FRAUD CREATED THE MARKET

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ABSTRACT

As we have shown in a series of prior Articles, and as scholars have accepted since, class actions are vital to protecting investors. Presumptions of reliance facilitate class-wide resolution of securities fraud claims. Without class certification, individual damages may be de minimis, and thus investors would be unlikely to bring a securities fraud suit. This underenforcement allows those who defraud investors to skate liability and impugn the integrity of the marketplace. Under Rule 10b-5, for securities fraud the Supreme Court has presumed reliance to facilitate class actions where there is an omission in the face of a duty to disclose or where there is a fraud on the secondary market. The new frontier is whether federal courts should likewise presume reliance where fraud occurs on the primary market, giving rise to the fraud-created-the-market theory. While some federal courts embraced the theory decades ago, a sharp conflict has arisen in the wake of the Supreme Court’s decision in Stoneridge, and the Third and Ninth Circuits have set the pace for rejecting the theory. In this Article we show, however, that the fraud-created-the-market theory is consistent with the fundamental basis for all presumptions in the law, comports with the Supreme Court’s interpretations of the federal securities laws as properly understood, and serves the investor-protection and market-integrity design of securities regulation.

We undertake the seminal comprehensive definition and defense of the fraud-created-the-market theory, and show why critics’ concerns regarding the presumption are unfounded. Properly understood, the fraud-created-the-market theory is about materiality—fraud is so material, without it, securities never would have made it to market. In this regard, we show that a presumption of reliance in the newly issued-securities context and the

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primary market is consistent with the Supreme Court's collapsing the elements of securities fraud into a single inquiry whether the omission or misrepresentation was material. We build upon Professor Donald C. Langevoort's fresh interpretation of Basic's fraud-on-the-market presumption and his interpretation of Stoneridge to show that the fraud-created-the-market presumption is grounded in the Court's jurisprudence. We also find support for a judicially crafted presumption in the context of new issues in the securities laws themselves and in the common-law bases for presumptions. Relying on scholarship both old and new, we support judicial recognition of the fraud-created-the-market theory, specifically in cases involving bonds, in which the primary market may be informationally efficient, and cases involving manipulative conduct, in which market efficiency is irrelevant. The need for an answer to whether federal courts should adopt the fraud-created-the-market theory is pressing. The fraud-created-the-market theory will play an increasingly important role in actions against those involved in fraud relating to the issuance of subprime mortgage-backed securities.

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I. INTRODUCTION

The Supreme Court has said, and recently reiterated in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., that reliance is an essential element for liability under Rule 10b-5 of the securities laws. Reliance, according to the Court, ensures the requisite causal connection between a defendant’s misrepresentation and the plaintiff’s injury. Yet what the Court has said differs from what the Court has done. The Court has largely abrogated the reliance requirement to facilitate securities fraud class actions, focusing instead on materiality. Under Rule 10b-5, the Court has presumed reliance where there is an omission in the face of a duty to disclose or where there is a fraud on the secondary market. Now the new frontier for presumptions of reliance is whether federal courts should presume reliance in the primary market, giving rise to the fraud-created-the-market theory. A decade ago the federal appellate courts presumed reliance where fraud occurred on the primary market. These presumptions enable class-wide resolution of securities fraud claims, without which injured investors would unlikely be able to recover. And as we have shown in a series of prior articles and as scholars have accepted since, class actions are vital to protecting investors. But the Court’s Stoneridge decision has caused sharp conflict as of late regarding the fraud-created-the-market theory, and the Third and Ninth Circuits have recently set the

2. Stoneridge, 552 U.S. at 159.
5. See infra Part II (discussing the rise and refinement of the fraud-created-the-market theory).
pace for rejecting the presumption. In this Article we show that the fraud-created-the-market theory is consistent with the fundamental basis for all presumptions in the law, comports with the Court’s interpretations of the federal securities laws as properly understood, and serves the investor-protection and market-integrity design of securities regulation.

We undertake the first post-Stoneridge defense of the fraud-created-the-market theory and show that critics’ concerns regarding the presumption are unfounded. First, Part II shows that the fraud-created-the-market theory is about materiality—fraud is so material that without it the securities never would have made it to market. As Part III illustrates, however, the federal courts, most notably the Third and Ninth Circuits, have misunderstood and rejected the presumption. Once the fraud-created-the-market theory is approached via materiality, Part IV demonstrates that the presumption in the new-issue and primary-market context is consistent with the Supreme Court’s collapsing the elements of securities fraud into a single inquiry whether the omission or misrepresentation was material. We rely upon Professor Donald C. Langevoort’s fresh interpretation of Basic’s fraud-on-the-market presumption and his interpretation of Stoneridge to show that the fraud-created-the-market presumption is grounded in the Court’s jurisprudence.

In Part V we also find support for a judicially crafted presumption in the context of new issues in the securities laws themselves and in probability, policy, and fairness—the common law justifications for judicially recognized presumptions. Relying on scholarship both old and new, we support judicial recognition of the fraud-created-the-market theory, specifically in cases involving bonds, in which the primary market may be informationally efficient, or in cases involving manipulative conduct, in which market efficiency is irrelevant. The need for an answer to whether federal courts should adopt the fraud-created-the-market theory is pressing. The fraud-created-the-market theory will play an increasingly important role in actions against those involved in fraud relating to the issuance of subprime mortgage-backed securities.

8. See infra Part III (discussing the demise of the fraud-created-the-market theory in light of Stoneridge).
10. See infra Part II.
11. See infra Part III.
12. See infra Part IV.A.
13. See infra Part IV.B.
14. See infra Part V.A–B.
II. RULE 10B-5, RELIANCE, AND THE RISE AND REFINEMENT OF THE FRAUD-CREATED-THE-MARKET PRESUMPTION

The securities laws protect investors by ensuring autonomous investment decisions, which can only be made if investors have access to all material information. Congress had to ensure the accuracy of the information disclosed so that investors could rely upon it, and, to that end, provided several private rights of action to victims of securities fraud to deter false or misleading information. The courts also fostered the goal of investor protection by implying remedies, the most potent of which is an implied private right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Rule 10b-5 makes it unlawful, directly or indirectly, by use of interstate commerce to either: (a) employ any device, scheme, or artifice to defraud; (b) make any untrue statement or omission of material fact; or (c) engage in any act, practice, or course of business which operates or would operate as a fraud. Although the judiciary has implied a right to sue under Section 10(b) and Rule 10b-5, the Supreme Court has constructed positive and common-law elements for the cause of action that make it less attractive to investors. To recover for securities fraud under Rule 10b-5, the Court has said, investors must establish six elements, one of which is reliance. Reliance, although

19. Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 235 (5th Cir. 2009) (per curiam) (noting that for investors to obtain class certification of a securities fraud claim they “must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action”).
20. To establish a securities fraud claim under Section 10(b) and Rule 10b-5, a plaintiff must allege and prove the following: (1) that the defendant made a material misrepresentation or omission
“bewildering,” is often understood as the subjective aspect of causation, or whether the fraud was a substantial factor in bringing about the investor’s purchase or sale of a security.\(^{21}\) In this sense, reliance is a confluence of materiality and causation.\(^{22}\)

By insisting that reliance is essential to liability under Rule 10b-5, the Supreme Court had to deal with the obstacle that individual questions of reliance pose to class certification under Federal Rule of Civil Procedure 23.\(^{23}\) Without class certification, the economic incentive to bring securities fraud claims is likely de minimis, and without enforcement of the securities laws by these private attorneys general, the markets lack the holistic regulation that Congress and the courts have prized. Presumptions of reliance overcome the class-action barrier by making questions of reliance common to a diverse group of investors.

The Supreme Court has recognized two presumptions of reliance, ergo distinguishing reliance under the securities laws from “actual reliance” required for fraud under the common law. Before turning to these two presumptions, however, a word about presumptions generally. Presumptions, “the slipperiest member of the family of legal terms,” are common in the law.\(^{24}\) They allocate the burden of proof in a civil case by requiring the trier of fact to draw a particular conclusion once basic facts are established.\(^{25}\) Presumptions often arise because (1) public policy inclines courts to favor one contention by giving it the benefit of a presumption; (2) direct proof is rendered difficult and a presumption corrects an imbalance resulting from one party’s superior access to proof; or (3) proof of a certain fact renders the inference of the existence of another fact so probable that courts save time presuming the truth of the

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\(^{21}\) Harold S. Bloomental & Samuel Wolff, 3B Securities & Federal Corporate Law (Securities Law Series) § 13:25 (2d ed. 2011). “Materiality is the objective test of causation; material information is information that would have been a substantial factor in the decision of a reasonable man.” Id.

\(^{22}\) See, e.g., Stark Trading v. Falconbridge Ltd., 552 F.3d 568, 572 (7th Cir. 2009); Eckstein v. Balcor Film Investors, 58 F.3d 1162, 1171 (7th Cir. 1995); Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp., 910 F.2d 1540, 1546 (7th Cir. 1990); Titan Grp., Inc. v. Faggen, 513 F.2d 234, 239 (2d Cir. 1975).


\(^{24}\) McCormick on Evidence § 342 (John W. Strong ed., 5th ed. 1999); see also id. § 343 (stating that hundreds of presumptions exist in the law).

Presumptions can be conclusive or rebuttable; a conclusive presumption is akin to a substantive legal rule and cannot be rebutted by any evidence while a rebuttable presumption shifts the burden of production to the other party, which then disappears if enough counterproof is offered.27

The Supreme Court has established two rebuttable presumptions of reliance: (1) under Affiliated Ute Citizens of Utah v. United States, if a defendant makes a material omission to an investor to whom the defendant owes a duty, then reliance is presumed;28 and (2) under Basic Inc. v. Levinson, if the defendant makes a material misrepresentation in a well-developed and efficient market, then reliance is presumed.29 Under the theory adopted in Basic, which is known as the fraud-on-the-market theory, courts presume investors’ reliance when pursuing recovery for fraud on an efficient secondary market, but investors do not enjoy a presumption of reliance if the fraud occurred in an undeveloped or inefficient market.30

To obtain a presumption of reliance in the context of newly issued securities, plaintiffs devised the fraud-created-the-market theory, which assumes investors relied upon the market itself to prevent the entry of “unmarketable” securities.31 For a security to be issued, a company must disclose material information such that potential buyers can make an informed investment decision.32 Companies might misrepresent or omit material information to cause otherwise invalid securities to be issued into the market, however. And the Securities and Exchange Commission (SEC) might not catch this because the agency generally does not perform due diligence to ensure that disclosures are accurate, and other gatekeepers might be asleep at the switch as well.33 If gatekeepers cannot prevent
securities from being issued, injured investors may seek to recover their losses under Rule 10b-5 and the fraud-created-the-market theory.34

The seminal case endorsing the fraud-created-the-market theory came in the Fifth Circuit’s decision in Shores v. Sklar, which predates Basic, and involved a securities fraud action brought under Rule 10b-5(a) and (c) against the issuers by a purchaser of tax-exempt bonds.35 In Shores, the buyer claimed that the defendants fabricated the offering documents to induce the municipality to issue and the investors to buy the bonds.36 The sole income source used to amortize the bonds defaulted in payment, however, and the bonds free-fell, leaving them worthless.37 The plaintiff did not read or rely on the issuer’s offering documents, but nonetheless asserted that the defendants engaged in a fraudulent scheme to induce the issuance and purchase of unmarketable bonds in violation of Rule 10b-5.38 The twelve-judge majority held, over the ten-judge dissent, that the plaintiff could sue under Section 10(b) by maintaining that the fraud permitted the securities to exist on the market and that the investor relied on its existence to his detriment.39 Under Shores, the investor relied on the market’s ability to furnish only those securities that are entitled to be marketed.40 According to the court, reliance is established when the plaintiff can prove that the fraud is so pervasive that absent the fraud, the bonds would have been “unmarketable.”41

The following Parts show that the fraud-created-the-market theory posits that the defendants’ fraud was so material that without it, the defendants would have been unable to market the securities.42 Under both the decisions that endorse and reject the theory, such as the Fifth Circuit’s Shores decision and the Seventh Circuit’s Eckstein decision, recovery is limited to cases in which the fraud is so material that without it the

34. Id.
36. Shores, 647 F.2d at 464.
37. Id. The municipality was going to build a mobile home facility, and it issued bonds to finance the project. The bonds were revenue bonds, not general obligation bonds, which meant that the bonds had to be secured by a pledge of revenue. In Shores, the bonds were secured by a pledge of rent payments that would be paid from a mobile home facility. Id. at 465.
38. Id. at 465, 467.
39. Id. at 469–71. The dissent disagreed with the majority on a number of grounds, namely that (1) the fraud-on-the-market theory does not warrant an extension of reliance in the context of newly issued securities; (2) the fraud-created-the-market presumption was counter to the purpose of the federal securities laws, which favor disclosure only; and (3) the theory would unduly broaden the scope of the Rule 10b-5 private cause of action. Id. at 472–73 (Randall, J., dissenting).
40. Id. at 470–71.
41. Id. at 469.
42. Securities are “unmarketable” if they have been issued only because of the issuer’s fraud. Dennin, supra note 9, at 2612.
securities would not be successfully marketed at all. The federal courts have recognized that misrepresentations or omissions that affect either the economic or legal marketability of a security can be facts that satisfy this degree of materiality. For example, reliance is presumed if the fraud renders the stock economically unmarketable. Investors face a high burden when arguing that the defendants’ fraud rendered the securities economically unmarketable—or “patently worthless”—as a bond or security can virtually always be sold at some combination of price and interest rate. The inquiry whether a security is patently worthless has a certain degree of subjectivity to it, but no more so than the materiality standard that applies to the securities laws and that the Supreme Court has trusted a trier of fact to determine. The presumption premised on economic unmarketability may be rebutted by showing the securities in fact had value. Legal unmarketability presumes reliance if defendants’ fraud meant the securities had no business by law being on the market. When premised on legal unmarketability, defendants may rebut the theory by showing legal compliance. Damages for a fraud-created-the-market case, like any other Rule 10b-5 case, are the plaintiff’s out-of-pocket losses. A review of the federal appellate courts reveals that before Stoneridge they accepted the fraud-created-the-market theory when properly understood, but rejected legal unmarketability and reliance premised on the integrity of the regulatory process.

