NOTE

MISPLACED RELIANCE: RETHINKING RULE 10B-5 AND THE CAUSAL CONNECTION

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INTRODUCTION

Basic Inc. v. Levinson’s fraudulent presumption lives to fight another day. The much-maligned case recently appeared in jeopardy when several justices strongly suggested they would overrule it were the issue properly before the Court. More recently, however, a majority of the Court

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2 See Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1204 (2013) (Alito, J., concurring) (stating that the presumption “may rest on [a] faulty economic
declined to overrule the case on stare decisis grounds,\(^3\) though not without vigorous debate.\(^4\) This was a lost opportunity. Since Basic was decided, criticism of the fraud-on-the-market presumption has been voluminous.\(^5\) While much of this criticism is well-warranted, this Note suggests that the source of Basic’s problem is not the presumption itself, but instead the reliance element. Reliance simply has no place in a cause of action designed to deal with complex transactions conducted in a highly impersonal market. As this Note chronicles, the reliance element vexed both contract and tort actions as well; in those areas of law, however, reliance was ultimately done away with by the principles of implied warranty and strict liability. The reasons for eliminating reliance in tort and contract apply with even greater force in securities law. This Note weighs its proposal against a variety of relevant criteria, including those that the Court considered this past year in Halliburton Co. v. Erica P. John Fund, Inc.\(^6\) Ultimately, by almost all relevant metrics, reliance has no place in the securities class action.

Part I outlines the history of Rule 10b-5 and its attendant criticism, describing how it came to serve as the linchpin of the modern securities fraud class action and analyzing the Basic, Amgen, and Halliburton opinions in the hopes of uncovering the fundamental policy and jurisprudential reasons for their respective outcomes. Part I concludes with a brief summary of Congress’s role in shaping Rule 10b-5, focusing primarily on its enactment of the Private Securities Litigation Reform Act (“PSLRA”). Part II proposes a set of fundamental criteria by which to evaluate this Note’s proposal, ultimately concluding that the statute, its history, and the attendant case law offer little help. Instead, economic policy and judicial efficiency should drive the Court’s analysis. Part III proposes that the rationale and history of the strict liability concept in tort and contract law apply equally to securities law and counsel in favor of doing away with the confusing and inconsistently applied reliance element. Part IV addresses potential sources of criticism.

\(^3\) Halliburton Co. v. Erica P. John Fund, 134 S. Ct. 2398, 2407 (2014).
\(^4\) Id. at 2418 (Thomas, J., concurring) (stating that because of “logic, economic realities, and our subsequent jurisprudence . . . Basic should be overruled”); see also Amgen, 133 S. Ct. at 1206 (Thomas, J., dissenting).
\(^6\) 134 S. Ct. 2398.
I. HISTORY OF RULE 10B-5 LITIGATION

The vast majority of private securities litigation is brought under Section 10(b) of the Securities Exchange Act of 1934. Congress intended for Section 10(b) to serve as a “catch-all” provision, supplementing the other narrower sections’ prohibitions. Section 10(b)’s language accordingly provides sweeping protection for investors against all manner of fraud. The Act is not self-enforcing, however. For that reason, the SEC promulgated Rule 10b-5. Almost a decade after Congress enacted the statute, the Second Circuit found an implied private cause of action in \textit{Kardon v. National Gypsum Co.} Other courts followed suit, and by 1971, the Supreme Court acknowledged the

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8 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) (“Of course [Section 10(b)] is a catch-all clause to prevent manipulative devices.”) (quoting \textit{Hearings on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce}, 73d Cong. 2d Sess., 115 (1934) (statement of Thomas G. Corcoran)).

9 See \textit{Securities Exchange Act of 1934} § 10(b), 15 U.S.C. § 78j (2012) (“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 . . . [to] use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”).

10 Birnbaum \textit{v. Newport Steel Corp.}, 193 F.2d 461, 463 (2d Cir. 1952) (“Section 10(b) of the Securities Exchange Act does not by its terms make unlawful any conduct or activity but confers rulemaking power upon the SEC to condemn deceptive practices in the sale or purchase of securities.”).

11 17 C.F.R. § 240.10b-5 (2014) (“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 any other facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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.”).


13 69 F. Supp. 512, 514 (E.D. Pa. 1946) (“[I]n view of the general purpose of the act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.”).
cause of action as well.\textsuperscript{14} Because the judiciary created the action, it was left to shape its contours as well.\textsuperscript{15} Courts eventually concluded that the phrases “deceit” and “manipulation” were employed as terms of art; the common law tort actions of deceit and misrepresentation\textsuperscript{16} provided the elements of proof.\textsuperscript{17}

This “solution” posed new difficulties. The common law’s emphasis on reliance fits poorly with the large and impersonal securities market, which was far removed from that in which the deceit action originated.\textsuperscript{18} Reliance made securities litigation difficult and class certification next to impossible. The element directly conflicted with Federal Rule of Civil Procedure 23’s requirement that common questions predominate over individual ones.\textsuperscript{19} Without the class action mechanism, plaintiffs had little incentive to file suit; this in turn detracted from the deterrent effect that the private 10b-5 action was supposed to create.\textsuperscript{20}


\textsuperscript{15} See Grundfest, supra note 7, at 33 (“While explicit legislative history addresses the question of reliance as a precondition to private damage recovery under Section 18(a), there is and can be no comparable history in connection with Section 10(b) for the simple reason that Congress didn’t know that it was creating a provision that would later support a judicially created right of action.”).

\textsuperscript{16} See Dura Pharm. v. Broudo, 544 U.S. 336, 341 (2005) (“The courts have implied from these statutes and Rule a private damages action, which resembles, but is not identical to, common-law tort actions for deceit and misrepresentation.”); Basic Inc. v. Levinson, 485 U.S. 224, 253 (1988) (“In general, the case law developed in this Court with respect to \textsuperscript{10}b-5 and Rule 10b-5 has been based on doctrines with which we, as judges, are familiar: common-law doctrines of fraud and deceit.”).

\textsuperscript{17} Dura Pharm., 544 U.S. at 341 (listing as the six elements of a 10b-5 action: (1) “a material misrepresentation,” (2) “scienter,” (3) “a connection with the purchase or sale of a security,” (4) “reliance,” (5) “economic loss,” and (6) “loss causation”).


\textsuperscript{19} Basic, 485 U.S. at 242 (“Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.”).

\textsuperscript{20} See Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975) (“The statute and rule are designed to foster an expectation that securities markets are free from fraud an expectation on which purchasers should be able to rely.”); Sec. & Exch. Comm’n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (including the Securities Exchange Act of 1934 among a “series of Acts designed to eliminate certain abuses in the securities industry [which] contributed to the stock market crash of 1929,” and “substitute a philosophy of full disclosure for the philosophy of caveat emptor”); see also Grundfest, supra note 7, at 6 (“[T]here is also a large and credible literature arguing that private enforcement of the federal securities laws is a valuable and necessary supplement to federal and state enforcement efforts. This literature suggests that private litigation under Section 10(b) private right of action provides valuable deterrence and offers compensation not otherwise available under the law.”).
A. Fraud-on-the-Market and Basic Inc. v. Levinson

In 1975, the Ninth Circuit introduced an early version of the fraud-on-the-market theory in Blackie v. Barrack,21 “eliminat[ing] the requirement that plaintiffs prove reliance directly.”22 According to the Blackie court,

A purchaser on the stock exchanges . . . 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.23

Following Blackie, several jurisdictions adopted variations of the fraud-on-the-market theory.24

Several years later, the Supreme Court adopted a similar theory in Basic Inc. v. Levinson. The plurality in Basic made it clear that reliance was an essential element of a Rule 10b-5 action because it “provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”25 At the same time, the Court concluded that requiring a demonstration of affirmative reliance “would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.”26

The Basic Court employed the fraud-on-the-market theory “out of considerations of fairness, public policy, and probability, as well as judicial economy. . . .”27 The Court also rooted the presumption in the efficient market hypothesis, which “posits that the price of a security reflects all publicly available information about a firm, and that prices react almost instantaneously and in an unbiased manner to any new information.”28 This explanation, while apparently of secondary consideration to the Basic Court, proved instrumental to lower courts as the case law developed.

The plurality was adamant that the presumption was rebuttable if a defendant could make a “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.”29 It proceeded to list three situations in which a defendant could do just that: (1) if market makers were aware of the truth, such that the misrepresentation did not affect the price; (2) if news of the

21 524 F.2d 891.
22 Id. at 907.
23 Id.
24 COFFEE & SELIGMAN, supra note 12, at 1140 n.2 (citing cases from five other circuit courts that adopted the fraud-on-the-market theory).
26 Id. at 245.
27 Id.
29 Basic, 485 U.S. at 248.
fraud entered the market and dissipated its effects, such that subsequent purchasers could not claim injury; and (3) if some other concern in fact caused the shareholders to divest their shares, such as political pressure or antitrust concerns. By adopting the presumption, the Court removed the greatest barrier to class certification.

