Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context

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"The relevant question to ask about the 'assumptions' of a theory is not whether they are descriptively 'realistic,' for they never are, but whether they are sufficiently good approximations for the purpose in hand."1

Milton Friedman

The typical modern investor often fails to read the detailed prospectus of an issuing company before purchasing its securities. It is therefore rare that all the plaintiffs in a class action suit can claim that they relied on the prospectus or other public information in deciding to buy these securities. Hence, the standard used by the court to establish collective investor reliance on such information under the Securities and Exchange Commission's Rule 10b-5² plays a critical and controversial role in class action suits.

The "fraud on the market" theory makes it easier for class action plaintiffs to show reliance. This theory posits that, under certain circumstances, plaintiffs may rely on the market process to incorporate information about the security into the price, and recover damages if the defendant has in some way "defrauded" the market. In Basic Inc. v Levinson, four of the six Supreme Court

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² The rule states in full:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a)To employ any device, scheme, or artifice to defraud,

(b)To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements make, in the light of the circumstances under which they were made, not misleading, or

(c)To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
in connection with the purchase or sale of any security.

Justices hearing the case suggested that investor reliance on the market price was appropriate in "open and developed" markets. The lower courts have been reluctant, however, to extend the fraud on the market theory to a market for initial public offerings (IPOs).

This Comment argues that these lower court decisions have distorted the Basic court's view of the fraud on the market theory. These courts have persistently failed to understand that Basic's rationale depended only on the existence of an "information efficient" market. As posited by the Efficient Capital Markets Hypothesis (ECMH), such a market is simply one which quickly incorporates new information into a security's price. The lower courts, however, have often misinterpreted the ECMH and based their decisions on a hypothetical "value efficient" market that sets the price for a security at its "true" worth. A requirement that the market be "value efficient" almost always will be more difficult to meet than a requirement that the market be "information efficient." This distinction is of particular importance in the context of IPOs, which do not manifest the characteristics of value efficient markets but which nonetheless may be sufficiently information efficient to warrant investors' reliance.

The courts' flawed analysis results from their failure to recognize plaintiffs' reasonable reliance on a sufficiently efficient market price. This Comment suggests that plaintiffs' reliance on the market price is indeed reasonable in many IPO situations, and that courts should consider the characteristics of the individual IPO market in applying the fraud on the market theory. Specifically, a market should be considered sufficiently efficient if there exists a class of independent professional investors whose activities will incorporate significant public information about a security into an unbiased market price. This "sufficient efficiency" approach to fraud on the market cases is consistent with finance theory and

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6 485 US 224, 244, 246 (1988).
4 See, for example, Freeman v Laventhal & Horwath, 915 F2d 193, 199 (6th Cir 1990); Lipton v Documation, Inc., 734 F2d 740, 746 (11th Cir 1984); Peil v Speiser, 806 F2d 1154, 1161 n 10 (3d Cir 1986); see also text at notes 55-74.
5 An IPO is the issuer's original sale of a security to the investing public. This initial offering occurs in what is known as the primary market. The secondary market, in contrast, is the market in which buyers and sellers trade the security after the initial sale. (The New York Stock Exchange and over-the-counter markets are examples of secondary markets.) IPO securities may be stocks, bonds, or other financial instruments.
6 This Comment will generally use the phrase "fraud on the market" to refer to "efficient market" versions of the theory, one of which the Basic Court used. Basic, 485 US at 246 n 24.
better serves the purposes of the securities laws than the approach currently used by most lower courts.

Section I of this Comment discusses the basic elements of a fraud on the market case and explores the financial and economic bases of the theory. Section II reviews the significant cases that have addressed the fraud on the market theory, and examines the judicial approaches taken in these cases in light of the financial theories outlined in Section I. Finally, Section III details a more appropriate understanding of reasonable investor behavior in the IPO context, suggesting the factors which, if present, would make a market sufficiently efficient such that investor reliance would be reasonable.

I. THE FRAUD ON THE MARKET THEORY: ELEMENTS AND THEORETICAL UNDERPINNINGS

A. The 10b-5 Action

Plaintiffs have had a private right of action under Rule 10b-5 since 1946. In order to recover under the Rule, the plaintiff must allege and prove as one of the elements of 10b-5 action that the defendant's misleading statement or omission made in connection with the purchase or sale of a security was, in fact, relied upon by the plaintiff in deciding whether to buy or sell the security. When each individual's monetary damages are small relative to the costs of a suit, 10b-5 actions may take the form of class action suits.

The reliance requirement often acts to thwart a class action suit because, frequently, individual plaintiffs were unaware of the defendant's fraudulent statement (and thus could not claim to have relied upon it). The fraud on the market theory, however, helps to establish the reliance element for the entire plaintiff class. The basic logic behind it is that the defendant's misstatements or omissions affected the price of the security, thereby undermining the entire market.

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8 See Basic, 485 US at 243, 249 (acknowledging the reliance element as part of the Rule 10b-5 cause of action); see also Daniel R. Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus Law 1, 5-8 (1982) (describing issues relating to this element of the Rule 10b-5 action). The plaintiff must also allege and prove the existence a misleading statement or omission, materiality of the misinformation, causation, and damages to recover under 10b-5.
B. Theoretical Underpinnings of the Fraud on the Market Theory

Courts find support for their acceptance of the fraud on the market argument in modern finance doctrine. The most useful current theory is the Efficient Capital Markets Hypothesis (ECMH). The ECMH asserts that an "information efficient" capital market will rapidly impound all available information into the price of any security. Accordingly, courts have used this hypothesis to justify the conclusion that the market price for a security in an information efficient market can be assumed to incorporate all relevant information about the security, including the defendant's misstatements or omissions.

Financial theorists have developed two explanations of the process by which a capital market is driven toward information efficiency. The first, the fundamental value theory, posits that current market prices are based on calculations of the economically "correct" values of securities. The second, the expected price theory, postulates that current prices are based on investors' expectations of future prices.

The following sections analyze these doctrines in order to provide a basis for understanding the strengths and weaknesses of the case law, and to provide the theoretical underpinnings for the approach to Rule 10b-5 IPO cases proposed in Section III.

1. The Efficient Capital Markets Hypothesis.

The ECMH asserts that certain markets are information efficient: they quickly process public information and, as a result, current market prices reflect all public knowledge about a security.
The assumptions under which such an information efficient, ECMH market will exist are that (1) transaction costs are zero; (2) information is free to all interested parties; (3) all participants have the same time horizon (the period over which they consider information relevant); and (4) all participants have the same expectations about how prices will react to information. Such conditions, however, exist only in theory, and are merely approximated in the real world. Consequently, no market will be perfectly information efficient, and the market price at any time will not reflect all available information. Still, courts and commentators have characterized those markets that most closely parallel the theoretical world. Such markets generally have (1) low transactions costs, (2) a number of skilled investors, (3) little evidence of superior performance by investment analysts, (4) high trading volume, (5) market makers and arbitragers, (6) required SEC registra-

in note 1). Contrast Macey, et al, 77 Va L Rev at 1022-24 (cited in note 10). This characterization of the ECMH reflects the “semi-strong” variant of the theory, the most widely accepted version of the ECMH and the one that appears to be the conceptual touchstone for courts adopting the fraud on the market theory. Daniel R. Fischel, Efficient Capital Markets, the Crash, and the Fraud on the Market Theory, 74 Cornell L Rev 907, 910-11 (1989). See also Lorie, Dodd, and Kimpton, The Stock Market at 65-73 (cited in note 1) (detailing empirical research). The “weak” form of the ECMH states that current prices reflect the historical patterns of a stock’s price. The weak form is also well accepted and counsels against using technical analysis of price patterns as a method of selecting winning stocks. Lastly, the “strong” form of the ECMH asserts that the prevailing market price reflects privileged or insider information. The strong form, however, is not well accepted. Id at 76-77.

