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SECURITIES FRAUD—THIRD CIRCUIT ADOPTS FRAUD-ON-THE-MARKET THEORY OF CAUSATION IN 10b-5 ACTIONS

Peil v. Speiser (1986)

Congress enacted section 10(b) of the Securities Exchange Act of 1934 (Exchange Act)\(^1\) to prevent all deceptive and manipulative practices in connection with securities trading.\(^2\) The Securities and Exchange Commission (SEC) subsequently promulgated rule 10b-5 to protect sellers as well as buyers from a wide variety of fraudulent activity.\(^3\) Traditionally, a plaintiff in a private action under rule 10b-5 had to

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2. H.R. REP. No. 1383, 73d Cong., 1st Sess. 10 (1934) (purpose is to provide fair and honest markets to investors by banning all manipulative practices); see also Note, Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5, 50 GEO. WASH. L. REV. 627, 630-31 (1982).


   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


Since the promulgation of the rule, the courts have held that rule 10b-5 prohibits a broad range of fraudulent activities. See Note, supra note 2, at 631 n.24. The courts have also inferred a private cause of action under rule 10b-5. See, e.g., Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971). Traditionally, a 10b-5 plaintiff had to prove "the scienter of the defendant, the materiality of any misrepresentation or omission by the defend-
prove actual reliance to show causation. The Ninth Circuit, however, stated in Blackie v. Barrack that the requirement of showing direct reliance by the plaintiff on the defendant’s statements, and the justifiability of the reliance. Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.) (footnotes omitted), cert. denied, 434 U.S. 911 (1977). For a further explanation of the 10b-5 plaintiff’s traditional burden of proof, see List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.) (requiring that misrepresentation be material and that reliance be placed thereon), cert. denied, 382 U.S. 811 (1965).


Section 10 of the Exchange Act was modeled after, and retained, many of the characteristics of the common-law tort action of deceit. See 3 L. Loss, Securities Regulation 1430-31 (1961). To prevail in such a deceit action, a plaintiff had to establish six elements: (1) a false representation of (2) a material (3) fact; (4) defendant’s knowledge of its falsity and his intention that plaintiff rely on it; (5) the plaintiff’s reasonable reliance thereon; and (6) his resultant loss. Id. at 1431.

Consequently, the causation rationale in private 10b-5 actions derives from the classic tort doctrines of misrepresentation and deceit:

The false representation must have played a material and substantial part in leading the plaintiff to adopt his particular course; and when he was unaware of it at the time that he acted, or it is clear that he was not in any way influenced by it, and would have done the same thing without it for other reasons, his loss is not attributed to the defendant.

Note, supra, at 1144 (quoting W. Prosser, Handbook of the Law of Torts § 108, at 714 (4th Ed. 1971)(footnotes omitted)). However, because the traditional face-to-face transactions regulated by the common law are distinguishable from securities trading in anonymous, national markets, the Supreme Court has recognized that the “common-law model” is of limited utility in 10b-5 actions. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975); see also Note, supra at 1144 n.3.

5. 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). The Blackie court was the first circuit court to embrace a generalized fraud-on-the-market theory. Note, supra note 4, at 1148. The facts in Blackie centered around the financial difficulties of Ampex Corporation. 524 F.2d at 894. After reporting a profit in 1970, the company, by January, 1972, was predicting an estimated $40 million loss for fiscal 1972. Id. The company’s annual report for fiscal 1972 stated a loss of $90 million, and the company’s independent auditors withdrew certification of the 1971 financial statements and declined to certify those for 1972 because of doubts that the loss reported for 1972 was in fact suffered in that year. Id. Several suits followed the corporation’s disclosure of its 1972 losses. Id. The plaintiffs in the consolidated action on appeal were purchasers of Ampex securities during the 27-month period between the release of the 1970 and 1972 annual reports. Id. The defendants included the corporation, its
ance "imposes an unreasonable and irrelevant evidentiary burden" in certain situations. Following the lead of Blackie, several courts have done away with the requirement of direct reliance and demand only proof of "fraud on the market"—fraudulent actions by a defendant that affect the market price of stock which, in turn, induces the plaintiff to purchase the stock. In other words, some courts, in the absence of

principle officers during that period and the company's independent auditor. Id. The gravamen of the claims was the misrepresentation by reason of annual and interim reports, press releases and SEC filings from the date of the 1970 report until the true condition was disclosed by the announcement of losses after the 1972 fiscal year. Id.

The Ninth Circuit held that "proof of subjective reliance on particular misrepresentation is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market." Id. at 906. The court noted that causation is adequately established in the impersonal market context by proof of purchase and of the materiality of misrepresentations. Id. "Materiality circumstantially establishes the reliance of some market traders," the court stated, "and hence the inflation in the stock price—when the purchase is made the causal chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case." Id. (citing In re Memorex Sec. Cases, 61 F.R.D. 88, 101 (N.D. Cal. 1973); Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 HARV. L. REV. 584, 593 (1975)).

6. 524 F.2d at 907. According to the Blackie court, this burden is unreasonable because a purchaser on the stock exchanges may either be unaware of a specific false representation or may not directly rely on it, purchasing instead for some other reason, such as a favorable earnings trend or price-earnings ratio. Id. The purchaser, however, relies generally on the assumption that the market price is validly set and that no unknown manipulation has artificially inflated the stock price. Id. Thus, the purchaser relies indirectly on the truth of the representations underlying the stock price. Id. Whether or not he is aware of it, the purchaser pays a price that reflects material misrepresentations. Id.; see also Note, supra note 2, at 628-29 (rule 10b-5 plaintiffs face serious evidentiary burden in proving subjective reliance on defendants' conduct in open-market transactions).

Blackie and its progeny represent a significant departure from the traditional burden of proof in private 10b-5 actions. Note, supra note 4, at 1143. For further discussion of the traditional burden of proof, see supra note 3.

Courts have also noted the difficulty of proving subjective, individual reliance in the context of class actions in securities fraud litigation. See In re Memorex Sec. Cases, 61 F.R.D. 88 (N.D. Cal. 1973). There, the court pointed out the "overwhelming task" of examining the subjective intent of each class member in his decision with respect to his stock. Id. at 100. The court further stated that "it appears that reliance of the actual, subjective, individual nature necessary in the classical fraud case would unnecessarily encumber large 10b-5 actions and thereby thwart the Congressional interest in providing a means by which investors may recover against market manipulators in federal court." Id. at 99.

7. Blackie, 524 F.2d at 906-07. The fraud-on-the-market theory has been accepted in some form by the Second, Fifth, Ninth, Tenth and Eleventh Circuits. See, e.g., Lipton v. Documation, Inc., 734 F.2d 740 (11th Cir. 1984) (theory is properly applied in class action alleging defendant's manipulations inflated open market price), cert. denied, 469 U.S. 1132 (1985); T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330 (10th Cir. 1983)(applying theory to new issue of bonds), cert. denied, 465 U.S. 1026 (1984); Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981)(plaintiff's reliance on integrity of market in producing report in newspaper is merely extension of Blackie), cert. denied, 458 U.S.
Supreme Court attention to the issue, have allowed indirect reliance on the integrity of the securities market to substitute for direct reliance on the defendant or the defendant's conduct. In *Peil v. Speiser*, the United States Supreme Court has vacated a district court's decision in *Price Waterhouse v. Panzirer*, 459 U.S. 1027 (1982); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. May 1981)(en banc)(applying theory to purchase of newly issued stock), cert. denied, 459 U.S. 1102 (1983); Blackie, 524 F.2d 891 (9th Cir. 1975).

The phrase "fraud on the market" actually originated in *Herbst v. Able*, 47 F.R.D. 11, 16 (S.D.N.Y. 1969). *Herbst* was an action on behalf of all persons who converted certain debentures of the Douglas Aircraft Company, Inc. (Douglas) into common stock of that company during a three-week period in 1966. *Id.* at 14. The plaintiffs alleged that false and misleading statements made by the defendants had artificially inflated the value of Douglas securities and induced them to convert their debentures into common stock. *Id.* at 16. Although the case focused on the issue of class certification under Rule 23 of the Federal Rules of Civil Procedure and not on the application of the fraud-on-the-market theory, the *Herbst* court noted that if the plaintiffs could prevail in their "fraud on the market" theory, there might be sufficient grounds to sustain recovery under section 10(b), given its "broad anti-fraud provisions" that extend beyond the common-law actions for fraud and deceit. *Id.*

In general, courts look for the following three elements in the fraud-on-the-market complaint: "(1) the misrepresentations have affected the price of the firm's security; (2) the plaintiff detrimentally relied on the integrity of the market price when trading in the security; and (3) when the firm's true situation came to light, the price of the security reacted adversely." Note, *The Fraud on the Market Theory: Efficient Markets and the Defenses to an Implied 10b-5 Action*, 70 IOWA L. REV. 975, 977 (1985) [hereinafter Note, *Fraud on the Market*]; see also *Lipton v. Documenta*, Inc., 734 F.2d 740, 741-42 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985); Blackie, 524 F.2d at 894.


