established a due diligence requirement. See Wheeler, Plaintiff's Duty of Due Care under Rule 10b-5: An Implied Defense to an Implied Remedy, 70 NW. U. L. REV. 561 (1976). Since Hochfelder, the due diligence standard has at least been questioned in several circuits. The Third, Fifth, Seventh and Tenth Circuits have rejected the requirement. See, e.g., Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1040 (7th Cir. 1977); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), cert. denied, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976). The First Circuit also has signaled its rejection of due diligence. See Holmes v. Bateson, 583 F.2d 542, 559 n.21 (1st Cir. 1978). The Second Circuit has retained due diligence as a defense. See Hirsch v. du Pont, 553 F.2d 750 (2d Cir. 1977). But see Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980) (plaintiff may negate recklessness but not establish due diligence).

35. Generally damages are recoverable only to the extent that they can be shown. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386 (1970). Most courts employ the out-of-pocket rule for damages. Under this rule, the plaintiff's damages are limited to his actual loss and not what he would have made on the transaction. The Supreme Court Speaks, supra note 31, at 122. See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977).

36. The Supreme Court's most recent definition of materiality in a securities case requires proof of a substantial likelihood that a reasonable investor would consider that fact important in making its decision. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Prior to TSC, the Supreme Court had defined materiality as a defect that a reasonable investor might have considered important. Mills v. Electric Auto-Lite, 396 U.S. 375 (1970). The Supreme Court adopted the Mills test for rule 10b-5 violations in Affiliated Ute Citizens v. United States, 406 U.S. 178 (1972). In TSC, however, the Supreme Court modified the Mills definition of materiality, and restated it as whether there is a substantial
causation and the related concept of reliance has proven to be the greatest source of consternation to the federal courts.\textsuperscript{38}

**CAUSATION**

*Traditional Proof of Causation: Reliance*

In both a rule 10b-5 action for a fraudulent misrepresentation and a common law action for deceit, the plaintiff must prove that the alleged false representation caused damage to the plaintiff.\textsuperscript{39} At common law, this necessary causal connection is established through justifiable reliance.\textsuperscript{40} To prove justifiable reliance, a plaintiff must show first, that he actually relied upon the defendant's misstatement,\textsuperscript{41} and second, that his reliance was justified.\textsuperscript{42} Because deceit actions at common law required privity between the defendant and the plaintiff, an action for fraud could arise only in face-to-face transactions. As a result of this privity requirement, the subjective proof of actual reliance was easily satisfied.\textsuperscript{43} The plaintiff's major hurdle in establishing a common law action for fraud, therefore, was proof that the plaintiff's actual reliance was justified.
The standard for establishing justifiable reliance at common law was whether a reasonable person under the circumstances would have relied upon the misrepresentation. Since a reasonable person would not attach significance to a trivial misrepresentation, a plaintiff had to show that the statement was material or of sufficient importance that any reasonable person would have relied upon it. In other words, reliance upon the misrepresentation had to be reasonable as measured by an objective standard of materiality. For example, a plaintiff who believed and detrimentally relied upon the defendant’s misstatement would be denied relief if he failed to demonstrate that a reasonable person would have relied upon it. Thus, to establish causation at common law, a plaintiff, in addition to showing actual reliance, a subjective standard, had to show reasonable reliance according to an objective standard of materiality.

A rule 10b-5 action requires the same causal link between the plaintiff’s injury and the defendant’s actions as that required in a common law action for deceit. Proof of causation varies, however, in a rule 10b-5 action. Materiality, the common law reasonableness standard, is specifically required as a separate and distinct element of a rule 10b-5 action. Therefore, to establish causation in securities fraud cases, many courts predicated recovery on a showing that the injury was caused by plaintiff’s actual reliance on a defendant’s fraudulent act. Thus, the individual reliance standard became the traditional means of establishing causation in rule 10b-5 actions.

