MISMATCH: THE MISUSE OF MARKET EFFICIENCY IN MARKET MANIPULATION CLASS ACTIONS

CHARLES R. KORSMO*

ABSTRACT

Plaintiffs commonly bring two distinct types of claims under section 10(b) of the Securities Exchange Act of 1934: (1) claims of material misrepresentations or omissions, and (2) claims of trade-based market manipulation. Despite the distinctive features of the two types of claims, courts have tended to treat them identically when applying the “fraud on the market” doctrine. In particular, courts have required both types of plaintiffs to make identical showings that the relevant security was traded in an “efficient market” in order to gain a presumption of reliance. The reasons for requiring such a showing by plaintiffs in a misrepresentation case are, however, inapplicable in market manipulation cases. Plaintiffs alleging market manipulation should not be required to demonstrate an efficient market in order to benefit from the fraud on the market doctrine’s presumption of reliance. If plaintiffs are made to make any showing at all, it should be a showing of loss causation.

* Visiting Assistant Professor, Brooklyn Law School. I am grateful to Edward Cheng, Robin Effron, James Fanto, Henry Hansmann, Roberta Karmel, Minor Myers, James Park, Roberta Romano, and Ralph K. Winter, Jr., for their helpful comments, and to Dean Joan Wexler for research support. All errors are my own.
TABLE OF CONTENTS

INTRODUCTION .............................................. 1113
I. 10B-5 ACTIONS AND THE FRAUD ON THE MARKET
   DOCTRINE ............................................. 1119
      A. Origins of the 10b-5 Action ......................... 1119
      B. The Fraud on the Market Doctrine ................. 1123
         1. Theoretical Underpinnings of the
            Fraud on the Market Doctrine .................. 1124
         2. Basic Inc. v. Levinson .......................... 1128
         3. Implementation by the Lower Courts—The
            Requirement of an “Efficient Market” .......... 1131
II. MARKET MANIPULATION ................................. 1135
      A. Defining Market Manipulation .................... 1135
      B. Real-Life Examples of Alleged Market
         Manipulation ........................................ 1137
            1. United States v. GAF Corporation ............ 1138
            2. United States v. Milken ..................... 1139
            3. United States v. Mulheren .................. 1139
            4. In re IPO Securities Litigation ............... 1140
            5. Desai v. Deutsche Bank Securities ............ 1141
      C. Conditions for Successful Market Manipulation .... 1143
         1. Liquidity and Demand Effects ....................... 1143
         2. Information Effects .............................. 1148
III. THE “EFFICIENT MARKET” REQUIREMENT IN
     MANIPULATION CLAIMS ............................... 1151
IV. IPO AND DESAI—THE “EFFICIENT MARKET”
    REQUIREMENT IN ACTION ............................... 1157
      A. In re IPO Securities Litigation .................. 1158
         1. Initial District Court Proceedings ............. 1159
         2. Appeal to the Second Circuit—IPO III .......... 1160
         3. Back to the District Court .................... 1163
      B. Desai v. Deutsche Bank Securities ............... 1165
         1. Minnesota District Court ....................... 1165
         2. California District Court ....................... 1166
         3. The Ninth Circuit Opinion ....................... 1168
V. OUT OF THE MUDDELE: A “LOSS CAUSATION”
    REQUIREMENT ......................................... 1171
CONCLUSION ............................................... 1180
INTRODUCTION

On May 20, 2009, the SEC filed a civil complaint against eight participants in an alleged scheme to manipulate the prices of at least four “penny stocks”—a scheme which allegedly netted the participants illicit profits of at least $6.2 million. The allegations regarding one of the four companies, Asia Global Holdings Corporation, are representative. Asia Global shares trade over-the-counter, and traded for around $0.11 per share in August of 2006, just prior to the manipulation. Average trading volume was extremely light, with only a few hundred thousand shares—less than $100,000 worth—changing hands in a typical trading week. On August 9, 2009, the manipulators sprang into action and began to engage in massive “wash sales, matched orders, and other manipulative trading, to give the market the false impression that there was real demand for these securities.” Trading volume jumped to more than ten million shares per week, and the share price jumped to an intraday high of $0.41 on August 25. Between August 30 and September 5, a week during which trading volume peaked at more than forty million shares, the manipulators dumped nearly eight million shares into the wave of demand, netting approximately $1.3 million. By December of 2006, Asia Global stock was selling below

1. A penny stock is one with a price under $5 per share, usually trading in an over-the-counter market. For a full definition, see SEC Rule 3a51-1, 17 C.F.R. § 240.3a51-1 (2010).
2. See Complaint at 1, SEC v. Dynkowski, No. 1-09-CV-00361-GMS, 2009 WL 2491686 (D. Del. May 20, 2009). Although the allegations are still mere allegations at this point, they will be treated here as if they are true, in order to avoid an unsightly “allegedly” in every sentence.
3. Id. at 6.
5. See id.
6. Complaint, supra note 2, at 2, 12. “Wash sales” are securities transactions in which there is no change in actual, beneficial ownership, whereas “matched orders” are offsetting purchases and sales entered into by a single party or by members of a pool. See infra notes 31-32 and accompanying text.
7. Complaint, supra note 2, at 12; Google Finance, supra note 4.
9. Complaint, supra note 2, at 12.
That these manipulations took place in small, thinly traded stocks—far from the glare of Wall Street analysts and the financial press—is wholly predictable. To see why, one need only ask what conditions must be met for such a “trade-based” market manipulation to succeed. First and foremost, a would-be manipulator seeks to create a fraudulent price/volume “signal,” giving other traders a misleading impression of increased demand for the stock and falsely suggesting that someone has uncovered important new information about the company.

To do so, a manipulator seeks to create a noticeable “spike” in a stock’s price—a spike that other traders, perhaps naïve day traders searching for stocks with “momentum,” will notice and then amplify through their own trading, allowing the manipulator to sell into the resulting wave at a profit. How can such a price spike be created? One potential way would be to buy enough shares all at once to overwhelm the readily available supply of sellers, forcing the price up through liquidity effects.

Even if this fails to create a price spike, it may still create a noticeable surge in the stock’s trading volume—a surge that could convince other traders that someone has uncovered valuable new information, and lead them to adjust their estimate of the stock’s value upward.

Such a strategy is highly unlikely to be successful with a blue-chip stock like Microsoft. Would a manipulator be able to create a price spike by overwhelming the readily available supply of Microsoft shares? More than fifty million shares of Microsoft stock change hands on an average day—well over $1 billion worth. How many hundreds of millions, or billions, of dollars would need to be put at risk for manipulative buying to stand out in this torrent of trading? Even if the manipulator is able to stand out, how likely is it that the sophisticated arbitrageurs following Microsoft will be fooled into thinking the “signal” is the result of new material infor-
mation about a company covered relentlessly by the press and hundreds of professional security analysts?

The natural targets for trade-based manipulations are not blue-chip stocks like Microsoft—the chances of success are too remote, the financial risk too ruinous. The natural targets are cow-chip stocks like Asia Global.13 A relatively modest buying spree could easily cause a noticeable spike in price and trading volume, which in turn could attract momentum traders and stimulate a wave of buying. Furthermore, it will seem far more plausible to the penny stock traders that the manipulative trading activity signals the presence of new material information about a less closely followed company.

Thus, that the manipulations alleged by the SEC in its May 20, 2009, complaint took place in penny stocks is entirely unsurprising. What may seem surprising, however, is that no follow-up class actions have been filed by injured shareholders. It may be that the amounts at stake are too small to attract litigation. But it may also be for another reason—one having little to do with economics and everything to do with the legal rules governing class actions alleging market manipulations. Due to a doctrinal flaw, shareholders of Asia Global would almost certainly be unable to achieve class certification, no matter how compelling their allegations of manipulation. Conversely—and perversely—shareholders of Microsoft would face few difficulties in certifying a similar class, and thus obtaining leverage for a settlement, no matter how implausible their allegations of manipulation. The sources of this curious result—and a suggestion for remedying it—are the subject of this Article.

The problem finds its root in Basic Inc. v. Levinson, the landmark case in which the Supreme Court adopted the “fraud on the market” (FOTM) doctrine,14 allowing plaintiffs in Rule 10b-515 securities fraud claims a presumption of reliance in class action cases involving transactions in open and developed securities markets.16

13. One survey of SEC enforcement actions from 1990 to 2001 found that “most manipulation cases happen in relatively inefficient markets, such as the OTC Bulletin Board and the Pink Sheets, that are small and illiquid.” Rajesh K. Aggarwal & Guojun Wu, Stock Market Manipulations, 79 J. Bus. 1915, 1917 (2006).
16. As will be discussed in Part I.B, the basic intuition of the FOTM doctrine is that the
Prior to the acceptance of the FOTM doctrine, the need to show individual reliance served as a virtually insurmountable barrier to class certification in 10b-5 cases. In order to gain this presumption of reliance, however, the Court required plaintiffs to demonstrate that the relevant security traded in an “efficient market.” Though sometimes criticized and often inconsistently applied by lower courts, requiring plaintiffs to show market efficiency has, since Basic, served as one of the primary gatekeeping requirements for class certification—a role that takes on added significance in a world where securities lawsuits are virtually always settled once a class has been certified. In arguing the logic and necessity of the requirement that plaintiffs demonstrate an “efficient market,” however, courts and commentators have focused on the kind of claims at issue in Basic—allegations of material misrepresentations or omissions affecting the market price of a security (“misrepresentation claims”). At the same time, they have largely ignored the other common type of claim under section 10(b) of the Securities Exchange Act of 1934—allegations of the kind of trade-based manipulative schemes discussed above (“manipulation claims” or “market manipulation claims”). Allegations of market manipulation have been lumped together with more straightforward allega-

17. See, e.g., Cannon v. Tex. Gulf Sulphur Co., 55 F.R.D. 306, 307 (S.D.N.Y. 1971); Reynolds v. Tex. Gulf Sulphur Co., 309 F. Supp. 566, 567-69 (D. Utah 1970), aff’d sub nom. Mitchell v. Tex. Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971). The difficulty existed for two distinct reasons. First, as a matter of fact, most ordinary investors may not have read the relevant documents, or otherwise have seen or heard the alleged misrepresentations. Second, the need to show which of the plaintiffs did, in fact, hear about and rely on the alleged misrepresentations would cause individual issues to predominate, making class certification inappropriate. Fed. R. Civ. P. 23(b)(3); Basic, 485 U.S. at 242 (recognizing that individualized proof of reliance effectively makes it impossible to proceed as a class because “individual issues then would ... overwhelm[] the common ones”).


19. See Richard A. Nagareda, Class Certification in the Age of Aggregate Proof, 84 N.Y.U. L. Rev. 97, 99 (2009) (“With vanishingly rare exception, class certification sets the litigation on a path toward resolution by way of settlement, not full-fledged testing of the plaintiffs’ case by trial.”).

20. See infra Part II (discussing market manipulation).
tions of misrepresentations and treated, without analysis, as if they were interchangeable for the purposes of FOTM analysis.

In particular, plaintiffs alleging market manipulation have been required to make the same showing of market efficiency as plaintiffs alleging misrepresentations in order to invoke the FOTM doctrine and gain the benefit of a presumption of reliance. In misrepresentation cases, market efficiency serves a clear purpose: forging a causal chain between the defendant’s misrepresentation and the plaintiff’s loss. In an efficient market, it is reasonable for the plaintiff to rely on the market price, and any material misrepresentation will be quickly and accurately reflected in that price. Thus, the plaintiff can be said to have indirectly relied on the misrepresentation. This analysis, however, is turned on its head in cases involved trade-based manipulative schemes. Such schemes are more likely to have a significant effect on prices in inefficient markets and are unlikely to succeed in efficient markets. In such cases, market efficiency is likely to sever any causal connection. Nonetheless, both types of claims have been treated identically for FOTM purposes.

Although this failure to distinguish between the two kinds of 10(b) claims has long created the potential for perverse results, it has finally bloomed into the kind of doctrinal confusion on display in In re Initial Public Offering Securities Litigation and—most

22. Id.
23. See supra notes 11-13 and accompanying text.
24. “Although generally discussed in terms of misrepresentations, the reasoning [of FOTM] applies equally to instances of alleged market manipulation or other schemes to defraud. To obtain the benefit of this presumption, plaintiffs first must allege that the relevant market was open and developed or, in other words, efficient.” In re Parmalat Sec. Litig., 375 F. Supp. 2d 278, 303 (S.D.N.Y. 2005) (citation omitted); see also In re Citigroup Auction Rate Sec. Litig., 700 F. Supp. 2d 294, 304 (S.D.N.Y. 2009); In re HiEnergy Techs., Inc. Sec. Litig., No. SACV04-122600C, 2005 WL 3071250, at *4 (C.D. Cal. Oct. 25, 2005); 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 7:469 (2d ed. 2010) (noting that the Supreme Court’s decision in Basic made no distinction between the clauses of Rule 10b-5).
25. The nearly decade-long saga of In re Initial Public Offering Securities Litigation generated four published opinions of interest. The first, In re Initial Public Offering Securities Litigation (IPO I), 241 F. Supp. 2d 281, 297-98 (S.D.N.Y. 2003), denied the defendants’ motion to dismiss the original complaint. The second, In re Initial Public Offering Securities Litigation (IPO II), 227 F.R.D. 65, 122 (S.D.N.Y. 2004), granted the plaintiffs class certification in six focus cases. The third, In re Initial Public Offering Securities Litigation (IPO III), 471 F.3d 24, 45 (2d Cir. 2006), vacated the class certification. The fourth, In re
recently and most pointedly—in the recent Ninth Circuit opinion Desai v. Deutsche Bank Securities Ltd. In both cases, complaints of market manipulation foundered at the class certification stage for inability to establish market efficiency.

This Article endeavors to provide what the existing case law and academic literature sorely lacks—a principled examination of how the FOTM doctrine should be applied in the context of market manipulation claims. Part I gives a brief introduction to 10b-5 litigation and how it differs from common law fraud actions, and provides an overview of the FOTM doctrine, showing that the Basic Court adopted a form of the doctrine giving plaintiffs a double presumption—of reliance and loss causation—once they establish an efficient market.

Part II analyzes the concept of market manipulation. It discusses the various types of potential manipulative schemes and the contexts in which they are most likely to succeed, and concludes—as is suggested above—that manipulative schemes are most likely to have an effect on share prices in undeveloped, inefficient markets.

Parts III through V form the analytical core of the Article. Part III asks whether the reasons for requiring a showing of market efficiency are applicable in market manipulation cases, and finds that they are not. Indeed, because manipulations are most likely to succeed in inefficient markets, a requirement of market efficiency has the perverse effect of screening out the most plausible claims of market manipulation while allowing the most dubious lawsuits to proceed. Part III concludes by arguing—in a sharp departure from current law—that a showing of market efficiency should not be required in market manipulation cases. Part IV discusses several real-life examples of post-Basic 10b-5 actions alleging manipulative schemes and shows how courts have required plaintiffs in such cases to make the same showing of market efficiency required in misrepresentation cases.

Part V canvasses potential solutions to the problem identified here and concludes that, although the requirement that plaintiffs demonstrate market efficiency should be abolished, some gate-
keeping requirement at the class certification stage would be appropriate, particularly in light of the fact that class certification in section 10(b) cases nearly always leads to settlement before trial. To create a logical gatekeeper, the requirement that plaintiffs show market efficiency should be replaced with a requirement that plaintiffs make a preliminary showing of loss causation at the class certification stage. A showing of loss causation would (1) provide the requisite causal connection between the plaintiffs’ reliance on the integrity of the market and the manipulative conduct; (2) focus attention on the crucial question in any manipulation suit—whether the alleged manipulation distorted the market price; and (3) not require any action from Congress or the overruling of any Supreme Court precedent.

I. 10B-5 ACTIONS AND THE FRAUD ON THE MARKET DOCTRINE

A. Origins of the 10b-5 Action

In an effort to restore investor confidence in the wake of the market crash of 1929, Congress passed the Securities Act of 1933 (1933 Act), creating an elaborate system of registration and disclosure of material information to investors. The next year, Congress passed the Securities Exchange Act of 1934 (1934 Act), which sought to address the problem of stock market manipulation. The 1934 Act forbids various “manipulative” trading

30. Section 2 of the 1934 Act declares that “[n]ational emergencies, ... which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices,” 15 U.S.C. § 78b(4). Popular imagination assigned a great deal of blame for the economic catastrophe to the so-called “stock pools”—nefarious corporate insiders, banks, and speculators who allegedly combined to manipulate the stock market and cause wild gyrations in security prices. See Paul G. Mahoney, The Stock Pools and the Securities Exchange Act, 51 J. FIN. ECON. 343, 344 (1999) (“The purpose of the pools, the Senate concluded, was to manipulate the price of the chosen stock upward through the pool’s purchases, then to sell the overpriced stock prior to the inevitable price decline.”); Norman S. Poser, Stock Market Manipulation and Corporate Control Transactions, 40 U. MIAMI L. REV. 671 (1986). Registration and disclosure, however, would be insufficient to stop the widespread
practices, such as wash sales\(^{31}\) and matched orders,\(^{32}\) which could potentially be used to create a false impression of heightened trading activity and fool ordinary investors into entering the market.

In the same vein, the 1934 Act also contains a broader prohibition on trading in a security “for the purpose of inducing the purchase or sale of such security by others.”\(^{33}\) Such trading—running up the price of a stock in an attempt to excite ordinary investors into buying—was thought to be characteristic of manipulative “stock pools” prior to the crash,\(^{34}\) and the prohibition of such activities was said to be “the very heart” of the securities acts.\(^{35}\) For reasons that will soon become clear, it would have behooved Congress to maintain a clean distinction between market manipulation, on the one hand, and fraud, through false disclosure or nondisclosure, on the other. Instead, section 10(b) of the 1934 Act\(^{36}\) serves as a catchall provision making it “unlawful for any person” to “use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance” in violation of rules promulgated by the SEC.\(^{37}\) The SEC duly promulgated Rule 10b-5, titled “Employment of manipulative and deceptive devices by brokers or dealers,”\(^{38}\) which lumps together into a brief, all-encompassing rule the prohibitions on market manipulation and on material misrepresentations or omissions, categorizing them all as


\(^{32}\) Id. § 78i(a)(1)(B),(C).