44. See Part II.A–C.
45. Dennin, supra note 9, at 2623–24.
46. Investors cannot recover, however, by proving only that the bonds or securities would have been offered at a different price. Shores, 647 F.2d at 471; see Jonathan R. Macey & Geoffrey P. Miller, Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory, 42 STAN. L. REV. 1059, 1060 n.5 (1990); Daniel S. Rosefelt, Note, Fraud on the Undeveloped Securities Market, 20 STETSON L. REV. 335, 357 (1990).
48. Dennin, supra note 9, at 2624.
49. Ross v. Bank S., N.A., 885 F.2d 723, 743 (11th Cir. 1989) (Tjoflat, J., concurring); see also Ambassador Hotel Co. v. Wei-Chuan Inv., 189 F.3d 1017, 1030 (9th Cir. 1999) (“The usual measure of damages for securities fraud claims under Rule 10b-5 is out-of-pocket loss; that is, the difference between the value of what the plaintiff gave up and the value of what the plaintiff received.”).
50. KAUFMAN, 26 SECURITIES LITIGATION: DAMAGES, supra note 15, § 10:31. The Eighth Circuit and the D.C. Circuit have recognized the divergent approaches regarding the viability of the fraud-created-the-market theory, but neither has endorsed or rejected the theory. In re Interbank Funding Corp. Sec. Litig., 629 F.3d 213, 219–20 (D.C. Cir. 2010); In re NationSmart Corp. Sec. Litig., 130 F.3d 309, 321 (8th Cir. 1997). The First and Fourth Circuits have yet to address the issue.
A. A Security’s Economic Marketability

Some courts of appeals have adopted the fraud-created-the-market theory when premised on economic unmarketability and used it to enable class certification. In *Abell v. Potomac Insurance Co.*, the Fifth Circuit presumed reliance because the defendants knew the enterprise itself was “patently worthless” and because the defendants had no plans to operate an actual business. These federal courts of appeals somewhat disagree over what it means to be patently worthless. The Fifth Circuit considers minimal assets sufficient to justify the presumption. The Tenth Circuit and Eleventh Circuit interpret “patently worthless” to mean that the securities have absolutely zero underlying assets or that the fraud goes to the very existence of the securities. Regardless of this difference, “economic marketability” is a high standard and misrepresentations or omissions cannot go to the possibility of some future event or a mere allegation that estimates fell below projections. Securities might be patently worthless, for example, if the fraud goes to the events that are vital to the ultimate success of a project or business that provided the basis for the offering.

Two other circuit courts of appeals have openly questioned the fraud-created-the-market presumption, but their reasoning suggests a misunderstanding of the theory. The Sixth Circuit, in *Ockerman v. May Zima & Co.*, refused to accept the theory for class certification because, according to the court, the market does not control the price of a newly issued security; public information is not incorporated into the price of a security on an inefficient market. The Seventh Circuit rejected the theory.

51. See Regents of Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 391 (5th Cir. 2007); Joseph v. Wiles, 223 F.3d 1155, 1165 (10th Cir. 2000); Ross, 885 F.2d at 729; Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122 (5th Cir. 1988); Finkel v. Docutel/Olivetti Corp., 817 F.2d 356, 364–65 (5th Cir. 1987).
52. 858 F.2d at 1121–22; see also Regents of Univ. of Cal., 482 F.3d at 391 n.36.
53. Abell, 858 F.2d at 1122.
54. Joseph, 223 F.3d at 1164; Ross, 885 F.2d at 731 n.16; see also Ockerman v. May Zima & Co., 27 F.3d 1151, 1160 (6th Cir. 1994). In Joseph, MiniScribe Corp. sold more than $97 million worth of convertible debentures in a public offering issued under a registration statement filed with the SEC. 223 F.3d at 1157. About two years after its offering, MiniScribe announced that it was restating its financial statements because of accounting irregularities. MiniScribe cooked its books by shipping bricks instead of product to warehouses, thus overstating revenues and earnings. The company reported that it had overstated its revenues and earnings for years and in fact had a negative net worth of $88 million. On appeal, the Tenth Circuit concluded that the investors were not entitled to the fraud-created-the-market presumption because the securities were economically marketable; although the business was seriously troubled, it was not illegitimate or a sham business entirely. Id. at 1164–65.
56. Id.
57. 27 F.3d at 1159. In *Freeman v. Laventhal & Horwath*, the Sixth Circuit specifically declined to address whether the fraud-created-the-market theory was valid. 915 F.2d 193, 199–200 (6th Cir. 1990). In *Freeman*, purchasers of tax-exempt municipal bonds used to finance the construction of a retirement center sued persons involved in the issue of the bonds, claiming that they withheld from the
in *Eckstein v. Balcor Film Investors*, stating that although full disclosure may lower the price, it does not exclude the securities from the market. According to the Seventh Circuit, therefore, “the linepin of *Shores*—that disclosing bad information keeps securities off the market, entitling investors to rely on the presence of the securities just as they would rely on statements in a prospectus—is simply false.”

If *Eckstein* is correct, however, that full disclosure of adverse information would in fact have lowered the price, then the fraud would be actionable under the fraud-on-the-market theory—by impounding information into price, the market is consequently informationally efficient and therefore can be relied upon. Even if *Eckstein* is wrong, the factors relied upon by *Ockerman*—(1) complete assimilation of information into a security’s market; and (2) price—are still irrelevant. The fraud-created-the-market theory focuses not on an intentionally altered or mispriced market price, but on the securities having a completely fraudulent price. Actual price is not critical in fraud-created-the-market cases as the markets are undeveloped and may not even have existed until soon before the

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58. 8 F.3d 1121, 1131 (7th Cir. 1993) (“Full disclosure of adverse information may lower the price, but it does not exclude the security from the market. Securities of bankrupt corporations trade freely; some markets specialize in penny stocks.”). In *Eckstein*, Balcor Film Investors (BFI) tried to raise $50 million in an initial public offering of limited partnership interests. When it failed to do so, it lowered the minimum solicitation requirement to $35 million, offered to refund initial investments, and began soliciting anew. The films the company invested in flopped, and about four years after its inception, BFI informed investors that they would likely lose some of their capital. The plaintiffs consisted of investors who had read the prospectus and those who had not. Those who had not read the prospectus asserted that they bought the partnership interests relying on the integrity of the securities offering process and that the IPO would not have gone forward without the misrepresentations and omissions by BFI.

59.  *Id*.


61.  *Dennin*, supra note 9, at 2639.

plaintiff bought the security.63 Price is usually set by an issuer and underwriter without reference to an existing market for the security.64

B. A Security’s Legal Marketability

The Tenth Circuit has adopted the fraud-created-the-market theory when premised on economic unmarketability and also when premised on legal unmarketability.65 In T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority, the court upheld the plaintiffs’ reliance on the presence of bonds in the market because the defendant failed to comply with numerous state laws and thus did not properly form a public trust.66 The Tenth Circuit stated that investors were entitled to rely on the market to provide minimum assurance that securities are legally qualified to be issued.67 No other circuit has adopted legal unmarketability. This branch of the fraud-created-the-market theory is largely criticized because gatekeepers, such as auditors, underwriters, and the SEC, do not vouch for the substantive value of any issue or the veracity of any of the representations by the issuer.68 The Seventh Circuit in Eckstein, for example, observed that the fraud-created-the-market theory when premised on legal unmarketability is incoherent because the existence of a security does not depend on the adequacy of disclosure, as securities can and do exist on the market even though there may be some incomplete disclosures associated with them.69

C. The Integrity of the Regulatory Process

The Ninth Circuit has interpreted the fraud-created-the-market theory most broadly. In Arthur Young & Co. v. District Court, the Ninth Circuit held that an investor relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies at the time the security is issued.70 Contrary to economic and legal unmarketability, the Ninth Circuit’s approach focuses

64. Id.
66. 717 F.2d at 1333.
67. Id.
69. Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1130–31 (7th Cir. 1993) (“The existence of a security does not depend on, or warrant, the adequacy of disclosure. Many a security is on the market even though the issuer or some third party made incomplete disclosures. Federal securities law does not include ‘merit regulation.’”).
70. 549 F.2d 686, 695 (9th Cir. 1977).
on the integrity of the regulatory process and is not dependent on compliance with applicable regulations. 71 No other court has accepted this approach. 72 Critics complain that reliance is unreasonable because regulatory bodies, such as the SEC, do not evaluate companies or perform due diligence on behalf of investors. 73

III. THE DEMISE OF THE FRAUD-CREATED-THE-MARKET PRESUMPTION OF RELIANCE

Stoneridge Investment Partners v. Scientific-Atlanta was the Supreme Court’s first decision to address reliance since Basic in 1988. 74 In Stoneridge the Court held that those who aid and abet securities fraud, such as lawyers, accountants, or third-party vendors, cannot be held liable under Section 10(b) and Rule 10b-5 absent a showing that the investors relied upon the defendants’ fraudulent conduct. 75 The Court reiterated the two reliance presumptions it created in Affiliated Ute for material omissions and in Basic for fraud-on-the-market cases, but concluded that neither presumption applied. 76 Although this boilerplate recital of the presumptions appears unimportant, this segment of the Court’s decision spurred the rejection of the fraud-created-the-market theory in some federal courts. 77

Because the Court delineated only two presumptions, the logic goes, only two are intended. The decision was also couched in charged language, with the Court making specific mention that expanding the scope of 10b-5 liability might deter overseas firms from doing business in the United States, and thus raising the cost of being a publicly traded company. 78 The

71. Id.
72. Dennin, supra note 9, at 2636–37.
73. See, e.g., Joseph v. Wiles, 223 F.3d 1155, 1165 (10th Cir. 2000).
75. Id. at 153.
76. Id. at 159.
federal courts used this general hostility to put the kibosh on the fraud-created-the-market theory.

A. Stoneridge and “Chary” Application of the Theory

Recently, the Ninth Circuit allowed a district court to reject the fraud-created-the-market theory, relying on Stoneridge’s policy that the 10b-5 action should not be extended and its statement that there are two presumptions as evidence that only two exist. In Desai v. Deutsche Bank Securities, Ltd., the plaintiffs alleged that Deutsche Bank and a vice president artificially inflated a company’s stock price by using securities loans to keep the price artificially high. The plaintiffs alleged that officers of the company issued themselves unregistered, privately held shares, then exchanged those shares to a broker-dealer for cash collateral and paid that broker-dealer a rebate payment, which is like interest. The officers then used the cash to buy the company’s publicly traded shares, which created the appearance of investor demand and inflated the stock price. Deutsche Bank developed a chain of broker-dealers to generate rebate payments in this way. But once the broker-dealers started demanding their cash collateral back, the company’s stock price collapsed.

Investors sued under Section 10(b) and Rule 10b-5(a) and (c), claiming that Deutsche Bank engaged in manipulative conduct and omitted material information. They moved to certify a class arguing that the court could presume that the investors relied on the integrity of the market. The investors insisted that the market efficiency was irrelevant because they saying “[i]nvestors sidelined with decimated 401(k)s will be unwilling to again risk their capital if Wall Street’s cop-on-the-beat increasingly comes to be seen by the public as a cop-on-furlough”).


80. Desai, 573 F.3d at 934. Securities lending is a method of finance in which securities are temporarily transferred from a lender to a borrower. The borrower must return the securities to the lender (either on demand or some other agreed upon date). Most securities loans are made against collateral, such as cash, to protect the lender if the borrower defaults. FRANK J. FABOZZI & STEVEN V. MANN, SECURITIES FINANCE: SECURITIES LENDING AND REPURCHASE AGREEMENTS 3–8, 17 (2005). “In the typical securities loan, a broker-dealer lends securities to another broker-dealer, the loan being secured by cash collateral . . . .” Desai, 573 F.3d at 934. The broker-dealer who borrows the securities receives rebate payments, which are like interest on the cash collateral transferred to secure the loan. “As the value of the security increases, the amount of cash collateral and the level of interest also increase.” Id. These securities loans can manipulate the market of a security by creating the illusion of more investor interest than really exists.

