Washington and Lee Law Review

Volume 39 | Issue 3 Article 7

Summer 6-1-1982

The Sec'S Version Of The Efficient Market Theory And Its Impact On Securities Law Liabilities

Marvin G. Pickholz

Edward B. Horahan III

THE SEC'S VERSION OF THE EFFICIENT MARKET THEORY AND ITS IMPACT ON SECURITIES LAW LIABILITIES

MARVIN G. PICKHOLZ*
EDWARD B. HORAHAN III**

I. INTRODUCTION

The efficient market theory essentially posits that securities prices reflect a significant amount of information from many different sources in the securities market.[1] This proposition affects both the methods and responsibilities of disclosure as mandated by the securities laws. To the extent the efficient market theory is valid, disclosure methods may be simplified because after information is translated into price, the investor receives considerable information merely by knowing price information.[2] Moreover, the element of reliance in fraud actions may properly be readjusted to allow a finding of reliance in situations involving the indirect processing of material misstatements or omissions through inaccurate or manipulated pricing of securities.[3]

---

* Partner, Arter Hadden & Hemmendinger, Washington, D.C.; A.B. 1963, New York University; LL.B 1966, Syracuse University; LL.M 1968, New York University.

** Associate, Arter Hadden & Hemmendinger, Washington, D.C.; B.A. 1973, LaSalle College; J.D. 1976, Yale Law School.

[1] *See generally* J. FRANCIS, INVESTMENTS ANALYSIS AND MANAGEMENT 566-86 (2d ed. 1976). The efficient market theory exists in several manifestations which vary in their assessment of how much and what type of information a security price incorporates. For example, "[t]he semistrong efficient markets hypothesis requires that all available relevant *public* information . . . be fully reflected in security prices." *Id.* at 573. "The strongly efficient markets hypothesis is that *all* (not just publicly available) information is fully reflected in security prices." *Id.* at 579.

[2] Some commentators have questioned the efficacy of disclosure mandated by the securities laws in view of the efficient market hypothesis.

> The rational average investor knows he cannot compete with . . . experts. He does not independently appraise information relating to security prices, but rather relies more or less directly on experts to obtain and process such information for him. Thus, the elaborate disclosure mechanism designed to protect unsophisticated investors not only has conceptual flaws . . ., but also fails to operate as intended because average investors do not make use of it in practice.

Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1070-71 (1977) (footnotes omitted).

[3] In a typical fraud action under the federal securities laws, a plaintiff must prove the defendant's making of a material misrepresentation, accompanied by some degree of scienter, upon which plaintiff reasonably relied to his detriment. *See, e.g.*, Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir. 1981), *modified*, 650 F.2d 534 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982). The "fraud-on-the-market" theory of liability reduces the element of reliance to a showing that a material misrepresentation has been made and the plaintiff has purchased the security on the open market. The presumption of reliance

The SEC's recent overhaul of the registration process[4] and the earlier acceptance by some courts of the "fraud-on-the-market" theory of liability[5] represent a partial incorporation of efficient market theory into securities regulation. But the recognition that diffuse and rapid processes supply information to the market requires that securities law liabilities for potential defendants undergo a concomitant transformation. The incomplete adoption of efficient market principles exposes underwriters, the research components of broker-dealers, and defendants in securities fraud actions to liabilities and responsibilities possibly inconsistent with their functions in the securities market.

This article will examine first the integrated disclosure system with an emphasis on the SEC's failure to provide a practical program for underwriters to follow in discharging their statutory duties. The article will then analyze the potential for overcompensation of plaintiffs under the "fraud-on-the-market" theory and examine the methods chosen by the courts to limit damage awards to the compensation provided by the Securities Exchange Act of 1934 ("Exchange Act"). Lastly, the article will propose a reorientation of securities regulation which would recognize the diminished capacity of underwriters to police the registration process and would restrict recovery in lawsuits brought under the "fraud-on-the-market" theory to those plaintiffs who actually sustained damages, in a developed market, as a result of misrepresentations and omissions.

II. INTEGRATED DISCLOSURE

In general, the integrated disclosure system streamlines the registration process under the Securities Act of 1933 ("Securities Act"). Three basic registration forms replace for most offerings the myriad of customized forms used in the past. The integrated disclosure system permits many issuers of new securities to rely on information they previously have generated in the periodic reports required by the Exchange Act to satisfy the disclosure requirements of the Securities Act.[6]

To engineer this change, the SEC, over time, enhanced the periodic disclosures required of all companies to equalize the quality and quantity of information required under the two Acts.[7] The beneficiaries of the ad-

---

garnered from the "fraud-on-the-market" theory has been utilized by several courts, *see, e.g.*, Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), and applauded by commentators, *see, e.g.*, Note, *The Reliance Requirement in Private Action under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

[4] Securities Act Release No. 6383, 47 Fed. Reg. 11,380 (1982).

[5] *See generally* Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982) [hereinafter cited as *Fraud-on-the-Market*]. *See also supra* note 3.

[6] Securities Act Release No. 6383, 47 Fed. Reg. 11,380 (1982).

[7] The Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964) made periodic disclosures more broadly applicable to issuers. The SEC had busily tinkered with the specifics of disclosure for years. *See, e.g.*, the rules, amended rules, and proposed alterations in various rules to conform disclosure documents under the two Acts. Securities

ditional disclosures are the companies entitled to incorporate these disclosures by reference into their offering materials and the community of investors who are provided with the free good of a reliable, coherent, and substantial flow of historical data concerning the business and operations of public companies.[8] The feature of the efficient market theory, borrowed to support the integrated disclosure system, is the recognition that in developed markets issuer information provided under the Exchange Act affects prices very quickly independent of the prospectus required by the Securities Act.[9]

But the SEC's acceptance of the efficient market theory has been partial and grudging. This reaction is particularly evident in the Commission's treatment of the liability concerns of underwriters. To understand the scope of the SEC's apprehensions concerning the efficient market theory, it is necessary to review the process and methodology utilized by the Commission in its development of the integrated disclosure system.

The SEC first adopted aspects of the efficient market theory in 1978 when the Commission expanded the availability of its short form registration statement, the S-16, to issuers about which information is widely disseminated among public investors.[10] The form permitted incorporation by reference of existing reports filed under the Exchange Act

---

Act Release No. 6231, 45 Fed. Reg. 63,630 (1980) (Form 10K and Regulation S-K); Securities Act Release No. 6233, 45 Fed. Reg. 63,660 (1980) (Regulation S-X); Securities Act Release No. 6234, 45 Fed. Reg. 63,682 (1980) (Uniform Instructions to Financial Statements); Securities Act Release No. 6236, 45 Fed. Reg. 63,724 (1980) (Form 10-Q). *See also* earlier Regulation S-K releases: Securities Act Release No. 5893, 42 Fed. Reg. 65,554 (1977); Securities Act Release No. 5949, 43 Fed. Reg. 34,407 (1978).

[8] Commentators have long questioned the value to investors of historical data. *See* Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293, 316 (1975) and articles cited therein. Indeed, given the impact of information on price called for by the efficient market theory, the historical data itself generally should have a useful life equal only to the time it takes for that information to be translated into price.

[9] Section 5(b)(2) of the Securities Act of 1933, 15 U.S.C. § 77e(b)(2) (1976) provides: "It shall be unlawful for any person, directly or indirectly—. . . to carry or cause to be carried through the mails or in interstate commerce any . . . security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus. . . ." Literally, the prospectus delivery requirement does not contemplate delivery in time for the offeree's evaluation of the information in the process of making an investment decision. Rule 15c2-8(b), 17 C.F.R. § 240.15c2-8(b) (1982), does require delivery of a prospectus 48 hours before mailing of a confirmation to a purchaser of an issuer's securities if the issuer has not been previously subject to the reporting requirements of the Securities Act.

