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RULE 10b-5 AND "FRAUD-ON-THE-MARKET"— —HEAVY SEAS MEET TRANQUIL SHORES

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Fraud is infinite, and were a Court of Equity once to lay down rules, how far they would go, and no further, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes which the fertility of man's invention would contrive.¹

[T]he central purpose of the acts is the protection of investors . . . and the promotion of free and honest securities markets. . . . The acts reach complex fraudulent schemes as well as lesser misrepresentations or omissions. Full disclosure is only one means, albeit a central one, of achieving these paramount goals.²

I. INTRODUCTION

Lord Hardwicke's missive discloses the spark of dynamism which has guided the evolution of the body of law that today surrounds Section 10(b) of the Securities Exchange Act of 1934³ and SEC Rule 10b-5.⁴ That the section and the rule prohibit "fraud" in connection with the purchase or sale of a security, and that the proscriptions "must be read flexibly, not technically and restrictively,"⁵ is the stuff on which practitioners in the area have long been weaned. Yet post-1975 attention of the United States Supreme Court to matters of securities law which formed the heart and soul of an expansionist era has brought retrenchment and sober reconsideration of the proper role and scope of securities law protections. This is particularly true as to assertion of implied private remedies,⁶ and it is against that backdrop that the 1981 decisions in

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¹ Letter of Lord Hardwicke to Lord Kames (1785), *quoted in* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 193 (1963).

² *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc).

³ 15 U.S.C. § 78j(b) (1976).

⁴ 17 C.F.R. § 240.10b-5 (1976).

⁵ *Supt. of Ins. of New York v. Bankers Life Casualty Co.*, 404 U.S. 6, 10 (1971).

⁶ *See* *Marine Bank v. Weaver*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,481, at 92,764 (1982) (certificate of deposit issued by federally regulated bank not a "security" within the purview of the federal securities laws); *Aaron v. Securities and Ex-*

Shores v. Sklar,⁷ and *Panzirer v. Wolf*,⁸ by the Fifth and Second Circuits respectively, along with *Abrams v. Johns-Manville Corp.*⁹ in the Southern District of New York, stand spotlighted in their proposition of securities law antifraud liability based upon so-called integrity of the market.

Of critical concern, of course, is the absence in this approach to "fraud" of any direct causal connection between any allegedly deficient disclosure and the subject transaction. *Shores* thus upheld the assertion of antifraud claims based upon the fraudulent presence of securities in a market without regard for the failure of the plaintiff to read any

change Commission, 446 U.S. 680 (1980) (SEC must prove scienter as an element of a civil enforcement action for violations of § 10(b), Rule 10b-5, and § 17(a)(1) of the Securities Act of 1933); *Chiarella v. United States*, 445 U.S. 222 (1980) (silence, absent a duty to disclose, will not give rise to § 10(b) and Rule 10b-5 liability); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (refusal to imply any private right of action under § 206 of Investment Advisers Act); *Leroy v. Great Western United Corp.*, 443 U.S. 173 (1979) (Securities Exchange Act § 28 intended to protect rather than limit state authority with regard to corporate and securities transactions); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (refusal to imply any private damage remedy under § 17(a), Securities Exchange Act of 1934); *Burks v. Lasker*, 441 U.S. 471 (1979) (state law governs corporate directors' power to terminate derivative litigation); *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979) (interest in an involuntary, non-contributory pension plan not security within the purview of federal securities laws); *Securities and Exchange Commission v. Sloan*, 436 U.S. 103 (1978) (SEC statutory power to summarily impose ten-day trading suspension strictly construed to preclude series of summary suspensions based on single set of circumstances); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (only conduct involving manipulation or deception within the scope of § 10(b) and Rule 10b-5); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (refusal to imply any private right of action under § 14(e) of the Securities Exchange Act of 1934 on behalf of an unsuccessful tender offeror); *Radzanower v. Touche Ross & Co.*, 426 U.S. 148 (1976) (restrictive approach to proper venue for suits against a national bank under Securities Exchange Act of 1934); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (pronouncement of a materiality standard recognizing that "[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (*scienter* an element of private action for damages under § 10(b) and Rule 10b-5); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975) (traditional requirements, including that of irreparable harm, apply to claims for injunctive relief for violation of § 13(d) of the Securities Exchange Act); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (standing to assert § 10(b) and Rule 10b-5 claims limited to actual purchasers or sellers); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (shares of "stock" in state-sponsored housing cooperative not securities within the purview of federal securities laws); *but see Steadman v. SEC*, 450 U.S. 91 (1981) ("preponderance of evidence" standard appropriate in SEC administrative proceedings rather than more restrictive "clear and convincing" standard); *Rubin v. United States*, 449 U.S. 424 (1981) (pledge of stock as collateral for bank loan constitutes "offer or sale" within purview of § 17(a) of Securities Act of 1933); *United States v. Naftalin*, 441 U.S. 768 (1979) (protection of § 17(a) of Securities Act of 1933 extends beyond actual purchasers and investors to cover those involved in after-market trading frauds).

⁷ 647 F.2d 462 (5th Cir. 1981) (en banc), *petition for cert. pending*, No. 81-839.

⁸ 663 F.2d 365 (2d Cir. 1981), *cert. granted sub nom.* *Price Waterhouse & Co. v. Panzirer*, No. 81-1998.

⁹ [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,348, at 92,156 (S.D.N.Y. 1981).

disclosure documents. Applying a "chain of causation" analysis, *Panzirer* likewise looked to the "integrity of the market" to uphold the statement of claim based upon deficient disclosure in documents the plaintiff never saw, but which allegedly resulted in favorable media commentary.

No doubt mindful of an earlier reflection that the area of securities law liability analysis is one in which "glib generalization and unthinking abstractions are major occupational hazards",¹⁰ the Supreme Court, in its post-1975 securities law decisions, has taught that careful attention to the statutes and their desired purpose is a virtue to be practiced with solemn dedication.¹¹ In particular, the Court cautioned that the language of Section 10(b) and Rule 10b-5 establishes the outer limits of its own sphere of operation. Courts may not properly "add a gloss to the operative language of the statute quite different from its commonly accepted meaning."¹² That admonition in *Santa Fe Industries, Inc. v. Green* came in reaction to an attempt to extend the notions of "fraud" or "manipulation" within the ambit of Section 10(b) and Rule 10b-5 to unfairness or breaches of fiduciary duty in connection with a securities transaction. The *Santa Fe Industries* Court soundly rejected this attempt upon the recognition, among others, that the Supreme Court "repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure;' once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute."¹³

Though not entirely without tension among the circuits and occasional expansively imaginative interpretations, the post-1975 decisions of the high Court addressing the scope and breadth of the federal securities laws, particularly the antifraud provisions, have dominated throughout the judiciary. On fundamental questions of standing, materiality, and the very notion of "fraud", the appellate courts have carried the tenets of the Supreme Court decisions into varied applications. Moreover, the sense of the post-1975 positions of the Court has manifested itself in important considerations of other fundamental principles attendant to antifraud claims.¹⁴

¹⁰ SEC v. National Securities, Inc., 393 U.S. 453, 465 (1969).

¹¹ See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), in which the Court in considering the issue of standing to assert a private right of action under § 10(b) and Rule 10b-5 cautioned that expansive interpretations and applications must be consistent with policy considerations underlying the legislative scheme. See 421 U.S. at 737.

¹² *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977).

¹³ *Id.* at 477-78.

¹⁴ For example, paying particular heed to Justice Rhenquist's admonition in *Blue Chip Stamps* that in deciding questions concerning the scope of civil actions under § 10(b) and Rule 10b-5 "policy considerations" should be taken into account, the Sixth Circuit Court of Appeals opined in *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977), that the causation element of antifraud liability requires a direct causal relationship, tantamount to privity, between open market buyers and sellers of a security in order for there to be recovery under Rule 10b-5 for trading on "inside" information.

In decisions since *Santa Fe Industries, Inc. v. Green*¹⁵ the lower courts confronting antifraud allegations in so-called corporate "fairness" transactions, particularly those courts embracing the recalcitrant post-*Santa Fe* interpretation of the Second Circuit in *Goldberg v. Merridor*¹⁶ have demonstrated careful adherence to the fundamental proposition that Section 10(b) and Rule 10b-5 address deception in connection with the purchase or sale of a security.¹⁷

The Supreme Court's post-1975 limitations on the scope of private actions under Section 10(b) and Rule 10b-5 come in conjunction with its reference to the "modest aims and origins of the Rule",¹⁸ and the further view that an "inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good."¹⁹ The impact has profoundly changed the course of development of the law surrounding Section 10(b) and Rule 10b-5. It is in the midst of this new environment that the decision of the Fifth Circuit in *Shores v. Sklar*, and the subsequent decisions in *Panzirer v. Wolf* and *Abrams v. Johns-Manville Corp.*, which together articulate antifraud liability based upon extension of the established "fraud-on-the-market theory" to "integrity" of the market, must be confronted.

In *Shores*, a sharply divided *en banc* panel upheld the assertion of Section 10(b) and Rule 10b-5 claims by the purchaser of certain revenue bonds who alleged that the securities were "fraudulently" marketed, but who admitted that he had neither seen nor otherwise relied upon the disclosure document relating to the bonds containing alleged misrepresentations or omissions of material facts. The majority found the basis for Rule 10b-5 liability in a "broader theory of fraud" premised upon the fraudulent creation and distribution of the bonds in the marketplace which presumably would have been available for purchase otherwise.

Panzirer recognized the validity of a Rule 10b-5 claim relating to an allegedly fraudulent annual report which the purchaser never saw. The information was said to have led to statements made in a financial news column of the *Wall Street Journal*, however, which portrayed the issuer

¹⁵ 430 U.S. 462 (1977).

¹⁶ 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). In an opinion by Judge Friendly, the *Goldberg* court distinguished *Santa Fe* by reason of the misleading public disclosures and the availability of a state court injunctive remedy.

¹⁷ See, e.g., *Healy v. Catalyst Recovery of Pennsylvania, Inc.*, 616 F.2d 641 (3rd Cir. 1980); *Alabama Farm Bureau Mutual Casualty Co., Inc. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979); *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Merritt v. Colonial Foods, Inc.* [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,689, at 98, 617 (D. Del. 1980).

Whether or not these cases, in creating an exception to *Santa Fe*, operate to undermine the intent of the Supreme Court, clearly the focus on *deception* under Rule 10b-5 is now paramount.

¹⁸ *Blue Chip Stamps*, 421 U.S. 723, 736 n. 8 (1975).

¹⁹ *Id.* at 747-48.

in a favorable light in the marketplace, and on which the purchaser relied. Similarly, *Abrams* upheld Rule 10b-5 claims by an investor who had not read disclosure documents which contained allegedly false or misleading information. Rather than focusing upon fraudulent creation or marketing of the securities involved, these courts viewed the deficient disclosures—the “fraud”—as affecting either the totality of information available in the marketplace, or the market price for the shares.

The concept of “fraud-on-the-market” is not a new one in securities law liability. Indeed it previously formed the basis for important procedural determinations in securities litigation which have, in turn, produced substantive law in the area.²⁰ The emergence of the principle, restated in terms of “integrity” of the market, to sustain antifraud claims absent any traditional nexus between allegedly deficient disclosure documents and investment decisions stands rather dramatically in contrast to the sense of the post-1975 decisions of the Supreme Court. Indeed it stands in conflict with positions in other circuits. The extreme example in *Shores*, that the very creation and distribution of the securities constituted a “fraud” on the market irrespective of any consideration of deficient disclosure documents, raises fundamental questions in relation to the proper scope and application of the antifraud provisions. *Panzirer*, although more traditionally oriented toward information dissemination, raises equally fundamental questions of causation that neither can nor should be disposed of on presumptions or suppositions of pre-1975 vintage. *Panzirer* similarly contributed to a conflict among the circuits.

This article focuses upon the origins of the “fraud-on-the-market” approach to antifraud claims under Section 10(b) and Rule 10b-5, and considers the current applications in depth, particularly in light of the post-1975 decisions of the United States Supreme Court. In a legal environment demonstrably and increasingly skeptical, if not hostile, to expansive interpretations of the federal securities laws, *Shores* and *Panzirer* are anomolous, if not outrightly aberrant, in their treatment of elements which have been and continue to be fundamental to determining the scope of coverage of the implied private right of action under Rule 10b-5, namely, causation and reliance. In one form or another these elements form the basis of the necessary relationship between an investment decision—the object of antifraud protection—and a Rule 10b-5 prohibited act.²¹ Their respective approaches to Rule 10b-5 claims based

²⁰ See text accompanying notes 31-57 *infra*.

