Fraud on the Market: Short Sellers' Reliance on Market Price Integrity

Douglas A. Smith

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NOTES

FRAUD ON THE MARKET: SHORT SELLERS' RELIANCE ON MARKET PRICE INTEGRITY

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INTRODUCTION

Investors constantly determine "whether a given [security] should be bought, sold, retained, or exchanged for some other." In making these determinations, investors often seek to discern whether a security's market price overvalues or undervalues the security relative to the investor's personal opinion or analysis. According to the logic of some courts, however, an investor's belief that a security is either overvalued or undervalued may either prevent the fraud-on-the-market (FOM) presumption of reliance from arising, or may reb ut it.

The FOM presumption often provides the sole vehicle by which plaintiffs in class actions can prove the reliance element in Rule 10b-5 securities fraud cases involving publicly traded securities. Underlying the presumption is the assumption that security prices adjust to reflect fraudulent misrepresentations or omissions and that by relying on the integrity of the market price when undertaking buy or sell transactions, an investor indirectly relies on the fraudulent misrepresentation or omission incorporated into the security's price. The FOM presumption thus renders unnecessary a plaintiff's need to prove actual reliance on either the defendant who had a duty to disclose or the defendant's misrepresentation, as

2. Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp., 315 F. Supp. 2d 666, 676 n.13 (E.D. Pa. 2004) ("[A]ll rational investors purchase and sell securities when they believe that they can make profits because the securities are either undervalued or overvalued ...."); Graham & Dodd, supra note 1, at 18; John A. MacKerron, The Price Integrity Cause of Action Under Rule 10b-5: Limiting and Expanding the Use of the Fraud on the Market Theory, 69 Or. L. Rev. 177, 208 (1990) ("[E]fficient market investors seldom, if ever, purchase or sell a security because they believe the market price of the security accurately reflects the true value of the security. To the contrary, they trade because they believe that the security is either underpriced or overpriced.").
3. E.g., Zlotnick v. TIE Commc'ns, 836 F.2d 818, 823 (3d Cir. 1988) (holding that investors who believe in market price overvaluation cannot benefit from the FOM theory); Lewis v. Johnson, 92 F.R.D. 758, 760 (E.D.N.Y. 1981) (stating in a class certification decision that investors who believe in market price undervaluation cannot benefit from a theory similar to the FOM presumption).
was previously required in securities fraud cases. Instead, a plaintiff merely has to prove reliance on the integrity of the market price.

In regard to investors known as short sellers, who generally believe that market prices for securities are overvalued, a substantial split exists among federal district courts regarding whether a short seller's belief in overvaluation prevents the short seller from benefiting from the FOM presumption of reliance. This issue largely arises in pretrial class certification decisions in which judges, pursuant to Federal Rule of Civil Procedure 23, determine whether a class representative presents claims or defenses typical

8. Short sellers are investors who bet on security price declines, as these investors pick out "market losers" or securities that will likely decline in the future because the securities are overvalued. See generally KATHRYN F. STALEY, THE ART OF SHORT SELLING 4-5 (1997); JOSEPH A. WALKER, SELLING SHORT: RISKS, REWARDS, AND STRATEGIES FOR SHORT SELLING STOCKS, OPTIONS, AND FUTURES 1-3 (1991). To profit off of his expectations, a short seller borrows a security from a broker and immediately sells (selling short) to realize the prevailing market price. WALKER, supra, at 13-15. The short seller then waits for the anticipated market decline and then "covers" by hopefully purchasing the security back from the market at a lower price. Id. The short seller then returns the security to the broker and makes a profit on the buy-and-sell spread, minus any transaction and financing costs. Id. If the security's price increases instead of decreasing, the short seller may cut his losses and cover. Id. From a transaction standpoint, a short seller resembles a traditional investor (a long investor) except that the buy and sell transactions are reversed, and instead of betting on a security price increase, the short seller bets on a price decline. Id. at 3. Moreover, unlike a long investor, a short seller's loss can be infinite because a security's price can rise to infinity whereas a long investor's loss is capped at the purchase price because the security's price can only decline to zero. Id.
9. An investor may engage in a short sale for a reason other than believing that a security is overvalued. STALEY, supra note 8, at 4. For example, an investor may sell a security short to hedge against another market position. Id. Except for Part IV.E, this Note only addresses short sellers who sell short because of a belief that a security is overvalued.
of other class members\textsuperscript{11} and whether a class action provides the best vehicle for the lawsuit in that questions of law or fact common to class members will predominate over questions affecting only individual members.\textsuperscript{12} For example, courts have rendered an investor atypical of other class members and therefore unsuited to act as the class representative merely because the investor was a short seller.\textsuperscript{13} Similarly, courts, after asserting that short sellers cannot benefit from the FOM presumption, have excluded short sellers from a proposed class because their inclusion would result in individual issues of reliance overwhelming questions common to the rest of the class.\textsuperscript{14} In both of these examples, the courts' underlying rationale was that short sellers would have to prove actual reliance on either the defendant who had a duty to disclose or on the defendant's misrepresentation rather than benefiting, like other types of investors in the class, from the FOM presumption of reliance.\textsuperscript{15}