15 Lorie, Dodd, and Kimpton, The Stock Market at 63 (cited in note 1).


17 This imperfection helps to explain a paradox that emerges if the ECMH is taken at its face value. It would appear that because no amount of research can produce returns superior to those based on a random selection of securities, the incentive to undertake research does not exist. On the other hand, if no research is done, the market will not remain information efficient. However, this paradox is no different from that in other competitive markets. See Lorie, Dodd, and Kimpton, The Stock Market at 80-81 (cited in note 1), and Robert L. Heilbroner, The Worldly Philosophers 293-94 (Simon & Schuster, 6th ed 1986). Though competition tends to keep returns to an average level, entrepreneurs will nevertheless seek to exploit the occasional opportunity for abnormally high profits resulting from mistakes by their competitors. Lorie, Dodd, and Kimpton, The Stock Market at 77, 80-81 (cited in note 1). While the ECMH would suggest that abnormal returns are rare, it is consistent with the empirical conclusion that some inefficiency exists. Wang, 19 UC Davis L Rev at 401-02 (cited in note 12); Macey, et al, 77 Va L Rev at 1029 (cited in note 10). In fact, Lorie and his coauthors state that the conclusions regarding the ECMH apply only “on average,” and that better analysts can still gain substantial economic rents (above-average profits). Lorie, Dodd, and Kimpton, The Stock Market at 77 (cited in note 1).
tion, and (7) a causal relation between new information and price movements.18

2. Two possible explanations of efficient capital markets.

The ECMH is a descriptive theory. The ECMH asserts only that a market price quickly incorporates all relevant information; it does not explain what information is relevant to this market price or why the price changes in response to the information. An ongoing debate exists as to the types of information that are important to a security’s price, and the way in which prices react to such information. As Section II will detail, many courts expect markets that approximate the ECMH model to generate prices that reflect the “true,” intrinsic value of a security.19 This thinking is based on the fundamental value model. However, ECMH information efficiency does not necessarily imply that prices are always accurate reflections of the intrinsic value of a security. For instance, information unrelated to the issuer’s future financial performance may also affect prices. The market could then be information efficient, though not value efficient. The Keynesian “beauty contest,” which suggests that stock prices reflect expectations about future prices in addition to the security’s intrinsic value, is consistent with this situation.

a) The fundamental value theory. The fundamental value theory states that, given enough information about a security, an analyst can calculate one “true” price for it. Prices are conceptualized as the discounted present value of the future earnings (dividends, interest or principal payments, liquidation values, etc.) of the security.20 An analyst develops certain expectations about these future cash flows upon which to base an estimate of the fundamental value of the stock. New information about the security will change the analyst’s estimate of this value, and hence the analyst’s estimate of the stock’s price.21 Under the fundamental value

18 Carney, 44 Bus Law at 1281-84 (cited in note 10) (identifying as factors transactions costs, numerous skilled analysts, and no superior analyst performance); Cammer v Bloom, 711 F Supp 1264, 1286-87 (D NJ 1989) (identifying as factors trading volume, numerous analysts, market makers and arbitragers, S-3 registration requirements, and price movement). The Sixth Circuit has cited the factors in Cammer in determining whether to apply the fraud on the market theory. Freeman, 915 F2d at 199.

19 See note 12 and accompanying text.


theory, analysts act as market arbitragers, buying or selling stock in response to new information. They act to take advantage of the perceived difference between the value of the security based on “old” information and the new expected value. The quicker an analyst moves, the greater the differential between the pre- and post-information prices, and the greater the profit. Thus, the analyst’s belief that securities have a discoverable fundamental value would create incentives that explain why the ECMH works.

A major drawback to the fundamental value theory is that it requires a great deal of specific, sometimes unobtainable, information. Determining future cash flows involves analysis of present operations, future growth rates, relative risk levels, and the future levels of interest rates. Analysts cannot precisely ascertain future events and consequently cannot calculate a security’s “exact” value. The price that results from the analysts’ efforts is thus not necessarily accurate, but is simply a collective estimate of the value of the stock based on individual analysts’ expectations. True value efficiency remains elusive.

b) The expected price theory and the “beauty contest.”

The expected price model, an alternative explanation of why the market price incorporates public information, illustrates more clearly why value efficiency is a questionable proposition. This model is derived from Keynes’s “beauty contest” analogy. The “beauty contest” looks to the psychology of the market, positing that prices are based not on fundamental value, but instead on what an investor believes she will receive for the security at a later time. Of course, the expected price model may incorporate aspects of the fundamental value model. For example, expected future prices may depend on estimates of future cash flows. The diff-

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1 Lorie, Dodd, and Kimpton, The Stock Market at 82 (cited in note 1). Any difference between the trading price and actual “value” of the security would create a “money machine” which investors in any well-functioning capital market would take advantage of and thereby eliminate. Brealey and Myers, Principles of Corporate Finance at 31 (cited in note 14).


4 Id at 94-98.

5 “One common error is to think [that the ECMH] implies perfect forecasting ability.” Brealey and Myers, Principles of Corporate Finance at 289 (cited in note 14).


ference is that the expected price model allows other, non-cash flow factors (including psychological tendencies of investors) to play a role.

Markets can be information efficient under the expected information approach. Analysts will simply consider public information in a different way, basing their evaluation on expected future prices, not solely on fundamental values. A market may thus behave in a manner consistent with the ECMH, even while its prices do not necessarily reflect securities’ fundamental values.

When a court requires value efficient pricing to establish a fraud on the market claim, it is not surprising that the court also requires the presence of a sophisticated market. Only under such circumstances would the marketplace approximate value efficiency. As we have seen, however, value efficiency is a dubious proposition and information efficiency is a much more defensible one.

Thus, an important distinction must be kept in mind when thinking about the prices of securities. The widely-accepted ECMH is concerned with “information efficiency”: whether all available information is incorporated into the price of the stock. The fundamental value model, a far more controversial proposition, concerns “value efficiency”: whether the price of the security accurately represents its “value” at any point in time.

II. THE FRAUD ON THE MARKET THEORY IN CASE LAW

Courts have gradually accepted the fraud on the market doctrine over the course of the last fifteen years. Although the original purpose of the doctrine was to further the disclosure goals of the securities laws, courts have since narrowed the application of the doctrine and have applied it only to markets that are highly

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29 Indeed, both theories may drive the efficiency of the market. See Brealey and Myers, Principles of Corporate Finance at 286-87 (cited in note 14); Wang, UC Davis L Rev at 345 (cited in note 12).

30 See notes 41-54 and accompanying text.


32 See Blackie, 524 F2d at 906-08; Panzirer, 663 F2d at 365-68; Lipton, 734 F2d at 743 n 5.

33 See Blackie, 524 F2d at 907-08.
information efficient.³⁴ This methodology has led the courts to reject most plaintiffs' claims involving IPOs,³⁵ even though the disclosure goals of securities regulation would be furthered by allowing such claims. Section II illustrates this misguided trend away from the original purposes of the doctrine and toward a more technical approach in the context in which the trend developed: 10b-5 cases involving securities traded on large national exchanges. This Section also shows that this trend has unfortunately carried over into the IPO context, in which the courts' preference for this flawed technical analysis makes a critical difference.

A. The Courts' Acceptance of the Fraud on the Market Theory

The Ninth Circuit was the first federal appellate court to adopt the fraud on the market theory. In Blackie v Barrack,³⁶ the court certified a 10b-5 class action suit, allowing the plaintiffs to satisfy the reliance element through use of the fraud on the market theory. The court stated that in the "impersonal stock exchange context" the causal connection between the defendants' wrongdoing and the plaintiffs' losses could be satisfied through reliance on market price.³⁷ In so holding, the court expressly focused on the purposes of the Securities Exchange Act of 1934. The Ninth Circuit stated that the 1934 Act and the SEC regulations promulgated thereunder, including Rule 10b-5, "are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely."³⁸ The Ninth Circuit reasoned that if a defendant has artificially altered the price of a security through "unsuspected manipulation," the defendant has affected the investor's decision of whether or not to purchase the security.³⁹ The investor may have been more or less willing to purchase the security had the price been different.