\(^{33}\) Id. § 78i(a)(2).


\(^{35}\) LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 853 (2d ed. 1988) [hereinafter LOSS, FUNDAMENTALS] (quoting STAFF OF H. COMM. ON INTERSTATE & FOREIGN COMMERCE, 77TH CONG., REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, at 50 (Comm. Print 1941)).


\(^{37}\) Id.

\(^{38}\) 17 C.F.R. § 240.10b-5 (2010).
species of “fraud” or “deceit.” Not surprisingly, such a spare statutory and regulatory framework, stretched over a vast expanse of potential activities, has yielded a somewhat common-law-style interpretive approach by courts. First, although neither Rule 10b-5 nor the underlying statutes explicitly create a private cause of action, courts have been routinely recognizing an implied cause of action for more than sixty years. Most importantly for present purposes, courts have—in the absence of any controlling statutory language to guide them—invoked common law tort principles to draw the contours of this private cause of action. Just as Congress

---

39. Rule 10b-5 reads, in its entirety:
   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 statement 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.

Id.

40. See Louis Loss, The Assault on Securities Act Section 12(2), 105 HARV. L. REV. 908, 910-11 (1992) (suggesting that, because courts have essentially created a new federal tort from Rule 10b-5, “one should not be shocked to see them invoking Erie-resistant federal common law in order to invent appropriate qualifications of the new tort”); see also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (“When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.”).

41. The first court to recognize a private cause of action under 10b-5 was apparently the Eastern District of Pennsylvania. Kardon v. Nat’l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (“[T]he mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.”). Within five years, Louis Loss could say that the Kardon court’s recognition of an implied cause of action “has ... been followed in almost two score other cases” and “[n]o judge has expressed himself to the contrary.” LOUIS LOSS, SECURITIES REGULATION 1049-50 (1951) [hereinafter LOSS, REGULATION]. The Supreme Court ultimately recognized an implied private cause of action without discussion in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971), and by 1983 described its existence as “beyond peradventure.” Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983); see also 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, and constitutes an essential tool for enforcement of the 1934 Act’s requirements.”).

42. See Loss, supra note 40, at 910 (“In the common law tradition, the courts have read into rule 10b-5 not only scienter, but also the additional elements of justifiable reliance and
did not maintain a distinction between market manipulation and fraud, so, too, the courts did not distinguish between the two types of claims. Instead, the elements for all 10b-5 claims were derived by analogy to the common law tort of fraud.\textsuperscript{43} As a result, in addition to the requirements of scienter and materiality, courts have also required showings of justifiable reliance\textsuperscript{44} and loss causation.\textsuperscript{45} Though treated as separate elements in common law fraud cases—and, traditionally, in 10b-5 cases—reliance and loss causation are both relevant to the question of whether the defendant’s fraud can be considered an actual “cause” of any injury to the plaintiff. As such, the requirement of actual, justifiable reliance is often styled “transaction causation,”\textsuperscript{46} and asks whether the defendant’s fraud caused the plaintiff to enter into the relevant transaction in the first place.\textsuperscript{47} This requirement is distinct from the element of “loss causation,” which, in a 10b-5 case, asks whether the defendant’s conduct had a market impact that caused harm to the plaintiff.\textsuperscript{48} In a common law fraud case, satisfaction of the reliance element shows the causal connection between the fraud and the transaction, 

\textsuperscript{43} See Jeffrey L. Oldham, Comment, Taking “Efficient Markets” Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act, 97 Nw. U. L. Rev. 995, 1003 (2003) (“Derived primarily from the common law of fraud, the basic elements of a Rule 10b-5 cause of action have become materiality, scienter, reliance, and loss causation.”) (footnotes omitted).

\textsuperscript{44} See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976).

\textsuperscript{45} See, e.g., Robbins v. Koger Props. Inc., 116 F.3d 1441, 1447 (11th Cir. 1997). The term “loss causation” is a fraught one. In common law deceit, the alleged harm to the plaintiff is usually manifest, and “loss causation” usually functions simply to ensure that the fraud was the proximate or “legal” cause of the harm. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005). Thus, if the plaintiff were fraudulently induced to enter into a contract and was hit by a bus on the way home from signing the contract, loss causation would not be established. Many early securities law cases echoed this notion of proximate causation in defining “loss causation.” See RESTATEMENT (SECOND) TORTS § 548A (1999) (collecting cases). More recently, courts have held the loss causation requirement to mean more in the 10b-5 context—namely, that plaintiffs must demonstrate that the alleged misrepresentation or manipulation had a \textit{market impact} that caused them harm. See \textit{Dura Pharm.}, 544 U.S. at 345. This latter sense is the sense in which this Article uses the term.

\textsuperscript{46} \textit{Dura Pharm.}, 544 U.S. at 341.


\textsuperscript{48} \textit{Dura Pharm.}, 544 U.S. at 345; Robbins, 116 F.3d at 1447; see also IX \textit{LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION} 4405-07 (3d ed. 1992).
whereas satisfaction of the loss causation element shows the causal connection between the transaction and the injury to the plaintiff. Together, they work to demonstrate the causal connection between the fraud and the injury to the plaintiff.\footnote{Prior to the adoption of the FOTM doctrine, the reliance—that is, transaction causation—element in a typical 10b-5 claim required each plaintiff to show that he or she decided to buy or sell the relevant security in reliance upon the defendant’s alleged fraud. At the same time, loss causation was a more generalized question of whether the plaintiff “would not have suffered a loss if the facts were what he believed them to be,” because the stock would not have fallen in value, thus injuring the shareholders.\footnote{B. The Fraud on the Market Doctrine}

Prior to the adoption of the FOTM doctrine, the reliance—that is, transaction causation—element in a typical 10b-5 claim required each plaintiff to show that he or she decided to buy or sell the relevant security in reliance upon the defendant’s alleged fraud.\footnote{At the same time, loss causation was a more generalized question of whether the plaintiff “would not have suffered a loss if the facts were what he believed them to be,” because the stock would not have fallen in value, thus injuring the shareholders.\footnote{B. The Fraud on the Market Doctrine}}

B. The Fraud on the Market Doctrine

Although the general outlines of the 10b-5 action were borrowed by analogy from the common law tort of fraud, there are significant differences between face-to-face bargaining for real goods—the context in which the common law tort of fraud developed—and transactions on modern securities markets.\footnote{Courts have occasionally recognized that when the fraud is the type of fraud that would not have occurred in the absence of the fraud, the reliance element may be presumed. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1971) (“[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was...”)}
been forced to adapt the elements of fraud to cope with these differences.\textsuperscript{53} Perhaps the most controversial of these “adaptations” has been the adoption of the FOTM doctrine.

1. Theoretical Underpinnings of the Fraud on the Market Doctrine

Prior to the adoption of the FOTM doctrine, the requirement of individual reliance served as a barrier to class certification in 10b-5 cases.\textsuperscript{54} As early as 1967, a treatise suggested that such a requirement was both impractical and theoretically unnecessary in cases of misrepresentations involving open-market transactions,\textsuperscript{55} and argued that “a 10b-5 reliance requirement in open market transactions could be satisfied by showing that an investor who traded with reference to market price and conditions could be treated as indirectly relying on a misrepresentation which affected the market.”\textsuperscript{56} Early courts adopting the FOTM theory embraced this story of indirect reliance—the misrepresentation is heard and relied upon by some market participants, thus affecting the price in a

\textsuperscript{53} See LOSS, REGULATION, supra note 41, at 817 (“[T]he courts have repeatedly said that the fraud provisions in the SEC statutes are not limited to circumstances which would give rise to a common-law action for deceit.”); Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 Harv. L. Rev. 584, 585 (1975) [hereinafter Note, Reliance Requirement] (“[T]he courts have gone beyond the common law in defining the nature, scope, and requirements of the federal action under rule 10b-5.”).

\textsuperscript{54} See supra note 17.

\textsuperscript{55} See Oldham, supra note 43, at 1006-07.

\textsuperscript{56} BROMBERG & LOWENFELS, supra note 24, § 7:468; see also Daniel R. Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. Law. 1, 9 (1982).
measurable way, and the plaintiff then reasonably relies on the price set by the market.\textsuperscript{57}

This vision of indirect reliance suggested two possible approaches to the FOTM presumption. First, courts could presume only that the plaintiff reasonably relied on the market price and still require the plaintiff to demonstrate loss causation—that “the market price was in fact artificially affected by false information”\textsuperscript{58}—in order to connect reliance on the market to the underlying misrepresentation. Alternatively, courts could presume both reasonable reliance and loss causation—that is market impact—as long as the plaintiff can establish that the alleged misrepresentation was “material.”\textsuperscript{59} As the first circuit court to recognize the FOTM theory explicitly, the Ninth Circuit made clear that it was adopting the second of these approaches.\textsuperscript{60} In the years prior to \textit{Basic}, other circuit courts followed suit.\textsuperscript{61} Thus, allegations of a “material” misrepresentation would suffice to forge both links in the chain of indirect reliance: (1) a change in market price due to some market participants’ reliance

\textsuperscript{57} See, \textit{e.g.}, Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975) ("[A]n investor] 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."). Do not read too much into the court’s use of the term “manipulation”—the term is not being used in the specific sense reserved for it in this Article.

\textsuperscript{58} Fischel, \textit{supra} note 56, at 13.

\textsuperscript{59} Courts will consider information material “if there is a substantial likelihood that a reasonable shareholder would consider it important” in making the investment decision. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). The intuition underlying this second approach is that when there is “proof that the deception was material ... [there] is persuasive circumstantial evidence that a sufficient number of traders in the market did indeed rely.” Note, \textit{Reliance Requirement}, \textit{supra} note 53, at 593. The logic is that if the plaintiffs can establish materiality—that is, a reasonable investor would have found the misrepresentation important—then it is safe to assume that the misrepresentation actually affected the market price. Thus, reliance on the market price can be presumed to be indirect reliance on the misrepresentation.

\textsuperscript{60} Blackie, 524 F.2d at 906 (stating that “causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of [the alleged] representations,” and that “[m]ateriality circumstantially establishes the reliance of some market traders”). The Blackie court also held that the FOTM presumption could be rebutted if the defendant showed \textit{either} (1) that the particular plaintiff did not actually rely on the misrepresentation—no reliance; or (2) that an insufficient number of traders actually relied on it to cause a change in the stock price—no loss causation. \textit{Id.} As we will see, the \textit{Basic} Court adopted a very similar rebuttable presumption.

\textsuperscript{61} See, \textit{e.g.}, Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986); Panzirer v. Wolf, 663 F.2d 365, 367 (2d Cir. 1981).
on the material misrepresentation, and (2) the plaintiffs’ reasonable reliance on this altered market price.

In addition to its important practical advantages for courts, this “double-presumption” approach to the FOTM theory was given a crucial theoretical boost in 1982 when Daniel Fischel made the connection between the FOTM theory and the efficient capital markets hypothesis (ECMH). Fischel described an efficient capital market as “one in which the price of stock at a given time is the best estimate of what the price will be in the future.” In practice, when the current price of a stock is the best estimate of the future price of the stock, it means that the price reflects all available “information” about that stock. The ECMH allowed Fischel to do two

---

62. This “double-presumption” approach allows courts to avoid addressing the question of loss causation—whether, in fact, the misrepresentation had a measurable effect on the stock price—a question that is often hopelessly entangled with the merits of the lawsuit. By allowing materiality to suffice at the class certification stage, courts are able to certify classes while putting off potentially difficult, fact-intensive questions of loss causation until it is necessary to calculate damages, which is unlikely to ever be the case, given the prevalence of settlement upon class certification. See Nagareda, supra note 19, at 99.


64. Fischel, supra note 56, at 4 n.9. To put it in the language of statistics, the price of a stock in an efficient market is a martingale.

65. See Eugene F. Fama, Efficient Capital Markets, A Review of Theory and Empirical Work, 25 J. FIN. 383, 383 (1970). In principle, the ECMH can come in three forms—weak, semi-strong, and strong—depending on the type of “information” that can be considered as “fully reflected” in the price of the stock. Id. at 383-84. Weak form efficiency implies that prices fully reflect any information contained in the past movement of the stock price itself. Id. at 388. Thus, “an investor cannot enhance his/her ability to select stocks by knowing the history of successive prices and the results of analyzing them all possible ways.” JAMES H. LORIE, PETER DODD & MARY HAMILTON KIMPTON, THE STOCK MARKET: THEORIES AND EVIDENCE 56 (2d ed. 1985). Weak form efficiency is also known as the “random walk” hypothesis, because it suggests that successive price movements are independent of each other and thus will appear random. Fama, supra, at 386-87. Semi-strong form implies that prices fully reflect any information that is publicly available and quickly adjust to reflect any new publicly available information—including potential fraudulent misrepresentations. Id. at 388. At its limit, this suggests “that efforts to acquire and analyze [public] knowledge cannot be expected to produce superior investment results.” LORIE, DODD & KIMPTON, supra, at 56. Strong form implies that even nonpublic information—information known to any market participant—will be fully and quickly reflected in the price. Jonathan R. Macey & Geoffrey P. Miller, Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market
things. First, it allowed him to say that it is perfectly reasonable for individual investors to rely on the market price in efficient markets—indeed, it would be irrational for them to do otherwise.\footnote{66} Because information—including misrepresentations—in prospectuses, earnings reports, press releases, and other types of corporate disclosures will already be reflected in the market price, there is no reason investors should read them, or that the law should encourage them to do so. In fact, “investors would be wasting their money by doing so.”\footnote{67} Second, the ECMH allowed Fischel to put a more scientific gloss on the Ninth Circuit’s intuition that “[m]ateriality substantially establishes the reliance of some market traders,” and that the reliance of some market traders would affect the price, thereby establishing loss causation.\footnote{68} If the semi-strong form of the ECMH is accepted,\footnote{69} all new public material information—including misrepresentations—will by definition rapidly be reflected in the stock price.\footnote{70} The invocation of the ECMH in support of the FOTM doctrine cements the Ninth Circuit’s “double presumption” approach...
as the logical approach.\textsuperscript{71} The ECMH supports the picture of indirect reliance and strengthens both links in the resulting chain of causation.\textsuperscript{72} Notably for our purposes, though courts and commentators tended to speak of “10b-5 actions” in general, the theory underpinning the FOTM doctrine was developed with fraudulent misrepresentations in mind, with little or no attention paid to how, if at all, the theory should apply in the context of market manipulations.\textsuperscript{73}

2. Basic Inc. v. Levinson

The Supreme Court finally took up the question of the FOTM doctrine in \textit{Basic Inc. v. Levinson}. The facts of \textit{Basic} are well known. During 1977 and 1978, “Basic made three public statements denying that it was engaged in merger negotiations.”\textsuperscript{74} In December of 1978, however, another company purchased Basic. Former share-
holders sued Basic and its board of directors, alleging that they violated section 10(b) and Rule 10b-5 by falsely denying the existence of merger negotiations. The plaintiffs sought to certify a class of investors who had sold their stock after the first denial of the merger negotiations but prior to the announcement of the merger. In certifying a class, the district court permitted a presumption of reliance. The Sixth Circuit affirmed the presumption of reliance, relying on the FOTM theory and noting that Basic stock traded “in an impersonal, efficient market.” The two questions before the Supreme Court were whether false denials of preliminary merger negotiations could be material, and whether a FOTM presumption of reliance was appropriate. After determining that preliminary merger negotiations could be material, the Court took up the FOTM theory. As with prior commentary and cases, the Court analyzed the FOTM doctrine in the context of an alleged fraudulent misrepresentation—the plaintiffs did not allege any trade-based manipulations. Nor did the Court, in speaking of 10b-5 actions, discriminate between fraudulent misrepresentations and market manipulations.

As a first step, the Court recommitted itself to the proposition that “reliance is an element of a Rule 10b-5 cause of action.” Then, although denying that its holding required full acceptance of the ECMH, the Court did, in fact, implicitly adopt a form of the ECMH

75. Id. at 227-28.
76. Id. at 228.
77. Levinson v. Basic Inc., 786 F.2d 741, 751 (6th Cir. 1986).
78. Basic, 485 U.S. at 230. Interestingly, the Court did not address “whether companies have the freedom to hide preliminary merger negotiations from public scrutiny in order to make them more likely to come to fruition.” Donald C. Langevoort, Basic at Twenty: Rethinking Fraud on the Market, 2009 Wis. L. Rev. 151, 156. “[W]hether and when securities law should permit issuers to lie in order to serve their shareholders” was the subject of “a lively debate” in the wake of Basic. Id.
79. Basic, 485 U.S. at 239-41.
80. Id. at 243. In doing so, the Court declined to follow Fischel’s advice to dispense with the concept of reliance altogether in favor of an exclusive focus on loss causation through market impact. See supra notes 67-71 and accompanying text.
81. See Basic, 485 U.S. at 246 n.24 (“We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory.”); id. at 248 n.28 (“By accepting this rebuttable presumption, we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.”).
in justifying a presumption of reliance. In particular, the Court held that a presumption of reliance was appropriate in cases involving “an open and developed securities market.” Crucially, the Court’s implicit acceptance of the principles underlying the ECMH led it to adopt the indirect reliance approach to the FOTM doctrine, with its double presumption of loss causation and reliance. First, the Court noted that “[r]ecent empirical studies have tended to confirm ... that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” The Court then went on to state that “[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.” Having forged the two links of the double presumption, the Court proceeded to join them by concluding that “[b]ecause most publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentations ... may be presumed for purposes of a Rule 10b-5 action.”