The presumption rested on shaky grounds, however. Three justices declined to participate in the decision, resulting in only a four-justice majority. Justice White dissented vigorously. His concerns were two-fold. First, it appeared that the presumption, while nominally rebuttable, would effectively eliminate the reliance element. Without reliance, according to Justice White, 10b-5 actions would effectively become a “scheme of investor’s insurance.” Second, the Court relied heavily on the efficient market hypothesis to justify the presumption. The hypothesis was relatively young when Basic was decided, and the Court was ill-equipped to adequately process the underlying data.

B. Post-Basic Criticism

Justice White’s critique was just the beginning; numerous critiques would spring up shortly thereafter. As Justice White predicted, the efficient market

30 Id. at 248-49.
32 Basic, 485 U.S. at 250.
33 Id. (White, J., dissenting).
34 Id. at 256 n.7 (“[i]n practice the Court must realize, as other courts applying the fraud-on-the-market theory have, that such rebuttal is virtually impossible in all but the most extraordinary case.”).
35 Id. at 252 (quoting Shores v. Sklar, 647 F.2d 462, 469 n.5 (5th Cir. 1981) (en banc)).
36 See id. at 246 (majority opinion) (“Recent empirical studies have tended to confirm Congress’ premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.”).
37 Id. at 253 (White, J., dissenting) (“[W]ith no staff economists, no experts schooled in the ‘efficient-capital-market hypothesis,’ no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.”).
38 Bernard et al., supra note 5, at 782-83 (“Since Basic, there has been an explosion of literature in financial economics casting doubt on the efficiency of at least some segments of the stock market. The [efficient market hypothesis] has undergone so much questioning that leading researchers are now creating new theories to explain how in equilibrium, market prices could reflect random factors that have nothing to do with firms’ underlying fundamental values.” (footnote omitted)).
hypothesis itself became the subject of much criticism. This was not necessarily surprising since the theory was already contested when Basic was decided. The attacks were both theoretical and empirical. At the theoretical level, some argued that the hypothesis simply defied common sense; many investors participate precisely because they think securities are mispriced. Of course, the hypothesis relies on this contradictory behavior, which is even more troubling; without this irrational pursuit, the market would cease to be efficient. Several underlying assumptions of the theory may also rest on shaky ground.

Empirical research also casts doubt on the hypothesis’s accuracy. Professor Carol Goforth has persuasively argued that because certain investors consistently see above-average returns under certain investment strategies, some securities must be routinely mispriced. Other empirical phenomena cast

39 Basic, 485 U.S. at 254 (White, J., dissenting).
40 Carol R. Goforth, The Efficient Capital Market Hypothesis – An Inadequate Justification for the Fraud-On-The-Market Presumption, 27 WAKE FOREST L. REV. 895, 895-96 (1992) (“By the time of the 1988 decision in Basic, Inc., this hypothesis had been debated intensely for more than twenty years, particularly in economic circles.”).
42 Goforth, supra note 40, at 920 n.177 (“The essential paradox of the [efficient capital market hypothesis] is that although the theory posits that traders cannot outperform the market by acquiring new information, the theorists must concede concurrently that if no traders seek to acquire that useless information, the market will cease to be efficient.”).
43 Id. at 899-900 (highlighting the fragility of the assumptions that perfect pricing exists, that news travels instantaneously, and that no investor possesses monopolistic power in the market); ANDREW SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 10-16 (2000) (pointing out numerous ways in which investors exhibit irrational behavior and explaining how arbitrage risk limits the theoretical ability for informed investors to correct pricing).
44 Goforth, supra note 40, at 905. Four such strategies are particularly prominent: (1) investors can outperform the market by exploiting the “small firm effect,” id. at 906-07 (“The small-firm effect exemplifies this anomaly and permits investors in small firms to make above-average returns, despite the ECMH’s prediction that no investor can consistently reap above-average profits.” (footnote omitted)), (2) the “low-price to earnings ratio effect,” id. at 907 (“Studies supporting the . . . effect indicate that the efficient market hypothesis cannot account for the higher-than-average returns consistently realized from stocks of firms with a low price-to-earnings ratio.”), (3) the “neglected-firm effect,” id. (“This effect predicts that the securities of firms which are not generally held by major institutional investors, or which are not followed by a significant number of financial analysts, will experience above-average rates of return.”), or (4) the “period-of-listing effect,” id. (“Data supporting this anomaly indicates that securities which are listed for a relatively short period of time will experience abnormally high rates of return.”). In each case, if the market were efficient, the strategy would be ineffective. Id. at 906-09; see also SHLEIFER, supra note 43, at 16-23 (chronicling several other empirical studies that undermine fundamental assumptions of the efficient market hypothesis).
further doubt on the hypothesis. Markets are significantly more volatile than the efficient market hypothesis would suggest and frequently overreact or underreact to certain types of information. Behavioral economists have also persuasively demonstrated that in several situations the market is simply not rational, which undermines one of hypothesis’ central assumptions.

Commentators have also taken issue with the presumption’s application. While the Court emphasized that the presumption was rebuttable, this hasn’t been the case in practice. Courts have also proven inconsistent in determining whether markets are efficient in the first place. The combination of these concerns has led some to believe that 10b-5 has become little more than a scheme of investor’s insurance, as Justice White feared.

Less than a decade after Basic, Congress passed the PSLRA. The PSLRA served as a response to an allegedly sharp uptick in private securities litigation in the wake of Basic. Some have argued that this effect was greatly exaggerated. Regardless, Congress was clearly concerned with the amount of

45 Paul A. Ferrilo, Frederick C. Dunbar & David Tabak, The “Less Than” Efficient Capital Market Hypothesis: Requiring More Proof From Plaintiffs in Fraud-On-The-Market Cases, 78 ST. JOHN’S L. REV. 81, 108 (2004) (“Research showed that stock prices are more volatile than can be explained by this model. Therefore, it followed that stock prices are based on factors other than or in addition to information about future dividends, i.e., factors besides fundamental value.”). The recent Twitter IPO serves as an example: the firm saw its shares rise 73% on the first day only to fall 7.2% less than 24 hours later—a pattern which is far from unique, and one that suggests that the market is not truly tracking fundamental value. See Benjamin Pimentel, Twitter Volatility Follows Social Stocks Pattern, MARKET WATCH (Nov. 8, 2013, 4:35 PM), http://www.marketwatch.com/story/twitter-volatility-follows-social-stocks-pattern-2013-11-08, archived at http://perma.cc/EYB7-8D7D.

46 Ferrilo et al., supra note 45, at 111.

47 Id. at 114 (highlighting several behavioral economic studies which may cast doubt on the efficient market hypothesis).

48 Grundfest, supra note 7, at 47 (“Cases in which the presumption has been rebutted once it attaches are thus as rare as hen’s teeth, and there appear to be only five instances in which lower courts have held that plaintiffs have successfully rebutted the presumption.”).

49 Rapp, supra note 5, at 305 (surveying nine cases and concluding that “[t]he courts embrace a laundry list of factors economists have suggested as indicators of market efficiency, but fail to show an aptitude for considering these factors in a deeper, contextual fashion”).


52 Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 103d Cong., 2 (1993) (statement of Sen. Chris Dodd), available at http://ia700401.us.archive.org/16/items/privatelitigation00unit/privatelitigation00unit.pdf (“[M]any of our witnesses this morning are going to tell us . . . that securities litigation has gotten out of hand and is destroying the very capital formation policy it seeks to promote.”).

53 See COFFEE & SELIGMAN, supra note 12, at 1218 (“While anecdotal impressions were
litigation. Despite this concern, the PSLRA does not appear to have had the desired impact on the volume of securities class actions.\textsuperscript{54} Thus, Congress’s concern, legitimate or not, has largely gone unaddressed.

II. \textsc{Post-Basic Criteria}

This Note proposes that the Court do away with the reliance element of private 10b-5 actions.\textsuperscript{55} Before detailing that solution, this Note sets forth a set of evaluative criteria.

A. \textit{Faithfulness to Legislative Intent}

Reliance can only be removed from the 10b-5 action consistent with legislative intent. The inquiry begins with Section 10(b) itself.\textsuperscript{56} The provision enables the SEC to promulgate regulations prohibiting the use of “any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”\textsuperscript{57} Section 10(b)’s stated aim is to protect investors and promote the public interest, but this could suggest a focus on either compensation or deterrence. Since Section 10(b) does not contemplate a private cause of action, it’s not clear that much can be inferred from the language at all.\textsuperscript{58}

The legislative history provides little additional guidance. Section 10(b) is only one part of the Act, and Congress only comments on it in passing. In fact, abundant, hard data did not establish any significant increase in volume over time, but rather revealed very high variance from year to year.