After Blackie, the Second Circuit was the next to accept the fraud on the market doctrine.⁴⁰ Beginning in 1984, however, courts

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³⁴ Freeman, 915 F2d at 197; Peil, 806 F2d at 1160-61.
³⁶ 524 F2d 891 (9th Cir 1975).
³⁷ Id at 906.
³⁸ Id at 907.
³⁹ Id.
⁴⁰ Panzirer v Wolf, 663 F2d 365 (2d Cir 1981), vacated as moot, Price Waterhouse v Panzirer, 459 US 1027 (1982). The court in Panzirer mirrored the Blackie court in presuming that material misrepresentations would affect the market price of the security. Like the
began to overlook the purposes of the securities laws, and instead to concentrate on a technical analysis of information efficiency. In *Lipton v Documation, Inc.*, the defendant corporation, whose stock was traded on an open market, disseminated false financial reports and its officers made statements claiming earnings while knowing that the company had actually suffered significant losses. The Eleventh Circuit acknowledged the need to advance the purposes of the securities laws, and properly took note of the importance of the fact that the security's price reflected available information. But in discussing the information efficiency of the market, the court also emphasized—improperly—the existence of a highly efficient secondary market in which the security was actively and openly traded. The court felt that in such a market it was plausible to assume that the misinformation directly affected the price and, as a result, the causal nexus between the misinformation and the decision to purchase was more direct. However, the court expressed doubt as to whether a plaintiff could reasonably rely on the market to process the information in the primary or new issues market, in which a rigorous form of information efficiency did not inhere.

In *Peil v Speiser*, the Third Circuit drifted even farther from Blackie's focus on the purposes of the securities laws. The class action plaintiffs, purchasers of stock trading on the American Stock Exchange, alleged that exaggerations of expected earnings artificially inflated the stock's market price, thus inducing them to make a losing investment. The court, however, did not focus directly upon the plaintiff's reliance on the defendants' fraudulent actions. Rather, it emphasized the plaintiff's reliance "on the marketplace's reflection of the value of the stock." The court noted that such reliance is appropriate in "open and developed" markets, such as the active secondary market in the case, precisely because the price of the stock in such situations "is determined by the

Ninth Circuit, the Second Circuit stated that in the context of the case, the plaintiffs could reasonably rely on the market to "validly set" a price for the security in an environment free from "unsuspected fraud." Id at 368.

41 734 F2d 740 (11th Cir 1984).
42 Id at 745.
43 Id at 746.
44 Id.
45 Id.
46 806 F2d 1154 (3d Cir 1986).
47 The corporate officers allegedly intentionally failed to reveal that one of the company's new products was likely to be ineffective. Id at 1158.
48 Id at 1161.
available material information regarding the company and its business." Apparently, the court in *Peil* incorrectly construed presumed reliance as requiring a value efficient market. The Fifth and Eleventh Circuits continued this trend.

These later decisions, which incorporated a restrictive and technically flawed interpretation of the ECMH, formed part of the basis of the Supreme Court's 1988 decision in *Basic*. In *Basic*, the Court was willing to uphold the lower court's certification of a class in a 10b-5 case, in part because the security was traded in an efficient market. The Court unfortunately quoted passages from the earlier decisions (discussed above) that had erroneously equated the instantaneous incorporation of information with security prices that reflect fundamental values. These references, then, reflect a distorted conception of the market as one in which price accurately reflects the fundamental value of a security. While *Basic*'s holding was sound on its facts and did not address IPOs, its reference to "value efficiency" has since led lower courts astray. These courts have read *Basic* as supporting their incorrect analyses of what constitutes a sufficiently efficient IPO market.

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49 Id at 1160, 1161 n 10.
50 See *Finkel v Docutel/Olivetti Corp.*, 817 F2d 356, 360 (5th Cir 1987) ("the market price of a security... accurately reflects the value of that security if all relevant information has been disclosed in the marketplace"); *Kirkpatrick v J.C. Bradford & Co.*, 827 F2d 718, 723 (11th Cir 1987) (the "market [will] set a price accurately reflecting the security's value").
51 *Basic*, 485 US at 248. The Court cited the analysis of the court of appeals which noted that the plaintiffs traded their stock on an "impersonal, efficient market." Id. The Court also noted with approval the lower court's requirement that "a plaintiff must allege and prove... that the shares were traded on an efficient market." Id at 248 n 27.
52 See id at 244 (citing *Peil*, 806 F2d at 1161), 246 (citing *Lipton*, 734 F2d at 748). See also id at 244 ("The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.") (quoting *In re LTV Securities Litigation*, 88 FRD 134, 143 (N D Tex 1980)), 246 ("The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings [sic] about a situation where the market price reflects as nearly as possible a just price.") (citing HR Rep No 1383, 73d Cong, 2d Sess 11 (1934)).
53 The Supreme Court's analysis of market efficiency is confusing. While the Court required an efficient market, the Court also explicitly refused to establish some standard by which to evaluate the timeliness of the market's adjustment to the information, which is one of the best indicators of the information efficiency of the market. See *Basic*, 485 US at 248 n 28.
54 See *Freeman*, 915 F2d at 197-98 (citing *Basic* to support its conclusion that efficiency requires the market price of a security to be "an accurate reflection of its worth"); *Eckstein v Balcor Film Investors*, 740 F Supp 572, 580 (E D Wis 1990)(reading *Basic* to permit use of the fraud on the market theory only if the price of a stock reflects its value). See also *In re Bexar County Health Facility Development Corp. Securities Litigation*, 130 FRD 602, 607 (E D Pa 1990) (listing five requirements that a market must meet for the fraud on the market theory to apply).
B. Fraud on the Market in Actions Involving Initial Public Offerings of Securities

Early IPO cases correctly looked to the purposes of the securities laws in fashioning broad remedies under Rule 10b-5. Later courts, perhaps confused by decisions involving securities heavily traded in secondary markets, have mimicked the trend in these secondary market cases away from furthering the purposes of the securities laws, toward focusing on a rigorous ECMH market and value efficiency. In the IPO context, market prices may respond sufficiently to information even though the market will never be perfectly information efficient. Consequently, a court's demand that an IPO market closely approximates the assumptions for information efficiency inherent in the ECMH will, as a practical matter, eliminate IPO class action claims based on the fraud on the market theory.

1. Non-efficiency approaches to 10b-5 cases involving IPOs.

Some circuits have allowed plaintiffs to use arguments not based on information efficiency to establish the reliance element in a 10b-5 action. These cases have usually involved palpable misconduct by the defendant. Regrettably, courts have construed this line of cases narrowly.

In *Shores v Sklar*, the Fifth Circuit first allowed the use of the fraud on the market theory to establish reliance for a Rule 10b-5 claim in the context of an IPO. The plaintiffs in *Shores* were purchasers of industrial park bonds who alleged that various misrepresentations had inflated the value of the bonds. The district court granted the defendant's motion for summary judgment, holding that the plaintiffs had been unaware of the misrepresentation at the time of the purchase. The Fifth Circuit vacated the decision and remanded the case. Specifically, the Fifth Circuit found that the securities laws were enacted not only to ensure full disclosure, but also to promote "free and honest markets," to protect investors, to promote ethical standards of honesty, and to instill confidence in securities markets. A narrow interpretation of the laws, the court concluded, would not achieve these broader

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55 647 F2d 462 (5th Cir 1981).
56 Id at 464 n 2, 470.
57 Id at 470.
58 Id.
purposes. To help establish the degree to which the misrepresen-
tations undermined the integrity of the market, the court further
stated that had fraud not been involved, the securities could not
have been offered on the market at any price.

Using a similar approach, the Tenth Circuit responded to the
IPO situation by allowing a cause of action if the securities were
issued unlawfully; that is, if they were not issued in strict compli-
ance with securities laws. The decision in T.J. Raney & Sons, Inc.
v Fort Cobb, Okla. Irrigation Fuel Authority founded its reasoning
on the plaintiffs’ right to rely on the integrity of the securities reg-
ulatory process.