8. Note, supra note 4, at 1146. Central to the fraud-on-the-market theory is the premise that securities markets are efficient and that market prices respond to information disseminated (or not disseminated) concerning the companies whose securities are traded. *Id.* at 1154. In an efficient market, securities prices reflect all available information, according to certain analysts and commentators. See, *e.g.*, Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANALYSTS J. Sept.-Oct. 1965, at 55, 56, excerpted in R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 156, 157-58 (1980). This hypothesis is referred to as the efficient market hypothesis, theory or thesis. Note, *Fraud on the Market Theory, supra* note 7, at 979. For a discussion of the SEC's acceptance of the efficient-market thesis, as indicated by its adoption of an integrated disclosure system, see Black, supra note 7, at 468-72.

States Court of Appeals for the Third Circuit joined the growing number of circuits that have adopted the fraud-on-the-market concept and expressly held the theory applicable to rule 10b-5 claims in general and rule 10b-5(b) claims in particular, in the context of a securities fraud action by purchasers of corporate stock in an open and developed market against corporate personnel who affirmatively misrepresented corporate information.\(^9\)

The plaintiff in *Speiser* sued on behalf of a class of individuals who

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The issues raised by *Blackie* and its progeny arose in the context of “large, impersonal, actively traded markets,” which might be termed “developed markets.” Note, *supra* note 4, at 1154. In this setting, the reliance of some traders upon material misrepresentations by issuers of securities influences market prices and thereby affects even those traders who have never read or heard of the deception. *Id.*; see also In re LTV Sec. Litig., 88 F.R.D. 134, 145 (N.D. Tex. 1980).

Importantly, the presumption that the market price of stock reacts to and reflects the available information may not be plausible in the case of undeveloped markets, such as the market for newly issued stock. Black, *supra* note 7, at 472-73; Note, *supra* note 4, at 1156-58. Because most empirical studies of efficient markets have taken place in developed markets, it is not clear whether the efficient-market hypothesis can be used to support the application of the fraud-on-the-market theory to undeveloped markets such as those for new offerings and restricted resale securities or to thin markets. Note, *supra* note 4, at 1157. For a further discussion of the limitation of the fraud-on-the-market theory to developed markets, see *infra* notes 85-90 and accompanying text.

Two other assumptions on which the fraud-on-the-market theory arguably rests are that the average investor does not need access to all available information to make sound investment decisions and that damages due to misrepresentation can be quantified. Note, *Fraud on the Market Theory*, *supra* note 7, at 978-79. Some writers have argued that acceptance of these two assumptions and the efficient market hypothesis makes the traditional 10b-5 defenses of nonreliance and immateriality inappropriate in the fraud-on-the-market action. *Id.* at 979 (citing Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law 1, 13 (1982)).

9. 806 F.2d 1154 (3d Cir. 1986). Circuit Judges Seitz, Higginbotham and Becker heard the case. *Id.* at 1156. Judge Becker authored the opinion. *Id.* Because he disagreed with the views set out in Part IV of the opinion, regarding the preclusive effect of the jury verdict, Judge Becker drafted a separate dissenting statement on that specific issue. *See id.* at 1156 n.1 & 1167-68 (Becker, J., dissenting). Judge Seitz did not join in part III of the opinion. *Id.* at 1156 n.2. Although he assumed that the fraud-on-the-market theory applied to 10b-5(b) claims, Judge Seitz declined to reach that question, believing it was unnecessary given the court’s holding in part IV of the opinion. *Id.*

10. 806 F.2d at 1162-63. For a further discussion of the court’s holding, see *infra* notes 24-29 and accompanying text.
had purchased corporate stock from defendant Health-Chem Corporation during a seventeen-month period and later sold the stock at a loss.\textsuperscript{11} The individual defendants were officers of Health-Chem.\textsuperscript{12} Plaintiff, Raymond K. Peil, purchased 500 shares of Health-Chem's stock on December 5, 1980, in the midst of a surge in the stock's price due to favorable publicity surrounding Health-Chem's development of technology designed to combat gypsy moths.\textsuperscript{13} After the price of the stock declined, Peil sold his shares for a loss in excess of $6,000. Other members of the plaintiff class sustained similar losses.\textsuperscript{14}

Peil brought a class action in the United States District Court for the Eastern District of Pennsylvania against Health-Chem Corporation and its officers and directors alleging violations of section 10(b) of the Exchange Act and section 11 of the Securities Act of 1933, in addition to

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11. 806 F.2d at 1156-57. Specifically, the plaintiff class consisted of individuals who had purchased Health-Chem's stock between April 15, 1980 and November 2, 1981. \textit{Id.} at 1157. Pursuant to Federal Rule of Civil Procedure 23(b)(3), the United States District Court for the Eastern District of Pennsylvania certified the class on March 9, 1983, finding that the joinder of all members was impracticable, common questions were presented in the action; claims of the representative party were typical of claims of the class; the representative would fairly and adequately protect the interests of class; questions of law or fact common to members of the class predominated over any questions affecting only individual members; and the class action was a superior method of adjudication. \textit{Peil v. Speiser}, 97 F.R.D. 657, 658-62 (E.D. Pa. 1983).

12. \textit{Speiser}, 806 F.2d at 1156-57. The individual defendants included: Marvin Speiser, chairman of the board and president; Roy Marcus, senior vice-president; Leon C. Baker, a member of Health-Chem's executive committee; and Agis Kydonieus, executive vice-president of Health-Chem's Hercon Division. \textit{Id.} Drexel Burnham Lambert, Inc., the investment banking firm that had underwritten an April 15, 1981, offering of Health-Chem convertible debentures, was named as a defendant in connection with plaintiffs' claim under section 11 of the Securities Act of 1933. \textit{Id.} at 1157; see also 15 U.S.C. § 77k (1982). For a discussion of the section 11 claim, see \textit{infra} note 15.

Health-Chem was a diverse company engaged in several lines of business at the time of the transaction, including the development of technology that would permit the regulated release of chemicals through plastic membranes. \textit{Id.} at 1156.

13. \textit{Speiser}, 806 F.2d at 1157. For a discussion of the circumstances under which Peil purchased the stock, see \textit{infra} note 18. During the late 1970s, Health-Chem developed technology designed to combat gypsy moths with the aid of a chemical called pheromone. \textit{Id.} at 1157. The gypsy moth is a brownish or white European moth, now common in the Eastern United States, whose larvae feed on leaves and do great damage to trees and plants. \textit{Webster's New World Dictionary} 648 (College ed. 1960). Pheromone is an aphrodisiac that female insects release during the mating season. \textit{Speiser}, 806 F.2d at 1157 n.4. Health-Chem developed pheromone spraying technology as well as a gypsy moth trap for individual home owners to be used in combatting gypsy moth infestation of trees. \textit{Id.} As gypsy moth defoliation became a matter of great concern in 1980 and 1981, Health-Chem's work attracted the attention of security analysts, newspapers, scientific journals and gardening journals. \textit{Id.} at 1157. The price of Health-Chem's stock increased substantially during the latter half of 1980 and early 1981, but subsequently declined. \textit{Id.}

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various common-law offenses. Specifically, plaintiffs asserted that defendants' false and misleading statements about Health-Chem's business prospects had artificially inflated the price of Health Chem's stock, and that the price of the stock induced plaintiffs to purchase it.

Following certification of a class pursuant to Federal Rule of Civil Procedure 23(b)(3), the case proceeded through a five-week jury trial. After plaintiffs presented their evidence, the district court granted a

15. Id. For the texts of § 10(b) and rule 10b-5, see supra notes 2-3. With respect to their rule 10b-5 claim, plaintiffs alleged that Health-Chem and its directors and officers had violated clauses (a), (b) and (c) of that rule. Speiser, 806 F.2d at 1157.


Section 11 provides in pertinent part:

In case any part of the registration statement . . . [which] contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction, sue

(5) every underwriter with respect to such security.

Id.

16. Speiser, 806 F.2d at 1157. Plaintiffs further alleged that they had incurred financial losses when the falsity of defendant's representations became apparent and the price of Health-Chem's stock fell to its true value. Id.

17. Id. at 1157. During the trial, plaintiffs presented 29 witnesses and 200 exhibits. Id. They sought to establish that the Health-Chem defendants knew that the pheromone was not likely to be effective and that they had intentionally disseminated false and misleading information in order to increase the value of Health-Chem's stock. Id. Additionally, plaintiffs sought to prove the following:

1) that as a result of the misrepresentations and material omissions, Health-Chem's stock was very heavily traded and was a leading percentage gainer on the American Stock Exchange in 1980; 2) that the pheromone never lived up to its billing and was eventually abandoned by Health-Chem; and 3) that plaintiffs suffered losses as a result of their purchase of Health-Chem's stock.

Id. at 1157-58; see also id. at n.6 (summary of plaintiff's evidentiary presentation at trial).

Conversely, defendants argued at trial that their statements and financial figures were accurate and their predictions were reasonable. Id. Further, defendants argued that plaintiff Peil had not relied on the alleged misrepresentations. Id.

