ARTICLE

PRECAUTION COSTS AND THE LAW OF FRAUD IN IMPERSONAL MARKETS†

Paul G. Mahoney*

INTRODUCTION

The law of fraud is said to reflect the ethics of personal (that is, face-to-face) bargaining. It is therefore not surprising that courts find it difficult to apply the traditional elements of a cause of action for fraud to misstatements that affect a large number of transactions in an impersonal market. In Basic, Inc. v. Levinson, the United States Supreme Court removed one of the principal sources of this difficulty in federal securities fraud suits by holding that plaintiffs in a Rule 10b-5 class action need not prove reliance so long as they purchased the subject securities on an “efficient” market. The fact that prices in an efficient market quickly reflect publicly available information provides the requisite causal link between the defendant’s

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* Associate Professor of Law, University of Virginia.


3 By an “efficient” market, the Court meant one that rapidly incorporates all material information that is publicly available. Id. at 247.
lie and the plaintiff’s loss and gives rise to a rebuttable presumption of reliance.\(^4\)

This “fraud on the market” theory (which, for the sake of brevity, I will refer to as “FOTM”) has been widely lauded in the legal and academic communities. For lower courts, it represents the first intellectually coherent solution to the thorny practical problems of managing securities fraud class actions. For many academics, FOTM is a laudable example of courts responding to advances in economic theory. Daniel Fischel, one of FOTM’s earliest proponents, argues that a reliance requirement makes sense only in markets where purchasers engage in extensive search, including receiving and analyzing representations made by sellers.\(^5\) FOTM, on the other hand, is more consistent with a “market model” in which investors engage in little or no search (because they are unlikely to discover anything that would enable them to “beat the market”) and act as price-takers.\(^6\)

Nevertheless, the near-universal support for FOTM is puzzling. Despite the significant break it makes with standard fraud doctrine, there has been remarkably little analysis of whether FOTM is consistent with the general purposes of civil liability.\(^7\) The gap is all the

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\(^4\) See id. at 246-47. Although Basic therefore did not abandon reliance altogether, but simply created a rebuttable presumption of reliance, I ignore this distinction because the presumption is, for practical purposes, irrebuttable. See id. at 256 n.7 (White, J., concurring in part and dissenting in part); Daniel R. Fischel, Efficient Capital Markets, the Crash, and the Fraud on the Market Theory, 74 Cornell L. Rev. 907, 918 (1989). Moreover, the logic behind fraud on the market theory should lead to a complete abandonment of reliance as an element of the cause of action for fraud. See id. at 918-19.


\(^6\) See Fischel, supra note 5, at 10.

\(^7\) Indeed, Fischel explicitly noted in his seminal FOTM article that more analysis of this issue was needed. See Fischel, supra note 5, at 17. Fischel’s later work with Judge Frank Easterbrook on optimal deterrence of securities fraud suggests, again without extended analysis, that the optimal deterrence framework supports FOTM. See Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 343-44 (1991). Judge Richard Posner defends FOTM in a very brief discussion that concludes only that as between FOTM and awarding no damages at all, FOTM is preferable. See Posner, supra note 5, at 168-71.
more striking because the problem of applying fraud doctrine to impersonal markets extends beyond securities law, and taken to its logical extreme, FOTM could swallow up a considerable amount of the common law of fraud. This Article attempts to supply the missing analysis of FOTM's ability to serve the instrumental goals of fraud liability, which should be to minimize the social costs associated with lying. It concludes that rejecting FOTM and requiring individualized proof of reliance as a prerequisite to recovery under Rule 10b-5 would most closely approximate optimal deterrence.

Part I studies the ability of FOTM to minimize the social costs of fraud. It argues that in secondary securities markets, in which investors trade previously issued securities with one another, the most important social cost of fraud is the excessive resources potential victims invest in protecting themselves against fraud. Prior discussions of deterrence of securities fraud have recognized these "precaution costs" but have neither appreciated their importance nor carefully considered whether the choice between a rule that requires proof of reliance and one that does not can affect the amount of precaution costs investors will incur. The focus on precaution costs is valuable because in many situations, including those to which FOTM is relevant, other sources of social cost are likely to be of lesser significance. Because not all traders affected by fraud in secondary markets can be expected to incur significant precaution costs, it follows that the overall loss from such fraud is less than is generally assumed. Under an assumption of perfect and costless enforcement, the move from a system that requires proof of reliance to one that does not will not reduce—and may actually increase—the total precaution costs investors incur. FOTM, then, will either impose additional liability without additional social benefit, or divide up a fixed recovery among a greater set of investors to the detriment of those investors who require recovery in order to minimize precaution-taking. In either event, FOTM should be rejected. Part I finishes by noting that the precaution-cost framework, like FOTM itself, has important ramifications beyond the securities context.

Parts II and III examine the conclusions of Part I in light of costly and imperfect enforcement of federal antifraud rules. In particular, Part II considers and rejects the argument that requiring each investor to prove reliance is extremely expensive, whereas awarding recoveries that exceed the theoretically optimal amount is inconsequential
because fraud cannot be overdeterred. The argument fails to justify FOTM because, as Part II shows, overenforcement of Rule 10b-5 can impose significant costs on investors. Because FOTM facilitates and encourages Rule 10b-5 litigation, it is likely to increase these already-substantial costs.

Part III studies the ability of FOTM to economize on enforcement costs by dispensing with proof of reliance, the most significant consequence of which is to facilitate class action suits. Part III argues that even if FOTM might reduce the cost of adjudicating any given class action lawsuit, from a systemic perspective these suits may achieve less deterrence of fraud at a greater cost than would individual suits brought by investors who could prove reliance. The Article concludes that FOTM should be rejected and that Rule 10b-5 plaintiffs should be required to prove reliance.

I. PRECAUTION COSTS AND OPTIMAL DETERRENCE OF FRAUD

FOTM's proponents have praised the courts for using an important insight from financial economics, the Efficient Capital Markets Hypothesis, to shape the cause of action under Rule 10b-5. Stripped of the jargon of efficient markets, however, FOTM is simply a rule about what a class representative must plead in order to gain class certification and what she ultimately must prove in order to recover. On those issues, finance theory adds little or nothing. The desirability of facilitating class certification and recovery involves issues that are relevant to the analysis of any liability rule, such as deterrence, incentive-creation, enforcement costs, and institutional competence. FOTM must stand or fall, then, on an issue quite removed from financial economics: are the goals of Rule 10b-5 better served by a rule that requires plaintiffs to prove reliance or one that does not? This Part attempts to find the optimal rule under assumptions of perfect and costless enforcement, assumptions that I will relax in Parts II and III.

My starting premise is that the purpose of Rule 10b-5 liability is to minimize the social cost associated with securities fraud. There is substantial literature that begins from analogous premises and seeks

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8 See Fischel, supra note 5, at 10; Macey & Miller, supra note 5, at 1059. The Efficient Capital Markets Hypothesis is the term most often used to refer to the substantial academic literature on the informational role of prices in securities markets. For an accessible discussion, see Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549 (1984).
to determine optimally deterring sanctions for particular types of risky or dangerous activities. In the securities law context, the most prominent such treatment is Judge Frank Easterbrook and Professor Daniel Fischel’s work on optimal damages. They discuss fraud in both primary securities markets, in which issuers sell securities to investors, and secondary markets, in which all of the relevant buying and selling takes place among investors. Their conclusions regarding liability rules for secondary markets (which, as I discuss in more detail later, is the only context to which FOTM is relevant) are tentative, and they do not integrate their discussion of FOTM into the optimal deterrence model. This Part searches for more definitive answers about liability rules for secondary markets, with an explicit focus on FOTM cases.

A. Fraud in Secondary Securities Markets

1. The Precaution Cost Framework

The traditional measure of damages for a Rule 10b-5 claim is the plaintiff’s “out of pocket” loss, which, if accurately measured, should be the difference between the price paid and the value received. In theory, then, a successful FOTM suit would reimburse in full each person who suffered a trading loss as a consequence of a lie, regardless of reliance. That result is not necessarily correct from an optimal deterrence standpoint, however, and in many cases will result in excessive liability.

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11 See infra notes 26-27 and accompanying text.

12 See Easterbrook & Fischel, supra note 7, at 339-44.

13 See, e.g., Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971) (Friendly, J.) (holding that “a defrauded buyer of securities is entitled to recover... the excess of what he paid over the value of what he got”). Though courts have applied a substantial variety of different approaches to measuring damages under Rule 10b-5, Judge Henry Friendly’s formulation remains the majority approach. See Easterbrook & Fischel, supra note 7, at 315-16, 342; Michael J. Kaufman, No Foul, No Harm: The Real Measure of Damages Under Rule 10b-5, 39 Cath. U. L. Rev. 29 (1989) (extensive survey of damage measures under Rule 10b-5).
The reason stems from the distinction between gross and net social costs. For purposes of this Article, the "gross social cost" of an activity is the sum of all the costs it imposes on all affected persons, the defendant included. "Net social cost," on the other hand, is the gross social cost reduced by the sum of all benefits to all affected persons, again including the defendant. The optimal deterrence framework holds that liability rules minimize social cost by forcing defendants to choose levels of activity and care that reflect social costs and benefits rather than the defendants' own private costs and benefits. When an activity creates offsetting costs and benefits, liability rules cannot simply require defendants to bear gross social costs. If a defendant receives no offset for noninternalized gains to third parties, the result is not enough risky (but nonetheless beneficial) activity or too much care.

The notion of offsetting costs and benefits and its implications for optimal deterrence have been long recognized. Easterbrook and Fischel apply the insight systematically to the deterrence of securities fraud. They argue that when an activity creates both costs and benefits, the defendant should face a damages bill equal to (i) the "net harm" caused by the activity times (ii) a multiplier to account for the difficulty of detecting and prosecuting deviations from the relevant standard of care. It should be noted, however, that their "net harm" concept is not equivalent to "net social cost" as I have defined it. Net harm includes the defendant's trading gain, even though it must be exactly offset by somebody else's trading loss and result in a

14 In securities law, use of the insight that trading gains and losses offset can be traced at least as far back as Henry Manne's seminal work on insider trading. See Henry G. Manne, Insider Trading and the Stock Market 100-01 (1966). The notion of offsetting gains and losses also has important ramifications for the problem of recovery for economic loss in tort, which is similar in many respects to the problems considered herein. See, e.g., W. Bishop, Economic Loss in Tort, 2 Oxford J. Legal Stud. 1, 1-4 (1982); Mario J. Rizzo, A Theory of Economic Loss in the Law of Torts, 11 J. Legal Stud. 281 (1982).

Courts have also demonstrated some awareness of the problem, although there is no evidence of an imminent move towards revamping the measure of damages in securities fraud cases. See, e.g., Jordan v. Duff and Phelps, Inc., 815 F.2d 429, 441-42 (7th Cir. 1987) (noting distinction between damages based on plaintiff's loss and those based on defendant's gain), cert. dismissed, 485 U.S. 901 (1988); Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 170-73 (2d Cir. 1980) (rejecting recovery of plaintiff's gross losses in favor of disgorgement of defendant's gains in tipping case).

15 Easterbrook & Fischel, supra note 7, at 320.

16 Id. at 323.
net social cost of zero. Indeed, all trading gains and losses must offset because there must be a buyer for every seller. Trading gains and losses, then, whether of the defendant, plaintiffs, or third parties, are not sources of net social cost as I use the term.

To take an example, if an activity creates total monetary losses of $10,000, offset by gains to the defendant of $6,000 and gains to third parties of $1,000, the net social loss is $10,000 – ($6,000 + $1,000), or $3,000 (assuming for the moment that the activity imposes no costs on society other than the monetary ones I have identified). The net harm, as Easterbrook and Fischel define it, is the $3,000 net social cost plus the defendant’s $6,000 gain, or $9,000. As the above example illustrates, Easterbrook and Fischel believe that the most significant component of the net harm often will be the net transfer of wealth from the plaintiffs to the defendant.\(^\text{17}\)

Easterbrook and Fischel focus on trading gains and losses, even though they are not items of social cost, because such gains and losses appear highly relevant from a deterrence perspective. Unless the defendant is forced to pay damages that equal or exceed its gains, the defendant will continue to engage in the activity and regard the damage bill as a tax that reduces, but does not eliminate, the advantages of engaging in the activity. In the numerical example above, it is clear that we do not want the defendant to engage in the activity because it creates total losses ($10,000) that exceed total gains ($7,000). Yet the defendant will engage in the activity unless its damages bill is at least equal to the gains it realizes through the activity ($6,000). Indeed, as Easterbrook and Fischel point out, adequate deterrence requires a damages bill of $9,000.

