MALACK V. BDO SEIDMAN, LLP AND THE FUTURE OF THE FRAUD-CREATED-THE-MARKET THEORY

Sean M. O’Loughlin

I. INTRODUCTION

Congress enacted the Securities Exchange Act of 1934 with the underlying philosophy that full disclosure would lead to honest securities markets. Lacking the expertise to curb the speculation and dishonest business practices that had become all but ubiquitous by the stock market crash of 1929 through statute alone, Congress created the Securities Exchange Commission (SEC) and gave it broad authority over the securities markets. The arterial source of this authority is the general anti-fraud provision of Section 10(b) of the Exchange Act, which grants the SEC the authority to prescribe rules to combat deceptive practices in connection with the sale or purchase of a security. In 1942, the SEC promulgated Rule 10b-5 as a means...
to carry out Congress’s charge. The rule prohibits a person from employing a plan to defraud, making any material misrepresentations or omissions, or from engaging in any fraudulent act in connection with a purchase or sale of a security. Although Section 10(b) and Rule 10b-5 do not explicitly authorize private suits, federal courts first recognized such a right in 1946, and the Supreme Court later acknowledged the same. Since that time, private suits have dominated federal court securities litigation.

Private 10b-5 litigation evolved despite Congress’s and the SEC’s reticence. Struggling to define the rule’s scope and limitations, courts borrowed from the common-law tort actions of deceit and misrepresentation. Six elements have emerged that a plaintiff generally must articulate to state a valid Rule 10b-5 claim: (1) a material misrepresentation (or omission) (2) made knowingly (i.e., defendant acted with scienter) (3) in connection with the purchase or sale of a security where (4) the plaintiff’s reliance on the misrepresentation or

---

Id. 4 17 C.F.R. § 240.10b-5 (2012).
5 Rule 10b-5 provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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.

7 Basic Inc. v. Levinson, 485 U.S. 224, 230–31 (1988) (“Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5 . . . .”).
8 See Thel, supra note 2, at 462.
9 See Julie A. Herzog, Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5, 63 GEO. WASH. L. REV. 359, 360 n.5 (1995) (“[P]rivate actions under Rule 10b-5 . . . [are] a judicial oak which [have] grown from little more than a legislative acorn.” (alterations in original) (quoting Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975)) (internal quotation marks omitted)).
omission (5) was the proximate cause of (6) the plaintiff’s economic loss.\(^\text{11}\)

One of the most debated elements is that of reliance (which is often combined with causation and collapsed into a single inquiry).\(^\text{12}\) Traditionally, a plaintiff would satisfy this element by showing that some form of disclosure or nondisclosure amounts to a material misrepresentation, and that the misrepresentation influenced the individual plaintiff’s investment decision.\(^\text{13}\) Noting the difficulty in proving direct reliance in modern securities markets, however, courts eventually came to presume reliance in certain circumstances.\(^\text{14}\)

One of these presumptions is based on a theory known as the “fraud created the market.” First articulated by the Fifth Circuit in \textit{Shores v. Sklar}, the theory presupposes that were it not for the issuer’s intentional fraud, the security would not have been marketable.\(^\text{15}\) That is, investors are able to rely on a security’s availability in the market as evidence that the security is marketable. If the standard is met, investors can evade the traditional requirement of proving direct reliance on the issuer’s fraud in making the investment decision.\(^\text{16}\)

The Fifth Circuit’s decision is a controversial one. Some courts have accepted the fraud-created-the-market theory (at least in some variation); others have rejected it entirely.\(^\text{17}\) The theory was most recently addressed in \textit{Malack v. BDO Seidman, LLP}, a case arising from a bond issuance that led to substantial investor losses.\(^\text{18}\) After the issuer went bankrupt and the notes were rendered worthless, the plaintiff sued and sought class certification.\(^\text{19}\) The plaintiff did not allege that the investors relied on the defendant’s allegedly fraudulent conduct

\(^\text{11}\) \textit{See}, \textit{e.g.}, \textit{Broudo}, 544 U.S. at 341–42. While the scope of this Comment is restricted to the reliance requirement, all of the 10b-5 elements have been contested and the Supreme Court has addressed many of them. \textit{See}, \textit{e.g.}, \textit{Basic Inc. v. Levinson}, 485 U.S. 224 (1988) (materiality); \textit{Ernst & Ernst v. Hochfelder}, 245 U.S. 185 (1976) (scienter); \textit{Blue Chip Stamps v. Manor Drug Stores}, 421 U.S. 723 (1975) (in connection with the purchase or sale of a security); \textit{Dura Pharms, Inc. v. Broudo}, 544 U.S. 336 (2005) (causation).


\(^\text{13}\) \textit{See} \textit{Herzog, supra} note 9, at 361.

\(^\text{14}\) \textit{See infra} Part II.B.

\(^\text{15}\) 647 F.2d 462, 469–70 (5th Cir. 1981).

\(^\text{16}\) \textit{Id.} at 469.

\(^\text{17}\) \textit{See infra} Part II.C–D.

\(^\text{18}\) 617 F.3d 743 (3d Cir. 2010).

\(^\text{19}\) \textit{Id.} at 744.
when purchasing the notes. Instead, he argued for a presumption of reliance under the fraud-created-the-market theory. Specifically, the plaintiff alleged that were it not for the defendant’s fraud, the notes would not have been marketable and therefore would not and could not have been purchased. The Third Circuit disagreed. In what is perhaps the most vigorous rejection of the theory to date, the court rejected the fraud-created-the-market theory in its entirety. The Malack decision widened the current circuit split and thus invites a reexamination of the reliance requirement and the validity of the presumptions that have attached to it.

Part II of this Comment discusses the background and development of Rule 10b-5 private actions, presumptions of reliance, and the fraud-created-the-market theory. Part III discusses and analyzes the Malack decision and the rationale behind the Third Circuit’s rejection of the theory. Finally, Part IV argues that the Supreme Court should resolve the circuit split by endorsing a narrow form of the fraud-created-the-market theory. By doing so, the Court could resolve the split by eliminating some of the theory’s problems while maintaining an effective avenue for investor relief. The Supreme Court should prefer such a conciliatory course of action as opposed to rejecting the theory altogether.

