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Revisiting "Truth in Securities": The Use of the Efficient Capital Market Hypothesis

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REVISITING "TRUTH IN SECURITIES":
THE USE OF THE EFFICIENT CAPITAL
MARKET HYPOTHESIS

Michael W. Prozan
and
Michael T. Fatale

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The authors dedicate this article to the Operations Section of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. Their daily performance of tedious tasks earns them neither headlines nor appreciation. Nonetheless, the competent and accurate performance of their duties arrest fraud in the incipiency, assure market integrity, and implement the Congressional philosophy behind the Securities Act of 1933 and disclosure provisions of the Securities Exchange Act of 1934.
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The task of identifying what information is material to an investment and voting decisions is a continuing one in the field of securities regulation.¹

I. INTRODUCTION

One focus of securities regulation in the United States is to ensure that purchasers and sellers possess all necessary information

when making investment decisions. The Securities Act of 1933 ("Securities Act" or "’33 Act") and the Securities Exchange Act of 1934 ("Exchange Act" or "’34 Act") seek to accomplish this informational adequacy with a two-pronged approach. The registration provisions of the Securities Act and the reporting provisions of the Exchange Act respectively ensure that issuers using the capital markets provide adequate, timely information to initial purchasers of those securities and continually to the markets. Rule 10b-5 and other insider trading laws declare the use of certain types of information off-limits to market participants.2 These laws deny the use of information not generally available to the market and obtained through a special duty to a company to prevent use of an advantage not available to other market participants. Additionally, the use of Rule 10b-5 has been expanded to remedy material misstatements or omissions, absent insider trading. The use of 10b-5 as a remedy for disclosure violations thrusts it into a critical role in the regulatory process.3

The Efficient Capital Market Hypothesis ("ECMH") has substantially impacted the development of these areas of securities regulation.4 Application of the ECMH to these areas of securities law has

2. "Insider trading laws" refers to Rule 10b-5 promulgated under Section 10(b) of the Securities Exchange Act of 1934 as well as Sections 16 and 20A of that Act. Judicial application of the Efficient Capital Market Hypothesis has occurred only with respect to Rule 10b-5.

3. In general, the cases discussed in this article involve the use of Rule 10b-5 to remedy disclosures rather than as an insider trading provision. Since its inception, this expanded use of Rule 10b-5 has been consistently controversial. Compare the majority and dissent discussions in SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom. Coates v. SEC & Kline v. SEC, 394 U.S. 976 (1969); and Helt v. Weitzen, 402 F.2d 909 (2d Cir. 1968); see also Basic Inc. v. Levinson, 485 U.S. 224 (1988); Roeder v. Alpha Indus. Inc., 814 F.2d 22 (1st Cir. 1987); Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946, and reh'g denied, 448 U.S. 911 (1980). Academic literature on the topic also remains mixed. For those opposed to this use of Rule 10b-5, see Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1370 n.89 (1966). For those in favor of this use, see Jeffrey D. Bauman, Rule 10b-5 and the Corporation’s Affirmative Duty to Disclose, 67 GEO. L.J. 935 (1979). Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 STAN. L. REV. 385 (1990), discusses the history of Section 10(b) as a market regulation provision, rather than as a disclosure provision.

4. The Efficient Capital Market Hypothesis posits that the market for a security fully reflects all available information about a security. The theory takes three forms: weak, semi-strong, and strong. In the weak form, stock prices reflect past price histories. The semi-strong form assumes that stock prices fully reflect all publicly available information. The strong form posits that all information knowable about a security, public or not, is reflected in its price. The semi-strong form is widely accepted and was the model adopted for incorporating the theory in securities regulation. See Donald C. Langevoort, Information Technology and the
occurred unevenly, creating an imbalance in its operation. This Article examines the incorporation of that theory in the '33 Act registration provisions for domestic issuers and Rule 10b-5 case law. The discussion shows that the Securities and Exchange Commission ("SEC" or "Commission") applies the ECMH restrictively to the '33 Act registration provisions; however, the courts espouse expansive interpretations in finding reliance in Rule 10b-5 cases. In particular, the courts have often applied the fraud-on-the-market presumption of reliance in situations where the issuer in question would not have qualified for the reduced disclosure provisions of the integrated disclosure system in a primary equity offering. This dichotomy occurs despite the fact


The adoption of the ECMH by the SEC and the courts affects primarily the secondary market. See infra notes 95-97 and accompanying text. Mispricing of initial public offerings frequently occurs and remains problematic. See Stout, supra, at 664. Stout argues that federal securities regulation promotes inefficiency in the primary market by permitting underwriters to stabilize an offering. Id.

5. A primary equity offering as distinguished from an initial public offering ("IPO") involves an original issuance of equity securities by a company whose securities (whether of the same or a different class) already trade on one of the existing stock markets. An IPO involves an issuance on the public markets by a company whose securities have never been previously traded on the public markets. Our remarks on the integrated disclosure system throughout this article are focused on the system as it applies to primary equity offerings. To use the integrated disclosure system for a primary equity offering, an issuer must have, among other things: (1) voting stock of an aggregate market value of $150 million held by nonaffiliates, or (2) a) $100 million aggregate market value of voting stock held by nonaffiliates, and b) an annual trading volume of 3 million shares. See 17 C.F.R. § 239.13(a)-(b) (1988). For a discussion of instances where the courts have applied the fraud-on-the-market theory of reliance where the issuer would not have received the benefit of reduced disclosure in a primary equity offering, see L. Brett Lockwood, Note, The Fraud-on-the-Market Theory: A Contrarian View, 38 EMORY L.J. 1269, 1316 (1989). Mr. Lockwood used MOODY'S INDUSTRIAL MANUAL, STANDARD & POOR'S STOCK GUIDE and STANDARD & POOR'S PROFILES to determine that the issuers in the following cases were subjected to 10b-5
that both results are premised on the existence of an efficient capital market. Even the securities of Basic, Inc., the subject of the Supreme Court decision validating the fraud-on-the-market presumption, would not have qualified for reduced disclosure in the event of a primary equity offering.6

Stating the assumptions behind the two approaches helps one understand the differences between them. The SEC incorporated the ECMH into the registration provisions on the premise that brokerage house and other industry research on an issuer means that the issuer’s securities trade in an efficient market. On the other hand, courts take the position that issuers listed on the NYSE or the AMEX, as well as those widely traded in the over-the-counter ("OTC") market, trade in an efficient market, for purposes of establishing the reliance element in a Rule 10b-5 cause of action.

Some may prefer the present system because it assures the most information provided to the market through the disclosure system and the greatest liability in court actions. This Article posits that the incorporation of the ECMH in the registration provisions and Rule 10b-5 actions should be done consistently. Applying the theory consistently will result in either increasing the ability of issuers to use the integrated disclosure system in the registration process, decreasing the courts’ use of the fraud-on-the-market theory, or both.7 In any event, a more consistent application of the theory will reduce the costs to issuers and their investors without diminishing investor protection.


A secondary offering involves sales by holders of securities where the issuer receives no funds from the sales. The ’33 Act also applies to these transactions. In general, secondary offerings are not the focus of this article.


7. Ronald J. Gilson and Reinier H. Kraakman first suggested the “dual market” approach as an analytical tool in The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 627 (1984). They felt that the dual market approach established that “the case for entirely deregulating insider trading is weak, and that the case against mandatory disclosure is far from convincing.” Id. at 629.
We take the position that the ability to use the integrated disclosure system should be increased. We take this approach for four reasons. First, since the last substantial amendment to the integrated disclosure system in 1982, speed and access to information has increased, ensuring that market professionals receive more information and receive it faster. Second, the courts have been expanding the definition of when a stock trades in an efficient market and are unlikely to reverse this trend. Third, making more issuers eligible for integrated disclosure increases the reliability of and accountability for '34 Act reporting. Fourth, the present system requires that issuers and investors “pay,” through increased registration costs, for additional information not needed by investors under the expansive court holdings.

We also take the position that the fraud-on-the-market rulings of the federal courts have been too expansive. These rulings burden issuers and their investors with substantial costs and ideally would be restricted by either Commission rulemaking, congressional legislation, or further Supreme Court clarification of the pertinent issues.

The Article begins by discussing the integrated disclosure system, its origin, the adoption of the present system, and its technical requirements. Next we turn to the “fraud-on-the-market” theory. Here we focus on the validation of the theory in Basic and the tests used in the post-Basic cases to establish the existence of an efficient market for a particular security. We conclude that while subtle differences may exist in the methodology used, the cases generally reach the same result. Further, the result is inconsistent with the application of the ECMH in the registration provisions. We then discuss the possible types of systemic changes based on these differences and conclude that expanding the use of the integrated disclosure system and decreasing the use of the fraud-on-the-market theory of reliance would make the application of the ECMH more consistent and maintain investor protection at a lower cost to issuers.

8. For an overview of the impact of the speed of information on the securities markets, see Langevoort, supra note 4. The SEC’s Electronic Data Gathering and Retrieval (EDGAR) system is in its final stages of testing. In the very near future, issuers will be required to file their disclosure reports electronically. Subscribers to the system will be able to get this information much faster than at present.

9. Reliability and accountability increase because the use of incorporation by reference in '33 Act offerings subjects '34 Act documents to '33 Act liability.
II. DEVELOPMENT OF THE INTEGRATED DISCLOSURE SYSTEM

Generally, the '33 Act regulates the issuance and sale of securities, while the '34 Act regulates the market for securities and broker dealers selling securities. The '33 Act regulates the offer and sale of securities in public offerings by requiring registration of the securities offered and sold. The SEC developed the integrated disclosure system to ease the regulatory burden on issuers registering securities under the '33 Act.10

This section examines the technical development of the SEC's registration requirements for securities of domestic issuers. It traces the origin of the process, adoption of the system and technical requirements of the present forms. The review provides guidance for the changes suggested in our conclusion.