[10] Securities Act Release No. 5923, 43 Fed. Reg. 16,672 (1978). The concept and process of integrating the disclosure requirements of the two Acts had been endorsed by blue-ribbon advisory panels. *See* REPORT AND RECOMMENDATIONS TO THE SECURITIES AND EXCHANGE COMMISSION FROM THE DISCLOSURE POLICY STUDY, DISCLOSURE TO INVESTORS, A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE 1933 AND 1934 ACTS (1969) [hereinafter cited as WHEAT REPORT]; ADVISORY COMM. ON CORPORATE DISCLOSURE, 95TH CONG., 1ST SESS., REPORT TO THE SECURITIES AND EXCHANGE COMMISSION (Comm. Print 1977) [hereinafter cited as ADVISORY REPORT].

as a substitute for redundant disclosure under the Securities Act. The use of the form depended on the issuer's compliance with rigorous quality standards.[11]

Those submitting comments to the SEC on this proposal represented diverse philosophical perspectives. Some argued that the less comprehensive disclosures permitted under the Exchange Act were poor substitutes for the thorough historical compilation required under the Securities Act. Those same critics touted the beneficial effects of the underwriter's review of an issuer's operations and financial standing included in the registration process and worried over the possible elimination of this important safeguard.[12] The Commission's response played down this concern:

> The Securities Act liability for Exchange Act filings which results from the incorporation by reference of the Exchange Act documents into a registration statement on Form S-16 should result in an improvement in the quality of disclosure in the Exchange Act filings.[13]

---

[11] Subsequent to the tentative acceptance of the efficient market theory, the Commission confronted the practical problem of identifying the issuers of those securities most likely to perform in the manner suggested by efficient market theory. The Commission wanted to "assure that information about the issuer and the securities was available publicly and that some type of market in the securities existed. Under these circumstances the offering price of the new securities would likely be reasonable because the price could be established by reference to the market price and the market price would be established by reasonably well-informed investors in the open market." Securites Act Release No. 5879 [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,360, at 88,691 (1977).

The Commission had learned that financial analysts ordinarily followed issuers with market capitalizations of $50 million or more. *Id.* at 88,692-93 n. 3. Accordingly, to assure a substantial following among analysts, the Commission limited the availability of the integrated disclosure system to issuers who met the $50 million capitalization criterion.

[12] Some critical respondents believed that under the integrated disclosure system underwriters would not have the same access to an issuer's periodic reporting system that they had enjoyed under the traditional registration process. Indeed, some commentators noted that underwriters had avoided short form registration statements because of their potential liability for incorporated Exchange Act reports. *See* Securities Act Release No. 5879, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,360, at 88,691 (1977). The theme of inserting an agent to evaluate independently public disclosure is a recurrent one in securities regulation. Congress placed underwriters and accountants in that position by section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1976).

Accountants, in particular, are treated by the Commission as valued intermediaries despite the professionally limited nature of their role and function. For example, in evaluating potential eligibility requirements for determining those issuers who can use the abbreviated disclosure of Form S-16, the Commission noted that commentators preferred a disclosure requirement similar to the footnotes accompanying quarterly financial data in annual reports over a requirement based exclusively on the size of capital assets. The primary reason for this position was that a footnote requirement would ensure that accountants will have reviewed the quarterly financial data of such issuers. Securities Act Release No. 5879, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,360, at 88,691 n.2 (1977).

[13] Securities Act Release No. 5923, 43 Fed. Reg. 16,672, 16,673 (1978).

The SEC always supposed that underwriters would still function as guardians of the accuracy of disclosure regardless of the manner in which information was provided to and utilized by the market.[14]

The SEC rejected suggestions by others submitting comments on this proposal to loosen the eligibility criteria by eliminating a requirement that an issuer have $50 million in non-affiliate market capitalization. They urged that requiring issuers to have been subject to the Exchange Act reporting requirements for three years, to have not defaulted on any payment on debt or preferred stock for three years, and to have had net income of $250,000 in three of the previous four years sufficed to identify the issuers about which information was widely and accurately reported. In rejecting the suggestion, the Commission argued:

> The $50 million market capitalization standard is adopted because . . . this requirement will provide some assurance that, in addition to wide dissemination of information about such companies in the market place, securities analysts will follow companies of this size. . . . [P]rofessional interest should help assure market reaction to material information about a company and thereby alleviate the need to provide the information directly to offerees when securities are registered on Form S-16 for a primary offering.[15]

Thus, the Commission demonstrated considerable uncertainty about the efficacy of the efficient market theory. Moreover, as a further backup system to efficient market processing of information, the Commission has required that primary offerings be handled as firm commitment underwritings and that incorporated documents be provided upon written request and without charge to offerees.[16]

Accordingly, the Commission, while committing itself to the efficient market theory in form and for a strictly limited group of issuers, in substance enlisted the aid of underwriters, financial analysts, and issuers to assure that the efficient market theory comported with the workings of securities markets. Underwriters, in view of their "due diligence" liabilities, would police disclosure under both Acts and enhance the quality of Exchange Act reports.[17] When those submitting comments to the SEC objected to the imposition of unfamiliar periodic

---

[14] Securities Act Release No. 5879, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,360, at 88,693 (1977).

[15] 43 Fed. Reg. at 16,673-74.

[16] *Id.* at 16,674-77.

[17] Securities Act Release No. 5879, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,360, at 88,693 (1977). Also, a firm commitment underwriting would assure an orderly marketing of the shares as to number and price. *Id.*

reporting responsibilities on underwriters, the Commission agreed to consider rulemaking directed to the issue of an underwriter's liability for Exchange Act reports.[18]

To assuage underwriters' concerns, the SEC initially tinkered with the Securities Act format for underwriter liability. Section 11 of the Securities Act[19] permits persons involved in the registration process, other than the issuer,[20] to escape liability for material misstatements and omissions in a registration statement if these persons have conducted a reasonable investigation of the accuracy of the registration statement as of its effective date.[21] The Commission accepted, without discussion, the premise that an underwriter is responsible, in some manner, for the accuracy of materials incorporated by reference into a registration statement without regard to the generation of the information outside of the registration process.[22] The SEC noted that Congress had established specific liability provisions for underwriters in the Securities Act "in recognition of their greater obligation to the public because of their importance in the distributive process; their ability to obtain information from the registrant; and the reliance placed on these persons by public

[18] The WHEAT REPORT, *supra* note 10, at 98-102, had recommended that underwriters be freed, in substantial part, from due diligence responsibilities with respect to Exchange Act reports incorporated by reference into registration statements for certain offerings. The Commission acknowledged this suggestion, as well as the alternative suggestion of the Advisory Committee on Corporate Disclosure, ADVISORY REPORT, *supra* note 10, at 451-55, that such incorporation by reference be taken into account in assessing the liability of underwriters. The Commission, however, was not prepared at that time to accept either approach without further staff analysis. 43 Fed. Reg. at 16,674. Naturally, the SEC did not question the regulatory need for an underwriter to mediate between an issuer's periodic reports and public investors. The Exchange Act contemplates no such mediation. But the ADVISORY REPORT, *supra* note 10, at 451-55, and, to a much less extent, the WHEAT REPORT, *supra* note 10, at 98-102, accepted the premise that when an Exchange Act report intrudes into the underwriter's bailiwick, the underwriter possesses some—albeit diminished—responsibility for such a report. This premise transfers the concept of expertization from section 11 of the Securities Act to an Exchange Act report. But Exchange Act reporting is produced by its own system of validation through its own liability rules and the value of the additional validation concepts from the Securities Act is questionable.

[19] 15 U.S.C. § 77k (1976).