82. Id. at 246 n.24 (“For purposes of accepting the presumption of reliance in this case, we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.”). Justice White, in dissent, certainly believed that the Court had accepted the presumption based on the ECMH, and scholars have tended to agree with him. Id. at 250, 253-55 (White, J., dissenting); Edward S. Adams & David E. Runkle, Solving a Profound Flaw in Fraud-on-the-Market Theory: Utilizing a Derivative of Arbitrage Pricing Theory To Measure Rule 10b-5 Damages, 145 U. Pa. L. Rev. 1097, 1109 (1997) (“The Court based its adoption of the fraud-on-the-market theory on its implicit assumption of the validity of the principles underlying the ECMH.... Although the Court did not state its acceptance of the ECMH by name, the Court unmistakably stated its acceptance of the ECMH in substance.”); Macey & Miller, supra note 65, at 1077 (“Despite this disclaimer, the Court was adopting the semi-strong version of the efficient capital markets hypothesis, whether it was aware it was doing so or not.”).


84. Id. at 246.

85. Id. at 247.

86. Id. That the Court adopted the double presumption is emphasized by the examples it gave for how the presumption may be rebutted. The Court provided three such examples. First, the defendant can show that “the ‘market makers’ were privy to the truth,” which would demonstrate “that the market price would not have been affected by the[ ] misrepresentations,” breaking the “causal connection.” Id. at 248. Second, the defendant can show “truth” on the market—that “news” of the misstatement leaked out and “dissipated the effects of the misstatements,” again breaking the connection. Id. at 248-49. Finally, the defendant could show that the individual plaintiff was not “relying on the integrity of the market,” but “sold his shares nevertheless because of other unrelated concerns.” Id. at 249. Thus, in keeping with the vision of indirect reliance, the defendant can rebut the FOTM presumption by showing either a lack of loss causation or a lack of reliance.
coherence of the FOTM doctrine in light of the ECMH, practical concerns of evidence and procedure also motivated the Court’s conclusions. The Court emphasized that presumptions arise “out of considerations of fairness, public policy, and probability, as well as judicial economy,” suggesting that a presumption of reliance may be preferable to requiring statutorily favored plaintiffs “to show a speculative state of facts” at such an early stage in the proceedings.87

3. Implementation by the Lower Courts—The Requirement of an “Efficient” Market

The Supreme Court’s official recognition of the FOTM presumption led to an explosion of securities fraud litigation.88 No longer able to argue against the FOTM presumption in general, defendants at the crucial class certification stage seized upon the Court’s

87. Id. at 245. One scholar goes so far as to argue that “Basic cannot be understood except by appreciating that the Court’s response is far more a lesson in civil procedure than financial economics.” Langevoort, supra note 78, at 158. Even if this is an overstatement, it is clear the Court was alert to considerations of what kinds of evidence a plaintiff can and should be expected to present at class certification. Adopting the more sweeping double presumption avoided the need for a fact-intensive inquiry into loss causation at the class certification stage—an inquiry necessarily intertwined with the merits.

88. The number of suits filed nearly tripled in the three years after Basic, and “continued to rise dramatically over the next fifteen years.” Langevoort, supra note 78, at 179; see also Vincent E. O’Brien, The Class-Action Shakedown Racket, WALL ST. J., Sept. 10, 1991, at A20 (counting section 11 actions as well). In light of this increase, Fischel’s claim that “[i]n all probability” his approach would “decrease the overall amount of litigation under rule 10b-5” might strike the modern reader as almost touchingly naïve. Fischel, supra note 56, at 16. In fairness to Fischel, the version of the FOTM theory adopted by the Court bears only a superficial resemblance to the theory he advocated. On the one hand, as noted above, the Court declined to eliminate the reliance requirement altogether. More importantly, the Court did not accept the notion that the absence or presence of a market reaction is the only real measure of the materiality of an alleged misrepresentation. Three years after Basic, in fact, the Court held that defendants could not avoid liability by arguing that market professionals had seen through a misrepresentation, thus preventing any impact on the market price. See Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991) (“If it would take a financial analyst to spot the [misrepresentation], whatever is misleading will remain materially so, and liability should follow.”). This “notion that a statement can be materially misleading even if informed investors are not fooled (and accordingly price remains unchanged) is flatly inconsistent with the premises” underlying the FOTM theory, and shows that, for the Court, “belief[] in the informational content of prices ... is merely a one-way street.” Paul G. Mahoney, Precaution Costs and the Law of Fraud in Impersonal Markets, 78 VA. L. REV. 623, 662 n.96 (1992).
language about “open and developed” markets, and began arguing that the market for the particular security at issue was not sufficiently efficient to support the presumption in the individual case. These arguments—together with the need for some gatekeeping requirement to staunch the flood of securities fraud suits—forced courts to formulate “tests” for the required level of efficiency. Demonstrating the requisite market efficiency quickly became one of the major hurdles for plaintiffs seeking to bring 10b-5 class actions, and the question of market efficiency took on a significance that would not be immediately obvious from a casual reading of Basic’s plurality opinion. Basic itself said little about how “efficient” the relevant market needed to be, or how such efficiency should be established. The lower courts were left to deal with those questions themselves.

Though lower courts have agreed that a showing of market efficiency is required to invoke the FOTM presumption, they have been inconsistent in their approach to determining whether a market is sufficiently efficient. Among the earliest—and still prob

89. Langevoort, supra note 78, at 166-68.

90. Indeed, although Basic unmistakably reflected the Supreme Court’s approval of the FOTM presumption of reliance, it provided relatively little guidance as to how lower courts should implement the doctrine. See Macey & Miller, supra note 65, at 1077.

91. In Basic itself, the relevant stock was traded on the New York Stock Exchange (NYSE) and the Court apparently assumed an efficient market without further discussion. Basic, 485 U.S. at 227-28, 247-50. Some lower courts have followed the Supreme Court’s lead and assumed market efficiency when the relevant security trades on a major exchange like the NYSE or National Association of Securities Dealers Automated Quotations (NASDAQ). See, e.g., Anderson v. Transglobe Energy Corp., 35 F. Supp. 2d 1363, 1369 (M.D. Fla. 1999) (finding, without analysis, that a stock listed on the NASDAQ and several Canadian exchanges traded in an efficient market); Levine v. Metal Recovery Techs., Inc., 182 F.R.D. 102, 107-08 (D. Del. 1998) (finding, without analysis, that a stock listed on the NASDAQ Small Cap Market traded in an efficient market). Other courts have argued that market efficiency cannot be assumed based on the exchange on which a security is traded—it is the market for the individual security itself that must be efficient. See, e.g., O’Neil v. Appel, 165 F.R.D. 479, 504 (W.D. Mich. 1996); Cammer v. Bloom, 711 F. Supp. 1264, 1281-83 (D.N.J. 1989). Some courts have extended the FOTM presumption to initial public offerings (IPOs) and securities traded in over-the-counter markets. See, e.g., Endo v. Albertine, 863 F. Supp. 708, 726 (N.D. Ill. 1994) (extending the FOTM presumption to IPOs); Cammer, 711 F. Supp. at 1297 (extending the FOTM presumption to securities traded in over-the-counter markets), But see IPO III, 471 F.3d 24, 42 (2d Cir. 2006) (finding that “the market for IPO shares is not efficient”); Freeman v. Laventhal & Horwath, 915 F.2d 193, 199 (6th Cir. 1990) (finding that “a primary market for newly issued municipal bonds as a matter of law is not efficient”). Still others have suggested that a slow market reaction to obscure news could call into question the efficiency of even heavily traded blue-chip stocks. See In re Merck & Co. Sec. Litig., 432
ably most widely used—tests for market efficiency was a multi-factor test formulated by a New Jersey district court in Cammer v. Bloom.92 The so-called “Cammer factors” have proved influential, with courts sometimes adding additional factors of their own.93 The result, as one scholar describes it, was “an ad hoc approach informed by expert testimony, but in fact largely unconstrained.”94

A related question is when the required showing should be made. Although Basic itself involved class certification, consensus was slow to materialize as to whether the FOTM presumption—and the associated inquiry into market efficiency—needed to be settled at that stage of the litigation. Courts were torn between the necessity of deciding the presumption of reliance in order to satisfy Federal Rule of Civil Procedure 23, and the Supreme Court’s admonishment against conducting fact-intensive, merits-related inquiries at the class certification stage.95 In the past few years, however, a rough consensus has emerged that a district court must make a determination—prior to certifying a class—that each of the Rule 23 requirements has been met, even if a Rule 23 requirement overlaps with a merits issue.96 Unlike under Federal Rule of Civil Procedure F.3d 261, 269-70 (3d Cir. 2005) (suggesting that if Merck’s common stock was slow to respond to confusing revenue data, it would demonstrate an inefficient market and thus be grounds for denial of class certification).

92. The Cammer court set forth five factors that could be indicative of market efficiency: (1) average weekly trading volume, (2) number of securities analysts following the stock, (3) number of market makers and arbitrageurs, (4) status as an S-3 filer, and (5) responsiveness of the market price to “unexpected corporate events or financial releases.” Cammer, 711 F. Supp. at 1286-87.

93. See, e.g., Unger v. Amedisys Inc., 401 F.3d 316, 323 (5th Cir. 2005) (considering additional factors, including market capitalization and bid-ask spread).


96. See IPO III, 471 F.3d at 42; In re Polymedica Corp. Sec. Litig., 432 F.3d 356, 366 (4th Cir. 2004) (“[T]he factors spelled out in Rule 23 must be addressed through findings, even if they overlap with issues on the merits.”); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 166 (3d Cir. 2001); Szabo v. Bridgeport Machs., Inc., 249 F.3d 672, 676 (7th Cir. 2001) (“[A] judge should make whatever factual and legal inquiries are necessary under Rule 23,” even if “the judge must..."
12(b)(6), courts are required to make “factual findings” that all of the requirements for Rule 23 class certification are met. If the plaintiff seeks to invoke the FOTM presumption, the need to make such findings necessarily requires rigorous scrutiny of efficiency claims at the class certification stage, a fact-intensive inquiry that can entail lengthy discovery.  

The net result is that district courts are required to perform a searching and relatively wide-ranging inquiry into market efficiency prior to class certification. In a world where concerns over the costs and efficacy of securities litigation are increasingly widespread, this inquiry has become one of the primary gatekeepers to class certification. Indeed, given that the overwhelming majority of 10b-5 actions settle upon certification of a class—seemingly with little make a preliminary inquiry into the merits.”).

97. See, e.g., IPO III, 471 F.3d at 41-42; Unger, 401 F.3d at 322; Gariety, 368 F.3d at 366. This trend toward increased scrutiny of market efficiency at the class certification has arguably been reinforced by two legal changes that were, at least in part, driven by concerns about the swarm of securities fraud class actions spawned by Basic: (1) the Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.) and (2) the 2003 amendments to Rule 23. The PSLRA, with its overt skepticism of securities class actions, cast doubt on the Basic Court’s assumption that private class actions are a legislatively favored remedy for securities fraud, suggesting that greater judicial scrutiny would be appropriate. The initial bill, H.R. 10, was drafted by then-Congressman Christopher Cox and would have undone Basic altogether. See Common Sense Legal Reforms Act, H.R. 10, 104th Cong. § 204 (1995). Ironically, in light of the fact that a stringent test for market efficiency became one of the primary roadblocks to class certification, the PSLRA’s damages provision actually suggests congressional skepticism of the ECMH. See Nathaniel Carden, Comment, Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency, 65 U. Chi. L. Rev. 879, 894-95 (1998); Oldham, supra note 43, at 1028-29; Michael Y. Scudder, Comment, The Implications of Market-Based Damages Caps in Securities Class Actions, 92 Nw. U. L. Rev. 435, 461 (1997).

The 2003 amendments to Rule 23 made two relevant changes. First, they eliminated the provision from prior Rule 23(c)(1)(C) allowing “conditional” certification of classes. FED. R. CIV. P. 23 advisory committee’s note. Second, Rule 23(c)(1)(A) was altered, replacing the requirement to certify a class “as soon as practicable” with an instruction to certify “at an early practicable time.” Id. The advisory committee’s notes state that “[a] court that is not satisfied that the requirements of Rule 23 have been met should refuse certification until they have been met,” and instruct courts that “it is appropriate to conduct controlled discovery into the ‘merits,’ limited to those aspects relevant to making the certification decision on an informed basis.” Id.


99. See Nagareda, supra note 19, at 99.
regard for the merits\textsuperscript{100}—the need for a gatekeeping requirement of some sort is manifest, and may help explain the recent consensus.\textsuperscript{101} The question addressed in Part III whether this particular gatekeeping requirement has any logical force in cases alleging market manipulation, even if it is defensible for cases involving material misrepresentations. Before we can address this question, a better understanding of “market manipulation” is needed.

II. Market Manipulation

A. Defining Market Manipulation

One of the main difficulties in talking and thinking about how to treat claims of market manipulation is the lack of an agreed-upon meaning for “market manipulation.” Beyond banning wash sales and matched orders, the relevant statutes do not define the term, and courts have struggled to find a meaningful definition.\textsuperscript{102} Before the application of the FOTM doctrine to market manipulation claims can be examined, some common misunderstandings must be cleared away, and a plausible definition of manipulative conduct must be identified.

The most obvious types of trade-based manipulations are the types of wash sales and matched orders alleged by the SEC in the case discussed in the Introduction. The potential class of “market manipulations,” however, is broader than these economically fictitious transactions. Fischel and Ross make the most thorough and satisfying attempt to define this broader class of market manipulation.\textsuperscript{103} In their analysis, they show that a meaningful


\textsuperscript{101} See West v. Prudential Sec., 282 F.3d 935, 937 (7th Cir. 2002) (“[V]ery few securities class actions are litigated to conclusion, so review [of the district court’s interpretation of the FOTM] may be possible only through the Rule 23(f) device.”).

\textsuperscript{102} “Even though both have the prevention of manipulation as a primary goal,” neither the Securities Exchange Act nor the Commodity Exchange Act provides a definition of “market manipulation.” Daniel R. Fischel & David J. Ross, \textit{Should the Law Prohibit “Manipulation” in Financial Markets?}, 105 HARV. L. REV. 503, 506 (1991); see also LOSS, FUNDAMENTALS, supra note 35, at 860 n.75 (“[T]he word ‘manipulative’ as used in §§ 10(b) and 15(c)(1) has never had any precise meaning.”).

\textsuperscript{103} Fischel & Ross, supra note 102, at 506.
definition of manipulation involving real trades (as opposed to economically fictitious trades) must be subjective—that is, it must depend on the intent of the trader. After rejecting attempts to define manipulation more broadly, Fischel and Ross settle on a

104. Id. at 510. See also ATSI Commc’ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 102 (2d Cir. 2007) (“[I]n some cases scienter is the only factor that distinguishes legitimate trading from improper manipulation.”). In fact, Fischel and Ross go on to conclude that wash sales and matched orders—the most obvious types of market manipulations—are better analyzed as a “species of fraud” than as a separate category of market manipulations. Fischel & Ross, supra note 102, at 510-12. Although this argument may have merit, it is uncomfortable doctrinally, as wash sales and matched orders are among the few potentially “manipulative” practices explicitly barred by the securities laws. See 15 U.S.C. § 78i(a)(1) (2006). In any case, one need not go so far for the purposes of this Article.

105. Specifically, Fischel and Ross reject attempts to define manipulation as conduct “designed to do one of three things: (1) interfere with the free play of supply and demand; (2) induce people to trade; or (3) force a security’s price to an artificial level.” Fischel & Ross, supra note 102, at 507. They reject the first formulation because the term “interfere” is “circular absent a definition of manipulation.” Id. All trades and trades are a part of the “play of supply and demand.” Id. A large investor who places a large order in the honest belief that the stock is a good investment will alter the supply and demand in the same fashion as one who places a large order for manipulative purposes. In attempting to define manipulation, the entire problem is to distinguish between demand that is in some sense “legitimate” and demand that is somehow “illegitimate.” Without some definition of manipulation “that distinguishes between legitimate and illegitimate demand, the concept of interference with supply and demand does not advance the inquiry.” Id.

Although acknowledging that “inducement of trading ... is sometimes said to be the essence of manipulation,” Thel, supra note 34, at 410, Fischel and Ross reject this second formulation as “hopelessly overbroad.” Fischel & Ross, supra note 102, at 507. At one extreme, of course, every bid or offer is intended to induce someone to trade—the counterparty to the trade. Id. at 507-08. Clearly this cannot be what is meant. There are also many perfectly legitimate situations in which firms or individuals may act to induce trades by people other than counterparties. Most obviously, any time a firm discloses new information about the “value or riskiness” of the firm’s securities, it is “likely [to] lead to increases in the volume of trading and thus can be said to have ‘induced’ trading.” Id. at 508. Less obviously, a firm may purchase its own shares or change its capital structure, in part “as a way of communicating information about the value of its securities.” Id. at 508 & n.27 (collecting sources). Similarly, prominent executives will often purchase shares in order to “signal confidence” in the prospects of the firm. See Eric Martin & Michael Tsang, Immelt’s GE Purchases Signal Sell as Insiders Buy, BLOOMBERG, Nov. 17, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aLCAhR7E5RJJE (General Electric CEO Jeffrey Immelt’s share purchase “reflects his confidence in the company,’ said Gary Sheffer, a spokesman for [GE].”). Such activities are not generally thought of as manipulative.