²¹ Reliance in Rule 10b-5 analysis is more precisely addressed as an aspect of causation-in-fact, which is in all cases one of the determinative factors as to the scope of coverage. The development of the case law under Rule 10b-5 has been shaped significantly by varying interpretations of the parameters of the element and its own subclasses: transaction causation and loss causation. “Transaction causation” turns upon a direct causal connection between the transaction complained of and the offending act. “Loss causation” means only that nexus between the offending act and the economic harm exists. See Comment, 32 WASH. & LEE L.

upon "integrity of the market" invited careful scrutiny; for they seemingly stand at the crossroads on the way to future development of the scope of Rule 10b-5. In evaluating these current approaches to investor protection, this article shall first examine the roots of the "fraud-on-the-market" notion and its early and ostensibly procedural applications. When coupled with pre-1975 policy analysis, the roots of the notion and its early applications set the stage for broadened applications. The article will then turn to the post-1975 decisions of the Supreme Court and their progeny, fundamental policy and legal analysis of the elements of a Rule 10b-5 claim. The article concludes with an in-depth analysis of the *Shores* and *Panzirer* approaches, the conclusions to be drawn from them, and their vitality in the future dynamics of the law. Finally, the article addresses the role of causation in those future dynamics.

II. THE ORIGINS OF "FRAUD-ON-THE-MARKET" AND ITS EARLY APPLICATIONS UNDER RULE 10b-5

In *Joseph v. Farnsworth Radio & Television Corp.*²² the scope of Rule 10b-5 protection in a private action was first addressed in a meaningful way. The *Joseph* court considered what class of persons may recover in such an action. Plaintiff asserted Rule 10b-5 claims arising out of the open market purchase of shares of stock in a company based upon published information regarding the Company's financial condition. When later the Company disclosed the true facts about its financial condition, the price of the stock fell, and plaintiff sued the defendant directors for the difference. The District Court dismissed the complaint upon grounds that no "semblance of privity" existed between the plaintiffs

REV. 693 (1975). Ascertaining the presence of requisite causation-in-fact in terms of either the more restrictive transaction causation or less restrictive loss causation approach historically, by design or otherwise, has turned upon the type of Rule 10b-5 violation alleged. Compare *Schlick v. Penn Dixie Cement Co.*, 507 F.2d 374 (2d Cir. 1974) (only loss causation necessary where manipulation scheme depressed market price for shares in merger transaction) with *Ketchum v. Green*, 557 F.2d 1022 (3rd Cir.), cert. denied, 434 U.S. 940 (1977) (alleged misrepresentations not causally connected to plaintiff's decision to sell shares). The differing approaches resulted in no small measure from the analysis of the Supreme Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-154 (1972). The Court in *Affiliated Ute* opined that in a case involving "primarily a failure to disclose," requisite causation is established when an obligation to disclose exists, and the facts withheld are material "in the sense that a reasonable investor might have considered them important" in making his investment decisions. Moreover, in *Supt. of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), the Court, interpreting the "in connection with" language of Rule 10b-5, without any particular reference to disclosure deficiencies, rejected any restrictive transaction causation approach to Rule 10b-5 claims involving schemes to defraud.

The unmistakable post-1975 turn toward a more restrictive definition of Rule 10b-5's proper scope brought with it renewed consideration of the importance of causation-in-fact. See, e.g., *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976); *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978). *Shores* and *Panzirer* now literally compel it.

²² 99 F.Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952).

and the defendant directors. Whether or not the "semblance of privity" referred to in *Joseph* means reliance,²³ the court for certain required that a direct causal connection exist between would-be claimants under Rule 10b-5 and defendants' misdeeds. Later cases in the Second Circuit and elsewhere emphasized reliance as an element of a Rule 10b-5 claim,²⁴ and indeed some went so far as to engraft a reasonableness requirement upon the reliance element.²⁵

The seeds of a broadened scope of coverage in the open-market setting were sown in 1968 with the decisions in *SEC v. Texas Gulf Sulphur Co.*²⁶ and *Heit v. Weitzen*,²⁷ in which the court viewed fraudulent conduct as directed toward trading markets as a whole. In *Texas Gulf Sulphur* the Second Circuit focused upon the "in connection with" language of Rule 10b-5 in enunciating this view of its role vis-a-vis the impersonal open-market setting.²⁸ The court thus established the root of the "fraud-on-the-market" theory of Rule 10b-5 liability by directing attention to the impact of a Rule 10b-5 proscribed act on a generalized market and to those members of the investing public who suffer from that act "in connection with" their trading.

Heit v. Weitzen, decided by the same court just a short time later, cemented the development. The representative plaintiff brought *Heit* as a class action on behalf of purchasers of securities of Belock Instrument Corporation who alleged, among other things, that the corporation failed to disclose material facts in its annual report, public statements and SEC filings concerning income. The named plaintiffs sought to represent a class of purchasers of the securities in open-market transactions. The plaintiffs allegedly purchased at prices which they contended the defendants artificially inflated by disseminating bad information. On defendants' motion to dismiss, the court, confronted with the private action

²³ The *Joseph* court reasoned that nothing in the history of the Act or the Rule permits the far reaching effect sought herein by the plaintiffs. A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite and it is entirely lacking here. 99 F.Supp. at 706.

²⁴ See, e.g., *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965); *List v. Fashion Park, Inc.* 340 F.2d 457 (2d Cir.), cert. denied sub nom. *List v. Lerner*, 382 U.S. 811 (1965); *Kohler v. Kohler*, 319 F.2d 634 (7th Cir. 1963); *Ross v. Licht*, 263 F.Supp. 395 (S.D.N.Y. 1967).

²⁵ See *City National Bank v. Vanderboom*, 442 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970).

²⁶ 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom. *Coates v. SEC*, 394 U.S. 976 (1969).

²⁷ 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969).

²⁸ The court held that:

Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.

401 F.2d at 858-862.

counterpart to *Texas Gulf Sulphur*, concluded that plaintiffs met the "in connection with" requirement.²⁹

Together *Texas Gulf Sulphur* and *Heit* established the principle that a Rule 10b-5 violation may relate to an entire marketplace and affect all purchases and sales in that marketplace, a decidedly significant departure from the earlier *Joseph* approach to scope of coverage. Further development of the principle came in a decidedly procedural setting.

As noted above, *Heit* arose as a class action on behalf of all persons who purchased the subject securities and suffered loss as a result. Plainly the generalized market orientation is critical to the procedural propriety of a class action, a form of action which presupposes identity of interest and status among class members, and that would be subject to serious challenge on an application of a restrictive rule requiring a privity-type relationship among all class members and defendants. Indeed a prerequisite to proceeding with class action litigation is the finding, among other things, that questions of law or fact common to the class members predominate over questions affecting only individual members.³⁰ How the relationship between an individual plaintiff and a Rule 10b-5 proscribed act is defined is obviously of controlling significance in this procedural context. If the requisite relationship is one of traditional privity or reliance, the *individual* question predominates. *Texas Gulf Sulphur* and *Heit* paved the way toward finding commonality through "fraud-on-the-market", and the procedural analysis in *Green v. Wolf Corporation*³¹ led to further substantive development of the point.

Green originated as a class action on behalf of open-market purchasers of common stock and debentures of the defendant corporation. The named plaintiffs focused on alleged information deficiencies in three prospectuses covering the security and sought recovery under Rule 10b-5. The plaintiffs alleged that material misrepresentations and omissions in the disclosure documents artificially inflated the price of the stock and that the plaintiffs relied upon the defective information in purchasing those securities. The central issue in the case was the propriety of a class action in the circumstances presented. Of particular concern was the effect of a reliance requirement for a Rule 10b-5 claim upon requisite commonality of would-be class members. While the court was satisfied that the complex factual background of the case as related to defendants' liability presented a "common and consistent course of conduct" vis-a-vis the putative class, and thus was suited for class action treatment,³² the defendants' contention that "each person injured must

²⁹ 402 F.2d at 913; see also *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 101 (10th Cir. 1971) (the privity requirement vanished from 10b-5 proceedings while the "connection" element is retained).

³⁰ FED. R. CIV. P. 23(b)(3).

³¹ 406 F.2d 291 (2d Cir. 1968).

³² *Id.* at 300.

show that he personally relied on the misrepresentations in order to recover"³³ obviously jeopardized the predominance of common questions among the class members. While recognizing that reliance is an issue "lurking" in every action under Rule 10b-5, the *Green* court refused to accept the proposition that individual questions of reliance, if they existed, should bar class action status. To do so would negate any attempted class action. The court decreed instead that it could determine any issue of individual reliance via separate trials on the issue, if necessary.

With the stage thus set, the cases to follow wholly embraced the notion put forward in *Green* that a generalized market may be affected by Rule 10b-5 proscribed conduct. Furthermore, the cases demonstrate that requisite causation—or "nexus"—between such wrongful conduct and individual participants in that marketplace being so established, no further individual issue, reliance or otherwise, was relevant or controlling.³⁴ *Green* and its progeny effectively eliminated reliance as an element of a Rule 10b-5 claim in the class action setting—an important substantive product from a decidedly procedural orientation. The decision of the Supreme Court in *Affiliated Ute Citizens v. United States*³⁵ provided the impetus toward even broader relaxation of the causation requirement under Rule 10b-5.

Affiliated Ute involved allegations under Rule 10b-5 of a failure to disclose material information that securities purchased from members of the plaintiff class were selling for a higher price elsewhere. Confronting the question of reliance, Mr. Justice Blackman noted that:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . The obligation to disclose and the withholding of a material fact establish the requisite element of causation in fact.³⁶

Following *Affiliated Ute* and its express rejection of "positive proof of reliance" as a prerequisite to Rule 10b-5 recovery in an omission setting, the lower courts generally regarded the case as establishing a

³³ *Id.* at 301.

³⁴ See, e.g., *Herbst v. Able*, 47 F.R.D. 11 (S.D.N.Y. 1969); *Weiss v. Tenney Corp.*, 47 F.R.D. 283 (S.D.N.Y. 1969); *Dolgow v. Anderson*, 43 F.R.D. 472 (E.D.N.Y. 1968). As the plaintiffs in *Herbst* advanced, and the court accepted, the impact of the misrepresentations was on the market, manifested in a heightened market price for securities.

³⁵ 406 U.S. 128 (1972).

³⁶ *Id.* at 153-154. The Supreme Court had actually first addressed a relaxed causation standard in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), a decision arising under § 14(a) of the Exchange Act and Rule 14a-9, which prohibits misstatements and omissions of material facts in proxy material. In that situation the *Mills* Court held materiality to be the only element necessary to establish causation under Rule 14a-9. 396 U.S. at 385.

"presumption" of reliance in nondisclosure cases.³⁷ At the same time *Affiliated Ute*, with its principal emphasis on loose causation as the key element, provided further meaningful contribution to full-fledged emergence of fraud-on-the-market as a basis for Rule 10b-5 recovery, without regard to any distinctions between affirmative misrepresentation and "primarily" nondisclosure cases.³⁸

The eradication of traditional reliance as an element of Rule 10b-5 "fraud-on-the-market" claims in open-market settings, and the emergence in its place of a loose causation approach to the scope of coverage, lent itself to broadened applications. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,³⁹ for example, the Second Circuit applied loose causation analysis to establish a sufficient causal link between the defendants' failure to disclose material, nonpublic information to the marketplace prior to engaging in securities transactions, and transactions by all individuals in that "tainted" marketplace. Applying the so-called "disclose or abstain" rule of *SEC v. Texas Gulf Sulphur Co.*,⁴⁰ *Shapiro* turned upon the court's determination that defendants owed a duty to disclose to the entire open market, and that the breach of that duty resulted in liability to all participants in that market who suffered losses. In so imposing liability, the court opined that to do otherwise would frustrate a major purpose of the antifraud provisions, namely, "to ensure integrity and efficiency of the securities markets."⁴¹

In a different setting, *International Controls Corp. v. Vesco*⁴² upheld the application of Rule 10b-5's broad "umbrella of protection" over the securities markets. The *International Controls* court held that a spin-off of a subsidiary's stock to shareholders of the parent corporation as a dividend in kind under circumstances involving deficient disclosure of information concerning the self-dealing character of the transactions by the controlling stockholder, along with the disposition of various assets, constituted a "fraud" on the corporation within the purview of Section 10(b) and Rule 10b-5.⁴³

³⁷ See, e.g., *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 238-39 (2d Cir. 1975); *Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975). But see *Chelsea Associates v. Rapanos*, 527 F.2d 1266 (6th Cir. 1975) ("presumption" of reliance in a non-disclosure setting not conclusive). As to the role of presumed reliance vis-a-vis class action determinations, see, *Herbst v. ITT*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,481, at 95,682 (2d Cir. 1974); *Livesay v. Punta Gorda Isles* [1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,730, at 96,420 (E.D. Mo. 1974); *Parish v. Boetel & Co.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶94,802, at 96,666 (D. Neb. 1974); *Entin v. Borg*, 60 F.R.D. 108 (E.D. Pa. 1973).