A. Origin of the Process

In 1966, Milton Cohen published his seminal article, "Truth in Securities" Revisited,11 calling for substantially more integration between the registration provisions of the Securities Act of 1933 and the ongoing reporting provisions of the Securities Exchange Act of 1934. Cohen noted that the '33 Act's registration, disclosure, and prospectus delivery requirements developed without regard to the continuous reporting system established in 1934 by the Securities and Exchange Act.12 This bifurcated development caused a system of needless duplication and confusion. From Cohen's article grew a movement to integrate the '33 and '34 Acts.

Through the late 1960s into the early 1980s, the Commission embarked on a series of revisions intended to simplify the registration and disclosure process.13 The process began in 1967, with the adop-

12. Actually, President Roosevelt sought to enact legislation regulating both securities issuances and exchanges simultaneously. However, early attempts at such a bill failed. RALPH F. DE BEDTS, THE NEW DEAL'S SEC, THE FORMATIVE YEARS 56 (1964).
tion of Form S-7. Criteria for use of this early Form centered on a strong record of earnings and continuity of management and business. Use of Form S-7 meant reduced information in the '33 Act registration process, without the investor protection provided by incorporation by reference of '34 Act documents.

Responding to the "Wheat Report," the Commission took steps to strengthen the '34 Act reporting system to provide better information to the trading markets and provide for more coordination with the '33 Act. To this end, quarterly reporting through Form 10-Q replaced the existing requirement of semiannual reporting. The next
step involved the adoption of '33 Act registration Form S-16, which reduced prospectus disclosure requirements by providing for incorporation by reference to Exchange Act reports. Additionally, the Commission expanded the disclosure in and dissemination of annual reports to security holders.

In 1976, the Commission refined the system. Use of Forms S-7 and S-16 were amended to permit use by more issuers subject to the Exchange Act reporting requirements. Simultaneously, the Commission rescinded Form S-9, a document implemented in 1954 for non-convertible debt offerings, because “virtually all issuers who qualified to use Form S-9” could now use Form S-7. As the Commission considered expanding the use of Form S-16, it received a report from the Advisory Committee on Corporate Disclosure (“ACCD Report”) which suggested further integration. In response to the ACCD Report, the Commission expanded the types of transactions eligible for S-16 registration.

In 1980, the Commission continued reducing disclosure obligations filed by issuers and infrequently used by investors.

19. Optional Form for Registration of Additional Issues of Securities Registered on National Securities Exchanges, or for Offerings to Holders of Certain Classes of Convertible Securities, or to Holders of Certain Types of Warrants, Securities Act Release No. 5117, 36 Fed. Reg. 777 (Jan. 16, 1971). Initially, eligibility to use the Form was extremely restrictive. Basically, it was available to issuers meeting the eligibility requirements of Form S-7 for registration of secondary market transactions.


21. See Amendments to Disclosure Items of Forms S-7 and S-16, Securities Act Release No. 5791, 41 Fed. Reg. 56,304 (Dec. 28, 1976). The changes were: (1) the expanded use of the forms to permit use by any companies with equity or debt registered under '34 Act § 12(b) or § 15(d) companies (additionally requiring that § 15(d) companies must have provided an annual report to security holders within 12 months of the offering); (2) reduced the time of compliance with the '34 Act from five years to 36 calendar months and timeliness requirement from three years to 12 calendar months; (3) eliminated the continuity of management requirement; (4) reduced the no default requirement from ten years to 36 calendar months; (5) reduced the minimum earnings requirement from $500,000 for each of the last five fiscal years to $250,000 for three of the last four fiscal years, including the present fiscal year; (6) eliminated the requirement that dividends over the past five fiscal years have been paid from earnings; (7) permitted all successor entities to be S-7 eligible if predecessor was eligible; (8) permitted the use of the form where securities were guaranteed by an eligible parent owning a majority of the issuer; and (9) expanded eligible consideration from cash to include exchange offers.


23. See Short Forms For Registration of Securities, Securities Act Release No. 5923, 43 Fed. Reg. 16,672 (Apr. 11, 1978). The additional transactions included primary offerings of debt or equity offerings by companies with a market capitalization of $50 million, offerings to existing security holders pursuant to rights or dividend reinvestment plans, and offerings to holders of convertible securities or holders of outstanding transferable warrants.
tions for registrants through adoption of new Form S-15, which provided for reduced issuer disclosure in certain business combination transactions. 24

B. Adoption of Present System

Based on the recommendations in the ACCD Report, the Commission proposed the three-tier structure presently in effect. 25 The Commission divided issuers into three groups based on: (1) longevity of '34 Act reporting obligations; (2) dissemination and professional analysis of '34 Act reports; and (3) financial stability. 26 The Agency focused on determining the necessary information to be received in a '33 Act registration statement, how to provide the information, and who should receive the information. 27

24. Form S-15, the predecessor to the current Form S-4, required, in addition to the Form S-7 tests, that: (1) the transaction be a) a Rule 145(a) transaction (generally a reclassification of securities, merger, consolidation, or acquisition of assets), b) a merger not requiring a vote by security holders of the target company 'under state law, or c) an exchange offer where acquirer will hold at least 50% of the target company's securities upon completion of the transaction; (2) the acquisition be of a small company by a large company (defined to not involve a change of more than 10%, for the issuer, on a pro forma combined consolidated basis, giving effect to the transaction in question of gross sales, operating revenues, net income, total assets and total shareholders' equity); (3) the transaction be approved or recommended by both boards of directors (as of the date of effectiveness of the registration statement); (4) the prospectus be delivered 20 days prior to the meeting date or the date of vote consent or authorization (even if not solicited); and (5) the issuer has furnished its latest annual report to security holders. Form S-15 specifically excluded investment companies from its use. See Securities Act Release No. 6232, 45 Fed. Reg. 63,647 (Sept. 2, 1980).

25. Securities Act Release No. 6235 presents the framework. See Securities Act Release No. 6235, supra note 1. The three tiers pertain both to eligible issuers and types of information. The tiers of information are: "1) the information comprising the registration statement; 2) the information delivered to offerees; and 3) the information available on request." Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess. at 425 (Nov. 3, 1977). The three issuer tiers are: (1) issuers widely followed by professional analysts; (2) issuers not widely followed but subject to '34 Act reporting requirements for over three years; and (3) issuers subject to '34 Act reporting for less than three years. See Proposal of Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 6331/Exchange Act Release No. 18,007, 46 Fed. Reg. 41,902 (Aug. 18, 1981).[hereinafter Securities Act Release No. 6331/Exchange Act Release No. 18,007 or Release 6331].


27. The Commission divided the information into two types, issuer specific and transaction specific. Issuer specific information included information relating to the Company and its performance such as description of business, discussion and analysis of management, and financial statements. Transaction specific information relates to the transaction, such as use of proceeds, terms of the particular security involved, underwriting arrangements and the like.
The Commission explicitly adopted the ECMH in its refinement of the registration process. The Commission used certain factors to determine when to apply the ECMH to particular issuers and allow company-specific information to be incorporated by reference. These factors include: (1) whether the issuer's securities fall into a category that cause broker dealers to research and publish reports on them; (2) the likelihood that the financial press would report on the issuer; and (3) the composition of the market for the security. These factors attempt to reduce reliance on the quality of the registrant and focus on the degree of marketplace dissemination of information about the issuer.

Through the process of integration, the Commission concluded that "equivalency" existed between the information necessary for decisions made in the initial distribution and trading markets. In 1982, the Commission settled on the current system. The present system provides a uniform system of textual disclosure through Regu-

The Commission sought to reduce disclosure burdens relating to issuer specific information. All transaction specific information needed to be disclosed in each registration statement. Registration Statement and Prospectus Provisions, 17 C.F.R. §§ 229.500-12 (1992) defines the transaction specific information that is currently required.

28. For example, Securities Act Release No. 6235, supra note 1, states: information is regularly being furnished to the market through periodic reports under the Exchange Act. This information is evaluated by professional analysts and other sophisticated users, is available to the financial press and is obtainable by any other person who seeks it for free or at nominal cost. To the extent that the market accordingly acts efficiently, and this information is reflected in the price of the registrant’s outstanding securities, there seems little need to reiterate this information in a prospectus in the context of a distribution. Id. at 63,694. In addition, Securities Act Release No. 6331/Exchange Act Release No. 18,007, supra note 25, states: "[p]roposed Form S-3 recognizes the applicability of the efficient market theory to the registration statement framework." Id. at 41,904.


30. See Securities Act Release No. 6235, supra note 1, at 63,695. The SEC felt that the financial press plays a vital role in the information process: "[t]his country has a uniquely active and responsive financial press which facilitates the broad dissemination of highly timely and material company oriented information to a vast readership." Id.

31. See id. (recognizing technical analysis by indicating that analysts also expend efforts to analyze the markets in which a security trades as well as the fundamentals of the particular company involved).

32. See id. at 63,694; see also Securities Act Release No. 6331/Exchange Act Release No. 18,007, supra note 25, at 41,902. The equivalency theory led to the standardization of the '33 and '34 Act reporting documents and the integrated disclosure system.

lation S-K\textsuperscript{34} and accounting through Regulation S-X,\textsuperscript{35} so that when a particular '33 or '34 Act form calls for certain disclosure, consistent disclosure appears among the forms.