18. Id. at 1158. The court of appeals noted that the most significant testimony was Peil's own. Id. Peil testified that he had purchased Health-Chem stock based on the recommendation of his broker, who had advised him of an article in Financial World magazine which predicted a large increase in the value of the stock. Id. According to plaintiffs, the article included false representations by individual defendants about the company's outstanding prospects. Id. At trial, Peil conceded that he had never read the magazine article and that,
directed verdict for defendants on the common-law claims and the rule 10b-5(b) claim, concluding that plaintiffs had failed to prove reliance.\(^{19}\) Although the district court decertified the class with respect to the rule 10b-5(b) and common-law claims, it denied defendants' motion for a directed verdict with respect to the rule 10b-5(a) and (c) claims.\(^{20}\) The court stated that "direct" reliance by the plaintiffs on defendants' misrepresentations was not an essential element of those claims and that defendants could be found liable if they committed a fraud on the market.\(^{21}\)

The district court then submitted plaintiffs' rule 10b-5(a) and (c) and section 11 claims to the jury by special interrogatories.\(^{22}\) Based upon the jury's responses to the special interrogatories and the court's prior rulings on defendants' motions for directed verdicts, the district court entered judgment for defendants on all claims.\(^{23}\) After plaintiffs unsuccessfully moved for judgment n.o.v. on the section 11 claim, the court entered judgment on the verdicts and plaintiffs appealed.\(^{24}\) apart from his broker's advice to read the article, he had neither read nor heard of the defendants' alleged misrepresentations.  

19. Id. at 1158-59. Defendants moved for a directed verdict on the ground that Peil had failed to produce evidence from which a jury could conclude that he had relied on defendants' alleged misrepresentations and omissions. Id. at 1158. In granting the directed verdict, the district court stated that Peil's testimony that he was unaware of defendants' representations conclusively rebutted the presumption of reliance. Id. at 1159. Specifically, the court stated that "[n]o reasonable person could conclude that the named plaintiff relied in any way on any recommendation or misrepresentation by defendants. . . . The named class representative's own testimony rebuts the presumption of reliance." Id. at 1159 (citing App. at 1867-68). For a discussion of the necessity of proving reliance in 10b-5 actions, see supra notes 4-8 and accompanying text.


21. Speiser, 806 F.2d at 1159. The district court's definition of fraud on the market was similar to that of the Third Circuit. See Peil v. Speiser, 97 F.R.D. 657, 663 (E.D. Pa. 1983). The Third Circuit defined fraud on the market as a theory under which purchasers of securities can establish causation by demonstrating that, in making their purchase, they relied on the market price of the stock which had been "skewed" by the fraudulent actions of defendants. 806 F.2d at 1156. For an elaboration of the court's interpretation of the fraud-on-the-market theory, see infra notes 25-51 and accompanying text.

22. Speiser, 806 F.2d at 1159. Plaintiffs' claims were submitted pursuant to Federal Rule of Civil Procedure 49(a). Id.

23. Id. The verdict for defendants on the § 11 claim resulted from the jury's finding in response to a special interrogatory that the registration statement and prospectus contained no false statements of material fact and made no material omissions. Id. at n.8.

24. Id. at 1159. On appeal, the plaintiffs sought: 1) vacatur of the verdicts and the final judgment; 2) reversal of the judgment on the § 11 claims; 3) a new trial on plaintiffs' § 10 and pendent common law claims; and 4) a trial on a civil RICO (Racketeer Influenced and Corrupt Organizations) claim that the district court refused to allow plaintiffs to amend their complaint to interpose.
The applicability of the fraud-on-the-market theory to rule 10b-5 claims was a question of first impression for the Third Circuit. In holding that plaintiffs who purchase stock in an open and developed market need not prove direct reliance on defendants' misrepresentations, but can satisfy their burden of proof on the element of causation by showing that defendants made material misrepresentations, Judge Becker reviewed the legal background of rule 10b-5 and the fraud-on-the-market theory.

As to the development of the theory in the Third Circuit, Judge Becker stated that the court foreshadowed adoption of the theory in its opinion in Sharp v. Coopers & Lybrand. Sharp involved a question left open by the United States Supreme Court in Affiliated Ute Citizens of Utah v. United States, in which the Court held that when the alleged fraud consists chiefly of material omissions rather than affirmative misrepresentations, reliance is to be presumed and the burden shifts to defend-

Id. The appeals court had jurisdiction pursuant to 28 U.S.C. § 1291. Id.
25. Id. at 1160.
26. Id. at 1161.
27. Id. at 1160-61. For a discussion of the legal background of rule 10b-5, see supra notes 3-4 and accompanying text. For a discussion of the legal background of the fraud-on-the-market theory, see supra notes 5-8 and accompanying text.
29. 406 U.S. 128 (1972). Affiliated Ute involved a group of “mixed-bloods” of the Ute Indian Tribe who sued a bank, two bank employees and the United States, charging violations of the Securities Exchange Act of 1934 and rule 10b-5. Id. at 140. The claimed violations involved plaintiffs' sales of shares of the Ute Distribution Corp. (UDC), a company formed to manage oil, gas and mineral rights and unadjudicated or unliquidated claims against the government as part of a plan for distributing assets of the Ute tribe to individual “mixed-bloods,” in 1963 and 1964. Id. at 136. The Affiliated Ute Citizens (AUC) was an unincorporated association formed along with the UDC to manage asset distribution. Id. at 135-36. The case involved misrepresentations and omissions by the defendant bank employees and a breach of a duty to disclose. Id. at 150-53. The case, however, was primarily a duty-to-disclose case in which plaintiffs alleged that the “defendants devised a plan and induced the mixed-blood holders of UDC stock to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell.” Id. at 153.

The Court, in an opinion by Justice Blackmun, upheld the appellate court's determination that two defendant bank employees had violated rule 10b-5 by making misrepresentations of material fact within 10b-5(b), namely that the prevailing market price of the UDC shares was the figure at which the defendants' purchases had been made. Id. at 152. However, the Court focused primarily on defendants' omissions and concluded that the Tenth Circuit had erred in holding that there was no violation of rule 10b-5 unless the record disclosed evidence of reliance on the misrepresentations. Id. Because paragraphs (a) and (c) of rule 10b-5 do not contain the restriction of materiality, the Court read rule 10b-5 more broadly in holding that proof of reliance is not a prerequisite to recovery in such misrepresentation/omission cases. Id. For a concise statement of the Court's holding, see infra note 30.
ants to rebut it. In Sharp, the Third Circuit faced the question of

30. Speiser, 806 F.2d at 1161 n.11 (citing Affiliated Ute, 406 U.S. at 153-54). Specifically, the Affiliated Ute Court held:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that in necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. Affiliated Ute, 406 U.S. at 153-54 (citations omitted). The Third Circuit has held this standard of materiality applicable to rule 10b-5 actions, as well. See, e.g., Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 647 (3d Cir. 1980). In Healey, the plaintiff alleged that a material misrepresentation or omission on the part of the defendants operated to prevent the plaintiff from enjoining a contemplated merger through a state injunction. Id. at 646. The Third Circuit held that in such a case the plaintiff must prove "that at the time of the misrepresentation or omission, there was a reasonable probability of ultimate success in securing an injunction had there been no misrepresentation or omission." Id. at 647. In so holding, the court defined materiality as "a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." Id. (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

Two Second Circuit opinions subsequently developed the Affiliated Ute distinction, holding that victims of schemes to manipulate stock prices need only establish causation and not reliance. See Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974) (applying Affiliated Ute in context of allegations that defendant issued materially defective proxy statement which failed to disclose manner in which defendant had inflated value of its shares at expense of potential merger partner), cert. denied, 421 U.S. 976 (1975); Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341, 374-75 (2d Cir.) (applying Affiliated Ute in context of allegations of securities law violations in connection with contest between two corporations for control of third corporation), cert denied, 414 U.S. 910 (1973). These decisions applied the fraud-on-the-market theory to situations in which the deceptions were carried out by someone other than the issuer and the plaintiff's investment decision was less clearly linked to the deceptions. Note, supra note 4, at 1147.

The purported reason for shifting the burden of proof as to the reliance element in a case of material omission has been an assumption that the plaintiff is generally incapable of proving that he relied on an omission. Lewis v. McGraw, 619 F.2d 192, 195 (2d Cir.), cert. denied, 444 U.S. 951 (1980). "This incapacity arises from the difficulty of proving a speculative state of facts: Had the facts not been omitted, would plaintiff have acted on the information made available and thereby averted his loss?" Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981), cert. denied, 455 U.S. 935 (1982). However, the Sharp court was troubled by this shift in the burden of proof for two reasons: (1) the defendant, like the plaintiff, must prove a speculative state of facts in order to refute the presumption of reliance and (2) the problem of speculation is not unique to cases involving omissions. Id. Therefore, the Third Circuit in Sharp concluded that the proper approach to determining which party has the burden of proving reliance is to examine "the plaintiff's allegations in light of the likely proof at trial" and, from that examination, to place the burden of proof where it most reasonably belongs. Id.