81. An employee of the broker-dealer would falsify records to make it look like the shares had come from other broker-dealers rather than the GENI officers themselves. Desai, 573 F.3d at 934.

82. Id. at 934–35.

83. Id.

84. Id. at 935.

85. Id. at 937–38.
alleged that the defendants manipulated the market and not that they made a misrepresentation or omissions; in a market-manipulation claim the integrity of the market is what is being attacked. The district court denied the motion and held that the theory was logically flawed because the inference of reliance is broken if the market price of a security does not reflect the manipulative activity. On appeal, the plaintiffs asked the court to recognize the fraud-created-the-market theory and reverse the district court.

The Ninth Circuit held that the district court was not required to endorse the presumption because Stoneridge stated that the 10b-5 action was not to be extended and Stoneridge named only two presumptions of reliance, meaning that only two are intended. Ultimately, the Ninth Circuit, although “chary” of the theory, avoided deciding whether the fraud-created-the-market theory was sound and simply concluded that the district court did not abuse its discretion.

In concurrence, Judge O’Scannlain faulted the majority for avoiding the question and concluded that the presumption was legally unsupported and logically inadvisable. Although most investors generally assume that the markets are not corrupt, the concurrence began, to presume reliance on this basis alone would obviate the need to prove reliance in any case. The concurrence was concerned that the theory would presume reliance no matter how unlikely it is that the market price actually reflected the alleged manipulation.

87. Id. at *8, *15.
88. Desai, 573 F.3d at 942.
89. The court said:
   In Stoneridge, the Court listed the Affiliated Ute presumption and the fraud on the market presumption as the two reliance presumptions it has recognized. After concluding that “[n]either presumption appl[ied],” it did not inquire into any other presumption that seemed appropriate, but simply analyzed whether the plaintiffs could prove reliance directly. These passages may not forbid the recognition of new presumptions, but they do illustrate that the district court did not have to recognize this one.

Id. (alteration in original and citations omitted).
90. Id.
91. Judge O’Scannlain wrote:
   [T]o reach the integrity of the market presumption on its merits is not a matter of choice . . . . Where the district court ‘based its ruling on an erroneous view of the law,’ then it ‘necessarily abuse[d] its discretion.’ . . . I would address the integrity of the market presumption on the merits. In my view, the presumption is legally unsupported and logically inadvisable.

Id. at 943 (O’Scannlain, J., concurring) (second alteration in original and quoting Cooter & Gell v. Hartmarx Corp., 496 U.S. 384, 405 (1990)).
92. Id. at 944 (O’Scannlain, J., concurring).
93. Id. at 945 (O’Scannlain, J., concurring) (stating that the presumption would “[p]rove too much, because it would obviate the need for plaintiffs in manipulative conduct cases to prove reliance;
B. Stoneridge as a Catalyst to Impugn the Theory Entirely

The Third Circuit’s decision in *Malack v. BDO Seidman, LLP* is the most full-throated rejection of the fraud-created-the-market presumption of reliance since *Eckstein* and *Ockerman*. The Third Circuit’s decision in *Malack v. BDO Seidman, LLP* is the most full-throated rejection of the fraud-created-the-market presumption of reliance since *Eckstein* and *Ockerman*. In *Malack*, an investor bought nontransferable notes with no market for resale issued by American Business Financial Services, Inc., a subprime-mortgage originator that services primarily credit-impaired or subprime buyers. During the subprime mortgage meltdown, the notes were rendered worthless, and ABFS filed for bankruptcy. The investor sued ABFS’s accountant, BDO Seidman, who provided clean audit opinions used to register the notes with the SEC, and sought to certify a class of similar purchasers.

The investor argued that without the clean audits provided by BDO Seidman, ABFS would have been unable to register the notes with the SEC and the notes would have been unmarketable, and thus never bought. The registration statements, according to the investor, failed to disclose that ABFS had weak internal accounting controls and erroneously informed investors that ABFS expected to pay back the notes with interest, but the representations lacked a reasonable basis because ABFS’s loan portfolio was of poor quality, the value of its servicing agreements was materially less than reported, and it overestimated assets and operating results. But several investors admitted that they did not read the audits or the registration statements before buying ABFS notes. Without a class-wide

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96. *Id.*, 617 F.3d at 744–45.

97. *Id.* at 744.

98. *Id.* at 745.

99. *Malack*, 2009 WL 2393933, at *2. For example, the plaintiffs claimed that ABFS altered its loan delinquency ratio by labeling loans as delinquent only after sixty or ninety days passed, rather than the required thirty days and engaging in aging techniques such as forbearance and deferment, thereby improperly lowering the number of loans reported as delinquent. *Id.*

100. *Id.* at *5.
presumption of reliance afforded by the fraud-created-the-market theory, the proposed investor-class could not show that common issues of reliance predominated. The district court concluded that the investors failed to show that the notes were unmarketable and denied class certification.

On appeal, the Third Circuit rejected the fraud-created-the-market theory. The court said that an investor’s reliance on a security’s availability on the market as an indication of its apparent genuineness was unreasonable, and that “unmarketability” was an unworkable standard. The court also opined that the theory lacked any basis in fairness, public policy, or probability. First, the court turned to probability—whether the proof of one fact renders the inference of the existence of another fact so probable that courts save time by assuming the truth of the other fact until the adversary disproves it. The Third Circuit said that reliance was unreasonable because the entities responsible for bringing a security to market do not imbue the security with any guarantee against fraud. According to the court, promoters, underwriters, auditors, and lawyers cannot be relied upon to prevent fraud because all have a significant self-interest in marketing the securities at the highest possible price. With respect to the SEC, the court continued, the agency does not review the merits of a registration statement or offering, and ergo cannot be relied upon. The Third Circuit also repeated Eckstein’s oft-quoted language that although disclosure of adverse information may lower the price, it would not prevent the security from going to the market. (In this regard, the Third Circuit repeats Eckstein’s error: if disclosure would have affected the price, it cannot be differentiated from the fraud-on-the-market theory.)

Second, the court asked whether the presumption furthered any sound policy. The court was concerned that adoption of the fraud-created-the-market theory would encourage investors to forego reading disclosure

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101. Malack, 617 F.3d at 745.
104. Malack, 617 F.3d at 749.
105. Id. at 749.
106. Id. Though the court framed its inquiry in terms of “common sense” as well as probability, the inquiry is essentially the same: whether the proof of fact A renders the inference of fact B more probable.
107. Id. at 749–50.
108. Id.
109. Id. at 750–51.
110. Id.
documents because no matter what, the security’s presence on the market would be enough to satisfy the element of reasonable reliance.\textsuperscript{111}

The court also found support for rejecting the theory in Stoneridge. According to the court, Stoneridge and Central Bank evidence a general intent to narrow the scope of Section 10(b) liability.\textsuperscript{112} The court pointed to the Private Securities Litigation Reform Act of 1995 (PSLRA) as evidence that Congress wants to end costly securities lawsuits.\textsuperscript{113} With respect to a new presumption of reliance in particular, the court was worried that a presumption of reliance would be too powerful a tool for investors seeking class certification.\textsuperscript{114} Class certification, the court stated, unduly pressures defendants to settle frivolous claims.\textsuperscript{115}

IV. THE SUPREME COURT AND THE FRAUD-CREATED-THE-MARKET THEORY

The fraud-created-the-market theory must be consistent with the Supreme Court’s securities fraud jurisprudence.\textsuperscript{116} Several federal courts, including the Third and Ninth Circuits, have concluded that the theory is inconsistent with Stoneridge or at least that the decision casts doubt on its continued viability.\textsuperscript{117} Other critics contend that the theory is inconsistent with the fraud-on-the-market theory as adopted in Basic or the general requirement of reliance.\textsuperscript{118} These critics read too much into Stoneridge and too little into the Court’s other securities-fraud decisions. As these next Parts show, the recent rejection of the theory is unwarranted. The fraud-created-the-market theory is consistent with the Court’s precedent

\textsuperscript{111} Id. at 753.
\textsuperscript{112} Id. at 753–54. “Although the Stoneridge Court was not specifically considering the fraud-created-the-market theory, we view its instruction as general support for rejecting such new presumptions of reliance.” Id. at 754.
\textsuperscript{113} Id.
\textsuperscript{114} Id. at 755.
\textsuperscript{115} Id.
\textsuperscript{116} See, e.g., Rodriguez de Quijias v. Shearson/Am. Express, Inc., 490 U.S. 477, 484 (1989) (“If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions.”).
\textsuperscript{118} See Malack, 617 F.3d at 750–51; Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1130–31 (7th Cir. 1993) (criticizing the fraud-created-the-market doctrine as inconsistent with the efficient-market theory); Levine v. Prudential Bache Props., Inc., 855 F. Supp. 924, 932–33 (N.D. Ill. 1994); see also Julie A. Herzog, Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5, 63 GEO. WASH. L. REV. 359, 374–75, 388–91 (1995); Macey & Miller, supra note 46, at 1060 n.5.
generally, and with Stoneridge in particular. The hallmark for liability under 10b-5 is materiality, thus obviating the need to show reliance in many cases. Furthermore, the Court has interpreted reliance consistent with this materiality-focused bent specifically to achieve class-wide resolution of securities fraud claims. Further, Stoneridge despite appearances, has nothing to do with reliance, but rather a defendant’s duty under the securities laws.

A. The “Material” Essence of Liability Under Rule 10b-5

The 10b-5 action evolved to remedy the shortcomings of common-law fraud for injured investors. The Supreme Court and the federal appellate courts have largely reduced liability under Rule 10b-5 to a single question of materiality, by which we mean whether a material misstatement or omission creates a negative disparity between the price at which the plaintiff trades a security and its real value at the time of the transaction. The six traditional elements of securities fraud are listed as: (1) a material misrepresentation or omission; (2) scienter, or a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. Each element dovetails into the materiality inquiry.

First, investors can show that the fraud was in connection with the purchase or sale of a security by showing that the defendant’s conduct created a price–value disparity. Second, investors can show that the

119. See supra Part IV.A.
120. See supra Part IV.A–B.
121. See supra Part IV.C.
122. Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 173 (2008) (Stevens, J., dissenting); Basic Inc. v. Levinson, 485 U.S. 224, 244 n.22 (1988); Herman & MacLean v. Huddleston, 459 U.S. 375, 388–89 (1983); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744–45 (1975) (“[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable.”).
125. In Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12–13 (1971), the Supreme Court held that Rule 10b-5 requires only that the fraud “touch” the sale or purchase of a security, and in proving that conduct “touched” the transaction, showing that the conduct created a disparity between the transaction price and the value of the security is always sufficient. Kaufman, Living in a Material World, supra note 123, at 6–7.
defendant acted with scienter by showing some degree of recklessness, which courts have taken to mean that the defendant knew or should have known about a material misstatement’s or omission’s likely effect on the stock price. The “core operations” inference of scienter makes the connection between scienter and materiality clear. Under the core operations inference, courts presume scienter because a fact is so critical to a business’s core operations or so important generally, that it would be absurd to suggest that key officers lacked knowledge of it. Third, loss causation likewise depends on plaintiffs showing that fraud proximately caused “economic loss,” which has been interpreted to mean “market impact,” i.e., a post-transaction decline in stock price.

Most important for the fraud-created-the-market presumption, the Supreme Court deviated from the common-law requirement of actual reliance and presumed reliance when either fraud occurred on the
secondary market under Basic,\textsuperscript{131} or in the case of a material omission in the face of a duty to disclose under Affiliated Ute.\textsuperscript{132} Abrogating direct proof of reliance in the context of new issues is consistent with the displacement of many of the common-law elements of securities fraud in favor of an analysis focused on materiality. Adopting the fraud-created-the-market presumption eliminates positive proof of reliance and simplifies Rule 10b-5 by discarding the need for investors to classify the defendant’s fraud as involving an omission, half-truth, or misrepresentation, which is often a difficult task.\textsuperscript{133} And materiality is the upshot of Shores and the fraud-created-the-market theory: the fraud-created-the-market theory posits that the misrepresentation was so material that if it had been known, then the securities never would have made it to market.\textsuperscript{134}

\textbf{B. Pragmatic and Normative Presumptions of Reliance}

The Supreme Court’s presumptions of reliance are grounded in pragmatic concerns to enable class certification and promote normative reliance. The fraud-created-the-market presumption is consistent with both these aims. To begin, take Affiliated Ute, which established a rebuttable presumption in cases involving omissions under Rule 10b-5.\textsuperscript{135} Originally it

\begin{itemize}
  \item Grzebielski, supra note 123, at 349; see also In re Interbank Funding Corp. Sec. Litig., 668 F. Supp. 2d 44, 50 (D.D.C. 2009) (discussing the difficulty of distinguishing between omissions and misrepresentations).
  \item Ross v. Bank S., N.A., 885 F.2d 723, 729 (11th Cir. 1989) (“[T]he fraud must be so pervasive that it goes to the very existence of the bonds and the validity of their presence on the market.”); see also Kaufman, Living in a Material World, supra note 123, at 47–48. Basic’s accepted materiality/cause/fixation substitute for reliance provides strong support for the fraud-created-the-market theory. Bromberg & Lowenfels, supra note 32, § 7:485.
  \item In Affiliated Ute, the Supreme Court presumed reliance on a defendant’s misrepresentations rather than requiring proof of actual reliance. 406 U.S. at 153–54. The plaintiffs, two mixed-blood members of the Ute Indian tribe, sold securities to bank employees who later resold the stock at a higher price in the secondary market without disclosing that the securities were being traded in the secondary market at a higher price. \textit{Id.} at 135–39, 145–48. The plaintiffs sued and claimed that the bank employees violated Rule 10b-5(a) and (c)—which prohibits fraud in the course of business or through a device, scheme, or artifice—because the defendants failed to disclose material information to the persons for whom they traded stock. \textit{Id.} at 145–46. The Tenth Circuit concluded that the plaintiffs could not recover because they failed to show that they actually relied on any material misrepresentations by the defendants. Reyos v. United States, 431 F.2d 1337, 1348 (10th Cir. 1970). The Court rejected the Tenth Circuit’s decision and presumed that the investors relied on the omitted information. Affiliated Ute, 406 U.S. at 153–54.