C. Technical Registration Requirements

The present system provides for three tiers of issuers,\textsuperscript{36} each having differing obligations in their '33 Act registration provisions. The Commission recognized these three tiers through the promulgation of Forms S-3, S-2, and S-1 and the rescission of Forms S-7 and S-16.\textsuperscript{37} This section of the Article reviews the application by the Commission of the ECMH to these registration forms, as well as the bases underlying this application.\textsuperscript{38}

1. Form S-3

Form S-3 issuers provide minimal information in their Securities Act registration statements. In designing this form, the Commission sought to restrict its use to issuers who were focused upon by the research branches of the brokerage houses. To be eligible to use Form S-3, issuers must meet registrant and transactional requirements. The registrant requirements, premised on the '34 Act reporting, are designed to ensure that the issuer has and will continue to provide appropriate information necessary for the stock to trade in an efficient market. The registrant requirements are that the issuer: (1) a) has a class of registered securities under § 12(b), b) has a class of equity securities registered under § 12(g), or c) is required to file reports


\textsuperscript{36} See supra notes 25-26 and accompanying text.


under § 15(d); (2) has been subject to §§ 12 or 15(d) and has filed all §§ 13, 14 or 15(d) reports for 36 calendar months; (3) has been timely in filing such reports over the previous 12 months; (4) has not defaulted on a preferred stock dividend or sinking fund installment subsequent to the most recently audited financial statements; and (5) has not defaulted on borrowed money or on a long-term lease subsequent to its most recently audited financial statements when such defaults in the aggregate are material to the position of the registrant and its subsidiaries.\(^{39}\)

The transactional requirements include: (1) in the case of a primary equity offering by the registrant or an affiliate a) $150 million in float, or b) $100 million in float and an annual trading volume of 3 million shares; (2) for primary debt and nonconvertible preferred stock, a rating of "investment grade" by a nationally recognized rating agency; and (3) for secondary offerings, that the securities be the same class as securities that are exchange listed or NASDAQ quoted. Float is defined as the aggregate market value of voting stock held by non-affiliates.\(^{40}\) Because the Commission’s most detailed analysis of the ECMH was with respect to primary offerings, it is that analysis which is the focus of this article.\(^{41}\)

For primary offerings for cash of other than investment grade securities, the Commission used a $150 million float requirement as a criterion and threshold level to show that the security traded in an

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Other requirements include that the registrant must be organized under the laws of the United States, any State or Territory therein, or the District of Columbia, and have its principal business operations in the U.S. or its territories. 17 C.F.R. § 239.26 (1976).


41. The SEC’s analysis with respect to primary debt was minimal. It stated that “security ratings are also based on marketplace information about the registrant which is analogous to the efficient market for widely followed equity securities. Moreover, security ratings issued by nationally recognized statistical rating organizations are widely used and relied upon by the marketplace.” See Securities Act Release No. 6331/Exchange Act Release No. 18,007, supra note 25, at 41,910.

As to secondary offerings, the SEC initially set an identical standard as that used for primary equity offerings, but modified its stance in light of commentator criticism. Id. Commentators argued that such a standard would harm venture capital companies and issuer affiliates seeking to sell issuer stock and that such a standard was unwarranted in light of the fact that history with respect to Form S-16 revealed very little abuse as to secondary offerings. Id.
efficient market. 42 This criterion seeks to ensure that appropriate industry research resources are devoted to the company. 43 The Agency reviewed criteria used by: (1) investment institutions in making research coverage decisions; (2) publishers and service providers in making reporting decisions; and (3) market trading organizations in making listing and delisting decisions. 44 The findings indicated float to be a prominent factor in the decisions of investment institutions; a negligible factor in reporting coverage decisions; and a primary measure of depth-of-market by market trading organizations. 45

The Commission examined the possible use of other factors as measures of market interest. These elements included: (1) trading volume; (2) market capitalization (value of all stock outstanding, including stock held by affiliates); (3) number of shareholders; (4) number of market makers; and (5) asset size and revenue. 46 Although the study found trading volume to be a prominent criteria used to make investment research decisions, it also added too much uncertainty to an issuer's eligibility and operated against issuers whose investors retained their investments. 47 Similarly, market capitalization had a strong correlation to float but tended to include substantial amounts of stock held by affiliates, making float a better indicator of market interest. 48 The number of shareholders simply was not indicative of market interest because this criteria operated against a company with smaller numbers of large shareholders. 49 The number of market makers proved a good measure of interest in the OTC, but not the exchanges. The float was a better indicator for all markets. 50 Finally, an earnings test was not indicative of market interest and was not used in making research coverage decisions. 51

Generally, each of these criteria were found to either: (1) "have no relationship to the breadth of information dissemination in the market"; or (2) be "so statistically related to float that the criterion would

43. Id.
44. Id. at 41,907.
45. Id.
46. Id.
47. Id.
48. Id. at 41,908.
49. Id.
50. Id.
51. Id.
have had a largely duplicative effect as an eligibility standard."\(^{52}\)

The primary objective in selecting a float level may have been maintenance of the status quo. A threshold level of float needed to be selected for a bright line determination of eligibility for issuers to use Form S-3. The goal in selecting a threshold level was to assure that companies using Form S-3 be "the focus of extensive ongoing monitoring and evaluation."\(^{53}\) Release 6331 first discussed a $50 million float. The Commission estimated that this float level made almost 50% of NYSE and AMEX listed and NASDAQ quoted companies (collectively hereinafter "listed companies") eligible for use of Form S-3 (a total of 2400 eligible issuers at that time).\(^{54}\) After noting generally that each of the major investment houses can only focus their research energies on 300 to 500 companies, and that there is a propensity for wide overlapping research, the Commission did not feel comfortable with a $50 million float level.\(^{55}\) The Commission next discussed a possible $250 million float requirement, and noted that this would encompass about 22% of listed companies or 1,084 issuers.\(^{56}\) The Commission found this level too restrictive but failed to indicate whether 1084 companies could be supported by industry research capabilities.

The $150 million float requirement selected meant that 30% of listed companies (1485 entities) would be eligible to use Form S-3.\(^{57}\) No discussion was provided as to whether industry research ability could support this many companies. Release 6331 extensively discussed the effect of a $150 million float requirement on issuers then able to use Form S-16. It noted that only 1.4% of companies with a float of less than $150 million used Form S-16 for primary equity issues and proposed an alternate $100 million float, 3 million share annual trading volume test which expanded the range of Form S-3 eligible companies to 32%.\(^{58}\)

The Commission's rejection of a $50 million float level on the basis of insufficient industry research capability was inconsistent with its selection of a $150 million float level, since that selection was without a public finding of ample industry research capability. The
failure to make a finding of adequate research capability indicates that other factors may have gone into the SEC's calculation. The proximity of the number of companies eligible to use the $150 million float requirement with the number of companies using Form S-16 for primary equity offerings, and the extensive discussion of this similarity, are indicators that the Commission's concern was maintenance of the status quo. In addition, the fact that Release 6331 is inconclusive on industry research capability and that it notes no complaints about the then-existing system indicates that the Commission may have been more restrictive than necessary in creating the top tier of issuers.

2. Form S-2
The Commission designed Form S-2 to be used by former Form S-16 eligible issuers not eligible to use Form S-3. The distinguishing feature between Form S-2 and Form S-3 is the lack of a transactional requirement for Form S-2. Benefits of filing on Form S-2 include incorporation by reference of '34 Act documents on file with the SEC up to the date of effectiveness, and the ability to satisfy the registrant related disclosure by delivering a copy of the annual report along with the transaction specific information.

3. Form S-1
Issuers not eligible for use of Forms S-3 or S-2 must file on Form S-1. Form S-1 provides for minimal incorporation by reference, requiring that the complete informational package be in the prospectus.

4. Conclusion
The SEC engaged in a 15-year process culminating in 1982, intended in part to incorporate the ECMH in its registration forms. This process, which has gone substantially unmodified since that time,

59. Similarly, in adopting its test for secondary offerings, the SEC relied substantially on maintaining the results under Form S-16, with little consideration as to whether such results were consistent with the ECMH. See supra note 41.
61. Id.
62. Form S-1, 17 C.F.R. §239.11 (1992). Note that some issuers may be eligible to use some of the other specialty forms in lieu of Form S-1, i.e., Form S-4 (business combinations) and Form S-11 (real estate). These other forms are not central to the Commission's application of the ECMH to the '33 Act registration provisions.
resulted in the present scheme, featuring Forms S-3, S-2, and S-1 for domestic issuers.

One rationale for the process was the effect of technological advances on the dissemination of securities information. These advances have continued since 1982 and suggest that more and more issuers are likely to trade in an efficient market.

III. DEVELOPMENT OF THE FRAUD-ON-THE-MARKET THEORY

[Section] 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws... We enter this virgin territory cautiously. These questions arise in an area where glib generalizations and unthinking abstractions are major occupational hazards...

In 1988, in Basic Inc. v. Levinson, the Supreme Court reaffirmed reliance as an element of proof in a Rule 10b-5 action needed to evidence the causal connection between a defendant's misrepresentation and a plaintiff's injury. A plurality of the Court adopted the fraud-on-the-market ("FOTM") theory of reliance as one means of meeting this requirement. This section discusses the development of the FOTM theory in four parts. The first section discusses Basic

64. See supra note 8.
67. Id. at 243.
68. The theory behind this presumption of reliance is clearly stated in Note, The Fraud-on-the-Market Theory, 95 HARV. L. REV. 1143 (1982).
and the procedural significance of the FOTM presumption. The second part summarizes the cases since Basic which have focused on the efficient capital market question. The third segment discusses the cases referenced in part two on a case-by-case basis. The fourth section concludes that the holdings in the FOTM cases have been too expansive.