But this analysis should strike us as somewhat incomplete. Economists are used to ignoring distributional consequences in a wide variety of circumstances. Why then is the amount of a simple wealth transfer so relevant to the deterrence of securities fraud? The best answer is that we do not really believe that the numerical example above takes account of all of the social costs. When the defendant can obtain a wealth transfer from one or more plaintiffs, the defendant has an incentive to invest resources in the attempt, and the plaintiffs have

\(^{17}\) Id. at 325-26.
an incentive to invest resources to prevent the wealth transfer.\textsuperscript{18} Both investments are wasteful from a social perspective because they create no wealth but rather attempt to affect its distribution.\textsuperscript{19} The "real" social cost is seen to be not $3,000 but (at least) $9,000. Thus Easterbrook and Fischel's emphasis on wealth transfers as a principal component of net harm is just an indirect way of accounting for these less obvious social costs.

If so, one might wonder why it is worth making so much of the distinction. The principal advantage of the social cost approach is that it focuses more explicitly on why we want to prevent an activity in the first place. The reason is not that it alters a particular distribution of wealth, but that the possibility of an uncompensated wealth transfer may cause certain socially detrimental investments and result in other reductions in societal wealth. In this respect, securities fraud is no different from theft. The social cost of theft is not the transfer of wealth from the victim to the thief (assuming that we do not assign a lower value to the thief's utility than we do to the victim's utility). Rather, theft is bad because it imposes other costs, such as encouraging victims to hire security guards and erect large fences, and encouraging thieves to invest in lock-picking devices.\textsuperscript{20} Theft may also reduce allocative efficiency by diverting resources from higher-valuing to lower-valuing uses.

Similarly, fraud is bad because it imposes costs other than the transfer of wealth from the plaintiff to the defendant. The costs, for the most part, fall into three categories.\textsuperscript{21} The first is precaution costs. If fraud is not deterred, market participants will take expensive precautions to uncover fraud so as to avoid entering into bargains they would not have concluded in an honest market. If investors are

\textsuperscript{19} See id. at 228.
\textsuperscript{20} See id. at 228-30.
\textsuperscript{21} Although Posner also identifies increased stockmarket volatility as a social cost of fraud, Posner, supra note 5, at 170, I do not, because the impact of the problem seems at root to be the same as that of trading losses. To the extent fraud increases the volatility of individual stocks only, that risk can be avoided by diversification, and to the extent it results in increased risk for the market as a whole, it presumably will lead investors to value stocks less highly and perhaps switch some of their investment dollars to other investments (i.e., take precautions).

I also ignore detection and litigation costs, which Easterbrook and Fischel identify as elements of social cost, see Easterbrook & Fischel, supra note 7, at 323-26, because I believe that these would decrease considerably in a world without FOTM. See infra Parts III.B. & D.
unable to guard against fraud in the stock market, they may simply put their money in less desirable investments, such as government securities or land; this is also a form of precaution.\footnote{In a world of costly enforcement, it will be desirable for potential victims to take some precautions against the harmful activities of others; for example, it is cheaper for me to lock my front door than for the government to station a policeman outside my house. When I relax the assumption of costless enforcement in the next Part of this Article, precaution costs should be differentiated into two categories: those that are efficient (in that they cost less than the cost of enforcing antifraud laws) and those that are inefficient. For ease of exposition, however, I will, in Parts II and III, continue to use the phrase "precaution costs" as a shorthand for these latter, excessive precautions.}

Second, fraud requires investments in lying. Because a lie can produce a wealth transfer to defendants that would have been impossible in an honest market transaction, defendants will have an incentive to devote a positive amount of resources to lying. Such investments are a source of net social cost because any positive allocative outcomes they produce could be achieved through an honest market transaction. The costs of lying do not seem substantial in most securities fraud cases, but that may be because investors have responded to legal prohibitions against fraud by taking few precautions against it. If the legal system stopped deterring fraud, investors would take greater precautions, and it would be harder, and more costly, to mislead them.

Finally, fraud may impose allocative costs. Defendants might engage in fraud to achieve some allocative outcome (other than trading profits) that they cannot achieve honestly through the market. For example, they may want to manipulate the price of their stock so that corporate officers can take advantage of expiring stock options. When allocative outcomes do not result from an honest market transaction, they may move resources from higher-valuing to lower-valuing users, rather than the other way around. The "transactions" also send inaccurate price signals that may induce other inefficient transfers in both financial and real (commodity, product, labor, etc.) markets. In short, the notion of allocative cost includes many indirect costs of fraud.

There is little need to discuss these elements of social cost directly when we consider only frauds that occur in primary securities markets, because there the defendant's gain serves as a convenient benchmark. In general, any damage remedy less than the amount of the
defendant's trading gain will not adequately remove the incentive to lie and so will not sufficiently deter the fraud. The fraud will therefore be committed, and precaution costs, investments in lying, and allocative losses will all result. The magnitude of the wealth transfer itself provides a reasonable proxy for these other losses, and by removing all possibility of gain for the defendant, the recovery deters sufficiently to minimize these other losses.

It is useful to treat the three elements of social cost separately when we look at fraud that occurs in secondary trading markets, however. By definition, in secondary-market transactions, the issuer makes no trading gains because all buying and selling occurs among investors; the issuer simply affects the investors' outcomes by telling a lie.\textsuperscript{23} It is therefore not surprising that Easterbrook and Fischel's "net harm" analysis reaches only tentative conclusions when applied to secondary-market frauds. They note that the optimal amount of damages for such frauds is not zero because trading losses are not the only consequences of fraud.\textsuperscript{24} Because they do not examine the other consequences in detail, however, they conclude only that the loss-based damage measures used by courts might be efficient even for secondary-market frauds, although they appear to think it more likely that these measures overcompensate.\textsuperscript{25}

In order to evaluate FOTM, we need only concern ourselves with secondary-market frauds. Purchasers in primary distributions of securities have an express private right of action under Section 11 of the Securities Act of 1933,\textsuperscript{26} which makes issuers strictly liable for material misstatements. In a Section 11 suit, the purchaser may recover her trading loss without proving reliance; thus FOTM's pre-

\textsuperscript{23} I do not intend to deal with the problem of insider trading and the incentives it may create for the fabrication of overly optimistic or pessimistic information. Though these are important problems, they are analytically distinct from those under consideration here. Consequently, I will consider profits to "the issuer" to include profits to individual insiders. I will also refer only to lies told by issuers of securities, although some of the concepts expressed herein can be generalized to lies told by other market participants.

\textsuperscript{24} Easterbrook & Fischel, supra note 7, at 341.

\textsuperscript{25} Id. at 343-44; see also Posner, supra note 5, at 170-71 (contending that FOTM is efficient).

\textsuperscript{26} See 15 U.S.C. § 77k (1988); see also Securities Act of 1933 § 12(2), 15 U.S.C. § 77k(2) (1988) (private right of action for damages for purchasers of securities, whether or not required to be registered, sold by means of misleading statements or omissions).
Fraud in Impersonal Markets

sumption of reliance is unnecessary. Because, as shown above, the wealth transfer to the defendant is a good proxy for the net social cost of primary-market frauds, none of this is particularly surprising. By contrast, the private right of action in secondary markets is the judge-made private action under Rule 10b-5, now supplemented by FOTM. To justify FOTM (indeed, to justify any liability under Rule 10b-5), we must identify some source of social cost from secondary-market frauds. Of the three types of social cost discussed above, it is natural to look first to precaution costs. Torts scholars have long recognized that a paramount goal of compensation for loss is to limit investments in precaution by victims. In addition, Fischel argues that an important function of FOTM is to prevent investments in precautions by investors who cannot meet the standard reliance test. It seems likely that precaution costs will dominate the others in the case of secondary-market frauds, as the following discussion of the two other types of costs demonstrates.

Lies told in secondary markets have smaller allocative effects than those told in primary markets. Unlike primary-market lies, secondary-market lies do not result in misdirection of capital to the issuer. Such lies may result in a misdirection of the shares of stock traded before the truth comes out, because the relative prices of different firms will diverge from their “true” values. Unlike a physical, productive asset, however, the overall efficiency consequences of putting noncontrolling shares of stock in the hands of one investor rather

27 Of course, Rule 10b-5 may be used in the context of primary, as well as secondary, markets. See Herman & MacLean v. Huddleston, 459 U.S. 375 (1983). Indeed, many attempts have been made to use FOTM to address material misstatements in primary offerings of municipal securities, transactions that Congress chose to exempt from the Securities Act’s registration and civil liability provisions. See, e.g., Freeman v. Laventhal & Horwath, 915 F.2d 193 (6th Cir. 1990); Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), cert. denied, 459 U.S. 1102 (1983). Rule 10b-5 has also been used in primary markets to reach defendants not subject to suit under § 11 or § 12(2). See, e.g., Wachovia Bank & Trust Co. v. National Student Marketing Corp., 650 F.2d 342 (D.C. Cir. 1980), cert. denied, 452 U.S. 954 (1981)(10b-5 suit arising out of primary distribution and brought against, inter alia, attorneys not subject to suit under 12(2)). Although Huddleston permits such suits, it nevertheless seems odd to defend FOTM on the grounds that it provides even greater assistance to litigants who wish to evade the limits that Congress set on the use of §§ 11 and 12, and accordingly I ignore the use of FOTM in primary markets.


29 See Fischel, supra note 5, at 16.
than another is small. It does not seem likely, then, that a temporary mispricing of a security imposes much of an allocative loss on society.

Nor should investments in lying be a substantial component of the social costs avoided by Rule 10b-5 liability in secondary markets. The issuer has no incentive to invest substantial sums in lying to the secondary markets in order to make trading profits because, by hypothesis, the issuer is not trading. A look at the reasons why the issuer might lie to secondary-market participants demonstrates that increased Rule 10b-5 liability will not lead to a reduction in social costs associated with such lies.

There are three important reasons why the issuer might lie to secondary-market participants. First, the issuer may be hoping to mislead a regulator or a provider of capital who is not protected by the federal securities laws. For example, the issuer may wish to hide a default on a loan agreement from the lender or hide a violation of a regulatory provision. Stockholders will not regard such lies as harmful—they would prefer that the regulator or creditor not know the truth. Although the legal system should deter such lies by providing a remedy to those adversely affected, stockholders are clearly not members of that category. Rule 10b-5 liability, then, is a particularly poor means of deterring such investments in lying.

Second, the lie may be another manifestation of the familiar stockholder/manager agency problem. Because the interests of managers are not perfectly aligned with those of stockholders, managers may wish at times to achieve personal goals contrary to those of the stockholders. On occasion, those goals may lead managers to desire a temporary mispricing of the stock, perhaps to increase the incentive compensation of managers or to deter a takeover attempt. Managers will devote corporate resources to such lies. That is a real source of social loss, but it is one that we should ignore for present purposes.

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31 Were stockholders significantly better than banks and regulators at uncovering fraud, it might be efficient to convey a right of action on the former as a means of aiding the latter. It seems highly unlikely, however, that stockholders are the better monitors.

because it is completely clear that neither FOTM nor any other form of 10b-5 liability can reduce that cost. A 10b-5 judgment, which simply transfers wealth among shareholders (and from shareholders to lawyers), clearly will not deter managers. Even if liability could be imposed directly on managers, the contractual nature of the firm suggests that the liability will end up back with the shareholders. Private enforcement of Rule 10b-5, then, adds nothing to the arsenal of devices (principally the market for corporate control) used to reduce agency losses.