Proof of individual reliance, however, is far more difficult to es-

44. See Prosser, supra note 28, at 718-19.
46. See Gadsby, supra note 16, at 5-115; Stoll, supra note 27, at 172; Reliance Under Rule 10b-5, supra note 27, at 368.
47. Some courts and commentators have identified two components of causation: transaction causation, the misrepresentation, omission or fraudulent act caused the plaintiff to engage in the transaction; and, loss causation, the violations caused the plaintiff economic harm. See Shores v. Sklar, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,033 at 91,342 (5th Cir. May 26, 1981); Bromberg, supra note 15, § 8.7(2) at 216.
48. Rule 10b-5 states that “it shall be unlawful for any person . . . to make any untrue statement of material fact or to omit to state a material fact . . . .” 17 C.F.R. §240.10b-5 (1979) (emphasis added).
49. Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); In re Com. Oil/Tesoro Pet. Sec. Lit., 484 F. Supp. 253 (W.D. Tex. 1979); List v. Fashion Park, Inc. 340 F.2d 457 (2d Cir. 1965). The court in List stated that the abandonment of proof of reliance would result in the abandonment of proof of causation. Id. at 463.
tablish in rule 10b-5 actions than it is in common law deceit. Because of the privity requirement in common law deceit, individual proof of reliance was easily established since the false statements were made in face-to-face transactions. The privity requirement, initially required in rule 10b-5 actions, was eliminated because many fraudulent transactions occurred in open market settings where the plaintiff did not deal directly with the defendant. In open market cases, however, the plaintiff traditionally had to demonstrate that his injury primarily resulted from reliance on the defendant’s statement, and was not due to reliance on other factors. Proof of such reliance is often difficult to establish.

Furthermore, while the tort of deceit is often limited by courts to misrepresentations, rule 10b-5 actions include omissions as well as misrepresentations. A misrepresentation is a false statement of fact. An omission may take the form of a half-truth or non-disclosure. In cases involving omissions, a plaintiff had the burden of proving that he would have relied on the omitted fact

50. See note 43 supra and accompanying text.
51. In an open market setting, transactions between purchasers and sellers of securities are conducted through the impersonal stock exchange medium.


53. An investor trading in the open market deals through the impersonal stock exchange. A plaintiff who transacts through this medium lacks the direct contact with the defendant required in common law actions that enabled the common law plaintiff to demonstrate his reliance. Proof of reliance in open market situations is a burdensome requirement. Professor Bromberg states that proof of reliance in such situations is unfair since an investor who trades without knowledge of the defendant’s statement may, nevertheless, be affected by it. Bromberg, supra note 15, §8.6(2).

54. See JAMES, supra note 40, at 586.
55. See note 31 supra and accompanying text.
56. See 3 L. Loss, SECURITIES REGULATION 1431 (2d ed. 1961).

57. A half truth is a partial statement asserting the truth which is false or misleading if it is understood to be a complete statement. Id. A non-disclosure is complete failure to disclose facts which the defendant was under a duty to disclose. PROSSER, supra note 28, at 695-96.
had it been disclosed. Clearly, proof of actual reliance in such a hypothetical situation was an impossible burden.

The federal courts gradually recognized that proof of actual individual reliance was a significant and burdensome requirement on plaintiffs and was inconsistent with the broad remedial objectives of the acts. Courts began to look at other factors that could satisfy the causation requirement.

Omissions and Affiliated Ute

In 1972, the United States Supreme Court enunciated a causation test for at least one type of rule 10b-5 violation. In Affiliated Ute Citizens v. United States, the plaintiffs alleged that defendants' misrepresentations and omissions in connection with sales of securities violated rule 10b-5. In face-to-face transactions, the defendants, a bank and two of its employees, made purchases of securities directly from the plaintiffs, unsophisticated securities holders, without disclosing the fact that they were market makers. In addition, the defendants misrepresented to the plaintiffs that the plaintiffs' shares were being purchased at the prevailing market price. The Tenth Circuit Court of Appeals held that the defendants had made misstatements of material facts. Applying the common law rule requiring actual reliance, however, the court held that rule 10b-5 had not been violated because the plaintiffs failed to demonstrate actual reliance upon those misstatements.

60. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151-54 (1972). See also notes 61-133 infra and accompanying text.
63. Id. at 140.
64. Id. at 153. The defendants were deemed market makers because they induced the plaintiffs, Indian holders of stock, to dispose of their shares and they solicited and accepted standing orders from non-Indians to buy the stock. They not only actively encouraged a market for the stock but also received gratuities and commissions from the expectant purchasers.
65. Id. at 152.
67. Id. at 1348.
The Supreme Court reversed the Tenth Circuit.\textsuperscript{68} Characterizing the misstatements as "primarily omissions or failures to disclose",\textsuperscript{69} the Court held that in such cases, proof of actual reliance was not necessary.\textsuperscript{70} The Court determined that the plaintiff could satisfy the causation requirement of rule 10b-5 by demonstrating that the omissions or undisclosed facts were material.\textsuperscript{71} A material fact as defined by the Court was one which a reasonable investor might consider important when making an investment decision.\textsuperscript{72} Thus, the Supreme Court in \textit{Affiliated Ute} enunciated a new test of materiality as an alternate method of establishing causation in rule 10b-5 cases.

\textit{Causation After Affiliated Ute}

After the \textit{Affiliated Ute} decision, the lower federal courts grappled with application of the materiality test to securities fraud cases. The courts quickly complied with the Supreme Court's mandate for a new causation test in situations factually identical to \textit{Affiliated Ute}, involving omissions in face-to-face transactions.\textsuperscript{73} In \textit{Affiliated Ute}, however, the Supreme Court did not address the issue of whether the new materiality test or the old individual reliance test was the standard to prove causation when the rule 10b-5 violation consisted of misrepresentation as opposed to omissions.\textsuperscript{74} The Court's silence on proof of causation in misrepresentation cases has been interpreted by the majority of courts as an affirm-

\textsuperscript{69} Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. [Citing \textit{inter alia}, Mills v. Electric Auto-Lite Co.] This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.
\textsuperscript{70} \textit{Id.} at 153-54.
\textsuperscript{71} \textit{Id.}
\textsuperscript{72} \textit{Id.}
\textsuperscript{73} See, e.g., Lewis v. McGraw, 619 F.2d 192 (2d Cir. 1980); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1980); Continental Grain, Etc. v. Pacific Oilseeds, Inc., 592 F.2d 409 (8th Cir. 1979); Holmes v. Bateson, 583 F.2d 542 (1st Cir. 1978); Vervaecke v. Chiles, Heider & Co., 578 F.2d 713 (8th Cir. 1978); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3rd Cir. 1974); Zweig v. Hearst, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,851 (9th Cir. 1979).
\textsuperscript{74} See Brief for Petitioner at 32, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). The Court had the option of eliminating the reliance requirement or dispensing with it only in the context of non-disclosures. The Court apparently chose the latter option. \textit{But see In re Penn Central Sec. Litigation}, 347 F. Supp. 1327 (E.D. Pa. 1972). \textit{See The Supreme Court Speaks, supra note 32.}
ance of the use of the traditional individual reliance theory in those cases.\textsuperscript{75} A plaintiff alleging oral or written misrepresentations still must prove causation by demonstrating that the plaintiff actually relied on such misstatements.\textsuperscript{76} Thus, the Affiliated Ute materiality test has been limited to omission cases involving face-to-face transactions.

The lower courts have further limited the Affiliated Ute holding by inferring a rebuttable presumption of reliance.\textsuperscript{77} Even though the Supreme Court never considered a presumption of reliance,\textsuperscript{78} the majority of the courts have held that proof of materiality merely creates a rebuttable presumption of reliance that establishes causation.\textsuperscript{79} If the defendant can demonstrate that the plaintiff did not in fact rely on the defendant's statement, the plaintiff will be denied relief.\textsuperscript{80} Thus, these courts have not only limited the application of the Affiliated Ute materiality test to cases involving omissions but have also determined that proof of materiality establishes a presumption of causation rather than establishing causation.