II. BACKGROUND

A. The Reliance Requirement

To state a valid 10b-5 claim, the plaintiff must have relied on a material misstatement or omission in making the investment decision. Reliance is essential because it “provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.” The requirement further ensures that the Exchange Act’s philosophy of full disclosure is carried out and that diligent investors use those disclosures to make informed decisions.

20 Id. at 745.
21 Id. at 749.
22 Id. at 745.
23 Id. at 749.
24 Malack, 617 F.3d at 756.
25 See infra Part II.C–D.
27 Id.
28 AES Corp. v. Dow Chem. Co., 325 F.3d 174, 178 (3d Cir. 2003) (noting that the reliance requirement ensures that “the plaintiff exercised the diligence that a rea-
Neither Section 10(b) nor Rule 10b-5 contains a reliance requirement. Federal courts have instead embraced common-law fraud elements in imposing a reliance requirement on a 10b-5 action.\textsuperscript{29} Satisfying the requirement in early 10b-5 cases was particularly burdensome. Generally, a plaintiff had to show that he had read and relied upon the disclosure materials of the security, such as a prospectus or annual statement, and that the materials contained a material misrepresentation or omission.\textsuperscript{30} This intentionally onerous standard acted as a bulwark against excessive litigation. Indeed, courts and commentators have noted the importance of maintaining the direct reliance requirement in order to prevent private 10b-5 litigation from becoming a form of “investor’s insurance” that reimburses investors who have merely made a bad decision.\textsuperscript{31} Perhaps adapting to an evolving financial landscape, courts have nonetheless deemed the direct reliance requirement an unreasonable evidentiary burden, and, in certain situations, will forego the traditional standard and presume reliance instead.\textsuperscript{32}

B. Established Presumptions of Reliance

The Supreme Court has expressly adopted two presumptions of reliance—the first in \textit{Affiliated Ute Citizens v. United States},\textsuperscript{33} the second in \textit{Basic Inc. v. Levinson}.\textsuperscript{34}

1. \textit{Affiliated Ute Citizens v. United States}

\textit{Affiliated Ute Citizens v. United States} marks the Supreme Court’s first departure from the requirement of direct reliance. Two bank employees, whose employer acted as transfer agent for the security at issue, induced the plaintiffs to sell their stock.\textsuperscript{35} As a result, the plaintiffs captured a price lower than market value, and subsequently al-
leged that the employees withheld, for personal gain, information
about the market for the security.\footnote{Id.} The Court agreed and found the
defendants liable for failing to disclose material information appur-
tenant to the sale.\footnote{Id. at 153 (“The defendants may not stand mute while they facilitate the mixed-
bloods’ sales . . . . The sellers had the right to know that the defendants were in a
position to gain financially from their sales and that their shares were selling for a
higher price in the market.”).} Noting that Rule 10b-5 requires some flexibility,
the Court implicitly recognized the difficulty that a plaintiff faces in
trying to prove that he relied on an omission or a failure to disclose.\footnote{See Basic, 485 U.S. 224, 245 (1988).}
As a result, courts will now presume reliance in face-to-face transac-
tions when the nondisclosure or omission encouraged the purchase
or sale of a security.\footnote{Herzog, supra note 9, at 365.}

Courts that have analyzed the Affiliated Ute presumption have
held that the presumption is rebuttable notwithstanding the Supreme
Court’s silence on the issue.\footnote{See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159
(2008); Black v. Finantra Capital, Inc., 418 F.3d 203, 209 (2d Cir. 2005); DuPont v.
Brady, 828 F.2d 75, 78 (2d Cir. 1987); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402,
410 (3d Cir. 1974).} A defendant is thus given the oppor-
tunity to show that the nondisclosure did not affect the plaintiff’s in-
vestment decision by proving, for example, that the plaintiff never
read the offering materials and therefore would not have been influ-
enced by the information had it been proffered.\footnote{Shores v. Sklar, 647 F.2d 462, 468 (5th Cir. 1981).}

2. \textit{Basic Inc. v. Levinson} and the Fraud-on-the-Market
Theory

The second Supreme Court-endorsed presumption of reliance is
based on what is known as the fraud-on-the-market theory. The
Ninth Circuit, in \textit{Blackie v. Barrack}, was the first court to articulate this
theory.\footnote{524 F.2d 891, 905–09 (9th Cir. 1975).} The Supreme Court later adopted it in \textit{Basic Inc. v. Levin-
son}.\footnote{485 U.S. 224, 241–49 (1988).} Unlike Affiliated Ute, which involved fraudulent nondisclosures,
the fraud-on-the-market theory applies to affirmative misrepresen-
tations.\footnote{Blackie, 524 F.2d at 907–08.}
The presumption is based on the notion that an investor relies on the integrity of the market when making an investment decision. To avail herself of the presumption, a plaintiff must satisfy three requirements: (1) the information in question must have been material, (2) the market must have been efficient (i.e., open and developed), and (3) the misinformation must have been disseminated publicly. Using common stock as an example, the theory assumes that in an efficient market, a company’s share price represents the monetary value of all of the information that is available and accessible to investors. Good news might cause the shares to increase in value; bad news might send the stock tumbling. Misrepresentations or false statements that reach the open market will similarly affect share price. Thus, the misrepresentation could injure a buyer or seller of the stock, irrespective of whether that misrepresentation actually factored into the investment decision.

In Basic, a corporation made three public statements denying the possibility of a merger, only to complete the merger a few months later. Former shareholders brought a class action suit under Section 10(b) and Rule 10b-5, alleging that the false denials resulted in an artificially-low stock price at the time of sale. In other words, had the company acknowledged that a merger was imminent, the shareholders would have captured a higher price.

Basic, 485 U.S. at 245.


Basic, 485 U.S. at 241. The Court noted that the economic underpinning of the theory, known as the Efficient Capital Markets Hypothesis, garners support from empirical studies and economic analysis. Id. at 246, 247 n.24. Generally, the hypothesis maintains that investors’ and market professionals’ evaluation of all public information regarding a stock will form the stock’s price. Hazel, supra note 46, § 12.10. For a more detailed analysis of the Efficient Capital Market Hypothesis, see MacKerton, supra note 29.