³⁸ 61 F.R.D. 88 (N.D. Cal. 1973); see also *In re U.S. Financial Securities Litigation*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,844, at 96,844 (S.D. Cal. 1974); where Judge Turrentine reflected that the fraud-on-the-market theory eliminates the need for proof of individual reliance. Instead it is sufficient to show only a "common scheme to manipulate the price of the stock." See also 61 F.R.D. at 101.

³⁹ 495 F.2d 228 (2d Cir. 1974).

⁴⁰ See text accompanying note 56 *infra*.

⁴¹ 495 F.2d at 236-37.

⁴² 490 F.2d 1334 (2d Cir. 1974), *cert. denied*, 434 U.S. 1014 (1978).

⁴³ See 490 F.2d at 1356.

The sense of *International Controls* was certain—conduct involving securities jeopardized the integrity of the “securities markets,” despite the fact that such conduct was not market-oriented in the sense of a traditional price manipulation or artificial price based upon disclosure deficiencies, and despite the fact that the plaintiff was neither an open market purchaser or seller in the traditional sense.⁴⁴ By extending the “umbrella” of Rule 10b-5 protection, the *International Controls* court rendered a policy judgment that the plaintiff, as a participant in a securities transaction, was quite simply “well deserving” of antifraud protection for the sake of preserving public confidence in the securities markets. This application of Rule 10b-5 came in 1974 at a time when the expansionist view of Section 10(b) and Rule 10b-5 vis-a-vis corporate “mismanagement” and breach of fiduciary responsibilities was at its peak.⁴⁵ At the time, however, *International Controls* recognized the broad notion of market integrity—or “confidence”—which provided a basis for subjectively extending Rule 10b-5 coverage apart from any consideration of elements such as reliance or causation.⁴⁶

From this view a transition to a generalized conduct orientation such as that evidenced in *Competitive Associates v. Laventhol, Krekstein, Horwath & Horwath*⁴⁷ was achieved. In *Competitive Associates*, an accounting firm faced allegations that it violated Section 10(b) and Rule 10b-5 for certifying false or misleading financial statements of an investment fund. Plaintiff in the case alleged that the accountants’ conduct resulted in an overstatement of the fund’s performance and was part of a “fraudulent scheme” to induce the plaintiff to retain a particular fund manager at whose hands the plaintiff then suffered grievous losses. Disputed evidence indicated that the plaintiff’s representative had not seen the financial statements of the fund and, hence, did not rely on them in considering the decision to hire the manager.

The District Court granted summary judgment for the defendant on the grounds that proof of direct reliance on the financial statements in question was a requisite element of the claim. Further, even if the subject statements represented an inducement to plaintiff to hire the

⁴⁴ Standing to bring the action was an important issue the court confronted. The plaintiff was the corporation that had been looted through the issuance of a dividend in kind of its subsidiary’s stock. Defendant argued that such a disposition of securities occurred without “value”, and thus was not a sale within securities law protection.

In light of the broad “umbrella of protection” placed over securities transactions by § 10(b) and Rule 10b-5, the court, on policy grounds, deemed plaintiff to be a seller of the securities in question, despite the fact that prior examinations of spin-off situations provided no help. 490 F.2d at 1345.

⁴⁵ See *Supt. of Ins. v. Bankers Life & Casualty Co.*, 406 U.S. 6 (1971). In *Bankers Life* the Court upheld assertion of Rule 10b-5 liability for conduct amounting, essentially, to conversion. The Court considered the “in connection with” language of Rule 10b-5, and announced the broad “touch” test for its application. 406 U.S. at 12-13.

⁴⁶ See 490 F.2d at 1356.

⁴⁷ [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,090, at 97,863 (2d Cir. 1975).

manager, a relationship between the "fraudulent" acts and omissions and the securities transactions which caused the plaintiff's injuries was absent.

On appeal from that determination, the Second Circuit reversed. Speaking for the court, Judge Hays viewed *Affiliated Ute* as dispositive of a reliance requirement in the circumstances presented.⁴⁸ Whether or not liability under Rule 10b-5 required proof of positive reliance, the Second Circuit's assessment still focused on alleged deficient disclosure and its relationship to ultimate securities transactions. It was that relationship that posed the greatest question. On that score the court changed course to focus on what it referred to as substantial collateral conduct which, along with omissions and misrepresentations comprises a "comprehensive scheme to defraud."⁴⁹ Regarding the relationship, or nexus, between the ultimate transactions and the alleged fraud, the *Competitive Associates* court accepted the allegation of a fraudulent scheme "directly related to the trading process" which, on the basis of conflicting inferences in the record, the plaintiff should have an opportunity to prove.⁵⁰

This emergent orientation was, of course, highly complementary to the fraud-on-the-market theory of Rule 10b-5 coverage continuing to develop in the procedural setting. *Blackie v. Barrack*,⁵¹ a case prominently figuring in the current fraud-on-the-market decisions, best exemplified that continuing development. *Blackie* returned to the distinctly procedural setting, presenting the question of the propriety of class action status for assertion of claims relating to allegedly deficient disclosure of financial condition in annual reports of Ampex Corporation. The named plaintiffs sought to represent all purchasers of Ampex securities in the open market during the period in question. The essential allegation was that Ampex Corporation made misrepresentations in annual and interim financial reports, press releases and SEC filings from the date of the company's 1970 annual report until the Company disclosed its true financial condition in 1972.⁵² The issue of class action certification was before the

⁴⁸ *Id.* at 97,865. This view, the court noted, founded the court's decision in *Shapiro*, 495 F.2d 228 (2d Cir. 1974).

⁴⁹ [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,090, at 97, 866.

⁵⁰ *Id.*; see also *Woolf v. S.D. Cohn & Co.*, 515 F.2d 592 (5th Cir. 1975). The Fifth Circuit in *Woolf* further demonstrated a blending of disclosure notions into a conduct orientation. 515 F.2d at 607-608.

⁵¹ 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

⁵² Plaintiffs in *Blackie* alleged that the various financial reports and public statements overstated earnings, overstated the value of inventories and other assets, concealed various expenses and costs, misrepresented current ratios, failed to establish adequate reserves for receivables, failed to write off certain assets, failed to account for proposed discontinuation of certain product lines, and misrepresented prospects for future earnings. All of the misrepresentations were cast in nondisclosure terms. The company's financial reporting, for instance, failed to disclose the need for reserves, conditions reflecting on the value of the inventory, and other facts necessary to make reported figures not misleading.

Court of Appeals on an interlocutory appeal from the District Court decision conditionally granting that status.

Attacking the propriety of class action status, defendants in *Blackie* argued that common questions relating to the adequacy of the various subject disclosures failed to predominate over necessarily individual questions of reliance and causation among members of the putative class. The court rejected the argument on reliance on the same reasoning that paved the way in prior class actions—that proof of subjective reliance on particular misrepresentations is unnecessary to establish a Rule 10b-5 claim for deception which artificially inflates the price of a stock traded in the open market.⁵³

None of this is to say that the *Blackie* court sought to eliminate a nexus, or causation, requirement as between Rule 10b-5 proscribed conduct and a purchaser's injury. To the contrary, the court reaffirmed that the plaintiff must demonstrate a "reasonable transactional nexus" between the fraud and the loss. The court viewed its pronouncement as simply "amplify[ing] on the manner in which that nexus may be proved"⁵⁴—by proof of materiality "coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock."⁵⁵

The *Blackie* court thus firmly established "fraud-on-the-market" as a basis for recovery in a private action under Rule 10b-5, with the violative conduct being causally connected to each transaction in the marketplace at an artificial price, and the scope of coverage so defined. Through all of the analytical process the requirement for causal connection, or nexus, survived. Lost, however, was the definition of nexus in terms of traditional reliance or privity. All of the cases were cast in terms of deficient disclosure in an open market setting, where a meaningful class-wide Rule 10b-5 remedy demanded the elimination of a traditional reliance or privity requirement. *Affiliated Ute* and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* departed from this norm in the sense of focusing upon duties to disclose in what were otherwise pure nondisclosure situations, and the breach of which was causally connected to subject transactions. *Shapiro* might also be viewed as a market-directed conduct case, as opposed to a disclosure case. In *Shapiro* the act of trading on nonpublic information is proscribed conduct. It is the breach of a duty to disclose the information or abstain from that trading that gives rise to the liability, however, rather than the act of trading itself.⁵⁶ Pure market-directed,

⁵³ 524 F.2d at 907. The court noted that the supposition is that the market price is validly set and that no manipulation has artificially inflated it. In a sense, then, the market price of a security is itself an implicit representation that it is validly set.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ The so-called "disclose or abstain" rule, and its extension to the totality of a marketplace, was articulated in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). The Court recognized that §10(b)

conduct, such as manipulation within the contemplation of Section 9 of the Exchange Act,⁵⁷ for example, did not enter into any of the cases which proceeded on the fraud-on-the-market theory. Clearly, however, the concept of market "integrity" or "confidence" lurked throughout—as an expressed basis for recognition of the claim in *International Controls*, and as a fundamental policy of Section 10(b) and Rule 10b-5 to assure true and honest securities markets.

III. THE IMPACT OF POST-1975 SUPREME COURT DECISIONS ON THE FRAUD-ON-THE-MARKET APPROACH TO RULE 10b-5 LIABILITY

The securities law decisions of the Supreme Court since 1975 have significantly altered many of the pre-existing expansive conceptions of the scope of federal securities law protections, and the antifraud provisions in particular. Though none of the cases decided by the Court have involved "fraud-on-the-market" as an asserted basis of liability, the Court's analysis of the proper scope and elements of Rule 10b-5 liability directly impact the essential underpinnings of the theory which stress the absence of any direct relationship between an alleged Rule 10b-5 violator and a prospective claimant.

The particular decisions of the high Court impacting fraud-on-the-market analysis are *Blue Chip Stamps v. Manor Drug Stores*,⁵⁸ *Ernst & Ernst v. Hochfelder*,⁵⁹ *Sante Fe Industries, Inc. v. Green*⁶⁰ and, perhaps most importantly, *Chiarella v. United States*.⁶¹ All focus upon the elements of Rule 10b-5 liability or its proper scope of coverage.⁶²

In *Blue Chip Stamps* the Court brought finality to the debate over the long standing rule of *Birnbaum v. Newport Steel Corp.*⁶³ that only an

and Rule 10b-5 are predicated "on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information". 401 F.2d at 848; see also *In re Roberts & Co.*, 40 S.E.C. 907 (1961).

⁵⁷ 15 U.S.C. § 78f (1976). Section 9 proscribes conduct designed to manipulate prices of securities traded on a national securities exchange, including wash sales and other activity designed to convey a false appearance of trading activity. Section 9 also creates an express right of action establishing the liability of any person "who willfully participates in any act or transaction" to "any person who shall purchase or sell any security at a price which was affected by such act or transaction" for "the damages sustained as a result of any such act or transaction". 15 U.S.C. § 78f (1976).

⁵⁸ 421 U.S. 723 (1975).

⁵⁹ 425 U.S. 185 (1976).

⁶⁰ 430 U.S. 462 (1977).

⁶¹ 445 U.S. 222 (1980).

⁶² Though it did not involve consideration of § 10(b) or Rule 10b-5 directly, the decision of the Court in *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) is instructive as well. In *TSC* the Court enunciated the definition of materiality for purposes of proxy disclosure. This definition of materiality has since been fully imported into Rule 10b-5 analysis. The *TSC* Court established a "general standard" of materiality. 426 U.S. at 449. Clearly, this view of materiality is transaction oriented and, at least in the traditional disclosure context, bespeaks of probable effect.