Third, managers may lie in order to protect the firm's investments in valuable information. Such lies may, as in Basic itself, be used to increase the probability of a takeover that will be extremely beneficial to the firm's shareholders. It may also be used to keep proprietary information from the firm's competitors. Note that these benefits, unlike trading profits, cannot be obtained through "honest" market transactions because honesty would mean disclosing (and therefore losing) the valuable information or declining to comment, which may well be tantamount to disclosure. The firm's investment in keeping secrets is socially beneficial in many instances and, therefore, should not be categorically deterred.

The above discussion of the reasons why issuers might lie to secondary markets suggests that expanding Rule 10b-5 liability is unlikely to reduce undesirable investments in lying at an acceptable cost. First, not all investments in lying are socially undesirable; there is, thus, a real danger of overdeterrence. Second, and more importantly for present purposes, to the extent firms make socially undesirable investments in lying, Rule 10b-5 liability is an extraordinarily poor device for deterring such investments. By contrast, Rule 10b-5 liability, appropriately limited, may reduce precaution costs. The primary focus of the deterrent analysis of FOTM, then, should be on whether it reduces precaution costs, a question to which I now turn.

33 See Easterbrook & Fischel, supra note 7, at 340.
34 See Macey & Miller, supra note 5. Macey and Miller's broader contention is that managers should be allowed to lie with impunity (so far as Rule 10b-5 is concerned) whenever lying is consistent with their fiduciary duties to shareholders. See id. at 1091; see also Jonathan R. Macey & Geoffrey P. Miller, The Fraud-on-the-Market Theory Revisited, 77 Va. L. Rev. 1001 (1991) (same). Their thesis has, of course, generated controversy. See, e.g., Ian Ayres, Back to Basics: Regulating How Corporations Speak to the Market, 77 Va. L. Rev. 945, 950-64 (1991) (arguing that the optimal rule may be a default "no lying" rule that permits opting out).
Does FOTM Minimize Precaution Costs?

The preceding discussion of precaution costs suggests an appropriate and convenient criterion for deciding between a regime that predicated recovery on reliance and one that does not. We should consider whether a move from the former to the latter induces recipients of information to take fewer precautions. If not, FOTM will do one of two things. If current damage measures are left intact, FOTM will impose additional liability without additional social benefit. Alternatively, if damage measures are modified so that the defendant’s total damage bill is set at the optimal level, FOTM will serve to divide up a fixed recovery among a greater number of investors. In either event, the net effect of FOTM will be a redistribution of wealth among shareholders without resultant social benefits. Note that a redistribution among shareholders that does not enhance deterrence is every bit as bad as fraud itself. Just as fraud may lead to investments in lying and precautions, so the possibility of using litigation as a purely redistributive tool will lead to excessive investment in litigation. Redistribution by litigation, like redistribution by fraud, may also have adverse allocational consequences.

The comparison between a reliance requirement and FOTM can be made through a simple model involving two classes of investors. The first group, informed investors, search actively for information they can use to make trading profits. Their search and trades are the mechanism through which new price equilibria are established. In contrast, the second group, uninformed investors, engage in no search. They act as price-takers and, consequently, do not attempt to “beat the market” by trading on the basis of information that happens to come their way. The rational uninformed investor will hold the market portfolio and trade only in response to changes in her wealth or consumption.

Consider first the behavior of informed investors. Their reaction to a statement by an issuer can be modeled as follows. Assume that at time $t_0$ the issuer makes a statement about the firm. The statement may be true or false, so that we can define a random variable $g$ that can take on the values 1 (if the statement is true) and 0 (if the statement is false), with associated probabilities $p$ and $(1 - p)$, respectively. At time $t_0$ the $i$th informed investor holds a portfolio that includes $Y_{i0}$ shares of the issuer’s common stock, each having a market price of $V_0$ (for simplicity, I will hereafter drop the subscript $i$ and
talk simply of a “representative trader”). At time $t_1$, the informed traders will trade based on the new information, and at time $t_2$ that trading will have resulted in a new equilibrium stock price that fully reflects the new information. At time $t_3$, the value of $g$ will be revealed, and the price will adjust instantaneously.

Assume further that the statement contains good news. If $g = 1$ (that is, if the statement is true), the stock price at $t_3$ will be $V_0 + V'$, where $V' > 0$; however, if $g = 0$ (that is, if the statement is false), the stock price at $t_3$ will be $V_0$. I will continue to assume costless enforcement and will also assume, for the sake of argument, that the damages bill is optimally calculated; thus the aggregate damages bill will not change when moving from a reliance rule to a FOTM rule, although the identity of the traders who recover and the amounts recovered by individual traders will vary. The representative trader might consider taking one of two possible courses of action:

(a) Assume, without investing in any information other than the issuer’s statement, that $p = 1$ and consequently that the stock price at $t_3$ will equal $V_0 + V'$. As a result, this investor will purchase some number, $Y'$, of additional shares of the issuer’s stock, so that $Y_1 = Y_0 + Y'$; or,

(b) Invest in further information, denoted by $q$, which will permit calculation of a conditional probability, $p | q$. If $p | q = 1$, the investor will purchase $Y'$ additional shares, so that $Y_1 = Y_0 + Y'$; if $p | q = 0$, the investor will purchase no additional shares, so that $Y_1 = Y_0$; and if $0 < p | q < 1$, the investor will purchase some number of shares $Y''$ where $0 < Y'' < Y'$, so that $Y_0 < Y_1 < Y_0 + Y'$.

One might ask at the outset why any informed investor would choose strategy (b). So long as the statement will lead to an increase in the stock price, informed investors should simply buy prior to the establishment of a new equilibrium price and sell as soon as the new equilibrium is established; when the truth comes out, the informed investor will already have liquidated his position and will be indifferent to whether $g = 0$ or $g = 1$. This would be a correct strategy if informed investors’ beliefs and talents were homogeneous. They are not, however, and there is profit to be made in anticipating the price adjustment, if any, at $t_3$. Thus there may be investment in learning the actual value of $g$ prior to $t_3$, and some concomitant risk that the stock price will decline before informed investors who adopt strategy (a) are able to liquidate their positions. The unrealistic assumption
that price adjusts instantaneously at $t_3$ is merely a proxy for that risk. Put more simply, if traders could discover the actual value of $g$ prior to $t_3$ at no cost, every trader would wish to do so. Because information $q$ comes only at some cost and may not result in complete knowledge of $g$ (that is, $p | q$ may equal neither exactly 1 nor exactly 0), some, but not all, traders will invest in $q$.

Strategy (a) coincides with the traditional understanding of reliance. The investor believes the statement (she assumes $p = 1$) and changes her position as a consequence. Strategy (b) constitutes precaution-taking. The investor acquires information about the distribution of $g$ in lieu of assuming that $p = 1$. The information $q$ will generally be available only at some cost, and even if the marginal cost of $q$ is zero (perhaps the investor previously acquired the information for some unrelated purpose), the fact that for any $p | q < 1$, the investor will set $Y_i < Y_0 + Y'$ is itself a precaution.

Investors who adopt strategy (a) will purchase $Y'$ shares at some price or prices between $V_0$ and $V_0 + V'$. If, at $t_3$, it is revealed that $g = 0$, those investors suffer a loss. Investors who adopt strategy (b) may or may not purchase additional shares and therefore may or may not suffer a loss. Under a reliance test, only those investors who adopt strategy (a) can recover. Under a FOTM rule, however, each investor who adopts strategy (a), and each investor who adopts strategy (b) and loses money, can recover.

This framework simply clarifies the notion that the prohibition on fraud is designed to induce contracting parties to rely on representations without independent investigation. The underlying intuition is that it is cheaper for the legal system to compel the party who makes a material representation to make it truthfully than for the other party to attempt to verify the truth of the representation. The choice between a FOTM rule and a reliance rule, therefore, has much to do

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35 Cf. W. Keeton et al., supra note 1, at 751 (reliance requires that the plaintiff believed the statement to be true).

36 Courts typically deny recovery to those who rely not on the false statement but on their own investigation. See, e.g., McCormick & Co. v. Childers, 468 F.2d 757, 768 (4th Cir. 1972); McNabb v. Thomas, 190 F.2d 608, 611 (D.C. Cir.), cert. denied, 342 U.S. 859 (1951).

37 In this respect, fraud law is analogous to contract law, which seeks to induce parties to rely on certain types of promises without taking costly measures to self-insure against the possibility that the promise will not be kept. See Charles J. Goetz & Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 Yale L.J. 1261, 1266-71 (1980).
with the likelihood that investors will adopt strategy (a), rather than strategy (b), under either rule.

The incentives of informed investors to follow strategy (b) under a FOTM rule and a reliance rule can be compared as follows: If the issuer's statement is true, both those investors who adopt strategy (a) and those who adopt strategy (b) will have the same outcomes under either rule. If the statement is false, investors who adopt strategy (a) are made worse off by FOTM because the amount of their recovery must decline once the damages are shared with the strategy (b) investors. Investors who adopt strategy (b), however, are better off as a group under a FOTM rule if the statement is false: None of those investors would recover under a reliance rule, but some will recover under a FOTM rule. Thus moving from a reliance rule to a FOTM rule reduces the expected payoff to strategy (a), but it increases the expected payoff to strategy (b). At a minimum, we can conclude that moving from a reliance rule to a FOTM rule will not induce movements from strategy (b) to strategy (a); in fact, it may produce the opposite effect. Adopting a FOTM rule does not, therefore, decrease—and may actually increase—the amount of precautions taken by the informed, as compared to a reliance rule.38

The analysis of the incentives of the uninformed investors is a bit simpler. These are investors for whom, by hypothesis, any investment in information other than price has a net negative expected value. They do not even invest in acquiring the issuer's initial statement, much less in determining whether the statement is true or false. Any lies that these investors could uncover would likely be uncovered first by the informed, and the uninformed thus should prefer to free ride on the efforts of the informed instead of taking precautions. Moreover, the losses associated with lies issuers tell to secondary-market participants are diversifiable risks from the latter's viewpoint. Investors who hold the market portfolio and trade only in response to changes in their income and consumption levels are as likely to make trading gains as trading losses from secondary-market fraud. The risk of trading losses can, like any other firm-specific risk, be diversified away, and consequently there should be no reward to reducing such

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38 This assumes that the choice of a rule does not affect \( p \)—that is, that the move from a reliance rule to a FOTM rule does not decrease the amount of lying. This should be the case given the assumption of optimal damages.
Moving from a reliance rule to FOTM will not reduce precaution-taking by the uninformed; they will invest in little or no precaution under either rule.

One final consideration is whether a change from a reliance rule to a FOTM rule might reduce precautions by inducing informed investors who would otherwise adopt strategy (b) to become uninformed instead. FOTM increases somewhat the returns to being uninformed, because some uninformed investors will trade, for reasons having nothing to do with the issuer’s statement, at times $t_1$ and $t_2$. Although, as discussed above, the expected loss from any such trade is zero (due to the diversifiability of trading losses due to fraud), under a FOTM system, they will nevertheless recover their losses while keeping their gains. This increase in return might induce some strategy (b) investors to become uninformed, thus reducing the overall level of precaution. Such moves seem unlikely, however. The primary reason to choose between being informed and uninformed lies to do with the abnormal returns that can be gained from investing in information generally, and those returns should dwarf the abnormal returns gained by uninformed investors as a result of FOTM windfalls.

Of course, there may be some switching between informed and uninformed at the margin. Nevertheless, the investors who would otherwise adopt strategy (a) have a greater incentive to become uninformed in response to FOTM than those who would otherwise choose strategy (b). As shown above, strategy (a) investors are made worse off by the move to FOTM, and strategy (b) investors are made better off; the former, then, have a greater incentive to become uninformed in response to FOTM than the latter. Such a switch does not reduce precautions—it reduces reliance, which is just the opposite of the purpose of fraud law. Assuming costless enforcement, then, a reliance

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39 It is a tautology that the investor who buys and holds the market portfolio must earn the market return. A change from a FOTM rule to a reliance rule would induce uninformed investors to take precautions, then, only if that change altered the market return or its variance. If such a change resulted in a dramatic increase in the amount of lying, the difficulties that high-quality firms might face in distinguishing themselves from low-quality firms could reduce the overall return to holding equities. See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 673-74 (1984). Again, however, so long as damages are correctly calculated, the amount of lying should be the same under either rule. See supra note 38.
requirement achieves the optimal reduction in precaution costs, and a move to FOTM threatens to deviate from the optimum.