Basic, 485 U.S. at 242. To invoke the presumption, a plaintiff must allege that: The defendants made public misrepresentations; The misrepresentations were material in that they would induce a reasonable relying investor to misjudge the value of the share; The shares were traded in an efficient market; and The plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.

Basic, 485 U.S. at 248, n.27.

Id. at 227–28.

Id. at 228.
Under the traditional reliance requirement, each member of the Basic plaintiff class would have had to prove that she relied on the corporation’s denials when making the decision to sell in order to certify the class.51 For a stock with many shareholders, this would prove quite difficult. Accordingly, the Court found that a presumption of reliance existed under the fraud-on-the-market theory and the class action could proceed despite the absence of individualized reliance.

Justice Blackmun’s opinion emphasized the difficulty that a plaintiff class would face without the presumption.55 Because class certification under the Federal Rules of Civil Procedure requires common questions to predominate over individual questions, each class member would have to prove individual reliance on the misrepresentations, and all reliance arguments would have to share some form of commonality.55 Such a requirement would create an unreasonable evidentiary burden, especially in light of the modern and largely anonymous securities markets that handle millions of trades daily.56 This would not only preclude investor recovery but might also act as an impetus for a company to engage in fraudulent activity.

Although Basic represents a substantial gain for investors, the fraud-on-the-market presumption is rebuttable.57 The Court articulated a number of ways in which a defendant would go about “sever[ing] 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,” including showing that the market price would not have been affected by the misrepresentations, that the truthful merger discussions were disseminated into the market, or that the investor knew that the merger denial was false but sold the stock anyway.58

The fraud-on-the-market theory and the Affiliated Ute presumption are particularly helpful to plaintiffs seeking relief under Section 10(b) and Rule 10b-5. In Affiliated Ute, the Court recognized the difficulty plaintiffs would face in trying to prove they relied on an omis-

51 Id. at 242.
52 Id. at 250.
53 Id. at 243.
54 See Fed. R. Civ. P. 23(a) (2), (b) (3).
55 Basic, 485 U.S. at 242.
56 Id. at 243.
57 Id. at 248.
58 Id. at 248–49.
In Basic, the Court similarly recognized the evidentiary burden that traditional reliance requirements would impose on a plaintiff class. As a result, a plaintiff can generally forego the traditional reliance requirement if she can show that the circumstances surrounding the investment decision fit into one of the two presumptions.

C. The Fraud-Created-the-Market Theory

The protections that the Affiliated Ute and Basic presumptions cast over investors do not extend to securities being issued (i.e., the primary market) or to inefficient (e.g., thinly-traded) markets. Imagine, for example, that an investor bought bonds from a corporation wishing to raise capital. The disclosure literature that was distributed with the bond offering contained fraudulent information, and the bond subsequently lost its value. The two reliance presumptions provide the investor no relief: the Affiliated Ute presumption is inapplicable outside of a failure to disclose and the fraud-on-the-market theory requires an efficient market. An efficient market is one in which regular trading occurs—an element lacking in the primary market. To bring a Section 10(b) and Rule 10b-5 claim, then, the investor would need to prove that he directly relied on the misrepresentation in the disclosure materials. This would make class certification a near impossibility.

Some courts have responded to this dilemma by employing a third presumption of reliance in a primary-market context. The Fifth Circuit was the first court to expressly endorse this presumption. In Shores, a mobile-home manufacturer and proposed underwriter persuaded a town board to issue revenue bonds. The bonds funded the construction of an industrial facility, which the manufacturer leased in order to conduct operations, and the manufacturer’s rent payments were to be used to pay the interest on the bonds. The plaintiff had purchased three municipal bonds from the offe-

---

59 See supra note 38 and accompanying text.
60 See supra notes 55–58 and accompanying text.
61 See Herzog, supra note 9, at 373.
63 See HAZEN, supra note 46, § 12.10.
64 See infra Part II.C.1–3.
65 See Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981).
66 Id. at 465.
67 Id.
Less than a year and a half after the initial offering, the manufacturer defaulted on its rental payments and the value of the bonds dropped precipitously. Investors recovered approximately thirty-seven percent of their original investment. The plaintiff alleged that the offering circular, drafted by the bond counsel Sklar, contained material misrepresentations and omissions.

Although a plaintiff in this situation could typically invoke the Affiliated Ute presumption to encompass the material information that was omitted from the offering circular, here, the plaintiff admitted that he was not aware of the offering circular. Thus, the plaintiff foreclosed use of the Affiliated Ute presumption—essentially performing the defendant’s job of rebutting the presumption—by admitting that he had not relied on the fraudulent documents. For this reason, the district court granted summary judgment for the defendants. The Fifth Circuit vacated, however, paving the way for a new presumption of reliance.

The Court of Appeals held that the issuers’ fraud was an “elaborate scheme” that went beyond the misrepresentations and omissions contained in the offering circular. Accordingly, the plaintiff’s allegations were sufficient under parts (a) and (c) of Rule 10b-5, which use broad terms to define the actionable activity. The scheme was deemed to be so pervasive that, without it, the bonds would not have been offered on the market at any price. Thus, just as in the case of the fraud-on-the-market theory, the plaintiff was relying on the in-

---

68 Id. at 467.
69 Id. at 463–64, 464 n.1.
70 See id. at 464 n.1.
71 Shores, 647 F.2d at 465–66. Indeed, the court found some of these misrepresentations and nondisclosures to be quite egregious. For example, the circular failed to mention that an SEC investigation and civil action was proceeding against the proposed underwriter and misrepresented the financial soundness of the manufacturer and its shareholder. Id.
72 Id. at 468.
73 Id. at 464.
74 Id.
75 Id. at 468.
76 Section (a) of the Rule prohibits the employment of a “scheme” to defraud; section (c) prohibits any “act” that operates as a fraud; section (b) requires reliance on a specific statement or omission and thus was eliminated as an avenue for relief when the plaintiff admitted to not having read the offering material. 17 C.F.R. § 240.10b-5 (2012).
77 Shores, 647 F.2d at 463–64 n.2.
78 The similarities and differences between the two theories have generated significant debate between the circuits. See infra Part IV.
tegrity of the market in making the investment decision and not a
specific statement or omission by the defendant.\textsuperscript{79} That is, the securi-
ty’s availability in the marketplace allowed the plaintiff to presume its
genuineness. The major difference, however, is that the fraud-
created-the-market theory applies to primary markets, whereas the fraud-on-the-market theory is restricted to efficient secondary mar-