The decisions in Shores and T.J. Raney were based upon the
broad, remedial purposes of securities laws. Ironically, subsequent
courts have relied on these cases to justify a highly restrictive ap-
proach to the fraud on the market theory in IPO cases. For in-
stance, when the Fifth Circuit revisited the issue in Abell v Poto-
mac Ins. Co., the court, ignoring its earlier discussion of the
purposes of the securities laws, relied on Shores in stating that if
the plaintiffs could not establish the efficiency of the market in
question, they had to show that the securities they purchased were
not marketable at all. The court first concluded that the market
for bonds issued to finance construction of a home for the mentally
retarded was not an active secondary market, and was thus not
information efficient. Therefore, reliance could only be estab-
lished under the Shores “totally unmarketable” rationale. The
court then decided that because the bonds always had some legiti-
mate value, they were entitled to be marketed. In short, the Fifth
Circuit effectively required that a security be entirely worthless
before the fraud on the market theory would apply in the IPO con-

** Id at 464 (asserting that the securities laws encompass all “deliberate, manipulative
schemes to defraud which can annul not only the purpose of disclosure but also the market’s
honest function”).

** Id at 464 n 2. The Shores court appears to have ignored the fact that any security, no
matter how risky, has some value on the market. See Fischel, 38 Bus Law at 12 (cited in
note 8); Brealey and Myers, Principles of Corporate Finance at 481 n 8 (cited in note 14).
As demonstrated by subsequent lower court decisions, the Shores “totally unmarketable”
standard may be impossible to meet. See Dalton v Alston & Bird, 741 F Supp 1322, 1329 (S
D Ill 1990) (citing Ross, 885 F2d at 736 (Tjoflat concurring)).

*717 F2d 1330, 1333 (10th Cir 1989).

** 858 F2d 1104, 1121 (6th Cir 1989), vacated on other grounds and remanded, Fryar v

** Id at 1121-22.

** Id.

** Id at 1122-23. See also Ross, 885 F2d at 731, for a similar determination with regard
to retirement home bonds.
text, a condition that very rarely holds true in real world situations.

The result in Abell is typical of those found in district court cases that consider non-market efficiency approaches. Once the analysis focuses on such approaches, very few plaintiffs can show that a security is totally worthless, or was issued in violation of securities regulations. This anti-investor result is contrary to the original broad and remedial purposes underlying the Rule 10b-5 action.

2. ECMH analysis of 10b-5 claims involving IPOs.

Plaintiffs in IPO cases have also met with little success in attempts to establish reliance using the ECMH. The Sixth Circuit recently expressed the general judicial attitude to fraud on the market claims involving IPOs. In Freeman v Laventhal & Horwath, the court refused to allow the plaintiffs, holders of over $18 million in tax exempt municipal bonds, to use the fraud on the market theory to establish reliance for the purposes of a Rule 10b-5 action. On its facts, however, Freeman appeared to be fairly well-suited to a fraud on the market claim: the active market for the securities included over one thousand investors and numerous underwriters and securities brokers. Yet the court held that the market did not satisfy its stringent requirements, and upheld summary judgment for the defendants. Although the court properly recognized that in an ECMH market the price of the security reflects all available information, the court confused this insight with value efficiency, stating that “[i]nvestors rely on the price of the security as an accurate reflection of its worth.”

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66 See, for example, Stinson v Van Valley Development Corp., 719 F Supp 362, 366-67, aff’d, 897 F2d 524 (3d Cir 1990). It is not surprising that most securities are found to have some value. Securities represent a claim to a future cash flow. As long as there is some probability, no matter how low, that some payment, no matter how small, will be made on the claim, the security has some value.

67 915 F2d 193, 199 (6th Cir 1990).

68 Id at 196.

69 Id at 198-200. The court referred to the factors listed in Cammer, 711 F Supp at 1276 n 17, in deciding that the market was insufficiently efficient. In Cammer, the court asserted that “a developed market will almost always be an open one. And an efficient market will almost invariably be a developed one.” According to the Cammer court, such a market exists when the conditions which characterize ECMH information efficiency prevail. See note 18 and accompanying text.

70 Id at 197 (emphasis added). A number of district courts have made similar erroneous statements in deciding IPO fraud on the market claims. See, for example, In re Fortune Systems Securities Litigation, 680 F Supp 1360, 1371-72 (N D Ca 1987) (plaintiffs relied on the market to set an “accurate” price); Steiner v Southmark Corp., 734 F Supp 269, 276 (N
Freeman's rationale reflects a poor understanding of the ECMH. It ignores the possibility of reasonable investor reliance on a sufficiently information efficient market, and thereby fails to effectuate the purposes of the securities regulations.

C. Criticisms of Lower Courts' Interpretation of the Fraud on the Market Theory

The current approach to fraud on the market cases is flawed in two related ways: the courts overrely on the fundamental value theory in characterizing the ECMH, and underrely on the information efficiency of markets for IPOs. The manner in which the courts apply the ECMH is problematic because courts often fail to distinguish between value efficiency and information efficiency. Once a court becomes concerned with value efficiency, plaintiffs are in a difficult position, because IPO markets rarely approximate value efficiency.

The second problem is the courts' underestimation of the vigor of IPO markets. In fact, shareholders of many large corporations may rely on underwriters and the IPO process to act as independent judges of the progress and performance of the corporations’ managers. Moreover, when a corporation’s securities are already traded in an active secondary market, the basic characteristics of information efficiency—low transaction costs and numerous similarly situated investors—may often also be met for the IPOs of similar securities of the same corporation. In the case of smaller IPOs, the elements of an active market remain: multiple parties, arm’s length bargaining, and a profit motive. Underwriters play a key role in creating this environment. Although the market for an IPO may be less efficient than a large secondary market in responding to new information, it will not price securities without regard to such information.

As a result of the courts' overly rigorous requirements for information efficiency in IPO fraud on the market cases, most courts do not recognize an ordinary investor’s reasonable reliance on an

D Tex 1990) (failure to distinguish between value and information efficiency); In re LTV Securities, 88 FRD at 143 (“the value of stock is its market price”); Frankel v Wyllie & Thornhill, Inc., 557 F Supp 730, 736 n 10 (W D Va 1982) (quoting In re LTV Securities).
72 See notes 14-18 and accompanying text regarding the factors indicating information efficiency.
73 See notes 89-102 and accompanying text.
74 See id.
IPO market price to reflect sufficiently material public information. As a result, IPO plaintiffs are forced to establish their fraud on the market claims under the arbitrary, conceptually unappealing, and severe standards of *Shores* and *T.J. Raney*, as the courts have interpreted these cases. The sufficient efficiency approach, discussed below in Section III, would alleviate many of these problems.

**III. A SUFFICIENT EFFICIENCY APPROACH TO FRAUD ON THE MARKET IN IPOs**

This Section outlines and defends an approach to the fraud on the market theory in the IPO context that reconciles the good intentions of the *Shores* and *T.J. Raney* courts with the realities of financial markets. First, the Section explains how most investors reasonably rely on professionals to process relevant information and generate unbiased market prices for securities. Second, the Section discusses why many IPO markets are sufficiently information efficient due to the activity of underwriters and other professionals. Third, the Section explains how the sufficient efficiency approach is consistent with the purposes of the securities laws. Finally, the Section applies the sufficient efficiency approach to a number of prior cases.

**A. A Conceptual Framework**

A critical inquiry in a Rule 10b-5 case is whether the plaintiff-investor reasonably relied on the market to incorporate all significant public information into the price of a security. An approach to this question that is based on sufficient information efficiency, rather than on value efficiency, would eliminate much of the judicial confusion and inconsistency surrounding the issue, and would further the policies and purposes of securities regulation. Two basic financial concepts which underlie the sufficient efficiency approach are the market model of investment behavior and unbiased price estimation.