A. Basic and the Procedural Impact of the FOTM Presumption

The FOTM theory posits that where a security trades in an efficient market, purchasers and sellers may justifiably rely on the market price of the security in making their determination of whether to buy or sell, creating a rebuttable presumption of reliance. To invoke the presumption, the investor must allege and prove that: (1) the defendant made public misrepresentations; (2) the misrepresentations were material; (3) the shares were traded on an efficient market; (4) the misrepresentations would induce a reasonable investor relying on the misrepresentations to misjudge the value of the shares; and (5) the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.

Basic involved a motion to certify a class. The FOTM presumption was of practical significance because absent the presumption, individual class members would have had to prove direct reliance to proceed with their 10b-5 claims. In this event, each plaintiff's

70. See generally Note, The Fraud-on-the-Market Theory, supra note 68.
71. Basic, 485 U.S. at 248 n.27. The Court noted elements (2) and (4) may sometimes collapse into each other. Basic noted as to the facts before it: "The Court of Appeals found that petitioners 'made public, material misrepresentations and [respondents] sold Basic stock in an impersonal efficient market. Thus the class, as defined by the district court, has established the threshold facts for proving their loss.'" Id.
72. Id.
claim would have involved individual issues of fact and law, thus preventing class certification.\textsuperscript{74} Denial of class certification significantly increases costs to each plaintiff resulting from the loss of the economies of scale provided by the class action vehicle.\textsuperscript{75}

Conversely, invoking the FOTM presumption greatly increases the risk of loss to the defendant. Basic's statement that the presumption may not be rebutted at the class certification stage, but only at trial,\textsuperscript{76} greatly enhances this risk because the vast majority of 10b-5 actions settle pre-trial.\textsuperscript{77} Thus, a "ruling for or against the class in

\begin{itemize}
\item \textsuperscript{74} See FED. R. CIV. P. 23(e)(2) and (b)(3); see also Basic, 485 U.S. at 242 ("Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones."); cf. Garfinkel, 695 F. Supp. at 1403 n.13 (a determination that the FOTM presumption is not warrant:x will not necessarily defeat class certification); Laser Arms, 794 F. Supp. at 495 (same); AmeriFirst, Fed. Sec. L. Rep. (CCH) at 91,821-24 (same); MDC Holdings, 754 F. Supp. at 806-07 (same); Guenther, 123 F.R.D. at 337-38, 339 (same).
\item \textsuperscript{75} In addition, proof of direct reliance may be more difficult. See Basic, 485 U.S. at 245; see also Cammer v. Bloom, 711 F. Supp. 1264, 1292 n.49 (D.N.J. 1989) ("It is noted if a company trades in an efficient market, plaintiffs would be relieved of substantial discovery and proof burdens concerning direct reliance—which could add months of trial preparation to this dispute.").
\item \textsuperscript{76} The Court observed:
\begin{quote}
We note there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. Proof of that sort is a matter for trial, throughout which the District Court retains the authority to amend the certification order as may be appropriate.
\end{quote}
\item \textsuperscript{77} See William Tucker, Shakedown?, FORBES, Aug. 19, 1991, at 98. The article states that over 98% of these cases settle. Further, at any given time 500 to 700 Rule 10b-5 actions are pending. Approximately 30% of the total costs go to attorney's fees, with insurance companies picking up the bulk of all of the litigation costs. High premiums paid for this insurance burdens companies and depletes funds for dividends to shareholders. See also Michael Selz, Lawsuits Often Follow When Small Firms Go Public, WALL ST. J., Jan. 13, 1992, at B2 (stating that 614 securities class action suits were filed in 1990 and 1991, more than the previous five years combined, and that more than 95% of such suits settle).
\end{itemize}
practice often determines the fate of the [FOTM] case.\textsuperscript{78}

The FOTM cases not involving a class certification motion generally involve either a motion to dismiss on the pleadings under F.R.C.P. 12(b)(6),\textsuperscript{79} or a motion to dismiss for failure to plead with particularity under F.R.C.P. 9(b).\textsuperscript{80} Counsel in these cases often argue that the plaintiffs may not proceed with their FOTM claim either because: (1) they have not sufficiently alleged or proved the existence of an efficient capital market, or (2) the market is in fact not efficient. Resolution of these issues at this stage is as procedurally significant as at the class certification stage.\textsuperscript{81}

B. In Summary: The Efficient Capital Market Cases Post-Basic

While Basic states that an efficient market must be alleged and proved for the FOTM presumption to apply, it does not define the term.\textsuperscript{82} Moreover, neither the Sixth Circuit Court of Appeals opinion affirmed in Basic,\textsuperscript{83} nor other cases relied upon by the Supreme Court,\textsuperscript{84} define the term “efficient market.” For example, in Levinson

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\textsuperscript{78} Cammer v. Bloom, 711 F. Supp. 1264, 1292 (D.N.J. 1989) (quoting 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 8.6 (1988)).


\textsuperscript{81} See generally Cammer, 711 F. Supp. at 1287-93.

\textsuperscript{82} See Abell v. Potomac Ins. Co., 858 F.2d 1104, 1120 (5th Cir. 1988), vacated on other grounds sub nom. Fryar v. Abell, 492 U.S. 914 (1989) (Basic “announced its support for a . . . largely undefined version of the [FOTM] presumption of reliance [and] essentially allows each of the circuits to develop its own fraud on the market rules”); Steiner, 734 F. Supp. at 277 (“Basic did not define the standards to be applied in fraud on the market cases.”).

\textsuperscript{83} Levinson v. Basic, Inc., 786 F.2d 741 (6th Cir. 1986).

\textsuperscript{84} Basic relied most heavily on Peil v. Speiser, 806 F.2d 1154 (3d Cir. 1986); In re LTV Securities Litigation, 88 F.R.D. 134 (N.D. Tex. 1980); and the seminal case of Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); see also Basic, 485 U.S. at 247 n.25 (citing additional cases for support).

Peil and Blackie, like many of the early FOTM cases, do not speak specifically of an “efficient market.” Their analyses, however, make clear that they rely on this concept. For example, Peil states: “The ‘fraud on the market’ theory rests on the assumption that there is nearly a perfect market in information, and that the market price of a stock reacts to and reflects the available information. While this presumption is plausible in developed markets, it
v. Basic, Inc., the Sixth Circuit concluded that the stock in question was traded on an efficient market. Therefore, one of the elements required for application of the FOTM presumption was met. However, in a subsequent opinion the Sixth Circuit acknowledged that it did not define in its Basic opinion the qualities that characterize an efficient market, since that was not an issue in the case.

The only fact recited in the Sixth Circuit's opinion which supports the conclusion that Basic's stock traded in an efficient market is that the stock traded on the NYSE. The Supreme Court's affirmance of this opinion does not provide any additional relevant facts. Therefore, Basic suggests that stocks traded on the NYSE per se trade in an efficient capital market.

Basic's reliance on FOTM cases involving securities traded on the AMEX likewise suggests that AMEX securities per se trade in an efficient capital market. For example, Basic quoted extensively from Peil v. Speiser, which concluded that the FOTM presumption was applicable to a security traded on the AMEX without discussing the characteristics of the market. Cases decided subsequent to Basic generally assume that securities traded on the NYSE or AMEX trade in an efficient market. Consistent with this view, very few of these

may not be in the case of a newly issued stock. As the case at bar involves a widely traded and established stock, we need not consider whether or not we would apply the 'fraud on the market' theory in other instances." Peil, 806 F.2d at 1161 n.10.

85. 786 F.2d at 750-51.
86. Id. at 751.
88. See Basic, 786 F.2d at 743.
89. This proposition is supported by Basic's reliance on In re LTV Securities Litigation, 88 F.R.D. 134 (N.D. Tex. 1980); and Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). In LTV, the court stated with reference to the stock in question, "the prices of stocks of larger corporations, such as those listed on the NYSE, seem exceptionally efficient." 88 F.R.D. at 144. Blackie similarly involved a stock traded on the NYSE and that case applied the FOTM presumption with little analysis of the market in question.

On March 5, 1992, the SEC approved lower financial listing standards for certain AMEX stocks. See William Power & Sandra Block, AMEX's New Home for "Start-Ups" Wins SEC Nod, WALL ST. J., Mar. 16, 1992, at Cl. Because the change is intended to lure NASDAQ stocks to the AMEX, and NASDAQ stocks are generally deemed by the courts to trade in an efficient market, the change should not affect case law.

91. See, e.g., Freeman, 915 F.2d at 199 ("[S]ecurities traded in national secondary
cases involve claims that securities traded on either the NYSE or AMEX do not trade in an efficient capital market.92

Most of the recent cases focusing on the efficient capital market question involve either securities traded OTC93 or revenue bonds.94 Where the cases involve revenue bonds, the courts find that the securities do not trade on an efficient capital market.95 On the other

markets such as the New York Stock Exchange, as was the case in Levinson, are well suited for application of the fraud on the market theory.); see also Tapken v. Brown, Fed. Sec. L. Rep. (CCH) ¶ 96,805, at 93,168-69 (S.D. Fla. Mar. 13, 1992); In re MDC Holdings Sec. Litig., 754 F. Supp. 785, 805 (S.D. Cal 1990); Steiner v. Southmark Corp., 734 F. Supp. 269, 277 (N.D. Tex. 1990); Hurley v. FDIC, 719 F. Supp. 27, 33 (D. Mass. 1989); Harman v. Lyphomed, Inc., 122 F.R.D. 522, 525 (N.D. Ill. 1988). But see Cammer, 711 F. Supp. at 1281 (some companies listed on national stock exchanges are relatively unknown and trade there only because they meet eligibility requirements).