⁶³ 193 F.2d 641 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

actual purchaser or seller of securities may maintain an action under Section 10(b) and Rule 10b-5. The Court looked narrowly upon congressional intent and restricted the scope of the private remedy to the parameters of express remedies contained in other provisions of the Exchange Act.⁶⁴ Express causes of action provided in the Exchange Act, in particular Section 9⁶⁵ and Section 18,⁶⁶ require a direct causal relationship between a claimant's transaction and the proscribed act. Section 18 explicitly requires reliance on the defective statement, as well as a transaction at a price which was "affected" by such statement. Similarly, the principal express private remedies provided in the Securities Act of 1933, Sections 11 and 12(2), likewise stress a direct relationship, or "transactional" privity, between a purchaser and proscribed conduct, or expanded liability for such conduct, which the statute expressly prescribes.⁶⁷

In both *Hochfelder* and *Santa Fe*, the Court further pursued its strict construction of the language of Section 10(b) and Rule 10b-5—rejecting in *Santa Fe* the notion that "fraud" within the contemplation of the statute and the Rule should, or could, encompass "all breaches of fiduciary duty in connection with a securities transaction."⁶⁸ The Second Circuit Court of Appeals⁶⁹ had formulated an interpretation of the elements of "fraud" cognizable under Rule 10b-5 based upon the Supreme Court's earlier expressed notion of "equitable" fraud.⁷⁰ The Supreme Court criticized this interpretation as arising from the use of the term "fraud" in other decisions involving other contexts, and not focusing on Section 10(b) and Rule 10b-5, which by their terms so clearly address deception and "manipulation".

Previously the Supreme Court in *Hochfelder* rejected the assertion

⁶⁴ See 421 U.S. at 736.

⁶⁵ 15 U.S.C. § 78f (1976); see text accompanying note 57 *supra*.

⁶⁶ 15 U.S.C. § 78r (1976).

⁶⁷ 15 U.S.C. § 77k (1976). Section 11 of the Securities Act creates an express remedy for a purchaser of securities which are the subject of a registration statement containing a false or misleading statement. The remedy operates against a specified list of persons who have a relationship to the defective registration statement and who are unable to satisfy statutorily prescribed "due diligence" defenses. In certain instances § 11 imposes the further express requirement that plaintiffs rely on the defective disclosure.

Section 12(2), 15 U.S.C. § 77l(2) (1976), creates an express right of action for a purchaser against his or her seller for rescission (or damages as a rescissional equivalent) of a transaction involving a materially false or misleading disclosure. Though historically not interpreted to represent a strict privity requirement, the "seller" limitation on Section 12(2) liability has resulted in the requirement of a direct causal involvement in the plaintiff's transaction. See Rapp, *Expanded Liability Under Section 12 of the Securities Act: When is a Seller Not a Seller?* 27 CASE WES. RES. L. REV. 445 (1977).

⁶⁸ See 430 U.S. at 472.

⁶⁹ *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir. 1976).

⁷⁰ See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963). There the Court spoke of "fraud" in terms of acts, omissions and concealments which involve a breach of a legal or equitable duty, trust or confidence.

of negligence as a basis for imposition of liability in a private action for damages under Rule 10b-5. This rejection came in light of the statutory scheme for antifraud protections and in recognition that Section 10(b) and Rule 10b-5 are explicit in their terms—"manipulation and deception, and of implementing devices and contrivances." Furthermore, in *Hochfelder* the Court specifically rejected the broad scope of coverage offered by the Securities and Exchange Commission, as *amicus*, that would have extended liability over "... any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not."⁷¹

Collectively, these cases evidence more impact upon fraud-on-the-market theory than an avowed strict construction of Section 10(b) and Rule 10b-5 in terms of who may sue, for what conduct, and who shall be liable. The Supreme Court's message in these cases is that Rule 10b-5 has a definite *transactional* focus, as to which the Rule protects a buyer or seller of a security from injury arising out of traditional deception as to the value of the security bought or sold, or by reason of that value being falsely determined in a marketplace tainted by manipulative activity. The direct relationship of deceptive or manipulative conduct to an investment decision determines the scope of Rule 10b-5 coverage rather than the existence of undesirable conduct *somewhere* in the milieu of securities transactions.

The message that the relationship of fraudulent conduct to an investment decision determines the scope of Rule 10b-5, as related to fraud-on-the-market analysis, was prominently considered in an important aspect of *Ross v. A.H. Robins Co., Inc.*⁷² In *Ross*, the plaintiffs brought a class action on behalf of all open-market purchasers of Robins Company securities during an approximate two-year period. Plaintiffs alleged that the company advertised its "Dalkon Shield" intrauterine device in medical journals and patient brochures, and made other public statements and agency filings, without disclosing substantial liability risks to the company associated with the product which would result in loss of sales or revenues. Plaintiffs thus alleged that the company and certain of its officers and directors violated Section 10(b) and Rule 10b-5 in deceiving the investing public concerning the true financial condition and prospects of the company, as related to the Dalkon Shield, and thus "manipulated" the market price for Robins' shares.⁷³

⁷¹ See 425 U.S. at 212.

⁷² [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,388, at 93,350 (S.D.N.Y. 1978).

⁷³ Plaintiffs more particularly alleged that:

Said advertisements and the representations contained therein had the effect, as Robins and the individual defendants knew, of manipulating the market price for A.H. Robins securities in that, *inter alia*, they were designated [sic] to promote, stimulate, and to increase (a) the sales of the Dalkon Shield and A.H. Robins earnings and profits therefrom and (b) the standing and reputation of A.H. Robins as a developer and producer of safe, reliable and efficacious [sic], ethical phar-

Defendants moved to dismiss the *Ross* complaint on the contention that advertising in medical journals and patient brochures could not be viewed as sufficiently connected to the plaintiffs' purchases to support the application of Section 10(b) and Rule 10b-5 for the alleged deception. Plaintiffs countered with the argument that the effect of the statements made in advertising and brochures was a "fraudulent" increase in overall sales and prosperity of the company, and that such effect constituted "a form of market manipulation which inflated the price of Robins' stock."⁷⁴ The District Court applied *Santa Fe* to deny Rule 10b-5 coverage.⁷⁵ The court dismissed those portions of the plaintiff's complaint based upon the claimed impact of advertisements in the medical journals and patient brochures. Subsequent consideration of the case by the Second Circuit on other issues raised by subsequent pleadings⁷⁶ left the district judge's determination on the matter of the advertisements as an improper basis of Rule 10b-5 coverage untouched.⁷⁷

On the foundation of *Santa Fe*, the defendants failed to persuade the court that advertisements in medical journals and patient brochures could provide sufficient nexus. Nor was the court convinced that company statements about a new product were of such "subject matter" as to be reasonably expected to impact investor decisions with regard to company securities. Thus, the transactional focus is certain, and the necessity of a demonstrable causal relationship between would-be

maceutical products, thereby affecting A.H. Robins sales, earnings, growth and overall prosperity." [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,388, at 93,351, quoting, *Complaint*, ¶ 20.

⁷⁴ *Id.* at 93,352.

⁷⁵ *Id.*

⁷⁶ The court dismissed the balance of the complaint with leave to replead upon grounds that plaintiffs had failed to plead with the requisite particularity prescribed by Rule 9(b), FED. R. CIV. P. The court subsequently considered an amended complaint on a motion to dismiss. 465 F. Supp. 904. The court again dismissed, but this time on grounds that § 18 was plaintiff's exclusive remedy for false or misleading statements made in reports or documents filed with the Securities and Exchange Commission under the 1934 Act. The court refused to imply a remedy under § 10(b). On appeal the court reversed this conclusion. *Ross v. A.H. Robins Co., Inc.*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,115, at 96,181 (2d Cir. 1979). With the focus of the subsequent pleadings being placed on Associated Press releases and documents and reports filed with the Securities and Exchange Commission, the Second Circuit was satisfied that Rule 10b-5 claims based upon an artificially inflated market price were consistent with the "fundamental policies" recognizing that § 10(b) and Rule 10b-5 are the "primary mechanisms by which open market investors can seek redress against those who manipulate the market by fraudulent activity." *Id.* at 96,190.

⁷⁷ In the *Ross* decision the court fully embraced the vitality of the long-standing principle enunciated in *SEC v. Texas Gulf Sulphur Co.*:

Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public, e.g. by means of the financial media . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. 401 F.2d at 862.

"fraud" and an investment decision is clear. The court did not implement *Santa Fe* to deny such a relationship where the alleged informational deficiency is value determinative vis-a-vis company securities and presented in a cognizable medium,⁷⁸ but it recognized that cognizable "fraud" for purposes of Rule 10b-5 coverage does not occur in a vacuum.⁷⁹

The most recent Supreme Court consideration of the scope of Rule 10b-5 in *Chiarella v. United States*⁸⁰ brings the matter into bold perspective. *Chiarella* focused upon the asserted criminal liability under Section 10(b) and Rule 10b-5 of an employee of a financial printer. The employee deduced the names of target companies for certain upcoming takeover bids from documents delivered to the printing firm, purchased the subject securities in advance of public announcements of the bids and profitably sold them thereafter. The jury convicted the defendant on all counts of a seventeen count indictment following the District Court's charge to the jury that the jury could convict the defendant if it found that he had willfully failed to inform sellers of the target companies' stocks in which he traded, and that he knew of the material nonpublic information concerning the forthcoming takeover bids that would make the securities more valuable in the marketplace. The Second Circuit affirmed the conviction.⁸¹ The Supreme Court then addressed the question whether silence in the absence of a duty to speak gives rise to liability under Section 10(b) and Rule 10b-5. In an opinion by Justice Powell the Court held that it did not, and reversed the conviction.

Starting with the premise that liability under Rule 10b-5 for non-disclosure depends upon the existence of a duty to disclose, the Court emphasized that a purchaser of stock who is neither a corporate insider nor a fiduciary, both positions giving rise to a cognizable duty, has no obligation to reveal material facts.⁸²

Though *Chiarella* addressed the would-be liability of one engaging in trading on the basis of material nonpublic information, the Court's rejection of a nonspecific market-directed duty under Rule 10b-5 is much broader, especially when considered in conjunction with *Santa Fe Industries, Inc. v. Green*,⁸³ in which the Court underscored the scope of Section 10(b) and Rule 10b-5 as being defined solely in terms of the statutory

⁷⁸ The court approved the view that two factors affect the scope of Rule 10b-5 coverage vis-a-vis information dissemination: the medium through which the statement is made and the subject matter of the statement. See A. JACOBS, *THE IMPACT OF RULE 10b-5*, § 65, at 3-283 (1977).

⁷⁹ See also *Nash v. Farmers New World Life Ins. Co.*, 570 F.2d 558 (6th Cir. 1978) (allegation that merger transaction "destroyed the market" for the subject securities held not to amount to manipulation of prices within contemplation of Rule 10b-5 after *Santa Fe*).

⁸⁰ 445 U.S. 222 (1980).

⁸¹ 588 F.2d 1358 (1978).

⁸² See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (corporate insiders); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (fiduciaries).

⁸³ 430 U.S. 462 (1977).

language.⁸⁴ Though *Santa Fe* focused principally on the question of "deception", the Court's observations on the notion of "manipulation" are instructive.⁸⁵ The Court's views of Rule 10b-5 covered "deception" and "manipulation", as expressed in *Santa Fe*, coupled with the view as to the necessary relationship between a putative violator and a plaintiff, as expressed in *Chiarella*, demonstrate the real significance and impact of the post-1975 developments on Rule 10b-5 applications. The Court's contemporary decisions, and these two in particular, clearly indicated that Rule 10b-5 does not address all bad conduct, however reprehensible, simply because the conduct touches upon or indeed impacts a security transaction.⁸⁶ Rule 10b-5 is not an all-powerful purifier of the securities markets. As the Court emphasized in *Chiarella*, neither the Congress nor the SEC has ever imposed a market-directed parity-of-information rule.⁸⁷ To imply a broad, nonspecific duty from a nonexistent relationship between persons buying and selling in that market-place would be "inconsistent with the careful plan that Congress has enacted for regulation of the securities markets."⁸⁸ This is not to say that whenever false or misleading assertions are made in a manner "reasonably calculated . . . to influence the investing public",⁸⁹ Rule 10b-5 will not operate, or that traditionally recognized market manipulation should escape the Rule's protective umbrella. It is to say, however, that the proper application of the Rule requires demonstration of a direct connection or nexus, by way of breach of an extant duty, or by deception, or by market rigging, between the bad act and the object of antifraud protection: an investment decision.