One commentator has reasoned that "[s]ince nothing is affirmatively represented in a non-disclosure case, demanding proof of reliance would require the plaintiff to demonstrate that he had in mind the converse of the omitted facts, which would be virtually impossible to demonstrate in most cases." Note, The
whether the burden should be similarly shifted in a case where plaintiffs alleged both misrepresentations and omissions. While refusing to adopt a per se rule on the allocation of the burden of proof of reliance, the court held that, on the facts of that case, it was appropriate to pre-


For decisions indicating that the presumption of reliance is proper in cases of alleged omissions, but that no presumption arises in cases of alleged misrepresentations, see Vervaeke v. Chiles, Heider & Co., 578 F.2d 713, 717-18 (8th Cir. 1978); Rifkin v. Crow, 574 F.2d 256, 262-63 (5th Cir. 1978); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975).

It is important to note the distinction between Affiliated Ute and Speiser, a distinction which arguably explains why Affiliated Ute and its progeny are not controlling here. Affiliated Ute involved material omissions by defendants. 406 U.S. at 153-54. Speiser, conversely, involved affirmative misrepresentations by defendants. 806 F.2d at 1156. The distinction between omissions and misrepresentations can be determinative. Compare Vervaeke v. Chiles, Heider & Co., 578 F.2d 713 (8th Cir. 1978)(in 10b-5 action involving misleading prospectus on bond issue, plaintiff not entitled to presumption of reliance because case was pleaded as misrepresentation case) with Dekro v. Stern Bros. & Co., 540 F. Supp. 406 (W.D. Mo. 1982)(in 10b-5 action involving misleading bond offering circulars, plaintiff entitled to presumption of reliance because he pleaded case as omission case).

31. Sharp, 649 F.2d at 187. The Sharp court noted that Affiliated Ute made clear that in at least some situations a presumption of reliance in favor of the rule 10b-5 plaintiff is proper. Id. (citing Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974)).

In Sharp, the purchaser of a limited partnership interest in an oil and gas-drilling venture brought a securities fraud suit against Coopers & Lybrand, the accounting firm that had prepared an opinion letter dealing with tax treatment of investors. Id. at 178-79. The plaintiff alleged violations of section 10(b) and rule 10b-5, common-law fraud and breach of the common-law duty of due care. Id. at 179 & n.3. After class certification and a jury trial, the jury found that the tax opinion letter contained material misrepresentations and omissions and awarded damages in the amount of the actual value of a proportionate share of the partnership. Id. at 179. On appeal, the Third Circuit, in an opinion by Judge Aldisert, held that: 1) the accounting firm knew that investment decisions would be made on the basis of the opinion letter and, therefore, the firm was required to exercise a "stringent" duty to supervise its employees in drafting and issuing the letter and could be held liable under the doctrine of respondent superior; 2) the district court did not err in instructing the jury that the defendant had the burden of refuting reliance; and 3) the district court erred in instructing the jury that the measure of damages was to be the actual value of an interest in the partnership. Id. at 183-190.

The defendant accounting firm argued on appeal that the trial judge had erred in instructing the jury that the plaintiffs were entitled to a rebuttable presumption of reliance when plaintiffs alleged both omissions and misrepresentations. Id. at 185. The Third Circuit rejected appellant's assertion that the presumption of reliance should be limited to omissions situations, noting the analytical confusion and possible unfairness that would result from a strict application of the omissions-misrepresentations dichotomy. Id. at 187-88. The Sharp court stressed that reliance would be presumed only "where it is logical to do so," and that a strict rule requiring the defendant to refute a presumption of reliance would be neither equitable nor logical. Id. at 188 (citing Lewis v. McGraw, 619 F.2d 192, 195 (2d Cir.), cert. denied, 449 U.S. 951 (1980)).
sume reliance and to shift the burden to defendants to rebut that presumption.\textsuperscript{32} Although the \textit{Sharp} court did not expressly consider whether to adopt the fraud-on-the-market theory, the court observed that reliance was simply "one aspect of the ubiquitous requirement that losses be causally related to the defendant's wrongful acts."\textsuperscript{33} "Where it is logical to do so," the court said, the burden should be shifted to defendants to disprove reliance.\textsuperscript{34}

The \textit{Speiser} court read \textit{Sharp} as recognizing two important facts: "1) that the linchpin of the reliance requirement is a causal connection between defendants' actions and plaintiff's purchase of stock; and 2) that in certain cases, it is sensible to shift the burden of disproving reliance to the defendants."\textsuperscript{35} The court in \textit{Speiser} believed the fraud-on-the-market theory to follow from a combination of these observations.\textsuperscript{36} Judge Becker noted that, in the case of a developed market, a plaintiff's securities purchase can be causally related to the defendants' misrepresentations even if plaintiffs did not directly rely on the misrepresentations.\textsuperscript{37} "Moreover," Judge Becker concluded, "the likelihood of this causal connection is so strong that it is logical to presume reliance and to shift the burden of rebutting that presumption to defendants."\textsuperscript{38} \textit{Sharp} thus supports the Third Circuit's adoption of the fraud-on-the-market theory, according to the \textit{Speiser} court.\textsuperscript{39}

\textsuperscript{32} \textit{Id.} at 189. The \textit{Sharp} court expressly declined to adopt a strict rule allocating the burden of proof as to reliance. \textit{See id.} at 188-89. The court remained unpersuaded that the existence of misrepresentations or omissions, without more, necessitated any particular treatment of the reliance issue. \textit{Id.} at 188. Additionally, the court noted that a strict misrepresentation-omission dichotomy would necessitate a problematic, dual jury instruction in such cases. \textit{Id.} The \textit{Sharp} court thus favored a more flexible solution and concluded that the proper approach to the reliance problem is to "analyze the plaintiff's allegations, in light of the likely proof at trial, and determine the most reasonable placement of the burden of proof of reliance." \textit{Id.} (citing \textit{Affiliated Ute}, 406 U.S. at 153-54 ("positive proof of reliance" not required "under the circumstances of this case").) This flexible approach, the \textit{Sharp} court noted, "avoids the potential problems of a broad judicial pronouncement of a precept governing reliance." \textit{Id.} at 189 (footnote omitted). Applying this flexible approach to the facts of \textit{Sharp}, the Third Circuit upheld the district court's placement of the burden on Coopers & Lybrand because the defendant "undoubtedly foresaw" that its opinion letter would influence investors. \textit{Id.}

\textsuperscript{33} \textit{Id.} at 186 (citing Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974)).

\textsuperscript{34} \textit{Id.} at 187-88 (quoting Lewis v. McGraw, 619 F.2d 192, 195 (2d. Cir. 1980)).

\textsuperscript{35} 806 F.2d at 1161 n.11.

\textsuperscript{36} \textit{Id.}

\textsuperscript{37} \textit{Id.} For a discussion of the proposition that the fraud-on-the-market theory should be limited to developed markets, as opposed to markets for new or restricted securities, see \textit{infra} notes 85-90 and accompanying text.

\textsuperscript{38} \textit{Speiser}, 806 F.2d at 1161 n.11.

\textsuperscript{39} \textit{Id.} (citing \textit{In re LTV Sec. Litig.}, 88 F.R.D. 134, 142 (N.D.Tex. 1980))("Market reliance theory can also be viewed as an extension of the pre-
Judge Becker next turned to the central issue in Speiser, the applicability of the fraud-on-the-market theory to rule 10b-5(b) claims.40 Defendant Speiser argued from several cases that applied the fraud-on-the-market theory to 10b-5(a) and (c) allegations of a widespread scheme to defraud, but declined to apply it where plaintiffs alleged only misrepresentations or omissions under 10b-5(b).41 The court stated that, for its purposes, the “salient distinction” between paragraph (b) and paragraphs (a) and (c) is that the latter arguably require proof of a scheme to defraud, whereas paragraph (b) is “indisputably satisfied by a single fraudulent action.”42

Even assuming the validity of such a distinction, however, the court stated that the existence of a scheme to defraud is irrelevant to the applicability of the fraud-on-the-market theory because plaintiffs must still show that defendant’s misrepresentations were material under the theory.43 The court noted that, by definition, material misrepresentations or omissions are likely to influence the behavior of buyers and sellers.

40. Id. at 1162. Defendants did not contest the validity of the fraud-on-the-market theory generally, but argued that it ought to be limited to rule 10b-5(a) and (c) claims, and that plaintiffs should retain the burden of establishing direct reliance in rule 10b-5(b) claims. Id. Conversely, plaintiffs argued that there was no reason for limiting the theory in such a manner and that it ought to be applied to all rule 10b-5 claims, whether under paragraph (a), (b) or (c). Id. The court noted that this issue was “complicated by the uncertainty surrounding the differences and overlap among the three [paragraphs] of rule 10b-5.” Id. (footnote omitted). For the text of rule 10b-5, see supra note 3.