The market model of investor behavior shows that an ordinary investor may reasonably rely on a class of professional investors to analyze new information and to seek arbitrage profits by trading securities. These professional investors force the market price to reflect the latest public information concerning the security. The unbiased estimate model asserts that while the price produced by

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75 MacKerron, 69 Or L Rev at 194-95 (cited in note 31).
the activities of the professional investors may not be value efficient, it will not systematically err in one direction. This Comment argues that the interplay of these two models suggests that an ordinary investor's reliance on the market price is reasonable if the market is sufficiently information efficient. It further argues that the market will possess "sufficient efficiency" when there exists a class of professional investors whose activities result in the incorporation of all material public information about a security into a competitive market price.

1. Investor reliance on a sufficiently efficient market: the market model of investor behavior.

The market model of investor behavior posits two classes of investors. The first is a group of market professionals whose job it is to seek out new information and evaluate its effects on the price of securities. The incentive for these analysts is the arbitrage profit they may claim before the security's price adjusts to the new information. The second group is made up of ordinary investors, individuals who lack the time, resources, or expertise to evaluate all the information concerning a security. Without becoming professionals themselves, ordinary investors will be unable to act in time to take advantage of opportunities for arbitrage profits.

This division of labor is perfectly sensible. Those with the desires and abilities to participate in the fast-paced, technical and financially-oriented world of the market analyst will play this role and receive commensurate rewards, while those with skills and desires in other areas will rely on the analysts to do market research for them. Thus, the ordinary investor acts reasonably

76 Although a number of studies have concluded that securities may be systematically underpriced relative to the secondary market, this phenomenon, if true, does not disturb the relevance of the unbiased estimate analysis to conclusions of this Comment. See notes 98-102 and accompanying text.

77 See notes 21-23 and accompanying text. This motivation helps to foster information efficiency. The difference between the courts' restrictive and narrow approach and this Comment's sufficiency approach to information efficiency is one of degree. The issue is how much faith one puts in the market process. The courts' rigorous technical analysis posits a relatively broad range of outcomes, in which near-perfect value and information efficiency exist in large markets and insufficient pricing rationality pervades small markets. In contrast, the sufficient efficiency approach is founded on the belief that large markets are not as efficient, and smaller markets are not as irrational, as courts seem to think.

78 MacKerron, 69 Or L Rev at 195 (cited in note 31).

when she relies on the market price because it is more efficient for her to accept this price than to dedicate considerable personal resources to determining whether the price is fair. The market professionals have already made this evaluation and pushed the price to a level they believe is appropriate. As such, the market price does not necessarily reflect only the fundamental value of the security or only its expected future selling price; the price may reflect both these perceived values. Nonetheless, the ordinary investor’s reliance is still reasonable, since the market professionals’ estimate will, on average, be unbiased.

2. Security prices as an unbiased estimate of value.

Because securities prices may not accurately reflect either the underlying fundamental value or the future selling price of the security, changes in market prices will be imprecise even if the market is information efficient. The exact amount of the change is influenced by a number of factors. At best, it can only be said that the market price is “unbiased.”

An unbiased estimate means that, while the market price of the security may not accurately reflect some appropriate price of the security, the amount and direction of any error in the price will be random. As an example, assuming the price which would generate a return commensurate with the riskiness of the security is $100, the market price may be $120, or $80, or even $200, due to

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80 See notes 19-31 and accompanying text.
81 As the riskiness of an investment increases, its expected return must necessarily increase due to the risk averse nature of investors. See Brealey and Myers, *Principles of Corporate Finance* at 136-39 (cited in note 14). The price of a security, if theoretically perfect, will be such that the cash flows generated by the security, including any expected gain from its future sale, yield the appropriate return. As long as the price of the security reflects this unbiased estimate of its appropriate price, the return will be consistent, on average, with the riskiness of the security.
82 Three factors are: (1) the number of analysts involved in the market, (2) psychological factors unrelated to the cash flows, and (3) error in prior estimates as to the value of the stock. See notes 19-31 and accompanying text.
83 See, for example, Carney, 44 Bus Law at 1283 (cited in note 10) (claiming that the best one can say is that prices reflect an “unbiased consensus about future events”). Macey and his coauthors believe that the fundamental value is the value around which the market price will vary, see Macey, et al, 77 Va L Rev at 1023 (cited in note 10), while this Comment argues that expected future prices may also have an impact on market price. The ultimate argument that markets are not systematically biased, however, is unaffected by this difference.
84 Carney, 44 Bus Law at 1283-84 (cited in note 10) (prices will be “unbiased,” but only in those markets where market forces act with “relative speed on new information”). See notes 110-11 and accompanying text for discussion of why “relative speed” is relatively unimportant in the context of an IPO.
differences in analysts' methodologies and to human inability to forecast the future. Nonetheless, over time (and over a large group of analysts), the average differences between the security's trading price and its appropriate price would be zero.

Unlike the rigorous ECMH-based approach to information efficiency used by most courts, the unbiased estimate theory simply posits that market prices react to new information. The reaction may be neither value efficient nor highly information efficient. Nevertheless, the unbiased estimate theory says with a high degree of confidence that, first, the market price will be affected by the new information, and second, the resulting price will not be systematically biased in either direction. The remainder of this Comment is based on the argument that it is reasonable for the average investor to rely on markets that are sufficiently information efficient and unbiased, regardless of whether they are value efficient or highly information efficient in a strict ECMH sense.

B. Sufficient Efficiency and Unbiased Estimates in the IPO Context

An IPO market will often be sufficiently information efficient so that investors may reasonably rely on the market price. A lack of rigorous information efficiency in IPO markets would only result in greater price volatility, and as noted earlier this variability will not be systematically biased. A sufficient efficiency approach also helps advance one of the purposes of the securities laws: to create an informationally efficient market for securities.

1. Professionals in IPO markets.

a) The role of professionals in IPO markets. The presence of a group of independent market professionals is strong evidence that the market price is sufficiently information efficient. Thus, to determine whether an IPO market is sufficiently information efficient to warrant a Rule 10b-5 class action plaintiffs' reli-

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While the reaction will not necessarily be value efficient, one would expect the reaction often to be based on notions of fundamental value, such that the direction and amount of the reaction would at least reflect (albeit not fully) these notions. But see discussion of other possible factors at notes 27-31 and accompanying text.

That is, the reaction will not be instantaneous. Even in those markets that best mimic the theoretical ECMH market, the price adjustment will take at least five to ten minutes. Brealey and Myers, Principles of Corporate Finance at 287 n 10 (cited in note 14).

ance thereon, a court should begin by asking for evidence of such market makers. This Section argues that such market professionals do exist in the IPO context and that investors are reasonable in relying upon the resulting market price.

In a routine IPO, particularly those of smaller companies, the volume of transactions, and the number of analysts, market makers, and arbitragers involved in the offering, will not create an extremely close approximation of an ECMH market. Nonetheless, when an adequate number of interested market professionals become involved, the IPO market satisfactorily approximates the assumptions of the ECMH, ensuring that the market is sufficiently information efficient to generate reliable prices.

It is rare for a corporation to issue its securities directly to the public. Rather, underwriters are usually employed to handle the offering. The underwriter typically purchases the securities outright from the corporation and resells them to the public. The issuer generally sells the security to the underwriters at a percentage discount from the expected price which the public will purchase the security, known as the “spread.” This discount represents the underwriters’ compensation. Naturally then, underwriters will bargain with the issuer over the security’s offering price: the underwriter will not want a price that is too high (making sales more difficult), and issuers will not want a price that is too low (reducing the capital influx). The underwriter has a powerful incentive to price the issue so as to yield a fair return to the investor, for only in so doing will it be able to sell the offering completely. Notably, the final price for an IPO is almost always not set until the day before, or even the morning of, the offering. In this way, the underwriter will have access to information almost up until the

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88 See notes 71-74 and accompanying text.
89 This is called an “indirect offering.” See Richard W. Jennings and Harold Marsh, Jr., Securities Regulation 29, 31 (Foundation, 6th ed 1987).
90 This is known as the “firm commitment” structure. Another significant form of underwriting contract is the “best efforts” arrangement, in which the issuer bears the risk of loss arising from shares which do not sell. Id at 32. See also Brealey and Myers, Principles of Corporate Finance at 336-37 (cited in note 14). The practical difference between these two methods may not be significant. Harold S. Bloomenthal, 1A Going Public and the Public Corporation § 8.03(4) at 8-60, 8-60.1 (Clark Boardman, 1991 rev).
91 Jennings and Marsh, Securities Regulation at 36 (cited in note 89).
92 Brealey and Myers, Principles of Corporate Finance at 330-31 (cited in note 14); Bloomenthal, 1 Going Public § 1.02 at 1-4, 1-5, § 2.01 at 2-18 (cited in note 90).
point when actual sales begin, and can use this information to set a market clearing price.