If the post-1975 decisions of the Supreme Court have taught nothing else, they surely taught that the special object of the entire scheme of antifraud protection is, and always has been, the decision to buy or sell a security. Liability under the Rule will not extend to the world at large. In *Blue Chip Stamps v. Manor Drug Stores*, the first of its post-1975 series, the Court affirmed the necessity of the purchaser-seller limitation for implied actions under Rule 10b-5, and emphasized the necessity of an actual transaction.⁹⁰

⁸⁴ Said the Court: "The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception". 430 U.S. at 473.

⁸⁵ *Id.*

⁸⁶ *Id.* at 474-477.

⁸⁷ Following the decision in *Chiarella*, the SEC adopted Rule 14e-3 under the 1934 Act in attempt to regulate the use of material nonpublic information in trading in tender offers. With certain exceptions, Rule 14e-3 imposes a "disclose or abstain" rule upon persons who possess material information relating to a tender offer if that person or his "tippee" knows or has reason to know that the information is nonpublic and was received from a source related to the subject corporation. See Securities Exchange Act Rel. No. 17120 (Sept. 4, 1980).

⁸⁸ 445 U.S. at 235.

⁸⁹ SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 864 (2d Cir. 1968).

⁹⁰ 421 U.S. at 747.

The focus on investment decisions and the necessary relationship of Rule 10b-5 conduct to the decisions is fundamentally important in considering the "fraud-on-the-market" theory of liability. The emergent views of the Supreme Court demonstrate severe erosion in the once hospitable and expansive interpretations of federal securities law protections that marked pre-1975 analyses. They manifest outright hostility toward open-ended postulations of liability based upon undefined duties and national commitments to the remedy of "bad" conduct which happens to occur in proximity to a securities transaction.

Beyond the particular cases which bear directly and critically upon the scope of liability under Section 10(b) and Rule 10b-5, the post-1975 decisions of the Court, which have consistently refused to expand the law through the implication of additional private remedies, demonstrate the disenchantment with pre-1975 trends. These decisions portend further retrenchment and refinement of existing remedies to assure close adherence to perceived congressional intent as best evidenced by the language of the statutes, and, when necessary, by policy and by commercial and economic realities. In *United Housing Foundation, Inc. v. Forman*⁹¹ the Court declined to permit application of the antifraud protections of the securities laws to the purchase of "stock" in a state-sponsored housing cooperative. Common sense and economic reality dictated that purchasers of the "stock" in question were not investors in an enterprise, but rather individuals seeking a place to live.⁹² *Piper v. Chris Craft Industries, Inc.*⁹³ rejected implication of a private remedy under the tender offer provisions of the Exchange Act for a defeated tender offeror against a target company and competing offeror. Among other things, the Court refused to view "the narrow intent" of this aspect of federal regulation of securities as supporting an extension of coverage of a federal remedy to the claimant.⁹⁴ In *Touche Ross & Co. v. Redington*,⁹⁵ denying implication of any private right of action under Section 17(a) of the Exchange Act, the Court looked entirely to the face of the statute to determine whether the Court might imply any private remedy. In doing so the Court emphasized that invocation of the "remedial purposes" of the 1934 Act could not and would not carry the day.⁹⁶

The signal in all of this bodes ill for those who would paint in broad strokes on the matter of expanding the scope of antifraud coverage into

⁹¹ 421 U.S. 837 (1975). See also *International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America v. Daniel*, 439 U.S. 551 (1979).

⁹² The *Forman* Court discussed the proper scope of federal securities law protections, emphasizing the focus on "capital markets" and the sale of securities to raise capital. 421 U.S. at 849.

⁹³ 430 U.S. 1 (1977).

⁹⁴ *Id.* at 38.

⁹⁵ 442 U.S. 560 (1979).

⁹⁶ *Id.* at 578, quoting, *SEC v. Sloan*, 436 U.S. 103, 116 (1978). See also *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979).

areas or in a manner not firmly rooted in traditional deception or delimited by traditional elements. It is into this dramatically altered judicial environment that *Shores v. Sklar* has been delivered, and in which the fraud-on-the-market theory of Rule 10b-5 liability has seen its maximum extension. Whether it can survive that environment is considered below.

IV. *SHORES V. SKLAR*—THE VERY EXISTENCE OF SECURITIES AS A "FRAUDULENT SCHEME"

In 1972, the Industrial Development Board of Fresco City, Alabama authorized issuance of First Mortgage Revenue Bonds for the purpose of financing the construction of and equipping a facility of Alabama Supply and Equipment Company for the construction of mobile homes. The law of Alabama authorized industrial development financing through local Industrial Development Boards having the authority to issue tax-exempt bonds. With the proceeds of such an issue, industrial facilities may be constructed and then leased to a manufacturing, industrial or commercial enterprise—in this case Alabama Equipment and Supply Company ("ASECo"). The enterprise is obligated, by way of rent payments, for satisfaction of principal and interest payments on the bonds. Because such bonds do not represent obligations of the municipality, the financial position of the lessee enterprise is highly significant in evaluating the worth of the bonds. The subject bonds in *Shores* were issued in connection with, and indeed had their genesis with ASECo, and Investors Associates of America, Inc., a Tennessee underwriting firm.⁹⁷

Hamilton, president of Investors Associates, retained the defendant Sklar, a Tennessee attorney, to act as bond counsel in connection with the offering. As bond counsel, Sklar in turn directed that Hamilton's firm conduct an "investigation" of ASECo. Sklar also retained Alabama counsel to act as bond co-counsel, to assist in preparation of paperwork and to issue requisite opinions concerning authorization and issuance of the bonds under Alabama law.

In connection with issuance of the bonds, Sklar prepared an "Offering Circular" from material furnished to him by the underwriter, Investors Associates, by ASECo, and by the individuals associated with both. Facts Sklar allegedly knew, or recklessly disregarded and omitted from the offering circular, included facts relating to a prior SEC enforcement action against the underwriter, the true worth of valuable real estate ASECo allegedly owned, and prior business success and experience of Harrelson, ASECo's president. Additionally, plaintiffs alleged a financial statement incorporated into the offering circular was

⁹⁷ Neither ASECo nor anyone associated with it possessed any financial or business acumen. The Court described ASECo's employees as essentially "inept and unsophisticated" in the business undertaken.

materially false or misleading because of numerous misrepresentations and omissions concerning the value of various ASECo assets. Plaintiff likewise alleged that the underwriter, the successor underwriter who actually offered the bonds for sale to the public on the basis of the offering circular,⁹⁸ and the bank which acted as trustee of the bond proceeds knew or recklessly disregarded these disclosure deficiencies.

Shores focused upon the purchase of bonds by Bishop. Bishop learned of the bonds in conversation with an Alabama securities dealer, who described them as a good investment opportunity. The dealer informed Bishop of others in the community who purchased such bonds. Bishop never saw the Offering Circular, or knew that one existed. He bought four of the bonds, however, on his broker's oral recommendation, and as part of the purchase of several other municipal securities.

Shortly after construction of the facility for which the bond financing had been obtained was completed, all operations ceased and ASECo defaulted in payment of rent. Harrelson, as individual guarantor, likewise defaulted and the Trustee Bank declared the lease in default. Purporting to represent a class of all purchasers of the bonds, Bishop sued for violations of the antifraud provisions of the federal securities laws. The District Court repeatedly dismissed his complaint in the face of his inability to plead reliance on the Offering Circular—which, he admitted, he neither saw nor read. A sharply divided Fifth Circuit bench, sitting *en banc*, vacated the dismissal of Bishop's Section 10(b) and Rule 10b-5 claims, and premised its decision on the assumption that the very existence of the security in the marketplace may be a Rule 10b-5 cognizable "fraud".⁹⁹

The majority analysis of the scope of Section 10(b) and Rule 10b-5 coverage in *Shores* has two aspects. As to claims of misrepresentations and omissions in the subject offering circular, the majority agreed that no antifraud claim would lie in the face of Bishop's admission that he had neither read nor attempted to read the document. The majority characterized such claims as the "usual 10b-5 misrepresentation or omission case."¹⁰⁰ But the majority remained unwilling to dispose of the balance of Bishop's antifraud claim on an application of "usual" criteria. Instead the majority viewed the broader claim to be that the defendants engaged in an elaborate scheme to create a bond issue "that would appear genuine but was so lacking in basic requirements that the bonds

⁹⁸ Jackson Municipals succeeded Investors Associates of America by assignment following the determination by Investors Associates that it did not possess sufficient capital to underwrite the issue. The Court characterized Jackson Municipals and its chief executive, Lamberson, as being fully cognizant of disclosure deficiencies relating to the offering materials and of the true facts concerning the backgrounds of individuals involved. See [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,033 at 91,332.

⁹⁹ The majority viewed the antifraud provisions as covering deliberate, manipulative "schemes" which annul the market's "honest function." *Id.* at 91,330.

¹⁰⁰ *Id.* at 91,333.

would never have been approved by the Board nor presented by the underwriters had any one of the participants in the scheme not acted with intent to defraud or in reckless disregard of whether the other defendants were perpetrating a fraud."¹⁰¹ Viewed in this light, the offering circular was but one part in a much more complex drama. Though no nexus or relationship, direct or indirect, existed between Bishop and any perpetrator of the alleged fraud, though he claimed no breach of any particular duty the defendants owed him and though his investment decision was not specific as to these bonds or the result of any deficient disclosure, the majority viewed his allegations as allowing him to introduce proof that he sought to make investments which were entitled to be marketed. In addition under subsections (1) and (3) of Rule 10b-5, his complaint was not subject to dismissal for failure to state a cognizable claim.¹⁰²

The majority's view of the case literally cried out for consideration of causation, or the absence thereof, as bearing upon the availability of a Rule 10b-5 remedy. The issue was given scant attention, however, with the majority being satisfied that the "concept" of the scheme to defraud presented in the case demonstrated "transaction causation."¹⁰³

The majority approach to causation in *Shores* extends *Blackie*¹⁰⁴ and its fraud-on-the-market theory well beyond the parameters of its prior applications. In the first place *Blackie* and most of its progenitors focused upon deficient disclosure to an impersonal market in which transactions occurred at an assertedly artificial price made artificial by the deficient disclosure. The fundamental proposition of the entire fraud-on-the-market line of cases is that market-oriented deception which results in an artificially inflated or deflated market price of a security results in Rule 10b-5 liability. The "bad" act is, at least in theory, causally connected to each transaction in that market at a price so affected. Whether this approach to liability can survive the post-1975 retrenchment remains an open question. Certainly however, the *Shores* majority's attention of it to cover the concept of market integrity without the slightest regard to any deficient disclosure is unfounded. In *Blackie* itself the court recognized that while the materiality of a misrepresentation

¹⁰¹ *Id.*

¹⁰² *Id.* at 91,334.

¹⁰³ *Id.* (footnote omitted). Without elaboration, the *Shores* majority concluded that it was unnecessary to decide whether it should draw any distinction between the notion of "loss causation" and "transaction causation" like the Court did in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974). The majority noted, however, that were the focus on misrepresentations and subsection (2) under Rule 10b-5, the Court might require a "separate showing of transaction causation" and that the Court would determine causation in terms of reliance. To do otherwise, said the majority "... could establish a scheme of investors insurance." [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,033 at 91,334 n.5. On the significance of the distinction, see generally Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99 (1981).

¹⁰⁴ 524 F.2d 891 (9th Cir. 1975).

establishes causation under the principle of *Affiliated Ute*, that presumption only operates to shift the burden to defendants to disprove it. One of the ways defendants may disprove the presumption is to demonstrate that an insufficient number of market traders relied upon the deficient disclosure to artificially impact the market price.¹⁰⁵ *Blackie* undeniably goes to considerable length, and it does so on the proposition that persons buying in the securities markets legitimately expect that those markets are free from fraud. *Blackie* does not go nearly so far in its concept as the majority in *Shores* takes it. From the proposition that deficient disclosure may result in an artificial price for a security in the markets on which traders presumptively rely, *Shores* declares that the very existence of the security without regard to any market-directed disclosure impugnes the integrity of the marketplace.