41. Speiser, 806 F.2d at 1162-1163 & n.16. For cases limiting the application of the fraud-on-the-market theory to particular classes of 10b-5 actions, see Shores v. Sklar, 647 F.2d 462, 467-72 (5th Cir. May 1981)(en banc)(holding theory applicable to paragraph (a) and (c) allegations of a pervasive scheme, but inapplicable to paragraph (b) claims of particular misrepresentations or omissions), cert. denied, 459 U.S. 1102 (1983); Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981)(reliance presumed for omissions falling within first or third paragraphs of rule 10b-5 but not presumed for misrepresentations or omissions falling within second paragraph), modified on other grounds mem., 650 F.2d 815 (5th Cir. 1981), aff’d in part, rev’d in part on other grounds, 459 U.S. 375 (1983); Mottoros v. Abrams, 524 F. Supp. 254, 259 (N.D. Ill. 1981)(plaintiff’s burden of establishing illegal course of conduct satisfied by proving evidence of scheme itself, materiality of misstatements and omissions and some level of scienter on part of defendants; burden then shifts to defendants to rebut presumption of reliance). See also 4 H. Newberg, Newberg on Class Actions § 22.10 at 23 (2d ed. 1985)(assuming fraud-on-the-market theory to be applicable only to rule 10b-5(a) and (c) claims involving schemes).

42. Speiser, 806 F.2d at 1162. The Supreme Court has reached a similar conclusion as to the distinction between paragraph (b) of rule 10b-5 and paragraphs (a) and (c). See Affiliated Ute, 406 U.S. at 151-54. In Affiliated Ute, the Court noted that paragraph (b) premises liability on material misstatements, but that the other paragraphs are broader, encompassing “ ‘a course of business’ or a ‘device, scheme or artifice’ that operates as a fraud. Id. at 153. For the text of rule 10b-5, see supra note 3.

43. Speiser, 806 F.2d at 1162.
and thus affect the market.\textsuperscript{44} "A single misrepresentation or omission, like a more widespread scheme, may artificially inflate the price of stock and thus defraud plaintiffs who rely on the price of the stock in deciding to purchase shares," Judge Becker stated.\textsuperscript{45}

The Third Circuit found the district court's and the defendants' explanation of why rule 10b-5(b) claims should be exempt from the fraud-on-the-market theory unpersuasive.\textsuperscript{46} Judge Becker distinguished \textit{Speiser} from \textit{Shores v. Sklar}\textsuperscript{47} which held that the theory applies to para-

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\item[44.] Id.
\item[45.] Id. (citing Rosenberg v. Digilog, Inc., 648 F. Supp. 40, 42-43 (E.D. Pa. 1985)(applying fraud-on-the-market theory to 10b-5(b) action). In \textit{Digilog}, the district court stated that imposing the requirement of a scheme "creates another burden which could effectively preclude the maintenance of otherwise legitimate suits under the securities laws. Securities legislation, enacted for the purpose of avoiding fraud, is intended by Congress to be construed \ldots flexibly to effectuate its remedial purposes." Rosenberg v. Digilog, Inc., 648 F. Supp. 40, 43 (E.D. Pa. 1985).
\item[46.] \textit{Speiser}, 806 F.2d at 1162. The court stated that "[n]either the district court nor defendants have explained why rule 10b-5(b) claims should be exempt from the 'fraud on the market' theory." \textit{Id}. The defendants relied chiefly on \textit{Shores v. Sklar}. 806 F.2d at 1162 (citing \textit{Shores v. Sklar}, 647 F.2d 462 (5th Cir. May 1981)(en banc), \textit{cert. denied}, 459 U.S. 1102 (1983)). For a discussion of \textit{Sklar} see infra notes 47-50 and accompanying text.
\item[47.] 647 F.2d 462 (5th Cir. May 1981)(en banc), \textit{cert. denied}, 459 U.S. 1102 (1983). The plaintiff's decedent in \textit{Sklar} purchased industrial development bonds on the advice of his broker, without having seen the allegedly fraudulent offering circular. \textit{Id}. at 463-64. The sole source of the income necessary to amortize the bonds defaulted almost immediately, causing the value of the bonds to drop dramatically. \textit{Id}. at 463-64. The plaintiff sued most of those involved with the issuance of the bonds, alleging that he had been made the victim of a widespread scheme to defraud investors in violation of the securities laws. \textit{Id}. at 464. Defendant Sklar was the attorney who prepared the offering circular. \textit{Id}. at 465. He allegedly omitted information concerning an SEC investigation and subsequent commencement of a civil action against one of the underwriters of the bond issue. \textit{Id}.

The Fifth Circuit, in an \textit{en banc} opinion, held that plaintiff had failed to state a cause of action under rule 10b-5(b). \textit{Id}. at 468. The plaintiff based his claim upon an allegation that the offering circular contained material misrepresentations and omissions which, admittedly, he had neither relied upon nor read. \textit{Id}. Although the court noted that plaintiff had not read or otherwise relied on the circular, it stated that plaintiff's further allegations were sufficient to state a claim under rule 10b-5(a) or (c). \textit{Id}. at 469. These allegations included charges based on the circular's false statements or misleading omissions and other allegations that the existence of the security in the marketplace resulted from successful perpetration of fraud on the investment community and that plaintiff had purchased in reliance on the market. \textit{Id}.

The court noted that, while failure to read the circular or otherwise rely on it would defeat a 10b-5(b) claim, the plaintiff had stated a cause of action under the broader language of 10b-5(a) or 10b-5(c), because the circular was part of an elaborate fraudulent scheme. \textit{Id}. at 469-70; \textit{see also} Note, supra note 4, at 1153 (noting that \textit{Sklar} holding is limited to new issues and arguably requires conspiracy among issuer and other parties involved in initial underwriting and selling effort for recovery). Responding to criticism from the dissent, the \textit{Sklar} court argued that misrepresentation and omission cases under 10b-5(b), requiring re-
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graph (a) and (c) allegations of a pervasive scheme but is inapplicable to paragraph (b) claims of particular misrepresentations or omissions. The basis for the distinction was that Sklar involved a newly issued security rather than a security already being traded in a well-developed market. The Sklar rationale was inapplicable, according to the Speiser court, because a well-developed market, in contrast to the market for a newly issued security, can "reasonably be presumed to respond to even a single material misrepresentation or omission concerning a stock already being traded in that market."

The Speiser court also rejected other authority cited by the appellees in their attempt to limit the fraud-on-the-market theory. That authority included one circuit court opinion and one district court opinion, each of which applied the fraud-on-the-market theory to 10b-5(a) and (c) allegations of a widespread scheme, while refusing to apply it where only misrepresentations or omissions under 10b-5(b) were alleged. 49

48. Sklar, 647 F.2d at 467-70.

49. Speiser, 806 F.2d at 1162. Sklar involved the purchase of revenue bonds issued by an industrial development board. See Sklar, 647 F.2d at 463. Speiser, in contrast, involved the purchase of widely traded corporate stock on the open market. See 806 F.2d at 1157. According to the Speiser court's reading of Sklar, the Sklar court "believed it unlikely that a single misrepresentation or omission would result in the sale of a new security; only a widespread scheme could have that effect." Id. at 1162-63.

50. 806 F.2d at 1163 (footnote omitted). The Speiser court added that there has been some disagreement as to the exact holding of Sklar and the strength of the Sklar rationale for limiting the fraud-on-the-market theory. Id. at 1162 (citing Lipton v. Documation, Inc., 734 F.2d 740, 747 n.11 (11th Cir. 1984) (expressing discomfort with Sklar's limitation of fraud-on-the-market theory to cases involving scheme), cert. denied, 469 U.S. 1132 (1985)). In Speiser, Judge Becker pointed out that there was a suggestion in Sklar that "the court believed the . . . theory to be applicable only in the case of newly-issued [sic] stocks that would not have been sold at all—and hence would not have been issued—without the issuer's fraudulent conduct." Id. at 1163 n.15 (citing Sklar, 647 F.2d at 471)(emphasis in original). Judge Becker stated, however, that even though the Eleventh Circuit was procedentially bound by Sklar, that circuit has rejected such a reading as "untenable," and that no other courts have posited such a limitation. Id. (citing Lipton v. Documation, Inc., 734 F.2d 740, 745 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985)). Therefore, Judge Becker concluded that, "[r]egardless of what Sklar did in fact hold, we agree with the Lipton court that there is no rationale for limiting the 'fraud on the market' theory to the issuance of new securities." Id.

51. Id. at 1163 n.16 (citing Huddleston v. Herman & Maclean, 640 F.2d 534, 548 (5th Cir. 1981), modified on other grounds mem., 650 F.2d 815 (5th Cir. 1981), aff'd in part, rev'd in part on other grounds, 459 U.S. 375 (1983); Mottoros v. Abrams, 524 F. Supp. 254, 259 (N.D. Ill. 1981)). The Speiser court noted, however, that neither of these courts had articulated a valid reason for applying the distinction. Id. at 1163 n.16.
Having concluded that the fraud-on-the-market theory of causation applies to 10b-5(b) claims, the court turned to the dispute over the preclusive effect of the jury’s verdict for defendants on the rule 10b-5(a) and (c) claims. The plaintiff argued that he was entitled to a new trial on the 10b-5(b) claim if the court found the fraud-on-the-market theory applicable to 10b-5(b) actions. Judges Seitz and Higginbotham disagreed with plaintiff’s argument, holding that the jury necessarily addressed the rule 10b-5(b) claim, which was based on misstatements, in finding defendants not liable under rule 10b-5(a) and (c), thus precluding a new trial on the 10b-5(b) claim. The majority’s holding turned chiefly on the jury’s negative answer to a special interrogatory, under which a jury finding of even a single fraudulent act, including a single misstatement, would have warranted an affirmative answer. Moreover, the Speiser court stated that the seminal fraud-on-the-market case, Blackie v. Barrack, apparently involved a 10b-5(b) claim. Id. (citing Blackie, 524 F.2d at 891). Although the Blackie court never explicitly stated under which paragraph of rule 10b-5 the plaintiff’s claim fell, the Speiser court noted that the case involved only a few misrepresentations in a company’s annual report and the court “quite clearly did not require a scheme in order to invoke the fraud on the market theory.” Id.; see also Rosenberg v. Digilog, Inc., 648 F. Supp. 40, 43 (E.D. Pa. 1985) (“Blackie did not require proof of a ‘common scheme.’”); Note, supra note 4, at 1148 n.25 (“The Blackie reasoning makes a fraud-on-the-market theory available in a rule 10b-5(b) claim as well as in claims based on 10b-5(a) and 10b-5(c).”). For a discussion of Blackie, see supra notes 5-7 and accompanying text.