\textsuperscript{55} This argument is distinct from that of former SEC Commissioner Roberta Karmel. See Roberta S. Karmel, \textit{When Should Investor Reliance Be Presumed in Securities Class Actions?}, 63 BUS. LAW. 25 (2007). Karmel argues that the fraud-on-the-market presumption as “outlived its utility” and calls on Congress to eliminate it, replacing it by remedying the defects of Section 18. \textit{Id.} at 52. Karmel contends that investors can reasonably expect statements in SEC filings to be true, and that reliance can be presumed in this narrow class of cases. \textit{Id.} at 53. Karmel, realizing that this reform does not address non-filing misstatements, also calls on Congress to reform the reliance requirement. \textit{Id.} Karmel cautions that Rule 10b-5 should not unduly impair capital formation, but also that the Congress should not gut the Rule entirely. \textit{Id.} She fails to specify how exactly this can be accomplished. I contend in this Article that the reliance element is itself untenable and should be eliminated instead of reformed.

\textsuperscript{56} Duncan v. Walker, 533 U.S. 167, 172 (2001) (“Our task is to construe what Congress has enacted. We begin, as always, with the language of the statute.”).


\textsuperscript{58} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (“[W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express ‘intent of Congress’ as to the contours of a private cause of action under Rule 10b-5.”).
Congress only mentions the provision twice in the legislative history.\(^{59}\) The Senate declared that effective regulation should be “aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.”\(^{60}\) A spokesman for the drafters described the provision as a “catch-all clause to prevent manipulative devices” and asserted as its command: “Thou shalt not devise any other cunning devices.”\(^{61}\) In both instances, the focus is on the misrepresentation itself, which could indicate either concern for the market or condemnation of the guilty issuer. Neither statement focuses on the investor or alludes to compensation. At the end of the day, however, the statements are cursory, and neither speaks to reliance directly.

Rule 10b-5 provides only slightly more assistance. The Rule states:

> 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 other facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.\(^{62}\)

Ambiguity stems from the phrase “operates or would operate as a fraud or deceit upon any person.” The phrase emphasizes the innocent investor, whereas Section 10(b) focuses primarily on policing misrepresentations. This may suggest that Rule 10b-5’s drafters had a compensatory goal in mind. Perhaps more importantly, the phrase is also unclear on causation. Since the reliance element is closely tied to proof of causation, this ambiguity plays a role in the reliance dilemma. Rule 10b-5 makes a distinction between acts that operate as a fraud in fact, and those that “would operate as a fraud,” policing both.\(^{63}\) The distinction is unclear, but could suggest that 10b-5 does not require causation at all.

It is problematic that courts have read “deceit” and “fraud” as terms of art.\(^{64}\) While this approach is now deeply embedded in precedent, the SEC may not


\(^{60}\) Ernst & Ernst v. Hochfelder, 424 U.S. 185, 204-05 (quoting S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934)).

\(^{61}\) Id. at 202-03 (quoting *Hearings on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. 2d Sess. 115 (1934) (statement of Thomas G. Corcoran)).


\(^{63}\) Id.

\(^{64}\) See supra text accompanying notes 16-17.
have actually intended to incorporate these causes of action into the Rule. In fact, when the SEC drafted the Rule, it included no private cause of action. Had the SEC known that a private action would develop, it may have settled on an entirely different and more appropriate set of elements. Regardless, Rule 10b-5 does not directly address reliance.

The history of Rule 10b-5 is of even less help. The SEC hardly considered the Rule at the time it was promulgated. One of the Rule’s drafters recalled that in drafting the provision, “the only discussion we had there was where [the phrase] ‘in connection with the purchase or sale’ should be, and we decided it should be at the end.”

When the Rule was presented to the SEC, “[the commissioners] passed a piece of paper around... all the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said: ‘Well... we are against fraud, aren’t we?’” Little authority can be derived from this history.

Congress has only had occasion to revisit Section 10(b) once, when it enacted the PSLRA. Congress enacted the PSLRA to respond to the perception that the volume of securities class actions had increased dramatically after Basic. While the PSLRA created several additional hurdles for 10b-5 plaintiffs, it did not undo the fraud-on-the-market presumption. Interestingly, the original version of the bill would have effectively reversed Basic, eliminating the presumption. The relevant language didn’t make its way into the final version of the legislation, however, and little can be concluded from its absence.

The PSLRA does provide some guidance through its imposition of a loss causation element. In order to ensure that unmeritorious suits do not lead to recovery, Congress broke the causation inquiry into two separate elements: loss causation and transaction causation. Transaction causation is equivalent

66 Id. at 1045.
67 See supra text accompanying notes 51-54.
68 See Langevoort, supra note 5, at 153 n.8.
69 See Jeffrey Oldham, Taking “Efficient Markets” Out of the Fraud-On-The-Market Doctrine After the Private Securities Litigation Reform Act, 97 NW. U. L. REV. 995, 1025 n.200 (2003) (arguing that, because the fraud-on-the-market presumption does not flow necessarily or logically from the statute, Congressional restatement of 10(b) cannot indicate approval; that because some members of Congress specifically expressed dissatisfaction with the presumption, one cannot infer approval from the PSLRA’s ultimate silence; and that because the presumption has been applied so inconsistently, there is less of an expectation that Congress would explicitly overrule it in the first place).
to the reliance element. The PSLRA thus reinforces reliance’s role as a proxy for proof of causation. But by imposing the additional loss causation requirement, Congress implicitly expressed dissatisfaction with reliance and the fraud-on-the-market presumption. It thus stopped short of affixing its seal of approval to the presumption.

Other PSLRA provisions can be read to comment on the efficient market hypothesis. The look-back provision of the PSLRA—which prevents plaintiffs from recovering if the price of the stock at issue rebounds shortly after the misrepresentation is revealed—assumes a different version of the efficient market hypothesis than the Court appears to have employed in Basic. At the same time, Congress’s acknowledgement of at least some form of the efficient market hypothesis is significant: by recognizing that misrepresentations affect the market price for securities, Congress lays the groundwork for a market-based harm theory. While it is tempting to conclude that Congress intended to comment on the presumption through the PSLRA, such implications must be drawn by inference. This weakens their import. At a minimum, however, nothing in the law or its history suggests that reliance is a necessary element of the 10b-5 action.

B. Stare Decisis

The rule of law mandates consistency between any new rule governing 10b-5 class actions and previous case law. This is all the more important given that Section 10(b) and Rule 10b-5 provide little guidance. Rule 10b-5 is by and large a judicial creation. Respect for precedent ensures a consistency and continuity that adherence to legislative will cannot. At the same time, in order to correct Basic’s flaws, it is necessary to disregard some amount of precedent. The inquiry is thus where to draw the line.

Reliance entered Rule 10b-5 actions early on, when courts began to look to the common law actions for deceit and fraud to interpret Section 10(b). Reliance, as an essential element in the common law action for deceit, was incorporated into the 10b-5 action. Courts quickly noted, however, that,

71 See id.
72 See Oldham, supra note 69, at 1028 (arguing that the Basic assumes at least a semi-strong version of the hypothesis while “the PSLRA’s damages provision, and its pragmatic approach to calculating damages . . . recognizes that the market does not immediately react to information [and] evidence[s] congressional skepticism of the EMH as a descriptive theory of the marketplace”); see also Goforth, supra note 40, at 896-97 (outlining the differences between the weak, strong, and semi-strong forms of the efficient market hypothesis).
74 The Court has acknowledged that, in working with Rule 10b-5, it “deal[s] with a judicial oak which has grown from little more than a legislative acorn.” Id.
75 See supra note 16.
76 RESTATEMENT (SECOND) OF TORTS § 525 (1977) (“One who fraudulently makes a
misplaced reliance

“although derived from it, the 10b-5 action is not coterminous with a common law fraud action.”77 The Supreme Court has often, when interpreting Section 10(b) and Rule 10b-5, striven to promote their “fundamental purpose[:] . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”78 This aim, on occasion, requires the Court to stray from the principles of common law deceit. When doing so, the Court has applied Section 10(b) and Rule 10b-5 “not technically and restrictively, but flexibly to effectuate its remedial purposes.”79

Basic represents the Court’s introduction of the fraud-on-the-market presumption, but by the time the case was decided, many jurisdictions had already dealt with the reliance issue and supported their own versions of the presumption.80 In Basic, the Court began its discussion of fraud-on-the-market by strongly asserting the centrality of reliance, writing, “[w]e agree that reliance is an element of a Rule 10b-5 cause of action.”81 At various points in the history of Rule 10b-5 litigation, however, the Court has done away with the reliance element altogether when it stood in the way of the philosophy of Section 10(b). For example, in Affiliated Ute Citizens of Utah v. United States,82 the Court held that where circumstances “involv[ed] primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.”83 In the seminal fraud-on-the-market case, Blackie v. Barrack, the Court relied on the logic of Affiliated Ute Citizens to justify the presumption:

[I]n this context we think proof of reliance means at most a requirement that plaintiff prove directly that he would have acted differently had he known the true facts. That is a requirement of proof of a speculative negative (I would not have bought had I known) precisely parallel to that

misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.” (emphasis added)).