Sensing the breadth of its proposition, and in defense against a stinging dissent, the *Shores* majority articulated the underpinnings of its position.¹⁰⁶ The stated, and essential, premises of the majority's decision to uphold the statement of a Rule 10b-5 claim is the fraud-on-the-market theory. Like *Blackie*, the presumption of impact upon the market price or value assessment of a security in making an investment decision operates as its keystone. At the same time, the majority opined that the demonstration of such an impact without more would preclude recovery. Presumably if impact on the price were the sole demonstration, the case would turn only on deficient disclosure, which, as admitted, played no role in the subject transaction. Circuity abounds.

The *Shores* majority fully acknowledged that the "scheme" upon which Rule 10b-5 liability is premised must, under *Santa Fe*, be one "... within the 'manipulative' condemnation of the securities law".¹⁰⁷ Though summarily concluding: "This one clearly is", the majority ignored *Santa Fe*'s admonition that "manipulation" is "virtually a term of art when used in connection with securities markets".¹⁰⁸ There is no suggestion of

¹⁰⁵ The *Blackie* court identified the avenues available to defendants as being determined by the absence of materiality or market effect, and secondly, by demonstrating a plaintiff's knowledge. See 524 F.2d at 906.

¹⁰⁶ See [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,033, at 91,335.

¹⁰⁷ *Id.* at 91,335 n.8.

¹⁰⁸ See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). Broad assertions of "manipulation" as the touchstone for extending Rule 10b-5 coverage have not survived *Santa Fe*. For example, in *Shivers v. Americo*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,064 at 92,930 (9th Cir. 1982), the court refused to recognize the assertion of Rule 10b-5 claims by minority shareholders of a corporation who accused the majority of "destroying" the trading market in shares of the stock by certain practices. Plaintiffs in *Shivers* alleged that certain actions undertaken by the majority prevented "free and honest balancing of investment supply with investment demand" and constituted "manipulation" of stock prices under § 10(b) and Rule 10b-5. They based their assertion upon the proposition that Rule 10b-5 prohibits "a broad range of manipulative practices." The Ninth Circuit affirmed dismissal of the case on other grounds relating to standing. On the "manipulation" claim, however, the court observed that plaintiffs could state a claim for manipulation only if they

such conduct in *Shores*. The "manipulation" in the contemplation of the majority is simply the introduction of bad securities into the marketplace.

There can be no quarrel with the majority's view of the broad purposes of Section 10(b) and Rule 10b-5, and indeed the entirety of the Exchange Act. Provisions creating on-going disclosure mechanisms, liberalized antifraud protections and prohibitions on manipulative activities manifest the concern for assuring free and honest markets. These provisions seek an important object: an informed investment decision. As the post-1975 era has taught, however, broad statements of remedial purpose neither require nor justify extension of the federal securities laws to all conduct viewed as "bad".¹⁰⁹

The dissenters in *Shores* would impose a reliance requirement as an universal limit upon the class of persons who may recover under Rule 10b-5.¹¹⁰ Reliance as the limiting factor for the scope of the implied remedy under Rule 10b-5 remains a subject of debate. However defined, causation-in-fact is and will always be essential to recognition of a Rule 10b-5 claim. The "fraud on a broader scale" envisioned by the *Shores* majority is at odds with any traditional notion of causation. The majority demonstrated sensitivity to this fundamental point, and attempted rationalization based upon the principle of duty so prominent in *Affiliated Ute Citizens v. United States*.¹¹¹ In *Affiliated Ute*, since the defendants acted as "market makers" for the stock and were in a position to influence selling decisions, the Supreme Court found that Rule 10b-5 created an "affirmative duty" to disclose facts to the plaintiff sellers concerning the existence of a better price for their shares. No "reliance" on material misrepresentations occurred, for the focal point in the case was a failure to disclose. The Supreme Court viewed the conduct alleged as constituting a "course of business" or a "device, scheme or artifice that operates as a fraud and deceit" upon the Indian sellers based upon the special relationship between them and the defendants.¹¹²

The *Shores* majority found solace in the *Affiliated Ute* duty analysis, and in *Schlick v. Penn-Dixie Cement Corp.*¹¹³ In *Schlick* the Court upheld the statement of a Rule 10b-5 claim in a merger and other conduct the defendants allegedly undertook to manipulate and depress the market value of securities to achieve an unfair exchange ratio. In this pre-*Santa Fe* case the Second Circuit was satisfied that the appellant sold his shares to Penn-Dixie on the basis of an exchange ratio that reflected adversely the manipulated market value of his stock. The Second Circuit

alleged that defendants artificially affected market activity in order to mislead investors. [Current] FED. SEC. L. REP. (CCH) ¶ 98,604 at 92,933.

¹⁰⁹ See [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,233 at 91,344 (dissent).

¹¹⁰ *Id.* at 91,345.

¹¹¹ 406 U.S. 128 (1972).

¹¹² *Id.* at 153-154.

¹¹³ See text accompanying note 102 *supra*.

held that the plaintiffs allegations stated a cognizable claim for relief, and that it would not require strict transaction causation.¹¹⁴ These cases, in the view of the *Shores* majority, stand four-square for the proposition that Rule 10b-5 is not limited to a narrow right to recover for fraudulent misrepresentations and omissions.

Doubtless few would disagree with this observation, but it begs the question. *Affiliated Ute* above all demonstrates the necessity of causation and the importance of a set of circumstances giving rise to a duty, while breach of that duty supplies the requisite nexus. In *Chiarella* the Supreme Court most recently dispelled any doubt about the necessity of such a relationship. Chiarella's act of trading on nonpublic information—of failing to disclose material information in his possession to the marketplace—tainted that marketplace by creating an informational imbalance. Yet in the absence of Chiarella's duty to that marketplace and the traders in it, the Supreme Court declined to extend Rule 10b-5 coverage. In a similar situation prior to *Chiarella* the Sixth Circuit viewed proffered logic of causation based upon assumptions of injury to be flawed.¹¹⁵

Plainly, no assumptions operate to supply requisite causation. Breach of an extant duty owed to a particular plaintiff can supply that element, as *Affiliated Ute* illustrates. But such duties are not imagined, as *Chiarella* well illustrates. An imperfect marketplace does not alone give rise to the existence of a cognizable duty.

Stripped to the bone, *Shores* is not at all a fraud-on-the-market case. The court makes no attempt to justify it in terms of a market price affected by deficient disclosure or nondisclosure in the face of a duty to disclose. It is, rather, the case of a fraudulently created security which was marketed. The difference as a matter of law is one of substance and not semantics. If any act or conduct falls within the purview of Rule 10b-5, it is now clear that such activity must be "fairly viewed as 'manipulative or deceptive' within the meaning of the statute."¹¹⁶ Deception is the child of informational deficiency—the principal target of all of federal securities regulation. Manipulation, the virtual "term of art", has its own special focus. Both deception and manipulation involve "bad" conduct, but not all "bad" conduct vis-a-vis securities constitutes manipulation or deception within the purview of the antifraud provisions. These are the lessons of the post-1975 era.

Shores turns on a simple proposition. The very presence in a marketplace of a security having no legitimate entitlement to be in the market place is Rule 10b-5 cognizable fraud. The security's presence is fraud without regard to the circumstances of any purchase of that security or the presence or absence of adequate information. The

¹¹⁴ 507 F.2d 374, 384 (2d Cir. 1974).

¹¹⁵ *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

¹¹⁶ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

majority's reasoning, a reaction to reprehensible circumstances, is not supported by sound legal analysis. The majority was content to note the absence of any Supreme Court precedent "contrary" to its position,¹¹⁷ but ignored the obvious sense of virtually every post-1975 decision.¹¹⁸ Under the banner of market "integrity", the *Shores* majority extended the umbrella of Section 10(b) and Rule 10b-5 over circumstances involving the use of the market to carry out a "scheme". The scheme did not, however, impact the investment decision of the plaintiff purchaser except to the extent that the bonds were available for purchase in the first place. Whatever remedy may exist for this purchaser as a matter of state or common law, his claim is not properly the province of Section 10(b) and Rule 10b-5. The plaintiff's claim lacks cognizable deception or manipulation as well as the requisite causation.¹¹⁹

Missing from *Shores* is the factor which is fundamental to the fraud-on-the-market theory of Rule 10b-5 coverage—that plaintiff purchased the security at an artificial price affected by the deficient disclosure of defendants. That factor was also missing from *Panzirer v. Wolf*, in which the Second Circuit, addressing the "integrity of the market," upheld the statement of Section 10(b) and Rule 10b-5 claims by a purchaser of securities who relied on a favorable mention of a company in the "Heard on the Street" column in the *Wall Street Journal*. The plaintiff never saw the report said to underlie the newspaper comment, but she successfully established a chain of causation when she argued that had the annual report of the company been accurate, the published comment

¹¹⁷ See [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,033 at 91,335.

¹¹⁸ The dissenters in *Shores* observed that the decision conflicted with every prior Circuit Court and Supreme Court decision in the field. [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,033 at 91,336. See also *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978). In circumstances not at all unlike *Shores*, the plaintiff in *Vervaecke* purchased hospital authority bonds, but neither saw nor read the offering circular until after his purchase. The plaintiff sought to represent a class of purchasers of the bonds, asserting § 10(b) and Rule 10b-5 claims based upon deficient disclosure in the offering documents. The Eighth Circuit affirmed dismissal of the claims upon finding that the complaint claimed deficient disclosure in documents which the plaintiff did not read. In doing so, the court rejected any presumption of reliance—and causation in fact. See 578 F.2d at 717.

¹¹⁹ But see *Dekro v. Stern Brothers & Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 98,724, at 93,631 (W.D. Mo. 1982), in which the court, relying upon *Shores*, opined that "receipt of a written offering circular prior to purchase is not the litmus test of causation." Like *Shores*, the *Dekro* case involved the offering and sale of tax exempt bonds. Plaintiffs asserted violations of the antifraud provisions of the federal securities laws in connection with oral "sales pitches" received by them based upon offering circulars which plaintiffs did not see. Faithful to *Shores*, plaintiffs alleged that the bond issues were so thoroughly tainted by fraud as to owe their very existence to fraud. The court denied defendants' motion for summary judgment, recognizing two "alternative" theories of causation in the process: one based upon the *Affiliated Ute* presumption of reliance in a non-disclosure setting, the other being "fraud-on-the-market" *a la Shores*, requiring only a "causal nexus". Such a nexus, according to the court, may be established by something other than reliance, depending on what is appropriate in the particular case.

would not have been published, in which case she would not have purchased the securities.

V. *PANZIRER V. WOLF* AND THE "CHAIN OF CAUSATION"

Without mention of *Shores*, the Second Circuit four months after *Shores* decided *Panzirer v. Wolf*.¹²⁰ Plaintiff in *Panzirer* entered upon a losing investment in shares of Allied Artists Industries after reading about the company in the popular "Heard on the Street" column of the *Wall Street Journal*. The particular column focused upon the video cassette market, and devoted two short paragraphs to Allied, including mention of the company's head start in the pre-recorded video tape and cassette market, and attractive market prospects for informational and educational applications. This was an item of particular significance to the plaintiff, a substitute school teacher.¹²¹ Indeed the item struck such a responsive note as to prompt the plaintiff to interrupt her trip to call her broker with an inquiry concerning any "negative" news. Her broker consulted a Standard & Poor's Corporation tear sheet on Allied and advised the plaintiff that no negative news appeared. Following these communications Plaintiff, still on the road, placed her order for purchase of 200 shares, and later an additional order for 500 shares. In the weeks and months following plaintiff's purchases the stock price declined, and eventually Allied filed a Chapter XI petition in bankruptcy.

The plaintiff brought her action under Section 10(b) and Rule 10b-5. She alleged that the Allied annual report for the fiscal year, abstracted in the Standard & Poor's tear sheet that her broker consulted, contained misrepresentations and omissions relating primarily to the profits of the company for that year. The abstract omitted a qualification by the company's accountants stating their doubts as to Allied's ability to function as a going concern. The Company issued the annual report one month prior to plaintiff's purchases. Plaintiff never saw the annual report, but asserted in her complaint that it affected the market, and that she relied on the report by relying on the "integrity of the market." On defendant's motion for summary judgment the District Court dismissed Plaintiff's Rule 10b-5 claims. The District Court found that the plaintiff relied

¹²⁰ 663 F.2d 365 (2d Cir. 1981), cert. granted sub nom. Price Waterhouse v. Panzirer, No. 81,1998.