52. Speiser, 806 F.2d at 1163-67.
53. Id. at 1164-65.
54. Id. at 1165. Judge Becker dissented on the preclusion issue. 806 F.2d at 1167-68 (Becker, J., dissenting). Specifically, Judge Becker differed from the majority on this issue based chiefly on his reading of the charge to the jury. Id. at 1167 (Becker, J., dissenting). The majority concluded that the jury instruction did not preclude a finding of liability based on a single misstatement. Id. at 1165-66. Judge Becker, however, asserted that the district court’s instruction gave the jury the “clear impression” that, while it was to consider any misrepresentations or omissions, such acts could violate the rule only if they were part of a larger scheme. Id. at 1167. (Becker, J., dissenting) (emphasis added). Under a previously enunciated standard concerning potential jury confusion, Judge Becker stated that the court was required to reverse and remand for a new trial on the 10b-5(b) issue. Id. (citing Ayoub v. Spencer, 550 F.2d 164 (3rd Cir.) (reversal appropriate because relationship between proximate cause and contributory negligence was not properly clarified for jury), cert. denied, 432 U.S. 907 (1977)). Given the confusion as to whether the jury charge allowed liability based on a single misstatement or omission, he asserted that the plaintiff’s 10b-5(b) claim could not be said to have been rejected by the jury. Id. at 1167 (Becker, J., dissenting). In conclusion, Judge Becker stated that the district court had erred in granting a directed verdict for defendants on the 10b-5(b) claim and by holding that the jury verdict on the paragraph (a) and (c) claims was not preclusive. Id. at 1168 (Becker, J., dissenting).

55. Id. at 1165-66. In permitting the plaintiffs to proceed on a fraud-on-the-market theory with respect to their rule 10b-5(a) and (c) claims, the district court charged the jury accordingly and submitted the following special interrogatory:

Did any of the following defendants knowingly or recklessly employ any device, scheme or artifice which defrauded plaintiffs in connection with
mary, the Third Circuit stated that the error of the district court in taking the 10b-5(b) claim from the jury was harmless "because none of the plaintiffs' evidence was excluded and the jury's determinations on the (a) and (c) claims necessarily excluded any factual basis for liability on the (b) claim." 56

It is submitted that the Third Circuit's acceptance of the fraud-on-the-market theory of causation in Speiser is a sensible adoption of principles previously enunciated in Blackie57 and Sharp.58 These cases recognized that it is difficult if not impossible for a plaintiff to prove subjective reliance on specific misrepresentations or omissions of defendants in cases in which an investor has purchased securities in an open, developed market.59 Given the intent of Congress to prevent all deceptive and manipulative practices in connection with the sale of securities, it is incongruous in such cases for courts to require proof that the plaintiff investor relied directly on the misrepresentation or omission.60 Adop-

their purchase or sale of Health-Chem stock, or knowingly or recklessly engaged in any act, practice or course of business which operated as a fraud or deceit upon plaintiffs in connection with their purchase or sale of Health-Chem stock?

Id. at 1165. The jury answered the interrogatory in the negative, and the court entered a verdict for defendants on both the rule 10b-5(a) and (c) claims. Id.

On appeal, defendants argued that the jury's negative answer to the special interrogatory required the court to conclude that defendants had committed no improper act, including any misrepresentations or omissions in violation of rule 10b-5(b). Id. at 1164. Plaintiffs, conversely, asserted that the interrogatory, when read in conjunction with the court's charge to the jury, dictated that only a "scheme" to defraud warranted a finding of liability. Id. at 1164-65 & n.18. Recall that paragraphs (a) and (c) arguably require proof of a scheme to defraud, while clause (b) is satisfied by a single fraudulent action. Id. at 1162. For a discussion of this distinction, see supra notes 41-45 and accompanying text.

In support of its holding that the jury's finding was preclusive, the majority stated that: 1) none of the plaintiff's evidence was withheld from the jury as a result of the directed verdict on the 10b-5(b) claim; 2) in charging the jury on the paragraph (a) and (c) claims, the court defined each element required to prove a section (b) claim; and 3) under the interrogatory, a single fraudulent act, even a single misstatement, would have warranted an affirmative answer. Speiser, 806 F.2d at 1165-66.

56. Speiser, 806 F.2d at 1167.

57. For a discussion of Blackie, the seminal fraud-on-the-market case, see supra notes 5-7 and accompanying text.

58. For a discussion of Sharp, the Third Circuit opinion that arguably foreshadowed the court's holding in Speiser, see supra notes 28-39 and accompanying text. As noted by the Speiser court, the fraud-on-the-market theory is now "widely accepted." For a list of circuits that have accepted the theory, see supra note 7.

59. See Sharp, 649 F.2d at 188-89; Blackie, 524 F.2d at 907.

60. Note, supra note 2, at 645. In enacting the Securities Act of 1933 and the Exchange Act, Congress intended to protect investors in the national securities markets and to promote informed investment decisions by requiring full disclosure of material information with respect to the issuance and trading of securities. See S. Rep. No. 792, 73d Cong., 2d Sess. 2 (letter from Franklin D. Roosevelt to Duncan V. Fletcher, chairman of the Banking and Currency Com-

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tion of the fraud-on-the-market theory eases plaintiff's burden of proof in these cases, and thereby promotes the deterrent effect of rule 10b-5 and contributes to achieving the goals for which Congress enacted the securities legislation.61

Opponents of the fraud-on-the-market theory of causation have advanced numerous arguments in opposition to this extension of the securities laws.62 Despite the surface appeal of some of these assertions, it

mittee, February 9, 1934), 2-4 (discussion of investigation of securities sales practices conducted by Committee on Banking and Currency and general analysis of Senate bill) (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 10-11 (1934)(manipulative practices are prohibited to "insure to the multitude of investors the maintenance of fair and honest markets"). For the House report on the Securities Act of 1933, see H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-5 (1933) ("there should be full disclosure of every essentially important element" concerning sale of securities). See also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (Securities Act of 1933 was "designed to provide investors with full disclosure of material information" concerning issuance of securities; Exchange Act "was intended to protect investors against manipulation of stock prices"). Courts developed the fraud-on-the-market theory to "enhance the enforceability" of these laws. Note, supra note 2, at 645; see also Blackie, 524 F.2d at 907 (court eliminated requirement that plaintiff prove reliance in open market case because to do otherwise would leave such plaintiffs unprotected).

The effectiveness of the securities laws is, of course, dependent upon their enforceability. Note, supra note 2, at 645 n.106. The fraud-on-the-market theory closes a "loophole" in the scheme of federal securities regulations. Id. In allowing investors who cannot prove actual reliance nevertheless to bring their claims, the courts acknowledge the "practical realities of securities trading in the national securities markets." Id.

61. Note, supra note 2, at 645-46 (asserting that fraud-on-the-market theory, by promoting honest and efficient market, can also increase investors' confidence in marketplace).

62. Id. at 646-54; see Black, supra note 7, at 457-68. In his article, Black states that the principal objections to the fraud-on-the-market theory are that "it contradicts the disclosure rationale of federal securities regulation, increases the likelihood of complex litigation of questionable utility, and makes the potential damages claims exorbitant." Black, supra note 7, at 457. The first objection is not persuasive, given evidence that there is no rational reason for a reasonable investor to himself read disclosure documents. See id. at 458; cf. Kripke, The Myth of the Informed Layman, 28 Bus. Law. 631, 632 (1973) (usefulness of disclosure is limited because documents are directed at "man in the street" instead of those with sophisticated knowledge who could make investment decisions)[hereinafter Kripke, The Myth].

Whether adoption of the fraud-on-the-market theory as a means of encouraging class action suits is an appropriate policy depends on one's evaluation of the benefits of private securities fraud actions. Black, supra note 7, at 459. Acceptance of Black's second objection to fraud on the market thus turns on one's opinion of private enforcement of securities laws. See id. For an argument that qualified adoption of the fraud-on-the-market theory serves to promote the purpose and effect of federal securities laws, see supra note 60.