Although the issue of whether short sellers can benefit from the FOM presumption largely arises in pretrial class certifications, these decisions are not reviewed at the trial or appellate level due to the high settlement and dismissal rates for securities fraud cases.\textsuperscript{16} Indeed, only the Third Circuit has thus far considered whether short sellers can benefit from the FOM presumption. In \textit{Zlotnick v. TIE Communications}, the Third Circuit held that short sellers cannot benefit from the FOM presumption,\textsuperscript{17} but it did so shortly before the Supreme Court's decision in \textit{Basic v. Levinson}, which officially adopted the FOM presumption of reliance in federal

\textsuperscript{11} \textit{FED. R. CIV. P. 23(a)(3)}.

\textsuperscript{12} \textit{FED. R. CIV. P. 23(b)(3)}.

\textsuperscript{13} \textit{E.g., In re Terayon Commc'ns Sys., Inc. Sec. Litig., No. C 00-01967 MHP, 2004 WL 413277, at *7-8} (N.D. Cal. Feb. 23, 2004).

\textsuperscript{14} \textit{E.g., In re PolyMedica, 224 F.R.D. at 43-44}.

\textsuperscript{15} \textit{E.g., Weikel v. Tower Semiconductor Ltd., 183 F.R.D. 377, 392 (D.N.J. 1998)}.

\textsuperscript{16} Elaine Buckberg et al., \textit{Recent Trends in Securities Class Action Litigation: 2003 Update}, 5 Class Action Litig. Rep. (BNA) 304, 304-07 (Apr. 23, 2004), \textit{available at} http://www.nera.com/image/200405BNA_Trends.pdf (reporting that roughly eighty percent of federal securities class action lawsuits end in settlements and nineteen percent are dismissed, thereby leaving only one percent that are ultimately decided).

\textsuperscript{17} 836 F.2d 818, 823 (3d Cir. 1988) ("While we believe that Zlotnick should be allowed to proceed with this action and prove all the necessary facts at trial, he should not be awarded the considerable additional advantage of the [FOM presumption] which he seeks ....").
securities fraud cases.\textsuperscript{18} By precluding short sellers from benefiting from the FOM presumption, the Third Circuit made proving reliance in Rule 10b-5 cases extremely difficult for short sellers, especially given today's highly impersonal securities markets, and severely weakened the possibility of short sellers succeeding at trial. The Third Circuit's reasoning, however, has been criticized,\textsuperscript{19} and in 2004, even a district court within the circuit questioned whether the Third Circuit's reasoning comports with the Supreme Court's adoption of the FOM presumption in Basic.\textsuperscript{20} This Note