The third formulation—forcing security prices to an artificial level—“has intuitive appeal because creation of artificial prices, unlike trading, is socially undesirable.” Fischel & Ross, supra note 102, at 508. The problem with this formulation as an attempt to craft an “objective” definition of manipulative conduct—not depending on the intent of the trader—is the inability to determine whether a price level is “artificial.” What is to distinguish between a manipulator and an investor who trades in the genuine belief that prices will move in a
definition focused on “profitable trades made with ‘bad’ intent”—that is, trades where:

1. the trading is intended to move prices in a certain direction;
2. the trader has no belief that the prices would move in this direction but for the trade; and
3. the resulting profit comes solely from the trader’s ability to move prices and not from his possession of valuable information.

This definition—together with economically fictitious transactions like wash sales and matched orders—will be the definition of market manipulation used in this Article.

B. Real-Life Examples of Alleged Market Manipulation

The contours of this definition become clearer by examining real-life examples of alleged market manipulation. Below are five cases involving alleged manipulation—three criminal prosecutions given direction, but who proves to be mistaken, with prices ultimately moving in the other direction? “Trading based on a genuine belief that prices will ultimately move in the direction of the trades is the essence of nonmanipulative trading,” but the third proposed formulation provides nothing to distinguish it from manipulation. Id. at 509.

More subtly, “[d]efining manipulation by reference to whether the trades move prices closer to their correct level” could threaten “property rights in information.” Id. “[T]rades, as well as disclosures, can reveal information.” Id. Just as share purchases by a firm’s CEO can signal confidence based on the presumably superior information possessed by the CEO, trades by other investors can also signal the presence of new or superior information. Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 572-79 (1984). If trades were perfectly informative, however, it would destroy the ability of investors to profit from generating new information, imperiling the very mechanisms on which market efficiency depends. See id.; Sanford Grossman, On the Efficiency of Competitive Stock Markets Where Trades Have Diverse Information, 31 J. Fin. 573, 585 (1976) (“The price system can be maintained only when it is noisy enough so that traders who collect information can hide that information from other traders.”). In order to preserve incentives for investors to acquire information in the first place—and thus fulfill the information-generating function of markets—“[t]raders must be allowed to disguise their trades to avoid disclosing the information they possess to other traders.” Fischel & Ross, supra note 102, at 509-10. A definition of market manipulation built around forcing prices to an artificial level would threaten the ability of traders to disguise their trades.

106. Fischel & Ross, supra note 102, at 510.
107. The actual facts and motivations in each of the examples are, of course, hotly disputed. Indeed, the conviction in United States v. Mulheren was ultimately overturned. 938 F.2d 364, 372 (2d Cir. 1991). In lieu of inserting an unsightly “allegedly” into every clause, the
examined by Fischel and Ross,\textsuperscript{108} and two recent, prominent 10b-5 class actions.\textsuperscript{109}

\textit{1. United States v. GAF Corporation}

In October of 1986, GAF Corporation was looking to sell a large block of the approximately ten million shares of Union Carbide it had acquired in an unsuccessful takeover attempt.\textsuperscript{110} GAF desired to boost the market price of Union Carbide stock, in hopes of receiving a better price for its shares in a negotiated transaction pegged to the market price.\textsuperscript{111} To do so, GAF asked Jeffries & Co., a broker-dealer, to make open-market purchases of Union Carbide stock to drive the closing price above $22 on October 29 and 30, “and guaranteed Jeffries & Co. against any loss.”\textsuperscript{112} Jeffries & Co. proceeded to do so,\textsuperscript{113} and on November 10, GAF sold five million shares in an off-market transaction—allegedly receiving $5 million more than it would have absent the manipulation.\textsuperscript{114}

\textsuperscript{108} Mulheren, 938 F.2d 364; United States v. GAF Corp., 928 F.2d 1253 (2d Cir. 1991); United States v. Milken, 759 F. Supp. 109 (S.D.N.Y. 1990); see Fischel & Ross, supra note 102, at 527-34. Although these three examples all led to criminal prosecutions, the types of manipulations alleged could easily support 10b-5 actions, as well.

\textsuperscript{109} Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931 (9th Cir. 2009) (per curiam); IPO I, 241 F. Supp. 2d 281 (S.D.N.Y. 2003).

\textsuperscript{110} See Fischel & Ross, supra note 102, at 527 & n.97 (citing Indictment, United States v. GAF Corp., No. 88 Cr. 962 (S.D.N.Y. July 6, 1988)); Stephen Labaton, GAF Fined; Executive Sentenced, N.Y. TIMES, Mar. 31, 1990, at 31.

\textsuperscript{111} Fischel & Ross, supra note 102, at 527-28.

\textsuperscript{112} Id. at 528.

\textsuperscript{113} Jeffries & Co. purchased approximately 60,000 shares near the close of trading on October 29, and approximately 40,000 shares near the close of trading on October 30. \textit{Id.} As a result, “Union Carbide closed at $22.8... on October 29,” and at “$22-7/8 on the [NYSE] and $22-3/8 on the Pacific Stock Exchange” on October 30. \textit{Id.} “Jeffries & Co. sold [these] shares on November 3 and 4 at a loss. On November 6 and 7, Jeffries & Co. purchased an additional 20,500 shares shortly before the close of trading,” selling them November 10-12 without loss. \textit{Id.}

\textsuperscript{114} \textit{Id.}
2. United States v. Milken

Wickes Corporation, an investment banking client of Michael Milken and Drexel Burnham Lambert, had “approximately eight million shares of ... convertible exchangeable preferred stock” outstanding as of April of 1985. Wickes had an option to redeem the preferred shares at $2.50 at any time prior to May of 1988 if the closing price of Wickes common stock was at any point greater than or equal to $6-1/8 for at least twenty of thirty consecutive trading days. As of April 22, 1986, “Wickes common stock had closed at or above [this threshold] on nineteen out of twenty-eight consecutive trading days.” Thus, a closing price at or above $6-1/8 on either of the next two trading days would allow Wickes to redeem the shares.

Seeking to make certain the necessary conditions were met, Milken asked Ivan Boesky’s organization to purchase enough Wickes stock to ensure that it would close at $6-1/8, and guaranteed Boesky against any resulting trading losses. During the last half hour of trading on April 23, 1986, Boesky’s organization purchased 1.9 million shares of Wickes stock, which it later sold at a loss. The stock closed at $6-1/8 on April 23, and Wickes redeemed the preferred shares on April 29. Drexel Burnham Lambert received a $2.3 million underwriting fee for the redemption.

3. United States v. Mulheren

In 1985, Ivan Boesky (again!) accumulated approximately 3.4 million shares of Gulf & Western Industries, Inc. (G&W). Boesky entered into discussions with G&W’s chairman about either taking

---

115. Id. at 530 & n.121 (citing Indictment at 55-56, United States v. Milken (S.D.N.Y. 1989) (No. 89 Cr. 41)).
116. Id. at 530. This kind of provision is similar to what is known as an “Asian option,” and is often intended to reduce the risk of manipulation.
117. Id.
118. Id.
119. Id.
120. Id.
121. Id.
122. Id.
control of G&W or selling his shares back to the company at $45 per share. On October 16, 1985, with the stock trading at $44-3/4, G&W's chairman expressed willingness to buy the shares back in a block transaction, but only at the prevailing price on the NYSE. The next morning, Boesky called John Mulheren, chief trader for Jamie Securities Co., and told him that he “liked” G&W stock and that “it would be great if it traded at 45.” Between 11:00 a.m. and 11:10 a.m., Mulheren placed a combination of limit and market orders, and at 11:17 a.m., Boesky successfully sold his 3.4 million shares back to G&W at the prevailing market price of $45 per share. The stock closed at $43-5/8, and Mulheren sold his shares at the end of the day at a loss.

All three of the preceding cases meet our definition of manipulation: (1) the trading was intended to boost the price above a certain level; (2) the defendants did not, apparently, believe the price would move in that direction absent the manipulative trades; and (3) the profits came from the negotiated off-market sales (in GAF and Mulharen) or underwriting fees (in Wickes).

4. In re IPO Securities Litigation

The manipulation alleged in In re Initial Public Offering Securities Litigation was both more systematic and less straightforward than in the cases discussed so far. The underwriters of initial public offerings (IPOs) of hot tech companies during the dot-com bubble “conditioned allocations of shares at the offer price on

124. Id.
125. Id. at 367.
126. Id.
127. Mulheren purchased a total of 75,000 shares of G&W stock at prices between $44-3/5 and $45. Id. at 367-68.
128. Id. at 366, 368.
129. Id. at 368.
130. In re Initial Public Offering Securities Litigation was a sprawling mass of thousands of individual securities class actions against 55 underwriters and 310 issuers in the wake of the dot-com collapse in 2001. IPO III, 471 F.3d 24, 27 (2d Cir. 2006). These cases were aggregated by issuer, resulting in 310 consolidated actions. Id. The plaintiffs in these class actions made allegations of multiple—sometimes contradictory—forms of misconduct. For present purposes, this Article will focus exclusively on the allegations of market manipulation and will, as above, treat the allegations as true for the sake of clarity. See supra note 108.
agreements to purchase shares in the aftermarket.” These “tie-in agreements” with the IPO allocants required the allocants to make aftermarket purchases at escalating prices—a practice known as “laddering”—which would create the illusion of market “momentum.” By unloading their shares into this momentum, “ladderers could stand to profit from such tie-in agreements by selling their large allocation of IPO shares as well as their after-IPO purchases at inflated prices resulting from the laddering activities.” The underwriters, in turn, would “profit by receiving higher than normal commissions from the ladderers,” or from other types of kickbacks. Although somewhat more complicated than the other manipulations we have seen, laddering still fits comfortably into our definition: (1) the allocants’ trading is intended to move the price upward, creating an illusion of momentum; (2) the trading is not motivated by a genuine belief that the shares would otherwise go up; and (3) the allocants’ profit came from selling into the momentum created by their own laddering trades, not from any new information. Similarly, the investment banks profited by receiving kickbacks from the allocants.

5. Desai v. Deutsche Bank Securities

Desai v. Deutsche Bank Securities Ltd. is another securities class action, filed by shareholders of GenesisIntermedia, Inc. (GENI). Deutsche Bank masterminded the manipulative scheme together with officers of GENI. The officers of GENI engaged in securities

131. IPO III, 471 F.3d at 27. The “aftermarket” simply refers to the open, public market for the shares following the IPO.
133. Ronen & Sarath, supra note 132, at 843.
134. Id.
135. The allocants and underwriters allegedly knew the issuing companies were of low quality, IPO III, 471 F.3d at 43-44.
136. 573 F.3d 931, 933 (9th Cir. 2009) (per curiam). At the time of the manipulation, GENI stock traded on the NASDAQ. Id.
137. Id. The version of the alleged scheme presented here is somewhat simplified. For greater detail, see Stephenson v. Deutsche Bank AG, 282 F. Supp. 2d 1032, 1045-51 (D. Minn. 2003).
loans, lending unregistered shares to a broker-dealer in exchange for cash collateral to the officers. Under the terms of the securities loans, as the value of the securities increased (or decreased), the amount of cash collateral would also increase (or decrease), with interest paid to the borrowers also increasing (or decreasing).

“Adjustments [to the amount of collateral and the interest payments]—marking the securities to the market—[were] made daily.” The shares were ultimately relaunched to Deutsche Bank, with “a chain of broker-dealers” interposed between Deutsche Bank and the initial broker-dealer “in order to increase the amount of capital for the scheme and to insulate Deutsche Bank from any fallout should the scheme collapse.” The GENI officers used the cash collateral received for their shares to “day-trade in GENI’s publicly traded shares.” This trading created a misleading “appearance of investor demand” that, in turn, inflated the stock price. The higher stock price “required the borrowers of GENI stock ... to provide more cash collateral to feed the cycle.”

By September 11, 2001, the scheme had driven GENI’s stock price from $12 per share to over $52 per share. When the markets reopened on September 17, following the terrorist attacks of September 11, GENI’s price collapsed, reaching $9 per share by September 25.

As the price collapsed, “borrowers of the stock, starting with Deutsche Bank, demanded their cash collateral back.” Deutsche Bank, at the end of the chain of borrowers, “was able to recover nearly all the collateral it had pledged, [but] the intermediary broker-dealers were not so lucky,” as the GENI officers had spent the bulk of the cash collateral.

---

138. Desai, 573 F.3d at 934.
139. Id. As the circuit court pointed out, “[t]his is not a typical creditor-debtor relationship, for the borrower, instead of the lender, receives a stream of income that resembles interest payments.” Id. at 934 n.3. The court goes on to note that it may be helpful to think of the arrangement as “a loan of money secured by stock.” Id.
140. Id. at 934.
141. Id.
142. Id.
143. Id.
144. Id. at 934-35.
145. Id. at 935.
146. Id.
147. Id.
148. Id.
through the [inflated interest] payments it received, [and still] managed to recover almost [all of] the cash collateral it had advanced.”

The scheme alleged in Desai is slightly confusing, but still squarely within our definition of manipulation: (1) the GENI officers’ day-trading—masterminded by Deutsche Bank—was intended to create a false impression of investor interest, causing the price to rise; (2) the trading was not motivated by a genuine belief that the shares would otherwise go up; and (3) the profits obtained by the GENI officers and Deutsche Bank came from the increased cash collateral and interest payments, respectively, received as a result of the securities loans—not from any new information.

**C. Conditions for Successful Market Manipulation**

With these examples of alleged market manipulations in mind, it is possible to examine the types of situations in which manipulations are likely to succeed, and those in which they are likely to fail. Fischel and Ross postulate that “[p]rofitable (successful) manipulations require two conditions: first, trading must cause the price of the relevant security to rise; and second, the manipulator must be able to sell at a price higher than the price at which the manipulator purchased (plus transactions costs incurred).”

In turn, trades can cause prices to rise in two ways: (1) directly, through liquidity or demand effects or (2) indirectly, through information effects.

**1. Liquidity and Demand Effects**

The most obvious mechanism by which trading could cause prices to rise is that the trades themselves directly move prices by increasing demand and reducing supply. Indeed, “[m]ost discussions of manipulation assume that there is a direct relationship between trading and price movements.” Three of the five manipulative schemes described above (GAF, Milken, and Mulheren) appear
to fit this mold—swamping the market with orders to create a brief uptick in prices. The reality, however, is not always so simple. The market for financial securities is, in important respects, completely unlike the familiar markets for real goods like cars or carrots, in which sloping supply and demand curves meet to set a market-clearing price.

Judge Easterbrook explained this vividly—if somewhat caustically—in *West v. Prudential Securities, Inc.* 154 In *West*—a case involving a nonpublic misrepresentation regarding Jefferson Savings Bancorp stock 155—Judge Easterbrook took to task plaintiffs’ expert, who assumed “that all trades affect prices by raising demand ... as if there were an economic market in ‘Jefferson Savings stock’ as there is in dill pickles or fluffy towels.” 156 As Judge Easterbrook pointed out, “investors do not want Jefferson Savings stock (as if they sought to paper their walls with beautiful certificates); they want monetary returns (at given risk levels), returns that are available from many financial instruments.” 157 The result is that “[t]here are so many substitutes for any one firm’s stock that the effective demand curve is horizontal[,] ... not sloped like the demand curve for physical products.” 158

Of course, Judge Easterbrook is talking about *efficient* markets, 159 and “[o]ne fundamental attribute of efficient markets is that information, not demand in the abstract, determines stock prices.” 160 The situation is different in relatively *inefficient* markets. In an

---

154. 282 F.3d 935 (7th Cir. 2002).
155. Id. at 936-38. This nonpublic misrepresentation was alleged to have affected the market price through the trades of the misled individuals. Id.
156. Id. at 939.
157. Id.; see also Fischel & Ross, supra note 102, at 513-14 (“Investors hold securities to obtain a stream of future income that can be used to finance future consumption and investment. To achieve this goal, they can choose from many possible combinations of available assets.”) (citations omitted).
158. West, 282 F.3d at 939. See also Fischel & Ross, supra note 102, at 513-14 (“Portfolio theory provides powerful reasons to believe that demand and supply [for stocks] are elastic .... [T]hus, a high percentage of block trades occurs at the existing market price.”).
159. The plaintiffs’ expert in *West* “took the view that the market for Jefferson Savings securities is efficient,” so that the plaintiffs could take advantage of the FOTM presumption. West, 282 F.3d at 939.
inefficient market, liquidity and price pressure effects can begin to be significant and cause large block trades to have an impact on price. Such liquidity costs often take the form of a wide bid-ask spread, which compensates market makers for serving as intermediaries until a counterparty can be found. Simply by placing a market purchase order, a would-be manipulator can often increase the observed market price by the amount of the spread, which can be significant in thinly traded stocks. By continually swamping the supply of ready sellers, a manipulator could, therefore, conceivably raise quoted prices.

Fischel and Ross also discuss “price pressure” effects, which could be caused by trading “if the demand and supply for securities are not perfectly elastic.” If the available supply of an individual security is not bottomless, and that “securities possess unique characteristics” such that “perfect substitutes do not exist,” then a downward-sloping demand curve can result. As a result, “increases in supply or demand can cause price changes,” just as they do for most real goods—like dill pickles and fluffy towels.

Two points about liquidity and price pressure effects require emphasis. First, both effects are likely to be symmetrical—that is, any change in price caused by manipulative trades is likely to be offset when the manipulative trades are unwound. “If purchases increase the demand and thus the price, sales will have the opposite effect.” The same is true of liquidity effects. But, as the above

161. Fischel and Ross describe “liquidity” effects as follows: An investor who wants to buy or sell a large quantity of shares immediately may be unable to do so at the market price because at that moment there are not enough market participants willing to take the other side of the trade. To induce others to participate, a buyer (seller) may have to pay a premium (sell at a discount). Such premiums (discounts) compensate intermediaries for the costs of maintaining a short (long) position until another investor willing to sell (buy) can be found.