77 Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975).
79 Id. at 195.
80 See Langevoort, supra note 5, at 153 (“By the mid-1980s, all courts of appeals that had considered the question had invoked some kind of reliance presumption in order to make fraud-on-the-market class-action lawsuits certifiable. In that sense, the Supreme Court simply endorsed what was by then a solid line of precedent.” (footnote omitted)).
83 Id. at 153-54.
held unnecessary in Affiliated Ute...  

While the Basic Court appeared to assert the centrality of reliance, it in fact marginalized reliance to advance the Rule’s purpose. In noting that reliance “provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury,” it subtly suggested that reliance was not entirely essential. Rather, reliance was simply one of many methods to circumstantially demonstrate causation. Immediately after asserting reliance’s importance, the Court detailed several situations in which causation can be established with no proof of reliance at all, specifically citing Affiliated Ute Citizens. The Court stopped short of arguing that proof of an efficient market establishes subjective reliance. Instead, when endorsing the fraud-on-the-market presumption, the Court described it as “consistent with” Section 10(b)’s policies and justified it as “[a]rising out of considerations of fairness, public policy, and probability, as well as judicial economy.” The Court only began to describe the efficient market hypothesis after arguing for the presumption’s usefulness. The presumption thus represents a clear break from precedent.

The majority in Halliburton ultimately declined to overrule Basic on stare decisis grounds. In doing so, however, it failed to consider the two competing visions of Section 10(b) that are embodied in that case, neither of which was entirely embraced by the Basic Court. Basic simultaneously asserts the centrality of reliance while chipping away at its foundation and stressing the “integrity” of the market. Professor Donald Langevoort, in assessing private letters exchanged between Justices Blackmun and Brennan, concludes that “Basic’s confusion is in part a product of trying to join the two justices’ conflicting ideas while trying to hold onto the vote of Justice Stevens, who worried about issues of loss causation and damages.” This tension is clear in the opinion itself. The precedential value of Basic is only further diminished by the fact that three justices abstained from the decision. The Halliburton Court

84 Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975).
85 Basic, 485 U.S. at 243.
86 Id. (“[W]e previously have dispensed with a requirement of positive proof of reliance, where a duty to disclose material information had been breached, concluding that the necessary nexus between the plaintiff’s injury and the defendant’s wrongful conduct had been established.” (citing Affiliated Ute Citizens, 406 U.S. at 153-54)).
87 Id. at 245.
88 Halliburton Co. v. Erica P. John Fund, 134 S. Ct. 2398, 2407 (2014) (“Halliburton urges us to overrule Basic’s presumption of reliance... Before overturning a long-settled precedent, however, we require a ‘special justification,’ not just an argument that the precedent was wrongly decided. Halliburton has failed to make that showing.” (citation omitted)).
89 Basic, 485 U.S. at 247.
90 Langevoort, supra note 5, at 153 n.9.
91 See supra text accompanying note 32.
missed an opportunity to seriously consider whether Basic itself undermines the reliance element.

C. Deterrence and Economic Incentives

It is critical to consider the economic impact of eliminating the reliance element from private 10b-5 actions. Some have argued that Section 10(b)’s fundamental purpose is to mitigate harms to the market as opposed to harms to individual investors. The Court “has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions.” Section 10(b) was not enacted with a private cause of action in mind, which means that the compensatory function is largely an invention of the courts. The private cause of action was grafted onto a statute that originally aimed to deter fraud and envisioned sole enforcement by the SEC. Any solution to the reliance dilemma must therefore be aimed primarily at deterring fraud.

There are several reasons why deterring fraud is beneficial from an efficiency standpoint, which are well summarized by Professor Paul G. Mahoney. According to Mahoney, fraud imposes three sources of social cost: precaution costs, investments in lying, and allocative costs. Of the three, precaution costs are most significant since they are likely the most costly and they appear to be those most directly targeted by tort actions. Investments in lying and allocative costs are less significant, but still deserve some consideration.

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92 See Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 STAN. L. REV. 1487, 1488 (1996) (“Securities class action litigation . . . is a primary enforcement mechanism for a regulatory regime whose purpose is to protect the public interest in the integrity of the capital markets.”); Jill E. Fisch, The Trouble with Basic: Price Distortion After Halliburton, 90 WASH. U. L. REV. 895, 913-14 (2013) (“Importantly, however, when fraud distorts securities prices, it produces a market-based harm. In the presence of a price distortion, all investors trade at the wrong price.”).


94 See supra text accompanying notes 13-15.

95 Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (“The securities statutes seek to maintain public confidence in the marketplace. They do so by deterring fraud, in part, through the availability of private securities fraud actions.” (citation omitted)).


97 Id. at 630-31.

98 See id. at 633 (“Torts scholars have long recognized that a paramount goal of compensation for loss is to limit investments in precaution by victims. . . . It seems likely that precaution costs will dominate the others in the case of secondary-market frauds. . . .” (footnotes omitted)).

99 Lying costs are those incurred by the executive in maintaining the deception. Mahoney hypothesizes that these costs are generally low due to the effectiveness of legal deterrence. Id. at 631. Allocative costs are those that result when the misrepresentation is motivated by
Investors incur precaution costs when they must conduct additional research in order to overcome misrepresentations.\(^{100}\) Basic is illustrative. In Basic, the defendant firm was engaged in merger discussions that were ultimately successful.\(^{101}\) When asked about the conversations, the firm denied them. Plaintiff investors sold their stock after the public denial, but before the merger.\(^{102}\) To avoid this lost opportunity, the investors would have had to somehow discover on their own that the firm was contemplating a merger. It is difficult to fathom how they might have done so, outside of surveilling the executives’ conversations. But even if such surveillance were an option, the costs would be wasteful. Another paradigmatic 10b-5 situation involves a firm misrepresenting its financial health in order to boost the price of its shares.\(^{103}\) In this case, the verification costs might entail scrutinizing the financial records of the company—or more likely, constructing estimates—in order to assess the firm’s underlying value. Again, this is both incredibly costly and a deadweight loss.

Precaution costs are particularly large in financial markets—as opposed to, say, markets for consumer goods—due to the nature of the participants and the enormity of these markets’ scopes. Financial markets are composed of two types of traders: uninformed traders, who diversify in order to minimize risk, and informed traders, who profit from correcting pricing errors but who must expose themselves to greater risk in order to do so.\(^{104}\) While uninformed traders avoid the risk of fraud, informed traders are necessarily exposed to the risks of misrepresentation.\(^{105}\) When the market is more risky for informed traders, they become less likely to attempt to correct smaller-price errors because the potential for profit fails to justify the exposure to fraud-related

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\(^{100}\) Id. at 630-31.


\(^{102}\) Id.

\(^{103}\) See, e.g., Lipton v. Documation, Inc., 734 F.2d 740, 741 (11th Cir. 1984) (describing how “defendants disseminated into the marketplace financial reports and statements falsely claiming that Documation had substantial earnings and revenue, when, in fact, the defendants knew that the company had suffered a significant net loss”).


\(^{105}\) Id.
loss. As a result, these pricing errors simply go uncorrected, and the market as a whole suffers.

Precaution costs tend to be larger in financial markets due to the sheer number of participants and the volume of shares they purchase. Participation in securities markets is global, and a security’s value does not diminish across borders. Precaution costs are also greater in securities markets because verification is simply more difficult. Nicholas L. Georgakopoulos, in surveying a range of litigated cases, concludes that, from the perspective of shareholders, “[v]erifying information about securities . . . is prohibitively costly and practically impossible.” Dirks v. SEC is illustrative: the misrepresentation in question influenced prices over the course of three years and was only uncovered due to an insider tip followed by interviews with several of the issuer’s employees. The government auditors who had examined the company’s books missed the fraud, demonstrating that even if verification costs are expended, there is no certainty that these verification costs will be effective. Because precaution costs are so large in financial markets, private actions under 10b-5 play a considerable regulatory role. The private cause of action can provide a deterrent effect in addition to the SEC’s enforcement power. Added deterrence in turn leads to lower precaution costs and increased market efficiency.