92. One case where such a claim was made as to securities traded on the NYSE is A & J Deutsch Family Fund v. Bullard, Fed. Sec. L. Rep. (CCH) ¶ 94,121 (C.D. Cal. Nov. 29, 1988). In light of semantical nuances by defendant's and plaintiff's experts (securities not traded in an efficient market versus market activity of the stock "not inconsistent" with market efficiency), the court denied the defendant's motion for summary judgment on this point. See infra notes 165-66 and accompanying text.


95. See supra note 94 for cases involving a motion to dismiss the FOTM claim which—with the exception of Taxable Municipal Bonds—resulted in dismissal.

All the cases referenced in note 94, except Taxable Municipal Bonds and Greenberg, involved newly-issued bonds traded mainly on a primary market. Because in these cases price is set primarily by the underwriter and offeror, the probability is diminished that price can reasonably be relied on as an accurate reflection of the bonds' value. See Freeman, 915 F.2d at 199. Several cases, including Bank of Denver, Stinson, Bexar and Abell have recognized a different presumption of reliance sometimes applicable in these situations commonly known as the "fraud created the market theory." See Bank of Denver, 763 F. Supp. at 1555; Stinson, 714 F. Supp. at 366, Bexar, 130 F.R.D. at 610; Abell, 858 F.2d at 1121; see also Ross v. Bank South, N.A., 885 F.2d 723, 729 (11th Cir. 1989) (en bane), cert. denied, 495 U.S. 905 (1990); T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983), cert. denied, 465 U.S. 1026 (1984); Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en bane), cert. denied, 459 U.S. 1102 (1983). Under this theory investors are
hand, where the cases involve OTC securities, they generally hold that the securities do trade in an efficient capital market warranting application of the FOTM theory, or alternatively, that the issue is to be decided at trial.96 As previously mentioned, using either approach to OTC securities results in the same outcome.97

presumed to rely not on the integrity of the market price, but on the integrity of the market itself (i.e., that the nexus between the defendant's fraud and the plaintiff's injury is not established by alleging and proving that the fraud affected the market price, but rather by alleging and proving that the securities could not have been marketed at any price). Because the fraud-created-the-market analysis is not premised upon the existence of a security trading within a capital market, efficient or not, it is outside the scope of this article.

96. The following cases take the former approach: AmeriFirst, Fed. Sec. L. Rep. (CCH) ¶ 96,419 (S.D. Fla. Aug. 7, 1991); Hurley, 719 F. Supp. 27; Cammer, 711 F. Supp. 1264; and Harman, 122 F.R.D. 522. But see Epstein, 1988 U.S. Dist. LEXIS 3382 (FOTM claim dismissed because securities trading in the OTC market do not trade in an efficient market). The latter approach is represented by Laser Arms, 794 F. Supp. 475; Garfinkel, 695 F. Supp. 1397; and Guenther, 123 F.R.D. 333; see also Taxable Municipal Bonds, Fed. Sec. L. Rep. (CCH) ¶ 96,836, at 93,334 (E.D. La. June 30, 1992) (plaintiffs' allegations that bonds traded on secondary market suggest the "possibility" of an efficient market; defendants' 12(b)(6) motion denied); Keegan, Fed. Sec. L. Rep. (CCH) ¶ 96,275, at 91,479 (N.D. Cal. Sept. 10, 1991) (court invokes FOTM presumption; plaintiff must prove that the market was "truly" efficient at the summary judgment stage or at trial); Newbridge, Fed. Sec. L. Rep. (CCH) ¶ 96,039, at 90,232 (D.D.C. June 18, 1991) (facts and allegations sufficient to raise substantial questions whether market was efficient; issue merited further factual development and therefore survived a motion to dismiss); A & J Deutscher Family Fund, Fed. Sec. L. Rep. (CCH) ¶ 94,121, at 91,274 (C.D. Cal. Nov. 29, 1988) (court refuses to dismiss FOTM claim where subject securities trade on NYSE; question of the market's efficiency to be determined at trial).

MDC Holdings discusses the different approaches. 754 F. Supp. at 804-05; see also Cammer 711 F. Supp. at 1292 n.50 (noting that its approach is different from that utilized in Garfinkel). Basic suggests that proof warranting application of the FOTM presumption must be presented at the class certification stage. See supra note 76 and the text accompanying notes 71-78. The cases that postpone the determination rely on the doctrine stated by the United States Supreme Court in Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177-78 (1974), that the merits of an action are not to be examined at the class certification stage. See Garfinkel, 695 F. Supp. at 1403; Guenther, 123 F.R.D. at 340; see also In re Data Access Sys. Sec. Litig., 103 F.R.D. 130, 139-40 (D.N.J. 1984).

97. See supra notes 76-78 and accompanying text. Two recent OTC cases illustrate the primary difference between OTC cases and revenue bond cases. See AmeriFirst, Fed. Sec. L. Rep. (CCH) ¶ 96,419 (S.D. Fla. August 7, 1991); Newbridge, Fed. Sec. L. Rep. (CCH) ¶ 96,036 (D.D.C. June 18, 1991). Both AmeriFirst and Newbridge involve class periods which commenced with the issuer's initial public offering. In both AmeriFirst and Newbridge, the courts allowed the FOTM claims to go forward; however, both courts indicated that from the time of the IPO to an undetermined time thereafter the market was by definition primary and therefore inefficient. See AmeriFirst, Fed. Sec. L. Rep. (CCH) ¶ 96,419, at 91,821 (so ruling); Newbridge, Fed. Sec. L. Rep. (CCH) ¶ 96,036, at 90,232 (indicating that it accepted this argument, but deferring on a ruling); see also Gruber v. Price Waterhouse, Fed. Sec. L. Rep. (CCH) ¶ 96,581 (E.D. Pa. Oct. 24, 1991) (the FOTM theory does not apply to IPOs).
C. Survey: The Efficient Capital Market Cases Post-Basic

1. The First Circuit: Hurley v. FDIC

In Hurley v. FDIC, the Massachusetts District Court considered whether the OTC stock of First Service Bank for Savings ("First Service") traded in an efficient market, which would enable plaintiffs to use the FOTM presumption. The procedural context was a F.R.C.P. 12(b)(6) motion to dismiss and a question of first impression in the Circuit. Defendants argued that OTC stocks per se do not trade in an efficient market. During the class period, First Service issued 5 million shares and the stock traded actively with 19.3 million shares sold. Based on these facts, the court concluded that there was "a sufficient showing of efficiency at this early stage of the litigation to invoke the fraud-on-the-market theory as a substitute for pleading actual reliance."  


In Garfinkel v. Memory Metals, Inc., the plaintiffs sought class certification for Rule 10b-5 violations with respect to the common stock of Memory Metals, Inc. The proposed class period was February 12, 1986 to September 26, 1986. The plaintiffs alleged that Memory Metals was publicly traded on the NASDAQ Supplemental OTC market during 1986. In addition, the plaintiffs demonstrated that Memory Metals had approximately 614 shareholders of record on...
December 17, 1986 and that nearly 18 million shares were outstanding and traded during the proposed class period. The defendants countered that market efficiency had not been properly proved and indeed that the security did not trade in an efficient market. The court deferred on the factual determination of market efficiency as an issue related to the merits of the case to be decided at trial. The decision states, "For purposes of class certification, the plaintiffs' allegation that an 'efficient' market was operating . . . is sufficient."


In the case of Cammer v. Bloom, the New Jersey district court provided the most detailed inquiry to date into the judicial definition of an efficient capital market. The court addressed the issue of whether the NASDAQ-NMS quoted common stock of Coated Sales, Inc. traded on an efficient market during the class period. The procedural posture was a motion to dismiss treated under the summary judgment standard. The court rejected the idea that the OTC markets are inefficient per se and that securities trading in these markets cannot be trading in an efficient market. Next, the court spurned the idea that only

103. Id. at 1401.
104. Id. at 1403.
105. See supra note 96.
106. Garfinkel, 695 F. Supp. at 1403; see also In re Laser Arms Corp. Sec. Litig., 794 F. Supp. 745 (whether a penny stock of an alleged fictitious corporation—listed on the National Quotations Bureau pink sheets—traded in an efficient market is a question of fact to be determined at trial).
108. The court noted that in FOTM cases, "Peil and Basic unambiguously require a plaintiff to allege . . . that the shares were traded on an efficient market." Id. at 1285. NMS stocks are stocks which trade on NASDAQ's premier "National Market System"—a grouping of the largest and most widely followed OTC stocks. Id. at 1283 [hereinafter NASDAQ-NMS].
109. The court held:

It would be illogical to apply a presumption of reliance merely because a security is traded within a certain "whole market," without considering the trading characteristics of the individual stock itself. Some well-followed stocks, such as Apple Computer and MCI Telecommunications, have chosen to trade in the over-the-counter market rather than on a national exchange. On the other hand, some companies listed on national stock exchanges are relatively unknown and trade there only because they meet the eligibility requirements. While the location of where a stock trades might be relevant, it is not dispositive of whether the "current price reflects all available information."