\textsuperscript{75} "In a misrepresentation case... a plaintiff must demonstrate that he relied on the misrepresentation in question when he entered the transaction that caused him harm." Schlick v. Penn-Dixie Cement Corporation, 507 F.2d 374, 380 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975). See also Verveaecke v. Chiles, Heider Co., 578 F.2d 713 (8th Cir. 1978); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1978); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976); Titan Group, Inc. v. Faggen, 513 F.2d 234 (2d Cir. 1975), cert. denied, 423 U.S. 840; Rochez Bros., Inc. v. Rhodes, 491 F.2d 402 (3rd Cir. 1974). But see Carras v. Burns, 516 F.2d 251 (4th Cir. 1975) (the court did not distinguish between misrepresentation and non-disclosure cases); 2 BROMBERG, supra note 14, §8.6 at 209-11.

\textsuperscript{76} Id.

\textsuperscript{77} See Rifkin v. Crow, 574 F.2d 256, 262 (5th Cir. 1978); Verveaecke v. Chiles, Heider & Co., 578 F.2d 713, 718-19 (8th Cir. 1978); Holdsworth v. Strong, 545 F.2d 687, 695 (10th Cir. 1976); Titan Group, Inc. v. Faggen, 513 F.2d 234, 239 (2nd Cir. 1975), cert denied, 423 U.S. 840 (1975); Thomas v. Duralite Co., Inc., 524 F.2d 577, 585 (3rd Cir. 1975); Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975); Chelsea Assoc. v. Rapanos, 527 F.2d 1266, 1271-72 (6th Cir. 1975); Reliance, supra note 59, at 597-600.

\textsuperscript{78} The Supreme Court clearly stated that the failure to disclose a material fact in an omission case was sufficient to establish causation. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1971). See Reliance, supra note 59, at 597-98 n.66.

\textsuperscript{79} Some courts have stated that proof of materiality establishes a presumption of causation. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970); Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975) ("[W]e prefer to recognize that materiality directly establishes causation more likely than not, and that reliance as a separate requirement is simply a milestone on the road to causation." Id. at n.22.) Other courts have held that materiality establishes a presumption of reliance which establishes causation. See cases cited note 73 supra. The net result of either view, however, is the same since both views are based on the assumption that if materiality is established, the individual investor is more likely than not to act as a reasonable investor. Blackie v. Barrack, 524 F.2d 891, 906 n.22 (9th Cir. 1975).

\textsuperscript{80} See cases cited note 77 supra.
In summary, differing tests for establishing causation have evolved for rule 10b-5 omission cases and misrepresentation cases. The materiality of any omission or misrepresentation must be established in all rule 10b-5 cases. Only materiality need be shown to establish causation in omissions cases, whereas individual reliance in addition to materiality must be demonstrated in cases involving misrepresentations. Proof of causation by demonstrating actual individual reliance, therefore, is an extra hurdle present only in some rule 10b-5 violations. This additional burden of proving actual individual reliance is particularly harsh and analytically suspect when viewed in the context of rule 10b-5 class actions.

Class Action Implications of Two Different Tests of Causation

The federal securities laws have been a major source of class action litigation. Often the individual investor's injury does not sufficiently justify the practical costs of litigation. The financial burdens and tactical delays which usually overwhelm the individual investor are minimized when an action can be brought on behalf of a class of defrauded investors. Thus, the class action device is a means frequently used in prosecuting securities fraud violations.

While the class plaintiff must satisfy certain prerequisites before a court will certify the class, the requirement that common issues


82. 5 H. Newberg, Class Actions § 8800 at 830 (1977) [hereinafter cited as Newberg].

83. Id. at 832.

84. "[A] class action may well be the appropriate means for expeditious litigation of the issues because a large number of individuals may have been injured although no one person may have been damaged to a degree which would have induced him to institute litigation solely on his own behalf." Green v. Wolf Corp., 406 F.2d 291, 296 (2d Cir. 1968).