\begin{itemize}
  \item \textsuperscript{18} The Supreme Court decided Basic Inc. v. Levinson, 485 U.S. 224 (1988), three months after the Third Circuit decided Zlotnick. The Zlotnick court based its decision on a FOM theory adopted in Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986). Zlotnick, 836 F.2d at 821-22. The Supreme Court in Basic, however, relied heavily on Peil. Basic, 485 U.S. at 243, 247 & n.25. Prior to the Supreme Court's official adoption of the FOM theory in federal securities fraud cases, several circuits had adopted some form of the theory. See Peil, 806 F.2d at 1161; Harris v. Union Elec. Co., 787 F.2d 355, 367 & n.9 (8th Cir. 1986); Lipton v. Documation, Inc., 734 F.2d 740, 745-46 (11th Cir. 1984); T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330, 1332-33 (10th Cir. 1983); Panzirer v. Wolf, 663 F.2d 365, 367-68 (2d Cir. 1981); Blackie v. Barrack, 524 F.2d 891, 905-08 (9th Cir. 1975).
  \item \textsuperscript{19} MacKerron, supra note 2, at 219 & n.161 ("Likewise, it should not be enough [to rebut the FOM presumption] for a defendant to show that the plaintiff traded based on the belief that the security was undervalued or overvalued for reasons other than the misrepresentation or omission. In both instances, this is normal investor behavior."). (footnote omitted)); R. Douglas Martin, Note, Basic Inc. v. Levinson: The Supreme Court's Analysis of Fraud on the Market and Its Impact on the Reliance Requirement of SEC Rule 10b-5, 78 KY. L.J. 403, 430 (1989) ("The Third Circuit's analysis fails to properly apply the fraud on the market standard."). This Note builds on this criticism but also argues that in some factual scenarios that give rise to Rule 10b-5 claims, the Zlotnick holding is correct in that a defendant can rebut the FOM presumption of reliance by showing a short seller's belief in market price overvaluation. See infra Parts II, IV.
  \item \textsuperscript{20} Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp., 315 F. Supp. 2d 666, 676-77 & n.13 (E.D. Pa. 2004). After reading the Third Circuit's opinion in Zlotnick as only holding "that a plaintiff who sells short because he believes that a stock is overvalued is not entitled to the fraud on the market presumption," id. at 676, the court noted the problem with this reasoning: Zlotnick's reasoning would lead to the conclusion that a plaintiff who bought stock believing that it was undervalued—like Zlotnick, who sold short because he believed that stock was overvalued—would not be entitled to the fraud on the market presumption of reliance. Because all rational investors purchase and sell securities when they believe that they can make profits because the securities are either undervalued or overvalued, the reasoning of Zlotnick, as we have explained it, would effectively eviscerate the fraud on the market theory of presumptive indirect reliance that the Court of Appeals recognized in Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986), [and that the U.S. Supreme Court acknowledged in Basic v. Levinson, 485 U.S. 224 (1988)]. Id. at 676 n.13; see also In re W. Union Sec. Litig., 120 F.R.D. 629, 637 (D.N.J. 1988) ("[W]e
examines whether short sellers should be entitled to the FOM presumption and, if entitled, whether showing a short seller's belief in market price overvaluation is sufficient for a defendant to rebut the presumption. In doing so, this Note seeks to resolve the split among federal district courts and to discern whether Zlotnick was correctly decided.

Part I discusses securities fraud, the reliance requirement in Rule 10b-5 cases, and how the FOM presumption changed the reliance requirement. Part II discusses whether short sellers should benefit from the FOM presumption and argues that merely because an investor is a short seller this should not prevent the FOM presumption from arising. After discussing the ways in which a defendant can rebut the FOM presumption and how they apply to short sellers, this Part also argues that in some factual scenarios, a court could logically, but paradoxically, conclude that the FOM presumption is simultaneously rebutted and not rebutted. Arising from this paradox is a question yet to be directly addressed by any court: whether transaction causation is met in FOM cases if a plaintiff does not rely on the integrity of the market price when deciding to enter into a securities transaction, but does rely on the integrity of the market price when trading so as not to suffer a loss or reduction in profit.21 Drawing on Federal Rule of Evidence 301, Part II will argue that when these competing conclusions about reliance arise, they should "burst" the FOM presumption and result in short sellers having to prove actual reliance. In that regard, this Note argues that Zlotnick's holding is not entirely wrong if interpreted as holding that a defendant may be able to rebut the FOM presumption by showing that the plaintiff was a short seller who believed the fraudulently affected security to be overvalued.

Part III examines FOM cases involving short sellers and argues that the divergent holdings in these cases exist because courts have (1) ignored the presumption's capability of being rebutted, (2)
incorrectly assumed that short sellers do not rely on the integrity of the market price because disclosure of the fraud would in some cases achieve a short seller's investment goals, or (3) inappropriately applied a per se rule against short sellers without regard to the factual scenario that gave rise to the securities fraud claim. After arguing in Part III that courts have misapplied the FOM presumption to short sellers, this Note, in Part IV, will outline—in a matrix of factual scenarios that give rise to Rule 10b-5 securities fraud cases—when a short seller who believed a security to be overvalued, and conversely, when a long investor who believed a security to be undervalued, should benefit from the FOM presumption.

I. SECURITIES FRAUD, RELIANCE, AND THE FRAUD-ON-THE-MARKET PRESUMPTION

In response to the stock market abuses that precipitated the Great Depression, Congress adopted the Securities Exchange Act of 1934 to protect against stock price manipulation. Promulgated pursuant to the 1934 Act, Rule 10b-5 makes it unlawful for a person in connection with the purchase or sale of any security to make any untrue statement of material fact or to omit a material fact necessary to make a statement not misleading. To prevail in a Rule 10b-5 case, a plaintiff must meet the statutory and regulatory prerequisites as well as the traditional common law elements for fraud, including causation. Causation under federal securities laws is a two-pronged requirement, as "[i]t is long settled that a securities-fraud plaintiff 'must prove both transaction and loss causation.'" Transaction causation, which is tantamount to