Finally, while computation of damages in fraud-on-the-market cases may certainly be problematic, it is submitted that concern over large "windfall" damage awards is not sufficient reason to justify denying recovery to investors who, although they cannot prove direct reliance on defendant's misrepresentations, suffer quantifiable loss at the hands of market manipulators. For a discussion of the damage issue in connection with fraud-on-the-market litigation, see Black,
is submitted that few withstand analysis. One recurrent argument is that the fraud-on-the-market theory runs counter to the trend of the Supreme Court's rule 10b-5 cases since 1975, which has been to restrict the plaintiff class and the range of potential liability.63 While that may well be the trend in the law, none of the fraud-on-the-market decisions conflicts with any of these Supreme Court holdings.64

In addition, other critics contend that this extension of the federal securities laws will render the expensive and time-consuming disclosures required by the securities laws meaningless and will establish a scheme of "investors' insurance."65 This argument misconceives the importance of documents filed with the SEC and does not comport with the manner in which the typical investor makes decisions.66 It is the rare

supra note 7, at 441-42 n.30, 460-61 (difficulty in computing damages, along with fact that most cases are settled before trial, supports argument that securities fraud litigation can be "ruinous" to corporation). See also Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 STAN. L. REV. 371 (1974) (methods for computing damages previously employed in 10b-5 cases are inapplicable to actively traded stocks; investors in such stocks should receive no more than out-of-pocket loss).

63. Note, supra note 4, at 1160; see also Sklar, 647 F.2d at 484-85 (Randall, J., dissenting); Black supra note 7, at 459-60 & n.155. For cases illustrating this trend, see Aaron v. SEC, 446 U.S. 680 (1980) (scienter requirement applicable to injunctive action); Chiarella v. United States, 445 U.S. 222 (1980) (in nondisclosure case defendant must have duty to disclose to be held liable under 10b-5); Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (10b-5 does not reach breach of fiduciary duty of majority shareholders to minority when there is no allegation of misrepresentation or deception); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (establishing requirement of scienter for 10b-5 damages actions); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (restricting plaintiff class in 10b-5 actions to those who actually bought or sold securities).

64. Note, supra note 4, at 1160. It is submitted that the Supreme Court's failure to address the fraud-on-the-market issue in the numerous security cases where it has had the opportunity to do so arguably implies tacit acceptance of the theory by the Court. One can assume that if the Court were dissatisfied with the increasing use of the theory, it would have taken the opportunity to express its objections.

65. See Sklar, 647 F.2d at 483 (Randall, J., dissenting); see also List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), cert. denied, 382 U.S. 811 (1965). The SEC requires the filing of a prospectus and other reports upon issuance of securities. See 17 U.S.C. §§ 77(e), (j), 78(m) (1982). These documents are generally long, complex and of little value to the average investor until they have been interpreted by a financial professional or reflected by the market's pricing mechanism. See H. Kri Pke, The SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 24-26 (1979); Kri Pke, The Myth, supra note 62, at 632 (it is "myth" that prospectus can be and is used by layman); Note, supra note 2, at 646 (length and complexity of documents discourages average investor from reading documents).

66. Note, supra note 2, at 646. In reality, investment decisions are made through a "trickle down" process in which financial intermediaries, such as investment analysts, play an integral role in interpreting and translating the complex financial data disclosed by security issuers. Id.; see also H. Kri Pke, supra note 65, at 14; Note, Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend, 29 STAN. L. REV. 1077, 1077-79 (1977).
investor who digests the lengthy and complex filing documents required by federal securities laws.67 Indeed, most investors rely on someone else to interpret and translate information disclosed to the SEC.68 Thus, the fraud-on-the-market theory comports with the reality of securities investment by not requiring a showing of direct reliance on the issuer’s documents, and instead presumes an indirect reliance on others and on the market for interpretation of these complex documents.69

Furthermore, the Third Circuit’s adoption of the fraud-on-the-market theory hardly opens the floodgates to a tide of 10b-5 litigation. The theory merely allows a plaintiff whose injuries resulted from trading in open-market transactions to benefit from several rebuttable presumptions. These include the presumptions that the dissemination of material misrepresentations or omissions distorts securities’ prices and that the plaintiff relied on the efficiency of the market’s “valuation mechanism” to establish prices that reflect all available financial information.70 The class of potential plaintiffs is of necessity limited. At some point, an investor’s reliance on market analysis and prices becomes so attenuated that his imprudence becomes superceding, and courts should deny recovery, thus preserving the analytical integrity of the securities laws.71 Regardless of the application of the fraud-on-the-market theory, a plaintiff’s reliance must still be reasonable or justifiable.72 For instance, had

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67. Black, supra note 7, at 458 (few investors actually read and understand disclosure documents).
68. Note, supra note 2, at 646 & n.111. At least one author has asserted that the SEC’s assumption that informed investment decisions can be made from SEC disclosures is unrealistic. See Kripke, The Myth, supra note 62, at 633. Professor Kripke argues that investors make decisions by extrapolating securities’ potential from companies’ past financial performance, not by relying on specific documents filed by securities issuers with the SEC. Id. at 637.
69. See Black, supra note 7, at 458-59.
70. Note, supra note 2, at 647.
71. Id. at 650. “[C]ausation becomes less proximate as an investor’s relationship with the deception becomes more remote.” Id. At some point, an investor’s loss must be caused by his own failure to properly investigate, rather than the alleged deception or market interference. Id.; see also Sklar, 647 F.2d at 470 n.6 (citing Dupuy v. Dupuy, 551 F.2d 1005, 1020 (5th Cir.), cert. denied, 434 U.S. 911 (1977)) (reasonable reliance means not intentionally refusing to investigate in disregard of known risk); Keirnan v. Homeland, Inc., 611 F.2d 785, 787, 790 (9th Cir. 1980) (defendants rebutted plaintiff’s proof of reliance by showing that plaintiff relied on advice of three physicians and not on defendant’s alleged deception).
72. Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981), modified on other grounds mem., 650 F.2d 815 (5th Cir. 1981), aff’d in part, rev’d in part on other grounds, 459 U.S. 375 (1983). The Huddleston court distinguished between reasonable and justifiable reliance. Id. at 548. Specifically the court noted that the latter requires an objective or “reasonable man” test. Id. (citing 5 A. JACOBS, THE IMPACT OF RULE 10b-5 § 64.01(b) (ii) (Supp. 1980)). In so doing, the court observed that the former “contemplates a subjective reliance standard, tempered by the requirement of due diligence on the part of the plaintiff, rather than the objective reliance test applicable under the justifiable reliance concept.” Id. The Fifth Circuit has also noted that reliance requires only that
the appellant in *Speiser* purchased stock after simply hearing about the *Financial World* article from a neighbor, his reliance would have been unreasonable and he arguably could have been denied recovery on that ground.\(^73\)

Those who warn of a deluge of vexatious 10b-5 actions fail to recognize that adoption of the fraud-on-the-market theory does not require courts to impose liability more often or to award damages more liberally.\(^74\) Courts still have considerable discretion in determining who may proceed under rule 10b-5 and how much they may recover.\(^75\) The judiciary retains its gatekeeping function in certifying a group of investors as a class pursuant to Rule 23 of the Federal Rules of Civil Procedure.\(^76\) Additionally, plaintiffs must still plead and prove the other elements of their rule 10b-5 actions. Relaxing the plaintiff's burden as to causation does not relieve the plaintiff of proving the justifiability of reliance and the independent elements of scienter, materiality and damages.\(^77\)

It also bears emphasis that the fraud-on-the-market theory, as adopted by the Third Circuit, merely sets up several rebuttable pre-
sumptions that may, by definition, be overcome by the defendants. 78
Several important defenses still exist. Despite the presumption of reliance, a 10b-5 defendant may nevertheless escape liability by proving that the market did not respond to the alleged misrepresentations or omissions (immateriality defense), or that plaintiffs knew of the falsity of defendants’ misrepresentations or would have purchased the securities even if they had known of them (nonreliance defense). 79

78. Id. at 647; see also Black, supra note 7, at 447 (plaintiff is afforded rebuttable presumption of reliance under prevailing view). Black, however, cautions against the total elimination of the reliance requirement in 10b-5 actions, especially in cases of less actively traded securities. Black, supra note 7, at 472. She agrees, though, that affording plaintiff a presumption of reliance in the case of widely traded securities “follows logically from the efficient-market theory” and that it is “appropriate to transfer to the defendant the burden of disproving reliance.” Id. at 473.

The Third Circuit’s view of the role of reliance as adopted in Speiser must be contrasted with the “pure causation” approach to rule 10b-5 liability. See id. at 448-49. Under the “pure-causation” approach, the only purpose of proving reliance is to establish causation. Id. at 448. If other means can be employed to establish causation then the need to demonstrate reliance is obviated. Id. A material misstatement, which substitutes for proof of causation, thus establishes plaintiff’s prima facie case. Id. at 449. This is to be contrasted with the prevailing view which the Third Circuit followed. Under this view, the plaintiff is afforded a rebuttable presumption of indirect reliance, necessarily easing his burden in establishing a prima facie case. Id. at 447-48.