[20] Section 77k(b) of Title 15 of the United States Code, 15 U.S.C. § 77k(b) (1976), specifically excludes issuers from the categories of persons involved in the registration process entitled to proffer a defense of "due diligence." Indeed, an issuer's responsibility with respect to the accuracy of a prospectus may be denominated that of a guarantor. *See* Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 554, 578 (E.D.N.Y. 1971).

[21] 15 U.S.C. § 77k(b)(3) (1976). With respect to portions of the prospectus prepared by an expert, other persons involved in the registration process need not evaluate the expert's findings. Rather, these persons simply must possess no reasonable ground to believe that such expert's opinion contains a material misstatement or omission. 15 U.S.C. § 77k(b)(3)(C) (1976).

[22] Securities Act Release No. 5998, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,761 (1978).

investors."[23] But the integrated disclosure system had undercut the bases for such liability. Public investors were presumed not to be relying on disclosure in a prospectus and underwriters typically were not included in issuers' periodic reporting programs. The Commission did admit, however, that practical problems confronted underwriters whose section 11 liabilities might require them to become involved in an issuer's Exchange Act disclosure process.

The SEC's provisional answer to these questions was to allow the effective date of incorporated disclosure documents to be the date of initial filing and to treat superseding disclosure incorporated by reference into the registration statement or appearing in the registration statement as modifying prior disclosure without being deemed an admission of liability under the federal securities laws.[24] But the Commission's proposal to treat the effective date of incorporated disclosure as the date of its initial filing with the SEC offered less solace to underwriters than the literal rule appeared to provide. The Commission simply refused to free underwriters from a due diligence investigation.

> The Commission believes that in order to establish a defense underwriters must review carefully the documents incorporated by reference into registration statements on the Form S-16 to assure that these documents, together with the prospectus, contain no false and misleading information and that the facts disclosed in these documents have not changed materially as of the date of incorporation.[25]

Thus, an underwriter might still suffer Securities Act liability for an Exchange Act filing in the event that it was false when filed or subsequent events made such a filing misleading.[26]

The SEC, however, never adopted these proposals in the context of short form registration. Rather, the Commission reissued the proposals for comment when it started its comprehensive reorganization of the Securities Act registration system.[27] Still, the Commission did not accept fully the terms of the efficient market theory. The Commission acknowledged that the market analyzes information and translates it into price, but nonetheless, the Commission required that the same information, the usefulness of which had been exhausted, be incorporated by reference into the prospectus for verification purposes. The SEC stated:

> [E]ven though the registration statement is abbreviated, it

[23] *Id.* at 81,058 n.6 (citation omitted).
[24] *Id.* at 81,057.
[25] *Id.* at 81,060.
[26] *Id.* at 81,061.
[27] Securities Act Release No. 6235, 45 Fed. Reg. 63,693 (1980).

should incorporate by reference the issuer's Exchange Act information which otherwise would be included in the prospectus *to ensure that the information previously furnished is accurate in all material respects.*[28]

Thus, although investors would not find the information contained in previously filed Exchange Act reports useful, the Commission maintained the fiction of incorporation to tag underwriters and others with potential liabilities under the Securities Act, without regard to the existing liabilities under the Exchange Act for the very same information.[29] The Commission was quite definite in its insistence that underwriters remain trapped in the registration system because "the presence of an underwriter who has a degree of responsibility for an offering serves to enhance the likelihood that investor protection will not suffer because of abbreviated disclosure in the prospectus."[30] But the Commission also solicited comments on whether it should make abbreviated disclosure available to qualified registrants regardless of the use of an underwriter for the offering.[31]

In its next incarnation, the SEC refined the eligibility requirements for use of the integrated disclosure system to eliminate most of the quality criteria previously used to identify the issuers eligible to use abbreviated registration statements.[32] One of the retained criteria required

---

[28] *Id.* at 63,698 (emphasis added).

[29] Section 7 of the Securities Act, 15 U.S.C. § 77g (1976), requires a registration statement to contain the financial data detailed in Schedule A, 15 U.S.C. § 77aa (1976). Section 7 provides, however, "that the Commission may by rules or regulations provide that any such information or document need not be included in respect of any class of issuers or securities if it finds that the requirement of such information or document is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement." 15 U.S.C. § 77g (1976). Based on this language, the SEC arguably has the statutory power to dispense with financial information in a registration statement based on the dissemination of Exchange Act reports. Moreover, the language that other material adequate for investors be included *within* the registration statement suggests that incorporation by reference or financial data satisfied this statutory mandate.

In creating the SEC, Congress believed, with respect to the Exchange Act at least, that the agency had discretion to formulate disclosure requirements: "The Commission is given complete discretion . . . to require in corporate reports only such information as it deems necessary or appropriate in the public interest or to protect investors." S. REP. No. 792, 73d Cong., 2d Sess. 10 (1934).

[30] Securities Act Release No. 6235, 45 Fed. Reg. 63,693, 63,700 (1980).

[31] *Id.*

[32] Securities Act Release No. 6331, 46 Fed. Reg. 41,902 (1981). The Commission stated that it had "made a concerted effort to revise the eligibility requirements in a manner that is simple and rational and is consistent with its intention to classify registrants on the basis of the degree of information disseminated and analyzed in the marketplace." *Id.* at 41,905.

Although the Commission hoped to eliminate quality criteria, vestiges remained. For example, a material default by an issuer since the filing of its last Exchange Act report containing a certified financial statement made the issuer ineligible for the abbreviated an issuer to have filed Exchange Act reports for three years.[33] The Commission touted this requirement as "necessary because the operation of an efficient market for a security depends on such information being made public promptly and its inclusion in filings made under the Exchange Act helps ensure its accuracy."[34] Thus, the SEC admitted that the Exchange Act system possesses a value as a validator of information provided to the market.

But the SEC still wanted to maintain Securities Act liabilities for the Exchange Act reports incorporated by reference into the abbreviated registration statement. The Commission moved the listing of the incorporated documents in the registration statement to that portion which is required to be repeated in the prospectus to assure potential liability for misstatements in both documents.[35] The SEC also questioned the efficacy of information disseminated under the Exchange Act by requesting comments on "the need for a brief prospectus description of subsequent material developments which are described in reports incorporated by reference."[36]

The Commission's equivocation on the vitality of the efficient market theory evolved into a system retaining the theory, in part, for purposes of the production of registration statements, but discarding it for the purposes of the Securities Act liabilities. Thus, the proposal to accept the effective date of an Exchange Act report as that of its initial filing was interpreted out of existence.[37] The Commission continued to recognize that the integrated disclosure system not only reduced the time necessary to prepare registration statements, but also increased the competitive pressures on underwriters under the system.[38] But these added pressures in the SEC's view did not warrant a relaxation of the

registration statement. *Id.* at 41,906. Also, the requirement of "$150 million in aggregate value of voting stock held by non-affiliates," although created to assure an avid following of the issuer among investors and, in particular, among institutional investors, can be seen as a preference for the larger companies. Oddly enough, the Commission's proposed "float" criterion would identify nearly 1500 issuers as possible users of the abbreviated registration statement. *Id.* at 41,909. The Commission's research, however, had shown that the research arms of larger investment institutions followed only about 300-500 issuers. *Id.*

[33] *Id.* at 41,905.

[34] *Id.* at 41,905-06.

[35] *Id.* at 41,914. Section 11 of the Securities Act, 15 U.S.C. § 77k (1976), covers registration statement liabilities and section 12(2), 15 U.S.C. § 77l(2) (1976), covers prospectus liabilities.

[36] 46 Fed. Reg. at 41,915. Interestingly, the Commission had previously suggested a minimum period of delay be maintained between filing and the effective date of the registration statement. Among the reasons for this suggestion was to enhance an underwriter's ability to complete his due diligence investigation. The Commission decided to deal with this question in terms of its authority to grant requests for acceleration of effective date. *Id.* at 41,913.