However, it should be noted that while deterrence is clearly an important goal, 10b-5 case law may stand as a barrier to its pursuit. “[T]he statutes make these . . . actions available, not to provide investors broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.” It is unclear whether this concern is one of fairness or of the adverse economic effects that might take place should the courts eliminate the investor’s incentive to investigate. Either basis is insufficient, however. It is unclear why insurance is unfair in the 10b-5 context: the Rule only insures against losses incurred due to fraud, not losses generally. No clear normative distinction exists in the realm of securities.

106 Id.
107 Id.
108 See id. at 690-91.
109 Id. at 695.
111 See id. at 648-50; see also Georgakopoulos, supra note 104, at 695-96.
112 Dirks, 463 U.S. at 648-50; see also Georgakopoulos, supra note 104, at 695-96 (“[N]umerous examples of financial fraud cases litigated show that the false information could not have been verified without the cooperation of its maker.”).
114 White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982) (placing the due diligence burden squarely on the 10b-5 plaintiff).
115 For example, tort law insures individuals against the risk that they will be harmed by another’s negligence. See Heidi Li Feldman, Harm and Money: Against the Insurance
Concern that investors will cease to investigate is also misguided. Because investigation is already prohibitively expensive, the vast majority of investors do not participate; the level of investigation cannot be expected to decrease significantly with further disincentive.\textsuperscript{116} Wasteful and inefficient, investor verification is best avoided instead of incentivized.\textsuperscript{117} While fear of investor’s insurance is embedded in precedent, it is not grounded in the language of the statute and is difficult to rationalize independently.

D. Judicial Economy

At the heart of the \textit{Basic} opinion is a concern for judicial economy. The very first argument the Court made to justify the presumption was centered on administrative efficiency: “Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult.”\textsuperscript{118} While commentators and lower courts have focused on the efficient market hypothesis,\textsuperscript{119} it is quite clear in reading the opinion that judicial economy was first and foremost on the mind of the Court. This concern is no less pressing today. Securities class actions consume a disproportionate amount of judicial time and effort for a variety of reasons, including heightened monitoring requirements, increasing numbers of opt-out plaintiffs, and the action’s unique discovery process.\textsuperscript{120} Streamlining and clarification are necessary given the inconsistency with which courts have applied the presumption.\textsuperscript{121}

III. THE MOVE TO IMPLIED WARRANTY AND STRICT LIABILITY

Eliminating the reliance element would solve many of the issues outlined above. In at least two related areas of law, reliance has already been eliminated under certain circumstances. These two areas—implied warranty and strict liability—operate as case studies. By looking at the history of the concepts and

\textit{Theory of Tort Compensation}, 75 TEX. L. REV. 1567, 1570-71 (1997) (“Legal economists . . . equate tort compensation with insurance, because damages, like insurance payments, spread the cost of providing financial resources for accident victims.” (footnotes omitted)).

\textsuperscript{116} See \textit{supra} notes 21-28 and accompanying text (discussing how the presumption of reliance eases the burden on individual plaintiffs who relied on stock prices to indicate market value).

\textsuperscript{117} See \textit{supra} notes 100-112 and accompanying text (outlining the inefficiencies and burdens associated with investor verification).

\textsuperscript{118} Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988).

\textsuperscript{119} Langevoort, \textit{supra} note 5, at 167 (arguing that “Basic’s obfuscation about the role of efficiency sent the courts on a long journey without a particularly good compass”).


\textsuperscript{121} See \textit{supra} notes 80-91 (discussing the Supreme Court’s inconsistent application of the presumption of reliance in 10b-5 cases).
the justifications offered for their development, one can see that securities law is similarly suited to move beyond reliance. Strict liability and implied warranty have influenced each other over time. At the same time, each retains some distinctive justification, which bears mentioning. Thus, this Note proceeds with a brief discussion of each, beginning with implied warranty.

A. **Implied Warranty’s Applicability to Section 10(b)**

Today, warranty actions represent certain aspects of both tort and contract law doctrines. As Prosser explains, however, “[i]n its inception, breach of warranty was a tort . . . and the wrong was conceived to be a form of misrepresentation, in the nature of deceit and not at all clearly distinguished from deceit.” The deceit action is also, of course, the basis for the 10b-5 action. Warranty eventually moved on from its tort law beginnings and was incorporated into the law of contracts.

In the leading implied warranty case, *Gardiner v. Gray*, the court stated that “[w]ithout any particular warranty, this is an implied term in every such contract. . . . [T]he intention of both parties must be taken to be, that [the good] shall be saleable in the market under the [denomination] mentioned in the contract.” The court demanded no inquiry into the seller’s assertions and required no reliance on the part of the buyer. Under *Gray*, the implied warranty stemmed from “the description in the contract,” but the implied warranty was later imposed as a matter of law “independent of any intent on the part of the seller to contract with regard to them, or to be bound by them.”

By the middle of the twentieth century, the implied warranty was codified in the Uniform Commercial Code. Under the Code, default contractual provisions entitle purchasers to goods in good title and free and clear of encumbrance, fit for their ordinary purpose and of adequate quality, and fit for the specific purpose required of them. Under the UCC, implied warranties adhere regardless of whether the seller has made any

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124 See supra text accompanying notes 15-16.
125 Bollas, supra note 122, at 767 (estimating that warranty was fully introduced into contract around 1778 with the decision in *Stuart v. Wilkins*, (1778) 99 Eng. Rep. 15 (K.B.).
126 (1815) 171 Eng. Rep. 46 (K.B.) 47.
127 Id.
128 Id.
129 Prosser, supra note 123, at 121.
131 Id. at § 2-312.
132 Id. at § 2-314.
133 Id. at § 2-315.
representations, and suits brought for their breach do not require any proof of reliance.\textsuperscript{134} Several justifications were given for eliminating reliance and imposing an implied warranty. These justifications have applicability in the securities context. Prosser’s seminal article on the implied warranty of merchantability provides a useful framework.\textsuperscript{135} According to Prosser, depending on the circumstances of the case, the implied warranty can be justified on one of three bases.\textsuperscript{136} The first justification emerges from tort principles: the warranty originates from the deceit action and “differs from deceit only in that it imposes strict liability for innocent misrepresentations, in the absence of any ‘sciente’ . . . ”\textsuperscript{137} Under this theory, the seller must have some knowledge of the particular purpose of the good and the buyer must reasonably rely on the seller’s supposed expertise.\textsuperscript{138} Because this justification requires reliance, it does not solve the present 10b-5 dilemma; nonetheless, Prosser’s argument is illuminating insofar as it explicitly ties the implied warranty to deceit concepts, which also form the basis for the 10b-5 action.\textsuperscript{139} Under Prosser’s framework, when reliance becomes an obstacle to the application of the warranty, reliance is abandoned in favor of a second justification.\textsuperscript{140}

The second justification of implied warranty proceeds from contract principles and envisions the implied warranty as an unexpressed term, nonetheless implicitly understood and agreed to by the parties.\textsuperscript{141} However, this explanation has little value in situations in which no privity exists between the buyer and seller. Securities generally trade hands at the blink of an eye, and it is rare for an investor to receive a security directly from the issuer. Thus, the second justification is also of little assistance.

Prosser’s third explanation touches most directly on the concerns that plague the 10b-5 action. As implied warranty evolved, the importance of privity and reliance diminished, and the third justification came to occupy the dominant position.\textsuperscript{142} The third justification is motivated by dual policy concerns: burden allocation and entitlement to protection.\textsuperscript{143} First, “[t]he loss due to defective

\textsuperscript{134} Michael J. Herbert, Toward a Unified Theory of Warranty Creation Under Articles 2 and 2A of the Uniform Commercial Code, 1990 COLUM. BUS. L. REV. 265, 265-66 (“Implied warranties . . . are automatically created by law and require no reliance. The mere fact that a transferor sold or leased something to a transferee creates a warranty or warranties regarding the goods transferred.”).

\textsuperscript{135} Prosser, supra note 123, at 122-25.

\textsuperscript{136} Id.

\textsuperscript{137} Id. at 122.

\textsuperscript{138} Id.

\textsuperscript{139} See supra notes 16-17 and accompanying text.

\textsuperscript{140} Prosser, supra note 123, at 125.

\textsuperscript{141} Id. at 123.

\textsuperscript{142} Id. at 124.

\textsuperscript{143} Id.
goods is placed upon the seller because he is best able to bear it and distribute it to the public.” 144 Second, “the buyer is entitled to protection at the seller’s expense.” 145 Both rationales apply equally to the 10b-5 action for several reasons.