B. Fraud in Other Markets

FOTM's apparent consistency with the Efficient Capital Markets Hypothesis is, as shown above, largely irrelevant to a welfare analysis of FOTM. Moreover, that consistency cannot justify the present gap between fraud doctrine under Rule 10b-5, which no longer requires proof of reliance, and under the common law, which generally still requires such proof. Although the substantial pro-FOTM literature overlooks the point, prices in any competitive market communicate information. As a result, traders in any such market rely, in some sense, on the "integrity of the market," as the Court in Basic used the phrase. In light of the foregoing, the mere fact that stock market traders rely on the information that stock prices convey cannot itself justify dispensing with a reliance requirement in favor of FOTM while maintaining a reliance requirement in other contexts.

1. The Informational Content of Prices

In any market where traders have asymmetric information about future states of the world, and the value of the thing being traded depends on which future state is realized, prices serve to aggregate and communicate the diverse information possessed by traders. Because prices permit inferences about future states, traders adjust their demand for a good upon learning its market-clearing price. Those changes in demand then affect the market-clearing price, and so on, in an iterative process that ends in an equilibrium. At the equilibrium point, no person would wish to recontract after learning the market-clearing price. Sanford Grossman has demonstrated that under certain limiting assumptions, this equilibrium results in allocations that could not be improved upon in the Pareto sense by a single central planner who possessed all of the information in the economy.

40 See supra note 4.
42 This has been long understood. See F.A. Hayek, The Use of Knowledge in Society, 35 Am. Econ. Rev. 519, 526-27 (1945). As the title of Hayek's article implies, he was concerned with the allocation of all of society's resources, not simply the trading of securities.
44 See id. at 3.
and who set out to maximize allocative efficiency. Put more loosely, under the right conditions, buyers and sellers will reach the same contracts that they would have reached if each of them possessed all of the information that any other possesses. This is why we say that prices convey information.

Importantly, none of this is unique to securities markets. Because most discussions of efficient markets focus on securities, this point is easily overlooked, but securities markets are only one of many types of markets that may approximate, more or less well, the ideal (and admittedly unrealistic) conditions of Grossman’s model. In general, we would expect prices to be most informative in markets where the product is fungible, there is perfect competition among large numbers of buyers and sellers, and the costs of acquiring information and of trading are low. These are relative concepts, however, and prices can be more or less informative depending on the characteristics of the particular market. Securities markets, as measured by size, liquidity, fungibility, and low information and transaction costs, may be some of the most informationally efficient markets, but the issue is one of degree rather than kind.

The uniqueness of securities markets lies in the speed with which new information leads to the establishment of a new equilibrium price. What has fascinated those who study stock markets is not that a firm’s disclosures affect traders’ demand for the firm’s stock (how could it be otherwise?), but that the new equilibrium is established so

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47 The purpose of the assumption of competitive markets is to avoid the problem of strategic withholding of information. See Jean-Jacques Laffont, The Economics of Uncertainty and Information 146-48 (John P. Bonin & Hélène Bonin trans., 1989) (under conditions of perfect competition, fully-revealing equilibrium is a dominant Nash equilibrium).

48 Grossman and Stiglitz have demonstrated that informational efficiency must be a relative, rather than an absolute, concept. See Sanford J. Grossman & Joseph E. Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 393 (1980). Their most important result is that the informational value of prices increases as the cost of information decreases. Id. at 399, 404. In a previous article, Grossman had demonstrated that informational value also increases as the cost of trading decreases. See Sanford Grossman, Further Results on the Informational Efficiency of Competitive Stock Markets, 18 J. Econ. Theory 81, 94-97 (1978).
quickly that the average investor is unable to profit from the new information. It follows that, for most investors, gathering information about firms would be a waste of time and money, and they should "rely" on the market to do it for them.

Nonetheless, let us pretend for a moment that brand-new academic research proves that stock markets are less efficient than previously thought and that, in fact, it takes forty-eight hours for new information to be reflected in the stock price. From the investor's point of view, the only change is that it now may make sense to gather any information that has been disseminated in the last forty-eight hours (any information older than that would be of no value). The force of the argument for FOTM is in no way diminished so long as it is now applied only to statements that were more than forty-eight hours old at the time of the investor's purchase or sale decision. Any such statement would have been fully reflected in the market price, and the investor should have "relied" on the market price rather than gathered the stale information. Consequently, the speed with which securities markets react to new information is of small relevance to FOTM; rather, the significant point is that prices do react, and in that respect, securities markets are not special.

Because securities markets are not uniquely efficient, they are not uniquely susceptible to the transmission of lies through market prices. Indeed, even face-to-face lies told in relatively inefficient markets can have some impact on unrelated transactions. Consider a standard face-to-face fraud in connection with the sale of a house. Assume the house is in a subdivision with relatively fungible properties. Seller A lies to Buyer A about certain characteristics of House A—perhaps that it has expensive copper pipes whereas in fact it, like all the others in that subdivision, has cheap lead pipes. Buyer A pays $125,000 for House A, but had she known the truth she would have been willing to pay only $100,000.

Now Seller B (Seller A's next-door neighbor) sells House B to Buyer B. Buyer B, of course, has no dealings with Seller A and knows nothing of the fraud. Buyer B does know, however, that House A sold for $125,000, and her demand for House B is undoubtedly influenced by that fact. Here common sense and economic theory provide the

49 See, e.g., Eugene F. Fama, The Behavior of Stock-Market Prices, 38 J. Bus. 34, 34-36 (1965); Gilson & Kraakman, supra note 8, at 552.
same result: we would expect a potential buyer to be willing to pay more for a house if a roughly comparable one recently sold for $125,000 than if the comparable house had sold for $100,000. It is not far-fetched to say that Buyer B suffers some harm from Seller A’s fraud. Thus prices can transmit lies in a wide variety of markets.

2. Reliance in Other Markets

The unpersuasiveness of the distinction between the informational content of prices in securities and other markets is not, of course, sufficient reason to dismiss FOTM. One might as easily move in the other direction and contend that reliance on market prices rather than misstatements should be permitted in all fraud cases. Though FOTM’s proponents have not yet made such a claim, plaintiffs’ attorneys have argued for FOTM outside the securities context.50 Plaintiffs’ attorneys have attempted, with varying degrees of success, to obtain class certification on FOTM-like theories in fraud cases involving tickets to sporting events, vacation tour packages, publishing serv-

50 Courts have been receptive to such claims when made by buyers or sellers of commodity futures contracts, which are certainly traded in efficient markets. See, e.g., Minpeco, S.A. v. Hunt, 718 F. Supp. 168, 175-77 (S.D.N.Y. 1989). Minpeco arose out of the Hunt brothers’ alleged attempt to “corner” the silver market. The district court permitted the plaintiff, a trader on the short side of the market, to use FOTM in its common-law fraud action despite the absence of any misrepresentation. The court reasoned that the plaintiffs were entitled to rely on the “integrity of the market” (i.e., on the absence of manipulation). Id. at 177.

Minpeco demonstrates another important shortfall of FOTM as formulated in Basic. The Basic Court’s careless use of the phrase “integrity of the market,” Basic, 485 U.S. at 247, invites lower courts to create new substantive duties where none have been provided by statute. In Minpeco, for example, the only plausible “fraud” theory is that the Hunts had a duty to disclose to the plaintiff that the intent of their purchases was to drive prices up—a duty not imposed by the Commodity Exchange Act, 7 U.S.C. § 1-26 (1988). If the “integrity of the market” theory requires disclosure of any and all “unfair” conduct, however, the Supreme Court’s admonition that nondisclosure is not actionable absent a duty to disclose, see Chiarella v. United States, 445 U.S. 222 (1980), has little practical significance.

In such contexts, FOTM is analogous to the use of a presumption of entitlement to “honest and faithful participation in governmental affairs” in cases involving political corruption. See United States v. Margiotta, 688 F.2d 108, 121 (2d Cir. 1982) (affirming federal mail fraud conviction premised on such “intangible rights” theory), cert. denied, 461 U.S. 913 (1983). Such a presumption was expressly rejected in McNally v. United States, 483 U.S. 350 (1987), but resurrected by Congress, see 18 U.S.C. § 1346 (1988). As the dissent in Margiotta noted, such a use of the mail fraud statute, 18 U.S.C. § 1341 (1988 & Supp. 1989), created a general duty, at the time unexpressed by Congress, to disclose all material facts relating to governmental affairs. See Margiotta, 688 F.2d at 139-41 & n.4 (Winter, J., concurring in part and dissenting in part). Though Congress later enacted such a general duty in the mail fraud context, it has yet to do so in § 10(b).
ices, appliances, and automobiles. Even outside the securities context, then, the reliance requirement is under attack. FOTM’s proponents might say this is a good thing because reliance should be abandoned wherever prices can incorporate information.

As in the securities context, however, the focus of fraud liability should be on minimizing social cost. The fact that lies in other markets may influence market-clearing prices to the potential detriment of many traders is not a sufficient reason to provide recovery to those traders. In the house hypothetical, for example, house purchasers and sellers other than Buyer A do not, in the aggregate, expect to lose from frauds committed by persons in the position of Seller A. (Note that Buyer B loses from frauds committed before her purchase, and gains from those committed after her purchase, so that her expected loss from fraud is zero.) Moreover, there are few cost-effective precautions available. Buyer B will, of course, engage in the sorts of ordinary, inexpensive precautions against fraud by her own seller that we would expect and encourage her to use. She is unlikely to undertake the effort of investigating whether the transaction between Seller A and Buyer A was tainted by fraud, however. Thus the net “secondary-market” impact of Seller A’s fraud is a wealth transfer from Buyer B to Seller B, but Buyer B incurs no additional precaution costs as a consequence of the lie. Absent some other social cost that can be reduced in a cost-effective manner by making Seller A liable to Buyer B, there should be no such liability; Seller A remains, of course, liable to Buyer A.

The same type of analysis can, and should be, applied generally to attempts to alter the traditional elements of the cause of action for fraud. It is beyond the scope of this Article to consider every possible

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51 See Vasquez v. Superior Ct., 484 P.2d 964 (Cal. 1971) (class action for rescission of contracts to purchase freezers based on fraudulent misrepresentations made in standard sales pitch); Strauss v. Long Island Sports, 401 N.Y.S.2d 233 (App. Div. 1978) (reversing certification of fraud class action on behalf of all purchasers of New York Nets season tickets alleging that Nets prominently displayed Julius Erving in newspaper advertising while intending to trade him prior to start of season); Stellema v. Vantage Press, 470 N.Y.S.2d 507 (Sup. Ct. 1983) (fraud class action against publisher based on representations in brochures); Guadagno v. Diamond Tours & Travel, 392 N.Y.S.2d 783 (Sup. Ct. 1976) (fraud class action against tour operator based on representations in advertising materials); Amato v. General Motors Corp., 463 N.E.2d 625 (Ohio Ct. App. 1982) (fraud class action by purchasers of Oldsmobiles based on failure to disclose that engines were manufactured by Chevrolet division).
market in which FOTM-like claims might be asserted, but a few general observations can be made. Informed traders outside the securities context, like those in it, will often have a greater incentive to take costly precautions than will the uninformed. Such traders may be wholesalers, for example, who will share many of the characteristics of securities speculators—they may invest heavily in information, take large positions, and try to buy or sell promptly upon receipt of new market information.

In contrast to securities markets, uninformed traders in product markets may have a positive expected loss from lies. If the uninformed are consumers of the product in question, they will be on the buy side more frequently than on the sell side and, therefore, will be vulnerable to lies that raise the price of the product. Producers, on the other hand, should usually enjoy a net trading gain. Producers of physical goods generally sell their products continuously. Product markets therefore may resemble primary securities markets, and, accordingly, the precaution costs, investments in lying, and allocative losses resulting from a lie about a product may be larger than those resulting from a lie of equivalent magnitude about a security in secondary markets. The optimal damages bill may, then, be larger in these markets than in secondary securities markets. Nevertheless, it seems reasonable to start from the presumption that those traders who rely on a misstatement will have a greater incentive to take precautions than those who do not and should, therefore, be the focus of compensatory measures.