The underwriter’s perception of the proper offering price will generally be driven by the expected price of an issue in the secondary market. Indeed, underwriters perform many of the same tasks in setting an offering price as do analysts in evaluating the secondary market. The underwriter will typically analyze the price to earning ratios of similar companies, the issuer’s expected growth, the risks of the business, managerial strength, and existing market conditions. A final motivating factor for selling securities at responsible prices is the underwriter’s strong incentive to preserve its reputational capital by dealing only with legitimate issuers.

Some commentators have noted that underwriters may have an incentive to underprice slightly the security relative to its ex-

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84 A number of commentators have asserted that the involvement of underwriters does not create a “market” for IPOs. See MacKerron, 69 Or L Rev at 206 (cited in note 31); Carney, 44 Bus Law at 1291 (cited in note 10); Comment, The Fraud-on-the-Market Theory, A Contrarian View, 38 Emory L J 1269 (1989). However, this line of analysis is flawed in that it misconstrues the nature of the securities “market.” The market is not some impersonal, undefined force but rather the result of the work of market professionals in evaluating information and adjusting the market price correspondingly. This type of evaluation and adjustment is precisely what underwriters do. Moreover, the underwriters have strong incentives to act rationally, since their reputations and funds are often ultimately at risk. See Easterbrook, 74 Am Econ Rev at 654 (cited in note 71) (arguing that the involvement of underwriters sends a valuable signal to investors).

85 Bloomenthal, 1 Going Public § 1.02 at 1-5 (cited in note 90). Importantly, most underwriters do not want to play the role of the long-term investor. Rather, their main concern is with selling out the issue; their goal is to set the price which will generate this level of sales. Note that if the market makers are privy to the truth regarding a misrepresentation, the issuer may assert a defense in a Rule 10b-5 suit. Basic, 485 US at 248-49. This conclusion makes perfect sense. If the market makers know the truth, the prices will reflect the truth and plaintiffs will have no basis to recover.

86 Joseph S. O’Flaherty, Going Public: The Entrepreneur’s Guide 87-88 (John Wiley & Sons, 1984); Brealey & Myers, Principles of Corporate Finance at 330 (cited in note 14); Taking Your Company Public 27 (Price Waterhouse, 1987); Deciding To Go Public: Understanding the Process and the Alternatives 46-49 (Ernst & Whinney, 1984) (“Underwriters examine a company and its prospects in much the same way that an investor would, but much more intensively.”). See also Bloomenthal, 1 Going Public § 2.02 at 2-15 (cited in note 90) (underwriters conduct an extensive investigation as part of their evaluation of a new issue).

87 Easterbrook and Fischel, 70 Va L Rev at 688-89 (cited in note 79); Brealey and Myers, Principles of Corporate Finance at 337 (cited in note 14); Carney, 44 Bus Law at 1288 (cited in note 10). The extent to which unsavory characters still operate in the underwriting market may be the result of underenforcement of the antifraud provisions of securities regulation. This only strengthens this Comment’s general call for a return to the purposes of the securities laws. See notes 106-07 and the accompanying text for discussion of the impact of unscrupulous underwriters on the presumption of reliance.
pected price in the secondary market. Underwriters may do this for a variety of reasons: to minimize their own risks, because requested to do so by the issuer, or to help stimulate secondary market interest in the issue. This may also be necessary to ensure an adequate return to the "ordinary" investor. Accepting arguendo that underpricing occurs, plaintiffs can hardly be said to be acting unreasonably in relying on the price due to a possible underpricing. Buying underpriced securities is eminently reasonable.

b) Factors indicating a sufficiently efficient market. In the IPO context, a number of factors will indicate whether a group of market professionals exists whose activities will create a sufficiently information efficient market. The factors include: (1) the issuance of a significant volume of securities; (2) a large number of potential investors; (3) participation by professional investors outside of the IPO (such as pension fund managers or brokerage firms); and most critically, (4) the direct involvement of an impartial, reputable underwriter in the offering. For example, the involvement of a moderately sized brokerage house would indicate that at least one set of professionals is monitoring the security. Similarly, it is likely that a number of other professional investors

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98 See table summarizing studies showing abnormal returns in Jay T. Brandi, Merit Securities Regulation, Market Efficiency, and New Issue Stock Performance, 12 J Corp L 699, 699-700 (1987). One commentator uses these and other studies to conclude that the IPO market is inefficient. See Lynn A. Stout, The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation, 87 Mich L Rev 613, 656-60 (1988). However, Stout is primarily concerned with the efficient allocation of capital in the markets; underpricing would tend to distort this allocation and is consequently of considerable importance to her thesis. This Comment does not address allocative efficiency.

100 See id at 661-63. This phenomenon would represent only a minor qualification to the general issuer impulse to sell at the highest price possible.

101 Taking Your Company Public at 27 (cited in note 96); Deciding To Go Public at 52 (cited in note 96).

102 The actual or perceived favored status of some investors with underwriters may necessitate lower prices to ensure an adequate average return to non-favored investors. See Kevin Rock, Why New Issues Are Underpriced, 15 J Fin Econ 187, 188 (1986).

103 These factors are similar in some respects to the ones courts have identified as characteristic of highly information efficient ECMH markets. See notes 14-18 and accompanying text. However, this Comment proposes using these factors liberally in determining the existence of a class of professional investors. Courts have used analogous factors stringently in deciding whether a market closely approximates a highly efficient ECMH market. The courts attempt to define the perfectly information efficient market, whereas this Comment attempts to define the sufficiently information efficient market in which it is reasonable to presume reliance.
Sufficient Efficiency

will be interested in the issue if it is of any substantial size. Evidence of such factors would support a presumption that the plaintiff class reasonably relied on an IPO market as being sufficiently information efficient to produce an unbiased market price for the security. Such reasonable reliance, in turn, should satisfy Basic's fraud on the market requirements for class certification.

c) When market professionals participate in or are aware of the misrepresentation. "Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff or his decision to trade at a fair market price should be sufficient to rebut the presumption of reliance." Specifically, defendants can rebut the presumption if they can demonstrate that underwriters were entangled in the web of fraud, or otherwise aware of material misrepresentations. Such an entanglement (or mere awareness) would effectively create a market unable to generate unbiased prices and unwilling to react to unfavorable information, and undercut the validity of presuming reliance on the resulting market price. As the Supreme Court noted, if "the 'market makers' were privy to the truth about the [fraud], and thus [] the market price would not have been affected by [the] misrepresentations, the causal connection could be broken." The presumption of reliance is just that—a presumption based on the reasonable expectations of investors that a market will be sufficiently information efficient to produce unbiased prices. If the actual market fails to meet these expectations, then the defendants may rebut the presumption.

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104 A substantial offering would be in excess of say, ten million dollars. In addition, the close involvement of a regional underwriter should lend sufficient expertise. Underwriters often specialize in particular types of issues, so that a regional firm may have as much or more expertise in evaluating a relatively small municipal bond issue as would a large, national firm which deals nearly exclusively in the IPOs of Fortune 500 companies. See Bloomenthal, 1A Going Public § 8.02[1] at 8-9 (cited in note 90) (describing three tiers of underwriters, each with its respective specialties).