[37] Securities Act Release No. 6335, 46 Fed. Reg. 41,015 (1981).

[38] *Id.* at 42,017. The Commission noted that commentators had asserted that by accepting incorporation by reference of Exchange Act disclosures, the Commission sacrified the

liability standards applicable to underwriters. "The Commission's efforts towards integration of the Securities Act and Exchange Act relate solely to elimination of unnecessary repetition of disclosure, not to the requirements of due diligence which must accompany any offering."[39] Due diligence, however, which requires independent verification of most matters presented in the registration statement, is little more than a repetition of the steps taken to formulate the information initially.[40] Thus, even though the Commission had previously recognized that the Exchange Act reporting system served, in some way, to ensure the accuracy of disclosure, the Commission still was willing to impose a repetitive validation system through the imposition of Securities Act liabilities.[41] The Commission reasoned that no unfair burden was imposed on an underwriter because "the underwriter is never compelled to proceed with an offering until he has accomplished his due diligence" and the integrated disclosure system did not preclude corrective disclosure by way of an additional Exchange Act report incorporated by reference or by correction in the registration statement.[42] But in view of the speed with which an abbreviated registration statement can be produced, the concomitant price pressures on investment bankers, the fact that the incorporated documents have been validated by the Exchange Act system of liabilities, and the fact that the issuer stands as guarantor of the accuracy of materials contained in the registration statement, little is gained in the way of investor protection, under the SEC's new system, by requiring an additional independent verification by underwriters.[43]

The Commission was careful to point out that, because of the compressed timetable for registration statement preparation in the integrated disclosure system, underwriters could practically discharge

---

"crucible" for adequate disclosure provided by the independent drafting of the prospectus without also relaxing the liability rules pertinent to such a process. *Id.* at 41,019.

[39] *Id.* at 42,020.

[40] Representations by management, in essence, should be verified by testing those representations against the written record. *See, e.g.*, Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

[41] The Commission declared:

> The *integrated disclosure system, past and proposed, is thus not designed to modify the responsibility of underwriters and others to make a reasonable investigation.* Information presented in the registration statement, whether or not incorporated by reference, must be true and complete in all material respects and verified where appropriate. Likewise, nothing in the Commission's integrated disclosure system precludes conducting adequate due diligence.

Securities Act Release No. 6335, 46 Fed. Reg. 42,015, 42,020 (1981) (emphasis added).

[42] *Id.*

[43] Yet redundant verification is precisely what the SEC contemplated.

> The Commission specifically rejects the suggestion that the underwriter needs only to read the incorporated materials and discuss them with representatives of the registrant and named experts. Because the registrant would be the sole source of virtually all information, this approach would not, in and of itself, include the element of verification required by the case law and contemplated by the statute.

Id.

their due diligence functions by either: 1) a delay in filing of the registration statement until a due diligence investigation can be conducted; or 2) the development "in advance [of] a reservoir of knowledge about the companies that may select the underwriter to distribute their securities registered on short form registration statements."[44] Since the chief advantage of abbreviated registration statements is speed, the latter alternative is the only meaningful possibility. The Commission also suggested that "the need for elaborate original investigations by underwriters" could be minimized by inserting the underwriter and its counsel into the preparation process for the issuer's annual report on Form 10-K.[45] The Commission did not offer any reason for an underwriter (or prospective underwriter) to subject itself to potential Exchange Act liabilities for participating in the preparation of a prospective client's Form 10-K; nor did it identify the persons (presumably the investing public) who would bear the costs for these additional activities.

To mitigate against some of the dangers confronting underwriters, the SEC proposed a rule delineating the permissible factors affecting the variability of a due diligence investigation.[46] But the Commission eliminated the potential protections the rule afforded by setting the effective date on an incorporated disclosure document as the date of its initial filing with the SEC.

> The declaration that the effective date of a prior filing is its initial filing date does not mean that it must be evaluated for purposes of Section 11(a) as of that date or that if there is an error in that filing a liability will attach under the Securities Act based solely on the contents of the document at the time of its initial filing. Rather, inaccurate or out-dated information in a prior filing should not be deemed to make the prospectus false or misleading if updating or correcting information is included in a later filing or in the registration statement.[47]

---

[44] *Id.* The Commission indicated that the advance accumulation of information about issuers would only facilitate the due diligence investigation and not replace it. *Id.* at 42,021.

[45] *Id.*

[46] *Id.* at 42,021-22. The SEC based the proposal governing due diligence investigations on section 1704(g) of the ALI's Federal Securities Code, ALI FED. SECURITIES CODE § 1704(g) (1980). The proposal included factors such as the type of issuer and security, and the nature of the person's relationship with the issuer and to the documents incorporated by reference. Because the Commission had also recommended that underwriters be involved in the Exchange Act reporting system, it eviscerated the possible benefit accruing to underwriters under this rule when the underwriters had no responsibilities for an issuer's Exchange Act reporting system.

Interestingly enough, the Commission, in proposing rules for Form S-16 registration statements, did not include a rule setting forth the variables affecting the reasonableness of a due diligence investigation. The Commission noted that such a rule was unnecessary in view of existing judicial constructions recognizing that such an investigation would vary with the individual circumstances of the offering. Securities Act Release No. 5998, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,761, at 81,060 (1978).

[47] Securities Act Release No. 6335, 46 Fed. Reg. 41,015, 42,023 (1981).

Thus, regardless of the paucity of time available to underwriters to conduct due diligence investigations and the minimal opportunities for underwriters to participate meaningfully in the development of Exchange Act disclosure documents, the Commission determined that investors could, and should, rely on underwriters to perform an investigatory function.[48]

The Commission's final rulemaking on the integrated disclosure system adopted the abbreviated registration statement for widely followed issuers substantially as proposed.[49] If anything, the SEC expanded the availability of the short-form S-3 to include secondary offerings and offerings of preferred stock regardless of the amount of outstanding voting stock in the hands of non-affiliates.[50] Also, the Commission recognized that information contained in virtually any report filed with the SEC affects a developed market and is, therefore, eligible for incorporation by reference instead of repeating the disclosure in the registration statement.[51]

Therefore, the Commission has largely accepted the efficient market theory for the strata of issuers the Commission believes are most likely to have securities that behave in the manner suggested by the theory. Yet the Commission has not altered the requirement that underwriters for those issuers must verify the accuracy of the information that has already been incorporated into the prices for the securities of those issuers. The putative salve for those subject to the duty to perform due diligence is a rule detailing some of the factors which might necessitate a greater or lesser obligation to investigate[52] and a rule related to the

---

[48] *Id.* The militance of the SEC in the cause of retaining the due diligence requirement cannot be gainsaid. The Commission quoted, with approval, the following language from Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973):

> No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter . . . . Prospective investors look to the underwriter . . . to pass on the soundness of the security and the correctness of the registration statement and prospectus.

46 Fed. Reg. at 42,023 n. 73. Indeed, the Commission also solicited comments on whether to require managing underwriters to represent that adequate time had existed for conducting a due diligence investigation in connection with the underwriter's request to accelerate the effective date of the registration statement. *Id.* at 42,023. This proposal did not become a part of the Commission's final rulemaking on integrated disclosure. Securities Act Release No. 6383, 47 Fed. Reg. 11,380, 11,399 (1982).

[49] 47 Fed. Reg. at 11,380.

[50] *Id.* at 11,384.

[51] *Id.* at 11,385. The primary example of an incorporated disclosure document is the proxy statement.