The court articulated three requirements that a plaintiff must
show in order to be entitled to the presumption: (1) the defendants
knowingly conspired to bring securities that were not entitled to be
marketed onto the market intending to defraud the purchaser, (2)
the plaintiff reasonably relied on the security’s availability in the mar-
ket as an indication of the security’s apparent genuineness, and (3) as
a result of the scheme to defraud, the plaintiff suffered a loss.\textsuperscript{81}

The fraud-created-the-market theory, as envisioned by the \textit{Shores}
court, arguably sets a higher threshold than the fraud-on-the-market
theory—merely affecting share price will not do; the fraud has to be
so significant as to make the security totally unmarketable.\textsuperscript{82} But just
what does “not entitled to be marketed” mean? \textit{Shores} failed to elabo-
rate.\textsuperscript{85} Hence, courts analyzing the fraud-created-the-market theory
have necessarily focused on the first requirement of the \textit{Shores} test.
Courts have interpreted this concept differently, and three main vari-
ations have emerged.\textsuperscript{84}

1. Legal Unmarketability

Legal unmarketability focuses on whether a regulatory agency or
issuing municipality would have been required to prevent the security
from being issued had it known about the misrepresentation or omis-
sion.\textsuperscript{85} \textit{T.J. Raney \& Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Au-

\textsuperscript{79} \textit{Shores}, 647 F.2d at 471.
\textsuperscript{80} \textit{Id.} at 469–70; \textit{see also supra} note 46 and accompanying text.
\textsuperscript{81} \textit{Shores}, 647 F.2d at 469–70.
\textsuperscript{82} \textit{Id.} at 470.
\textsuperscript{83} \textit{See Ross v. Bank South, N.A.}, 885 F.2d 723, 735 (11th Cir. 1989) (Tjoflat, J.,
concurring) (“Marketability, as envisioned by the \textit{Shores} court, is an elusive con-
cept.”).
\textsuperscript{84} There has been some confusion and overlap regarding the three types of un-
marketability in the Circuits. For purposes of this comment, the author adopts the
terms as the Third Circuit articulated them. \textit{See Malack v. BDO Seidman, LLP}, 617
F.3d 743, 748 (3d Cir. 2010).
\textsuperscript{85} \textit{Id.} (quoting \textit{Ockerman v. May Zima \& Co.}, 27 F.3d 1151, 1160 (6th Cir.
1994)).
Thority is the seminal legal unmarketability case. There, the plaintiff, a broker-dealer distributing the defendants’ bonds, alleged that the defendants never intended to use the bond proceeds to construct a gas distribution facility, as they had claimed. The plaintiff further alleged that the bond counsel concealed this fact during the offering, and that the bonds were not issued pursuant to Oklahoma law.

The Tenth Circuit, adopting the reasoning set forth in Shores, held that even though federal or state regulators do not consider the truthfulness of representations made in an offering circular, an investor should be able to assume that the securities were lawfully issued. Thus, because the plaintiff established that the defendant was prohibited from issuing the bonds under Oklahoma law, the bonds were unmarketable and the court affirmed the class certification. Although the court described the fraud-created-the-market theory as an extension of the fraud-on-the-market theory that the Supreme Court endorsed in Basic, the court significantly limited its holding to the narrow grounds that reliance can be presumed only for securities that were issued in contravention of some state or federal law. The Tenth Circuit therefore equated “not entitled to be marketed” with illegality. This holding refines the Shores standard and distinguishes the Tenth Circuit from other courts that would later apply their own variation of the fraud-created-the-market presumption.

2. Economic Unmarketability

Economic unmarketability directs the inquiry to whether the security is “patently worthless” such that no investor would buy the security. This is arguably the original standard that the Fifth Circuit

---

86 717 F.2d 1330 (10th Cir. 1983).
87 Id. at 1331.
88 Id.
89 Id. at 1333.
90 Id.
91 Id.
92 In Joseph v. Wiles, 223 F.3d 1155, 1164 (10th Cir. 2000), the Tenth Circuit affirmed its legal unmarketability standard but also discussed economic unmarketability. The court did not rule on the validity of economic unmarketability because the plaintiff failed to meet the requirements, but the opinion implies that the court might allow it under different circumstances. See id.
93 Malack v. BDO Seidman, LLP, 617 F.3d 743, 748 (3d Cir. 2010) (quoting Ockerman v. May Zima & Co., 27 F.3d 1151, 1160 (6th Cir. 1994)) (internal quotation marks omitted); see also Ross v. South Bank, N.A., 885 F.2d 723, 736 (11th Cir. 1989) (Tjoflat, J., concurring) (“[T]he majority today focuses on what I term the economic unmarketability of the bonds: could the bonds, because of the enormous risk
first put forth in *Shores*. There, the court noted that the fraud-created-the-market theory cannot be satisfied merely by showing that the fraud caused the security to be issued at an aberrant price; the plaintiff must show instead that the security would never have been issued “at any price.” That is, the security must be patently worthless.

The economic unmarketability standard has generated controversy since its *Shores* beginnings. Critics have doubted whether a security can ever be so flawed that it could not be offered at any price. Indeed, applying this worthlessness standard to *Shores* arguably casts doubt on the court’s holding because the plaintiffs recovered approximately thirty-seven percent of their initial investment. Thus, the bonds were not patently worthless and could have been issued at some price—namely, thirty-seven percent of the original offering. Nonetheless, the Eleventh Circuit later followed *Shores* by applying the economic unmarketability standard in *Ross v. South Bank, N.A.*

Perhaps responding to the problems associated with valuing the worth of a security, the Fifth Circuit later refined the economic unmarketability standard in *Abell v. Potomac Ins. Co.* There, the court opined that the Supreme Court’s decision in *Basic* allows the circuit courts to formulate their own tests to meet the reliance presumption. Consequently, the court held that the presumption is only available “where the promoters knew that the subject enterprise was worthless when the securities were issued, and successfully issued the

---

94 See Herzog, supra note 9, at 379.
95 Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981).
96 Id. at 464 n.2.
97 See Ross, 885 F.2d at 736 (Tjoflat, J., concurring) (“[N]o matter how great the risk of nonpayment, a bond can virtually always be sold at some combination of price and interest rate . . . . [A] bond can never be completely worthless . . . . [Economic unmarketability] creates a test that in both theory and practice cannot be met . . . .”); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122 (5th Cir. 1988) (“[S]aleable assets may bless even the most worthless enterprise.”).
98 Shores, 647 F.2d at 464 n.1.
99 885 F.2d 723 (11th Cir. 1989). The Eleventh Circuit, an offspring of the former Fifth Circuit, adopted as binding precedent all Fifth Circuit decisions handed down prior to October 1, 1981. Bonner v. City of Prichard, 661 F.2d 1206, 1209 (11th Cir. 1981).
100 Abell, 858 F.2d at 1122.
101 Id. at 1120.
This revision focuses on the intent of the promoter.