106 Id at 248. At least one observer has argued for eliminating the reliance requirement, advocating instead a pure causation approach. See Barbara Black, The Strange Case of Fraud on the Market: A Label in Search of a Theory, 52 Albany L Rev 923, 954-55 (1988). This Comment, though it asserts that presumptive reliance should be easier to establish, does not advocate eliminating the reliance element altogether, and continues to afford defendants an opportunity to rebut the presumption on the facts of each case.

107 Basic, 485 US at 248.
2. The variability of market price in an initial public offering.

Unbiased estimate analysis supports the assertion that prices in smaller markets like the one for IPOs, that are not information efficient in a strict ECMH sense, may still reflect all material public information about a security.\textsuperscript{108} The major difference between markets for IPOs and larger, more developed markets is that the trading price of an IPO will vary more from its appropriate level. In general, fewer analysts act to incorporate relevant information into the price of an IPO than into the price of a security trading in an extremely active secondary market. The resulting additional price volatility is analogous to a firm-specific risk that investors can eliminate through diversification.\textsuperscript{109} Notably, this type of risk exists in all capital markets. Its more evident presence in IPO markets is not in of itself a proper basis for denying to IPO plaintiffs the protection from fraud the courts have granted to holders of Fortune 500 securities. Moreover, the reaction of a price to new information does not have to be instantaneous for a market to be sufficiently information efficient, such that reasonable investor reliance is warranted.\textsuperscript{110} A time lag merely represents an additional risk. A plaintiff may be acting quite reasonably in deciding to accept that risk, particularly since the final price for an issue is typically set within a day of the actual offering,\textsuperscript{111} when the underwriter is watching the issue most carefully.

The greater price variability associated with IPO markets will affect the court's analysis of materiality\textsuperscript{112} and damages, alleviating concerns that a sufficient efficiency approach will allow too many Rule 10b-5 class actions to succeed. Judicial analysis must take into account the increased volatility inherent in a relatively small issue of securities in considering the materiality issue.\textsuperscript{113} The wider

\textsuperscript{108} See notes 71-74 and accompanying text.
\textsuperscript{109} The diversification concept is basic to modern financial investment theory. The example here is in its simplest form, that of eliminating variance in individual security price estimates. Brealey and Myers, \textit{Principles of Corporate Finance} at 131-33 (cited in note 14).
\textsuperscript{110} The time that it takes the market to respond to the new information will not only have an effect on the plaintiff's chances of winning a Rule 10b-5 claim, but it will also influence the amount recoverable in damages. See notes 114-19 and accompanying text.
\textsuperscript{111} See note 93 and accompanying text.
\textsuperscript{112} Materiality is another element of a Rule 10b-5 cause of action. \textit{Basic}, 485 US at 231-32.
\textsuperscript{113} Macey, et al, 77 Va L Rev at 1045 (cited in note 10). If a security is traded in a secondary market, courts may use the evidence generated by an event study to estimate both materiality and damages. Event studies statistically isolate and measure a security price's reaction to a single event, taking into account the volatility of the applicable market. Id at 1028-30. In this way, these studies assess simultaneously both the materiality and
the range over which prices may vary (that is, the less efficient the market), the greater the relative impact that a fraudulent statement must have in order to be considered material. This reasoning helps to ensure that defendants will not be liable for mere volatility in the price of risky IPO securities, which would exist independent of any misrepresentation.

The greater volatility in most IPO markets also makes the measurement of damages in Rule 10b-5 cases more difficult. The correct way of measuring damages in such cases is an unsettled issue.\textsuperscript{114} Courts usually adopt one of two approaches. The controversial “rescission” approach allows the plaintiff to recover her entire purchase price.\textsuperscript{115} Under this approach, the measurement of damages is simple.\textsuperscript{116} However, if the court uses the more conventional “out of pocket” method, damages are equal to “the difference between the fair value of all the [plaintiffs] received and the fair value of what [they] would have received had there been no fraudulent conduct.”\textsuperscript{117} Obviously, this approach is the more difficult to employ in that the price a plaintiff would have received is hypothetical. To calculate this hypothetical amount, some courts look at how market price reacted when the fraud was revealed, and measure damages based on the difference between the pre- and post-information trading prices.\textsuperscript{118} Of course, difficulty remains in using the effect of information at one time to predict the effect if the information had been revealed earlier. Alternatively, the court may require evidence of the pricing of similar securities. Although either of these two approaches could easily turn into a battle of the experts, the hardly unique need for expert testimony should not preclude adoption of the sufficient efficiency approach. Importantly, in those cases where the defendants’ behavior is egregious,
plaintiffs will often easily be able to show materiality and damages.\footnote{See examples of factual patterns at notes 55-68 and accompanying text. In dramatic instances of fraud, plaintiffs should have no difficulty establishing the impact of the misrepresentations since the value of the security if the fraud had been disclosed would presumably have been close to zero.}

3. The sufficient efficiency approach and the purposes of securities regulation.

The sufficient efficiency approach serves the purposes and policies of securities regulation that the Supreme Court has identified. Securities legislation and regulations are, in large part, intended to prevent fraud as well as to ensure “fair and orderly” markets for securities.\footnote{See Jennings and Marsh, \textit{Securities Regulation} at 38, 41 (cited in note 89).} Courts should construe actions under the Securities Act of 1934 “flexibly to effectuate its remedial purposes.”\footnote{\textit{Affiliated Ute}, 406 US at 151 (citations omitted).} Moreover, the Supreme Court has concluded that “[d]efrauded investors are among the very individuals Congress sought to protect by the securities laws.”\footnote{\textit{Herman & MacLean v Huddleston}, 459 US 375, 390 (1983). The Court’s expansive view of remedies for securities violations is reflected in the very act of permitting a private cause of action under Rule 10b-5 for purchasers of initial offerings, despite the fact that plaintiffs could already recover under Rule 11 of the 1933 Act. Rule 10b-5, which originally regulated secondary markets, was promulgated under the 1934 Securities Act. See id at 382-83. By allowing an action under Rule 10b-5, the Court sought to preserve “the basic purpose of the 1933 Act: to provide greater protection to purchasers of registered securities.” Id at 383.}\footnote{\textit{SEC v Capital Gains Research Bureau, Inc.}, 375 US 180, 186-87 (1963)(citations omitted)(emphasis added).}\footnote{\textit{Herman}, 459 US at 389. See also \textit{Affiliated Ute}, 406 US at 151.} Defrauded, rational investors are those to whom the sufficient efficiency approach would extend additional protection.

Congress also hoped to encourage “the highest ethical standards . . . in every facet of the securities industry.”\footnote{\textit{Herman}, 459 US at 389. See also \textit{Affiliated Ute}, 406 US at 151.} Congress thought this necessary to ensure public confidence in markets.\footnote{See \textit{Basic}, 485 US at 246 (“Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor’s reliance on the integrity of those markets.”); \textit{Blue Chip Stamps}, 421 US at 728 (noting that one purpose of full disclosure is to prevent fraud). See also \textit{Capital Gains}, 375 US at 185 (arguing that Congress intended to substitute a philosophy of full disclosure for one of caveat emptor).} The sufficient efficiency approach will also help to advance these goals.

Congress established corporate financial disclosure requirements as important mechanisms for meeting the antifraud and ethical goals of the securities laws, and for ensuring that the markets were more information efficient.\footnote{See Basic, 485 US at 246 (“Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor’s reliance on the integrity of those markets.”); Blue Chip Stamps, 421 US at 728 (noting that one purpose of full disclosure is to prevent fraud). See also Capital Gains, 375 US at 185 (arguing that Congress intended to substitute a philosophy of full disclosure for one of caveat emptor).} The issuer of an IPO has a
duty to disclose important information to potential investors. Disclosure essentially lowers the analyst’s cost of obtaining the information, and thus helps to ensure that the issuing price better reflects the true financial condition of the issuer.