As an aside, defendants may rebut this presumption by showing that regardless of the disclosure of the material information, the investor still would have invested. \textit{See, e.g.,} Regents of Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 383 (5th Cir. 2007). For example, if the case involves a defendant’s failure to disclose a material fact in offering materials, then the defendant may show that
was thought that the Court’s abrogation of reliance in *Affiliated Ute* applied to all Rule 10b-5 actions. But later decisions clarified that reliance is presumed only if the defendant omits material facts while under a duty to disclose. The Court interpreted reliance flexibly. The presumption reflects the Court’s concern that practically speaking, to saddle a plaintiff with proving reliance upon concealed information would saddle the plaintiff with a nearly impossible burden. By presuming reliance, *Affiliated Ute* departed from the common law’s requirement of actual reliance and emphasized that the focus in a failure-to-disclose case is on the materiality of the omitted information. The Court’s holding in this regard echoed its earlier holding in *Mills v. Electric Auto-Lite Co.*, in which it recognized that proof of actual reliance by thousands of persons would not be feasible and that nondisclosure of a fact is a particularly difficult matter to define or prove. The federal courts have echoed this interpretation and observed that *Affiliated Ute* is an indication “that the securities laws do not use ‘reliance’ in the lay sense, [and] that only the conjunction of materiality and causation matters.”

As now understood, *Affiliated Ute* established a narrow presumption that applies only to a defendant’s failure to disclose material information in the face of a duty to disclose. But the Supreme Court adopted a much broader presumption of reliance in *Basic Inc. v. Levinson*. In *Basic*, the plaintiff never read the offering materials and therefore did not rely upon them. 3 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.10[1] (5th ed. 2005).

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137. *Affiliated Ute*, 406 U.S. at 153–54. In cases where the plaintiff alleges both a material omission and an affirmative misrepresentation, if the gravamen of the fraud is a failure to disclose material information, then the court will presume reliance. See Smith v. Ayres, 845 F.2d 1360, 1363 (5th Cir. 1988). The omission need not occur face to face. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238, 240 (2d Cir. 1974); *In re Intelligroup Sec. Litig.*, 527 F. Supp. 2d 262, 374 (D.N.J. 2007).
138. *Affiliated Ute*, 406 U.S. at 151, 153–54; see Steven A. Fishman, *Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. CORP. L. 251, 305 (1987) (“Without the presumption, the plaintiff in a nondisclosure case would be required to prove what he would have done in the event that the undisclosed material information had been disclosed. This burden would be a very difficult one to meet.”); A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform, 2008 CATO SUP. CT. REV. 217, 220 (2008) (“[I]t was obviously impossible for the plaintiffs to plead actual reliance because the violation was a failure to speak, rather than a misstatement . . . .”)
141. Eckstein v. Balcor Film Investors, 58 F.3d 1162, 1171 (7th Cir. 1995); see also Latigo Ventures v. Laventhal & Horwath, 876 F.2d 1322, 1326 (7th Cir. 1989); Harris v. Union Elec. Co., 787 F.2d 355, 366 (9th Cir. 1986); Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 529 (7th Cir. 1985); Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 92 n.6 (2d Cir. 1981).
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Court held that plaintiffs were entitled to a presumption of reliance under Rule 10b-5(b) if the defendant makes a material misstatement in an efficient market—the fraud-on-the-market theory. The Court’s analysis shows that it superseded reliance as an element in favor of materiality out of considerations of fairness, public policy, and probability.

First, the Court stated that reliance is essential to recover under Rule 10b-5. Professor Langevoort notes that this starting point is significant: “the Court could have said that causation was the only requirement,” and that reliance is just one way to show the causal connection between the harm and the fraud; if the Court took this route, then the decision would have been straightforward. But once the Court made reliance essential, Langevoort explains, the Court had to explain how a typical investor relies on a corporate misrepresentation of which one is likely unaware and why that kind of reliance is so pervasive that it can be deemed common among all purchasers or sellers of securities to justify class treatment under Rule 23. To that end, Basic adopted the fraud-on-the-market presumption of reliance for securities traded on efficient markets. The Court’s solution was pragmatic—“presumptions make judges’ work manageable, are useful responses to uncertainty, and help pursue sound public policy.” Courts could presume that an investor relies generally on the assumption that the market price is validly set and that no unsuspected manipulation has artificially inflated that price. The fraud-on-the-market theory allows a

that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations.” 524 F.2d 891, 907 (9th Cir. 1975).

144. Basic, 485 U.S. at 247. Basic was interesting in that the segment of the decision that adopted the fraud-on-the-market presumption of reliance was a 4-2 decision, from which Justices O’Connor and White dissented. Justices Rehnquist, Scalia, and Kennedy took no part in the decision. But in Erica P. John Fund Inc. v. Halliburton Co., 131 S. Ct. 856 (2011), the full Court reaffirmed the fraud-on-the-market theory and its presumption of reliance for securities fraud class actions.


146. Langevoort, Basic at Twenty, supra note 23, at 157. Reliance is not an element of enforcement actions by the SEC. See, e.g., SEC v. Wolfson, 539 F.3d 1249, 1256 (10th Cir. 2008).

147. Langevoort, Basic at Twenty, supra note 23, at 158. To certify a class action under Rule 23 investors must show that common issues predominate. See Fed. R. Civ. P. 23(b)(3).


149. Langevoort, Basic at Twenty, supra note 23, at 158.

150. Basic, 485 U.S. at 245–46; Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975). Defendants may rebut the presumption by, among other ways, showing that the investors would have bought or sold regardless of what was known about the issuer or the stock. Basic, 485 U.S. at 248. The fraud-on-the-market presumption is rebuttable at trial. Basic, 485 U.S. at 248–49 n.29. When a defendant may rebut the fraud-on-the-market presumption has recently divided the federal courts of appeals despite this clear indication from the Supreme Court and resulted in unjustified merits inquiries when plaintiffs attempt to certify a class action. See Conn. Ret. Plans & Trust Funds v. Amgen, Inc., No. 09-56965, 2011 WL 5341285 (9th Cir. Nov. 8, 2011) (discussing the circuit split).
court to certify a class of injured investors by presuming reliance even though there may be different levels of reliance among its members.151

The Supreme Court justified the presumption of reliance first by relying on the efficient-market hypothesis. The efficient-market hypothesis posits that in an efficient market, stock prices fully reflect all available information.152 Too much uncertainty is inherent in economic life, however, to contend that markets always prove correct.153 Accordingly, the central claim of the efficient-market hypothesis is that “consensus valuation of an efficient market will be the best possible, least biased measure of value at any given time.”154 Professor Eugene Fama has distinguished three forms of the efficient-market hypothesis: strong, semi-strong, and weak.155

The weak version posits that prices incorporate information in a way that prevents only the historical pattern of prices from being used to predict changes in price—in other words, the price history of a security provides no useful information to the investor, and only someone with new information can make a trading profit.156 The semi-strong version contends that publicly released information, such as information contained in SEC filings, provides no useful information to the investor—the investor can ignore new information and rely solely on prices.157 Last, the strong version hypothesizes that even nonpublic information is reflected in price—prices set in this way accurately reflect the firm’s value.158 The fraud-on-the-market doctrine rests on the semi-strong form: public statements are impounded in the stock price.159

A presumption based on the efficient-market hypothesis is problematic, though, because for every investor who passively relies upon just the price,

151. Dennin, supra note 9, at 2621.
152. The efficient-market hypothesis posits “that available information about securities traded in the principal securities markets is impounded into stock prices with sufficient speed that even sophisticated investors cannot systematically profit by trading on newly available information.” COFFEE, JR., ET AL., supra note 32, at 213. The court in Cammer v. Bloom, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989), identified five factors that prove useful in proving that a security was traded in an efficient market: (1) a large weekly trading volume; (2) the existence of a significant number of reports by securities analysts; (3) the existence of market makers and arbitrageurs in the security; (4) the eligibility of the company to file an S-4 Registration Statement; and (5) a history of immediate movement of the stock price caused by unexpected corporate events or financial releases.
153. COFFEE, JR., ET AL., supra note 32, at 214.
154. Id.
156. COFFEE, JR., ET AL., supra note 32, at 214; see Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010); In re PolyMedica Corp. Sec. Litig., 432 F.3d 1, 10 n.16 (1st Cir. 2005).
158. COFFEE, JR., ET AL., supra note 32, at 214.
159. Schleicher, 618 F.3d at 685; Oscar Private Equity Invs. v. Allegiance Telecomm., Inc., 487 F.3d 261, 269 (5th Cir. 2007); In re PolyMedica Corp. Sec. Litig., 432 F.3d at 10 n.16.
millions of others rely on their broker or adviser.\textsuperscript{160} So passivity as a basis for the presumption “is a hopeless fiction,” and thus, the failure to exclude the investors with actively managed portfolios implies overcompensation.\textsuperscript{161}

To remedy this problem, Langevoort continues, Basic justified the presumption of reliance on more than the efficient-market hypothesis alone; the Supreme Court also said that investors rely on a security’s integrity—implicitly assuming that the price has not been distorted by fraud—as well as its price.\textsuperscript{162} By resting the presumption on the idea that investors considered the market price to be honest, Langevoort observes, the problem of over-breadth within the class diminishes.\textsuperscript{163} This justification is problematic as well, however, in that no reasonable investor assumes that fraud and manipulation are completely absent from the stock market.\textsuperscript{164} Yet to the extent the presumption is normative—“a declaration that investors should be able to rely on stock-price integrity,” and purely a matter of “juristic grace”—the presumption is consistent with congressional intent underlying the securities laws.\textsuperscript{165}

Additionally, Basic was the apex of a series of decisions in which the Supreme Court interpreted the substantive elements of securities fraud to facilitate their class-wide resolution.\textsuperscript{166} The Court first adopted a presumption of reliance in Mills v. Electric Auto-Lite Co., for private Rule 14a-9 claims.\textsuperscript{167} Then, in Affiliated Ute, the Court adopted a presumption of reliance in Rule 10b-5 claims.\textsuperscript{168} And finally, in TSC Industries, Inc. v. Northway, Inc., the Court adopted an objective approach to materiality to make classwide adjudications possible.\textsuperscript{169}

The fraud-on-the-market theory in Basic is a practical response to the problem of producing proof in impersonal markets and to satisfying the requirements for class certification. The presumption remedies the conundrum of how investors could have been defrauded by information

\textsuperscript{160} Langevoort, Basic at Twenty, supra note 23, at 159.
\textsuperscript{161} Id.; Donald C. Langevoort, Reading Stoneridge Carefully: A Duty-Based Approach to Reliance and Third-Party Liability Under Rule 10b-5, 158 U. Pa. L. Rev. 2125, 2139 (2010). Professor Langevoort also notes that “[m]ore troubling . . . the class of investors invited to seek recovery, and thus the amount of recovery, would be grossly inflated.” Langevoort, Basic at Twenty, supra note 23, at 159.
\textsuperscript{162} Langevoort, Basic at Twenty, supra note 23, at 159–60.
\textsuperscript{163} Langevoort, Reading Stoneridge Carefully, supra note 161, at 2140.
\textsuperscript{164} Langevoort, Basic at Twenty, supra note 23, at 160; Langevoort, Reading Stoneridge Carefully, supra note 161, at 2140.
\textsuperscript{165} Langevoort, Basic at Twenty, supra note 23, at 160–61.
\textsuperscript{168} 406 U.S. 128, 150–54 (1972).
\textsuperscript{169} 426 U.S. 438, 449 (1976).
they never heard, read, or understood if they did. Presuming reliance from a single fraud on the market means that issues of reliance common to the proposed class predominate, as required under Rule 23. Similar to Affiliated Ute, Basic supplants reliance as an independent element and allows the market price to transmit both information and cause the loss. Basic holds that a court “need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.” The fraud-on-the-market presumption is appropriately best understood as an entitlement to rely on the market price as undistorted by fraud.

C. Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: Reliance or Duty?

The Supreme Court’s decision in Stoneridge Investment Partners v. Scientific-Atlanta, was its first decision since Basic to seemingly address reliance. In actuality, however, Stoneridge deals only with a defendant’s duty under the securities laws. As Professor Langevoort explains, Stoneridge is best understood in terms, not of reliance, but of duty—as


171. Schleicher v. Wendt, 618 F.3d 679, 682 (7th Cir. 2010); see Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1218 (1st Cir. 1996) (stating that Basic obviates plaintiffs’ need to prove individualized reliance); Flamm v. Eberstadt, 814 F.2d 1169, 1173 (7th Cir. 1987) (observing that reliance is just a code word for causation); see also Kaufman, Living in a Material World, supra note 123, at 30 (stating that despite Basic’s assertion that reliance is an element of Rule 10b-5 liability, Basic’s explanation of reliance effectively removes it as an element in most Rule 10b-5 cases).


173. See Langevoort, Basic at Twenty, supra note 23, at 176. Langevoort ultimately concludes that:

To the extent that we continue to insist on reliance—an insistence that Stoneridge repeats—overcompensation comes from allowing recovery as a result of the practical impediments that effectively make the presumption conclusive by those who simply would not be able to demonstrate justifiable reliance on the fraud if put to the task.

Langevoort, Reading Stoneridge Carefully, supra note 161, at 2140.

174. The decision is generally understood as delineating the scope of reliance as an element of securities fraud. See, e.g., Black, supra note 131, at 334.

175. Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 159 (2008). Stoneridge was the Court’s follow-up to Central Bank. In Central Bank, the Court held that Section 10(b) did not extend to aiding and abetting, rather only a “primary violator” could be liable under the securities laws. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177 (2004). The Court’s decision in Central Bank is notable in that the Court on its own motion determined that aiding and abetting liability was unavailable; the issue was not presented by the parties to the Court. Charles W. Murdock, Corporate Corruption and the Complicity of Congress and the Supreme Court—The Tortuous Path from Central Bank to Stoneridge Investment Partners, 6 Berkeley Bus. L.J. 131, 163, 203 (2009). Indeed, before Central Bank, all federal courts of appeals had recognized a private cause of action against aiders and abettors under Rule 10b-5. Id. at 163, 203.
saying that only certain kinds of actors and conduct ought to be subjected to the extraordinary risk of a fraud-on-the-market lawsuit—i.e., that the enforceable duty of candor owed specifically to all investors in the capital marketplace should be limited and should not attach to “the whole marketplace in which the issuing company does business” unless the actors can fairly be said to owe a cognizable duty to the marketplace. \(^{176}\)

In *Stoneridge*, investors sued two of their company’s vendors, Scientific-Atlanta and Motorola, alleging that they agreed to swap advertising for inflated prices on cable boxes. \(^{177}\) Even though the advertising was essentially free to the vendors, the company reported revenue in its earnings reports. \(^{178}\) To hide the swap from the company’s auditor, the company and the vendors backdated documents and represented the sales as cable-box sales. \(^{179}\) The investors alleged that even though the vendors had nothing to do with the company’s false earnings reports, the vendors engaged in a deceptive scheme in violation of Rule 10b-5. \(^{180}\) The Supreme Court concluded that the investors did not rely on the vendors’ actions, and thus could not maintain a suit under Rule 10b-5. \(^{181}\)

It is significant that the Court framed its decision in terms of reliance, and that it reiterated the presumptions it applied in *Affiliated Ute* for material omissions and *Basic* for fraud-on-the-market cases, but concluded that neither presumption applied. \(^{182}\) First, federal courts took *Stoneridge*’s recitation of the two presumptions of reliance under Rule 10b-5 to mean that there can be only these two. This expressio unius logic does not apply,

\(^{176}\) Langevoort, *Reading Stoneridge Carefully*, supra note 161, at 2137 (quoting *Stoneridge*, 552 U.S. at 160). Professor Langevoort’s thesis has been implicitly recognized by other scholars. For example, Professor Roberta S. Karmel states that:

> 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.

Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25, 49 (2007). Professor Charles W. Murdock also implicitly recognizes that *Stoneridge* is best understood in terms of duty, but criticizes this approach as “nonsensical to constrain the application of the securities laws by common law notions of ‘duty,’ when the securities laws were enacted because inadequacies in the scope of responsibility under the common law.” Murdock, *supra* note 175, at 205.

\(^{177}\) *Stoneridge*, 552 U.S. at 154.

\(^{178}\) *Id.* at 154–55.

\(^{179}\) *Id.* at 154.

\(^{180}\) *Id.* at 154–55.

\(^{181}\) *Id.* at 166–67.

\(^{182}\) *Id.* at 159.
however, if context suggests that the listing is noncomprehensive.\textsuperscript{183} Frankly, the fraud-created-the-market theory was not on the Court’s radar.\textsuperscript{184} But in any event, \textit{Stoneridge} is not about reliance and, as a consequence, has no bearing on the fraud-created-the-market theory.\textsuperscript{185} The federal courts inappropriately converted a descriptive statement into a normative one.

Second, by framing the holding in terms of reliance, \textit{Stoneridge} forces us to confront the tension between its holding that secondary actors cannot be liable if their deceptive acts are not disclosed to the public (and thus were not relied upon), and the Court’s statement that conduct itself can be deceptive and therefore satisfy Rule 10b-5.\textsuperscript{186} \textit{Stoneridge} involved a classic case of indirect reliance: the investors alleged that the vendors directly misled Charter’s auditor, which in turn led the auditor to certify false financials, which then distorted Charter’s market price.\textsuperscript{187} “The notion that the plaintiffs had not relied on [the vendors’] misrepresentations because the plaintiffs had not seen those misrepresentations seems inconsistent with the indirect reliance inherent in the fraud on the market theory adopted by the Supreme Court in Basic Inc. v. Levinson.”\textsuperscript{188} Rather, to distinguish the indirect reliance at issue in \textit{Stoneridge}, the Court insisted that the investors’ reliance upon the vendors’ actions was an indirect chain that was too “remote” and attenuated for liability to attach.\textsuperscript{189} Thus, \textit{Stoneridge} does not build on reliance as explained in \textit{Affiliated Ute} or \textit{Basic}.\textsuperscript{190} It’s a different animal altogether.

\begin{thebibliography}{99}
\bibitem{187}Langevoort, \textit{Reading Stoneridge Carefully}, supra note 161, at 2133.
\bibitem{189}\textit{Stoneridge}, 552 U.S. at 159–60.
\bibitem{190}See Pritchard, supra note 138, at 241. Professor Robert A. Prentice persuasively argues that \textit{Stoneridge} even left open whether scheme liability is valid, the exact issue the Court set out to resolve. Robert A. Prentice, \textit{Scheme Liability: Does it Have a Future After Stoneridge?}, 2009 Wis. L. REV. 351, 394 (2009).
\end{thebibliography}
Once *Stoneridge* is framed in terms of duty rather than reliance, according to Langevoort, the Court’s discussion of “attenuation” and “remoteness,” and the rules surrounding secondary-actor liability make sense: *Stoneridge*’s discussion of “attenuation” and “remoteness” in terms of reliance is premised “on the assumption that too much attenuation or remoteness makes it unfair to hold the third party liable for extraordinary fraud-on-the-market damages.”

Reading *Stoneridge* in this fashion, Professor Langevoort derives five duty-based rules in fraud-on-the-market cases, several of which exemplify the propriety of the fraud-created-the-market theory.

First, a third party owes a duty to an investor if that third party identifies itself, or allows itself to be identified, in a manner that would lead a reasonable investor to believe that the third party was assuming responsibility for the accuracy of the public communication by the primary violator. This rule explains the vein of cases that require “attribution”—that public misstatements be attributed to the third party at the time of dissemination—in order for an investor to be said to rely on the third party. Second, a third party owes a duty to an investor via a fiduciary relationship. This situation would impose liability upon corporate officers, directors, and other agents (all fiduciaries), to their own investors.

Third, a third party owes a duty to an investor if the third party enjoys a professional status or expertise in the world of finance such that the third party appreciates both the regulatory constraints and the economic harm that would flow from misinformation spread into the investment marketplace. The Court in *Stoneridge* stressed that the vendors were dealing with the company in “the realm of ordinary business” operations as opposed to the realm of finance. But, as Langevoort observes, this

192. In *Janus Capital Grp., Inc. v. First Derivative Traders*, the Supreme Court greatly narrowed the scope of 10b-5 liability and held that only “the maker of a statement” may be liable under Rule 10b-5, and that a maker “is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” 131 S. Ct. 2296, 2302 (2011). The Court’s holding may throw water on several of Professor Langevoort’s five rules.
193. Langevoort, *Reading Stoneridge Carefully*, supra note 161, at 2154; see also Black, supra note 131, at 335 (“First, the public must have knowledge of the conduct that was deceptive, not knowledge of the deception (since the latter would destroy reliance). Second, the defendant must be publicly identified as a participant in the conduct.”).
194. See *Affco Invs. 2001, LLC v. Proskauer Rose, LLP*, 625 F.3d 185, 194 (5th Cir. 2010); *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 121–24 (4th Cir. 2009).
196. Id. at 2154–55.
distinction is incoherent as accounting and financial reports are nothing more than the quantitative expression of the results of business operations, and indeed, the SEC could pursue a cause of action against the vendors.\textsuperscript{198} Yet if \textit{Stoneridge} is understood to say that a duty applies to those who enjoy a professional status or expertise in the world of finance because those persons appreciate the regulatory constraints and economic harm that would follow from misinformation, then \textit{Stoneridge}’s distinction between commerce and finance makes sense: more can reasonably be expected of those in the latter category.\textsuperscript{199}

This rule supports extending the presumption of reliance to new issues. In new issues, the price is often set by the company and its underwriter.\textsuperscript{200} Underwriters, as hallmark finance professionals, understand the economic harm that flows from fraud in the investment marketplace and they uniquely appreciate regulatory constraints as they are charged specifically with investigating registration statements.\textsuperscript{201} Investors should be able to rely upon the underwriter, a hallmark finance professional, to set a price undistorted by fraud.

Fourth, a third party owes a duty to an investor if the third party actually helps engineer or design a deception, thereby making it more likely to succeed.\textsuperscript{202} According to Langevoort, this rule explains \textit{Stoneridge}’s emphasis on the fact that the vendors were only “supernumeraries to [the company’s] role as producer, director, and writer of the fraud.”\textsuperscript{203} Langevoort’s fifth rule similarly states that a third party owes a duty to an investor if the third party has a sufficiently high form of purpose or desire to deceive investors in the general marketplace.\textsuperscript{204} If the third party “throw[s] one’s lot in” with the scheme, then the third party’s intent obviates any concern about disproportionality.\textsuperscript{205} This rule supports the fraud-created-the-market theory as well. Both this duty-based rule Professor Langevoort derives and the fraud-created-the-market theory focus on scienter that approaches specific intent. The fraud-created-the-

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\bibitem{198} Langevoort, \textit{Reading Stoneridge Carefully}, supra note 161, at 2134.
\bibitem{199} \textit{Id.} at 2154–55. Professor Langevoort also points out that this rule provides room to extend liability to licensed securities professionals, such as broker-dealers and investment advisers. \textit{Id.} at 2155. He notes though that lawyers’ duties present special concerns “because of the special obligations of zealous advocacy and confidentiality.” \textit{Id.}
\bibitem{202} Langevoort, \textit{Reading Stoneridge Carefully}, supra note 161, at 2155.
\bibitem{203} \textit{Id.}
\bibitem{204} \textit{Id.}
\bibitem{205} \textit{Id.}
\end{thebibliography}
market theory is premised on the idea that defendants deliberately set out to place securities on the market that had no business being there.

The fraud-created-the-market theory allows injured investors to proceed via class action, a policy the Supreme Court specifically sought to achieve in *Affiliated Ute* and *Basic*. Moreover, the presumption is consistent with Professor Langevoort’s *Stoneridge*-derived rules imposing liability on those who appreciate the gravity of fraud in the marketplace and set out to facilitate a market fraud.


Not only is the fraud-created-the-market presumption grounded in the Supreme Court’s precedent, but it is also consistent with the securities laws and the traditional common-law concerns of fairness and public policy that justify judicial presumptions. This Part shows that the presumption, when assessed in conjunction with its practical purpose, may be justified with sufficient probability. This Part also shows that the presumption serves sound public policy by promoting investor protection and market integrity, encouraging accurate disclosure of material information, and balancing the need to enforce the securities laws with concerns of overdeterrence.