[52] Rule 176, 17 C.F.R. § 230.176 (1982), provides:

> In determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in section 11(c), relevant circumstances include, with respect to a person other than the issuer.
>
> (a) The type of issuer;
>
> (b) The type of security;

methodology and effect of modifying or superseding disclosure made in filings incorporated by reference into the registration statement.[53] The Commission went so far as to grant that "the availability of information with respect to the registrant" might affect the content of a due diligence investigation.[54] But the Commission noted that this allowance concerned information within the control of third persons and did not relate to information within the control of the issuer.[55]

Consequently, an integrated disclosure system is in place with equivalent disclosures required under both the Securities Act and the Exchange Act. Indeed, for issuers in a developed market with a wide following among professional investors, the Securities Act disclosure merely includes the Exchange Act disclosure in deference to the efficient market theory. Those Exchange Act disclosures, produced under

---

(c) The type of person;

(d) The office held when the person is an officer;

(e) The presence or absence of another relationship to the issuer when the person is a director or proposed director;

(f) Reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);

(g) When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registration; and

(h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

[53] Rule 412, 17 C.F.R. § 230.412 (1982) provides:

(a) Any statement contained in a document incorporated or deemed to be incorporated by reference shall be deemed to be modified or superseded for purposes of the registration statement or the prospectus to the extent that a statement contained in the prospectus or in any other subsequently filed document which also is or is deemed to be incorporated by reference modifies or replaces such statement.

(b) The modifying or superseding statement may, but need not, state that it has modified or superseded a prior statement or include any other information set forth in the document which is not so modified or superseded. The making of a modifying or superseding statement shall not be deemed an admission that the modified or superseded statement, when made, constituted an untrue statement of a material fact, an omission to state a material fact necessary to make a statement not misleading, or the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business or artifice to defraud, as those terms are used in the Act, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Investment Company Act of 1940, or the rules and regulations thereunder.

(c) Any statement so modified shall not be deemed in its unmodified form to constitute part of the registration statement or prospectus for purpose of the Act. Any statement so superseded shall not be deemed to constitute a part of the registration statement or the prospectus for purposes of the Act.

[54] Securities Act Release No. 6383, 47 Fed. Reg. 11,380, 11,399 (1982).

[55] *Id.*

threat of liability for misrepresentations or omissions, possess a certain degree of reliability which is backed by the reporting company, and, often, by their professional advisors who comment on or assist in preparing the reports. When those same reports are utilized in the context of a registration statement, the issuer stands as guarantor of their accuracy. To add an underwriter's independent investigation to the safeguards peculiarly present in the Securities Act may be seen as unfairly favoring the purchasers of new offerings over ordinary traders. There is no apparent reason to prefer the one class over the other. Indeed, since the majority of trades are conducted in the aftermarket for securities, it would seem that the greater danger to investors arises in that market—particularly when one restricts the additional safeguard of an underwriter's due diligence investigation with respect to Exchange Act reports to the group of issuers eligible to utilize an abbreviated registration statement. The argument that traders in the aftermarket would benefit from any new information revealed in an underwriter's investigation can be dismissed since such an investigation would only occur under the fortuitous circumstance of a new securities offering. Other issuers abound and investors in their securities are no less worthy.

Further, to the extent that the integrated disclosure system enables issuers to react quickly to market conditions by preparing and floating a new issue of securities, the requirement of a largely redundant due diligence investigation by underwriters serves to impede capital formation without a demonstrable boost to the goal of investor protection. If the corporate management of an issuer in the class qualified to use the abbreviated registration statement can confound the corporation's board of directors, accountants, and lawyers with respect to disclosure, corporate management can similarly dupe the underwriter with or without a due diligence investigation. Accordingly, the retention for underwriters of due diligence responsibilities in the context of short form registration statements is not useful.

III. "FRAUD-ON-THE-MARKET" LIABILITY THEORY

The "fraud-on-the-market" theory of liability permits plaintiffs to prove reliance indirectly by proving a purchase or sale of a security subsequent to a material misrepresentation by the defendant. Under the theory, the plaintiff need not prove actual reliance on, or even knowledge of, the misrepresentation.[56] This liability theory is grounded on the basic principle of the efficient market theory that the securities market translates information about the issuer into the market price for the issuer's securities.[57] Thus, according to the theory, an investor relies on the data about an issuer, including misrepresentations, that the

[56] *See generally Fraud-on-the-Market, supra* note 5. *See also* Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

[57] *See, e.g.,* Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975); *In re* LTV Securities Litigation, 88 F.R.D. 134, 142-44 (N.D. Tex. 1980).

market has translated into the market price in the same manner in which the investor would rely on direct representations or misrepresentations concerning a security.[58]

Commentators have urged that the SEC should restrict the "fraud-on-the-market" theory to securities for which there is a developed market.[59] In establishing the criteria for determining which issuers are eligible to use the abbreviated registration statement on form S-3, the SEC has attempted to identify the issuers followed closely by the market and market professionals.[60] Accordingly, to the extent the courts decide to restrict the "fraud-on-the-market" theory to stocks likely to behave in the manner suggested by the efficient market theory, the SEC has provided the judiciary with a useful means to identify those securities. But the courts will also have to develop a coherent means to recognize defenses made pertinent by the efficient market theory.

The classic application of the "fraud-on-the-market" theory occurred in *Blackie v. Barrack.*[61] In *Blackie*, the plaintiff class alleged misrepresentations and omissions over a 27 month period in a series of SEC filings and press releases which served to inflate the market price of the securities.[62] The court determined that "proof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market. . . . We think causation is adequately established in the impersonal stock exchange context by proof of purchase and the materiality of misrepresentations, without direct proof of reliance."[63] The court shifted the burden of proof on this element of causation to defendants by permitting them to disprove "transactional causation."[64]

---

[58] In a way, an investor's reliance on the validity of the market price is more convincing than reliance on a face-to-face representation, since the market price involves a collective evaluation of the impact of data and a direct representation may simply relate to an atomistic assessment peculiar to a particular investor.

[59] *Fraud-on-the-Market, supra* note 5, at 1156-58.

[60] 17 C.F.R. § 239.13 (1982). Briefly, the issuer must be a U.S. corporation with registered securities and must be subject to the Exchange Act reporting system for three years. The issuer may not be in default on any debt repayment since the end of the last fiscal year for which a certified financial statement has been filed with the SEC. The issuer must also have either $150 million in aggregate market value of voting securities held by non-affiliates or $100 million in aggregate market value of voting stock held by non-affiliates and annual trading volume in that stock of 3 million or more shares. *Id.*

[61] 524 F.2d 891 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

[62] *Id.* at 902.

[63] *Id.* at 906 (citations omitted).

[64] *Id.* In Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975), the court defined the term "transaction causation" to mean "that the violations in question caused the appellant to engage in the transaction in question." Although this definition appears to imply that the violation must have induced the transaction, the court's treatment of the issue suggested that the violation need only accompany the transaction. "In a misrepresentation case, to show transaction causation a plaintiff must demonstrate that he relied on the misrepresentations in question *when* he entered into the transaction which caused him harm." *Id.* (citation omitted, emphasis added).

> Defendants may do so in at least 2 ways: 1) by disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; 2) by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it.[65]

The court conceded that the ability to disprove causation would not greatly assist potential defendants since it was unlikely that "a defendant would be able to prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material fraud."[66] The court also recognized that the reliance of the market participant in entering the transaction would not be on the specific misrepresentation or omission charged. Rather, the market participant may have determined to enter the transaction for reasons unrelated to or regardless of the misrepresentation.

> Nevertheless, [the market participant] relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations.[67]

Thus, the court accepted that the pricing accuracy of the market is an assurance to investors that the price they pay incorporates such information as the federal securities laws require the issuer to disclose.[68]

The defenses outlined by the court in *Blackie* suggest possible limitations on a "fraud-on-the-market" case. But those limitations are not meaningful. The court's disjunctive proffer that a defendant could escape liability either by disproving the materiality of the misrepresentations or by proving that, despite materiality, the misrepresentations did not affect the price of the security can be viewed as a single test for the purposes of "fraud-on-the-market" liability. Indeed, there is no difference between the tests because if the misrepresentation did not alter the market price, no compensable injury has occurred to an investor nominally relying on the accuracy of the market price.