The burden allocation applies for two reasons. First, the issuer, as the source of the misrepresentation, can rather easily bear the verification costs. As scienter is an element of the 10b-5 action, in any meritorious claim, the issuer is aware of the true state of affairs and chooses to provide a false statement. Avoiding the misrepresentation is thus costless from a verification perspective. 146 Of course, the issuer’s agents likely contemplate some extraneous source of benefit from the misrepresentation, and so the issuer may bear monitoring costs. 147 Regardless, because only the issuer can avoid the misrepresentation altogether, it is clear that the issuer is best able to avoid the fraud.

Second, the issuer most efficiently bears the expense of the fraud because verification costs are multiplied exponentially when borne by the shareholders. Each shareholder must bear the verification costs individually if they decide to investigate the misrepresentation. This multiplies the overall expense significantly, simply due to the number of shareholders involved. Perhaps more importantly, there are qualitative differences between the type of verification necessary for stockholders and the verification undertaken by issuers. As previously explained, “[v]erifying information about securities . . . is prohibitively costly and practically impossible.” 148 Clearly, the expense of misrepresentation is most efficiently borne by the issuer, not only because of its advantageous position in avoiding the fraud, but also because the net verification cost is lower when borne by the issuer.

Issuers may also best be able to bear the costs of the harm to the extent that they purchase insurance for this very purpose. 149 While some investors may self-insure by diversification, informed traders, who cannot diversify, are left susceptible to the fraud. Purchasing investor’s insurance, if available, would only cut into their margins and again minimize the incentive to correct

144 Id.
145 Id.
146 For now, this Note will ignore the possibility that an unmeritorious claim may nevertheless lead to liability. See infra note 197 and accompanying text.
147 See Mahoney, supra note 96, at 634-35 (outlining the three principal reasons why issuers might lie to the market, including hopes that they may mislead regulators, misalignment of shareholder and manager goals, and the protection of the firm’s investment in information).
148 Georgakopoulos, supra note 104, at 695.
149 This may present its own problems in terms of effective deterrence. See Alexander, supra note 92, at 1498-99 (“Deterrence is further complicated by the fact that the individuals responsible for the violation hardly ever have to contribute to any payment made to the class. Half or more of the settlement payment typically comes from insurance, and thus is not borne directly by either individual or entity defendants.” (footnote omitted)).
mispricing. This is harmful from an efficiency standpoint because the presence of informed investors promotes overall efficiency.150

Prosser’s “entitlement to protection” policy also easily applies to the Section 10(b) action. The “protection of investors” is, in fact, an explicit goal of Section 10(b).151 While the statute generally provides little guidance, in this instance, there is a clear policy objective. Implied warranty principles are designed to protect buyers who are otherwise incapable of protecting themselves. Section 10(b) bears the same aspiration. The history of implied warranty suggests that this goal is best served by eliminating reliance.

B. **Strict Products Liability and Section 10(b)**

While warranty originated in tort, it was long considered part of contract law. Implied warranty began to reshape tort law once the privity element was eliminated.152 Implied warranty concepts readily applied to products liability, and strict liability quickly became distinct from its warranty origin.153 While many of the policies underlying implied warranty and strict liability are shared, several unique justifications for strict liability also exist.

Strict products liability was first formalized in *Greenman v. Yuba Power Products, Inc.*154 Justice Traynor tackled the reliance issue directly:

Implicit in the machine’s presence on the market, however, was a representation that it would safely do the jobs for which it was built. Under these circumstances, it should not be controlling whether plaintiff selected the machine because of the statements in the brochure, or because of the machine’s own appearance of excellence that belied the defect lurking beneath the surface, or because he merely assumed that it

150 Georgakopoulos, *supra* note 104, at 698-99 (“Informed traders must be compensated for losses they incur due to misrepresentations, or they will not service the market and correct prices.”).


153 *See Greenman*, 377 P.2d at 901 (detailing the connection between strict liability and implied warranty and ultimately establishing strict products liability as an independent principle); *see also* Daly v. General Motors Corp., 575 P.2d 1162, 1165 (Cal. 1978) (“Warranty actions, however, contained their own inherent limitations requiring a precedent notice to the vendor of a breach of the warranty, and absolving him from loss if he had issued an adequate disclaimer.”).

154 377 P.2d 897, 901 (Cal. 1963). Prior to *Greenman*, Justice Traynor had advanced the theory in a number of concurring opinions without decided precedential force. See EDWARD G. WHITE, TORT LAW IN AMERICA: AN INTELLECTUAL HISTORY 197-202 (2003). These early opinions borrowed heavily from Prosser’s work. *Id.* at 198-200 (comparing the similarities between a 1941 Prosser treatise and Traynor’s opinion in *Escola v. Coca-Cola Bottling Co.*). *Greenman* was the first case in which Traynor was able to gather a majority. *Id.* at 202. The case also fleshes out the theory to an extent not seen in some of Traynor’s prior opinions, and so it serves as a useful starting place in dealing with the underlying rationale.
would safely do the jobs it was built to do.155

Traynor argued that strict liability should be imposed “to insure that the costs of injuries resulting from defective products are borne by the manufacturers that put such products on the market rather than by the injured persons who are powerless to protect themselves.”156 The ability of the manufacturer to procure insurance was perhaps central to Traynor’s assignment of liability.157 Perhaps even more critical was the presence of asymmetric information.158

Only a few years later, Section 402A of the Second Restatement of Torts endorsed Traynor’s principle.159 Section 402A rapidly became the definitive statement of strict liability.160 The principle was justified in the comments to Section 402A.161 First, strict liability gave force to the normative vision that “the public has the right to and does expect, in the case of products which it needs and for which it is forced to rely upon the seller, that reputable sellers will stand behind their goods . . . .”162 Like implied warranty, strict liability was premised on the idea that the seller would most efficiently bear the harm from the products it sold and that the buyer was “entitled to the maximum of protection at the hands of someone, and the proper persons to afford it are those who market the products.”163 The argument has also been made in economic terms, that liability should be assigned to the least cost avoider in order to minimize primary accident costs.164 As set forth above, these policies apply in the 10b-5 context.

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155 Greenman, 377 P.2d at 901.
156 Id.
157 WHITE, supra note 154, at 190 (highlighting the importance of insurance as “a rationale for the imposition of strict liability”).
158 Id. at 202-04 (arguing that “equal access to information about risks . . . emerges as a central principle” in Traynor’s strict liability cases).
159 RESTATEMENT (SECOND) OF TORTS § 402A (1965).
161 RESTATEMENT (SECOND) OF TORTS § 402A cmt. c (1965).
162 Id.
163 Id.
164 Guido Calabresi & Jon T. Hirschoff, Toward a Test for Strict Liability in Torts, 81 YALE L.J. 1055, 1060 (1972) (“Liability [in tort actions is] placed on the party initially free of responsibility only if the deicer found the benefits of avoidance . . . to be greater than the costs of such avoidance to that party. The strict liability test . . . does not require that a governmental institution make such a cost-benefit analysis. It requires . . . only a decision as to which of the parties to the accident is in the best position to make the cost-benefit analysis between accident costs and accident avoidance costs . . . .”).
Strict liability’s other justifications also apply. The relationship between the issuer and the investor is similar to that of the buyer and seller. Like the seller, the issuer has unique access to information. The issuer necessarily knows more about the state of affairs underlying its representations; in fact, a showing of scienter requires that the issuer know the true state of affairs and recognize the inaccuracy of its statement.\textsuperscript{165} The issuer is also uniquely able to prevent the misrepresentation’s harm by simply avoiding it altogether.\textsuperscript{166} The investor has no equivalent way to avoid the harm; investigation is frequently impossible and the costs are prohibitive.\textsuperscript{167} The informed investor is also unable to protect himself from the harms of misrepresentation.\textsuperscript{168} Only the uninformed trader can diversify, and even if investor’s insurance were available, it would cut into profitability, leading to sub-optimal price correction.\textsuperscript{169} Thus, at least one prominent justification for strict liability operates in the 10b-5 context.

The Basic opinion also evinces a normative vision mirroring the rationale for strict liability. Blackmun’s argument was replete with references to the “integrity”\textsuperscript{170} of the markets. At one point, Blackmun famously quoted Schlanger v. Four-Phase Systems Inc.\textsuperscript{171} stating that “it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?”\textsuperscript{172} Langevoort goes so far as to argue that Basic can only be read as creating a normative entitlement to reliance on the markets since most investors are well aware of the presence of fraud in financial markets and assume that risk when they invest.\textsuperscript{173} To the extent Langevoort is correct, it’s clear that strict liability principles have ready applicability to Section 10(b) actions.