II. FOTM AND IMPERFECT ENFORCEMENT

In light of the conclusions of Part I, if FOTM can be justified, it must be as a response to enforcement costs. A plausible argument is that the cost of a separate reliance inquiry as to each plaintiff exceeds the cost of imposing excessive liability on the defendant because lying

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52 The situation again can be analogized to the law of contracts, in which the goal is to induce reliance. See supra note 37. The impracticality of awarding only reliance-based damages, however, has led to a preference for the expectancy measure of damages. See Goetz & Scott, supra note 37, at 1290-91. One might argue that in the law of fraud, as in the law of contracts, "[t]o encourage reliance we must therefore dispense with its proof." L.L. Fuller & William R. Perdue, Jr., The Reliance Interest in Contract Damages (pt. 1), 46 Yale L.J. 52, 62 (1936).
cannot be overdeterred.\textsuperscript{53} A 10b-5 plaintiff must prove that the defendant acted with scienter; thus liability cannot be premised on negligent or innocent mistakes.\textsuperscript{54} It should be costless for defendants to avoid intentional falsehoods (they need only decide not to lie), and any positive allocative outcomes that lies facilitate can be duplicated through honest bargaining, so that the optimal amount of fraud is zero. Consequently, even a draconian penalty for fraud cannot overdeter, so the argument goes, and we should err on the side of too much, rather than too little, liability. Indeed, too much liability is desirable because not all frauds are caught; thus FOTM also serves as a de facto punitive damages provision.\textsuperscript{55} The best rule, therefore, might be FOTM with each plaintiff awarded her full out-of-pocket loss.

Moving from the ideal to the pragmatic, however, does not so clearly favor FOTM. The problems of adjudicating reliance justify FOTM only if it is easy to adjudicate scienter; however, adjudicating scienter is difficult and prone to error, and using FOTM to increase damages in Rule 10b-5 cases will therefore deter issuers of securities from disclosing beneficial information. Thus, the costs of failing to limit Rule 10b-5 recoveries to something approaching the optimal amount is actually quite high, especially given that the cost saved by dispensing with reliance is actually not as great as FOTM’s proponents have presumed.

A. The Danger of Overdeterrence

Issuers of securities speak to the market often. Though some of the information they provide is mandated by the federal securities laws, many of their statements are made without legal compulsion. As a general matter, these statements are valuable to investors because they impart information about the firm that the informed investors would otherwise acquire at some cost, if at all. Once the informed investors have this information, the market price of the firm’s securities adjusts accordingly, ultimately benefiting all investors.

\textsuperscript{53} See Easterbrook & Fischel, supra note 7, at 322-23.
\textsuperscript{54} Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
\textsuperscript{55} See Easterbrook & Fischel, supra note 7, at 332-33 (arguing that punitive damages generally would be appropriate in Rule 10b-5 cases).
Of course, innocent and negligent misstatements do occur, and investors would prefer that the issuer take care to speak accurately. Were we to impose any liability for negligent misstatements, however, it would have to be carefully limited to avoid overdeterring beneficial speech. The same analysis does not, in theory, apply to lies. Unlike statements that attempt to impart the truth, lies are of no value at all, and there is thus no such thing as overdeterring them. If the legal system could accurately distinguish lies from misstatements intended to provide truthful information, it could penalize the former out of proportion to the actual harm they cause, without deterring beneficial speech.

There is thus an important pragmatic link between FOTM and the scienter requirement under Rule 10b-5. If Rule 10b-5 liability could be strictly limited to speech that is without social value and that the defendant could avoid at trivial cost, then FOTM would not be objectionable; as suggested above, it would simply be a form of punitive damages. For two reasons, however, Rule 10b-5 liability is not so limited. First, the adjudication of scienter is difficult, and it is likely that adjudicative errors are frequent. Second, even absent such errors, the scienter requirement, as currently formulated, does not draw an adequate line between intentional and merely negligent misstatements.

In Ernst & Ernst v. Hochfelder, the Supreme Court announced the scienter requirement but expressly declined to decide whether scienter necessitated actual intent to mislead or some lower standard such as recklessness. The lower federal courts that have considered the issue are unanimous in concluding that "recklessness" is sufficient to satisfy the scienter requirement; unfortunately, there is no such uni-

57 There is a third objection, addressed in more detail infra Part III.A.: Not all lies are without social value, as some serve to protect desirable investments in information.
59 Id. at 194 n.12.
60 See, e.g., McLean v. Alexander, 599 F.2d 1190, 1197 & n.12 (3d Cir. 1979) (noting cases from other circuits); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-46 (2d Cir.), cert. denied, 439 U.S. 1039 (1978).
formity in the definition or application of the recklessness standard.\textsuperscript{61} The definitions are far too imprecise to pinpoint behavior that the defendant can avoid at no cost. Given that the determination of the appropriate level of culpability under Rule 10b-5 is a "veritable quagmire,"\textsuperscript{62} one can hardly be confident that a firm can costlessly identify and avoid conduct that will result in liability.

When the possibility of adjudicative error is introduced, the danger of overdeterrence becomes even more pronounced. Even in the case of face-to-face fraud, the scienter requirement cannot be as good a tool for pinpointing genuinely valueless behavior as, for example, the intent requirements of the intentional torts of battery or conversion. Negligent and even innocent misstatements are inevitable in negotiations; by contrast, it is rare that a person punches another or takes another's property by stealth, without really meaning to do so. In other words, the fact of the harm is a much better indicator of guilty intent in the cases of battery and conversion than in the case of fraud, and courts that infer intent based on the circumstances should make fewer errors in battery and conversion cases than in fraud cases. The standard theories of deterring intentional torts, therefore, must be applied to fraud with a certain degree of care. Moreover, scienter is a fact-bound inquiry that is usually inappropriate for resolution on a motion for summary judgment.\textsuperscript{63} Because 10b-5 cases almost always settle if the defendant cannot obtain dismissal or summary judgment,\textsuperscript{64} the issue of scienter is addressed through circumstantial evidence with the plaintiff entitled to the benefit of the doubt. Consequently, FOTM will not simply deter lies, but will also deter the provision of beneficial information to the market.

\textsuperscript{61} For a sampling of the different approaches, see, e.g., Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979) ("it is not necessary for us to precisely define what constitutes reckless behavior since it is ultimately a factual determination"); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir.) ("reckless conduct may be defined as a highly unreasonable omission ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it" (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976))), cert. denied, 434 U.S. 875 (1977).


Some commentators have concluded from the lower court applications of the recklessness standard that the standard of care in 10b-5 cases is closer to negligence than intent. Others have argued that as a practical matter the scienter requirement is no longer an independent element of the cause of action because courts rarely find an absence of scienter so long as a misstatement is material. No one has to my knowledge made an attempt to defend the proposition that 10b-5 liability can be avoided at trivial cost. As I will discuss below, the predominance of class actions in 10b-5 cases only intensifies the problem.

B. The Costs of Overenforcement

Nowhere in Basic did the Supreme Court acknowledge the critical link between FOTM and the scienter requirement, yet it seems impossible to justify FOTM on deterrence grounds unless the Court is willing to impose a strict, unambiguous intent standard in Rule 10b-5 cases. Until it does so, FOTM will deter the disclosure of socially beneficial information by firms. There is great danger in severely punishing an activity (lying) that is hard to distinguish from a socially valuable activity (providing information about the firm). When it is not easy for an issuer of securities to avoid fraud liability while providing investors with valuable information, the issuer will respond by

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65 Paul S. Milich, Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense, 11 J. Corp. L. 179, 180-81 (1986); see also Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 50 (2d Cir.) (Mansfield, J., dissenting) (stating that the recklessness standard, as applied by the majority, is “indistinguishable in any significant respect from that reversed” in Ernst & Ernst), cert. denied, 439 U.S. 1039 (1978). Indeed, the same concern has been expressed with reference to the scienter requirement under the common law of fraud. See W. Keeton et al., supra note 1, at 742 (stating that “there is a certain amount of leeway in the direction of holding the defendant to something like a reasonable standard of judgment”).


67 Even a commentator who believes that the present system of securities regulation works reasonably well has recognized the practical shortcomings of the scienter requirement:

Although the change from negligence to scienter undoubtedly made a difference and tilted the litigation balance in favor of the defendant, experienced plaintiffs’ attorneys quickly found imaginative ways by which to plead scienter. The net result was to reduce the settlement value of Rule 10b-5 litigation, but not to spell its demise. John C. Coffee, No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies, 53 Brook. L. Rev. 919, 930-31 (1988).
reducing the amount of such information it provides, and all investors will suffer as a consequence.

Note that focusing on the bare quantity of speech produced by issuers understates the overdeterrence problem. Liability concerns should also lead issuers to decrease what I will call the "usefulness" of the information—that is, its ability to influence market prices. The existence of a mandatory disclosure regime is unlikely to affect the issuer's output of useful information. Securities and Exchange Commission ("SEC") disclosure rules focus primarily on past information that is, in most instances, already reflected in price. By contrast, useful information will often relate to management's projections, beliefs, or plans; this sort of information is very difficult for informed traders to acquire even with substantial effort, and consequently its ability to influence price is great. The chance that management's beliefs or plans will come to pass is inherently speculative, however,

68 Easterbrook and Fischel argue that an overdeterring rule "would lead to quiet, not (necessarily) to an increase in the world's portion of truth." Easterbrook & Fischel, supra note 10, at 640. As the text demonstrates, the effect is worse than a simple reduction in the amount of speech—quality declines as well.

69 Fischel uses the same distinction between information that affects price and information that does not to provide a definition of "material" information. See Fischel, supra note 5, at 5-7.

70 In recent years the SEC has changed its position somewhat on so-called "soft" information, and, in some limited circumstances, affirmatively requires disclosure of management's beliefs about the future—but only to the extent that they are based upon presently known data. See, e.g., Item 303(a)(1) of Regulation S-K, 17 C.F.R. § 229.303(a)(1) (1991) (requiring identification of "any known trends or any known demands, commitments, events or uncertainties" that might affect issuer's liquidity position). But see id. Instruction 7 ("Registrants are encouraged, but not required, to supply forward-looking information."). The SEC's attempts to encourage disclosure of soft information has, however, had limited impact on firms and little discernable effect on courts. See Victor Brudney, A Note on Materiality and Soft Information Under the Federal Securities Laws, 75 Va. L. Rev. 723, 753-57 (1989).

71 Basic itself implicitly acknowledged that Rule 10b-5 does not create an independent obligation to disclose merger negotiations that SEC rules do not otherwise require to be disclosed. See Basic, 485 U.S. at 239 n.17 (suggesting "no comment" policy as means of protecting confidentiality of merger negotiations). Nevertheless, the Court overlooked the fact that current merger negotiations are not the type of soft information that is generally outside the mandatory disclosure regime; in many circumstances, an issuer has no choice but to disclose them. See Item 7 of Schedule 14D-9, 17 C.F.R. § 240.14d-1-101, Item 7 (1991) (requiring target company in takeover contest to disclose existence of certain "white knight" negotiations). See generally Ayres, supra note 34, at 957 (discussing uncertain contours of duties to disclose). Such provisions are the exception rather than the rule, however, and outside the merger context, companies have broad discretion to withhold forward-looking information. Unfortunately, the requirement to disclose forward-looking information appears
and it is always possible that the initial price movement will have to be adjusted as more information about the actual state of the world becomes available.

The disclosure of useful information that later proves overly optimistic or pessimistic is likely to be the occasion for a fraud lawsuit precisely because the disclosure will have affected the market price. By definition, the materiality hurdle will be cleared and the defendant's best hope of obtaining summary judgment gone. A rational issuer will view fraud recoveries as, in part, a progressive tax that increases as the usefulness of information increases and will restrict its output of useful information accordingly. As a result, not only does the amount of information imparted to investors decrease, but the information that is no longer provided is precisely the information of most value to investors.