Id. at 1281.
Form S-3 eligible issuers could be considered to be trading in an efficient market. In promoting this argument, the defendants noted Harman v. Lyphomed, Inc., which held that issuers eligible to use Form S-3 traded in an efficient market. Cammer concluded that a finding of Form S-3 eligibility, while important, was not the exclusive determinant of whether a security trades in an efficient market. To reveal the inequity in this proposed rule, it was noted that during the class period Coated Sales met all of the Form S-3 eligibility requirements except for the duty to file '34 Act reports for 36 months.

Cammer quoted extensively from the SEC Releases adopting Form S-3 which analyzed the question of when a market is efficient. However, in lieu of utilizing the SEC tests, Cammer devised its own. The court premised its decision on the notion that it is "not logical to draw bright line tests—such as whether a company is listed on a national exchange or is entitled to register securities on SEC Form S-3—to assist fact finders in determining whether a stock trades in an "open and efficient market." The court concocted its own rule despite noting that "it has been said that federal courts lack the expertise to evaluate securities markets and formulate substantive rules of law based on such evaluation and that Congress is better equipped for such tasks."

Cammer indicated the importance of the three year reporting requirement to the SEC in administering the integrated disclosure system, but not in determining whether a security trades in an efficient capital market. For purposes of proving that an issuer was traded in an efficient capital market, the court stated that "it would be helpful to allege that the Company was entitled to file an S-3 Registration Statement in connection with public offerings, or if ineligible, such ineligibility was only because of timing features rather than because the minimum stock requirements set forth in the instructions to Form S-3 were not met." Id. at 1287. Cammer misconstrued some of the SEC's other technical requirements. The case states that the "'public float' aspect of the Form S-3 requirements ensures that enough investors have in fact read the previously filed document," and that the number of shareholders and market capitalization of an issuer are facts which imply market efficiency. Id. at 1285. In fact, the SEC adopted a float requirement to ensure that a particular security was the subject of professional research and analysis. Moreover, the SEC rejected the two criteria—number of shareholders and market capitalization—in favor of float and annual trading volume in determining the best indicators of market efficiency. These slight mistakes in technical interpretations are indicative of why the SEC should be given substantial deference in this area.

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110. Id. at 1284-85.
111. 122 F.R.D. 522 (N.D. Ill. 1988).
112. Id. at 525.
113. Cammer, 711 F. Supp. at 1284 n.32. Cammer indicated the importance of the three year reporting requirement to the SEC in administering the integrated disclosure system, but not in determining whether a security trades in an efficient capital market. For purposes of proving that an issuer was traded in an efficient capital market, the court stated that "it would be helpful to allege that the Company was entitled to file an S-3 Registration Statement in connection with public offerings, or if ineligible, such ineligibility was only because of timing features rather than because the minimum stock requirements set forth in the instructions to Form S-3 were not met." Id. at 1287. Cammer misconstrued some of the SEC's other technical requirements. The case states that the "'public float' aspect of the Form S-3 requirements ensures that enough investors have in fact read the previously filed document," and that the number of shareholders and market capitalization of an issuer are facts which imply market efficiency. Id. at 1285. In fact, the SEC adopted a float requirement to ensure that a particular security was the subject of professional research and analysis. Moreover, the SEC rejected the two criteria—number of shareholders and market capitalization—in favor of float and annual trading volume in determining the best indicators of market efficiency. These slight mistakes in technical interpretations are indicative of why the SEC should be given substantial deference in this area.
115. Id. at 1287.
116. Id. at 1283 (noting White's dissent in Basic).
tional stock exchange listing does not imply an efficient market, more often than not the relevant characteristics would be associated with such companies.\textsuperscript{117}

The \textit{Cammer} factors are: (1) average weekly trading volume during the class period in excess of a certain number of shares; (2) a significant number of analysts following the company; (3) numerous market makers; (4) the Form S-3 factors (i.e., number of shareholders and market capitalization); and (5) empirical facts showing a causal link between unexpected corporate events or financial releases and an immediate response in the stock price.\textsuperscript{118} Using these factors, the court analyzed information provided to it and permitted the action to go forward.\textsuperscript{119}

\textit{Stinson v. Van Valley Development Corp.}\textsuperscript{120} used the \textit{Cammer} analysis and factors in dismissing the plaintiffs' complaint under F.R.C.P. 12(b)(6). The claim related to newly issued revenue bonds. The plaintiffs' strongest claims of an efficient market rested on their assertion that the bonds were sold throughout the United States in a diverse public market. The court premised the dismissal on the plaintiffs' failure to allege any facts that the bonds were traded on a secondary market with a relatively high level of trading activity and for which trading information, such as price and volume, was readily available.\textsuperscript{121}

\begin{flushright}
117. \textit{Id.} at 1281 n.26. \\
118. \textit{Id.} at 1286-87. \\
119. \textit{Inter alia}, the following facts provided by plaintiffs were relevant and operative during the class period: (1) Coated Sales stock was traded in an impersonal market; (2) 19 million shares of Coated Sales stock were outstanding, and the public float was 12 to 13 million shares; (3) Coated Sales stock was held by 1200 shareholders of record and thousands of beneficial owners; (4) 44 million shares of Coated Sales stock were traded, representing an average weekly trading volume of 750,000 shares; (5) investors had ready access to price quotations for Coated Sales stock through the daily financial press, and to current quotations through their brokers; (6) Coated Sales had 11 market makers who issued competing price quotations on the NASDAQ system; (7) at least 15 research reports on the company were issued by analysts during the class period; (8) Coated Sales utilized the services of a public relations firm and issued numerous press releases concerning its business operations; and (9) the market for Coated Sales stock reacted quickly and dramatically to key events at issue in the lawsuit. \textit{Id.} at 1283 n.30. \\
\end{flushright}

In Abell v. Potomac Insurance Co.,122 the Fifth Circuit viewed newly issued revenue bonds in the context of a denial of a judgment n.o.v. A small secondary market, exploited by brokers, had developed for the bonds during the period in question.123 Abell held that the FOTM presumption is available only "where the subject securities were traded actively in large markets."124 Because the market for the bonds was not an active, efficient secondary market capable of accurately measuring the value of the bonds, the theory did not apply.125

Abell was followed by a district court decision in Steiner v. Southmark Corp.126 which analyzed defendants' securities, including debt securities, under F.R.C.P. 9(b). Steiner stated that the applicable test was whether the "subject securities traded actively in large markets."127 While referring to virtually no facts to show that this test was met,128 Steiner stated that there was no dispute that the securities in question were traded actively in large markets.129

More recently, in In re Newbridge Networks Securities Litigation,130 the district court held that the plaintiff's complaint contained sufficient facts and allegations to survive a motion to dismiss.131 In that case, the focus was the OTC common stock of Newbridge Networks Corporation ("Newbridge"). The court summarily rejected an

123. Id. at 1121.
124. Id. at 1122. The court did note a second possible test, but that test is more commonly viewed separately as the fraud created the market theory. Id. See supra note 95.
125. Id.
127. Id. at 277.
128. The opinion notes merely that the debt securities were traded on an "open market." Id. In fact, Southmark's stock traded on the NYSE during the period in question and seven of its nine debt issuances traded on that same exchange. Two of the debt issuances did not trade at all.
129. Id.
131. In particular, plaintiff's complaint stated that there were over 33 million shares outstanding during the class period, that 3,750,000 shares were sold pursuant to the IPO, that 1.2 million shares were traded on one day during the class period, and that the stock price reacted quickly to information about the company. Id. at 90,232.
argument that the FOTM theory was unavailable because the OTC market was *per se* inefficient; however, the court indicated that the market may not have been efficient from the time of Newbridge’s IPO to an undetermined time thereafter.\(^{132}\)

5. **The Sixth Circuit: Freeman v. Laventhol & Horwath**

In *Freeman v. Laventhol & Horwath*,\(^{133}\) the Sixth Circuit addressed the issue of whether FOTM claims as to newly issued municipal bonds should have been dismissed by the district court. The court relied upon the *Cammer* factors in holding that such bonds do not trade in an efficient market as a matter of law.\(^{134}\) Specifically, the court noted that the market price for these bonds is not set by active trading but by negotiation between the underwriter and the offeror.\(^{135}\) The court stated that securities traded on national secondary exchanges are well suited to the theory because the high level of trading activity ensures that all knowable public information is subsumed into the market price.\(^{136}\)


While the Seventh Circuit has not yet ruled on the FOTM issue, several district courts within the Circuit have.\(^{137}\) In *Harman v. Lyphomed, Inc.*,\(^{138}\) the court ruled in favor of the plaintiffs on a motion for class certification where the claim involved an OTC stock, Lyphomed, Inc. The court found that the plaintiffs adequately pleaded that Lyphomed traded in an efficient market during the proposed class period by alleging that: (1) its average weekly trading volume during the class period was in excess of one million shares; (2) it

\(^{132}\) *Id.* The court’s postponement of the resolution of the efficient capital market question may have been influenced by the fact that a motion for class certification was forthcoming; see also *In re Taxable Municipal Bonds Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 96,836 (E.D. La. June 30, 1992) (12(b)(6) motion denied merely because plaintiffs alleged that the subject bonds traded in a secondary market created by defendants).

\(^{133}\) *Id.* at 199.

\(^{134}\) *Id.*

\(^{135}\) *Id.*

\(^{136}\) *Id.*

\(^{137}\) See *Greenberg v. Boettcher Co.*, 755 F. Supp. 776, 781 (N.D. Ill. 1991) (“The Seventh Circuit has not yet articulated a standard for determining the applicability of the fraud on the market theory.”); *Eckstein v. Balcor Film Investors*, 740 F. Supp. 572, 580 (E.D. Wis. 1990) (“The Seventh Circuit . . . has not defined the exact type of market in which it is certain that the market price reflects publicly available information.”).