85. Rule 23 of the Federal Rules of Civil Procedure provides:
One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interest of the class.


In addition to satisfying the above prerequisites, the plaintiff must meet the requirements in one of three categories of subsection (b) of rule 23. Class members, however, almost exclusively pursue securities class actions for damages within the (b)(3) category. See 5 New-
of law or fact predominate over individual issues is the pivotal prerequisite which must be satisfied in rule 10b-5 class actions. Since causation may be established by a showing of materiality in some rule 10b-5 actions, but only by an additional individual demonstration of actual reliance in other rule 10b-5 actions, class certification actually hinges upon which causation method is applicable. In situations in which causation may be proved by a showing of materiality alone, common issues with respect to the defendant's fraudulent conduct are easily established. Where causation must be shown by individual proof of actual reliance by each class member, the prospect of countless mini-trials on the individual issues of fact relating to such reliance usually leads courts to the conclusion that individual issues predominate over common questions. In the latter situation, class certification would be denied since the predominance prerequisite would not be satisfied. Hence, a class plaintiff alleging omissions may pursue a securities fraud class action, while a class plaintiff alleging misrepresentations will be denied class certification. The impracticability of maintaining two standards for causation is magnified in the class action context. A new theory has emerged, however, which may remedy this anomaly by focusing on the substance of the defendant's fraudulent act.

BERG, supra note 84, §8824 at 879. Rule 23(b) (3) provides in pertinent part:

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy . . .

FED. R. Civ. P. 23(b)(3).

86. See notes 61-72 supra and accompanying text.
87. See notes 73-81 supra and accompanying text.

Use of the bifurcation method, however, does not resolve what appears to be an inherent conflict between proof of reliance element of a 10b-5 action and the "predominance of common issues" requirement of Rule 23(b)(3); it merely delays resolution of the problem . . .

In re Memorex Security Cases, 61 F.R.D. 88, 98 (N.D.Ca. 1973). This method merely delays rather than resolves the conflict between these elements.

90. 5 NEWBERG, supra note 82, at 884.
91. 3 BROMBERG, supra note 15, §8.6(2), at 212; Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975); In re LTV Securities Litigation, [1980 Transfer Binder] Fed. Sec. L. Rep.
THE FRAUD ON THE MARKET THEORY

The fraud on the market theory, which has been adopted by the Second, Fifth, and Ninth Circuits and many federal district courts, was developed to remedy the shortcomings of the unequal application of the Affiliated Ute materiality test. According to the theory, an investor relies on the integrity of the stock market to purchase stock and is harmed by any deception that artificially inflates or deflates the price of the stock. The critical assumption of the theory is that the market price of a security at any point in time reflects all representations made concerning the security. The market price, therefore, also reflects all material misrepresentations and material omissions made concerning the security.

In order to establish rule 10b-5 causation under this theory, a plaintiff must prove (1) that he purchased the security, (2) that a material misrepresentation or omission was made concerning the security by the defendant, and (3) that an artificial change in the price resulted. Thus, no inquiry is made with respect to the form


96. See notes 73-91 supra and accompanying text.


98. Id.

of the rule 10b-5 allegation in order to determine which causation test must be used. Instead, the substance of the defendant's acts is the focus. If a defendant's actions are material and if they affect the price of the security, causation is presumptively established.

Blackie v. Barrack

The fraud on the market theory was first formally recognized by the Ninth Circuit in Blackie v. Barrack. In Blackie, a class action involving misrepresentations, the plaintiffs alleged that the defendant's material misrepresentations in numerous documents artificially inflated the price of the company's stock. The class plaintiffs sought relief on behalf of all purchasers of stocks during the two year period that the misrepresentations were made. The Ninth Circuit specifically rejected the traditional individual reliance test to establish causation as "an unreasonable and irrelevant evidentiary burden". The court held that a requirement of direct proof of reliance would defeat recovery by investors whose reliance was indirect. A purchaser on a stock exchange would not be able to prove individual reliance if he was either unaware of a specific misrepresentation or did not directly rely upon it. In fact, the court noted, many investors purchase because of the increase in the price of a security, a favorable price-earnings ratio, or other market factors. These investors generally rely upon the assumption that the market price is validly set and that no unsuspected manipulation has inflated the price. Thus, investors in the open market rely indirectly upon the truth of the representations underlying the stock price.