¹²¹ The column read:

Several analysts contend that Allied Artists is in a good position to take advantage of the growing demand for video tapes, having pioneered the development of recorded cassettes.

Andrew G. Racz of Philips, Appel & Walden, Inc. says Allied Artists, besides having a head start in video tapes and cassettes, is negotiating with TV networks, other film producers and makers of educational films to put their films on video cassettes. "The education and informational area constitutes a tremendous market for video cassettes", says Mr. Racz, adding: "We continue to be bullish on Allied Artists. It's an attractive turnaround situation." 663 F.2d at 366.

"primarily" upon the *Wall Street Journal* column, and that "secondary" reliance on the integrity of the market could not support a claim. The Second Circuit reversed since the law provides no support for a distinction between primary and secondary reliance, and held that the plaintiff demonstrated a sufficient connection between her loss and the allegedly fraudulent annual report to withstand a motion for summary judgment.¹²²

While the Second Circuit held the plaintiff to ultimate proof in tracing her reliance on the alleged fraud through the "reactions of third parties", her claim under Section 10(b) and Rule 10b-5 was not vitiated. Though the Second Circuit did not instruct what "reaction of third parties" the court contemplated, it appears that the ultimate focus would necessarily be upon the market price for the security involved.¹²³ The court offered *Blackie v. Barrack* as principal authority of the proposition, along with *Affiliated Ute*.

Were nothing more stated in *Panzirer*, the result could be viewed in the light of *Blackie* and the presumed reliance which provides foundation for traditional fraud-on-the-market theory. The plaintiff sought to represent a class of purchasers of Allied stock, and the broadly-reasoned decision is not out of line in the procedural setting. The thrust of the opinion, however, is not on the propriety of class action status. Indeed the court rejected the plaintiff as a "fit" representative of the purported class of purchasers because of an "abundantly clear" lack of credibility.¹²⁴

What the court pointed out, however, is that the plaintiff failed to rely on price. She relied instead upon the integrity of the market in producing the information reported in the *Wall Street Journal* column.¹²⁵

In its broad-brush view of the "chain of causation", *Panzirer* actually outdistances *Shores v. Sklar* in the expansion of the scope of Rule 10b-5 coverage. The case focuses on bad disclosure directed to the impersonal marketplace—disclosures made in a manner "reasonably calculated to influence the investing public."¹²⁶

The "integrity of the marketplace" is the integrity of the market price at which investors make investment decisions. If materially false or misleading disclosures artificially inflate the price, persons buying or selling at that affected price recognizably establish requisite causation for statement of a Rule 10b-5 claim. The object of protection is an invest-

¹²² *Id.* at 367. The court noted that the "validity" of the chain of causation would be tested at trial, but that the assertion withstood a motion for summary judgment by reason of the presumption of reliance accorded to plaintiff.

¹²³ *Id.*

¹²⁴ *Id.* at 368. The court's review of evidence relating to the named plaintiff's fitness as a class representative demonstrates the importance of the court's emphasis on the broad "integrity of the market" theory over any consideration of causation based upon particular items of information or alleged deficient disclosures. *Id.*

¹²⁵ *Id.*

¹²⁶ See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

ment decision in a market free of manipulative influences. Markets do not produce information, but rather react to it. The *Panzirer* court necessarily says as much by recognizing that the plaintiff would be held to proof tracing her "reliance" on the fraud through the "reaction of third parties". The only "reaction" of third parties is manifested in a market price for the securities which were the subject of the allegedly deficient information which plaintiff did not see. The court openly acknowledged that the case did not involve integrity of market price, and pointed out that the plaintiff's testimony indicated that a lower price, accurately reflecting the company's true financial position, might have led her to buy even more stock.¹²⁷

The *Panzirer* court's view of the causation requirement under Section 10(b) and Rule 10b-5 requires a showing that the fraud was a "substantial" or "significant contributing cause" to the inquiry of the plaintiff.¹²⁸ Shortly after the decision, Judge Pierce of the Southern District of New York, who sat by designation in *Panzirer*, issued his decision in *Abrams v. Johns-Manville Corp.*¹²⁹ *Abrams* was a fraud-on-the-market case based upon annual reports and disclosure documents from which plaintiffs alleged omitted material information concerning the company's potential liability in asbestos-related tort litigation. The named plaintiff in that purported class action admitted that she based her investment decision on her own determination that the stock represented a "good investment", and that she did not read the documents which contained allegedly deficient disclosure. In response to defendant's motion for summary judgment she noted, however, that the market price affected her decision to buy. Accordingly, on the basis of *Ross v. A.H. Robins Co.*, *Blackie v. Barrack* and *Panzirer*, Judge Pierce correctly upheld the claim as stating a case of "fraud-on-the-market".¹³⁰

Neither *Panzirer* nor *Abrams* mentions, let alone reflects upon, any post-1975 decisions of the Supreme Court as impacting the fraud-on-the-market theory of Rule 10b-5 coverage. Both rest squarely on the *Affiliated Ute* presumption of reliance as underlying their conclusions. Both are market-directed disclosure cases as opposed to the "bad" con-

¹²⁷ 633 F.2d at 367 n.3.

¹²⁸ See also *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981). While the Second Circuit in *Wilson* declined to accept that Rule 10b-5 proscribed conduct must be the "proximate cause" of a plaintiff's harm, it affirmed dismissal of Rule 10b-5 claims relating to disclosures contained in various financial reports and projections since plaintiffs did not rely on them. Indeed defendants demonstrated that other communications stimulated the subject purchases and the court rejected any presumption of causation. See also *Sharp v. Coopers & Lybrand* [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,971, at 91,009 (3d Cir. 1981). *Sharp* emphasized another contemporary observation of the Second Circuit that the court would presume reliance only where it is logical to do so. See *Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir. 1980).

¹²⁹ [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,348, at 92,156 (S.D.N.Y. 1981).

¹³⁰ *Id.* at 92,157.

duct case like *Shores*. *Panzirer* can no more ignore the thrust of the post-1975 cases, however, than can *Shores*. The fundamental issues are the same. Allied Artists did not deceive Mrs. Panzirer by false or misleading disclosures. She bought securities on the basis of a comment that the commentator presumably would not have made if the commentator knew of the company's true financial condition that a proper annual report would have disclosed. There is little practical difference between this position and that of Bishop in *Shores*, who presumably would not have purchased the securities but for the connivance which got them on to the market in the first place.

The "chain of causation" envisioned in *Panzirer* is virtually limitless,¹³¹ save for the presence somewhere of a Rule 10b-5 proscribed act that a plaintiff can somehow link to an ultimate investment decision. In an era marked by the Supreme Court's meaty admonition that: "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud,"¹³² this approach to the scope of coverage is at best troublesome. Though the *Panzirer* court viewed its decision as "no more than an extension of *Blackie*",¹³³ in fact it accomplished the endorsement of a theory not of fraud-on-the-market, as in *Blackie*, but fraud by happenstance. There is considerable and obvious danger in this, and it surely is inconsistent with the contemporary pronouncements of the Supreme Court restricting the scope of Rule 10b-5.

Courts should not leave liability under Rule 10b-5 to chance encounters. The fraud-on-the-market theory, with its presumptions, recognizes that in the open market setting all transactions at a fraud-affected price are linked to a material disclosure defect. Proof of individual reliance would preclude efficient class action treatment, and proof of reliance in nondisclosure cases would be impossible. The essential presumption, however, is the link between a Rule 10b-5 proscribed act and the price of the subject security, an objectively determinable impact. At a fundamental statutory level there is no small significance in this, for Section 28(a) of the Exchange Act limits an investor's remedy to actual damages.¹³⁴ Actual damage in the open market setting occurs only by reference to price. To hold that the "integrity of the market price"

¹³¹ In *Titan Group, Inc. v. Fagan*, 513 F.2d 234, 238-239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975), the Second Circuit emphasized the need for limitation. In *Fagan* the court focused on the role of reliance, and observed that materiality and reliance restrict the potential limitlessness of Rule 10b-5 to situations in which causation in fact exists between the act and the injury. 513 F.2d at 238. More recent decisions critical of broad fraud-on-the-market analyses have likewise cautioned that the theory must be applied so as to achieve the intended protections of the securities laws. See *Fausett v. American Resources Management Corp.*, 14 SEC. REG. L. REP. (BNA) 1291 (D. Utah 1982); *Oklahoma Publishing Co. v. Standard Metal Corp.*, 14 SEC. REG. L. REP. (BNA) 1246 (W.D. Okla. 1982).

¹³² *Chiarella v. United States*, 445 U.S. 222 (1980).

¹³³ 633 F.2d at 368.

¹³⁴ 15 U.S.C. § 78bb(a) (1976).

may be disregarded as the determining factor for Rule 10b-5 coverage in favor of an undefined concept of "integrity of the market in producing information" is to reject any genuine causal limitations upon potential liability. To assert reliance upon the "integrity of the market in producing information" is to assert that requisite causation will be found where the court desires to find it, and logic permits assembly of a "chain".¹³⁵

The decision in *Kennedy v. Nicastro*,¹³⁶ decided two months before *Panzirer*, highlights the fundamental issue and demonstrates considerable sensitivity to the problem. In *Kennedy*, the named plaintiff sought to represent a class of Xcor International shareholders, asserting claims under the antifraud provisions of both the Securities Act of 1933 and the Securities Exchange Act of 1934 relating to the open market purchase of Xcor stock. Plaintiff asserted liability based upon claimed misrepresentations and omissions in various disclosure documents. The plaintiffs neither relied upon nor read the documents. The plaintiffs premised liability on the fraud-on-the-market theory and in that regard relied primarily upon the then recently announced decision in *Shores*, as well as *Blackie v. Barrack* and *Ross v. A.H. Robins*. Plaintiffs specifically alleged that material misstatements and omissions artificially inflated the price of the Xcor stock.

The *Kennedy* court perceived development of the fraud-on-the-market theory along two lines. On the one hand was *Shores*, oddly viewed as a "limited version" of the theory, upholding an action under Rule 10b-5 "only if the securities were proved entirely unmarketable . . ." by reason of the fraudulent misrepresentations.¹³⁷ On the other hand was the "broader version" of the theory, in place in the Second and Ninth Circuits, which recognized a Rule 10b-5 claim for "any open market purchaser who alleges that defendants inflated the market price."¹³⁸ The *Kennedy* court refused to recognize a claim under either.

Kennedy declined to reject the *Panzirer* "chain of causation" rationale. Quite the contrary, the case stands as an endorsement of the principle, properly applied to demonstrate a direct nexus between the putative violation and the injury of an investor. Where the degree of proximity between the act and that injury becomes more and more attenuated and the "chain" stretches further and further, however, the prospect for chance liability grows accordingly, as does the prospect of

¹³⁵ A federal district court described causation as "a metaphysical concept and its meaning may differ in different contexts and the linkage between causation and result necessary to satisfy the legal concept is not always susceptible of direct proof or mathematical determination." *Gerstle v. Gamble-Skogmo, Inc.*, 298 F.Supp. 66, 98 (E.D.N.Y. 1969), *aff'd*, 478 F.2d 1281 (2d Cir. 1973).

¹³⁶ 517 F. Supp. 1157 (N.D. Ill. 1981). *See also* *Mottoros v. Abrams*, 524 F.Supp. 254 (N.D. Ill. 1981) (integrity of market claims as related to class action certification).

¹³⁷ *Id.* at 1159.

¹³⁸ *Id.*

some independent or intervening force disrupting the essential connection.¹³⁹

Although the court couched *Panzirer* in terms of deficient disclosure and the relationship between such disclosure and the particular plaintiff's purchase, the case necessarily stands for the proposition that the simple existence of a disclosure defect in an open market setting supports assertion of a Rule 10b-5 violation by any buyer or seller of the security in that market, where a defect taints the integrity of the market, whether or not the defect had anything to do with the transaction. Like the majority in *Shores* concluded that the presence of securities in a marketplace into which they were fraudulently introduced destroyed the "integrity of the market" without regard to any investor transaction, *Panzirer* essentially declares that "the market" reflects all facts and circumstances such that investors carry out any and all transactions in reliance upon its "integrity". What both analyses lack however, is any definition of market "integrity".