If, however, the *Blackie* court was correct in distinguishing between material facts[69] and facts affecting the market price for a security, it

---

[65] 524 F.2d at 906.

[66] *Id.* at 906-07 n. 22.

[67] *Id.* at 907. The *Blackie* decision did not discuss whether fraud-on-the-market should be brought under § 9 rather than § 10(b) of the Exchange Act. *See* Chemetron Corp. v. Business Funds, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 98,777 (5th Cir. 1982).

[68] The *Blackie* court did not rule on the appropriate damage measure in a "fraud-on-the-market" action, but did suggest that rescission might be an appropriate measure. 524 F.2d at 909.

[69] *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

would still be reasonable to apply the materiality test only to the facts that would alter the market price for the security. In this connection, the SEC's recognition that market professionals process the information which affects market price, as well as the SEC's view that the efficient market theory applies to those issuers closely followed by market professionals, might suggest that materiality in such cases could be measured by the standards of the professional investor rather than the reasonable investor.

The *Blackie* court also indicated that a defendant could defeat the "fraud-on-the-market" theory's presumption of reliance by proof either that an individual plaintiff purchased with knowledge of the misrepresentation or that he would have purchased anyway had he known of the misrepresentation.[70] Both aspects of this defense appear to miss the implication of the efficient market theory. If the "fraud-on-the-market" theory has been formulated to obviate the deleterious effects of mispricing of securities by the market, it would seem that an injured plaintiff's awareness of a misrepresentation would not remedy the mispricing or provide the injured plaintiff with the means to correct the mispricing unless the plaintiff acted to supply the information to the market. Further, the court's suggestion that a defendant prove that a plaintiff would have purchased anyway had he known of the misrepresentation appears to miss the point. An individual plaintiff's immunity to a particular misrepresentation provides no assurance that the market possesses a similar immunity. Also, such a plaintiff would purchase the security without the market's valuation of the information as to which the plaintiff is indifferent. Presumably, then, such a plaintiff would have purchased at a higher price than what the market would have set for the same security if the same information had been provided to the market. Even though the investor had been granted the opportunity to evaluate the misrepresentation himself, he would have foregone the opportunity to receive the input of other investors through the pricing mechanism of the market.

Nevertheless, the compensation theme[71] of the federal securities law dictates that a plaintiff with knowledge of a misrepresentation or omission will not recover for the known risk of an inaccurately priced security. For example, a court has held that a securities purchaser seeking to acquire the issuer cannot recover for alleged misrepresentations and omissions the issuer's management made while attempting to ward off the takeover.[72] Under these circumstances, the plaintiff knowingly paid the inflated price of the security.[73] The plaintiff could not demonstrate a connection between his loss and the misrepresentation or omission because,

[70] 524 F.2d at 906.

[71] *See* 15 U.S.C. §§ 77k(c), 78q(a) (1976).

[72] Oklahoma Publishing Co. v. Standard Metals Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 98, 750, at 93,774 (W.D. Okla. 1982).

[73] *Id.*

in a sense, he provoked the misrepresentations. This sort of conduct is segregated from actionable conduct by the application of the causation principle of reliance. It has been stated: "[a]bsent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."[74]

The application of causation principles would deny recovery to an individual plaintiff who, for whatever reason, misinterpreted the significance of a known misrepresentation or would have misinterpreted it.[75] Because the market price of a security presumptively represents an equilibrium position in the interaction between buyers and sellers, it presupposes different interpretations of information by the varied participants in the process. In *Blackie*, the court did not believe that, as a practical matter, a defendant could separate out those plaintiffs indifferent to the alleged misrepresentations.[76] It seems, however, that the identification of such plaintiffs would simply demonstrate the obvious existence of an array of market participants with different reactions to the same information or misinformation. Compensating individual investors who are indifferent to, or would misinterpret the significance of, certain facts violates the principle of restricting recoveries to those suffering injury as a result of the misrepresentation or omission of those facts. But this is precisely the bias of the "fraud-on-the-market" theory.

The use of the "reasonable investor" standard, in this context, to limit recoveries to the compensatory goals of the securities laws again appears overbroad. If the SEC is correct that an indicator of the existence of an efficient market in a security is the presence of a wide following by market professionals (assuring that information has an appropriate market impact), then the reaction of those market professionals could represent a more appropriate measure of the sorts of misinformation which would have a market impact and are, therefore, capable of redress through the "fraud-on-the-market" theory.[77] Adoption of the

---

[74] Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), *modified*, 650 F.2d 534 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982).

[75] By "misinterpret," in this context, we mean that the individual investor's reaction deviates significantly from the aggregate equilibrium market reaction.

[76] 524 F.2d at 906-07 n. 22.

[77] The difference between the reasonable investor and professional investor standards can be illustrated by reference to Greenapple v. Detroit Edison Co., 618 F.2d 198 (2d Cir. 1980). The majority found the prospectus presentation of a complex and specialized accounting concept imperfect, but not misleading. *Id.* at 211. Chief Judge Kaufman, in dissent, argued:

> It may well be, as the majority implies, that utility specialists and expert accountants were well aware of the non-cash nature of the AFDC [the accounting concept in question]. It may even be presumed that the success or failure of Detroit Edison's offering would rest largely upon these experts' careful analyses of the prospectus, and not the untutored scrutiny of the appellant or other hapless investors. But I fail to see how any of this bears on the issue before us, namely, whether there is a substantial likelihood that a reasonable investor would con-

"professional investor" standard would serve to reduce overcompensation for misrepresentations unlikely to have substantial market impact.

In *Panzirer v. Wolf*,[78] the Second Circuit wrestled with the issue of a plaintiff claiming under the "fraud-on-the-market" theory but eschewing reliance on the price set by the market. The plaintiff there claimed that she based her stock purchase on an article in the *Wall Street Journal* reporting that analysts believed that the issuer was "in a good position to take advantage of the growing demand for videotapes" and represented " 'an attractive turn-around situation.' "[79] The issuer had sent an annual report to shareholders weeks before and the plaintiff alleged that the report contained material misrepresentations. In what the court denominated the "chain of causation," plaintiff alleged that if the annual report had been accurate, the analysts would not have cited the issuer, the *Wall Street Journal* would not have printed the article, and the plaintiff would not have purchased the stock.[80] The court held:

> Where the plaintiff acts upon information from those working in or reporting on the securities markets, and where that information is circulated after a material misrepresentation or omission, plaintiff has stated a sufficient claim of reliance on the misrepresentation or omission.[81]

In so holding, the court eviscerated the statement in *Blackie* that a defendant could escape liability by proving that the plaintiff would not have acted differently given correct information about the issuer.[82] Indeed, the court believed it likely "that a lower price accurately reflecting [the issuer's] true financial position might have led her to buy more stock."[83]

The court explained its denial of this defense as follows:

> Our holding is no more than an extension of *Blackie*. Zelda Panzirer did not rely on the integrity of the market price because she did not rely on price, but she did rely on the integrity of the market in producing the information reported in the Wall Street Journal.[84]

---

sider the non-cash nature of AFDC income important in reaching an investment decision.

Id. at 215. In the context of the "fraud-on-the-market" theory, courts would use the reactions of market professionals rather than reliance by the investor as the benchmark to establish those misrepresentations which, because of their likely impact on market prices, can be treated as material misrepresentations.

[78] 663 F.2d 365 (2d Cir. 1981), *pet. for cert. filed*, 50 U.S.L.W. 3998 (U.S. June 28, 1982).

[79] *Id.* at 366.