Fischel & Ross, supra note 102, at 515-16.
162. Id. at 516.
163. Id. at 516, 518.
164. Id. at 516.
165. Id.; see also Andrei Shleifer, Do Demand Curves for Stocks Slope Down?, 41 J. Fin. 579, 588-89 (1986).
166. Fischel & Ross, supra note 102, at 516.
167. Id. at 519.
168. This symmetry led Fischel and Ross to conclude that such manipulative schemes fail
examples show, the manipulator does not necessarily need to profit from unwinding the manipulative trades themselves in order for the scheme as a whole to be profitable. In all but the IPO case, the bulk of the profits came from contractual payments tied to the market price of a security—not from being able to sell stock on the open market at artificially inflated prices. Thus, the symmetrical nature of liquidity and price pressure effects does not mean they cannot be the basis of successful manipulations.

The second point—which is even more important for present purposes—is that liquidity and price pressure effects are far more likely to be appreciable in inefficient markets than in efficient markets. To say that an efficient market will be difficult to manipulate is practically tautological at a theoretical level—a good working definition of an efficient market for a security is one in which (1)
the demand curve is horizontal and (2) there are sufficient arbitrageurs to take the opposite side of any trade that would move the price away from the best guess as to its fundamental value. Such a market would be immune to manipulation.

Even at a practical level, however, it is easy to see that liquidity and price pressure manipulations are far more likely to have appreciable effects in inefficient markets. It is now possible to return to the example from the beginning of the Article with a more refined intuition. For which security would an aspiring manipulator have more luck appreciably moving the price using liquidity effects: a blue-chip stock like Microsoft, which has a bid-ask spread that rarely exceeds a few cents, usually less than 0.1 percent of the share price, and more than fifty million shares changing hands daily? Or a cow-chip stock like Odyssey Marine Exploration, which frequently has a bid-ask spread of nearly 10 percent of the share price, and has only three hundred thousand shares changing hands on a typical day?

Likewise, is a manipulator likely to be able to tilt the demand curve for Microsoft, which has a market capitalization in the hundreds of billions of dollars and well over $1 billion in shares traded on an average day? If the available supply of Microsoft shares is not actually infinite, it is close enough for most purposes. As Fischel and Ross point out, “[t]o the extent that the evidence supports the existence of a price pressure effect, it indicates that securities have supply and demand elasticities no smaller in magnitude than 1.” This means that a manipulator would need to buy at least 1 percent of a company’s outstanding shares—a purchase that would be in the billions of dollars for Microsoft—in order to raise the share price by a measly 1 percent. The would-be manipulator might again find the going easier with Odyssey, with

172. See supra notes 11-13 and accompanying text.
175. See Yahoo! Finance, Microsoft Corp., supra note 12.
176. Fischel & Ross, supra note 102, at 518.
a market capitalization of less than $100 million and only a few hundred thousand dollars worth of shares trading on any given day.177

2. Information Effects

Aside from direct liquidity or price pressure effects, manipulative trading can have a more subtle effect on prices through “information effects.”178 In short, manipulators, through their trading activity, can affect prices by creating a false belief in other traders that the trading reflects the presence of new information. This false belief can be relatively sophisticated—a belief by sophisticated investors that the manipulator possesses some new nonpublic information—or

177. See Yahoo! Finance, Odyssey Marine Exploration Inc., supra note 174. Even stocks that normally trade in highly efficient markets can exhibit surprisingly dramatic liquidity effects under certain circumstances, as occasionally occurs in a short squeeze. For example, on January 25, 2010, a number of investment funds filed a claim against Porsche arising from a massive short squeeze triggered when Porsche made a surprise announcement that it had gained control of 74 percent of Volkswagen’s voting shares. Posting of Zachery Kouwe to Dealbook, http://dealbook.blogs.nytimes.com/2010/01/25/hedge-funds-sue-porsche-for-1-billion-lost-on-vw (Jan. 25, 2010, 14:17 EST). With almost all of the remaining shares either state-owned or tied up in index funds, short-sellers were forced to close their positions at hugely inflated prices, more than tripling Volkswagen’s share price and briefly making it the world’s largest company by market capitalization. Id. This violent liquidity shock came despite the fact that the market for Volkswagen stock is normally extremely efficient.

The so-called “flash crash” of May 6, 2010, provides an even more dramatic example. Broad market indexes fell by up to 10 percent, with the Dow Jones Industrial Average losing more than 600 points in approximately 5 minutes. Tom Lauricella, Market Plunge Baffles Wall Street - Trading Glitch Suspected in ‘Mayhem’ as Dow Falls Nearly 1,000, Then Bounces, WALL ST. J., May 7, 2010, at A1. Early inquiries suggest that a liquidity crunch exacerbated by program trading caused the wild swings. See SEC & CFTC, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010 (2010).

178. Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931, 934 (9th Cir. 2009) (per curiam) (“A common way to manipulate the market in a security is to cause its price to increase by creating the illusion of more investor interest than really exists.”). Fischel and Ross describe this effect as follows:

[Th]e price of a security at any point in time depends on the value investors expect it will provide in the future. That future value is uncertain. Investors who obtain information that the future value is high relative to today’s price will want to buy. Their purchases, however, may lead other market participants to revise upward their expectations about the value of the security and thus cause [the] price to rise. Because the market price is a function of the information available, trading may affect the market price by providing market participants with additional information.

Fischel & Ross, supra note 102, at 515.
relatively naïve—a belief by retail investors that a price movement reflects “momentum” for the stock. Of course, would-be manipulators face problems in creating the intended price effect. First, “[t]rading will affect prices only if the prospective manipulator can convince others that his trading was informed,” and “[t]rades in an anonymous market are not likely to have this effect.” As a result, many, if not most, block trades take place with no change in price at all. What is more, “the more informed [the manipulator] appears, the more likely prices will rise simultaneously with the purchase and not thereafter.” Again, it is markets for inefficient stocks that are more likely to be appreciably moved by manipulative “information effects.” Is a manipulator more likely to convince other traders, purely through his trading activity, that he has uncovered some new material information about Microsoft, or Odyssey?

179. See Harrison Hong & Jeremy C. Stein, Disagreement and the Stock Market, 21 J. ECON. PERSP. 109, 120-22 (2007). These information effects are, of course, inconsistent with extreme conceptions of perfect market efficiency. No real market, however, can be perfectly efficient without destroying the mechanisms that generate efficiency in the first place. See Sanford J. Grossman & Joseph E. Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 AM. ECON. REV. 393, 403-05 (1980). In any “real” market, decoding of the information content of trading activity is one of the primary “mechanisms” for generating efficiency. See Gilson & Kraakman, supra note 105, at 572-79. That said, empirical studies do not support the idea that prices have “momentum,” at least over time scales that are relevant to retail investors. Nonetheless, some models of investor behavior and bubble dynamics support the creation of feedback loops of momentum traders—investors believing that a stock has momentum buy the stock, causing the price to go up and attracting even more momentum investors. See Robert A. Jarrow, Market Manipulation, Bubbles, Corners, and Short Squeezes, 27 J. FIN. & QUANTITATIVE ANALYSIS 311, 311-12, 326, 332-33 (1992).

180. Fischel & Ross, supra note 102, at 517. A recent survey of SEC enforcement actions found that manipulators are likely to be “potentially informed parties” such as corporate insiders, brokers, underwriters, large shareholders, and market makers.” Aggarwal & Wu, supra note 13, at 1917.


182. Fischel & Ross, supra note 102, at 517. In addition, the would-be manipulator faces the same problem of symmetry as we saw in our discussion of liquidity and price pressure effects—as the manipulator sells off his shares he depresses the price, which lessens his profit.” Desai, 573 F.3d at 934. Again, though, apart from IPO, none of the examples of manipulation we have seen required the manipulator to unwind the manipulative trades to profit. As the court in Desai said of the securities loan arrangement in that case, “this scheme solved the classic problem of market manipulators everywhere: it allowed them to profit from fraudulently inflating a stock’s price without having to sell the shares.” Id. at 935.

183. Remember that any overt fraudulent statements would be better analyzed as misrepresentations. We are concerned here only with pure, trade-based manipulations.
Consider the possibilities for Microsoft. The manipulator would need to engage in trading that would be discernible among the tens of millions of shares traded daily, and that would somehow convince sophisticated price-decoders that the manipulator possesses new material information about Microsoft—a company followed closely by the financial press, hundreds of professional security analysts, and countless deep-pocketed arbitrageurs. Alternatively, the manipulator would need, through the type of liquidity or price pressure effects discussed in Part II.C.1, to create enough of a price movement to gull naïve investors into discerning “momentum.” As we have seen, such price movement would be difficult or impossible to create in any reasonably efficient market.

The chances of success would be much greater for a thinly traded stock like Odyssey. First, it would be more plausible that the manipulator could have new material information about a less closely followed company. Furthermore, it would be easier to create a noticeable spike in price, or at least in trading activity, that could attract momentum investors and create a feedback loop.

This reasoning is supported by recent economic research. Indeed, modeling of the kind of “laddering” alleged in IPO requires a downward-sloping demand curve for the relevant stock—a condition that is inconsistent with an efficient market—in order for the manipulation to be successful.\footnote{184} Experience supports these theoretical predictions. A recent survey of SEC enforcement actions alleging market manipulation between 1990 and 2001 found “that most manipulation cases happen in relatively inefficient markets, such as the OTC Bulletin Board and the Pink Sheets, that are small and illiquid.”\footnote{185} In sum, whether the alleged manipulation is the kind of direct liquidity or price pressure trading at issue in GAF, Milken, 

\footnote{184. See Ronen & Sarath, supra note 132; Hao, supra note 132, at 102-22; Rajesh K. Aggarwal, Amiyatosh K. Purnanandam & Guojun Wu, Underwriter Manipulations in Initial Public Offerings (Dec. 19, 2005), available at http://ssrn.com/abstract=686252. Ronen and Sarath also conclude that “laddering is not a sustainable activity” unless there is a large number of momentum traders and a lack of short-sellers or other arbitrageurs—again, conditions inconsistent with market efficiency. Ronen & Sarath, supra note 132, at 843. Even under these assumptions, the actual manipulative trading is not profitable: “Laddering becomes feasible only in the sense that the profits made through the initial [IPO allocation] at low issue prices outweigh the losses made in the aftermarket; it does not mean that prices are inflated for any significant length of time.” Id. at 844. 

185. Aggarwal & Wu, supra note 13, at 1917.}
and Mulheren, the “information effect” trading at issue in Desai, or the “laddering” at issue in IPO, the manipulations are far more likely to have a material impact on prices in inefficient markets. Despite this, it is the shareholders of Microsoft who would have an easier time getting past the crucial class certification stage on a well-pleaded claim of market manipulation. The unfortunate shareholders of Odyssey Marine Expeditions would struggle to gain class certification for a well-pleaded claim of market manipulation, as they would likely stumble on the required showing of an efficient market.

III. THE “EFFICIENT MARKET” REQUIREMENT IN MANIPULATION CLAIMS

Having established that market manipulation schemes are most likely to succeed in thinly traded, inefficient markets and are likely to fail in efficient markets, it is now possible to address the central question of this Article: does it make sense to require 10b-5 plaintiffs alleging market manipulation to establish an efficient market in order to gain the benefit of the FOTM presumption of reliance? Does such a requirement follow from the principles evidenced by the case law? The answer at this point should be clear: no. The “efficient market” requirement manages to screen out the cases where manipulation is most likely to occur and have an appreciable impact. Indeed, the type of evidence that would tend to show that a market manipulation scheme had a material effect on the market for a security would be precisely the type of evidence that would tend to show that the market was inefficient. At the same time, the “efficient market” requirement does nothing to prevent truly dubious claims of manipulation of blue-chip stocks from getting past the crucial class certification stage, where they are likely to be settled. Furthermore, as we shall see, there is a paradox at the heart of the concept that an investor can simultaneously rely

186. This is not to say that manipulation is never possible in more efficient markets. As the Volkswagen and “flash crash” examples show, highly efficient stocks—or even broad market indexes—can occasionally exhibit characteristics permitting successful manipulation. See supra note 177. It is simply to say that a requirement that screens out inefficient stocks will be screening out many—and probably most—cases of effective manipulation.
upon prices set by an efficient market and a manipulative price signal.

Although this position—that a showing of market efficiency is an inappropriate “gatekeeping” requirement for class actions alleging market manipulation—would mark a clear break with current practice, it is actually a relatively modest proposition. One need not reject either the FOTM doctrine or the relevance of the ECMH to that doctrine in order to accept the conclusion here. Others have called for far more extreme breaks with precedent—breaks that would likely require new legislation or overruling of Supreme Court precedent.

For example, some scholars and practitioners have called for abandoning the FOTM presumption altogether, usually on the practical grounds that it generates a potential for crushing liability divorced from the merits, but also on theoretical grounds. Others have criticized courts’ use of concepts of market efficiency at all. More to the point, several scholars have questioned whether a stringent showing of market efficiency should be required for any 10b-5 claims at all, without drawing any distinction between misrepresentation claims and market manipulation claims. This attack has been on both links of the chain of indirect causation. First, scholars have noted that perfect efficiency—or even high efficiency—is not required for a stock price to be distorted by a

---

187. See Alexander, supra note 100; Romano, supra note 100.
188. See, e.g., Mahoney, supra note 88, at 625 (arguing that “rejecting FOTM and requiring individualized proof of reliance as a prerequisite to recovery under Rule 10b-5 would most closely approximate optimal deterrence”).
189. The principal thrust of these criticisms has tended to be that economists have, in light of the rise of behavioral economics, “become less convinced that market efficiency works quite so cleanly or powerfully” as might have seemed likely when Basic was decided. Langevoort, supra note 78, at 197. Similarly, the PSLRA also casts doubt on the extent to which courts should inject notions of market efficiency into securities law. See Carden, supra note 97; Oldham, supra note 43, at 1003; see also Donald C. Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. Pa. L. Rev. 851, 853-56 (1992) [hereinafter Langevoort, Theories]; Jonathan R. Macey et al., Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson, 77 Va. L. Rev. 1017, 1017-21, 1049 (1991); Robert G. Newkirk, Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context, 58 U. Chi. L. Rev. 1393, 1394-95 (1991).
190. See Langevoort, supra note 78; Langevoort, Theories, supra note 189, at 889-94, 904-05; Jonathan R. Macey et al., supra note 189, at 1049.
misrepresentation. Second, they have argued that a high standard for market efficiency is unnecessary to make reasonable an investor's reliance on the integrity of the market price. This Article takes no position on whether a showing of market efficiency should be required in misrepresentation cases; indeed, this Article assumes it should. Whether the arguments against the use of market efficiency are persuasive as applied to misrepresentation cases—and the courts have not appeared to find them persuasive—the market efficiency requirement is, at the very least, not inherently illogical as applied in such cases. Perhaps it is true that even inefficient markets can be distorted in a measurable way by misrepresentations. But it is also true, as the First Circuit pointed out in its recent In re PolyMedica Corp. Securities Litigation opinion, that market efficiency creates greater confidence that the particular misinformation alleged by the plaintiffs was, in fact, reflected in the price, and reflected in a rapid and predictable fashion.

Similarly, even if it would be reasonable for a retail investor to rely on the market price in a less-than-efficient market, presumably

191. Langevoort, for example, notes that “contemporary literature suggests that even for widely traded stocks, substantial deviations from the efficiency ideal are quite possible.” Langevoort, supra note 78, at 175 (citing Bradford Cornell & James C. Rutten, Market Efficiency, Crashes, and Securities Litigation, 81 Tul. L. Rev. 443, 450 (2006)). Indeed, the price of a stock trading on relatively inefficient markets can also be distorted by public misrepresentations. See, e.g., Bell v. Ascendant Solutions, Inc., 422 F.3d 307 (5th Cir. 2005). In Bell, the Fifth Circuit "affirmed a refusal to certify a Nasdaq-traded stock with some twenty or so market makers and high trading volume in the context of a case where immediately after a surprise disclosure of bad news, the stock price fell by some 30 percent." Langevoort, supra note 78, at 173. Furthermore, as was discussed in Part II, commentators and courts were invoking the FOTM presumption long before the ECMH made a home for itself in the legal academy.

192. Langevoort argues that Basic “makes sense only if we see it as creating an entitlement to rely on market-price integrity, even though there is no good reason for any investor simply to assume the absence of fraud.” Langevoort, supra note 78, at 178. From this proposition, he reasons that the FOTM presumption “should permit recovery without a showing of actual reliance ... so long as the market is sufficiently well organized that we have reason to believe that fraud is likely to distort the price.” Id. In this view, inefficiency should only bar the presumption “where the institutional price-setting mechanism is so weak that reliance on price integrity is manifestly unreasonable. It takes a high level of inefficiency for that to be the case.” Id.

193. One court did recognize the increasing academic skepticism of the ECMH, but decided that any reexamination of Basic in light of this skepticism was a job for the Supreme Court. Unger v. Amedisys Inc., 401 F.3d 316, 322 n.4 (5th Cir. 2005).

194. 432 F.3d 1, 19 (1st Cir. 2005).
it is more reasonable for them to rely on the market price in an efficient market. Certainly it would not be less reasonable. Thus, the requirement of an efficient market is not actually counterproductive in misrepresentation cases. At the very least, the links in the chain of indirect causation are strengthened by a showing of market manipulation, not weakened.

Securities class actions are inherently complex, uncertain, and expensive undertakings. It is only prudent to impose a gatekeeping requirement limiting the universe of cases to those in which the mechanism of injury is relatively clean and well-understood. The market efficiency requirement—even if imperfect—is at least a gesture in this direction in misrepresentation cases. It functions to screen out cases in which the relationship between the alleged misrepresentation and the price impact—if any—is likely to be muddled or attenuated, while preserving those in which the relationship is likely to be more straightforward. The same, however, cannot be said about applying the market efficiency requirement in manipulation cases. As we have seen above, market manipulations are most likely to have a relatively straightforward impact on prices in inefficient markets and least likely to have an impact in efficient markets. And yet, blind application of the efficient market requirement screens out those cases in which plaintiffs are most likely to suffer injury from manipulation, while waving through those cases in which plaintiffs are least likely to have suffered any injury. The results of the market efficiency requirement are positively perverse in manipulation cases—market efficiency actually severs one of the links in the chain of indirect causation.