24. Specifically, "a plaintiff must show that 'in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material misrepresentation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused plaintiff injury.'" Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 763, 769 (2d Cir. 2001) (quoting Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 534 (2d Cir. 1999)).
25. Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005) (quoting First Nationwide Bank v. Gelt Funding Corp., 27 F.3d 763, 769 (2d Cir. 1994)). Because the FOM presumption only pertains to transaction causation, this Note will not address loss causation. Loss causation refers to a fraudulent misrepresentation or omission's effect on a security's
reliance, requires the plaintiff to prove that "but for the claimed [fraudulent] misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction." To meet the test for transaction causation in Rule 10b-5 cases, the plaintiff must not only show that a reasonable person would have acted based on the fraudulent misrepresentation or omission, but also that the plaintiff himself acted based on the fraud. This latter requirement of subjective reliance on the fraudulent misrepresentation is necessary to prevent Rule 10b-5 from becoming a "scheme of investor's insurance"; otherwise, even investors who actually knew of the fraud but traded anyway would not be precluded from recovery under Rule 10b-5.

Prior to the development of the FOM presumption of reliance, plaintiffs could only prove reliance by individually showing direct reliance. In fraudulent omission cases, a plaintiff had to directly rely on a defendant who had a duty to disclose, whereas in fraudulent misrepresentation cases, the plaintiff had to directly rely on the defendant's statements. Requiring subjective reliance on either the defendant or the defendant's misrepresentations, however, impeded securities fraud class actions and ultimately private recovery and enforcement of federal securities laws. Specifically, requiring each plaintiff to prove subjective reliance resulted in members of securities fraud class actions having market price and whether the misrepresentation or omission indeed caused the market price change that resulted in the plaintiff's injury. See, e.g., Michael Bobelian, Shareholder Suits Split U.S. Circuits: High Court Set To Mend Split; "Loss Causation" a Key in Fraud Cases, NAT'L L.J., Sept. 6, 2004, at 8.

26. Lentell, 396 F.3d at 172 (quoting Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d Cir. 2003)); see also Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) ("We agree that reliance is an element of a Rule 10b-5 cause of action.").


28. Id. at 463.

29. See Note, FOM Theory, supra note 6, at 1145-46. In practical terms, direct reliance on a defendant in fraudulent omissions cases required the plaintiff to have a face-to-face or similar interaction with the defendant whereas in fraudulent misrepresentation cases, the plaintiff must have been aware of the defendant's statements that are claimed to be fraudulent. See id.

difficulty meeting Federal Rule of Civil Procedure 23(b)(3), which requires that "questions of law or fact common to the members of the class predominate over any questions affecting only individual members." As adopted in Basic, the FOM presumption of reliance does not require plaintiffs to directly rely on either the defendant who had a duty to disclose or the defendant's misrepresentations to prove reliance. Instead, the Basic Court noted that there is "more than one way to demonstrate the causal connection" and adopted the FOM presumption by holding that if an investor relies on the integrity of the market price of a security traded in an efficient market, the investor is entitled to a presumption of reliance. Drawing on an economic theory known as the efficient markets hypothesis, the Court noted that "most publicly available information is reflected in the market price" and because of this, the Court reasoned that a security's market price would also reflect any material fraudulent misrepresentation or omission. Thus, if a plaintiff relies on the integrity of the market price in the sense that the plaintiff relies on the fact that "no unsuspected manipulation has artificially inflated [or deflated] the price," the plaintiff has relied, albeit indirectly, on the defendant's fraudulent misrepresentation or omission. By adopting the FOM presumption, the Basic Court made bringing class action lawsuits easier, as plaintiffs could simply prove reliance on the integrity of the market price rather than having to prove direct individual reliance.

31. 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.").
32. FED. R. CIV. P. 23(b)(3).
33. See Basic, 485 U.S. at 243-47.
34. Id. at 243, 246-48.
35. For a discussion of the efficient market hypothesis, see infra Part II.A.
37. Id. at 246; see also In re LTV Sec. Litig., 88 F.R.D. 134, 144 (N.D. Tex. 1980) ("[T]he central assumption of the fraud on the market theory [is] that the market price reflects all representations concerning the stock.").
38. Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975).
plaintiff in a 10b-5 securities [fraud] class action involving publicly-traded securities will [now] allege that he 'relied on the integrity of the market price' in purchasing the company's stock."41

In adopting the FOM presumption, the Basic Court did not eliminate the reliance requirement but merely made it easier for plaintiffs to prove.42 The Court adopted the presumption because it assumed that most—if not all—investors rely on the integrity of the market price.43 Indeed, "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price."44 Recognizing, however, that some investors may not rely on either the market price or the integrity of the market price, the Basic Court made the presumption rebuttable rather than conclusive.45 The FOM presumption of reliance thus operates like any other legal presumption:

[T]here are two components to the fraud on the market presumption of reliance—the predicate facts, and the presumed fact. The predicate facts are: (1) the market is efficient; (2) the allegedly misrepresented or omitted information was material; and (3) the alleged misrepresentation or omission affected the market price [at which the plaintiff traded]. The presumed fact is the plaintiff's reliance.46