\(^{138}\) 122 F.R.D. 522 (N.D. Ill. 1988).
was followed by over a dozen analysts; (3) it had numerous market makers; and (4) it was eligible for the use of Form S-3. The court in *Harman* placed greater weight on Form S-3 eligibility than did the court in *Cammer*, suggesting it to be the most important factor. Like in *Cammer*, the court in *Harman* dismissed the contention that securities trading in the OTC market do not trade in an efficient market.

The case of *Greenberg v. Boettcher & Co.* focused on the requirement established in *Cammer*, *Harman* and *Stinson* that use of the FOTM theory "clearly requires a plaintiff to specifically plead facts that show a well-developed, efficient market." The securities in the case were municipal bonds held by investors on a date approximately seven years after initial issuance. The allegations included insufficient disclosure about the securities’ redemption provisions and the inability of investors to adequately value the bonds in light of misstatements and omissions. The court found the plaintiff’s pleading on the efficient market question conclusory and dismissed the action pursuant to F.R.C.P. 12(b)(6).

*Epstein v. American Reserve Corp.* involved the stock and debentures of American Reserve Corp. traded in the OTC market between the period December 1, 1974 and March 12, 1979. The

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139. *Id.* at 525.
140. *Id.* at 525. *Harman* stated: "[T]he SEC established reporting requirements for Lyphomed on the premise that the stock traded in an open and efficient market." *Id.* at 525 n.1.
141. *Id.* at 525. *Harman* stated:

[N]othing in the theory limits its application to stocks which trade on a particular exchange. Rather, the question is always whether the stock trades in an efficient market, i.e. one in which material information on the company is widely available and accurately reflected in the value of the stock . . . . While some over-the-counter stocks no doubt trade in a less developed market than some New York Stock Exchange issues, the inquiry in an individual case remains the development of the market for that stock, and not the location where the stock trades.

*Id.*

143. *Id.* at 782.
144. *Id.* at 782-83. The factual allegations included the assertion that municipal bonds generally trade in an efficient market and that a few professional investors had read the portions of the prospectus involving the controversial disclosure. Because the court also found the action time-barred, it is unclear whether it would have allowed plaintiff to amend her complaint but for this finding.
146. During 1979, the securities traded on the NASDAQ-NMS. Prior to that, the NMS listing of securities did not exist.
case involved a motion for class certification and the issue was whether the FOTM presumption applied so as to prevent individual issues of reliance from predominating at trial.\(^{147}\) Epstein concluded that securities trading in the OTC market \textit{per se} do not trade in an efficient market and that therefore the class could not be certified.\(^{148}\)


The Ninth Circuit has yet to address the question of when a market is efficient.\(^{149}\) However, several district court cases in that circuit have resolved the issue by using different approaches.

In \textit{Guenther v. Pacific Telecom, Inc.},\(^{150}\) the plaintiffs sought class certification for FOTM claims relating to the stock of American Network, Inc. traded from January 1984 through December 1986. Plaintiffs made no factual allegations that the stock was traded on an efficient market.\(^{151}\) Defendants argued that this failure meant that the motion must fail and further noted that the stock was not quoted on the NASDAQ until halfway through the class period, was delisted shortly after the period, and was not quoted on the NASDAQ-NMS until after the close of the class period.\(^{152}\) The court stated that it could not conclude on the record whether the plaintiffs would be successful. Because the court was unwilling to closely scrutinize the merits of the action at the class certification stage, it refused to deny class certification to the plaintiffs.\(^{153}\)

\(^{147}\) \textit{See supra} notes 73-74 and the accompanying text.

\(^{148}\) Epstein, 1988 U.S. Dist. LEXIS 3382. Epstein relied on \textit{In re Data Access Systems Securities Litigation, 103 F.R.D. 130 (D.N.J. 1984)}, which viewed the stock of Data Access Systems, Inc. ("Data") for the class period October 31, 1978 - August 24, 1981. For approximately the first six months of this class period, the Data stock traded OTC (it then traded on the AMEX). The court stated in dicta that a stock trading on the OTC market "may not" constitute the market necessary for the application of the FOTM theory. \textit{See id.} at 138. This was dicta in the case, in part because the court was unwilling to scrutinize the merits of the action at the class certification stage. \textit{See id.} at 139-40.

\(^{149}\) \textit{See In re MDC Holdings Sec. Litig., 754 F. Supp. 785, 804 (S.D. Cal. 1990)} ("The Ninth Circuit has not addressed [what constitutes a freely developed and efficient market] nor set forth pleading requirements for the fraud on the market presumption of reliance.").


\(^{151}\) The court noted the plaintiffs' failure to state either the amount of stock which was publicly traded or whether the stock was traded on the NYSE. \textit{Id.} at 340.

\(^{152}\) \textit{Id.}

\(^{153}\) \textit{See supra} note 74 and accompanying text. The court was also unwilling to deny
In contrast, *In re MDC Holdings Securities Litigation*\(^{154}\) ruled that the plaintiff’s pleadings were inadequate to invoke the FOTM presumption. *MDC Holdings* involved a class certification pertaining to the common stock and subordinated notes of MDC Holdings, Inc. during the period April 1, 1985 to April 6, 1989. The defendants did not contest certification as to the stock, which traded on the NYSE. As to the notes, the defendants argued that certification should be denied because they traded on the OTC, and plaintiffs had failed to allege the existence of any of the *Cammer* factors used to determine the efficiency of a market for securities.\(^{155}\) The court rejected the first argument, but found the second persuasive.\(^{156}\) The failure to discuss the activity of the notes, the number of securities analysts reporting on the notes and the number of market makers troubled the court.\(^{157}\) For this reason, the court required the plaintiffs to amend their complaint to set forth facts indicating that the notes traded in an efficient market. It noted that, since some discovery had taken place, this “should not be an insurmountable burden.”\(^{158}\)

*In re Keegan Management Co. Securities Litigation*\(^{159}\) exam-
ined FOTM claims made with respect to the stock of Keegan Management Company. The context for the action were motions to dismiss under F.R.C.P. 12(b)(6) and 9(b). Plaintiffs alleged that the Keegan stock traded in an active and efficient market, and supported this allegation by alleging that the stock: (1) was publicly traded on the NASDAQ; (2) was priced daily in newspapers and financial periodicals; and (3) was followed by financial analysts. Defendants countered that the plaintiff’s allegations were deficient because they did not meet each of Cammer’s five factors and that in any event the market for Keegan stock was not efficient. The court rejected the first argument because Cammer’s factors merely suggest possible ways of alleging an efficient market and do not delineate the minimum pleading requirements. The court stated the second argument was to be addressed at summary judgment or trial, where the plaintiffs would have to prove market efficiency. The court ruled that the plaintiffs had alleged facts sufficient to invoke the FOTM presumption.

In A & J Deutscher Family Fund v. Bullard, the court considered a summary judgment motion as to a FOTM claim. In question was NYSE stock, Pacific Scientific Corp., Inc., during the class period March 7, 1983 to February 11, 1984. Defendants’ expert presented empirical evidence that the market’s behavior was not efficient. Plaintiffs’ expert countered that the market’s behavior was not inconsistent with efficiency. The court determined that it was impossible to resolve the dispute in light of the scarce authority concerning the application of the FOTM theory, and therefore found summary judgment inappropriate.

160. Id. at 91,479.
161. Id.
162. Id.
163. Id.
164. Id. The court’s reasoning seems flawed in light of Basic. In this regarded, the court stated: “[T]his order should not be read to state that plaintiffs’ more [sic] proof of their three supporting allegations cited above will establish that the market was truly efficient . . . . This court does not now decide what facts plaintiffs must prove to establish that the market was truly efficient.” Id. at 91,479; cf. Basic Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988) (holding that “in order to invoke the presumption, a plaintiff must allege and prove . . . (3) that the shares were traded on an efficient market”).
165. Fed. Sec. L. Rep. (CCH) ¶ 94,121 (C.D. Cal. Nov. 29, 1988). The same case had previously been before the court on a class certification motion. See supra note 158 for a discussion of the prior case.
166. Id. at 91,274. The court stated: “There is nothing in Basic which suggests that an empirical analysis is an integral part of showing an efficient market such that, in its absence,

In Bank of Denver v. Southeastern Capital Group, Inc.,167 the court viewed a motion to dismiss a FOTM claim pertaining to newly-issued revenue bonds. The court agreed with the defendants that the FOTM presumption did not apply since the plaintiffs did not allege that the bonds were traded on an efficient market.168

9. The Eleventh Circuit: In re AmeriFirst Securities Litigation

In In re AmeriFirst Securities Litigation,169 the district court relied on the five factors in Cammer in ruling that the common stock of AmeriFirst Bank ("AmeriFirst") traded on an efficient market.170 In doing so, the court rejected the defendant’s argument that the OTC market, including the NASDAQ-NMS upon which the AmeriFirst stock traded, was per se inefficient.171

The court, however, did note that because the 50-day class period commenced on the date of AmeriFirst’s initial public offering, that from the date of the offering until sometime thereafter the market was by definition of a primary nature and therefore inefficient.172 Accordingly, plaintiffs’ purchasing stock during this time period could not rely on the fraud-on-the-market theory, but could possibly rely on the fraud created the market theory.173