[80] *Id.* at 367.

[81] *Id.*

[82] *See* text accompanying notes 61-68 *supra*.

[83] 663 F.2d at 367 n. 3.

[84] *Id.* at 368.

The court need not have gone so far. The plaintiff very likely purchased an inaccurately priced security.[85] The fact that the plaintiff in *Panzirer* was not price sensitive does not alter this inaccuracy. Accordingly, she paid a price for the security in excess of what the market would have otherwise demanded of her. If recoveries under securities laws were not limited to compensation attributable to violations of those laws, the plaintiff's compensable interest would be equal to the market impact of the misrepresentation under either the Second Circuit's market integrity rationale or an alternative thesis that "fraud-on-the-market" theory need not deny recovery to investors who would have purchased even given accurate information. A possible method for determining the extent of damages under either theory is to measure the market impact of a misrepresentation in terms of the effect such misrepresentation had on a market professional.[86]

The "professional investor" standard would allow investors to recover who would not have reacted differently to a correct pricing signal by the market. Significantly, this method fails to distinguish those investors who provoked the incorrect pricing from other kinds of investors.[87] Assuming investors who provoke incorrect pricing should be without a remedy, some means of distinguishing these investors from other kinds of investors is necessary. One possible solution is to evaluate the investor's expectation interest in the accuracy of the market price. This analysis may be appropriately undertaken in connection with an assessment of "loss causation."[88] As one court put it: "Causation requires one further step in the analysis: even if the investor would not otherwise have acted, was the misrepresented fact a *proximate* cause of the loss."[89] All investors acting through the market purchase or sell at the price set by the market. Investors who have misinterpreted the potential market

[85] Whether the plaintiff in *Panzirer* purchased an inaccurately priced security is not altogether clear. The stock price reacted only slightly in the period between issuance of the annual report and the announcement of the issuer's entry into the video cassette market. *Id.* at 367 n. 2.

[86] Shores v. Sklar, 647 F.2d 462 (5th Cir.) (*en banc*), *pet. for cert. filed*, 50 U.S.L.W. 3377 (U.S. Nov. 2, 1981), is not included in this analysis because it has no direct kinship with cases like *Blackie* or *Panzirer*. Although *Shores* uses "fraud-on-the-market" terminology, in substance, *Shores* substitutes an implied warranty of merchantability for the requirement of reliance when purchasers in a new offering do not read the prospectus. The *Shores* court stated that damages would be limited to instances in which the issuer could not bring a security into the market at all without committing fraud. *Id.* at 470.

[87] By reference to *Oklahoma Publishing Co.*, *supra* note 72, an investor seeking to acquire an issuer that tries to fend off the attempt by making material misrepresentations can be viewed as having provoked the misrepresentations or, at least, knowingly to have incurred the risk of purchasing mispriced securities as a result of misleading defensive tactics.

[88] Assessment of loss causation involves a showing "that the misrepresentations or omissions caused the economic harm. . . ." Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert denied*, 421 U.S. 976 (1975).

[89] Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981) (citation omitted, emphasis original), *modified*, 650 F.2d 534 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982).

impact of information will have traded at an erroneous price but may be seen as having accepted the risk that their interpretive skills are different from those of other market participants. An investor pursuing a takeover target, regardless of price, might be seen as suffering a loss based on his own failed acquisition attempt rather than the mispricing of the security caused by misrepresentations. If the aim is to compensate those who have paid, contrary to their expectation, an erroneous price for a security, the purchase of a security, for reasons other than the price, may require no compensation.

IV. A Suggested Reorientation for Securities Law Liabilities

Currently, investment bankers are contesting certain applications of the integrated disclosure system. Underwriters are urging the SEC to delay or deny the short-form registration process so that underwriters can conduct their due diligence investigations.[90] The underwriters are correct in pointing out that the SEC cannot practically maintain a system which allows prompt access to the capital markets, based on the observation that the securities markets reflect available data about the issuer, but insists nonetheless that underwriters conduct a due diligence investigation to validate information which has previously affected the market. The underwriters are willing to accept the latter duty in exchange for a delay in the registration process.[91] But it is not clear that this would be a fair tradeoff. As noted above, a due diligence investigation by underwriters does not significantly add to the goal of investor protection in view of the more extensive liabilities of issuers.[92] Moreover, to the extent such an investigation possesses value, it distinguishes purchasers of new offerings from traders in the aftermarket for no reason other than the separate development of the Securities Act and the Exchange Act. To further integrate the operations of the two Acts and to provide investors in new offerings and the aftermarket with roughly equivalent protections, the SEC should dispense with the due diligence investigation by underwriters in favor of the prompt access to the capital markets allowed by the short-form registration process for the issuers attracting a wide following in the market.

There is Commission precedent to sustain such a position. The SEC had, over the years, explored the possibility of allowing registrants to utilize the ratings assigned to debt issues by certain organizations in their registration statements.[93] A possible bar to the use of these ratings

---

[90] *See* Ehrbar, *Upheaval in Investment Banking*, FORTUNE, Aug. 23, 1982, at 90-92. Commissioner Thomas has suggested roll-back of the integrated disclosure to allow underwriters an opportunity to discharge their due diligence responsibilities. Securities Act Release No. 6423, [Current] FED. SEC. L. REP. (CCH) ¶ 83,250, at 85,279-90 (1982).

[91] *Id.* at 92.

[92] *See* pp. 951-56 *supra*.

[93] *See* Securities Act Release No. 6336, 46 Fed. Reg. 42,024 (1981).

would be the refusal by the debt rating organizations to consent to the use of their ratings in a registration statement because of the potential liability accruing thereby under the Securities Act.[94] To avoid this hurdle, the Commission eliminated potential Securities Act liabilities for these organizations.[95] In so doing, the Commission conceded that the ratings would be relied on by market participants regardless of the technical inclusion of the ratings in a registration statement and that existing liabilities under the Exchange Act protected investors for the fraudulent development of such ratings.[96]

A similar exemption has been granted accountants in connection with their limited review of interim, unaudited financial reports.[97] The Commission recognized that such information would be valuable to investors even though not produced pursuant to an audit, the customary indicator of professionally prescribed due diligence by accountants. The Commission, therefore, removed the potential liability of accountants for such statements under section 11 of the Securities Act on the grounds that the accountants' antifraud liabilities and the due diligence obligations of other persons were sufficient means to protect investors.[98]

Similarly, underwriters should be freed from their due diligence obligations with respect to short-form registration statements. The recognition that the developed market incorporates information available under the Exchange Act and thus eliminates the necessity for its repetition in a registration statement allows issuers prompt and relatively less expensive access to the markets. There is no sound reason to forego these benefits to enable underwriters to conduct due diligence investigations on information produced under the threat of Exchange Act liabilities and further backed by the issuer's guarantee of accuracy under the Securities Act.

The Commission's suggestion that underwriters can accelerate their due diligence investigation by becoming involved in issuers' Exchange Act reporting programs creates for underwriters the further risk of possible Exchange Act liabilities. Recently, the Circuit Court of Appeals for the District of Columbia suggested that securities professionals at some point owe a duty to the public to share their analyses.[99] The case arose from the activities of a market professional who uncovered the

---

[94] *Id.* at 42,027.

[95] *See* Rules 134(a)(14) and 436(g), 17 C.F.R. §§ 230.134(a)(14), 230.436(g) (1982). *See also* Regulation S-K, 17 C.F.R. § 229.10(d) (1982).

[96] 46 Fed. Reg. at 42,021-28. The Commission cited as examples of the potential antifraud liabilities the cases Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231 (S.D.N.Y. 1976) and University Hill Foundation v. Goldman, Sachs & Co., 422 F. Supp. 879 (S.D.N.Y. 1976). 46 Fed. Reg. at 42,028.