A. The Confluence of Policy and Probability: The Bond Market and Manipulative Conduct

The first hurdle the fraud-created-the-market theory must overcome is probability. The Third Circuit in *Malack* faulted the fraud-created-the-market theory on this basis, stating that unlike the fraud-on-the-market theory, the fraud-created-the-market theory is unsupported by empirical study or economic theory. When assessed in conjunction with the practical need for a presumption of reliance to facilitate class-wide resolution of securities fraud claims, however, the theory is supported by at least minimal theoretical justification.

206. See supra Part V.A.
207. See supra Part V.B(1)–(3).
208. Most presumptions have come into existence primarily because judges believe that proof of fact B renders the inference of the existence of fact A so probable that it is sensible and timesaving to assume the truth of fact A until the adversary disproves it. *McCormick on Evidence*, supra note 24, § 343.
209. *Malack v. BDO Seidman*, LLP, 617 F.3d 743, 751–52 (3d Cir. 2010); see also *Ross v. Bank S., N.A.*, 885 F.2d 723, 738 (11th Cir. 1989) (Hill, J., concurring) (“The expression, ‘fraud on an undeveloped market’ is a contradiction in terms. It may be translated as ‘fraud on a nonexistent market.’ An undeveloped market is less than a twinkle in an issuer’s eye. It says no more than ‘an unwritten book’ or ‘an uncomposed song.’”).
First, although the probabilistic (or “theoretical” or “empirical”) support for a theory supports judicial recognition, the lack thereof by no means bars crafting a presumption. Presumptions can and do exist under the securities laws based on common sense alone. For example, *Affiliated Ute* did not cite any empirical analysis or literature to support a presumption of reliance in the case of an omission in the face of a duty to disclose. The Supreme Court presumed reliance because common sense dictates that to show reliance upon undisclosed information would be impossible. The presumed fact under the fraud-created-the-market theory likewise is grounded in common sense. Under the fraud-created-the-market theory, the market is used merely to determine that a given security is worth more than zero dollars, a simple inquiry that seems to require about as much empirical support as the presumption under *Affiliated Ute*.

Second, theoretical support for a presumption under the securities laws need not be and is not based on perfect science. For example, the fraud-on-the-market theory is universally accepted by federal courts. But the premise of the fraud-on-the-market theory, the efficient-market hypothesis, has been heavily criticized. Proponents of behavioral finance observe irrationality in investor behavior and argue that markets are in the main inefficient. One way in which behavioral finance scholars question the efficient-market hypothesis is by pointing out that stock prices are inconsistent with fundamental value; if the market were efficient and publicly available information impounded in the stock price, then price should provide an objective measure of value, but it doesn’t. Proponents of behavioral finance also question the validity of the assumption that mispricing does not exist in an efficient market because factors like arbitrage, the demise of the irrational trader, and the cancellation of white noise (or misinformed trading) correct any disparity in price. For example, as a counter, behavioral finance scholars point to a range of pricing anomalies and irrational individual behavior.

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211. *Id*.
213. *See, e.g.*, Malack, 617 F.3d at 751–52 n.9.
Yet even in light of these new criticisms, the Supreme Court has reaffirmed its adherence to the fraud-on-the-market theory. Why, and what then supports the presumption of reliance without probability? The main focus of any presumption, and Affiliated Ute and Basic make this clear, is policy. The presumptions are justified by the practical need for class-wide reliance to meet the requirements of Rule 23. That there wasn’t a completely workable science in Affiliated Ute or Basic did not caution against a legal presumption. Judges, with one or two exceptions, are not scientists or economists. With a legal presumption, the Court aimed to relieve judges from acting in this way and to overcome the procedural problem posed by Rule 23 for Rule 10b-5 claims. Legal presumptions provide optimal deterrence and presumptions of reliance recognize that prices are more likely to be correct, capital-allocation decisions likely to be more accurate, and individual investment decisions likely better when full information is provided to the market.

Nevertheless, despite the subsidiary importance of probability, in some cases, the fraud-created-the-market theory contains empirical and theoretical support in two scenarios: (1) if the claim involves the primary bond market; or (2) if the claim involves manipulative conduct. First, some fraud-created-the–market cases deal with “informationally efficient” markets. Some have argued that markets in the context of initial public offerings, although rarely value efficient in that they often misprice securities, can still be informationally efficient—the new market quickly incorporates new information into a security’s price. A more compelling case is made for the primary bond market, in which scholars remarked a decade ago that “the primary market for newly issued bonds is more informationally efficient than the secondary bond market.” Fraud-created-the-market cases commonly involve fraud in the primary bond

220. Id. at 525–26.
221. BLOOMENTHAL & WOLFF, supra note 21, § 13:32; Robert G. Newkirk, Comment, Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context, 58 U. Chi. L. Rev. 1393, 1394 (1991); see also In re Enron Corp. Sec., 529 F. Supp. 2d 644, 770–71 (S.D. Tex. 2006); Joseph De Simone, Note, Should Fraud on the Market Theory Extend to the Context of Newly Issued Securities? 61 Fordham L. Rev. S151, S177 (1993). The theory has, however, been criticized as ignoring the literature on the underpricing of IPOs and being more applicable to the aftermarket for IPOs than the offering itself. Janet Cooper Alexander, The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced, 41 UCLA L. Rev. 17, 36 n.68 (1993). This underpricing may be intentionally built into the price, however, as a way to reduce risk, avoid litigation, reward customers or attract new business, or to encourage investors to bid up the price. Richard A. Booth, Going Public, Selling Stock, and Buying Liquidity, 2 Entrepreneurial Bus. L.J. 649, 651–54 (2008).
A new market could be sufficiently “efficient” if there exists a class of independent professional investors whose activities incorporate significant public information about a security into a market price. If a buyer of that new security is defrauded, then all who purchased in the initial public offering are defrauded. Because the market for newly issued securities can be informationally efficient, a categorical rejection of the fraud-created-the-market presumption casts too wide a net. Rather, courts should first ask whether the market is informationally efficient, not just liquid, similar to how courts require investors to show that a market is efficient before invoking the fraud-on-the-market theory. Rejecting the fraud-created-the-market theory categorically because it is inconsistent with the efficient-market hypothesis leaves no room for evidence that the market in that case was in actuality informationally efficient. Hence, at least one district court has approached each suit case by case to determine if there is a theoretical foundation. Indeed, both Eckstein and Malack—in which the courts rejected the fraud-created-the-market theory because it had no empirical support—seem to implicitly recognize the possibility that primary markets can be efficient. Both courts recognized that disclosure would lower the market price. If disclosure would have affected the price, then the fraud-created-the-market theory is indistinguishable from the fraud-on-the-market theory.

Second, with respect to manipulation claims under Rule 10b-5(a) and (c)—another common scenario in which plaintiffs invoke the fraud-created-the-market theory—fraudulent schemes are more likely to have a significant effect on prices in inefficient markets than in efficient markets, thus making reliance premised on market efficiency nonsensical.


224. BLOOMENTHAL & WOLFF, supra note 21, § 13:32; Newkirk, supra note 221, at 1394.

225. BLOOMENTHAL & WOLFF, supra note 21, § 13:32.


227. Id.

228. Malack v. BDO Seidman, LLP, 617 F.3d 743, 744, 750–51 (3d Cir. 2010).


230. Charles R. Korsmo, Mismatch: The Misuse of Market Efficiency in Market Manipulation Class Actions, 52 WM & MARY L. REV. 1111, 1118 (2011). Professor Roberta S. Karmel also implicitly recognizes this point when she says:
Professor Charles Korsmo shows that in the context of market manipulation claims—by which he means profitable trades made with bad intent, wash sales, and matched orders—the conditions for successful market manipulation belie the need for an efficient market. In fact, he concludes, manipulation is least likely to have an impact in efficient markets. First, Professor Korsmo shows that manipulative trades in inefficient markets can influence price by affecting the supply and demand of a stock; and second, he demonstrates that manipulative trading can influence price through information effects, like in Desai. Because the market efficiency requirement perversely screens out valid manipulation claims, he surmises, reliance premised on an efficient market is equally incoherent.

B. Public Policy, Fairness, and the Justifiable Reliance Concerns of the Presumption

The fraud-created-the-market theory is also consistent with the securities laws and the common law concerns of public policy and fairness that justify a judicially created presumption. Courts create presumptions when fairness and public policy warrant them. The ultimate goal or policy aim of the securities laws is to protect investors from fraud and promote the integrity of American markets. The securities laws try to achieve this goal by allowing investors to make autonomous investment decisions, as opposed to paternalistically allowing the federal government to advise the public on the merits of securities offerings. Autonomous investment decisions can only be made if investors have access to information necessary to make an informed decision, and as a consequence, the securities laws require those with the greatest degree of access to this information to disclose it to the investing public. Yet Congress also

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.

Karmel, supra note 176, at 52.

232. Id. at 1154.
233. Id. at 1144–47.
234. Id. at 1154.
235. MCCRORICK ON EVIDENCE, supra note 24, § 343.
236. KAUFMAN, 26 SECURITIES LITIGATION: DAMAGES, supra note 15, § 1:3.
237. Id.
238. Id.
wanted to avoid deterring honest and fruitful business practices, so Congress required disclosure of only material facts.\textsuperscript{239} So, the goals of the securities laws include: (1) promoting market integrity and protecting investors; (2) encouraging accurate disclosure of material information; and (3) balancing the need for enforcement with overdeterrence. This Part shows that the fraud-created-the-market theory accomplishes all three.

1. Promoting Investor Protection and Market Integrity

Any presumption of reliance facilitates class-wide resolution of securities fraud claims. The class-action device is vital to deterring securities fraud and remedying its victims, who almost never suffer losses sufficient to justify an individual suit.\textsuperscript{240} The fraud-created-the-market theory in particular protects a vulnerable group of investors and promotes market integrity by allowing investors to recover through the class-action device, promoting normative reliance on the SEC and other gatekeepers, and supplementing SEC enforcement efforts.

To begin, the fraud-created-the-market theory protects a uniquely susceptible group of investors and will likely have increased influence in lawsuits regarding the subprime mortgage meltdown. The fraud-created-the-market theory helps investors recover primarily in cases involving internet fraud, including online initial public offerings and the bond market on the Web.\textsuperscript{241} Online initial public offerings and sales of municipal bonds are becoming more common, and unfortunately, internet securities fraud is keeping pace.\textsuperscript{242} And “[a] significant portion of this fraud is the marketing of securities that are patently worthless or complete shams.”\textsuperscript{243} Internet fraud usually victimizes “unsophisticated investors”—those trading without the benefit of analyst evaluations or broker recommendations.\textsuperscript{244} In a sophisticated, secondary market, investors rely upon informed experts.\textsuperscript{245}

\begin{itemize}
\item \textsuperscript{239} Id.
\item \textsuperscript{241} See Dennin, supra note 9, at 2651–52; SEC, Avoiding Internet Investment Scams: Tips for Investors, http://www.sec.gov/investor/pubs/scams.htm (last visited Jan. 9, 2012) (observing that “[m]any online investment scams involve unregistered securities”).
\item \textsuperscript{242} See Dennin, supra note 9, at 2652–53; see also Laura S. Unger, Remarks at the Association of Retired Persons National Legislative Council Annual Meeting, Investing in the Internet Age: What You Should Know and What Your Computer May Not Tell You . . . (Feb. 3, 2000) (transcript available at http://www.sec.gov/news/speech/spch342.htm) (observing that the SEC has brought enforcement actions against fraud actions “involving false [internet] offerings of everything from interests in eel farms, coconut plantations, to even a new underwater city meant to be a Caribbean tax haven”).
\item \textsuperscript{243} See id.; Sachs, supra note 166, at 477.
\item \textsuperscript{244} See id.; Sachs, supra note 166, at 477.
\item \textsuperscript{245} See id.; Sachs, supra note 166, at 477.
\end{itemize}
These investors thus have less incentive to determine whether a public statement concerning an issue is misleading. In contrast, in a smaller issue in a lesser developed market, where the level of analyst investigation is lower and investors are less sophisticated, the investors are more at risk and thus in need of more protection. With the wide reach of internet marketing, many investors can potentially be defrauded by fraudulent initial offerings, and the fraud-created-the-market theory is well suited to facilitate resolution of claims via the class action.

In addition to protecting unsophisticated consumers, the theory may play an increased role in protecting investors in suits against financial institutions involved in the subprime mortgage debacle. In suits against underwriters of auction rate securities, for example, investors have alleged that the products sold by banks were marketed as highly liquid investments, but were in fact more akin to holding money in a money market account. But these purchasers will not be entitled to the fraud-on-the-market presumption because the fraudulent statements were made only to a limited number of customers rather than to the market as a whole. The fraud-on-the-market presumption does not apply if the security at issue is not traded on a developed market. Thus, the fraud-created-the-market theory may fill this gap.

by an investment professional, and even these sophisticated actors are unlikely to succeed in uncovering fraud.” Pritchard, supra note 138, at 223–24. Professor Pritchard though goes on to note that the best way for a passive investor to protect against fraud is to diversify. Id. at 224.