This scenario is far from academic speculation. A very common fact pattern in FOTM lawsuits is roughly as follows: The issuer makes a statement with possibly, but not necessarily, positive implications for the future. The firm might, for example, announce that it has introduced a new product, that it has embarked on a cost-cutting program, or simply that based on results to date, management believes that the current year's earnings will exceed the previous year's. In each case, of course, management cannot and does not provide assurance that the positive outcome will come to pass. At some later date, it becomes clear that the outcome will not be positive: the new product bombs, the cost-cutting measures fail to work, or fourth-quarter sales are much lower than expected. If the stock price falls much, the almost inevitable 10b-5 complaint alleges that management made its initial statement even though it knew or recklessly disregarded evidence, that the product was no good, that the cost-cutting measures would not work, or that sales would decline. Such a complaint is virtually dismissal-proof: the allegation of scienter raises a triable issue of fact, notwithstanding the significant likelihood that the suit is to arise in precisely the circumstance where it is most harmful to shareholders as a group—namely, the takeover context.

An excellent example is Good v. Zenith Elec. Corp., 751 F. Supp. 1320 (N.D. Ill. 1990). In its 1988 annual report, Zenith stated that it expected 1989 profits to exceed those in 1988. After the second quarter of 1989, Zenith backed off this prediction, and the plaintiffs promptly brought a FOTM suit, in which they alleged that Zenith had failed to disclose that its projections were based on unrealistic assumptions about inventories and currency adjustments.
simply Monday-morning quarterbacking by an attorney in search of a fee.\footnote{73}

Typically in such a case, the issuer was under no obligation to make the announcement or to provide as much information as it did. This use of Rule 10b-5 as essentially a strict-liability cause of action raises the cost of making such disclosures and must therefore reduce the amount and value of information disclosed. Though using Rule 10b-5 in this way does produce some benefits, in that it encourages issuers to correct any past statements that hindsight has shown to be too optimistic (in order to limit the size of the class that can sue), these benefits are much less substantial than the costs of deterring the disclosures in the first place. Disclosures that simply correct past disclosures by revealing objective facts about the company's performance are not the sort of speculative or forward-looking disclosures that analysts cannot replicate. The value of the statements forgone, therefore, is higher than the value of the statements encouraged by a strict liability regime.

Although it is obviously difficult to prove or disprove empirically the proposition that inefficient enforcement of Rule 10b-5 leads firms

\footnote{73 As a general matter, Rule 9(b) of the Federal Rules of Civil Procedure requires that fraud be pleaded with particularity, Fed. R. Civ. P. 9(b); however, scienter may be averred generally. Id. The United States Court of Appeals for the Second Circuit requires plaintiffs “to supply a factual basis for their conclusory allegations” of scienter in a complaint. See Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980). It does not appear that the Second Circuit's rule, which has not been followed by the other circuits, has interfered greatly with the ability of plaintiffs' counsel to state nondismissal causes of action. Indeed, given the liberal venue provisions of the federal securities laws, the fact that large numbers of securities class actions continue to be filed within the Second Circuit suggests that plaintiffs' counsel do not view the likelihood of dismissal to be materially higher there. See O'Brien & Hodges, A Study of Class Action Securities Fraud Cases I-10 (1991) (unpublished manuscript, on file with the Virginia Law Review Association) (in sample of 321 securities fraud class actions, 52 (16.2%) were filed either in the Southern or Eastern District of New York).}
to reduce their output of useful information, it is interesting to note that the proposition is consistent with one well-known but puzzling phenomenon—financial signaling. Financial economists have found that events such as stock splits and stock dividends tend to increase stock value. A number of explanations have been offered, many of which are based on the premise that managers use such devices as signals that the firm is undervalued. Economists have had a more difficult time, however, explaining why managers use stock splits and dividends to signal when a press release would achieve the same result for less cost. Unlike some financial signals, stock splits and dividends are not self-deterring because they impose no greater costs on overvalued firms than on undervalued firms and are therefore not inherently more believable than a press release.

In light of the above analysis, however, it may be that signaling devices are used to transmit particularly useful information precisely because a press release carries the risk of a fraud claim. Assume that management has good reason to believe that earnings are going to increase, but that belief cannot be adequately expressed through the disclosure of historic facts. Management can put out a press release

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75 See Grinblatt et al., supra note 74, at 463-65 (surveying signaling explanations); see also Josef Lakonishok & Baruch Lev, Stock Splits and Stock Dividends: Why, Who and When, 42 J. Fin. 913 (1987) (proposing "trading range" explanation but noting that data also supports signaling explanation).
76 See Grinblatt et al., supra note 74, at 464. Unlike Stephen Ross' well-known signaling model, see Stephen A. Ross, The Determination of Financial Structure: The Incentive-Signalling Approach, 8 Bell J. Econ. 23 (1977), a stock split involves no ex post settling up; the firm's managers are not penalized for sending an incorrect signal. Nor is the signal so costly that it cannot be mimicked by low-quality firms. For a general discussion of the differences between signaling models, see Robert Heinkel, A Theory of Capital Structure Relevance Under Imperfect Information, 37 J. Fin. 1141, 1141-42 (1982).
77 This raises the obvious question of why such a signal would ever be believed and why it is not used more often to send false information. One possible explanation is that when it becomes clear that there is no good news, the positive abnormal returns are reversed, thus netting the firm no gain. See Fama et al., supra note 74, at 16-17. It should be noted, however, that the empirical evidence suggests only that the initial positive effect is reversed—not that an additional "penalty" is extracted. See id. In any event, an answer to that question is not necessary here; the only important point is that investors do appear to believe the signal. For empirical evidence showing that news of a stock split results in excess returns, see sources cited supra note 74.
stating its belief, which (assuming management has developed a reputation for honesty and caution) will result in a jump in the stock price. Of course, management cannot be absolutely certain that its reasonable, good-faith belief is true. If management believes that an honest mistake can still lead to 10b-5 liability—as it most assuredly can, given the problems and concomitant errors of adjudicating scienter—it may decide to use a nonverbal signal like a stock split or dividend. Managers might use the normal channels of communication for information of modest usefulness (and thus modest liability risk) and signal especially useful information, which poses a higher risk of liability, through other means.

If “nonverbal” signals like stock splits could impart the same volume of information to the market at the same cost as press releases, then the problem of excessive 10b-5 liability would be less severe. Firms would adapt by using the low-liability, rather than the high-liability, methods of disclosure, and stockholders would bear the cost of occasionally fraudulent signals sent by such means (which cost might well be lower than the cost of bearing their pro-rata share of Rule 10b-5 litigation costs). It is highly unlikely, however, that stock splits or other nonverbal signals are adequate substitutes for press releases. The cost of issuing and listing additional shares is clearly higher than the cost of a press release. Because there are no equally cost-effective, nonverbal means of communicating to the market, the costs of overenforcing Rule 10b-5 against verbal means of communication are indeed significant.

C. Extension to Other Markets

The practical deficiencies of the scienter requirement shed additional light on the common law’s reliance requirement. The common law, like Rule 10b-5, permits recovery only for material misrepresentations—that is, those on which a reasonable person would rely. Having thus limited the cause of action to statements objectively relevant to a purchase or sale decision, why does the common law insist on a further test of subjective relevance?

78 See supra text accompanying notes 56-64.
79 See Grinblatt et al., supra note 74, at 464 (suggesting that liability concerns may influence signaling).
80 See Restatement (Second) of Torts § 538 (1977).
In addition to its connection to precaution-taking, requiring proof of reliance may serve to guard against overdeterrence of beneficial disclosures. Courts seem to have had nearly as much difficulty pinpointing intentional misstatements under the common law as under Rule 10b-5. Reliance, then, can be seen as an additional filter used to reduce the scope of liability in order to avoid deterring beneficial voluntary disclosures in the bargaining context. The reliance filter is an appropriate one because it removes that subset of plaintiffs whose ex ante behavior will be altered least by the denial of recovery—namely, those traders who either ignore or independently verify, and therefore do not rely on, misstatements.

III. FOTM AS A RESPONSE TO ENFORCEMENT COSTS

Though FOTM can impose substantial costs by deterring the voluntary disclosure of useful information, it might still be defended on the ground that an alternate system requiring proof of reliance puts such an imposing barrier in the plaintiff's path that it necessarily will result in underenforcement. Even though FOTM imposes more liability than necessary to achieve optimal deterrence and additionally deters beneficial disclosures, these deficiencies may be preferable to the alternative, substantial underdeterrence of fraud. FOTM, in this view, is a practical, if imperfect, means of economizing on enforcement costs.

If FOTM's proponents are correct in arguing that a world without FOTM is, in effect, a world without enforcement of securities fraud rules in secondary markets, they will have undercut significantly the case against FOTM. The literature on FOTM has identified at least three ways in which FOTM might economize on enforcement costs. First, focusing on easy-to-measure trading losses is easier than focusing on hard-to-measure net social costs. Second, it is less costly for courts to avoid overdeterrence by adjusting damages measures than by making individualized and subjective inquiries into reliance. Third, and most important, absent FOTM, class actions will be difficult or impossible to maintain in Rule 10b-5 litigation, a situation that would lead to persistent underenforcement. I address each of these arguments below.

81 See Posner, supra note 5, at 168-71.
A. Difficulty of Measuring Social Loss

The most straightforward rationale for permitting all traders to recover trading losses is that trading losses are the only variable that a court can measure with relative ease.\textsuperscript{82} It is much harder for a court to adjudicate reliance investor-by-investor; it is harder still to determine the optimally deterring damages bill, which requires making judgments about precaution costs, investments in lying, and allocative losses. Moreover, granting recovery only to those traders who suffer trading losses and who can prove reliance would underdeter securities fraud. The precaution-cost model in Part I makes it clear that even an informed trader who can plausibly claim that she failed to trade because she relied on a lie would have ex ante an incentive to take precautions, yet such a trader cannot recover because she did not suffer damages "in connection with the purchase or sale of any security" within the meaning of Section 10(b).\textsuperscript{83} FOTM might, therefore, be justifiable both as a matter of administrative convenience and as a second-best means of adjusting the damages bill upward to take account of the traders who suffer economic harm but who lack standing.\textsuperscript{84}

There are two responses to this argument. First, as noted above, the point would be much more persuasive were the Supreme Court to define the scienter requirement more narrowly. As things now stand, excessive liability seems a more serious problem than insufficient liability in secondary-market cases. The second response is that it is incorrect to assume that, in the typical 10b-5 case, the real social cost is substantially greater than the trading losses of those plaintiffs who can prove reliance. As previously discussed, some lies told in secon-

\textsuperscript{82} The argument that trading losses can easily be measured is subject to the objections noted infra Part III.B.

\textsuperscript{83} Section 10(b) prohibits fraud "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b) (1988). Only one who purchased or sold the subject security during the relevant time period meets this standing requirement. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

\textsuperscript{84} On this view, the investors who did not rely on a falsehood are allowed to recover damages not because they would otherwise take expensive precautions, but because they are a proxy for those who lose from fraud but who either cannot adequately prove reliance or cannot meet the standing requirement. Cf. Posner, supra note 5, at 170 (noting difficulty of identifying and quantifying actual social losses from fraud).
dary markets result in a net social gain, not a loss, by producing a benefit for the firm.85

To measure accurately the net social cost of secondary-market lies, we must compare the allocative losses, precaution costs, and investments in lying, on the one hand, with the benefits to the firm and its shareholders, on the other. In the typical case, the net social cost is not necessarily substantial (or even positive). This may be one reason why Congress chose to put enforcement of antifraud rules in the hands of the SEC rather than private plaintiffs. Because net social costs bear no a priori relation to gross trading losses and may be negligible or even negative in many instances, it may make more sense for the SEC to try to identify those lies that impose significant net costs and impose an appropriate penalty than for private plaintiffs (especially those private plaintiffs who did not have ex ante an incentive to invest in precaution) to seek compensation for their trading losses.

Although it is obviously difficult to determine the proportion of lies in secondary markets told for efficient, rather than inefficient, reasons, the possibility of substantial gains in the form of protecting investments in information should caution against cavalierly accepting substantial liability in 10b-5 cases as a deterrent against unmeasured losses. There are two possible reactions to the problem. One would be to permit courts to carry on a detailed case-by-case review of social costs and benefits, resulting in no recovery in cases like Basic, where the lie probably created more benefits than costs. The obvious danger with such a system is the high administrative costs and error costs involved. The other, and perhaps better, system would be one in which secondary-market frauds are deterred, but not so much as to eliminate "good" lies. A reliance requirement brings us closer to the latter system.