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168. Id. at 1557. The plaintiffs did not contest this ruling, but rather cited cases invoking the fraud created the market theory. See supra note 95. Consequently, the court interpreted the amended complaint as asserting this second type of presumptive reliance. See Bank of Denver, 763 F. Supp. at 1557.
170. The plaintiffs responded to each of the five factors in Cammer as follows: (1) during the class period more than 94 million shares were traded, with an average weekly volume of approximately 575,000 shares and an average weekly turnover of 5.2%; (2) six securities analysts issued reports on the stock during the class period; (3) the stock had over 20 market makers who reacted swiftly to AmeriFirst’s reported financial reports; (4) AmeriFirst was unable to use Form S-3, but only because of timing considerations; and (5) the stock responded swiftly to public information. Id. at 91,821.
171. Id. at 91,820.
172. Id. at 91,821.
173. Id. See supra note 95; see also Tapken v. Brown, Fed. Sec. L. Rep. (CCH) ¶ 96,805 (S.D. Fla. Mar. 13, 1992) (same court invokes FOTM presumption as to stock traded on the NYSE where plaintiffs’ allegations were essentially uncontroverted).
D. Conclusion

The judicial analysis of the FOTM question has been documented in a flurry of court decisions on pretrial motions subsequent to Basic. The cases generally assume that all securities traded on the NYSE or AMEX trade in an efficient market. Only one case, Epstein v. American Reserve Corp., held that OTC securities do not trade in an efficient market. The several OTC cases decided after Epstein hold either that the securities at issue trade in an efficient market or defer decision on the question until trial. Where the issue arises in the context of a class certification motion, deferring the issue until trial conflicts with the Supreme Court's handling of the matter in Basic. Moreover, irrespective of the procedural context, failure to definitively rule on these motions, combined with the high settlement rate of cases in this area of the law, results in a system in which plaintiffs possess substantial and unjustifiable settlement leverage. Where the cases involve securities traded on a primary market, typically revenue bonds, the cases find that the FOTM theory does not apply.

IV. PROPOSED APPLICATION OF THE THEORY

Our discussion has shown that the Commission takes a restrictive view of the Efficient Capital Market Hypothesis while the courts take an expansive approach. Quantifying the approaches reveals that under the SEC standard, about 32% of NYSE or AMEX listed companies and NASDAQ quoted entities (at the time of the system's adoption) were eligible for reduced disclosure. On the other hand, the courts impose the FOTM theory on almost 100% of similarly situated issuers.

This section examines the various possible combinations of judicial and regulatory approaches and their impact upon securities regulation. First, we look at a system with broad issuer eligibility to use the integrated disclosure system for the registration of securities, and narrow investor ability to utilize the FOTM theory in class action suits. This approach reflects an expansive view of the ECMH in the

174. See supra notes 91-92 and accompanying text.
176. See generally supra note 96.
177. See supra notes 95-97.
former instance, and a narrow perspective in the latter. Next, we look at the present system, with restrictive registration provisions and expanded liability. Finally, we turn to a system featuring relative equality among the registration and liability provisions.

A system where eligibility to use the integrated disclosure system is broad and the ability of aggrieved investors to utilize the FOTM theory is narrow thwarts the goals of the Securities Act of 1933 and the Securities Exchange Act of 1934. Under this approach, issuers would have the benefit of Form S-3 registration and reduced disclosure requirements, but investors would not have the similar broad ability to assert FOTM reliance. This system would result in uniformed investors, incapable of policing the fair and accurate dissemination of market information. The result is unsatisfactory, and probably impossible from a practical point of view, since the courts are unlikely to reverse their trend.

The present system of restricted registration benefits and expansive FOTM use has been the focus of this article. Basically, this system forces issuers to undergo the expensive exercise of providing complete information when registering securities while the courts relieve investors of their duties to examine this information. Many might call this system the best of all worlds because the investor has maximum protection. However, every dollar in legal, accounting, and other fees spent registering securities is a dollar that cannot be paid out as a dividend or spent on manufacturing. Therefore, investors are "paying" for the protection of prospectuses which they do not need. Under the current application of the FOTM theory, the extra expense of complying with Form S-1 for an exchange traded issuer is a loss both to the investor and the issuer. Moreover, the investor receives no corresponding benefit. Under the climate of trying to make our markets more efficient, the present system appears ripe for change.

The final possibility involves narrowing the discrepancy between the application of the ECMH to the integrated disclosure system and the FOTM theory. This result could be accomplished by the expansion of the integrated disclosure system by the SEC, ideally combined with a restriction of the use of the FOTM theory in establishing liability. Under this scenario, investors would receive adequate judicial protection, while issuers and those investing in them would receive a further cost reduction through the elimination of unnecessary documentation and possibly decreased litigation costs.

Expanding the use of the integrated disclosure system would enhance the reliability of '34 Act reporting because issuers permitted
to use the system would know that their '34 Act reports would be incorporated by reference into their '33 Act registration statements, thus subjecting them to the *in terrorem* impact of the '33 Act. The change would enable the SEC to acknowledge technological advances of the past ten years and is consistent with the flexibility the Commission has previously shown in updating the registration provisions.

Reducing the application of the FOTM theory of reliance constitutes the second phase of a responsible plan to narrow the discrepancy in the application of the ECMH. This approach could be accomplished through Commission rulemaking or Congressional legislation restricting courts in their application of the theory. While this action would be desirable, the SEC and Congress have never advanced a restrictive approach to Rule 10b-5 as it applies to class action suits. In addition to the legislative or regulatory action, the present judicial approach merits further scrutiny. The case law indicates a bias favoring plaintiffs, which conflicts with the Supreme Court's holding in *Basic*. This bias could be diminished by an articulation that the FOTM question is to be resolved at the class certification stage, consistent with *Basic*.

V. CONCLUSION

Any attempt to precisely match the benefits of the registration provisions with the burdens imposed by the applicability of the FOTM theory would be futile. Therefore, the changes made should err toward the present system of overprotection of investors to ensure that it carries out the fundamental purposes of securities regulation.

A present imbalance exists between the application of the Efficient Capital Market Hypothesis to the registration and antifraud provisions of the Securities Act of 1933, and the Securities Exchange Act of 1934, respectively. Narrowing the discrepancy in the application of the theory through a combination of expanding the integrated disclosure system and reducing the application of the FOTM theory of reliance would help provide a more viable system which balances the interests of short term investors, long term investors, and companies using the capital markets.
VI. ADDENDUM

In July, 1992, the SEC proposed amending the integrated disclosure system to expand the eligibility for Form S-3. The proposed changes may well be adopted by or shortly after publication of this Article. If adopted, these changes reflect a step towards a more consistent application of the ECMH in the registration provisions of the '33 Act, and in the liability provision of Rule 10b-5 promulgated pursuant to the '34 Act. However, Release 6493 fails to acknowledge the connection between the application of the ECMH to the registration provisions of the '33 Act and Rule 10b-5 class action suits.

One proposed change would expand the class of issuers eligible for Form S-3 through reduction of the transactional requirements. The Commission proposes to reduce the public float requirement from $150 million to $75 million. Release 6493 notes that this change would expand the number of companies eligible for Form S-3 by 449, from 1510 to 1959. Three hundred and seventy-four, or 83%, of these new companies trade on the NYSE, AMEX, or NASDAQ-NMS markets. This change would diminish the inconsistency between the application of the ECMH to the registration and liability provisions, but would not eliminate it. Significantly, the securities of Basic, Inc., the issuer deemed to trade in an efficient market in the Supreme Court's one pronouncement on the FOTM question, had a float of at most $45 million during the pertinent class period. Thus, Basic, Inc., though deemed to trade in an efficient market for purposes of Rule 10b-5, would have fallen substantially short of Form S-3 eligibility under the current SEC proposal.

Another proposed change illustrates the deficiency of Release 6493 in failing to acknowledge the connection between the FOTM cases and the Form S-3 requirements. Release 6493 proposes expanding the classes of issuers eligible for Form S-3 registration by reduc-

179. The Commission set forth an alternative, additional requirement of a three million share annual trading volume for companies with floats between $75 and $150 million. The release indicates that adding this test substantially reduces the number of companies that would be newly eligible for Form S-3 under the proposal. See Release 6493, supra note 178.
180. Id.
181. Id.
183. See supra note 6.
ing the required length of reporting obligations. Specifically, Release 6493 would decrease the required reporting time of an issuer from 36 to 12 months. This change is consistent with the approach taken by the most frequently cited FOTM case, Cammer v. Bloom. The Commission bases this recommendation on the same theory as Cammer: issuers meeting the Form S-3 public float requirements for primary equity offerings possess a sufficient market following such that a three year reporting history will not materially enhance the market following of those issuers. This reduction seems appropriate as it is of sufficient length to enable the Commission to satisfy itself that the issuer intends to carry out its reporting obligations under the Securities Exchange Act of 1934, but not so burdensome as to overly restrict the number of available issuers.

The proposed changes represent a step forward in a consistent application of the ECMH, whether or not the Commission intended such a result. The recommendation of an approach previously utilized by the district court in Cammer indicates the similarity of the issues faced by the SEC and the courts. Absent acknowledgement of the link between the ECMH as applied to the registration and liability provisions of the federal securities laws, the capital markets will remain subject to the erratic application of the ECMH discussed in this article. In light of the SEC’s superior expertise in regulating the capital markets, Release 6493 provides a good opportunity for the Commission to examine this connection and provide guidance to courts in determining whether an issuer trades in an efficient capital market.

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185. See Release, supra note 178; cf. Cammer 711 F. Supp. at 1285 ("The 'public float' aspect of the Form S-3 requirements ensures that enough investors have in fact read the previously filed document.").