[97] *See* Securities Act Release No. 6173, 45 Fed. Reg. 1601 (1979) and Financial Reporting Release No. 1, Section 605, 5 FED. SEC. L. REP. (CCH) ¶ 73,306 (1982).

[98] 45 Fed. Reg. at 1603.

[99] Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982).

Equity Funding fraud and first shared that information with his clients. The court stated:

> There is no question that securities industry professionals may legitimately engage in securities analysis for the benefit of their clients, and they may accumulate and sell information in order to make a profit. In the common run of day-to-day business, professional securities analysis is perhaps the best way to aggregate and evaluate information in the securities markets; the analysts thus serve themselves, their clients, and the public interest in efficient capital markets all at the same time. But it is intrinsic in our notion of 'business ethics' that at some point we are not content to let securities analysts' quest for fees and commissions define their obligations to the public at large. In this case, the role of analysis-for-hire ceased when its unavoidable result was to foster the sale of 'unsound, fraudulent, and worthless securities' to the uninformed public. At the very least, Dirks owed a duty to report what he had learned to the SEC and not to foster such sales.[100]

By extrapolation from this authority, an investment banker may expose himself to antifraud liabilities by participating in the development of an Exchange Act filing.[101]

The question becomes more difficult for the research arms of these same investment bankers. By becoming involved in issuers' Exchange Act reporting programs, the research analysts may acquire material information that would expose them to antifraud liabilities. To avoid possible liability, the analysts might restrict their research activities so as to minimize their potential liabilities. But the Commission has recognized that a following among market professionals serves to assure the operation of the efficient market. Accordingly, it may be counter-productive to create a system which tends to dissuade analysts from performing their market functions by imposing on them potential Exchange Act liabilities for their participation in the issuer's periodic reporting system.

Additionally, the Commission's antimanipulation rule[102] may interfere with the operation of an efficient securities market. Among other things, the rule limits the capacity of a broker-dealer to make inducements to buy, such as the issuance of research recommendations, in the context of their participation in a new offering. In connection with its promulgation of the integrated disclosure system, the Commission announced an interim no-action position permitting the distribution of any research report up until three days before commencement of sales in a distribution of securities.[103] Commentators had noted that a cut-off date

[100] *Id.* at 841.

[101] *But cf.* Chiarella v. United States, 445 U.S. 222 (1980).

[102] Rule 10b-6, 17 C.F.R. § 240.10b-6 (1981).

[103] Securities Act Release No. 6383, 47 Fed. Reg. 11,380, 11,398 n. 94 (1982); Securities Act Release No. 6387, 47 Fed. Reg. 11,482 (1982).

for inducements to buy far in advance of the commencement of the offering could interfere with the accurate pricing of the offered securities.[104] The Commission should consider eliminating this limitation to assure optimal market input from all market professionals whether or not they are participating in the new offering.[105]

Finally, as suggested previously, the "fraud-on-the-market" theory of liability should be refined to restrict its operation to developed markets as identified by the SEC in its criteria for issuers eligible to use the abbreviated registration statement on Form S-3.[106] These issuers deal in securities most likely to behave in the manner consistent with the efficient market theory according to the SEC. Further, the courts should consider limiting the application of the "fraud-on-the-market" theory to situations where the misrepresentation necessarily affected the market price subsequent to affecting the decisions of market professionals to buy or sell the security. The "reasonable investor" standard, unlike the "professional investor" standard, does not sufficiently identify information with such a market impact.

V. CONCLUSION

The recognition of the efficient market theory has significantly altered the manner in which issuers register and bring securities to the market. But these alterations require a similar transformation of securities law liabilities. In the foregoing discussion, we have suggested only a few areas which require reassessment in view of the principles of the efficient market theory as adopted by the SEC. Numerous other areas require reexamination to assure that securities law liabilities are consistent with the practical mechanics of the securities markets.

---

[104] 47 Fed. Reg. at 11,483-84.

[105] To avoid a discrete instance of manipulative activity, instead of avoiding a situation that possibly permits a person to engage in a manipulative activity, the Commission could rely on the flexible liabilities sustainable in antifraud suits, rather than by general rule.

[106] Under such a standard it appears likely that neither *Panzirer* nor *Shores* would be eligible for consideration under a "fraud-on-the-market" theory because the issuer in *Panzirer* appeared to have no wide following in the market (E.F. Hutton did not follow the company), 663 F.2d at 366, and the *Shores* case involved an industrial revenue bond issue, 647 F.2d at 463.

WASHINGTON AND LEE LAW REVIEW

Volume 39 | Summer 1982 | Number 3

FACULTY—SCHOOL OF LAW

ROBERT E.R. HUNTLEY, A.B., LL.B., LL.M., *President of the University and Professor of Law*
ROY L. STEINHEIMER, JR., A.B., J.D., *Dean and Professor of Law*
CHARLES VAILL LAUGHLIN, A.B., LL.B., LL.M., S.J.D., *Professor Emeritus*
EDWARD O. HENNEMAN, B.A., J.D., *Assistant Dean and Assistant Professor of Law*
ROGER D. GROOT, B.A., J.D., *Professor of Law*
FREDERIC L. KIRGIS, JR., B.A., LL.B., *Professor of Law and Director of the Frances Lewis Law Center*
LEWIS H. LARUE, A.B., LL.B., *Professor of Law*
ANDREW W. MCTHENIA, JR., A.B., M.A., LL.B., *Professor of Law*
J. TIMOTHY PHILIPPS, B.S., J.D., LL.M., *Professor of Law*
WILFRED J. RITZ, A.B., LL.B., LL.M., S.J.D., *Professor of Law*
THOMAS L. SHAFFER, B.A., J.D., *Professor of Law*
JAMES W.H. STEWART, B.S., LL.B., LL.M., *Professor of Law*
JOSEPH E. ULRICH, A.B., LL.B., *Professor of Law*
DENIS J. BRION, B.S., J.D., *Associate Professor of Law*
SAMUEL W. CALHOUN, B.A., J.D., *Associate Professor of Law*
MARK H. GRUNEWALD, B.A., J.D., *Associate Professor of Law*
JOHN W. LARSON, A.B., J.D., *Visiting Associate Professor of Law*
JAMES M. PHEMISTER, B.S., J.D., *Associate Professor of Law*
WILLIAM S. GEIMER, B.S., J.D., *Assistant Professor of Law*
STEVEN H. HOBBS, B.A., J.D., *Assistant Professor of Law*
TONI MARIE MASSARO, B.S., J.D., *Assistant Professor of Law*
BRIAN CAMERON MURCHISON, B.A., J.D., *Assistant Professor of Law*
SAMUEL E. STUMPF, JR., B.A., J.D., *Assistant Professor of Law*
SARAH K. WIANT, B.A., M.L.S., J.D., *Law Librarian and Assistant Professor of Law*
WILLIAM H. AGNOR, Ph.B., J.D., S.J.D., *Adjunct Professor of Law*
RUDOLPH BUMGARDNER, III, A.B., LL.B, *Adjunct Professor of Law*
ROBERT M. CAMPBELL, A.B., LL.B., *Adjunct Professor of Law*
CLARK R. MOLLENHOFF, J.D., *Adjunct Professor of Law*
WILLIAM W. SWEENEY, A.B., LL.B., *Adjunct Professor of Law*
PAUL R. THOMSON, JR., B.A., J.D., *Adjunct Professor of Law*
ROBERT C. WOOD, III, B.A., LL.B., *Adjunct Professor of Law*
HENRY L. WOODWARD, A.B., LL.B., *Adjunct Professor of Law*
ROSS D. YOUNG, JR., LL.B., *Adjunct Professor of Law*
HAROLD J. BERMAN, B.A., M.A., LL.B., *Frances Lewis Scholar in Residence*