C. Underlying Currents in the Market and Tort Law

The previous two subsections demonstrate that many of the justifications for strict liability and implied warranty apply with equal force in the securities context. This subsection posits that there are more fundamental reasons for the

\textsuperscript{165} See Dura Pharm., Inc. v. Broudo, 554 U.S. 336, 341 (2005) (stating that scienter is a basic element of an action for deceit and misrepresentations “involving publicly traded securities and purchases or sales in public securities markets”).

\textsuperscript{166} See supra Part II.C (describing how risk creators can prevent harm by not engaging in risky activities and the ways the law can be used to deter excessively risky behavior).

\textsuperscript{167} See supra text accompanying notes 116-117.

\textsuperscript{168} See supra text accompanying notes 103-104.

\textsuperscript{169} See supra text accompanying notes 104-107 (explaining how causes of action could serve as a form of investor’s insurance but that such insurance is difficult to rationalize independently).


\textsuperscript{171} 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

\textsuperscript{172} Basic, 485 U.S. at 246-47 (quoting Schlanger, 555 F. Supp. at 538).

\textsuperscript{173} See Langevoort, supra note 5, at 160-61 (arguing that “this really is the only persuasive, coherent interpretation of Basic’s presumption”).
elimination of reliance in tort and contract law. At the time that the strict liability and implied warranty doctrines developed, the U.S. economy was changing dramatically, and the fundamental purpose of tort law was evolving.\textsuperscript{174} The elimination of reliance was a natural response to these phenomena.\textsuperscript{175} Securities law was not immune to these effects, but it responded to them in a significantly different way, diverging from the path that tort and contract law followed. Much of the difficulty that securities law now faces with respect to the reliance element stems from this divergence.

Strict liability is a response to “the economic and social need for the protection of consumers in an increasingly complex and mechanized society.”\textsuperscript{176} At the time the doctrine developed, buyers were being left in a vulnerable position with respect to sellers; in a large, impersonal economy, it was increasingly less likely that a buyer would interact directly with a seller, leading to the fall of the privity and reliance elements.\textsuperscript{177} Warranty actions evolved as a response to these changing market conditions.\textsuperscript{178} Of course, the financial markets are, if anything, more complex and impersonal than those for consumer goods, “literally involving millions of shares changing hands daily.”\textsuperscript{179} The fraud-on-the-market presumption served as a response to this problem; investors were no longer required to prove reliance, but rather efficiency.\textsuperscript{180} As this Note has chronicled, efficiency analysis was no easy task for plaintiffs, defendants, or the courts.\textsuperscript{181} The presumption was a complicated solution to a problem that tort and contract had dealt with more simply, and more effectively.

\textsuperscript{174} See John C.P. Goldberg, Tort, in \textsc{The Oxford Handbook of Legal Studies} 22-26 (Peter Cane & Mark Tushnet eds., 2003) (describing the movement of tort law in the twentieth century towards a more “regulatory” conception whereby the “government deters, and compensates victims of, conduct . . . because it is socially undesirable”); see also, e.g., Daly v. General Motors Corp., 575 P.2d 1162, 1166 (Cal. 1978) (positing that society was becoming “increasingly complex and mechanized”).

\textsuperscript{175} See Frank J. Vandall, \textsc{A History of Civil Litigation: Political and Economic Perspectives} 13 (2011) (discussing how moving from negligence and reliance standards to strict liability standards was desirable from a social policy standpoint by encouraging optimal “loss shifting, availability of insurance, and ease of prevention”).

\textsuperscript{176} Daly, 575 P.2d at 1166.

\textsuperscript{177} See supra notes 152-153 and accompanying text.

\textsuperscript{178} Vandall, supra note 175, at 13 (“From 1916 through 1944, the courts struggled with various theories such as negligence, fraud, express warranty, and implied warranty in products liability cases. The results were unsatisfactory because the consumers constantly lost cases they should have won. The judicial frustration with these adverse results was articulated by Justice Traynor . . . [who] argued that recovery in products liability cases should rest upon absolute liability.”).


\textsuperscript{180} See text accompanying notes 24-27.

\textsuperscript{181} See supra Part I.
As the market changed, so too did the underlying philosophy of the tort action. As Robert Thompson explained:

Current writers are more inclined to deemphasize the common law lawyer’s “notions of wrongdoing and personal redress and have tended to regard tort law as a means by which government deters and compensates victims of conduct that is regulated not because it is wrong but because it is socially undesirable.”\(^\text{182}\)

Tort shifted from a pseudo-criminal law focused on punishment to a regulatory mechanism for internalizing negative externalities.\(^\text{183}\) Reliance is simply not necessary to the new regulatory tort. This shift in philosophy permeates the justifications for strict liability and implied warranty with the doctrines’ focus on shifting the liability to the party who best bears the costs.\(^\text{184}\) Again, securities law failed to fully account for this shift, using the fraud-on-the-market presumption as something of a stopgap. The development of tort and contract law in response to these phenomena suggests a different path would be effective. Not only would the elimination of reliance deal with the host of issues described in Parts I and II of this Note, but it would also accord with underlying legal trends and market realities.

IV. POTENTIAL CRITICISM

A. Comparisons to Section 11

Issuers are generally considered strictly liable for their misrepresentations in registration statements under Section 11 of the 1933 Act.\(^\text{185}\) Some may argue that, to the extent Section 10(b)’s language differs from Section 11’s, Congress did not intend to hold Section 10(b) defendants strictly liable as this Note proposes.\(^\text{186}\) Section 11 demonstrates that Congress knows how to write strict


\(^{183}\) \textit{See} \textit{id.} at 887.

\(^{184}\) \textit{See, e.g.}, \textit{Restatement (Second) of Torts} § 402A cmt. c. (1965) (“\textit{P}ublic policy demands that the burden of accidental injuries caused by products intended for consumption be placed upon those who market them, and be treated as a cost of production against which liability insurance can be obtained . . . ”); \textit{White}, \textit{supra} note 154, at 190 (discussing the significance of insurance in imposing strict liability).

\(^{185}\) 15 U.S.C. § 77k (2012); \textit{see e.g.}, Degulis v. LXR Biotech., Inc., 928 F. Supp. 1301, 1314 (S.D.N.Y. 1996) (“An issuer of securities is strictly liable for material misrepresentation and omissions in its registration statement and prospectus under Section 11.”).

\(^{186}\) On statutory interpretation grounds, some may contend that the maxim of meaningful variation precludes allowing Section 10(b) to impose strict liability when read in light of Section 11’s language. \textit{See generally} William N. Eskridge, Jr., \textit{et al.}, \textit{Cases and Materials on Statutory Interpretation} 347 (2012) (describing the maxim of meaningful variation such that there is a “presumption that a change in wording denotes a
liability into the securities laws; therefore, if Congress did not do so for Section 10(b), it may not have meant to. It is first worth noting that this argument may rest on a misunderstanding of this Note’s proposal. Unlike Section 10(b), Section 11 does not require proof of scienter. This lack of scienter is what leads some courts to conclude that liability in such cases is strict or absolute. This is not necessarily wrong; criminal law regularly uses “strict liability” to indicate a crime for which mens rea is not required. I do not propose abandonment of the scienter element, however. By “strict liability,” I mean the lack of a reliance element, which is the sense in which tort and contract law use the term.

If one uses “strict liability” in the same sense as this Note, Section 11 is not clearly a strict liability provision. Several courts have held that Section 11 simply entitles the plaintiff to a presumption of reliance. The presumption is, of course, rebuttable and thus not unlike the fraud-on-the-market presumption. Any dissimilarity between Section 10(b) and Section 11 does not necessarily caution against eliminating reliance. Other provisions of the securities laws expressly require proof of reliance. For example, Section 18 of the 1934 Act imposes liability for misrepresentations in filings with the SEC when the aggrieved party can demonstrate reliance on the misrepresentation.