B. Optimal Damage Measures Versus Reliance

The argument that FOTM will overdeter is based on an assumption that courts will continue to apply the traditional measure of damages. Fischel has argued that the possibility of overdeterrence is not sufficient reason to abandon FOTM.86 He suggests that a better response would be to adjust the measure of damages in securities fraud cases to

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85 See supra note 34 and accompanying text.
86 See Fischel, supra note 5, at 16-17.
focus on net social losses while maintaining FOTM. In practice, then, the optimal damage amount would be split not only among the investors who relied on the misstatement, but among all affected investors. Using a combination of FOTM with a correct measure of damages would, in his view, result in optimal deterrence and precaution-taking, as well as a reduction in overall 10b-5 litigation. The conclusions of Part I, however, challenge the argument that FOTM, even coupled with optimal damages, optimizes precaution-taking. Moreover, Fischel's optimistic prediction of less 10b-5 liability in a world with FOTM holds only under the assumption that courts will accurately determine the impact of lies on market prices.

FOTM substitutes a single, objective test of market impact for the individual, subjective, reliance test. Although the former inquiry would seem much simpler on its face, the difference in complexity between the two may not be as great in practice. Many factors can affect the price of a security, even over a fairly brief period. An intelligent application of FOTM requires that the trier of fact apply some form of equilibrium model for the pricing of risky assets in order to determine how the return on the security during the relevant period varied from that predicted by reference to the stock's historic correlation with, for example, a market or industry index. That portion of the stock's return that cannot be explained by systematic factors that affected other stocks in the relevant index will then be attributed to the lie.

A practical defect of the FOTM-plus-correct-damages solution is that it turns the court's focus away from the types of factual questions on which its expertise is greatest (e.g., Did the plaintiff hear the misstatement? What state of mind did the misstatement induce?) and toward factual questions on which its expertise is lowest (e.g., How does the stock's return during the relevant period compare with that predicted by its beta? Which index and time period should be used for calculating beta?). Proving the effect of a lie on the price of a security involves analytic techniques that are perhaps too complex for

87 Id.
88 Id.
a nonspecialist judge or jury. Though courts are, of course, called upon to use statistical techniques in a variety of situations, the task here is much tougher because there is likely to be substantial disagreement between the parties over what it is that the court should be trying to measure. There is, unfortunately, no easy way to determine which price moves are relevant to the damages calculation, and any intuitive shortcuts the court may take are likely to result in significant errors.\(^{90}\)

Consider *Basic* itself. At first blush, the effects on prices seem obvious—the lie brought prices to a level reflecting an absence of merger talks, whereas the truth would have brought them near the expected merger price. The actual effect is almost certainly quite different. Informed traders understand the concept of privately valuable information, and consequently they know that a firm will work hard to limit knowledge of merger negotiations to a small number of corporate insiders. Significantly, then, each informed trader of Basic, Inc. stock probably believed that no other informed trader was in a position to determine whether merger talks were actually underway. The existence or nonexistence of merger talks, then, could not have been “known” (that is, capable of objective verification) by any trader (save those who could trade only at peril of insider-trading sanctions). Thus, the only information that can be called “public” in *Basic* was that (1) a statement denying merger negotiations had been made, (2) the speaker had a considerable incentive to hide the truth, and (3) it was virtually impossible for any informed trader legally to have verified the truth or falsity of the statement.

Those facts—not an expectation that no merger talks were underway—were reflected in the stock price. It is hard to make any intuitive judgment about how and how much those types of facts affect price. The price movement that occurred when the truth came out is clearly an inappropriate proxy because the truth did more than just correct the lie, which was the failure to disclose the pendency of negotiations that were not certain to succeed. The later disclosure both corrected the lie and removed the uncertainty.\(^{91}\)

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\(^{91}\) Id. at 889-97.
Any savvy speculator who guesses (probably correctly) that judges and juries will not be sufficiently attuned to these subtleties will immediately sell whenever she hears a denial of merger talks. If the statement is true, she will have made the right move, and if the statement is false, she will have locked in a damages recovery that may approach the value of the merger premium, reduced by her share of the fee of the class' attorney.\textsuperscript{92} The only hope for a moderately accurate measure of damages is that the trier of fact (caught no doubt between two expert witnesses who differ on methodology\textsuperscript{93}) will both identify the appropriate security prices to insert into a factor model and then correctly apply that model to determine the excess return on the security during the relevant period. There is thus no real basis for concluding that FOTM can streamline and simplify the process of litigating Rule 10b-5 actions.

C. Extension to Other Markets

It should also be noted that to the extent FOTM is used outside the securities context, the danger of inaccurate damages measures becomes even more acute. In securities markets, the Capital Asset Pricing Model\textsuperscript{94} and variants such as market and factor models serve as respectable, if often criticized, methods of measuring a stock's deviation from its expected return over a given period. However unlikely it is that courts will adopt, understand, and correctly apply one of these models, they still exist as a theoretically sound means of making an approximate damage calculation. We have no such model to help courts determine damages in a FOTM case involving, for example, a consumer good.

\textsuperscript{92} There is some indication that plaintiffs attempt to do just that. See Flamm v. Eberstadt, 814 F.2d 1169, 1179 (7th Cir.) (describing the plaintiffs' theory of damages as "impl[y]ing] that the class is entitled to keep what it got for surrendering the opportunity of a higher bid and still receive the full price of that bid—all the while avoiding risk that the price will return to the original level"), cert. denied, 484 U.S. 853 (1987).

\textsuperscript{93} There is unfortunately no hope whatsoever that the parties' experts will agree on methodology because there are any number of intellectually honest means of calculating the expected price of a risky asset that could give considerably different results. See, e.g., Cornell & Morgan, supra note 90, at 897-911 (contrasting comparable index approach with event-study approach). For a nontechnical discussion of factor models that highlights the multiplicity of potential factors, see Stephen A. Ross, Randolph W. Westerfield & Jeffrey F. Jaffe, Corporate Finance 299-302 (2d ed. 1990).

\textsuperscript{94} For an accessible description of the Capital Asset Pricing Model, see Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 136-40 (3d ed. 1988).
It is possible to develop relatively simple methods of valuing financial assets precisely because they are financial assets—that is, sources of cash flow and not, directly, of utility. The valuation process can avoid interpersonal comparisons of utility and treat every purchaser of stock as a marginal purchaser whose demand for the stock is a function solely of risk and return. In these circumstances, there is no need to ask whether some purchaser may attach a subjective value to a share that is higher than the market’s valuation.

None of these conveniences is possible in product markets, however. It is clearly not the case that every purchaser is a marginal purchaser because, after all, demand curves for products slope downwards. It is therefore impossible to determine what the market-clearing price for a good will be without knowing what the purchasers’ demand schedules look like. Thus it does not seem possible for a court to avoid the very task that FOTM was designed to escape—an examination of the position of each individual purchaser.

D. FOTM and Class Actions

Whatever economic rationales may be used to defend FOTM, its raison d’être is the facilitation of class action lawsuits in order to increase Rule 10b-5 enforcement. The Supreme Court has acknowledged as much,95 and the Court appears to have accepted modern finance theory only for the purpose of encouraging class actions.96

95 See Basic, 485 U.S. at 245 (stating that the “presumption of reliance . . . facilitat[es] Rule 10b-5 litigation”).

96 For example, although the Court in Basic seemingly professed to believe in the informational content of prices, it later became clear that belief is merely a one-way street. Last Term, the Court stated that defendants may not invoke the informational content of prices to avoid liability for a lie even if the informed investors knew the truth all along. See Virginia Bankshares v. Sandberg, 111 S. Ct. 2749, 2760 (1991) (stating that “[i]f it would take a financial analyst to spot the [misstatement], whatever is misleading will remain materially so, and liability should follow”).

Virginia Bankshares’ 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 Basic. Though Basic’s presumption of reliance can be rebutted by showing that the lie did not affect the market price, Basic, 485 U.S. at 248, that is not enough. If the Court really accepts the “market model” of investment decisions, the correct answer should be that there is no basis for liability (not merely no basis for a class action) if market prices were not affected. See Flamm v. Eberstadt, 814 F.2d 1169, 1180 (7th Cir. 1987) (Easterbrook, J.) (opining in dicta that FOTM “implies that for widely traded securities only fraud on the market will establish entitlement to relief. Fraud-on-the-plaintiff won’t do—not when the market price itself was unaffected . . . .”), cert. denied, 484 U.S. 853 (1987).
The technique works: the rate at which securities fraud class action suits were filed nearly tripled between April 1988, just after Basic was decided, and June 1991. \(^{97}\)

Securities fraud cases are considered by many to be paradigmatic situations for use of the class action device. \(^{98}\) Rigorous application of Rule 10b-5's reliance requirement, however, would pose a significant obstacle to class actions. Insistence that each plaintiff prove reliance would ensure that individual questions dominate common ones; this would preclude class certification. \(^{99}\) Courts are uncomfortable with this result and had, even before FOTM was first recognized, subverted the requirement of individualized proof of reliance on a variety of theories. \(^{100}\) Perhaps that history explains the otherwise surprising eagerness of courts to seize upon sophisticated economic concepts that are not susceptible to proof in the courtroom: FOTM simply provides the most intellectually satisfying basis to continue doing what the courts had been trying, on an ad hoc basis, to do all along.

The argument for facilitating class actions in securities fraud cases is straightforward. Though a defendant's conduct may cause substantial aggregate losses, the average investor does not suffer a sufficient monetary loss to justify an investment in litigation. Permitting investors to pool their enforcement resources, however, results in a level of enforcement that approaches the optimal. This reasoning was virtu-

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\(^{97}\) See Vincent E. O'Brien, The Class-Action Shakedown Racket, Wall St. J., Sept. 10, 1991, at A20; see also O'Brien & Hodges, supra note 73 (underlying data). The study included § 11 class actions as well as Rule 10b-5 class actions. Thus part of the increase—namely, that part attributable to the § 11 suits—may be completely independent of FOTM.


\(^{99}\) Securities class actions typically seek to qualify for certification pursuant to Fed. R. Civ. P. 23(b)(3), which is satisfied if "the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members," id., a standard that is unlikely to be satisfied if individualized proof of reliance is required. See Basic, 485 U.S. at 242.

\(^{100}\) As early as 1971, a commentator had noted that "in certifying class actions under the securities laws some courts have by implication, and others expressly, written out the element of reliance in order to maintain actions which would otherwise be unmanageable." William Simon, Class Actions—Useful Tool or Engine of Destruction?, 7 Lincoln L. Rev. 20, 26-27 (1971). Examples include Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (reliance presumed if the claim of fraud is based "primarily" on a material omission); Voge v. American Sumatra Tobacco Co., 241 F. Supp. 369, 375 (D. Del. 1965) (no need to prove reliance because plaintiff may fairly be inferred to have relied upon the "honesty and fair dealing" of corporate managers).
ally an article of faith at the time of the 1966 liberalization of the
federal class action rule, Rule 23 of the Federal Rules of Civil Proce-
dure, and the efficacy of securities class actions was unquestioned.101
More recently, however, both courts and commentators have expressed reservations about the tangible results of securities class
actions.102

Most commentators, whether critics or supporters of class actions,
agree that such suits have identifiable incentive effects on the parties
and their attorneys. The small amounts at stake for the class mem-
bers ensure that they will neither finance nor monitor class counsel
and that counsel’s only source of fees will be the class recovery.103
Class counsel, therefore, acts as a wealth-maximizing entrepreneur,
identifying and investing in litigation in hopes of a sufficient return.
Because each such investment is inherently risky (counsel will be paid
only if she wins), counsel will seek to acquire a diversified portfolio of

101 See, e.g., Escott v. Barchris Constr. Corp., 340 F.2d 731, 733 (2d Cir. 1965) (“there must
be a practical method for combining . . . small claims, and the representative action provides
that method”), cert. denied, 382 U.S. 816 (1965); 3 Louis Loss, Securities Regulation 1819 (2d
ed. 1961) (“The ultimate effectiveness of the federal remedies . . . may depend in large measure
on the applicability of the class action device.”); Abraham L. Pomerantz, New Developments
(“where wrongs are done to masses of people who for one or another reason are unable or
unwilling to present their claims, nonetheless the wrongdoer must be made to disgorge”).