79. Speiser, 806 F.2d at 1161. For a more extensive discussion of the defenses to an implied 10b-5 action, see Note, Fraud on the Market, supra note 7, at 987-93. There, the commentator argues that the defenses of nonreliance and immateriality are inconsistent with the assumptions underlying the fraud-on-the-market claim. Id. at 986-87. He rejects the nonreliance defense by asserting that mere “[i]nvesting in the market demonstrates sufficient reliance on it, because no investor assumes the risk of fraud affecting the security’s price.” Id. at 988. A variation of this defense, or the “would have purchased anyway” defense, is, according to the commentator, also inconsistent with the concept of an efficient market, in which investors would pay a different price if there had not been a fraud on the market. Id. at 989. Rather than focusing on these supposed defenses, the proper inquiry under the assumption of an efficient market is whether the market price of the stock was affected. Id. at 990. Finally, the author asserts that the “efficient market underpinnings of the fraud on the market theory” should eliminate the materiality defense for three reasons: (1) the effect of any announcement exposing a misrepresentation can be measured for its effect on the market price of the stock; (2) the difficulty in distinguishing between information that will influence the investor’s decision and information that will not; and (3) the measure of damages in the fraud-on-the-market action does not require threshold materiality as in the traditional 10b-5 action. Id. at 991-92.
It is further submitted that the Speiser court, in refusing to limit application of the fraud-on-the-market theory to 10b-5(a) and (c) claims, correctly rejected the questionable rationale of Shores v. Sklar.\textsuperscript{80} Sklar, it will be recalled, held the theory applicable to paragraph (a) and (c) allegations of a pervasive scheme, but inapplicable to paragraph (b) claims of particular misrepresentations or omissions.\textsuperscript{81} Sklar is factually distin-

According to another author, there are four defenses under the prevailing view of the fraud-on-the-market theory: (1) defendant can attempt to demonstrate the immateriality of the misstatement; (2) defendant can show that an insufficient number of traders relied on the misstatement, and that the price was not affected by it; (3) defendant can prove that an individual plaintiff had purchased the security despite his knowledge of the material misstatement; and (4) defendant can demonstrate that an individual plaintiff would have purchased even if he had known of the falsity. Black, supra note 7, at 448.

In Speiser, the defendants urged that, even if the court would apply the fraud-on-the-market theory to the plaintiff's rule 10b-5(b) claim, Peil's testimony that he had not directly relied on the alleged misrepresentations conclusively rebutted the presumption of reliance. 806 F.2d at 1163. The court rejected this contention, however, noting that the defendants had not attempted to establish either means of rebutting reliance: "1) the misrepresentations did not affect the market price of the stock; or 2) plaintiff would have purchased the stock even at the price it would have been at but for the misrepresentations." \textit{Id.} According to the court, Peil's testimony "established only that he did not rely \textit{directly} on defendants' misrepresentations, a fact that is not relevant under the fraud on the market approach." \textit{Id.} (emphasis in original). The court added that the defendants misunderstood the theory since the theory permits a plaintiff to prevail even though he was completely unaware of the misstatements. \textit{Id.}

Although under Speiser, the fraud-on-the-market theory is good law with respect to the Securities Acts, no state courts have adopted the theory. \textit{Id.} at 1163 n.17; \textit{see also} Rosenberg v. Digilog, Inc., 648 F. Supp. 40, 43-44 (E.D. Pa. 1985). Thus, direct reliance remains an element of a plaintiff's common-law securities fraud claim. 806 F.2d at 1163 n.17. For this reason, the Third Circuit stated that the district court's direction of a verdict against Peil on his common-law claims was proper. \textit{Id.}

\textsuperscript{80} Several courts and commentators have questioned the Sklar holding. See Speiser, 806 F.2d at 1162-63 & n.15 (questioning whether Sklar court was correct in requiring direct reliance on misrepresentations); Lipton v. Documation, Inc., 734 F.2d 740, 747 n.11 (11th Cir. 1984) (expressing discomfort with Sklar's limitation of theory to cases involving scheme), \textit{cert. denied}, 469 U.S. 1132 (1985); Note, supra note 2, at 644 n.105 (noting that Sklar decision has not been "universally well-received").

Other courts have held directly contrary to the Sklar decision. See, e.g., Blackie, 524 F.2d 891; Rosenberg v. Digilog, Inc., 648 F. Supp. 40 (E.D. Pa. 1985). The Digilog court noted that imposing the requirement of a scheme "creates another burden which could effectively preclude the maintenance of otherwise legitimate suits under the securities laws." Rosenberg v. Digilog, Inc., 648 F. Supp. 40, 43 (E.D. Pa. 1985). In addition, the court reiterated that Congress intended that securities legislation, enacted for the purpose of avoiding fraud, be construed flexibly to effectuate its remedial purposes. \textit{Id.} For a further discussion of Sklar, see supra notes 47-50 and accompanying text.

\textsuperscript{81} Sklar, 647 F.2d at 467-70. The district court in Speiser followed Sklar and agreed with defendants' argument that the plaintiffs should retain the burden of establishing direct reliance in rule 10b-5(b) claims. 806 F.2d at 1162. In rejecting this position, the Third Circuit noted that, in addition to the Fifth Circuit in Sklar, only one other circuit court and one district court have applied the
guishable from Speiser in that it involved an issue of new securities rather than a security already being traded in a well-developed market. The Sklar rationale is arguably inapplicable in a well-developed market, which "can reasonably be presumed to respond to even a single material misrepresentation or omission concerning a stock already being traded in that market." Assuming the validity of the efficient-market hypothesis, it is submitted that the thesis that the well-developed market is distorted by a 10b-5(b) violation as well as by a 10b-5(a) or (c) violation is correct.

Despite the virtues of the fraud-on-the-market theory, it is suggested that courts should limit application of the principle to situations involving developed markets, as opposed to new or undeveloped markets where the efficient-market hypothesis is unlikely to hold true.

The fraud-on-the-market theory to 10b-5(a) and (c) allegations of a widespread scheme, while refusing to apply it when only misrepresentations or omissions under 10b-5(b) were alleged. Id. at 1163 n.16 (citing Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. Mar. 1981), modified on other grounds, 650 F.2d 815 (5th Cir. July 1981), aff'd in part, rev'd in part on other grounds, 459 U.S. 375 (1988); Mottoros v. Abrams, 524 F. Supp. 254, 259 (N.D. Ill. 1981)). At least one commentator has also suggested such a limit on the fraud-on-the-market theory. See 4 H. NEWBERG ON CLASS ACTIONS 23 (2d ed. 1985) (assuming theory to be applicable only to rule 10b-5(a) and (c) claims involving schemes).

82. Speiser, 806 F.2d at 1162. Sklar involved the purchase of newly issued revenue bonds of an industrial development board. 647 F.2d at 463-64. Speiser, conversely, involved the purchase of a widely traded stock which traded in a well-developed market. 806 F.2d at 1157. The Speiser court suggested that the Sklar court believed it unlikely that a single misrepresentation or omission would result in the sale of a new security. Id. at 1162-63. According to the court, though, a well-developed market can reasonably be presumed to respond to even a single material misrepresentation or omission concerning a stock already being traded on the market. Id. at 1163.

83. Speiser, 806 F.2d at 1163 (footnote omitted). For a discussion of the distinction between well-developed securities markets and markets for newly issued securities, see infra notes 85-90 and accompanying text.

84. See supra note 8.

85. See Note, supra note 4, at 1153-58; see also Black, supra note 7, at 472-73 ("relaxed view" of reliance not appropriate in cases of less widely traded securities). The Speiser court suggested in dicta that the fraud-on-the-market theory, resting on the analytical underpinnings of the efficient-market theory, may not apply in the case of newly issued stock. 806 F.2d at 1161 n.10. Because the case involved a widely traded and established stock, the court stated that it did not have to consider whether it would apply the theory in other instances. Id. Thus, the applicability of the fraud-on-the-market theory to fraud in connection with newly issued securities remains an open question in the Third Circuit. See id.

In this discussion, the term "developed markets" generally refers to large, impersonal, actively traded markets. See Note, supra note 4, at 1154. Such markets can be contrasted with "undeveloped markets," such as thin markets and markets for new offerings and restricted resale securities. Id. at 1157.

One commentator has noted that two assumptions must be valid for the fraud-on-the-market theory to apply—that securities prices reflect all available public information and that they adjust rapidly to the dissemination of new financial information. Note, supra note 2, at 647. It is suggested that this observation is consistent with the efficient-market hypothesis.
Available empirical evidence suggests that developed markets are indeed efficient. Given the dearth of empirical studies of undeveloped markets, it is not clear whether the efficient-market hypothesis supports the extension of the fraud-on-the-market theory to less developed markets. Common sense, though, suggests that prices of securities in undeveloped markets, especially those for new offerings, do not fully reflect all publicly available information in regard to those securities. Thus, until more information is available regarding the valuation process of securities in undeveloped markets, courts should restrict application of the fraud-on-the-market theory of causation to efficient, developed markets.

Jeffrey E. Fleming
at 473 (advocating that fraud-on-the-market theory only be applied to widely traded securities).