As with any other presumption under Federal Rule of Evidence 301, the FOM presumption will not arise if the trier of fact does not find the existence of the predicate facts.47 Moreover, even if the predi-
cate facts are proven, the defendant can rebut the FOM presumption by introducing enough evidence to satisfy a judge that the trier of fact could find the nonexistence of the presumed fact of reliance. If any of the predicate facts are not proven or if the presumed fact is rebutted, the plaintiff must then prove actual reliance on either the defendant who had a duty to disclose or the defendant’s misrepresentations.\textsuperscript{48}

The Basic Court held that “[a]ny showing [by the defendant] that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff\textsuperscript{49} would prove the nonexistence of one or more of the predicate facts.\textsuperscript{50} For example, the Court noted that if the ‘market makers’ were privy to the truth ... and thus that the market price [was] not affected by [the defendant’s] misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone.”\textsuperscript{51}

To rebut the presumed fact of reliance, the Basic Court noted that “[a]ny showing” that severs the link between the fraud and the plaintiff’s “decision to trade at a fair market price” would be sufficient.\textsuperscript{52} Although the Basic Court did not provide an exhaustive list of what a defendant could show,\textsuperscript{53} it suggested that if an investor traded or would have traded despite knowing of the fraudulent misrepresentation, then the presumed fact of reliance would be rebutted.\textsuperscript{54} For example, the Basic Court noted that if the

\begin{itemize}
\item[48.] See id.; see also Legille v. Dann, 544 F.2d 1, 6-7 & n.37 (D.C. Cir. 1976) (noting that Federal Rule of Evidence 301 adopted the “bursting bubble theory” of presumptions and, consequently, if the party opposing the presumption provides evidence sufficient to satisfy a judge that the trier of fact could find the nonexistence of the presumed fact, then the presumption disappears as a rule of law).
\item[49.] Basic, 485 U.S. at 248.
\item[50.] See id.
\item[51.] Id. The Basic Court also provided another scenario in which all of FOM presumption’s predicate facts could not be proven: “Similarly, if, despite petitioner’s allegedly fraudulent attempt to manipulate market price, news of [the misstatement or its subject matter] credibly entered the market and dissipated the effects of the misstatements, those who traded ... after the corrective statements would have no direct or indirect connection with the fraud.” Id. (footnotes omitted).
\item[52.] See id. (emphasis added).
\item[53.] Dougherty, supra note 41, at 23.
\item[54.] See Basic, 485 U.S. at 248-49; see also Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975) (holding that a defendant can rebut the FOM presumption by “proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he
defendant could show that an investor would have sold a security for “potential antitrust problems, or political pressures” despite awareness of the fraudulent misrepresentation, then the presumed fact of reliance would be rebutted. The FOM presumption of reliance thus does not weaken or eliminate the reliance requirement but rather merely shifts from the plaintiff to the defendant the burden of putting forth evidence showing that “but for the claimed [fraudulent] misrepresentation or omissions, the plaintiff would not have entered into the detrimental securities transaction.”

II. SHOULD SHORT SELLERS BENEFIT FROM THE FRAUD-ON-THE-MARKET PRESUMPTION?

The Third Circuit in Zlotnick v. TIE Communications held that short sellers cannot benefit from the FOM presumption, but did so prior to the Supreme Court’s decision in Basic. To determine whether Zlotnick was correctly decided then, it must be viewed in light of the Supreme Court’s adoption of the FOM presumption. Considering that the FOM presumption operates like any other presumption under Federal Rule of Evidence 301, Zlotnick can be interpreted two ways. Zlotnick can first be interpreted as the court preventing the FOM presumption from arising because allowing a plaintiff short seller to prove the FOM presumption’s predicate facts would be illogical given a short seller’s investment strategy. On the other hand, Zlotnick can also be interpreted as the defendant being able to rebut the FOM presumption’s presumed fact of

would have, had he known of it”).
55. Basic, 485 U.S. at 249.
57. 836 F.2d 818, 823 (3d Cir. 1988).
58. The Supreme Court decided Basic v. Levinson three months after the Third Circuit decided Zlotnick.
59. See In re W. Union Sec. Litig., 120 F.R.D. 629, 637 (D.N.J. 1988) (“Zlotnick can really be seen as an example of a defendant able to rebut the presumption of reliance, although the court there saw it as plaintiff’s failure to show he was entitled to the presumption of reliance.”)
60. See Zlotnick, 836 F.2d at 822-23 (noting that it would be illogical in the case of short sellers to find what was tantamount to the FOM presumption’s predicate facts because short sellers do not believe in the predicate fact’s theoretical underpinnings).
reliance because of the mere fact that the plaintiff was a short seller who believed the security price to be overvalued.\textsuperscript{61}