100. "[C]ourts have taken the common sense approach that the class is united by a common interest . . . a defendant's course of conduct . . . which is not defeated by slight differences in class members' positions . . . " Blackie v. Barrack, 524 F.2d 891, 902 (9th Cir. 1975).
102. 524 F.2d 891 (9th Cir. 1975). See also Reliance, supra note 59.
103. Id. at 894.
104. Id.
105. Id. at 907. See also note 121 infra.
106. Id.
107. Id. See also 3 Bromberg, supra note 14, §8.6(2) at 212.
108. Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975).
109. Id.
110. Id.
The Blackie court noted that the difficulty in proving individual reliance in the open market context is substantially similar to the difficulty the Supreme Court recognized in Affiliated Ute when plaintiffs are required to prove individual reliance in omissions cases. Guided by the Affiliated Ute materiality test, the Blackie court held that a plaintiff may establish causation by a showing of the materiality of the misrepresentation and purchase of stock, without proof of actual reliance. Such a showing of materiality circumstantially establishes the causal link between the defendant's illegal acts and the plaintiff's injury. Thus, the Blackie court applied the Affiliated Ute materiality test to establish a presumption of causation in a misrepresentation situation.

In addition, similar to many lower federal courts after Affiliated Ute, the Blackie court determined that this presumption of causation may be rebutted by the defendant. Once the plaintiff establishes that the defendant's acts are material, the burden shifts to the defendant to disprove the existence of causation. The defendant could disprove the presumption of causation either by proof that the misrepresentations were not material, or by proof that the plaintiff relied primarily upon another factor. For example, defendant may successfully rebut the presumption of causation in a situation where he can prove that the plaintiff purchased the security solely on the recommendation of a person unconnected with the fraud.

While the court noted that the presumption is difficult to rebut, it opined that the defendant's opportunity to disprove the presumption of causation will limit the possible claims of defrauded investors to those who were actually harmed by the defendant's misrepresentation.

111. Id. at 908. See generally Reliance, supra note 59.
112. Proof of reliance is adduced to demonstrate the causal connection between the defendant's wrongdoing and the plaintiff's loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price . . .

Id. at 906.
113. Id.
114. Id.
115. Id.
117. Blackie v. Barrack, 524 F.2d 891, 906-07 n.22 (9th Cir. 1975).
The Ninth Circuit’s holding in *Blackie* adopting the fraud on the market theory is a logical extension of the Supreme Court’s holding in *Affiliated Ute*. The Court in *Affiliated Ute*, a case involving material omissions in face-to-face transactions, noted the difficulty of proving individual reliance in omissions cases. The Court concluded that proof of materiality sufficiently established causation. The *Blackie* court extended the *Affiliated Ute* materiality test from omission cases in face-to-face transactions to both misrepresentation and omission cases in the open market context. Since the open market investor generally does not have any direct contact with the defendant or his fraudulent acts, his burden of proving individual reliance in the open market setting is quite similar to the difficult burden imposed on plaintiffs in face-to-face omission cases. In open market transactions, however, proof of reliance is virtually impossible in either misrepresentation or omission cases. The *Blackie* court adopted the fraud on the market theory to embrace all open market transactions.

**Recent Fraud on the Market Cases**

Since *Blackie*, the fraud on the market theory has gained increasing acceptance by the lower federal courts. Since 1978, there has been a surge of security fraud cases in which this theory has been successfully employed. Generally, the courts have adopted

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118. *Id.* at 906.