In fairness to the *Panzirer* analysis, the narrow issue before the court was the propriety of summary judgment. While the court spoke broadly of the "integrity of the market" approach to liability, the narrow issue was whether the record demonstrated "sufficient" connection between the plaintiff's loss and the allegedly fraudulent annual report so as to withstand the motion. The court further pointed out that the defendants had introduced no evidence to contradict the alleged chain of causation. There is clearly room here for further consideration of the "connection" along more traditional and appropriate lines. The *Panzirer* court left that door open, and presumably the Supreme Court will pursue it.

VI. THE FUTURE OF "FRAUD-ON-THE-MARKET"

"Fraud-on-the-market" as an approach to the scope of Rule 10b-5 liability was born of pragmatics. In nondisclosure cases it is impossible, and in most other cases it is impractical, to require individual demonstration of reliance by each investor in the impersonal open market. Initially recognized to allow class action to remedy market-oriented claims, the principle of class-wide causation-in-fact took on substantive effect in the law. With *Affiliated Ute Citizens*, causation-in-fact became engrafted upon the substantive law in open-market situations where courts placed principal focus upon failures to disclose material information.

None of the courts employing "fraud-on-the-market", however, interpreted it as involving something other than fraud in the traditional sense of a false or misleading disclosure disseminated in a manner reasonably calculated to influence the investing public. Ultimate liability

¹³⁹ *Id.*

for nondisclosure, as well as application of a relaxed causation standard, depended upon the existence of defendants' duty to disclose. The object of Rule 10b-5 protection being the informed investment decisions of buyers and sellers of securities, false or misleading information which artificially raised or depressed the market price for the security was both logically and necessarily causally connected to transactions at the artificial price.

The remedial purpose of, and policy underlying, Section 10(b) and Rule 10b-5 have been offered as broad support for historical expansion of their coverage. To the extent that courts applied "fraud-on-the-market" its evolution did not violate fundamental and accepted notions of traditional coverage. It was neither a logical nor insignificant step, however, to extend coverage under the rubric of the market "integrity", to supplant "fraud", to those situations demonstrating none of the premises on which "fraud-on-the-market" theory is based. Coverage does not extend to such situations demonstrating only the existence of a bad act in some aspect or a scenario in which a securities transaction occurs and an investor suffers loss.

In its post-1975 securities law decisions the Supreme Court has taught a fundamental lesson concerning the proper role and scope of the federal securities laws, and the antifraud provisions in particular. These provisions do not seek to remedy all bad acts associated with securities transactions; but rather only to assure that investors have accurate information on which to base investment decisions. In circumstances giving rise to a duty of disclosure, investors must be told of all such information, and have the benefit of trading markets free of manipulative influence. The traditional "fraud-on-the-market" theory, based on the artificially maintained or manipulated price of a security in the open market, is not at all inconsistent with this lesson, if loss causation, as opposed to the more restrictive transaction causation, is the applicable requirement. *Fridrich v. Bradford*,¹⁴⁰ *Chiarella*, and *Santa Fe* cast doubt on that assumption. Each of these cases places the broad notions of *Affiliated Ute* in jeopardy. Even *Shores* and *Panzirer* themselves acknowledged that beyond the pleading stage recovery demands some direct "chain" of causation.

Certainly, however, the "extension" of the "fraud-on-the-market" theory to what *Shores* and *Panzirer* claim to be "integrity of the market", which necessarily turns away from a disclosure orientation, is more than problematic. Section 10(b) and Rule 10b-5 surely prohibit fraudulent, deceptive or manipulative conduct, but such conduct in the open market setting is manifested in an affected market price of the subject security. This impact serves as the common causal thread upon which the beads of all investors in that market are strung. Without the impact there is no premise for "fraud-on-the-market."

¹⁴⁰ 542 F.2d 307 (6th Cir. 1976); see text accompanying note 115 *supra*.

Market "integrity" is a notion not susceptible of useful definition or limitation, although *Santa Fe* mandates that it involve deception if addressed within the parameters of Rule 10b-5. *Panzirer* made the attempt by reaching back to the decision of the Second Circuit in *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*¹⁴¹ for the proposition that the plaintiff established causation in fact in circumstances involving "collateral conduct". *Competitive Associates* indeed reversed summary judgment for defendants where plaintiffs' claimed that a "comprehensive scheme to defraud" resulted, or at least was appropriately linked to, an ultimate securities transaction. The Second Circuit considered substantial collateral conduct which involved misrepresentations and omissions as demonstrating a sufficient link with the subject transaction. The case was not founded on "fraud-on-the-market" theory, however, and though it established a conduct orientation, the validity of its contemporary invocation to support a general notion of market integrity is doubtful.

In *Beissinger v. Rockwood Computer Corp.*¹⁴² for example, plaintiffs asserted claims under Section 10(b) and Rule 10b-5 arising out of the purchase of shares of stock in the defendant corporation. Plaintiffs brought and tried the case as a class action, and alleged that misrepresentations and omissions in the corporation's annual report artificially inflated the market price of the stock above its true value. Defendants established that the named plaintiffs failed to rely upon the allegedly deficient annual report, and indeed the record revealed no direct evidence that any member of the class relied on it in purchasing the stock. Plaintiffs alleged that defendants perpetrated a fraud on the market. Upon consideration of the evidence at trial, the court concluded that plaintiffs failed to demonstrate a causal link between the alleged disclosure defects and the economic loss. The court further concluded, on the basis of *Competitive Associates*, that defendants engaged in no "comprehensive scheme to defraud". Interestingly, the court based the latter conclusion upon the finding that defendants engaged in no common scheme to manipulate the value of the stock. As a result, plaintiffs could not demonstrate an essential element of the fraud-on-the-market theory.¹⁴³

The market price of a security is both logically and necessarily the focal point of fraud-on-the-market theory, and *Beissinger* well illustrates

¹⁴¹ See text accompanying notes 47-49 *supra*.

¹⁴² [Current] FED. SEC. L. REP. (CCH) ¶ 98,613 at 93,024 (E.D. Pa. 1981).

¹⁴³ *Id.* at ¶ 93,036. The prominence of causation as an essential element of any § 10(b) and Rule 10b-5 claim continues. See *Coons v. Kidder, Peabody & Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 98,685, at 93,421 (S.D.N.Y. 1982), where causation was viewed as an element of materiality under § 10(b) and claims were dismissed for failure to link the alleged deception with plaintiffs' decision to sell their stock. See also *Oklahoma Publishing Co. v. Standard Metal Corp.*, 14 SEC. REG. & LAW REP. (BNA) 1246 (W.D. Okla. 1982) (fraud-on-the-market theory could not support antifraud claims where plaintiff was aware of misrepresentations that were said to have affected market price of the securities).

that recognition. *Panzirer* itself abounds with references to market price impact while eschewing any particular concern for it. The ultimate justification offered for the holding in *Panzirer* was that "an investor relies generally on the supposition that the market price is validly set and that no unsuspected fraud has affected the price."¹⁴⁴

But *Shores v. Sklar* stands on quite a different footing. Unabashedly rationalized on policy grounds—the so-called "paramount goals" of the federal securities laws to protect investors and promote free and honest markets—the majority opinion simply decries bad conduct.¹⁴⁵ The defendants may well have fraudulently created the securities, and authorized and introduced them into the market under those circumstances. But "integrity of the market", if it has sensible and predictable application as a theory of Rule 10b-5 liability, is not a function of the presence of good or bad securities any more than it is the function of whether good or bad people sell them. A market is impacted by proscribed fraud or manipulation, and thus denigrated, when the investors carry out transactions occurring in the market at artificial prices. The federal securities laws, and Section 10(b) and Rule 10b-5 in particular, indeed reach "complex fraudulent schemes", as envisioned by the *Shores* majority. Without impact on the investment decision, however, reprehensible conduct does not rise to the level of fraud for purposes of the Rule.

The Supreme Court cautioned that proper application of the anti-fraud provisions mandates careful attention to more than whether or not bad conduct occurred. The existence of deception or traditional market manipulation, the existence of defined duties relating to disclosure, the relationship between proscribed conduct and a would-be plaintiff, as to whether plaintiff can assert a claim in the first place, are all matters of great emergent importance. The most recent admonition of the Court that the Court is satisfied that Congress did not enact the securities laws intending to provide a broad federal remedy for all fraud¹⁴⁶ must guide substantive applications. Though fraud may be infinite, the scope of Section 10(b) and Rule 10b-5 is not.

The role of causation in Rule 10b-5 liability analysis has been described in many ways. The essence of the principle is that a plaintiff in such an action should not be entitled to recover damages when the alleged wrongful conduct had no relationship to the claimed harm. *Panzirer*

¹⁴⁴ [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,333, at 92,057. The so-called efficient market hypothesis has always presumed that the market price of a security is a reflection of all representations concerning the stock. See, e.g., *In re LTV Securities Litigation*, 88 F.R.D. 134 (N.D. Tex. 1980).

¹⁴⁵ [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,033, at 91,335.

¹⁴⁶ See *Marine Bank v. Weaver*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,471, at 92,764; 92,766 (U.S. 1982). The issue before the *Weaver* court was whether a certificate of deposit issued by a federally regulated bank was a "security" under the Securities Exchange Act, and in particular, under § 10(b) and Rule 10b-5. The court held that it was not.

spoke of a chain of causation and expressly recognized that ultimate recovery in that case would depend upon proof of the chain. The sense of the decision suggests that the chain ultimately shown would not be unduly attenuated. Were the chain analogy applied in *Shores*, however, it is plain that the chain is not a chain at all. Rather, it is but a naked link. Under the theory of *Shores* the simple presence of the security supplies the sufficient link to the transaction at issue. There is no sense of the decision similar to *Panzirer*, for the *Shores* majority specifically disavowed any notion that ultimate considerations would focus on a price-directed impact in the market.

Properly applied, the "fraud-on-the-market" theory performs a useful and important role in achieving the protective purposes of the antifraud provisions. But as transformed into "integrity of the market" in both *Shores* and *Panzirer*, it does not achieve these purposes. Whether such delineation comes through imposition of a traditional reliance requirement or a less restrictive notion of causation in fact, Rule 10b-5 requires some direct and meaningful linkage between a violative act and the investment decision of a plaintiff. It does not serve the protective purposes of the antifraud provisions to endorse their open-ended application without regard to the object of protection—an investment decision. If particular securities are "fraudulently" created and introduced into a marketplace, and if individuals whose investment decisions are in no way linked to alleged deception or informational deficiency ultimately purchase the securities in that marketplace, the result may be substantial losses and prompt legitimate concerns for an available remedy. Such concerns alone, however, neither compel nor justify extension of the implied private remedy under Section 10(b) and Rule 10b-5 where the plaintiff fails to demonstrate that an investment decision is linked to the putative violation.

The majority in *Shores* rationalizes the decision on the proposition that Section 10(b) and Rule 10b-5 assure "full disclosure" as only one means of achieving broader purposes of investor protection and market integrity. Disregarding the investment decision which serves as a specific object of protection and the basis for the private right of action, the broad proposition of *Shores* is sound, and may well serve as the basis for some regulatory action. As articulated by the Sixth Circuit in *Fridrich v. Bradford*, however, the question remains whether any civil remedy extends as far as the remedy available to the SEC.¹⁴⁷

The private remedy implied under Section 10(b) and Rule 10b-5 must be susceptible of rational limitation. The focus upon an investment decision and the role of an alleged violative act vis-a-vis that decision assures such a limitation. *Panzirer* at least recognized the necessity of a "chain of causation", however attenuated it might be. *Shores* does not even

¹⁴⁷ 542 F.2d at 320.

acknowledge the point, and in failing to do so turns attention entirely to the inquiry into whether someone did "something bad."

The "fraud-on-the-market" theory was born of practical necessity into a world decidedly more hospitable to expansionist views of the scope of Section 10(b) and Rule 10b-5. Although courts no longer favor such views, the practical necessity for recognizing the special aspects of the open market as related to the assertion of antifraud claims is not lessened. The validity of the fundamental proposition of a "fraud-on-the-market" remains. Fraud must be demonstrated, however, and that fraud must be linked to the investment decisions of investors in the open market. Without question, *Shores v. Sklar* rejects this essential element. *Panzirer v. Wolf*, though paying lip service, practically ignores it as well, and fails to further any protective purpose of the antifraud provisions in the process. Courts must guide future applications of the theory accordingly.