If the correct reading of \textit{Zlotnick} is the first interpretation, the decision misunderstands the FOM presumption's theoretical underpinnings and, consequently, courts that have followed this reasoning have also misapplied the presumption to short sellers.\textsuperscript{62} If the correct reading is the second interpretation, however, the \textit{Zlotnick} holding is not entirely wrong. Indeed, under certain factual scenarios that give rise to Rule 10b-5 securities fraud claims, a short seller, much like an investor who sold stock because of antitrust or political concerns as noted in \textit{Basic}, would in hindsight still have entered into the securities transaction notwithstanding that fraud tainted the market price at which the short seller traded.

\textbf{A. Preventing the Fraud-on-the-Market Presumption from Arising: Short Sellers and the Theoretical Underpinnings of the Presumption's Predicate Facts}

A court should never prevent the FOM presumption from arising solely because a plaintiff is a short seller. Courts holding or suggesting otherwise, including the Third Circuit under the first interpretation of the \textit{Zlotnick} holding, misunderstand the FOM presumption's theoretical underpinnings. These courts incorrectly assume that short sellers, given their investment strategy, do not believe in the theoretical underpinnings of the FOM presumption's predicate facts, namely that markets are efficient and that the alleged fraudulent misrepresentation or omission would therefore be reflected in the market price. Consequently, courts have barred

\textsuperscript{61} \textit{In re W. Union Sec. Litig.}, 120 F.R.D. at 637 ("\textit{Zlotnick} can really be seen as an example of a defendant able to rebut the presumption of reliance ....").

\textsuperscript{62} For an example of a federal district court following this reading of \textit{Zlotnick} and thus incorrectly applying the FOM presumption to short sellers, see \textit{Weikel v. Tower Semiconductor Ltd.}, 183 F.R.D. 377, 392 (D.N.J. 1998). Following \textit{Zlotnick}, the \textit{Weikel} court held that a short seller is not even entitled to the FOM presumption:

The \textit{Zlotnick} court found it was not reasonable to allow a purchaser to take advantage of a theory premised on the assumption the price of a given security reflected all available information when the purchaser sold the stock short on the belief the price did not reflect all available information. Pursuant to \textit{Zlotnick}, it appears [the plaintiff] will not be able to benefit from the fraud on the market theory to the extent he was a short seller.

\textit{Id.} (citations omitted).
short sellers from being entitled to the presumption, holding that allowing a short seller to prove the predicate facts would be illogical.\textsuperscript{63}

Before considering whether the FOM presumption applied to short sellers, the Zlotnick court noted that the presumption's underlying assumption is that market prices reflect all publicly available information, including fraudulent misrepresentations and omissions.\textsuperscript{64} Stating that reliance should be presumed only when logical to do so, the court held that it would be illogical to allow short sellers the benefit of the FOM presumption because short sellers believe that market prices do not reflect all available information.\textsuperscript{65} Short sellers, according to the court, should not be entitled to a legal theory that assumes that the market price reflects all available information when short sellers do not believe that to be true.\textsuperscript{66} Denying a short seller the benefit of the FOM presumption for this reason, however, misunderstands the difference between informational and fundamental efficiency, of which only the former underpins the FOM presumption's predicate facts.

The efficient market hypothesis (EMH) provides the theoretical basis for the FOM presumption.\textsuperscript{67} Generally, the EMH posits that security prices in an efficient market "fully reflect the available information."\textsuperscript{68} The EMH can be broken down into three forms, each of which represents different degrees of information assimilation: the weak form, the semi-strong form, and the strong form.\textsuperscript{69} The weak form posits that current securities prices incorporate all information about prior prices and returns, whereas the semi-

\textsuperscript{63} See, e.g., id.
\textsuperscript{64} Zlotnick, 836 F.2d at 822.
\textsuperscript{65} Id. at 822-23.
\textsuperscript{66} Id.
\textsuperscript{67} Ian Ayres, \textit{Back to Basics: Regulating How Corporations Speak to the Market}, 77 VA. L. REV. 945, 965 (1991). The EMH is also referred to as the Efficient Capital Markets Hypothesis. See id.
\textsuperscript{68} Andrei Shleifer, \textit{Inefficient Markets: An Introduction to Behavioral Finance} 1 (2000). The EMH gained favor among economists after empirical research provided support for it in U.S. and world financial markets. \textit{Id}. Indeed, one economist even commented that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Markets Hypothesis." \textit{Id} (quoting Michael Jensen, \textit{Some Anomalous Evidence Regarding Market Efficiency}, 6 J. FIN. ECON. 93, 95 (1978)).
strong form posits that current securities prices reflect all publicly available information, including prior prices and returns.\textsuperscript{70} The strong form posits that a security’s price incorporates all privately held information in addition to all publicly available information, including prior prices and returns.\textsuperscript{71} According to empirical research, U.S. financial markets provide support for the semi-strong form,\textsuperscript{72} as it remains possible to consistently profit from privately held information.