This incoherence extends to the question of whether an investor’s “reliance” on the market price was reasonable. As was discussed in

195. Even Langevoort—who argues that the presumption of reliance should be treated like “a common law-like entitlement to rely on stock-price integrity, granted as a matter of juristic grace”—appears to acknowledge that, as a practical matter, “[i]nvestors who buy or sell thinly traded stocks should not be assuming much of anything.” Langevoort, supra note 78, at 171, 198.

196. Macey, Miller, Mitchell, and Netter have pointed out that event studies—identifying the impact, if any, of alleged misstatements—can be done even for thinly traded stocks, but the threshold for statistical significance will likely be far higher to reflect increased volatility. Macey et al., supra note 189, at 1018. Viewed in this light, the courts’ insistence upon market efficiency can be seen as expressing skepticism regarding the applicability of event studies in inefficient markets.
Part I, scholars have occasionally questioned the analogy of securities fraud to common law fraud. Market manipulation claims are yet one more step removed from these common law origins than are the misrepresentation cases on which courts and commentators have focused. A market manipulator makes no statement or omission that an investor could be said to “rely on” in a straightforward way at all. Indeed, to the extent that investors “rely” on a manipulative price signal—that is, believe that it signals price “momentum” or the presence of new information—they are registering their belief that the market is not even weak-form efficient.

Even indirect reliance is incoherent in this setting. In a misrepresentation case, if the market reacts to the misrepresentation, clearly someone relied—a sufficient number of market participants to drive the price. But trading manipulation involving liquidity or price pressure effects can have an effect on price even with nobody “relying” on anything. In these situations, the only thing an investor could be relying on is the integrity of the market price, which, in turn, could be affected by manipulation without anyone directly “relying” in the traditional sense. If “reasonable reliance” can mean anything in such a context, it can only mean the kind of “common law-like entitlement” favored by Langevoort as a “matter of juristic grace.”

Indeed, insofar as market manipulators do more than simply seek to mislead investors—they actively seek to exploit the mechanics of the market—some support for such an “entitlement” in the manipulation setting can be gleaned from the Basic Court’s

---

197. See supra note 52. Most obviously, Fischel argued that the common law concept of reliance is altogether incoherent in the context of open market transactions and has no place at all in 10b-5 actions. Fischel, supra note 56, at 11.

198. Recall that weak-form efficiency implies that prices fully reflect any information contained in the past movement of the stock price itself, and thus that stock prices are an example of a martingale. See supra notes 63-64 and accompanying text. Thus, if an investor believes a previous price increase means that future price increases are more likely, then the investor does not believe the market is even weak-form efficient.

199. See supra note 16.

200. Langevoort, supra note 78, at 198. The question of whether relying on the market price for a given security is actually reasonable in practice is distinct from the question of whether the law should grant such an entitlement. We may chide a homeowner for foolishly leaving his door unlocked in a high-crime area but still not deny him an action against the burglar to recover his stolen property.
invocation of the market’s “integrity,” and its oft-quoted question: “Who would knowingly roll the dice in a crooked crap game?”

So what does this mean for market manipulation cases? Does it mean that the FOTM presumption should not be applied at all in such cases? No. But it does mean that the presumption must be supported by different reasoning and, consequently, different showings by the plaintiffs. If the FOTM presumption is to be recognized in market manipulation cases, it must be for one of two reasons. First, following Fischel, one could conclude that the reliance requirement should be discarded entirely as an inapt analogy from common law fraud. If, however, one believes that the Basic formulation provides a useful framework for misrepresentation claims, and should not be pulled up root and branch, a less sweeping argument is required to distinguish market manipulation claims.

The more limited possibility is the one advocated here—to acknowledge that Basic’s reasoning from market efficiency has some force for misrepresentation claims, but to deny its applicability to market manipulation claims. If a presumption of reliance is to be given to plaintiffs bringing market manipulation claims, it must be out of the sense of entitlement suggested by Langevoort. It must be simply because—as Fischel argues—investors do and rationally should rely on prices in open market transactions, and the law should protect this reliance through a presumptive entitlement, just as it protects other reasonable and desirable activities. Such an act of “juristic grace” may not be necessary in misrepresentation claims, in which the ECMH allows courts to construct a plausible chain of indirect reliance, but it is essential for market manipulation claims. Of course, if the interest being protected is only the

203. See supra note 192.
204. Fischel, supra note 56, at 3-5.
205. See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 111 (7th ed. 2007). The argument is that efficiency is enhanced by creating and enforcing a legal right to rely—on factual representations or on lack of manipulation—rather than forcing the parties to investigate the matter ahead of time. Id.
206. See supra note 200 and accompanying text.
207. An alternative justification for requiring market efficiency in misrepresentation cases would be that it is unreasonable for investors to assume an absence of public misinformation,
right to rely on the integrity of market prices, this entitlement should not, like Basic, create a double presumption of reasonable reliance and loss causation. A presumption of loss causation can only be justified by assuming that misrepresentations will be reflected in prices through the operation of efficient markets. But there is no direct analog to this causal mechanism in market manipulation cases—as we have seen, market efficiency is likely to actually sever the causal chain. Even in an inefficient market, there is no comparable reason to assume market impact and loss causation. Thus, the only plausible presumption, as a matter of “juristic grace,” is of reasonable reliance. Making this presumption hinge on a stringent standard of efficiency is unnecessary and incoherent.

In Part IV, we will see this incoherence play out—in extravagant, extended, and expensive fashion—in two high-profile lawsuits. But we need not await this demonstration to state our conclusion: “When the rationale for a given legal rule is inapplicable, so too must be the rule.”\textsuperscript{208} The rationales for requiring plaintiffs to demonstrate an efficient market are inapplicable in market manipulation cases. Thus, the requirement should be abandoned as incoherent and counterproductive. Even if the requirement plays a useful and logical role in misrepresentation cases, it fails to do so in manipulation cases.\textsuperscript{209}

\textbf{IV. IPO and Desai—The “Efficient Market” Requirement in Action}

To fully appreciate the counterproductive nature of the “efficient market” requirement in market manipulation cases,\textsuperscript{210} it is helpful to take a closer look at two recent, high-profile cases—\textit{IPO} and \textit{Desai}.\textsuperscript{211} Both cases ultimately foundered on the efficient market

\begin{flushright}
\textsuperscript{208} Nagareda, \textit{supra} note 19, at 137.  
\textsuperscript{209} This does not imply that having no gatekeeper requirement at all would be an improvement over the market efficiency requirement. Potential “replacement” gatekeepers are discussed in Part V.  
\textsuperscript{210} See \textit{supra} Part III.  
\textsuperscript{211} Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931 (9th Cir. 2009) (per curiam); cases cited \textit{supra} note 25.
\end{flushright}
requirement, but only after years of litigation that never progressed beyond the class certification stage. The outlines of the alleged manipulative schemes were described in Part II. A more detailed account of the ensuing litigation, however, demonstrates that the efficient market requirement eventually did serve as a gatekeeper—resulting in dismissal of both cases—but in a fashion almost entirely unrelated to the merits of the underlying claims, and only after years of expensive wrangling over class certification.

A. In re IPO Securities Litigation

In 2001, following the collapse of the dot-com tech stock boom of the 1990s, thousands of individual actions were filed against the issuers and underwriters for hundreds of IPOs during the bubble.\(^{212}\) The plaintiffs’ basic premise was that underwriters used various illegal schemes to artificially inflate the price of stock for the hundreds of new tech issuers in the immediate aftermarket of their IPOs.\(^{213}\) The initial allocants and insiders at the issuers were able to unload the worthless stock at these inflated prices, kicking back a portion of the profits to the underwriters through inflated fees and other “undisclosed compensation.”\(^{214}\) The plaintiffs alleged a mix of what we have been calling “market manipulation” claims and “misrepresentation” claims. As for market manipulation, the plaintiffs alleged that the underwriters “required their customers to enter into agreements to buy additional shares of the Issuer in the aftermarket as a condition of receiving the right to purchase the IPO stock.”\(^{215}\) As part of these so-called “Tie-in Agreements,” some “customers were ... required to make those purchases at predetermined escalating prices”\(^{216}\)—a practice referred to as “laddering.”\(^{217}\)

Although the exact causal mechanisms were left fuzzy, these market manipulations evidently are supposed to have inflated price through a combination of liquidity, price pressure, and information effects.\(^{218}\)

---

213. *Id.*
214. *Id.* at 293-94.
215. *Id.*
216. *Id.*
217. *See supra* note 132 and accompanying text.
218. *IPO I*, 241 F. Supp. 2d at 303-07. The plaintiffs also alleged a welter of misrep-
1. Initial District Court Proceedings

The primary struggle in IPO was over class certification, an issue that ballooned into a five-year war of experts centered on the issues of market efficiency and loss causation. The plaintiffs sought a class period for each stock ranging from the IPO date to December 6, 2000—a period that stretched over eighteen months for at least one stock—and sought to rely on the FOTM presumption of reliance. In an October 13, 2004, opinion, Judge Scheindlin granted class certification. On the basis of then-controlling precedents in the Second Circuit, Judge Scheindlin found that, in order to certify a class in which the elements of Rule 23 are “enmeshed” with the merits, plaintiffs needed only make “some showing” that those elements were met. As a result, Judge Scheindlin found that the question of market efficiency was ultimately a factual issue “to be resolved at trial.” Accordingly, upon noting that the focus stocks (1) traded on the NASDAQ, (2) traded at relatively high volume, and (3) were followed by analysts and the media, Judge Scheindlin

representations—in the registration statements and prospectuses themselves, and in analyst reports and other public statements—in support of these supposed market manipulations. Id. at 296. Claims for these misrepresentations were brought under sections 11 and 15 of the 1933 Act, and sections 10(b) and 20 of the 1934 Act. The potential damages stretched into the hundreds of billions. Id. at 296-98.


IPO II, 227 F.R.D. 65, 72, 74 (S.D.N.Y. 2004), vacated, 471 F.3d 24 (2d Cir. 2006). In addition to hundreds of pages of briefing and thousands of pages of exhibits and appendices, the parties submitted a total of eleven expert reports supporting or opposing class certification. Id. at 73-74.

Id. at 74, 122.


IPO II, 227 F.R.D. at 92-93.

Id. at 107.

Id. Judge Scheindlin mentioned that “[t]he Second Circuit has not adopted a test or method for determining whether the market for a security is efficient,” and listed the Cammer factors as plausible indicia, but held out the possibility that less stringent standards for market efficiency could also be appropriate. Id. at 107 & n.323.
found the undemanding “some showing” standard met for the purposes of class certification.\footnote{Id. at 107-08. Interestingly, without explicitly noting that she was doing so, Judge Scheindlin appears to have proceeded under the assumption that market efficiency did not entitle the plaintiffs to a presumption of loss causation for market manipulation claims. Instead, the district court analyzed loss causation separately, asking whether the plaintiffs had “present[ed] a methodology for determining loss causation that may be commonly applied to all members of the class.” Id. at 111. Again, the district court proceeded under the lenient “some showing” standard, declining to engage in a duel of the experts at class certification. Id. at 93, 114-15. Accordingly, the district court found that the plaintiffs had “satisfied their burden at this stage to articulate a theory of loss causation that is not fatally flawed.” Id. at 115. The plaintiffs’ proposed methodology was set forth in a trio of expert reports submitted by Fischel. See id. at 112-14.}

2. Appeal to the Second Circuit—IPO III

On appeal, the Second Circuit considered two issues: (1) whether the district court was correct to use the lenient “some showing” standard at class certification; and (2) whether the Basic presumption could apply.\footnote{IPO III, 471 F.3d 24, 31 (2d Cir. 2006).} Before the Second Circuit, in addition to a sweeping argument that the FOTM presumption should never apply to market manipulation claims,\footnote{Reply Brief for Defendant-Appellant Underwriters at 26, IPO III, 471 F.3d 24 (2d Cir. 2006) (No. 05-3349-cv), 2005 WL 6068757 [hereinafter IPO III Def. Brief]. In arguing that efficient markets are unlikely to be affected by manipulative trading, the defendants relied heavily on West v. Prudential Sec., Inc., 282 F.3d 935 (7th Cir. 2002), and on Fischel’s academic publications, including Fischel & Ross, supra note 102. IPO III Def. Brief, supra at 47-48, 68.} the defendants pointed out that, under Basic, a presumption of reliance could not be afforded to the plaintiffs because they had failed to demonstrate an efficient market.\footnote{IPO III Def. Brief, supra note 228, at 31-35. Among other things, the defendants argued that post-IPO “quiet period[s]” during which analysts cannot report, the inability of new issuers to file simplified Form S-3 statements, and the nature of the Internet “bubble” all weighed against a finding that the focus stocks traded in efficient markets. Id.} Furthermore, the defendants argued that the plaintiffs failed to establish that loss causation could be proved on a common basis, thus also tacitly recognizing that a presumption of loss causation is not warranted in market manipulation cases.\footnote{Id. at 32.} By now, the muddle is painfully obvious. Both sides—defendants and plaintiffs alike—are put in a Catch-22 situation by the combination of Basic’s seeming insistence on market efficiency and the seeming
incompatibility of efficiency and successful market manipulation. In order to survive a motion to dismiss, the plaintiffs must allege that the defendants’ manipulative trading had a significant and lasting impact on market price—a claim that is broadly inconsistent with actual market efficiency. But in order to get a presumption of reliance and gain class certification, the plaintiffs are then forced to turn around and argue market efficiency. On the other side of the coin, in order to combat class certification, the defendants are forced to argue that the relevant markets are inefficient. To prevail on the merits, however, they would have every reason to turn around and argue that, in fact, the markets were too efficient for any manipulative trading to have an appreciable effect.

The muddle is easily resolved, however, when one separates the justifications for the FOTM presumption in misrepresentation claims from those for the FOTM presumption in market manipulation claims. The district court and the defendants appeared to recognize—without saying so explicitly—that loss causation cannot be presumed for market manipulation claims. The double presumption is off the table, and the only question at issue is reasonable reliance. But as has been shown, the question of “relying” on a manipulation is often incoherent—manipulations can have an impact on price without anyone “relying” on anything. The court must either reject reliance as an element altogether or else must treat reliance as an entitlement to rely on the integrity of the market. If the court rejects reliance altogether, market efficiency is necessarily irrelevant. If the court treats reasonable reliance as a matter of entitlement, market efficiency is relevant only insofar as we condition the entitlement on some minimum showing that the relevant market was open and developed. In either case, the parties would not need to tie themselves up in knots arguing simultaneously for and against market efficiency.

Alas, the Second Circuit did not see fit to clear up the muddle and, in fact, did not appear to notice it. The bulk of the opinion is

231. Of course, this is not the only argument open to defendants. They could, for example, deny efficiency at the class certification stage and then argue on the merits that the allegedly manipulative trades were not motivated by manipulative intent. The point is simply that the parties—plaintiff and defendant alike—will generally find it in their interests to argue one way with respect to efficiency at class certification, and the other way on the merits.

taken up with the procedural question of the proper standard for determining whether the requirements of Rule 23 are met. The court joined other circuits in rejecting the lenient "some showing" standard, holding that a district court must make a firm determination—prior to certifying a class—that each of the Rule 23 requirements has been met, even if these requirements overlap with the merits.  

Because the applicability of the FOTM presumption will determine the predominance of common issues, this new standard entailed rigorous scrutiny of market efficiency at the class certification stage. Rather than remanding for reconsideration under the proper standard, the Second Circuit considered the question itself. Although the court suggested that it is "doubtful whether the Basic presumption can be extended, beyond its original context, to tie-in trading," the court did not consider whether the market efficiency requirement was appropriate in this different context, and instead cited precedent involving misrepresentation claims. The court went on to find that the plaintiffs were not entitled to the presumption in any case, because "the market for IPO shares is not efficient"—a finding based largely on the same factors cited by the defendants. The court went on to observe that "the [p]laintiffs' own allegations as to how slow the market was to correct the alleged price inflation despite what they also allege was widespread know-

233. See IPO III, 471 F.3d at 42; In re Polymedica Corp. Sec. Litig., 432 F.3d 1, 5-6 (1st Cir. 2005); Unger v. Amedisys Inc., 401 F.3d 316, 319 (5th Cir. 2005); Blades v. Monsanto Co., 400 F.3d 562, 566-67, 575 (8th Cir. 2005); Gariety v. Grant Thornton, L.L.P., 368 F.3d 356, 366 (4th Cir. 2004) ("[T]he factors spelled out in Rule 23 must be addressed through findings, even if they overlap with issues on the merits."). aff'd, 261 F. App'x 456 (4th Cir. 2008); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 166-69 (3d Cir. 2001); Szabo v. Bridgeport Mach., Inc., 249 F.3d 672, 676 (7th Cir. 2001) ("[A] judge should make whatever factual and legal inquiries are necessary under Rule 23 [even if] the judge must make a preliminary inquiry into the merits.").

234. See, e.g., IPO III, 471 F.3d at 42-43.

235. Id. at 43.

236. In describing the FOTM doctrine, the IPO III court cited Hevesi v. Citigroup Inc., 366 F.3d 70, 77 (2d Cir. 2004) ("The fraud-on-the-market doctrine, as described by the Supreme Court in Basic Inc. v. Levinson, creates a rebuttable presumption that (1) misrepresentations by an issuer affect the price of securities traded in the open market, and (2) investors rely on the market price of securities as an accurate measure of their intrinsic value."). IPO III, 471 F.3d at 42.