3. Factual Unmarketability

The third form of unmarketability is factual unmarketability. This approach focuses on whether a regulatory body or agency would have prevented the security from coming to market at its actual price and interest rate had it known of the information fraudulently withheld. Judge Tjoflat, who had previously dissented in Shores, coined the term in his concurrence in Ross v. South Bank, N.A. He interpreted Shores as setting forth a factual unmarketability test that allows an investor to rely on a regulatory entity to establish the correct price and interest rate of a newly-issued security.

The factual unmarketability standard relies on the reasoning of Arthur Young & Co. v. United States Dist. Court, where the court stated that "the purchaser of an original issue security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to appropriate agencies and the investors at the time of the original issue." Thus, factual unmarketability does not run into the difficulties that economic unmarketability faces because it does not require the security to be worthless. Nor does it require the security to be issued unlawfully, as is required by legal unmarketability.

Where the standard does face difficulty, however, is in its reliance on a regulatory body. Although factual unmarketability presumably allows an investor to rely on any regulatory entity to police

---

102 Id. at 1122–23 (emphasis added).
103 Malack v. BDO Seidman, LLP, 617 F.3d 743, 748 (3d Cir. 2010) (quoting Ross, 885 F.2d at 733–36 (Tjoflat, J., concurring)).
104 Id. at 1122–23 (emphasis added).
105 Id.
106 Id.
107 "Even an extraordinarily risky security is entitled to be marketed; but a security that presumably would never have been issued by an entity but for the fraudulent scheme, some 'regulatory' entity (whether official or unofficial) would not have allowed the security to come onto the market at its actual price and interest rate." Ross, 885 F.2d at 736 (Tjoflat, J., concurring).
108 See supra note 90 and accompanying text.
the primary markets, it is the SEC that regulates new issues of securities by requiring issuers to register and disclose certain information.\footnote{109} Relying on the SEC to prevent a fraudulent security from coming to market is problematic for two reasons. First, the securities laws provide several exemptions to SEC registration; the SEC does not review such exempted securities.\footnote{110} More importantly, while the SEC requires issuers to disclose certain information, the agency does not judge the merits of those disclosures.\footnote{111} The fact that an investor cannot rely on the SEC to set the correct price for a newly-issued security thus seriously undermines the validity of factual unmarketability.\footnote{112}

D. Rejections of the Fraud-Created-the-Market Theory

The Sixth and Seventh Circuits have failed to recognize the fraud-created-the-market theory despite having the opportunity to do so. The Seventh Circuit rejected the theory first in 
\textit{Eckstein v. Balcor Film Investors}.\footnote{113} The court, repudiating the holding in \textit{Shores} instead of parsing through the different unmarketability variations,\footnote{114} held that full disclosure does not keep a security from being marketed but may merely lower its price.\footnote{115} The court held that “the linchpin of \textit{Shores}—that disclosing bad information keeps securities off the market, entitling investors to rely on the presence of the securities just as they would rely on statements in a prospectus—is simply false.”\footnote{116}

The Seventh Circuit limited its holding to rejecting \textit{Shores} and thus left open the possibility that it would recognize the fraud-created-the-market theory under different facts.\footnote{117} That is, had the issuer known that the securities were worthless or had the securities

\footnotesize{
\begin{itemize}
  \item \textit{HAZEN}, supra note 46, § 9.2.
  \item See \textit{Herzog}, supra note 9, at 381.
  \item See \textit{id.}, infra Part IV.
  \item See \textit{Herzog}, supra note 9, at 381.
  \item 8 F.3d 1121 (7th Cir. 1993). The case involved partnership interests, registered and sold as securities, which declined in value after the issuer’s venture failed. \textit{Id.} at 1123. The interests were sold subject to a $35 million floor—the securities would not be issued if the issuer sold less than that amount. \textit{Id.} at 1130. A group of plaintiffs who had not read the prospectus sued on the theory that, but for the misrepresentations and omissions, the investors who had read the prospectus would not have purchased the securities and the $35-million-floor requirement would not have been reached. \textit{Id.} Thus, the securities would not have been issued. \textit{Id.}
  \item \textit{Id.}
  \item \textit{Id.} at 1131.
  \item \textit{Id.}
  \item \textit{See id.} at 1130.
\end{itemize}
}
been issued illegally—thus respectively satisfying the economic unmarketability or legal unmarketability standards—the court’s decision may have been different.

Following Eckstein, the Sixth Circuit failed to apply the fraud-created-the-market theory in a class action arising from a bond issuance.\(^ {118} \) In Ockerman, the bonds were issued to finance the construction and operation of a nursing home.\(^ {119} \) When the project went bankrupt, the bond purchasers suffered substantial losses, and the plaintiff sued on behalf of a class of investors.\(^ {120} \) The plaintiff asked the court to presume reliance even though some of the investors had not read the defendant’s offering circular and there was no efficient market for the bonds.\(^ {121} \)

The court refused to grant the presumption of reliance.\(^ {122} \) Although one of the problems with the fraud-created-the-market theory is defining “unmarketability,”\(^ {123} \) the court noted that the plaintiff’s claim would have failed under either economic or legal unmarketability.\(^ {124} \) First, the bonds were not worthless because the defendants sold the project after it declared bankruptcy (albeit for a fraction of the original issuance price).\(^ {125} \) Second, there was nothing in the record to indicate that the defendants used fraudulent means to issue the bonds illegally.\(^ {126} \) Thus, the plaintiff was not entitled to presume reliance and instead had to prove that the investors directly relied on the offering circular.\(^ {127} \) Notably, the court limited its holding to the facts of the case and withheld an absolute rejection of the theory.\(^ {128} \)

\(^ {118} \) Ockerman v. May Zima & Co., 27 F.3d 1151, 1161 (6th Cir. 1994). The Sixth Circuit had previously held that the fraud-on-the-market theory does not apply to inefficient primary markets without expressly ruling on the validity of the fraud-created-the-market theory. See Freeman v. Laventhal & Horwath, 915 F.2d 193, 197, 200 (6th Cir. 1990).