119. See notes 51-72 *supra* and accompanying text.

120. See, *Blackie* v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975); Reliance and Private 10b-5 Actions, *supra* note 56, at 594.

121. Certainly proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated prices justifies the presumption of causation without proof of individual reliance. *Blackie* v. Barrack, 524 F.2d 891, 908 (1975).

the reasoning of the Ninth Circuit in Blackie, concluding that in open market transactions the plaintiff can establish causation without proving individual reliance.123

Presumption of Causation Supported by Economic Data

In Blackie, the Ninth Circuit held that the material misrepresentations were reflected in the stock market price.124 The court stated that all purchasers in the open market who did not rely directly upon the defendant’s misrepresentations were not precluded from recovering because of the traditional reliance requirement. Upon proof of materiality, the court presumed reliance and the causation requirement was thereby satisfied.125

A recent case examined the validity of the presumption of causation in open market transactions.126 In In re LTV Securities Litigation,127 the district court looked to recent economic studies to justify the presumption of causation in fraud on the market situations.128 The court found that the studies indicate that all material statements, both true and false, are reflected in the current stock price.129 Since material misrepresentations cause the artificial inflation or deflation of the stock price, proof of materiality is all that is needed to establish the relational link between a defendant’s acts and a plaintiff’s injury.130 Thus, this court adopted the fraud on the market theory in the open market context because it found the

123. See cases cited in note 122 supra.
124. Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975).
125. See notes 111-113 supra and accompanying text.
127. Id.
128. The economic studies support the economic efficient market theory. This theory has been explained as follows:

Basically, efficient capital markets exist when security prices reflect all available public information about the economy, about financial markets, and about the specific company involved. Implied is that market prices of individual securities adjust very rapidly to new information. As a result, security prices are said to fluctuate randomly about their “intrinsic” values.

130. Id. at 98,231-32.
presumption of causation upon proof of materiality was valid and supported by economic data.

**The Rebuttable Presumption**

The courts also have continued to maintain that the fraud on the market theory creates only a rebuttable presumption of causation. The Blackie court stated that the fraud on the market theory affords the defendant the opportunity to rebut the presumption of causation either by proof that the statements were not material, or by proof that the defendant relied primarily on another source.\(^{131}\) This has been instrumental to the defense in fraud on the market claims. A defendant's successful rebuttal severs the relational link between the defendant's acts and the plaintiff's injury.

A successful rebuttal may have significant implications in a class action. It is particularly important that the class representative is not subject to this defense. If a named plaintiff has relied primarily on a source unrelated to either the integrity of one market or the defendant's fraudulent statements, the courts will deny class certification even if the defendant's misstatements were material and caused injury to a class of investors. The success of the class action could be unnecessarily prejudiced by this defense against the named plaintiff and therefore he is not a proper representative.\(^{133}\) Hence, while the fraud on the market theory enhances the certification of a class action, the existence of a rebuttable presumption of causation enables the defendant to effectively challenge an individual or class action fraud on the market claim.\(^{133}\)

**ADOPTION OF THE FRAUD ON THE MARKET THEORY**

The fraud on the market theory should be uniformly adopted and applied by the federal courts as a standard of causation in the open market setting. Under the traditional rule 10b-5 causation standard\(^ {134}\) a plaintiff must establish individual reliance in situations where the misrepresentations affect the price of the stock in

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\(^{131}\) See notes 114-117 supra and accompanying text.


\(^{133}\) See, e.g., Koos v. First Nat'l Bank, 496 F.2d 1162, 1164 (7th Cir. 1974); Greenspan v. Brassler, 78 F.R.D. 130, 133 (S.D.N.Y. 1978).

\(^{134}\) See notes 39-91 supra and accompanying text.
the open market.\textsuperscript{138} Proof of reliance is impossible for purchasers of stock on a securities exchange because the misstatements contribute to the artificially high price of the stock, but the misrepresentations usually are not made directly to the plaintiff.\textsuperscript{139} The fraud on the market theory, therefore, is the only means by which open market investors can vindicate rule 10b-5 written or oral misrepresentations in situations in which the misrepresentation is reflected in the market price of the stock and the actual misrepresentation is not communicated to the plaintiff.