237. IPO III, 471 F.3d at 42.
ledge of the scheme indicate the very antithesis of an efficient market." This final observation of the IPO III court perfectly encapsulates the impossible dilemma facing investors seeking to bring market manipulation claims as class actions. Because of the "efficient market" requirement, the more plausible the allegations of manipulation, the less likely a class is to be certified in the first place.

3. Back to the District Court

Following IPO III, the district court permitted the plaintiffs to amend their allegations to avoid the most glaring defects pointed out by the Second Circuit, and then rejected the defendants' motion to dismiss the amended complaints. At this point, the question again became one of class certification.

For the first time, the plaintiffs attempted to draw a distinction between the misrepresentation and market manipulation claims, and argued that the FOTM presumption should function differently for the different types of claims. For the market manipulation claims, the plaintiffs argued that if they could show that loss causation was susceptible to classwide proof, they should benefit from a presumption of reliance if they could show "that the market

---

238. Id. at 43. The court also pointed out several other aspects of the claims that were "bristling with individual questions." Id. at 44. Indeed, the IPO III court would have had ample reason to decertify the classes even if the FOTM presumptions had applied.
239. IPO IV, 544 F. Supp. 2d 277, 281, 302 (S.D.N.Y. 2008). Somewhat implausibly, Judge Scheindlin found that the Second Circuit's finding of market inefficiency applied only to the primary market for IPO shares, the initial allocation, and not to secondary trading in the aftermarket. Id. at 295. Incidentally, nearly a dozen more expert reports were generated in the course of briefing the new motion to dismiss. If nothing else, the IPO case highlights what a cash machine current doctrine can be for experts on market efficiency.
241. After arguing that Basic provided for a double presumption of reliance and loss causation, the plaintiffs acknowledged the need to show market efficiency to gain the FOTM presumption for their misrepresentation claims. Id. at 36, 44-45.
242. Plaintiffs argued that they had "submitted expert reports explaining how Plaintiffs intend to prove, on a classwide basis, that Defendants' manipulative conduct artificially inflated stock prices." Id. at 38.
appeared to be efficient to the average investor”—even if the market’s efficiency had been destroyed by manipulation.243

Although the IPO plaintiffs were unable to offer much in the way of support for this argument, it has some appeal when viewed in light of the analysis in Part III. Because the picture of indirect reliance—through the mechanism of efficient markets—does not apply to market manipulations, plaintiffs should not benefit from a presumption of loss causation. But if we are to keep reliance as a requirement at all, it should be presumed, in keeping with the purposes of the 1934 Act: “restoring investor[] confidence in financial markets” and “reducing transaction costs associated with a caveat-investor rule.”244 As such, investors should be required to show only that some basic indicia of efficiency were present in order for reasonable reliance to be presumed.245 For better or for worse, this argument never got a hearing in court. After eight years of litigation, never progressing past the class certification stage, the parties reached a settlement for $586 million.246

243. Specifically, the plaintiffs argued that

in a manipulation case, where the plaintiffs expect to bear the burden of establishing the existence of artificial inflation, so long as the plaintiffs can show that the market appeared to be efficient to the average investor, they should also be “presumed to rely reasonably on the integrity of the market price of a security that is traded in such a market.”

Id. (quoting Freeman v. Laventhol & Horwath, 915 F.2d 193, 198 (6th Cir. 1990)). The plaintiffs sought to bolster their argument by citing a recent Second Circuit opinion referring to “reliance on an assumption of an efficient market free of manipulation” as an element of a market manipulation claim. ATSI Commc’ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 101 (2d Cir. 2007). It seems unlikely, however, that the ATSI panel intended to redefine application of Basic in the manner suggested by the plaintiffs.

244. Futura Dev. Corp. v. Centex Corp., 761 F.2d 33, 40 (1st Cir. 1985); see also Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988) (“[Congress] enacted legislation to facilitate an investor’s reliance on the integrity of [securities] markets.”).

245. Unlike a showing of genuine market efficiency, this showing would not necessarily contradict a claim of market manipulation, though it still could rule out class actions for extremely thinly traded stocks, in which we might think manipulation would be most common.

B. Desai v. Deutsche Bank Securities

Desai presents another seven-year odyssey in failed pursuit of class certification.\textsuperscript{247} This time, however, the plaintiffs began arguing early on that the reliance requirement should work differently in market manipulation claims, forcing the courts to confront the issue. The results were dispiriting.

1. Minnesota District Court

After initially claiming that they were entitled to the FOTM presumption of reliance under Basic, the plaintiffs “waffled in their presentation of the theory of their case” upon realizing that market efficiency would be inconsistent with the allegations of enormous price swings due to manipulation.\textsuperscript{248} The plaintiffs “concede[d] that the market for Genesis stock was not ‘efficient’ as that term is used in establishing a fraud-on-the-market presumption of reliance, and [that] a showing of efficiency is essential to the applicability of this presumption.”\textsuperscript{249} Instead—like the plaintiffs in IPO eventually did—the plaintiffs in Desai claimed “that they ‘relied upon the integrity of the market, which had been secretly corrupted’ by Defendants.”\textsuperscript{250} Rather than treating reliance on the “integrity” of the market as an entitlement or judicial presumption, the district court proceeded to treat it as something that would have to be established for each individual plaintiff.\textsuperscript{251} As a result, the court found that individual issues would predominate, precluding class certification.\textsuperscript{252}

\textsuperscript{247} The allegations regarding manipulation of Genesis stock were described in some detail in Part II.B.5 and will not be repeated here. The procedural history is tangled. The suit itself was initially filed in the Central District of California and transferred to the District of Minnesota in 2003. Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931, 935-36 (9th Cir. 2009) (per curiam). Following denial of class certification, the case was transferred back to California. \textit{Id.} at 936.


\textsuperscript{249} \textit{Id.}

\textsuperscript{250} \textit{Id.} at 333.

\textsuperscript{251} \textit{Id.} at 334 (“Plaintiffs have not provided the Court with any authority to establish that reliance on the integrity of the market price, without a showing that the market was efficient, may create a class-wide presumption of reliance.”).

\textsuperscript{252} \textit{Id.} (‘Plaintiffs’ allegations that each member of the class relied on the integrity of the
2. California District Court

Class certification was considered again by the California district court, by which time the plaintiffs presented a more developed theory of reliance on the "integrity of the market."*253 At the hearing on class certification, plaintiffs’ counsel began by pointing out that market manipulation claims are different in character from the “traditional misrepresentation [or] omission case.”*254 Plaintiffs’ went on to argue that unlike in a misrepresentation case, in which false information affects the market price through the workings of an efficient market, in a market manipulation case, the "integrity of the market is really what has been attacked."*255 In such a case, plaintiffs should only be required to show reliance “upon the integrity of the market”—namely, “that had they known that the market do not, however, provide the Court with the mechanism by which to presume that each class member did so.”).

For good measure, the court also argued that because Desai himself was not a passive investor—he testified that he bought the stock because it was “mispriced” due to investor confusion over an announced stock split—then even the lead plaintiff did not actually rely on the “integrity” of the market. Id. at 333. As Fischel pointed out back in 1982, it is “difficult to know what to make” of this kind of argument, which “reflect[s] a conceptual confusion concerning the market model of the investment decision.” Fischel, supra note 56, at 11. “[A]n investor could only decide that particular information”—like a stock split—“was relevant by reference to the existing market price, ... when deciding whether to purchase/sell.” Id. “By definition, investors would have paid or received a different price” in the absence of manipulation. Id. Thus, even an investor who believes a stock is mispriced relies on the integrity of the market in making that judgment. This type of confusion resurfaces with a vengeance in the California district court. See infra Part IV.B.2.

253. In addition to the novel “integrity of the market” theory, the plaintiffs also argued that the Affiliated Ute presumption, for cases of material omissions, should apply, based on the defendants’ failure to disclose the manipulative scheme. In re GenesisIntermedia, Inc. Sec. Litig., 2007 WL 1953475, at *6 (C.D. Cal. 2007) (citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972)). The court rejected this argument, finding that the “[p]laintiffs' complaint cannot be construed as alleging ‘primarily’ claims of omissions.” Id. at *7.

254. Id. Plaintiffs’ counsel said the following:

‘Ninety percent of the cases that have been before Your Honor, someone will come in with a 10(K) or false financial and say, look right here on this piece of paper, they lied about the condition of the company. That piece of information is read by analysts, maybe read by individual investors, and permeates into the market price. That is—if the market is efficient, that information is absorbed and reflects itself in a higher price. That’s a traditional misrepresentation [or] omission case. That’s not this case.

Id.

255. Id.
[manipulation] was afoot ... they never would have purchased their stock.”

Plaintiffs went on to note the Catch-22 nature of requiring a showing of market efficiency: “you can’t possibly require the plaintiff to prove an efficient market when, by definition, his own expert and the whole proof of the case is going to be that these guys manipulated the market to destroy the very efficiency.”

Finally, the plaintiffs argued that market efficiency plays a causal role in misrepresentation cases that it does not play in market manipulation cases. When a defendant has made a false statement, “there has to be a showing that the market was efficient to absorb that information,” whereas in a manipulation case, “[t]here’s nothing that can be absorbed that’s going to matter.”

The California district court rejected this argument on four grounds: (1) that courts do not distinguish between misrepresentation and market manipulation claims for purposes of reliance; (2) that no courts have adopted an “integrity of the market” theory; (3) that the theory “is logically flawed because the inference of reliance is broken if the market price of a security does not reflect the manipulative activity”; and (4) that the plaintiffs had also brought misrepresentation claims.

This last ground is theoretically uninteresting—the question is whether an “integrity of the market” theory can ever apply to market manipulation claims. The first two grounds merely restate the same conclusion twice—one which is readily apparent at this point: that courts, to date, have not thought through the salient differences between misrepresentation and market manipulation claims. The question was whether this court would be any different. In the analysis supporting its third reason, the court answers with a resounding “no.”

In arguing that the plaintiffs’ theory is “logically flawed,” the court rehearses the usual story of indirect reliance. But the court reflexively extends this story to manipulations, stating that “[r]eliance on the stock price is presumed to demonstrate indirect

256. Id.
257. Id. at *8.
258. Id.
259. Id.
260. A legitimate question exists, of course, as to how plaintiffs should be permitted to establish reliance in cases involving both manipulation and overt misrepresentation.
reliance on a misrepresentation or manipulation because an efficient market reflects the misrepresentation or manipulation in the price of the stock. But, the court held, the plaintiffs conceded that the market was not efficient.

Therefore, the Court cannot presume that the Genesis stock price reflected any misrepresentations or manipulative conduct. As a result, even if a plaintiff relied on the stock price when purchasing Genesis securities, the Court cannot presume that such reliance constitutes indirect reliance on a manipulation or misrepresentation. In other words, a key link in the chain of inferences supporting the presumption of reliance is broken where the market is not efficient. Therefore, even if it is undisputed that the Plaintiffs relied on the integrity of the market when they purchased Genesis stock, the Court has no means to rationally infer that the Plaintiffs relied on the manipulations or misrepresentations at issue.

Unfortunately, this reasoning has it completely backward. As is shown in Part I.B.1, although it is perfectly true that market efficiency strengthens the supposition that a misrepresentation will be reflected in the price, market efficiency actually weakens any supposition that manipulative trading will have an effect on price. Of course, this makes the double presumption of Basic—reliance AND loss causation—untenable in manipulation cases. Plaintiffs will still need to show that the alleged manipulations actually affected the market price. If anything, however, such a showing would be made far less likely by the existence of a highly efficient market. But if plaintiffs can establish an effect on prices, then “[b]y definition, investors would have paid or received a different price had there been no fraud on the market,” efficient market or not.

3. The Ninth Circuit Opinion

On appeal, the Ninth Circuit’s majority opinion almost entirely dodged the “integrity of the market” question. After giving a brief

262. *Id.*
summary of the plaintiffs’ argument, the majority dismissed it in three words: “We are chary.” 264 After declaring their chariness, the majority simply noted that “[n]o authority required the district court to adopt [plaintiffs’] integrity of the market presumption,” 265 and that the Supreme Court had cautioned that “the § 10(b) private right should not be extended beyond its present boundaries.” 266 As a result, the majority concluded that “the district court did not abuse its discretion” in rejecting the “integrity of the market” theory. 267 A concurrence by Judge O’Scannlain faulted the court for passing the buck, noting that if the presumption put forth by the plaintiffs is “legally valid,” its rejection is necessarily an abuse of discretion. 268 O’Scannlain then proceeded to “address the integrity of the market presumption on the merits,” ultimately rejecting it. 269 First, O’Scannlain reiterated that current case law does not recognize such a theory. 270 He then went on to reject the theory on the merits, arguing that it “would permit a presumption of reliance no matter how unlikely it is that the market price in question would actually reflect the alleged manipulation.” 271

The traditional requirement of an efficient market does not address O’Scannlain’s concern, though, and in fact exacerbates it. As we have seen, market manipulations are most likely to affect market prices in inefficient markets, and most unlikely to affect market prices in efficient markets. Yet O’Scannlain would allow claims of manipulation in efficient markets an express lane to class certification—and almost certain settlement—but block claims of manipulation in inefficient markets.

264. Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931, 942 (9th Cir. 2009) (per curiam).
265. Id.
267. Desai, 573 F.3d at 942.
268. Id. at 943 (O’Scannlain, J., concurring) (“We review class certification decisions for abuse of discretion, but errors of law constitute per se abuses of discretion.”).
269. Id.
270. Id. at 943-44.
271. Id. at 945.
O'Scannlain concluded the plaintiffs’ theory “would prove too much while doing too little.” Too much, “because it would obviate the need for plaintiffs in manipulative conduct cases to prove reliance.” Too little, “because it does not complete the causal connection between a plaintiff’s transaction in securities and a defendant’s manipulation.” Tellingly, these concerns are only valid if O'Scannlain is picturing the double presumption from Basic. But, as the plaintiffs in IPO ultimately argued, a presumption of reliance on the integrity of the market does not necessarily entail a presumption of loss causation. The plaintiffs can still be required to show that the price during the class period was affected by the manipulation. Of course, because O'Scannlain is no doubt aware that securities class actions overwhelmingly settle upon certification of a class, it may be that he is really concerned that, unless the plaintiffs are required to show loss causation at class certification, they will never be required to show it at all.

At the end of his concurrence, O'Scannlain appeared to acknowledge the very problem discussed in this Article—that the market-efficiency-based story of indirect reliance underlying the double-preservation version of the FOTM theory might not really apply to manipulation cases. In a footnote, he noted that “a plaintiff must still show that the market in question could absorb into the price the misinformation communicated by the alleged manipulation,” but asked whether a plaintiff should be required to “show the same type of proof of an efficient market in a manipulation case as is required in a misrepresentation case.” Ultimately, however, O'Scannlain found that this question was not before the court, as the plaintiffs “forsook the fraud on the market theory.”

272. Id.
273. Id.
274. Id.
275. This is a very real concern and is addressed in Part V.
276. Desai, 573 F.3d at 945-46 n.1.
277. Id. This statement is perhaps questionable. The plaintiffs could be said to have argued for a different application of the FOTM theory to manipulation claims—just as O'Scannlain speculated was possible.
V. OUT OF THE MUDDLE: A “LOSS CAUSATION” REQUIREMENT

As Desai and IPO demonstrate, courts are likely to see increasing numbers of plaintiffs seeking to avoid the Catch-22 of the efficient market requirement—requiring both a showing of manipulation and a showing that a manipulation could not have succeeded—by urging a reconception of the FOTM doctrine in market manipulation cases.278 The arguments they make are likely to resemble those made in the dying stages of Desai and IPO—that plaintiffs making market manipulation claims should be granted a presumption that they reasonably relied on the “integrity” of the market. In dealing with these arguments, courts will eventually have to do better than “we are chary.”279

The best solution would be to replace the requirement that plaintiffs demonstrate market efficiency with a requirement that they demonstrate market impact—that is, loss causation. It is the loss causation link in the chain of indirect reliance that is missing in manipulation cases; plaintiffs should be required to supply it to gain class certification.

Courts have other options, but none are as appealing. First, they could—like the Desai majority—reject such arguments wholesale in favor of the status quo requirement of an efficient market for all 10b-5 claims. As should be clear at this point, the status quo is untenable.280 Unlike misrepresentations, it is not a matter of “common sense and probability”281 that trading manipulations will affect the price of stocks traded in efficient markets. Instead, the efficient market requirement filters out plausible claims, while posing little obstacle to class certification for implausible claims. In performing this topsy-turvy filtering, the “efficient market” requirement is not even “efficient” with respect to litigation costs.

278. See, for example, In re Citigroup Auction Rate Securities Litigation, 700 F. Supp. 2d 294, 301 (S.D.N.Y. 2009), in which plaintiffs alleging market manipulation explicitly acknowledged lack of market efficiency and sought to rely “upon the integrity of the market” for the defendant’s shares.
279. Desai, 573 F.3d at 942 (per curiam).
280. See supra Part IV.
Alternatively, the courts could embrace the Desai plaintiffs' “integrity of the market” theory with open arms, allowing a presumption of reliance without any showing at all.\textsuperscript{282} From a strictly theoretical point of view, this approach may make the most sense.\textsuperscript{283} Despite its theoretical appeal, however, powerful practical

\begin{footnotesize}
\textsuperscript{282} Desai, 573 F.3d at 942.
\textsuperscript{283} Recall that Fischel originally argued that, even for misrepresentations, “[t]he logic of the fraud on the market theory dictates that the reliance requirement as conventionally interpreted be discarded altogether.” Fischel, supra note 56, at 11. This is especially so in market manipulation cases, in which even Basic's story of indirect reliance is incoherent—when the manipulation distorts prices directly through liquidity and demand pressures, nobody can be said to have “relied” on false information at all in the conventional sense. See supra text accompanying notes 198-202.