\(^ {119} \) Ockerman, 27 F.3d at 1153.

\(^ {120} \) Id. at 1154.

\(^ {121} \) Id.

\(^ {122} \) Id. at 1161.

\(^ {123} \) Id. at 1160.

\(^ {124} \) The court did not mention factual unmarketability.

\(^ {125} \) Ockerman, 27 F.3d at 1160.

\(^ {126} \) Id.

\(^ {127} \) Id.

\(^ {128} \) Id.
III. THE MALACK DECISION

A. Overview of the Decision

An analysis of the decisions that have addressed the fraud-created-the-market theory readily demonstrates the lack of uniformity across the circuits. Some courts have accepted the theory but have branched out beyond Shores; others have rejected parts of the theory; still others have refused to rule on its validity. The Third Circuit inherited this jurisprudential morass when Malack v. BDO Seidman, LLP reached its docket. The court, perhaps in response to the confusion and controversy surrounding the theory, issued the most thorough rejection of the fraud-created-the-market theory to date.

The plaintiff, John Malack, and other investors purchased high-yield notes issued by subprime mortgage originator American Business Financial Services, Inc. (“American Business”) between October 2002 and January 2005. The notes were non-transferrable and thus did not trade in an efficient market. The notes were also registered with the SEC, and the defendant BDO Seidman, LLP (“BDO”) provided American Business with audit opinions needed to complete the SEC filings.

American Business filed for bankruptcy in early 2005. Three years later, Malack sued under Section 10(b) and Rule 10b-5 and sought class certification. Malack alleged that the BDO audit opinions were deficient and that, without clean opinions, American Business would not have been able to register the notes with the SEC, the notes would not have been issued, Malack would have never bought the notes, and there would be no injury. Malack requested that reliance be presumed based on legal unmarketability. The district court denied the request.

The Court of Appeals for the Third Circuit affirmed the district court’s denial of class certification, holding that Malack did not show

129 See supra Part II.C–D.
130 See supra Part II.C–D.
131 617 F.3d 743 (3d Cir. 2010).
132 Id. at 744–45.
133 Id. at 745.
134 Id.
135 Id.
136 Id. at 745–46.
137 Malack, 617 F.3d at 745.
138 Id.
139 Id. at 746.
that the class was entitled to a presumption of reliance. 140 The court first explained the two presumptions of reliance that the Supreme Court has already endorsed. 141 Next, the court defined and explained the fraud-created-the-market theory and the three variations of unmarketability that have emerged post-Shores. 142 The court then discussed presumptions and the factors that a court should use when considering whether to grant a presumption; such factors include common sense, probability that proof of one fact allows for an inference of another fact, and congressional policies. 143

According to the court, common sense called for rejecting the fraud-created-the-market theory. 144 The theory’s underlying assumption—that a security’s availability on the market is an indication of its genuineness—is illogical because none of the entities involved in the security’s issuance guarantee against fraud. 145 The corporate entities involved in issuing the security—the promoter, underwriter, auditor, and legal counsel—cannot be relied on to prevent fraud because they are seeking to profit from the issuance. 146 Thus, these entities are self-interested at best and dishonest at worst. 147 Relying on entities that are seeking to profit from the issuance to prevent fraud would therefore be contrary to common sense.

Similarly, the SEC—the entity with which the American Business notes were registered—cannot be relied on because the agency does not judge the merits of the disclosures associated with an issuance. 148 Instead, the SEC’s purpose is to ensure full disclosure without focusing on the accuracy of those disclosures. 149 Disclosure of negative information might lead to a reduction in offer price, but not to exclusion from the market. 150 The notes, therefore, would have been issued irrespective of whether BDO’s audit was accurate.

Probability also supported disallowing the presumption. 151 The fact that a security makes it to the market does not permit the infer-
ence that all securities that become marketable are free from fraud. Such an inferential leap would lead to an investor’s insurance that eliminates the need for a plaintiff to ever prove reliance. The court opined that “[a]ny investor who purchases any security could point to the security’s availability on the market to satisfy the reasonable reliance element of a Section 10(b) claim.” Moreover, the fraud-created-the-market theory is not supported by empirical studies and economic theory. The Efficient Capital Market Hypothesis, underlying the fraud-on-the-market theory, does not apply to issuances because primary markets are inefficient. Probability therefore does not lend itself to presuming that the bonds are free from fraud merely because they made it to the market.

The Third Circuit also highlighted that the fraud-created-the-market theory may disserve important policy goals. For one, recent legislation points towards Congress’s desire to narrow the scope of Section 10(b) liability. The Private Securities Litigation Reform Act of 1995, for example, mandates stricter requirements for private securities actions. Moreover, creating a form of investor’s insurance that could be invoked at any time that a security has made it to market is contrary to public policy. Instead of informing investors via disclosures, such a presumption incentivizes investors to ignore disclosures altogether because presence in the market alone is enough to satisfy the reliance requirement. In this sense, the theory also promotes frivolous lawsuits by relieving the plaintiff of an important evidentiary burden. In turn, plaintiff class certification becomes easier and issuers are pressured to settle claims. This harms all market participants as the overall cost of issuing securities increases. Thus, the court held that extending Section 10(b) liability is for Congress

---

152 Id. at 752.
153 Id.
154 See supra note 47.
155 Malack, 617 F.3d at 752–55.
156 Id. at 754 (citing Stoneridge Inv. Partners, LLC v. Scientific-Atlantica, Inc., 552 U.S. 148, 157 (2008)).
157 S. REP. NO. 104-98 (1995). The PSLRA attempts to establish a stricter loss causation requirement for securities fraud claims and seeks to limit meritless securities fraud claims. Id. at 4, 23.
158 Malack, 617 F.3d at 752.
159 Id. at 753.
160 Id. at 755.
161 Id.
not the judiciary and refused to adopt the fraud-created-the-market theory.\footnote{162}{Id. at 754.}