The FOM presumption relies on the semi-strong form because if the FOM presumption relied on the strong form, the market price would reflect the falsity of the defendant’s statements, and if the presumption relied on the weak form, only past security prices and not any misrepresentations would be reflected in the price.\textsuperscript{73} The Basic Court adopted the semi-strong form by stating that the presumption assumes that “most publicly available information [as opposed to private information or only past securities prices] is reflected in [the] market price.”\textsuperscript{74}

If U.S. financial markets are indeed efficient in that they reflect most, if not all, publicly available information, one would presume that investors could not use public information to beat the market.\textsuperscript{75} This would occur because the market would rapidly assimilate information,\textsuperscript{76} thereby quickly dissipating any opportunity to profit off of that information. Despite this difficulty, most investors nonetheless try to beat the market by undertaking various investment strategies.\textsuperscript{77} Such strategies may yield above-average returns because, although markets may be efficient in incorporating all

\textsuperscript{70} Id. at 5-6.
\textsuperscript{71} Id. at 7.
\textsuperscript{72} \textit{E.g.}, Eugene F. Fama et al., \textit{The Adjustment of Stock Prices to New Information}, 10 INT’L ECON. REV. 1, 20 (1969).
\textsuperscript{73} Ayres, \textit{supra} note 67, at 966.
\textsuperscript{74} Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988); see also Ayers, \textit{supra} note 67, at 966 (“Only the semi-strong formulation of the [EMH] supports fraud-on-the-market standing.”); Jonathan R. Macey & Geoffrey P. Miller, \textit{Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory}, 42 STAN. L. REV. 1059, 1077 (1990) (“[T]he [Basic] Court was adopting the semi-strong version of the [EMH], whether it was aware it was doing so or not.”).
\textsuperscript{75} \textit{See} SIMON M. KEANE, \textit{STOCK MARKET EFFICIENCY: THEORY, EVIDENCE AND IMPLICATIONS} 10 (1983).
\textsuperscript{76} Fama, \textit{supra} note 72, at 20.
\textsuperscript{77} \textit{See} DYCKMAN & MORSE, \textit{supra} note 69, at 6-7.
publicly available information, markets may be inefficient by either incorrectly reflecting assimilated information or by reflecting information irrelevant to the security’s underlying asset. 78

Indeed, economists as far back as John Maynard Keynes have noted two independent dimensions of market efficiency: informational efficiency and fundamental efficiency. 79 "Informational efficiency means ‘that stock prices will reflect certain classes of existing information;’ while ‘[f]undamental efficiency posits that, conditioned on the information available, stock prices will reflect the present value of corporations expected underlying profits." 80 A market can thus be informationally efficient while simultaneously being fundamentally inefficient. 81 For example, “[i]f a corporation [with one million shares outstanding] trad[es] in a fundamentally efficient market [and] unexpectedly earns an extra one million dollars, then its stock price should increase by one million divided by the number of outstanding shares,” or by $1 per share. 82 This may not always hold true, however, as markets can overreact to information by sending the share price up by more than $1. 83 By reacting to the information, the market exhibits informational efficiency, but by overreacting or underreacting the market exhibits fundamental inefficiency. 84 Securities prices can thus be overvalued or undervalued relative to their underlying fundamentals but still be efficient from an informational standpoint in that they reflect most, if not all, publicly available information.

The market’s overreaction or underreaction to public information is exactly how investors attempt to make a profit. Indeed, investors undertake their own analysis of a security to determine if, based on their analytical considerations, the price for the security is overval-

78. Ayres, supra note 67, at 971, 974-75.
79. Id. at 968-69.
81. Ayres, supra note 67, at 970-71, 973-75.
82. Id. at 970.
84. Ayres, supra note 67, at 968-70; see also DYCKMAN & MORSE, supra note 69, at 9 (noting that although a market can fully react to information in the sense that the security price responded to the information, the market can overact by sending the price to a higher level than justified by the news).
ued or undervalued. Investors believe that the market will eventually correct itself in the long run by adjusting to appropriately reflect the information. Although traditional long investors believe that the market will correct itself by increasing a security's price, a short seller believes that the market will correct itself by decreasing the security's price. In sum, both long investors and short sellers seek to exploit fundamental market inefficiency and do not necessarily believe that markets are informationally inefficient.