246. Newkirk, supra note 221, at 1419.

247. See Langevoort, Half-Truths, supra note 137, at 117; Newkirk, supra note 221, at 1419.

248. BLOOMENTHAL & WOLFF, supra note 21, § 13:32 (2d ed. 2010); Dennin, supra note 9, at 2653.

249. ROBERT R. LONG ET AL., Litigation Against Financial Institutions and Their Directors and Officers in the Global Economic Crisis, in 27 ALSTON & BIRD LLP, SECURITIES LITIGATION FORMS & ANALYSIS § 1:11 (2010). “Several distinct but interconnected shadow banking markets have emerged in recent years, including asset-backed commercial paper (ABCP), auction-rate securities (ARS), hedge funds, money market mutual funds (MMMF), repurchase agreements (repos), and credit derivatives like credit default swaps (CDS) and total return swaps (TRS).” Adam J. Levitin, In Defense of Bailouts, 99 GEO. L.J. 435, 464–65 (2011) (footnotes omitted).

250. Auction rate securities are long-term corporate or municipal bonds with interests rates that are periodically reset through an auction (a “Dutch” auction) in which bids with successively higher rates are accepted until all the securities in the auction are sold. Brendan P. Tracy, Note, If It’s Broken, Sometimes It Can’t Be Fixed: Why the Auction Rate Securities Market Was Faulty from Its Inception and How Broker-Dealers Caused Its Downfall, 4 BROOK. J. CORP. FIN. & COM. L. 297, 297–98 (2010). “Frequent issuers of municipal ARS include traditional issuers of tax-exempt debt such as municipalities, nonprofit hospitals, utilities, housing finance agencies, student loan finance authorities and universities.” DOUGLAS SKARR, CDIAC POLICY RESEARCH UNIT, ISSUE BRIEF: AUCTION RATE SECURITIES 1 (Aug. 2004), available at http://www.treasurer.ca.gov/cdiac/issuebriefs/aug04.pdf.

251. LONG ET AL., supra note 249, § 1:11.

252. Id.

253. Basic Inc. v. Levinson, 485 U.S. 224, 248 n. 27 (1975) (listing as an element of the presumption as “that the shares were traded on an efficient market”).
That the fraud-created-the-market presumption protects unsophisticated investors makes a normative presumption even more appropriate.\textsuperscript{254} \textit{Affiliated Ute} communicated that investors should be able to rely on those who owe them fiduciary duties, and \textit{Basic} communicated that investors should be able to rely on the integrity of the stock price.\textsuperscript{255} The fraud-created-the-market theory posits that investors should be able to rely on market gatekeepers, like underwriters or the SEC, to keep patently worthless securities off the market.\textsuperscript{256} Critics contend, erroneously however, that this reliance on the regulation of the market is unreasonable because gatekeepers do not guard against fraud or vouch for the substantive value of a security or an issuer’s representations.\textsuperscript{257}

With respect to the SEC, although the agency does not analyze the value of securities offered or the veracity of the issuer’s representations,\textsuperscript{258} the truthfulness of a representation is distinct from whether an offering adheres to the requirements of state and federal law.\textsuperscript{259} In this way, the fraud-created-the-market theory, when premised on legal unmarketability at least, represents a tradeoff between a securities regulation regime that focuses on full disclosure and “rewarding plaintiffs who fail to avail themselves of those disclosures.”\textsuperscript{260} And even though the SEC cannot

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\item \textsuperscript{254} See Langevoort, \textit{Half-Truths}, supra note 137, at 108 (observing that if unsophisticated investors are more at risk of fraud, a presumption is more appropriate).
\item \textsuperscript{256} T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983). Regardless whether the SEC vouches for the accuracy or validity of market disclosures, the SEC is nevertheless a lightning rod for criticism when it fails to uncover fraud. See, e.g., Murdock, \textit{Why Not Tell the Truth?}, supra note 197, at 871 (stating that the SEC’s relaxed enforcement is a major factor in the present economic crisis); see also Marcy Gordon, \textit{SEC Enforcement Chief Linda Thomsen Resigns}, POLITICO, Feb. 9, 2009, http://dyn.politico.com/members/forums/thread.cfm?catid=1&subcatid=2&threadid=2030791 (stating that the SEC Commission was a lightning rod of criticism when the SEC failed to detect Bernard Madoff’s fifty billion dollar Ponzi scheme despite red flags raised by outsiders over the course of a decade); Nicholas Rummell, \textit{Tumble in Restatements Sparks Criticism of SEC}, FINANCIALWEEK (Aug. 25, 2008, 12:01 AM), http://www.financialweek.com/article/20080825/REG/860815 (stating that a steep decline in restatements and material weaknesses in 2008 was more to do with a sleepier securities watchdog than with compliance with the Sarbanes-Oxley Act).
\item \textsuperscript{257} Malack v. BDO Seidman, LLP, 617 F.3d 743, 750 n.7 (3d Cir. 2010); Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931, 944 (9th Cir. 2009) (O’Scanlan, J., concurring); Joseph v. Wiles, 223 F.3d 1155, 1165 (10th Cir. 2000); Ockerman v. May Zima & Co., 27 F.3d 1151, 1159 (6th Cir. 1994); Ross v. Bank S., N.A., 885 F.2d 723, 739–40 (11th Cir. 1989) (Tjoflat, J., concurring); Camden Asset Mgmt. v. Sunbeam Corp., No. 99-CV-8275, 2001 WL 3455627, at *38 n.9 (S.D. Fla. July 3, 2001).
\item \textsuperscript{258} See 17 C.F.R. § 229.501(b)(7) (2011) (stating that if an SEC legend is needed on a registration statement or prospectus, then the document must state that the SEC has not approved or disapproved of the securities or passed on the accuracy of the disclosures).
\item \textsuperscript{260} In exchange for barring investors who fail to read offering documents from recovery, defendants must comply with the law. Cohen, supra note 259, at 760.
\end{itemize}
reasonably be expected to conduct a merits review of every offering document, the agency’s examination of registration statements and its use of orders refusing to permit registration or stop orders when uncorrected misrepresentations appear nevertheless have the practical effect of limiting more flagrant misstatements and omissions.\footnote{In re HealthSouth Corp. Sec. Litig., 261 F.R.D. 616, 643 (N.D. Ala. 2009) (quoting Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 566–67 (E.D.N.Y. 1971)). The SEC can refuse to allow a registration statement to become effective until it has been amended in conformity with the SEC’s wishes and issue stop orders preventing registration statements from becoming effective if they contain untrue statements or material omissions. 15 U.S.C. § 77h(b), (d) (2006).}

Permitting reliance on underwriters is less problematic than reliance on the SEC. The securities laws require underwriters to perform a reasonable investigation and form a reasonable belief that the registration statement is accurate.\footnote{15 U.S.C. § 77k(b)(3)(A) (2006); John C. Coffee, Jr., Gatekeepers: The Professions and Corporate Governance 352–53 (2006).} Ergo, investors should be permitted more confidence in an underwriter with an established reputation for fair dealing.\footnote{In re HealthSouth Corp. Sec. Litig., 261 F.R.D. at 643–44 (quoting Feit, 332 F. Supp. 2d at 581–82).} Similarly, gatekeepers, like auditors, exist to lend reputational capital to the offering and assure investors that they will not be sold “lemons.”\footnote{Coffee, supra note 262, at 2–3; Andrew F. Tuch, Multiple Gatekeepers, 96 Va. L. Rev. 1583, 1595–96 (2010).} The presence of these gatekeepers also makes the “unmarketability” standard workable. Critics of the fraud-created-the-market theory contend that the economic unmarketability standard is unworkable because the price of any security can be lowered until it is unmarketable.\footnote{Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1130–31 (7th Cir. 1993).} But as a practical matter, the underwriter and issuer who coordinate the offering incur “substantial legal, accounting, and registration fees,” as well as other transactions costs that provide a floor for the price of the security.\footnote{Case Note, supra note 43, at 1174.} Therefore, the securities would have to be marketed at an initial price high enough to justify the underwriter’s involvement.\footnote{Id.} As Chief Judge Easterbrook has recognized, “[t]he self-interest of those who seek to maintain reputations for honest dealing, and the legal rules against fraud, are the primary guarantors of the accuracy of representations in securities transactions.”\footnote{Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 526 (7th Cir. 1985).}

The fraud-created-the-market presumption also fosters market integrity by providing for holistic enforcement of the securities laws. Rejecting the fraud-created-the-market theory because the SEC does not screen for fraud is incoherent and inconsistent with the 10b-5 private right of action. If the SEC cannot protect investors against this fraud in newly issued securities, then why does Section 10(b) deny investors a remedy? The Supreme Court
constantly justifies the private right of action under Rule 10b-5 as a supplement to the enforcement efforts of the SEC.\textsuperscript{269} The fraud-created-the-market theory thus provides a deterrent through threat of litigation to help the SEC prevent this kind of fraud.

\section*{2. Encouraging Accurate Disclosure}

Critics of the fraud-created-the-market theory contend that the presumption is inconsistent with the securities laws’ purpose of encouraging complete disclosure of accurate information.\textsuperscript{270} Investors who buy or sell thinly-traded securities in the absence of an efficient market should read offering documents, and their failure to do so, critics argue, makes their reliance unreasonable.\textsuperscript{271} A presumption of reliance where investors fail to read offering documents, critics worry, would create passive and potentially negligent investors who fail to read any offering documents.\textsuperscript{272} But this criticism misunderstands the disclosure goal of the securities laws and places undue weight on the investors’ failure to read offering documents.

The securities laws protect investors by penalizing defendants for shirking their disclosure obligations, rather than penalizing investors for failing to investigate.\textsuperscript{273} (Indeed, several federal courts of appeals have rightly rejected as a defense investors’ failure to exercise due diligence.)\textsuperscript{274} The securities laws recognize that disclosure and investigation are cumulative ways of getting at the truth and that investigating facts already known to the defendant is a wasteful duplication of effort.\textsuperscript{275} Barring investors from recovery because they did not read offering documents—an

\textsuperscript{269} \textit{See, e.g.}, Tellabs, Inc. v. Makor Issues & Rights, Ltd., \texttt{551 U.S. 308, 313} (2007) (“[P]rivate actions . . . are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission . . . .”).


\textsuperscript{271} \textit{See, e.g.}, Ross, \texttt{885 F.2d at 738} (Tjoflat, J., concurring); Camden Asset Mgmt. v. Sunbeam Corp., No. \texttt{99-CV-8275}, \texttt{2001 WL 3455627}, at *11 n.9 (S.D. Fla. July 3, 2001). This is the ultimate reason why Professor Langevoort rejects the fraud-created-the-market theory. Langevoort, \textit{Basic at Twenty}, supra note 23, at 171.

\textsuperscript{272} \textit{See, e.g.}, Shores, \texttt{647 F.2d at 473, 483} (Randall, J., dissenting); Herzog, supra note 118, at 395–96.

\textsuperscript{273} \textit{KAUFMAN, 26 SECURITIES LITIGATION: DAMAGES, supra} note 15, \textsection 1:3.

\textsuperscript{274} \textit{JOSEPH C. LONG, 12A BLUE SKY LAW (SECURITIES LAW SERIES) \textsection 9:133} (2010); \textit{BROMBERG & LOWENFELS, supra} note 32, \textsection 7:453; Teamsters Local 282 Pension Trust Fund v. Angelos, \texttt{762 F.2d 522, 529} (7th Cir. 1985). \textit{But see} \textit{Mercury Air Grp., Inc. v. Mansour}, \texttt{237 F.3d 542, 546} (5th Cir. 2001) (requiring plaintiffs to establish due diligence).