Despite this outright rejection, the court proceeded to analyze Malack’s claim that the American Business notes were legally unmarketable.\footnote{163}{Id. at 755–56.} The claim easily failed this standard because nothing in the record supported the assertion that American Business or its notes were illegal, irrespective of whether BDO’s audit was deficient.\footnote{164}{Id. at 756.} In other words, there was nothing to stop the securities from coming to the market. As such, the court refused to presume reliance and it ultimately denied class certification.\footnote{165}{Id. at 756.}

\textbf{B. Discussion}

The \textit{Malack} court gave a thoughtful and thorough explanation as to why it rejected the fraud-created-the-market theory. Unlike prior circuits that have addressed the issue, the Third Circuit made clear that it was rejecting the theory as a whole, rather than declining to apply it to certain factual scenarios.\footnote{166}{Malack, 617 F.3d at 755 n.10.} This will likely bring welcomed clarity to lower courts and securities lawyers alike. Despite the absolute rejection, however, Malack’s claim was weak, and the court would have denied class certification under any of the unmarketability variations articulated in previous cases.

The legal unmarketability standard—perhaps the clearest of the three variations—requires a security to be issued illegally.\footnote{167}{See supra note 91 and accompanying text.} Here, there was no indication or allegation that the American Business notes were issued contrary to any state or federal law. Similarly, had the court endorsed economic unmarketability as set forth in \textit{Abell}, Malack would have had to show that the notes were patently worthless and that BDO knew the notes were patently worthless.\footnote{168}{Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122 (5th Cir. 1988).} As noted above, proving that a bond is worthless imposes a heavy, and perhaps impossible, burden on a plaintiff.\footnote{169}{See supra note 97 and accompanying text.} Here, the investors who purchased the American Business notes may have been able to recoup

\begin{itemize}
\item \footnote{162}{Id. at 754.}
\item \footnote{163}{Id. at 755–56. It is interesting that the Third Circuit analyzed the \textit{T.J. Raney & Sons} legal unmarketability standard despite promulgating a blanket rejection of the fraud-created-the-market theory. This inevitably invites the question of whether, had the fraud been more egregious or fit squarely into one of the unmarketability variations, the Court would have decided the case differently.}
\item \footnote{164}{Malack, 617 F.3d at 755–56.}
\item \footnote{165}{Id. at 756. }\textit{But see supra} Part II.D.
\item \footnote{166}{Malack, 617 F.3d at 755 n.10.}
\item \footnote{167}{See supra note 91 and accompanying text.}
\item \footnote{168}{Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122 (5th Cir. 1988).}
\item \footnote{169}{See supra note 97 and accompanying text.}
\end{itemize}
some of their principal after American Business went bankrupt. The investors could have also been paid interest on the notes up until bankruptcy. Either scenario would show that the notes were not patently worthless, thereby making an economic unmarketability argument unviable.

The Third Circuit might have presumed reliance under factual unmarketability if Malack could have shown that, absent the fraud, a regulatory entity would not have allowed the security to come onto the market at its actual price and interest rate. In one sense, this is a fairly easy standard to satisfy because most material misrepresentations or omissions will affect offering price. On the other hand, the standard is flawed for the same reasons set forth in the opinion—the SEC does not conduct merit review and the parties issuing the security are self-interested. Because there is no agency or entity passing on the adequacy of disclosure information, the court cannot presume reliance.

IV. THE FUTURE OF THE FRAUD-CREATED-THE-MARKET THEORY

The Malack decision widened the circuit split and should prompt calls for the Supreme Court to address the validity of the fraud-created-the-market theory. Without guidance from the Supreme Court, lower courts dealing with the issue face the difficult task of stemming frivolous litigation while maintaining effective avenues for relief where such relief would otherwise prove impossible. While the Third Circuit decided Malack correctly, the court went too far in closing off all possibilities of presuming reliance under the fraud-created-the-market theory.

The Exchange Act’s broad goal of promoting fair markets cannot be achieved by ensuring full disclosure alone. While full and fair disclosure is undoubtedly a central tenet of the Exchange Act, it should be considered one means of attaining fair and honest markets. The Supreme Court has espoused the view that securities legislation should be construed “not technically and restrictively, but flexibly to effectuate its remedial purposes.” To that end, where a fraudulent scheme is so pervasive and insidious that it renders a security completely unmarketable, individuals should not have to prove

170 See Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976)) (“The Supreme Court has held that the acts were designed ‘to protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing.’”).
171 Shores, 647 F.2d at 470.
that they meticulously analyzed every detail of a prospectus to satisfy the reliance requirement. Class certification should be attainable by a less onerous standard. Although the fraud-created-the-market theory is an imperfect doctrine and requires some flexibility, the theory provides a plaintiff class with such a standard. In order for it to be workable, however, the Court must clarify the theory in a way that limits frivolous litigation.

At the core of the fraud-created-the-market controversy is that almost every court analyzing the theory has treated it as an extension of the fraud-on-the-market theory. This reasoning is problematic because the economic justifications of the fraud-on-the-market theory are inapplicable to the primary market. In an actively-traded securities market, an investor can rely on the market to display all available information. But that market has yet to develop for newly-issued securities like the American Business notes, and the *Malack* court was correct in pointing out the differences between the two. If the fraud-created-the-market theory is to survive, then, the Court must first carefully distinguish between the two theories. The fraud-created-the-market theory should not be considered an extension of the fraud-on-the-market theory because the latter is supported by a rationale that is ill-suited for the primary market. The former can and should survive in some form, but only if the two theories remain distinct.

The Supreme Court must also revise and condense the economic, factual, and legal unmarketability variations. The circuit courts have had difficulty defining unmarketability and, consequently, they have defined and applied the three variations haphazardly. Setting forth a unified standard will provide investors, issuers, and courts with the necessary clarity for effective and efficient litigation. Though this is a better alternative than rejecting the theory completely, the Court will have to articulate one single standard.