Mandatory disclosure, however, has little bite if the only time its violation is readily sanctionable is in those large markets where prices instantly and precisely reflect public information. In fact, such a philosophy is somewhat perverse. In well developed markets, analysts have a greater incentive to ferret out the truth when corporations violate the full disclosure standards than they do in less developed markets. This is because major issues are traded on well developed markets in high volume, and analysts can reap larger arbitrage profits from major issues as compared to the relatively minor issues traded in less developed markets. This is because major issues are traded on well developed markets in high volume, and analysts can reap larger arbitrage profits from major issues as compared to the relatively minor issues traded in less developed markets. Since the potential benefits are greater, an analyst will be more willing to incur higher costs in determining whether a public statement (or lack thereof) concerning a large issue is misleading. In smaller issues handled in less developed markets, regulations must be enforced more rigidly in order to compensate for the lower level of analyst investigation. SEC disclosure requirements further this objective by placing the burden of disclosure on the party for whom the costs of acquiring information are lowest, the issuer itself. Effective enforcement of this policy is all the more critical in less developed markets.

emtior). The wisdom of mandatory disclosure is subject to a continuing debate in academia. See, for example, the exchange between the authors in Easterbrook and Fischel, 70 Va L Rev 689 (cited in note 79), and John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va L Rev 717 (1984).


129 The cost of acquiring financial information without the aid of securities laws is high. Outsiders will only pursue such information if the potential rewards are greater than these costs. The greater variance present in less developed markets would tend to create larger spreads between actual prices and calculated values (that is, greater potential rewards). However, these greater rewards might be diminished by a corresponding increase in the difficulty of moving large numbers of shares in the less developed market.

130 See Easterbrook and Fischel, 70 Va L Rev at 674-75 (cited in note 79). See also Stout, 87 Mich L Rev at 707 (cited in note 98) (asserting that additional information is most valuable in the IPO context).
C. The Sufficient Efficiency Approach Applied

The discussion thus far has demonstrated that by focusing on the relative information efficiency of the market, and the reasonableness of the plaintiffs' decision to rely thereon, rather than on the existence of a market which closely approximates that described by the ECMH, courts would better serve the purposes of the securities laws and act in a manner more consistent with current finance theory. In this Section, the Comment will show the impact of the sufficient efficiency approach by applying it to some of the cases previously discussed.

As a preliminary matter, the awkward and arbitrary standards for recovery established in Shores\textsuperscript{131} and T.J. Raney\textsuperscript{132} should be eliminated. The Shores "totally unmarketable" standard has been roundly criticized,\textsuperscript{133} because, among other reasons, securities are rarely worthless.\textsuperscript{134} The T.J. Raney regulatory compliance standard, while endorsed by at least one commentator,\textsuperscript{135} is extremely arbitrary and of little practical consequence. Moreover, the T.J. Raney standard is dramatically both over- and underinclusive, and is consequently unappealing.\textsuperscript{136}

Nevertheless, both the Shores and T.J. Raney courts cite an important policy concern—consistency with the purposes of the securities laws—as a rationale for their decisions.\textsuperscript{137} The error in these courts' decisions is in their means, not their end. The sufficient efficiency approach is simply a better means to the same end.

For example, Freeman\textsuperscript{138} involved the issuance of $18,230,000 in tax-exempt municipal bonds to more than 1500 investors. The

\textsuperscript{131} 647 F2d 462 (5th Cir 1981); see also notes 55-60 and accompanying text.
\textsuperscript{132} 717 F2d 1330 (10th Cir 1983); see also note 61 and accompanying text.
\textsuperscript{134} Even if the issuers absconded with the investors' money, the potential for future recovery of those funds, attachment of the absconders' personal assets, or garnishment of their wages would give the securities some potential value.
\textsuperscript{135} Note, 23 Ga L Rev at 761-62 (cited in note 133).
\textsuperscript{136} See notes 61, 74.
\textsuperscript{137} Shores, 647 F2d at 472 ("[Rule 10b-5] is recognized [] to provide the basis for a federal cause of action for more elaborate, intentional schemes which deceive or defraud purchasers of securities. ... This cause of action has its roots in congressional enactment, federal regulation and federal precedent."); T.J. Raney, 717 F2d at 1333 ("Federal and state regulation of new securities at a minimum should permit a purchaser to assume that the securities were lawfully issued.").
\textsuperscript{138} 915 F2d 193 (6th Cir 1990).
bond issue involved "various underwriters [and] broker-dealers."\footnote{Id at 196.} The Sixth Circuit, insisting that reliance is only reasonable in the context of an ECMH market, dismissed the case for failing the fraud on the market test.\footnote{Id at 198-99, discussed in notes 67-70 and accompanying text.} However, in Freeman, a professional group of investors was involved in adjusting the market price to reflect important information. Had the concealed information been revealed, the underwriter almost certainly would have lowered the issuance price, and the ordinary investor would not have suffered the alleged losses. The market was sufficiently efficient to warrant investor reliance. Thus, as a result of the Freeman court's analysis, a large class of apparently reasonable investors went unprotected. The sufficient efficiency approach would protect these investors.

This is not to say that all IPO cases would result in a victory for the plaintiffs. The decision for the defendants in Ross v Bank South, N.A.,\footnote{858 F2d 1104 (5th Cir 1988), vacated on other grounds and remanded, Fryar v Abell, 492 US 914 (1989).} would stand under the sufficient efficiency approach. In Ross, two different underwriters had rejected the issue as not currently marketable. Moreover, the eventual underwriter had a subsidiary that was involved in the project as a developer.\footnote{Id at 1111-12.} Under these circumstances, the court in Ross was correct in finding the plaintiffs' reliance on market price unreasonable. The market makers were tainted, and the market process was not sufficiently efficient to warrant such reliance. Thus, the defendants were allowed to rebut the presumption of reliance by simply establishing that the "'market makers'\footnote{Basic, 485 US at 248.} were privy to the truth."\footnote{Id at 1111-12.}

A more ambiguous set of facts is illustrated by the Abell case.\footnote{858 F2d 723 (11th Cir 1989), cert denied, 110 S Ct 1924 (1990).} Here, the issuer and the underwriter's counsel had conspired to suppress both an adverse feasibility study and various financial problems associated with the underlying project.\footnote{Id at 725-26.} It was unclear, however, whether the underwriters themselves were aware of the fraud. If not, it seems safe to assume that the market was sufficiently information efficient to reflect any significant public information, and that therefore the market price was worthy of investors' reliance.

138 Id at 196.
140 Id at 198-99, discussed in notes 67-70 and accompanying text.
142 Id at 198-99, discussed in notes 67-70 and accompanying text.
143 That is, the underwriter.
144 Basic, 485 US at 248.
145 858 F2d 1104 (5th Cir 1988), vacated on other grounds and remanded, Fryar v Abell, 492 US 914 (1989).
146 Id at 1111-12.
In all of these cases, an independent, professional underwriter was involved in the IPO, and functioned (or could have functioned) to create a sufficiently information efficient market. As in Freeman, when such market professionals are untainted by fraud, investors’ reliance is undeniably reasonable. When the scruples of these professionals is in doubt, however, plaintiffs should not be able to recover under Rule 10b-5. Instead, their remedy lies in a cause of action more specifically tailored to the abuses of issuer and underwriter fraud.

CONCLUSION

Purchasers of securities from initial public offerings may often reasonably rely on the market to incorporate all significant public information into the issuance price. The price almost certainly will not reflect the security’s fundamental value, but it will be unbiased. Asking whether the IPO market is sufficiently information efficient to warrant reliance on the market price avoids dependence on the overly rigorous approach to information efficiency that courts have applied. While the assumptions of the ECMH are not “realistic” in the IPO context, the IPO market often provides a “sufficiently good approximation” to justify investor reliance. The sufficient efficiency approach also serves the remedial and informational purposes of securities regulation.

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147 See notes 103-05 and accompanying text for suggested criteria of a market upon which a plaintiff may reasonably rely.

148 As an alternative remedy, defrauded investors may be able to take action under Section 11 of the 1933 Securities Act. See Jennings and Marsh, Securities Regulation at 918-19, 933 (cited in note 89).

149 See text accompanying note 1.