Likewise, Judge O'Scannlain's concern—that such a rule “would permit a presumption of reliance no matter how unlikely it is that the market price in question would actually reflect the alleged manipulation”—may be technically accurate, but theoretically misplaced in the context of the class certification decision. Desai, 573 F.3d at 945 (O'Scannlain, J., concurring). After all, in order to ultimately prevail at trial, plaintiffs would eventually have to show that prices were actually affected. But at class certification, the relevant question is not whether loss causation—and thus, indirectly, reliance—can be established. The relevant question is whether, if loss causation—and thus, indirectly, reliance—can in the end be established, it will be through common proof. Where the loss is allegedly caused by changes in market prices, loss causation can almost always be established through common proof.

Furthermore, the theoretical concern about the FOTM presumption raised by Mahoney is less pressing in the market manipulation context. Briefly, Mahoney argues that the purpose of a reliance requirement is to minimize the social costs of fraud, which are primarily precaution costs—society believes it is cheaper to protect investors against misrepresentations ex post by first requiring them to rely and then allowing them to recover via securities fraud claims, rather than requiring them to protect themselves against misrepresentations ex ante by independent investigation of the relevant information. See Mahoney, supra note 88, at 638-39. Although Fischel appeared to assume that the primary effect of a presumption of reliance would be to induce “informed” traders to become “uninformed,” Fischel, supra note 56, at 13, —thus saving unnecessary “precaution costs”—Mahoney argues that the primary effect would be to cause informed traders to engage in independent investigation, rather than to rely. Mahoney, supra note 88, at 640. After all, those who do not rely will be better off in the absence of a reliance requirement, although those who do rely will be worse off—they will have to share any 10b-5 recovery with those who did not rely. Thus, a presumption of reliance “does not reduce precautions—it reduces reliance, which is just the opposite of the purpose of fraud law.” Id.

This objection has far less force in the context of market manipulation claims. In manipulations carried out primarily through liquidity and demand effects, nobody has to “rely” on anything. In manipulations carried out primarily through information effects—in which the major effect on prices is achieved through other investors' credulous “price decoding” of the manipulative trades, the analysis is more complex. See supra notes 183-85 and accompanying text. The false “information”—a misleading price/volume “signal”—is, as a practical matter, instantly and costlessly available to investors. But this information cannot simply be “relied on” like a statement in a quarterly report. It must be interpreted by price decoding—a potentially costly and difficult undertaking. See Gilson & Kraakman, supra note
considerations weigh against such a course. First of all, eliminating
the reliance element altogether—in deed, if not in word—would
represent a clear break with an explicit holding of Basic.284 Second,
it would remove entirely any gatekeeper to class certification when
“[w]ith vanishingly rare exception, class certification sets the
litigation on a path toward resolution by way of settlement, not full-
fledged testing of the plaintiffs’ case by trial.”285

Some may argue that the gatekeeper problem is less pressing in
the wake of the Supreme Court’s recent holding in Bell Atlantic v.
Twombly.286 In Twombly, the Court “retired” the old pleading
standard—that a complaint may only be dismissed if it appears the
plaintiff can prove “no set of facts” entitling her to relief—in favor
of more stringent “‘plausibility pleading,’ in which the plaintiff is
required to plead facts sufficient to suggest that the claim for relief
is ‘plausible.’”287 Even under the new “plausibility” standard, how-
ever, courts are required to accept the pleaded facts as true for the
purposes of a Rule 12(b)(6) motion to dismiss.288 Thus, although
Twombly requires that the facts as pleaded present a plausible
claim for relief—a standard that should not present serious
difficulty to skilled plaintiffs’ lawyers—it does nothing to allow
courts to consider the plausibility of the alleged facts themselves
until after class action, when it is too late.289 In practice, then,

105, at 572-79.

If an investor “relies” on the price/volume signal—that is, assumes without investigation
that the signal is not a manipulation—the investor may waste resources fruitlessly
attempting to decode it. If the investor does not rely—that is investigates to determine
whether the signal is a possible manipulation—he may realize the signal contains no real
information, and not bother expending resources decoding it. Thus, the absence of a “reliance”
requirement in manipulation cases may increase “precaution costs,” but decrease the
resources wasted on price decoding.

284. Basic, 485 U.S. at 243 (“[R]eliance is an element of a Rule 10b-5 cause of action.”).

285. Nagareda, supra note 19, at 99. In practice, then, O’Scannlain’s concern, see supra text
accompanying note 271, is well placed.


recently, the Court has affirmed that this “plausibility” standard applies to all aspects of a


289. Similarly, the pleading particularity requirements of Rule 9(b) and the
PSLRA—although certainly increasing the legal skill necessary to bring a complaint that will
survive a motion to dismiss—do little to provide courts with the ability to reject factually
implausible claims prior to class certification.
O'Scannlain’s concern is well-placed.\textsuperscript{290} The pure “integrity of the market” presumption put forward by the \textit{Desai} plaintiffs would allow manipulation plaintiffs a free pass to class certification and settlement, without any assurance that the alleged manipulations actually affected prices.\textsuperscript{291}

The better solution is to allow plaintiffs—as a matter of juristic grace—an irrebuttable presumption that they relied on the “integrity” of the market, but require them to connect that reliance to the manipulation by demonstrating market impact at the class certification stage. This solution is tailored to the fact that, unlike in the case of a material misrepresentation, the ECMH cannot serve to establish—as a matter of “common sense and probability”\textsuperscript{292}—that market manipulations will affect stock prices. A showing of market impact, therefore, supplies the missing causal link between reliance and the manipulation. A requirement that this showing take place at the class certification stage also serves as a logical gatekeeper that actually pertains to the merits—blocking claims in which plaintiffs are unable to establish a link between the alleged manipulations and changes in prices, while allowing meritorious suits to progress beyond class certification to almost certain settlement. This is in contrast to the current gatekeeper—a showing of market efficiency—which screens out the most likely candidates for market manipulation but poses no obstacle to dubious claims.\textsuperscript{293}

Thus, the plaintiffs in \textit{IPO} and \textit{Desai} should have been required, in order to achieve class certification, to make a showing—supported by expert testimony—that the alleged manipulations did, in fact, affect prices in a manner that would harm the plaintiff class.\textsuperscript{294}

\textsuperscript{290} Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931, 943 (9th Cir. 2009) (O’Scannlain, J., concurring).

\textsuperscript{291} By contrast, the traditional FOTM doctrine—coupled with the requirement of an efficient market—does provide at least some assurance of market impact in misrepresentation cases. To survive a motion to dismiss, plaintiffs must allege material misrepresentations. To gain class certification, they must demonstrate an efficient market. In an efficient market, of course, any material misinformation would be reflected in prices.

\textsuperscript{292} Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988).

\textsuperscript{293} A requirement that plaintiffs show loss causation also goes far toward Fischel’s original view that the only relevant question in 10b-5 claims is “whether the alleged [misconduct] ... caused the security to trade at an artificially high or low price.” Fischel, \textit{supra} note 56, at 7.

\textsuperscript{294} In the typical FOTM misrepresentation case, the plaintiff usually demonstrates loss causation by showing an abnormal movement in the relevant stock price, relative to a broader
The key question, of course, is whether such a showing of loss causation is appropriate at the class certification stage. Interestingly, a divided panel of the Fifth Circuit in *Oscar Private Equity Investment v. Allegiance Telecom, Inc.*, recently announced a requirement that plaintiffs in all 10b-5 suits—misrepresentation and manipulation alike—demonstrate loss causation at class certification in order to benefit from the FOTM presumption. 295 Commentary on the *Oscar* majority’s reasoning has been skeptical, 296 and courts outside the Fifth Circuit have not been receptive to the holding. 297 Nonetheless, it is valuable to consider whether the majority’s reasoning applies in manipulation cases, and whether the criticisms lose their force in this context.

The *Oscar* majority notes that the “requirement [of a showing of loss causation] was not plucked from the air,” 298 but rather was based on *Basic*’s statement “that the presumption of reliance may be rebutted by ‘[a]ny showing that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff.’” 299 Through an extremely lenient “any showing” standard of rebuttal, the Fifth Circuit has, as a practical matter, “required plaintiffs invoking the fraud on the market theory to demonstrate loss causation.” 300

According to the majority, a showing of actual loss causation is required—as opposed to a generalized showing at class certification that loss causation can be established through common proof—because actual loss causation is necessary to provide a causal connection between the plaintiffs’ reliance and the defendants’ misrepresentation. 301 A mere showing of “market efficiency” does not

---

market index, that can be linked to the misrepresentation or subsequent disclosure. For market manipulation cases, the showing would be similar—an abnormal movement that can be linked to the alleged manipulative trades. For the most inefficient penny stocks, such a showing may be difficult, due to high volatility and lack of a stable “baseline” for the stock. Of course, this difficulty would have to be overcome in order to prevail on the merits—the only difference here is that the difficulty would have to be overcome to achieve class certification.

295. 487 F.3d 261, 269 (5th Cir. 2007); see also Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 665 (5th Cir. 2004).

296. See, e.g., Langevoort, supra note 78, at 184-89.


298. *Oscar*, 487 F.3d at 265.

299. Id. (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988)).

300. Id.

301. Id. at 269 (noting that a more generalized showing “might” be appropriate “if loss
necessarily establish this causal link because the market could be “demonstrated efficient by the usual indicia,” but still be “actually inefficient with respect to the particular type of information conveyed by the material misrepresentation.” 302 In sum, the Oscar majority was skeptical of the first prong of Basic’s double presumption—that material misrepresentations will necessarily be reflected in prices in efficient markets. 303

In addition to providing the necessary causal connection between reliance and the misrepresentation, the majority believed the loss causation showing must occur at class certification because, in modern litigation, class certification is the “signal event of the case,” conferring “in terrorem power” on the plaintiffs and allowing them to force settlement. 304 The court noted that the 2003 amendments to Rule 23 strongly suggest that such decisions should be made in a rigorous fashion prior to class certification, even if the issues overlap with the merits. 305 What is more, the majority argued, a showing of loss causation should not require extensive discovery, as the evidence will usually be “drawn from public data and public filings,” and the court’s findings will be “largely an empirical judgment that can be made [at class certification] as well as later in the litigation.” 306 The majority’s arguments in favor of a thoroughgoing showing of loss causation at class certification, then, take three forms. First, loss causation is necessary to establish a causal connection between reliance on the market price and the misrepresentation, and market efficiency does not necessarily imply loss

302. Id. Alternatively, the misrepresentation would also not be reflected in the price if the market is actually strong-form efficient. Id. (“A second possible explanation for a misrepresentation’s failure to move the market is that the market was strong-form efficient with respect to that type of information, i.e., due to insider trading, the [true information] was reflected by the stock price well before the ... corrective disclosure.”). For a general discussion of strong-form efficiency, see supra note 65.

303. Oscar, 487 F.3d at 264-65.

304. Id. at 266-67.

305. Id. at 267 (“These subtle changes [to Rule 23], as well as the less-subtle PSLRA, recognize that a district court’s certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it.”).

306. Id.
causation.\textsuperscript{307} Second, the class certification decision is the “signal event” in securities litigation.\textsuperscript{308} Third, establishing loss causation should not require significant discovery.\textsuperscript{309}

Of these, the first gains significantly in strength when applied to market manipulation cases, and the second remains the same, while the third loses some force. First, loss causation is positively \textit{required} to establish a causal connection between reliance on the “integrity” of the market and the manipulation itself—market efficiency serves to sever such a connection, not create one. Second, class certification remains the “signal event” of the litigation, and the implications of Rule 23 and the PSLRA remain the same. Third, however, it is less likely a full empirical inquiry into loss causation can take place without at least some discovery as to the defendants’ trading activities. Nonetheless, because the issue will be primarily empirical —did the defendants’ trading materially affect market price?—the discovery can be fairly limited in scope and need not extend to knottier issues of scienter.

The primary criticisms of the \textit{Oscar} majority’s reasoning are far less trenchant in the market manipulation context. The dissent by Judge Dennis in \textit{Oscar} gives a good account of these objections.\textsuperscript{310} The first objection is simply that requiring a showing of loss causation is inconsistent with \textit{Basic}.\textsuperscript{311} \textit{Basic} adopted a presumption that material misrepresentations are reflected in the stock price,\textsuperscript{312} and Judge Dennis claims \textit{Oscar}, together with an earlier decision, “improperly shifts the \textit{Basic} burden, changing it from a defendant’s right of rebuttal to a plaintiff’s burden of proof.”\textsuperscript{313} The result is that plaintiffs are “requir[ed] ... to prove, as a precondition to the application of the presumption, the very facts that are to be presumed under \textit{Basic}.”\textsuperscript{314}

As we have discussed, the \textit{Basic} Court was dealing with a misrepresentation case, and its rationales were fitted to such a context. The Court’s key presumption—that false statements and material

\begin{footnotesize}
307. \textit{Id.} at 265.
308. \textit{Id.} at 266.
309. \textit{Id.} at 267.
310. \textit{Id.} at 272 (Dennis, J., dissenting).
311. \textit{Id.}
313. \textit{Oscar}, 487 F.3d at 274.
314. \textit{Id.}
\end{footnotesize}
omissions will inflate or depress a stock’s price—simply does not apply, on its face, to trade-based manipulations. Requiring a showing of loss causation in market manipulation cases does not ignore or conflict with Basic’s holdings, it merely adapts them to a different context. Indeed, this is one of the great attractions of the solutions proposed here—they require no legislative or even Supreme Court action to implement. Abandoning the requirement of a showing of market efficiency in favor of a showing of loss causation is perfectly consistent with the underlying statutory scheme, as well as the policies expressed in Rule 23 and the PSLRA. Nor would taking these steps require action by the Supreme Court—the Court has never confronted the issue of how the FOTM doctrine should be applied to market manipulation claims, and the proposals here are consistent with the reasoning of Basic. Circuit courts, and even most district courts, could begin applying these solutions immediately.

Similarly, one may agree with Judge Dennis that actual loss causation—as opposed to a showing that loss causation can be established through common proof—is not necessary to find the requirements of Rule 23 met in misrepresentation cases, yet not be as troubled by this in misrepresentation cases. Langevoort, for example, heavily criticizes the Oscar majority, yet has argued in the past that courts should focus on “whether the market as a whole was fooled”—that is, whether misrepresentations have actually affected the price. In a recent paper, Langevoort argued in addition that such an inquiry—akin to the loss causation showing advocated here—needed “to be an early-stage determination,” made prior to class certification. In part, Langevoort is made comfortable with such an early-stage inquiry into loss causation because he believes that, rather than stemming from theories of market efficiency, “[t]he presumption of reliance is best thought of as an act of juristic grace, in the name of both fairness and efficiency. We need not follow it slavishly if there are doubts about either, much less both.”

315. See Basic, 485 U.S. at 244-45.
316. Oscar, 487 F.3d at 278.
317. Langevoort, Theories, supra note 189, at 904.
318. Langevoort, supra note 78, at 196.
319. Id. at 195.
reliance on the “integrity” of the market in manipulation cases must be thought of as an act of “juristic grace.” Such grace should not be bestowed unless there is some reason to believe it justified by “fairness and efficiency.” Furthermore, requiring plaintiffs to establish loss causation at class certification is more appropriate, and more consistent with precedent, for manipulation cases than for misrepresentation cases. Thus, one may believe such a requirement inappropriate for misrepresentation cases and still find it appropriate for manipulation cases.

The only remaining question is whether there should be any role at all for market efficiency in manipulation cases. That is, should plaintiffs need to establish that the relevant market was in some limited sense “open and developed” in order to benefit from our normative presumption of reasonable reliance? Probably so, but not much turns on the answer, because the showing should necessarily not be particularly demanding. After all, if it were too demanding we would be right back where we started—weeding out plausible claims of manipulation while allowing implausible claims a free pass. At most, plaintiffs should simply be required to make a cursory showing that the market possessed some of the general indicia of efficiency embodied in the Cammer factors. The purpose of such a showing is twofold. First, it would preserve some sense of reasonableness in the idea of “reasonable” reliance. After all, “[w]e want investors to act with some diligence, and blind reliance should not be rewarded. Investors who buy or sell thinly traded stocks should not be assuming much of anything.” Second, reliance on the integrity of patently inefficient markets arguably constitutes recklessness, which normally bars recovery under 10b-5.

320. See supra notes 204-07 and accompanying text.
321. Others have made similar arguments in favor of requiring a showing of loss causation at class certification for all 10b-5 claims. See Oldham, supra note 43, at 1003. More generally, Judge Posner has suggested that it would be desirable for judges to “make a preliminary examination of the merits of the suit and to refuse to certify it as a class action unless satisfied that the suit has a reasonable chance of succeeding on the merits.” RICHARD A. POSNER, THE FEDERAL COURTS: CHALLENGE AND REFORM 344 (1996).
322. See supra note 92. Of course, even this undemanding showing may rule out otherwise meritorious class actions in some small penny stocks like the one mentioned in the Introduction. It may be that such cases are best dealt with through individual litigation and SEC enforcement actions.
323. Langevoort, supra note 78, at 171.
324. See Margaret V. Sachs, The Relevance of Tort Law Doctrines to Rule 10b-5: Should
CONCLUSION

The traditional requirement for gaining the benefit of the FOTM presumption of reliance—a showing of market efficiency—should be abandoned in market manipulation cases. The rationales for the market efficiency requirement, although defensible in the context of misrepresentation claims, are inapplicable to manipulation claims. Market efficiency simply does nothing to suggest a causal connection between reliance on the market price and manipulative conduct. Indeed, market efficiency tends to sever this connection, and the requirement of market efficiency leads to perverse results in actual litigation.

Instead, plaintiffs alleging market manipulation should be presumed to rely on the integrity of even minimally efficient markets, but be required to establish loss causation at the class certification stage in order to link this reliance to the alleged manipulation. Such a requirement would serve as a logical and effective gatekeeper to class certification without doing violence to Supreme Court precedent.