102 See, e.g., Coopers & Lybrand v. Livesay, 437 U.S. 463, 476 (1978) (certification of large
class can make it economically infeasible for defendant to litigate despite presence of
meritorious defense); Piambino v. Bailey, 757 F.2d 1112, 1143-44 (11th Cir. 1985) (class
counsel may favor its own interests to detriment of class), cert. denied, 476 U.S. 1169 (1986);
Alexander, supra note 64 (probability of suit appears to bear little relation to presence or
absence of wrongdoing); cf. Daniel R. Fischel & Michael Bradley, The Role of Liability Rules
and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 Cornell
L. Rev. 261, 277-83 (1986) (finding no evidence that shareholder derivative suits increase
shareholder wealth).

Such criticisms have prompted various proposals to reform class litigation or the tort system
generally, proposals that have generated intense debate. Compare, e.g., Peter W. Huber,
Liability: The Legal Revolution and Its Consequences (1988) (expansion of liability has
reduced returns to innovation and decreased productivity) with Steven P. Croley & Jon D.
Hanson, What Liability Crisis?: An Alternative Explanation for Recent Events in Products
Liability, 8 Yale J. on Reg. 1 (1991) (proposals to reform tort system stem from faulty
premises).

103 See John C. Coffee, Jr., Understanding the Plaintiff’s Attorney: The Implications of
Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86
cases. To remain diversified, she must avoid investing too heavily in any one.\textsuperscript{104}

The lack of client monitoring implies that defendants can settle cheaply to the extent they can trade off a low recovery for the class with a high fee for the class attorney.\textsuperscript{105} Because the defendant's downside risk is much larger than that of the class attorney, and because the cost of maintaining the litigation is much larger for the defendant than for class counsel, any complaint that can withstand a motion to dismiss will have some settlement value. To the extent counsel has kept search costs low, that settlement value may be sufficient to provide a reasonable return on her investment in the litigation.\textsuperscript{106}

The structure of directors' and officers' insurance policies may provide additional reasons for defendants to prefer settlement to litigation. At the settlement phase the insurer has no practical alternative but to determine whether the suit is covered by the policy based on the allegations in the complaint, which are formulated with insurance coverage in mind. After a judgment, however, the insurer can base its decision on the facts found at trial, which are less susceptible to manipulation.\textsuperscript{107}

Though these concepts are quite straightforward, it is nonetheless controversial to argue that they make class actions a poor device for separating meritorious from nonmeritorious claims. One would expect a priori that settlement value will depend critically on the strength of the class' case. If so, class actions might be inefficient, but they will not undermine substantive legal rules. Janet Cooper Alexander has recently argued, however, that neither class counsel, because of the desire to remain diversified, nor the defendant, because of its higher litigation costs, enormous downside risk, and insurance considerations, can credibly threaten to go to trial. Consequently, the settlement value of a case is relatively independent of its legal merits,

\textsuperscript{105} Id. at 232.
\textsuperscript{106} See John C. Coffee, Jr., The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation, 48 Law & Contemp. Probs. 5, 17-19 (1985); see also D. Rosenberg & S. Shavell, A Model in Which Suits are Brought for their Nuisance Value, 5 Int'l Rev. L. & Econ. 3 (1985) (model in which defendant settles claims that both parties believe to have a low probability of success in order to avoid litigation cost).
\textsuperscript{107} See Alexander, supra note 64, at 550-54.
a claim she supports with empirical evidence.\textsuperscript{108} Roberta Romano recently studied the close cousin of securities class actions—the shareholder derivative suit—and found little evidence of deterrent value;\textsuperscript{109} this provides further evidence that such suits do a poor job of separating meritorious from nonmeritorious claims.

There is no need to make or defend such strong claims for present purposes. I propose simply that the above-described characteristics of class actions might make them a reasonable tool for enforcing a system of strict liability for material misstatements, but a poor tool for enforcing a system of liability for fraud. The reverse is true as well: to enforce a system of fraud liability, we should encourage individual suits rather than class actions.

Searching out and litigating cases of actual fraud is an inefficient use of class counsel's limited budget. The existence of fraud depends on the defendant's state of mind, and it is very costly to acquire knowledge about subjective mental states. Acquiring a portfolio of cases would be extremely expensive if for each case there had to be a significant probability of convincing the trier of fact that the defendant intended to mislead. It would also deprive class counsel of her comparative advantage. It is during the discovery phase, following denial of a motion to dismiss, that her cost differential vis-à-vis the defendant is greatest.\textsuperscript{110} If required to focus solely on cases involving a high likelihood of actual fraud, however, she would be forced to incur considerable expense prior to filing a complaint, at which phase she does not enjoy a substantial cost differential. Class counsel's overwhelming incentive, then, is to filter only for substantial price declines combined with arguable misstatements.

These problems do not exist if defendants are strictly liable for material misstatements. If materiality depends on ability to influence price, counsel can immediately narrow the search down to instances of substantial price movements that are not easily explainable by broader market moves. Because of the mandatory disclosure features of the securities laws, it is easy to find out what statements the defendant made. It is also quite likely that following a substantial price decline, a publication like \textit{Barron's, Forbes}, or \textit{The Wall Street Jour-}

\textsuperscript{108} Id. at 524-68.
\textsuperscript{110} See Coffee, supra note 106, at 17 (discussing cost differential at discovery phase).
nal will provide some analysis of the problems that led to the decline; if those problems are not identified in the disclosure documents, counsel has found a plausible material omission with a minimal investment. The bulk of counsel's investment dollars can then be saved for the discovery phase, where they can work to greater advantage. Thus, FOTM class actions could reasonably enforce a strict liability regime, which, of course, does not exist under Rule 10b-5.

Note that the converse is probably true as well: to the extent courts act to facilitate class actions, they may shift the prevailing substantive standards from fraud towards a strict liability regime. Indeed, the ambiguities in the scienter doctrine discussed above may exemplify this phenomenon. The viability of securities class actions depend critically on the availability of directors' and officers' liability insurance. Such insurance policies typically exclude coverage for intentional misconduct. At the settlement phase, the insurer will determine whether the defendants' conduct fits within this exclusion by reference to the complaint, so that if the law allows plaintiffs to plead something less than intentional wrongdoing, the insurance proceeds will likely be available. Adopting a stricter and less ambiguous definition of scienter, however, would risk making insurance unavailable in 10b-5 suits, thereby frustrating judicial attempts to streamline securities litigation.

Another reason why securities class actions will not adequately deter fraud is that the existence of class actions provides a disincentive for those investors who can afford to sue on their own behalf to do so, even when they detect a real lie. To illustrate the point, consider a

111 See Hal S. Scott, Comment, The Impact of Class Actions on Rule 10b-5, 38 U. Chi. L. Rev. 337 (1971) (arguing that Rule 23 will lead to change in substantive liability standards under Rule 10b-5).

112 See Nancy Rutter, Securities Class Action Scandal, Upside, Apr. 1990, at 18, 34 (reporting that directors' and officers' insurance provides approximately 50-80% of settlement money in securities class actions).


114 See supra note 106.

115 Cf. Morris v. St. Paul Fire & Marine Ins. Co., 1982 Fire & Casualty Cas. (CCH) 1125 (S.D.N.Y. 1982) (exclusion for "fraud" and intentional wrongdoing not applicable where jury verdict in common-law fraud case could have been based either on intentional or reckless conduct).

116 This is not to say that sophisticated institutional investors never bring suit alongside a class action. For one of the relatively rare examples, see T. Rowe Price New Horizons Fund v.
model in which entrepreneurial attorneys bring a class action suit whenever there is a substantial drop in stock price arguably resulting from a misstatement and in which they are always willing to settle for 20% of the class' loss (one-quarter of which goes to class counsel). Assume further that a large institutional investor would generally be willing to sue only if it has suffered a substantial loss and it believes that the probability of succeeding at trial (that is, of showing actual fraud) is at least 80%.117

A few points should be immediately obvious. Whenever an institutional investor has suffered a substantial loss from fraud, it can expect a class action suit to materialize. It can, of course, file a proof of claim in such a suit and, by hypothesis, recover 15% of its losses, net of counsel fees. The expected marginal recovery if it sues on its own behalf, then, is 65% of its loss (100% times the 80% probability of success, less 15%), but that 65% will come at a high price. The defendant should reasonably believe that if it settles with the institutional investor for, say, 50% of its losses, a court is much less likely to approve a settlement with the class whereby the class receives only 20% of its losses. The defendant may also perceive that if it litigates against the institutional investor, the class attorney will either take the riskless 20% without waiting for an adjudicated outcome, or else sit on the sidelines hoping for a later victory at virtually no cost thanks to collateral estoppel.118 Because it faces a counsel fee structure similar to that of the defendant, the institutional investor is less able than the class attorney to impose substantial litigation expenses on the defendant at low cost to itself. In short, the defendant is no longer in the usual position where the cost of litigating is substantially higher than the cost of settlement. The rational institutional investor will,

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117 This model, like most, is based on assumptions that may not accurately mirror the real world, and, in any event, it is not the only model that might explain the relative paucity of 10b-5 suits by institutional investors. Nonetheless, the model does serve to highlight the negative incentive effects FOTM has on such investors.

118 Another reason for the class attorney to do nothing during the pendency of the individual suit is that the class attorney may later be able to access some of the discovery material generated by the individual suit, thus economizing on its own efforts. See Note, Nonparty Access to Discovery Materials in the Federal Courts, 94 Harv. L. Rev. 1085 (1981). In that sense, individual litigation under current rules produces opportunities to free ride that should contribute to the underproduction of individual lawsuits.
therefore, see settlement as a relatively unlikely outcome and be less likely to sue alongside a class action.

A decreased emphasis on class actions, on the other hand, should increase the incentive to sue for those investors who can satisfy the traditional reliance test. Many (although not all) of these investors are institutions with substantial resources and substantial securities portfolios. These institutions tend to invest sufficiently large amounts so that they will be willing to bear some litigation costs in order to bring meritorious claims. Their willingness to sue will be increased further by the fact that the chances of a “piggyback” class action will be remote. Though institutional investors will invest in litigation only to the extent of their own losses (which may or may not be enough to achieve socially optimal deterrence), they should still do a better job at deterring actual fraud than do class attorneys.

**CONCLUSION**

Judging from the amount of commentary (and litigation) it has spawned, the Supreme Court’s adoption of FOTM in Rule 10b-5 class actions is one of the most significant developments in securities law in recent years. There is, indeed, some evidence to suggest that FOTM is the beginning of a trend toward “modernizing” fraud doctrine to take account of impersonal markets, rapid communications, mass advertising, and so on. The impetus for such a move is easy to understand: The possibility that uninformed traders in some markets might suffer uncompensated harms from a misstatement obviously grates, and courts have tried hard to avoid it. Nevertheless, that result is no more unjust than the fact that one who suffers harms inflicted by someone whose level of care just barely satisfied the negligence standard receives no compensation. In both instances, it is important to

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119 Cf. Alexander, supra note 64, at 576-77 (arguing that substantial investors have little incentive to bring their own suit under current system because they have little incentive to opt out of their class).

focus on the purposes of imposing liability and to determine whether those purposes are served by imposition of the proposed liability.

The failure to perform that examination in securities markets has resulted in a new doctrine, FOTM, that will probably reduce the aggregate wealth of investors. The use of FOTM in cases involving secondary securities markets adds nothing to, and indeed may subtract from, the reduction of social costs associated with fraud, most prominently precaution costs. Nor can FOTM be justified as a response to enforcement costs, at least absent a tightening of the scienter requirement under Rule 10b-5. A rule that conditions recovery on proof of reliance, on the other hand, can plausibly be implemented in such a way as to approximate optimal deterrence through individual suits supplemented by SEC enforcement actions. The Supreme Court would benefit shareholders by confessing that it erred in Basic when it adopted FOTM.