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187 Kaplan v. Rose, 49 F.3d 1363, 1371 (9th Cir. 1994) (“No scienter is required for liability under § 11; defendants will be liable for innocent or negligent material misstatements or omissions.”).
188 In re Adams Golf, Inc. Sec. Litig., 381 F.3d 267, 274 n.7 (3d Cir. 2004) (stating that Section 11 is “virtually [an] absolute liability provision[]” insofar as it “do[es] not require plaintiffs to allege that defendants possessed any scienter”).
189 Staples v. United States, 511 U.S. 600, 607-08 n.3 (1994) (explaining that the Court has used the term “strict liability” to refer to crimes that do not require mens rea, but acknowledging that “use of the term ’strict liability’ is really a misnomer”).
191 See APA Excelsior III L.P. v. Premiere Techs., Inc., 476 F.3d 1261, 1272 (11th Cir. 2007) (“The statute’s intended purpose as it concerns the presumption of reliance is well-documented. For example, various House and Senate bills relating to the Securities Act explain that when there is a defect in a registration statement, ‘the public shall be presumed to rely’ on the defect.” (citing H.R. Rep. No. 73-5480, at 60 (1993))); Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967) (“Both the House and Senate versions of the present § 11, in identical language, established a conclusive presumption of reliance upon the registration statement by every person acquiring any securities specified in such statements and offered to the public.” (internal quotation marks omitted)).
192 APA Excelsior III, 476 F.3d at 1272 (“To say that reliance is ‘presumed’ is simply not the same thing as saying that reliance is ‘irrelevant.’”); In re Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 635 (S.D.N.Y. 2007).
194 Id. (providing a cause of action for one “who, in reliance upon [a misrepresentation], shall have purchased or sold a security at a price which was affected by such
While Section 11 demonstrates that Congress knows how to impose liability without proof of reliance, Section 18 shows that it knows how to require reliance as well.\textsuperscript{195} Section 10(b) is simply silent, and thus ambiguous.

To determine whether reliance belongs within Section 10(b) by looking for analogous provisions in the securities laws, one need not look to either Section 11 or Section 18. Courts have long held that the SEC does not need to prove reliance when bringing an enforcement action under Section 10(b).\textsuperscript{196} This is the very same Section 10(b) that applies to private suits with the very same language being interpreted. In explaining the discrepancy, the Second Circuit has relied on the Supreme Court's interpretive statement: "'[T]he antifraud provisions of the securities laws are not coextensive with common law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry.'"\textsuperscript{197} This rationale, of course, would seem to apply to private suits. The fact that Section 10(b) can be interpreted without reliance effectively demonstrates that reliance is not an essential element of the action. That private enforcement actions are workable without a reliance element demonstrates that private suits would function without it.

B. Disproportionate Benefit to Plaintiffs

Perhaps the most persuasive argument against eliminating reliance is that it would tilt the scales of Section 10(b) too heavily in favor of the class action plaintiff. This argument is well taken; because of the immense costs of discovery and the incredible risk in going to trial, securities fraud defendants will often be forced to settle unmeritorious claims, leading to both inequity and inefficiency.\textsuperscript{198} Section 10(b) may very well already produce too many \textit{in terrorem} suits.\textsuperscript{199} Deterring strike suits is a serious problem.\textsuperscript{200} At the end of

\textsuperscript{195} Compare § 77k, with § 78r.

\textsuperscript{196} See, e.g., SEC v. Wolfson, 539 F.3d 1249, 1260 (10th Cir. 2008).

\textsuperscript{197} Geman v. SEC, 334 F.3d 1183, 1191 (2d Cir. 2003) (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983)).

\textsuperscript{198} See, e.g., \textit{In re} Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 978 (9th Cir. 1999) (describing the problem of professional securities plaintiffs who target "deep pocket defendants" and "misuse the discovery process" to drive up costs in the hopes of a quick settlement); but see Michael J. Kaufman & John M. Wunderlich, \textit{The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions}, 43 U. MICH. J.L. REFORM 323, 323 (2010) (arguing that the threat of \textit{in terrorem} settlements is "unfounded and illogical").

\textsuperscript{199} See, e.g., Benjamin A. Leisawitz, Matrixx Initiatives, Inc. v. Siracusano: Rejection of the Statistically Significant Standard Reopened the Door to Securities Fraud Strike Suits, 36 \textit{Del. J. Corp. L.} 675 (2011) (making the case that strike suits are especially troublesome in the pharmaceuticals industry).

\textsuperscript{200} See \textit{supra} notes 178-179.
the day, however, the reliance element is simply not a good vehicle for addressing this problem. Courts have been unable to apply the element consistently, which makes the outcome of any given case less predictable for 10(b) defendants.\textsuperscript{201} The fraud-on-the-market presumption—necessary to the 10(b) class action’s existence—is also effectively irrebuttable.\textsuperscript{202} It is thus highly questionable whether the reliance element is effective at deterring frivolous suits at all. Other avenues for deterring frivolous suits may be more effective. Congress could revisit the scienter element, for example. While the PSLRA creates a heightened pleading standard, it does nothing to alter the underlying \textit{mens rea} requirement.\textsuperscript{203} Congress could require a heightened mental state and limit plaintiffs’ ability to prosecute innocent misrepresentations.\textsuperscript{204} Congress could also rebalance Section 10(b) by bolstering the loss causation requirement.\textsuperscript{205} Other proposals exist, and some of course argue that—if anything—the securities laws are already too defendant-friendly. Which alternative proposal might be most effective or fair is outside the scope of this Note. What is important is that reliance is not the answer.

C. \textit{The Halliburton Decision}

The Supreme Court’s most recent securities law decision casts considerable doubt on the likelihood that any of this Note’s proposals might actually be adopted. In \textit{Halliburton}, the Court declined to eliminate the fraud on the market presumption on the basis of \textit{stare decisis}.\textsuperscript{206} The Court acknowledged that \textit{Basic} was long-standing precedent and required “special justification” in order to overturn the decision.\textsuperscript{207} The Court determined that the failures of the

\textsuperscript{201} See Rapp, \textit{supra} note 5, at 305 (“[C]ourts’ decisions as to the efficiency of particular security markets have turned out to be highly variable. Given remarkably similar facts, courts’ assessment of market efficiency range from findings of inefficiency to findings of efficiency.”).

\textsuperscript{202} See \textit{supra} note 48.

\textsuperscript{203} Tellabs v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) (noting, in the canonical case for scienter pleading, that “[t]he question whether and when recklessness satisfies the scienter requirement is not presented in this case”).

\textsuperscript{204} See Jill E. Fisch, \textit{Cause for Concern: Causation and Federal Securities Fraud}, 94 IOWA L. REV. 811, 866 (2009) (explaining that “the scienter element is significantly watered down from the common law requirement of intentional misconduct and often involves little more than gross negligence”).


\textsuperscript{207} \textit{Id.} at 2407 (“Halliburton urges us to overrule Basic’s presumption of reliance . . . . Before overturning a long-settled precedent, however, we require ‘special justification,’ not just an argument that the precedent was wrongly decided.”).
efficient market hypothesis did not provide that special justification. According to the Court, the Basic Court was aware of these same criticisms, and its use of the hypothesis was limited; so long as information has some effect on the market, Basic’s logic remains intact.

The Court seems to lean heavily on the idea that stare decisis has “special force” when applied to statutory interpretation. This is because Congress has the unique capability to alter that precedent by amending the underlying statute. While that logic is questionable, this Note acknowledges that the Court is unlikely to reverse course. That said, the Court’s argument highlights the alternative course; that Congress is free to expressly eliminate reliance for the reasons that this Note outlines. Moreover, this course may ultimately be more desirable because, as explained in Part IV.B, eliminating reliance threatens to upset the balance of Section 10(b). There are ways to counter this effect, but those measures would not be accessible to the Court. Congress could rework the securities laws with more precision, eliminating reliance without rendering Section 10(b) susceptible to harmful strike suits. The Court’s unwillingness to act should not ultimately inhibit necessary alterations to Section 10(b).

CONCLUSION

Reliance simply has little role in the regulation of complex and impersonal markets. The justifications advanced for the elimination of reliance in tort and contract law reveal that Congress and courts could do away with the reliance requirement in Rule 10b-5 on a similar theoretical basis. Reliance finds its origins in a substantially different market than exists in society today. Contract and tort actions evolved and eliminated reliance when it became apparent that economic efficiency and fundamental fairness demanded it. The 10b-5 action faces a very similar dilemma today. The same solution is readily applicable. Eliminating reliance could improve judicial economy, relieving courts of fact-intensive and inconsistently applied efficiency analyses. Eliminating reliance would also separate 10b-5 from the presumption’s problematic theoretical premises in favor of a simpler, analytically consistent standard of proof.

208 Id. at 2409-11.
209 Id. at 2410.
210 Id. at 2411.
211 Id.
212 See id. at 2425 (Thomas, J., concurring) (“Basic, of course, has nothing to do with statutory interpretation. The case concerned a judge-made element of the implied 10b-5 cause of action. . . . In statutory cases, it is perhaps plausible that Congress watches over its enactments and will step in to fix our mistakes . . . [b]ut this rationale is untenable when it comes to judge-made law like ‘implied’ private causes of action, which we retain a duty to superintend.”).
213 Id. at 2411 (majority opinion) (“Congress may overturn or modify any aspect of our interpretation of the reliance requirement, including the Basic presumption itself.”).
Implied warranty and strict liability principles will not solve the numerous other problems that the still-evolving 10b-5 action faces, but they can easily put the reliance question to bed and allow the Court to move on to more fruitful endeavors.