In addition, proof of individual reliance to establish Rule 10b-5 causation renders impossible the maintenance of a Rule 10b-5 class action, because the existence of individual reliance issues causes individual issues to predominate over common issues.\textsuperscript{137} The fraud on the market theory is the only method available to class action plaintiffs alleging rule 10b-5 misrepresentations to establish causation. The fraud on the market theory, therefore, serves to enhance the private enforcement of the securities laws by remedying the inadequacies of the other rule 10b-5 causation theories in both individual and class actions.\textsuperscript{138}

The fraud on the market theory also is essential to effective private enforcement of the securities laws in light of current judicial trends and recent administrative proposals. Prior to the 1970's, the Supreme Court's liberal interpretation of the federal securities laws enabled a wide variety of securities suits to be brought by private investors.\textsuperscript{139} Since the early 1970's, however, the Supreme Court has retreated from this position.\textsuperscript{140} The Court's current position limits the availability of the federal forum for private securities litigation to those areas of the securities laws that specifically provide private actions. In addition, the current administration recently proposed a severe reduction in the Securities Exchange Commission's staff.\textsuperscript{141} This reduction will inevitably limit the

\begin{itemize}
\item \textsuperscript{135} See notes 73-80 supra and accompanying text.
\item \textsuperscript{136} See notes 105-110 supra and accompanying text.
\item \textsuperscript{137} See notes 82-91 supra and accompanying text.
\item \textsuperscript{138} See, e.g., United States v. Charnay, 537 F.2d 341 (9th Cir. 1976); In re LTV Securities Litigation, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$97,605 at 93,232 (N.D. Tex. 1980).
\item \textsuperscript{139} See notes 21-25 supra and accompanying text.
\item \textsuperscript{140} See note 26 supra.
\item \textsuperscript{141} The Reagan administration's estimated budget for the Securities and Exchange Commission calls for the elimination of 159 positions in 1982. Federal Securities Law Reports No. 905 at 5 (March 18, 1981). The former SEC Commissioner, A. A. Sommer, Jr., stated that the Commission's effectiveness would be severely undermined by these cuts. He
\end{itemize}
SEC's ability to enforce securities laws. Thus, private enforcement actions, previously deemed to supplement the SEC's enforcement, virtually will become the primary means of enforcing the securities laws. The adoption of the fraud on the market theory by all of the federal courts would substantially increase the effectiveness of private actions under the federal securities laws, and thereby maintain federal securities law enforcement in light of the anticipated reduction in the SEC enforcement capacity.

**CONCLUSION**

Traditionally, two different tests of causation are applied to the same fraudulent act, depending upon whether the rule 10b-5 allegation is in the form of an omission or misrepresentation. Under these tests, open market investors who directly rely on the integrity of the market price for a stock, and therefore indirectly rely on misrepresentations which artificially inflated the stock's price, were not able to prove causation through individual reliance. In addition, rule 10b-5 class action plaintiffs were precluded from prosecuting misrepresentation cases because individual issues predominated over common issues of fact. These tests operated to exalt the form of the rule 10b-5 allegations over the substance of the illegal acts.

The fraud on the market theory embraces and extends the materiality concept of causation set forth by the Supreme Court in *Affiliated Ute*, to all cases involving open market transactions, regardless of the characterization of the fraud in the pleadings. This theory should be uniformly adopted by the courts because it properly directs inquiry into the substance of the alleged fraudulent and provides a unified concept of causation in open market securities fraud cases.

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indicated that the program prepared by the transition team which anticipates proposed decentralization of the Commission's enforcement activities, budget cuts and replacement of personnel in the top staff positions "might well destroy" the agency. Fed. Sec. L. Rep. No. 900 at 7-8 (Feb. 11, 1981).