Economic unmarketability is problematic because of the difficulties associated with determining whether a security is worthless. As

---

173 See Peter J. Dennin, Note, Which Came First, the Fraud or the Market: Is the Fraud-Created-the-Market Theory Valid under Rule 10b-5?, 69 FORDHAM L. REV. 2611, 2648 (2001).
174 See supra Part II.C.
175 See supra note 47 and accompanying text.
176 See supra note 47 and accompanying text.
177 See *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 751 n.9 (3d Cir. 2010).
178 See supra Part II.C.1–3.
179 See supra note 97 and accompanying text.
Judge Tjoflat pointed out in *Ross v. South Bank, N.A.*, nearly all bonds have some worth.\(^{180}\) Moreover, factual unmarketability relies on the existence of an entity conducting merit review that does not exist.\(^{181}\) The SEC does not have the capability to verify the accuracy of the offering disclosures for each security being issued, nor is it designed to do so.\(^{182}\) It is instead the responsibility of the individual investor to determine whether the investment is sound given the information provided.\(^{183}\)

Legal unmarketability offers the best starting point for developing a clear and concise standard that can close the circuit split. It is a narrow standard that allows an investor to rely only on the fact that a security was issued legally; the investor can assume that the issuing entities will not act contrary to any state or federal law.\(^{184}\) Relying on the issuing entities, as opposed to a regulator such as the SEC, alleviates the merit-regulation problem associated with factual unmarketability.

One problem inherent in a legal unmarketability standard is that investors are in effect relying on self-interested corporate entities.\(^{185}\) As such, issuers are not vouching for the lawfulness of the security; they merely want to get the security to the market for monetary gain. Critics thus argue that relying on entities involved in an issuance runs contrary to common sense.\(^{186}\) Although this criticism is logical, accepting it is to implicitly condone deceitful practices that are conducted to profit from unsuspecting and often underequipped investors. Thus, while relying on self-interested actors might require a stretch of logic, it allows the promotion of honest and fair markets to remain the central focus of the Exchange Act and Rule 10b-5. Given the Court’s flexibility in interpreting the securities laws to reach Congress’s goal, plaintiffs should be able to rely on a security’s legality. Moreover, the legal unmarketability standard is a high burden to meet—it requires the plaintiff to prove that the issue was marketed illegally, not merely that it was overpriced.\(^{187}\) Thus, plaintiffs will necessarily use the presumption in limited circumstances, and this will

\(^{180}\) Ross v. Bank South, N.A., 885 F.2d 723, 736 (11th Cir. 1989) (Tjoflat, J., concurring).

\(^{181}\) See id. at 735–36.

\(^{182}\) See Joseph v. Wiles, 223 F.3d 1155, 1165–66 (10th Cir. 2000).

\(^{183}\) See Herzog, supra note 9, at 390.

\(^{184}\) For a discussion of legal marketability, see supra Part II.C.1.

\(^{185}\) Ross, 885 F.2d at 739–41 (Tjoflat, J., concurring).

\(^{186}\) See, e.g., Malack v. BDO Seidman, LLP, 617 F.3d 743, 749–50 (3d Cir. 2010).

\(^{187}\) See supra note 91 and accompanying text.
hardly lead to the investor’s’ insurance that courts have been loath to create.

The scienter requirement built into Rule 10b-5 actions provides an additional protection against creating a form of investor’s’ insurance.\footnote{See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976). Lower courts have held that recklessness is sufficient to satisfy the scienter requirement in a 10b-5 action. See, e.g., Broad v. Rockwell Int’l Corp., 642 F.2d 929, 961–62 (5th Cir. 1981) (en banc).} Here, the Court can require that a plaintiff seeking the benefit of the fraud-created-the-market theory must show that the defendant issuer knew that it lacked the legal authority to offer the security but did so anyway. If the plaintiff cannot show an intentional breach of state or federal law, or the issuer can show that it acted innocently, the plaintiff cannot avail herself of the presumption and must prove direct reliance instead.

The Court should also make clear an additional limitation. Like in the two presumptions of reliance that have preceded the fraud-created-the-market theory,\footnote{See supra notes 40, 57 and accompanying text.} a defendant should have the opportunity to rebut the presumption. A defendant could accomplish this by showing that the security was not issued illegally or by showing that the purchaser knew of the illegality but purchased the security anyway. Such a measure would act to limit frivolous litigation, preserve the goals of securities laws, and avoid creating a form of investor’s’ insurance.

Thus, the Court might set forth this standard: A plaintiff is entitled to the fraud-created-the-market presumption if she proves that: (1) the defendant conspired to bring securities to the market intending to defraud purchasers when the defendant knew that the securities were not issued according to state or federal law; (2) the plaintiff reasonably relied on the security’s availability in the market as an indication that the security was issued legally; and (3) as a result of the scheme to defraud, the plaintiff suffered a loss.

V. CONCLUSION

The fraud-created-the-market theory is a contentious tool for private Section 10(b) and Rule 10b-5 actions. The theory allows plaintiffs to presume reliance in the primary market and thus allows for class certification where it would be unattainable otherwise. The courts of appeals that have addressed the issue have struggled to fit the theory within Section 10(b) and Rule 10b-5 jurisprudence.\footnote{See supra Part II.C.}
With the *Malack* decision, the Third Circuit joined the circuit split with a decisive rejection of the theory. *Malack* should prompt the Supreme Court to resolve the issue. A resolution is even more important during a time of unprecedented market change and regulatory upheaval.

Abrogating the fraud-created-the-market theory goes too far. The theory can be a valid mechanism for providing effective relief from egregious cases of securities fraud. This can only be accomplished, however, by distinguishing the theory from the presumptions of reliance that have preceded it and by unifying the variations of unmarketability that have emerged in the lower courts. Further, the Court must carefully articulate the limitations built into the presumption because such limitations will prevent the flood of frivolous litigation that could accompany a relaxation of the traditional requirement of direct reliance and will avoid rewarding investors for careless behavior.

Legal unmarketability, first articulated by the U.S. Court of Appeals for Tenth Circuit, offers the Supreme Court the best starting point for setting forth a workable standard. Investors should be able to rely on issuers to market securities that are legal, and issuers should be held liable for knowingly issuing securities that breach governmental regulations. It is here that the Court can achieve the critical balance of providing needed investor relief while upholding the goals of the securities laws.

---

101 *See supra* Part III.