\textsuperscript{275} \textit{Teamsters Local 282 Pension Trust Fund}, \texttt{762 F.2d at 526–27}.
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approach akin to contributory negligence—does not give the seller’s obligation to tell the truth the primacy that obligation must have.\textsuperscript{276}

And although justifiable reliance is an element of common-law fraud,\textsuperscript{277} the Restatement of Torts recognizes that the recipient of a fraudulent statement is still justified in relying upon its truth even though the recipient may have discovered the statement’s falsity through investigation.\textsuperscript{278} Moreover, to the extent fraud under Rule 10b-5 is incommensurable with common-law fraud, this difference is because common-law fraud is too restrictive of a remedy for modern frauds.\textsuperscript{279}

More to the point, Rule 10b-5 condemns only fraud made with scienter, which subsumes any due diligence defense.\textsuperscript{280} And emphasis on the defendants’ scienter is even more pronounced in fraud-created-the-market cases where investors must show that the defendants knew or reasonably should have known that the securities would not have been marketed if the truth had been known.\textsuperscript{281} Because of the scienter element, fraud under the fraud-created-the-market theory is more akin to an intentional tort, and the plaintiff’s contributory negligence was never a defense to an intentional tort under common-law fraud.\textsuperscript{282}

Even still, it is unclear why reading offering documents matters in a case properly invoking the fraud-created-the-market theory. The essence of the fraud-created-the-market theory is that the defendants committed a very egregious fraud: persons seek to perpetrate complete frauds and bring otherwise worthless securities to market that have no business being there.\textsuperscript{283} Full disclosure is irrelevant to these persons because they are intent on misrepresenting the securities to the public and attempting to persuade investors to buy them.\textsuperscript{284}

Not only is disclosure irrelevant to those committing the fraud, but also a judicial rule requiring investors to read offering documents to maintain a

\textsuperscript{276} See id. at 527–28.
\textsuperscript{277} RESTATEMENT (SECOND) OF TORTS § 537 (1977).
\textsuperscript{278} Id. § 540.
\textsuperscript{280} Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313–14 (2007); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976); see also Karmel, supra note 176, at 53 (recognizing that due diligence as a defense under Rule 10b-5 is subsumed by the scienter requirement).
\textsuperscript{281} Ross v. Bank S., N.A., 885 F.2d 723, 729 (11th Cir. 1989); Herzog, supra note 118, at 377; Sachs, supra note 166, at 481.
\textsuperscript{282} Allan L. Schwartz, Annotation, Applicability of Comparative Negligence Principles to Intentional Torts, 18 A.L.R. 525 (5th ed. 1994); see RESTATEMENT (SECOND) OF TORTS §§ 481, 482 (1965).
\textsuperscript{283} Dennin, supra note 9, at 2649.
\textsuperscript{284} Id.
fraud claim does not influence investor behavior. Prohibiting investors from recovering for failing to read offering documents “does not insulate investors from losses resulting from nonfraudulently issued securities,” and so their “incentive to gather information about risk remains.” Moreover, because the fraud-created-the-market theory applies only to securities that are worthless, investors are still motivated to read disclosure materials to ensure that they nevertheless do not buy overvalued, although not worthless, securities. In other words, investors are still motivated to read offering documents to ensure that they do not overpay.

Requiring investors to read offering documents, even though defendants were obligated to tell the truth, means that investors must investigate what the other party says, despite the fact that the defendant has the best access to pertinent information and can reveal it at low cost. And even though the less-widely distributed the investment, the more valuable any one investigation, many potential investors would have to undertake individual, costly investigations on every offering. But most important, courts should not “wink at the falsehoods or omissions of the sellers of the securities” and force investors to resort to “the costly self-help approach of investigations on pain of losing the protection of the principal legal safeguard, the rule against fraud.”

3. Balancing Enforcement of the Securities Laws with Overdeterrence

The securities laws seek a delicate balance between deterring fraud and promoting legitimate market activity. A subtext of many criticisms of the fraud-created-the-market theory is that it expands liability under Rule 10b-5. These critics assert that the presumption provides duplicative remedies under Section 10(b) and Section 18 of the 1934 Act and that it extends liability inconsistent with the Supreme Court and Congress’s trend of cabining the scope of Rule 10b-5. But the theory neither inappropriately usurps Section 18 nor expands liability under Rule 10b-5.

286. Id.
287. Id.
288. Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981); Schmidt, supra note 212, at 521.
290. Id. at 527–28.
293. See Shores, 647 F.2d at 473 (Randall, J., dissenting) (stating that the fraud-created-the-market presumption would open the floodgates and prolong frivolous litigation).
Section 18 provides that any person who makes or causes to be made a materially false or misleading statement to be filed with the SEC shall be liable to any person who relied upon this statement in buying or selling a security at a price that was affected by the statement.\(^{294}\) Section 18 requires actual “eyeball” reliance.\(^{295}\) Section 18, however, is not an exclusive remedy for false documents filed with the SEC.\(^{296}\) And even if it were, the Supreme Court has held that investors can pursue duplicative remedies under the securities laws.\(^{297}\) Moreover, the fraud-created-the-market theory reaches private but highly liquid markets that Section 18 misses. For example, the markets to invest in Facebook, Twitter, and LinkedIn, which are so liquid that many have argued that they need not go public at all,\(^{298}\) are not subject to many SEC filing requirements, which has caused the agency to take a closer look at the trading.\(^{299}\) Should fraud arise in a market like this, Section 18 would not apply, but Rule 10b-5 and a presumption of reliance under the fraud-created-the-market theory might.

Critics also contend that the fraud-created-the-market theory is an unwarranted extension of securities fraud liability inconsistent with the Supreme Court and Congress’s trend of limiting liability under Rule 10b-5.\(^{300}\) We agree that many of the Court’s 10b-5 decisions since 1975 have restricted the range of conduct that will result in liability.\(^{301}\) Congress

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294. 15 U.S.C. § 78r(a) (2006). To establish a prima facie case under section 18, investors must show (1) the purchase or sale of a security (2) in reliance upon (3) a materially misleading report filed under the 1934 Act (4) at a price affected by the misleading report (5) from which damages caused by the reliance flowed. Deephaven Private Placement Trading, Ltd. v. Grant Thornton & Co., 454 F.3d 1168, 1171 (10th Cir. 2006).

295. Heit v. Weitzen, 402 F.2d 909, 914 (2d Cir. 1968). Section 18 also differs from Rule 10b-5 because section 18 allows investors to recover litigation costs, including reasonable attorneys’ fees. 15 U.S.C. § 78r(a).


300. See Ockerman v. May Zima & Co., 27 F.3d 1151, 1161–62 (6th Cir. 1994); Shores v. Skylar, 647 F.2d 462, 473 (5th Cir. 1981) (Randall, J., dissenting) (stating that the fraud-created-the-market presumption would open the floodgates and prolong frivolous litigation); Herzog, supra note 118, at 394.

301. Much of the Supreme Court’s securities fraud jurisprudence since Blue Chip Stamps v. Manor Drug Stores has been consistent in only that regard. Michael J. Kaufman, Mending the
likewise passed the PSLRA (and its sister statute, the Securities Litigation Uniform Standards Act of 1998 to keep securities fraud class actions out of state court), which imposed a heightened pleading standard, stayed discovery pending a motion to dismiss, and altered rules for joint and several liability. And repeatedly in Senate and House reports, Congressmen expressed concerns with “frivolous” securities litigation. Even the Sarbanes-Oxley Act of 2002, enacted in the wake of the colossal Enron scandal, did not extend private rights of action for investors. The recent Dodd-Frank Wall Street Reform and Consumer Protection Act has similarly failed to enact proposals that would have reinstated 10b-5 as a basis for liability for aiding and abetting securities fraud.

Weathered Jurisdictional Fences in the Supreme Court’s Securities Fraud Decisions, 49 SMU. L. REV. 159, 183–84 (1996). Many of the Court’s recent decisions also continue this trend. In In Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011), the Court limited 10b-5 liability to only “the maker of a statement” “with ultimate authority over the statement, including its content and whether and how to communicate it.” In Morrison v. National Australia Bank, Ltd., 130 S. Ct. 2869, 2884 (2010), the said that Section 10(b) and Rule 10b-5 reaches only purchases or sales of a security in the United States or purchases or sales of a security listed on an American stock exchange. The result is that the Court has “expanded jurisdiction for foreign shareholders and narrowed it for US shareholders” because foreign shareholders can now bring a 10b-5 claim if a foreign company trades its shares on the New York Stock Exchange but American shareholders injured by fraud that occurs in the U.S. cannot sue if the company is traded on the Bulletin Board or anywhere else on the OTC market and the shares are bought overseas in a private placement. J. Robert Brown, Jr., Morrison v. National Australia Bank: Protecting Foreign Shareholders and Discouraging Listings on the NYSE, RACE TO THE BOTTOM (June 24, 2010), http://www.theracetothebottom.org/securities-issues/morrison-v-national-australia-bank-protecting-foreign-shareh.html. In Stoneridge Investment Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 159–64 (2008), the Court rejected scheme liability, in Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322–23 (2007), the Court heightened the pleading standard by requiring district courts to weigh both culpable and nonculpable inferences of scienter at the motion to dismiss stage, and in Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 342–44 (2005), the Court held that plaintiffs cannot plead loss causation by alleging that the price of the security on the date of purchase was inflated because of the misrepresentation.

305. SOX did have several effects on corporate governance, however, requiring principal, executive officers to certify that certain reports contained no false or misleading information, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745, 777 (codified at 15 U.S.C. § 7241(a) (2006); providing criminal penalties if the CEO knowingly certified false information, Sarbanes-Oxley Act of 2002 § 906 (codified at 18 U.S.C. § 1350(c)) (2006); and mandating that each annual report filed by a company contain a report on internal controls established to guard against fraud, Sarbanes-Oxley Act of 2002 § 404 (codified at 15 U.S.C. § 7262(a)–(b) (2006)).
306. Senator Arlen Spector introduced legislation—the Liability for Aiding and Abetting Securities Violations Act of 2009—that would have authorized securities actions against any person that knowingly or recklessly provides substantial assistance to another in violation of the federal securities laws. The proposed legislation had Central Bank and Stoneridge in its crosshairs:

PRIVATE CIVIL ACTIONS.—For purposes of any private civil action implied under this title, any person that knowingly or recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed to
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But the fraud-created-the-market theory does not expand 10b-5 liability at all. Section 10(b) and Rule 10b-5(a) and (c) forbid market manipulation already.307 Rather, underlying the criticism that the fraud-created-the-market theory expands 10b-5 liability is the idea that by establishing reliance, investors’ recovery is virtually assured. The court in Malack hints at this when it says: “the presumption of reliance is a powerful tool for plaintiffs seeking class certification and class certification puts pressure on defendants to settle claims, even if they are frivolous.”308

The concern that once a class is certified defendants are forced to settle cases in terrorem, however, is already addressed in the securities laws, speculative, and one-sided.309 First, a litany of safeguards exists that protect defendants in securities fraud cases. For example, investors must satisfy the rigorous pleading requirements under the PSLRA,310 which has proved an especially good defense after Tellabs.311 Indeed, in the recent wave of subprime securities class actions, defendants have been most successful arguing that plaintiffs have failed to establish the strong inference of fraudulent intent.312 Frivolous claims are further addressed by the enhanced Rule 11 provisions and the stay of discovery pending any 12(b)(6) litmus test under the PSLRA.313 Second, as Professor Arthur R. Miller notes,

be in violation of this title to the same extent as the person to whom such assistance is provided.


308. Malack v. BDO Seidman, LLP, 617 F.3d 743, 755 (3d Cir. 2010). The federal courts echo this sentiment in the context of all reliance presumptions, not just the fraud-created-the-market theory. See, e.g., Oscar Private Equity Invs. v. Allegiance Telecomm., Inc., 487 F.3d 261, 266–67 (5th Cir. 2007); Unger v. Amedisys, Inc., 401 F.3d 316, 320, 322 (5th Cir. 2005); Hevesi v. Citigroup, Inc., 366 F.3d 70, 80 (2d Cir. 2004).

309. For a fuller criticism of the in terrorem rationale, see generally Allan Kanner & Tibor Nagy, Exploding the Blackmail Myth: A New Perspective on Class Action Settlements, 57 BAYLOR L. REV. 681 (2005); Michael J. Kaufman & John M. Wunderlich, The Judicial Access Barriers to Remedies for Securities Fraud, 75 LAW & CONTEM. PROBS. 55 (2012); Miller, supra note 7; Charles Silver, “We’re Scared to Death”: Class Certification and Blackmail, 78 N.Y.U. L. REV. 1357 (2003).

310. Scienter as a stopgap may be problematic, however, in that almost all claims are directed at companies and other legal fictions, not persons, and corporate scienter is “admittedly fuzzy.” See Langevoort, Reading Stoneridge Carefully, supra note 161, at 2146.


312. LONG ET AL., supra note 249, § 1:11.

much is unknown about litigation costs. 314 For instance, although litigants face significant costs, we do not know the extent of these costs; whether they are overstated, self-inflicted, or aberrational; whether cost is attributable to frivolous or merited litigation; or whether costs of discovery are influenced by procedural rules, and if so which ones and by how much. 315 Third, the in terrorem concern is one-sided in that it fails to account for costs borne by investors, by the judicial system, and to society from resulting underenforcement of the securities laws. 316 Hence, without further study, this in terrorem concern simply has no place when analyzing the propriety of the fraud-created-the-market presumption.

VI. CONCLUSION

The fraud-created-the-market theory presumes reliance when a defendant’s fraud is so egregious that it places securities on the market that have no business being there. The federal courts that have rejected the theory by relying upon Stoneridge have misread that decision, ignored the Supreme Court’s jurisprudence that makes the materiality of any misstatement or omission the primacy of any Rule 10b-5 case, and misconstrued the fraud-created-the-market theory. The fraud-created-the-market theory is supported by probability, sound public policy, and fairness. Investors should be able to rely on a security’s presence on the market as minimum assurance that the security has business being there. This reliance is justified, and a presumption of reliance promotes investor protection.

314. Miller, supra note 7, at 61–64; see also John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and its Implementation, 106 COLUM. L. REV. 1534, 1536 n.5 (2006) (noting that the true “strike suit” is “a beast like the unicorn, more discussed than directly observed”).


316. Miller, supra note 7, at 61.