The first interpretation of Zlotnick can be understood as precluding short sellers from being entitled to the FOM presumption because of their disbelief in informational efficiency, which underpins the presumption. The Zlotnick court, however, confused informational efficiency with fundamental efficiency and thus incorrectly precluded short sellers from benefiting from the FOM presumption because of their disbelief in fundamental efficiency. Plaintiff Zlotnick “believed the market price of the stock overvalued [the company’s] present earnings and underestimated its potential competition.” Zlotnick’s rationale does not evidence a disbelief in informational efficiency but instead only shows Zlotnick’s belief that the market incorrectly reacted to the publicly available information by overreacting to the company’s present earnings and underreacting to the competition the company would encounter. Zlotnick thus believed that the market reflected all publicly available information—information efficiency—and that the market was fundamentally inefficient by reacting, according to Zlotnick, to

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85. See, e.g., GRAHAM & DODD, supra note 1, at 15; see also Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp., 315 F. Supp. 2d 666, 676 n.13 (E.D. Pa. 2004) (“[A]ll rational investors purchase and sell securities when they believe that they can make profits because the securities are either undervalued or overvalued ....”).

86. For example, a long investor may read a company’s annual report and conclude that the company has highly favorable prospects going forward. If the investor does not believe that these prospects are appropriately reflected in the stock’s current market price, the investor will decide to purchase that stock. When these prospects are actually realized, the investor hopes that the market price will adjust favorably by taking into account the publicly available information that it previously discounted as being insignificant.

87. Zlotnick v. TIE Commc’ns, 836 F.2d 818, 823 (3d Cir. 1988) (referring to Zlotnick’s rationale for the short sale: “Though [the short seller] believed the price of the stock overvalued at the time of the short sale, he relied on the market’s ability, given accurate information, to correct its valuation of the stock and set a better price”).

88. See id. at 822-23.

89. Id. at 823.

90. Id.
that information incorrectly.\textsuperscript{91} Zlotnick's belief was not inconsistent with economists' theories of market efficiencies, as one can believe without hypocrisy that the market is informationally efficient but not fundamentally efficient.\textsuperscript{92} Because informational efficiency, and not fundamental efficiency, underlies the rationale for the FOM presumption, a disbelief in fundamental efficiency should not preclude the FOM presumption from arising in regard to short sellers.

In sum, despite their belief in fundamental inefficiency, short sellers should be entitled to the FOM presumption if the predicate facts are proven. This, however, does not foreclose the possibility that the FOM presumption can be rebutted if the defendant can show a short seller's belief in fundamental inefficiency, namely that the short seller believed the security to be overvalued when deciding to buy or sell. Reliance should be presumed only where "logical to do so,"\textsuperscript{93} and, as argued in the next subpart, a defendant who can show a short seller's belief in fundamental inefficiency will rebut the presumed fact of reliance in certain scenarios that give rise to Rule 10b-5 securities fraud cases. In such cases, the plaintiff short seller's belief in fundamental inefficiency severs the link between the defendant's misrepresentation and the short seller's decision to trade at a fair market price.\textsuperscript{94}

\textbf{B. Rebutting the Fraud-on-the-Market Presumption's Presumed Fact of Reliance}

In accord with \textit{Basic}, a defendant can rebut the FOM presumption's presumed fact of reliance with evidence sufficient to show that the plaintiff actually knew of the fraud, did not rely at all on the security's market price, or did not rely on the integrity of the market price when deciding to buy or sell.\textsuperscript{95} Before proceeding, a distinction needs to be made between relying on the market price

\begin{itemize}
\item \textsuperscript{91} See id. at 822-23.
\item \textsuperscript{92} Ayres, \textit{supra} note 67, at 984, 997-98. The failure to realize that markets can be informationally efficient but not fundamentally efficient resulted in the disagreement between the dissent and plurality in \textit{Basic}. Id. at 983-85.
\item \textsuperscript{93} Peil v. Speiser, 806 F.2d 1154, 1161 n.11 (3d Cir. 1986) (quoting Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981)).
\item \textsuperscript{94} See infra Part II.B.
\item \textsuperscript{95} See \textit{Basic} v. Levinson, 485 U.S. 224, 248-49 (1988).
\end{itemize}
and relying on the *integrity* of the market price. Relying on the market price itself means that an investor took the price into consideration when deciding to buy or sell. Relying on the *integrity* of the market price means that an investor relies on the fact that the market price is untainted by fraud. To take advantage of the FOM presumption, a plaintiff must rely on both the market price and the *integrity* of the market price. If the plaintiff does not rely on the market price or the *integrity* of the market price, the link is severed between the defendant's fraudulent misrepresentation or omission—which only reveals itself to the plaintiff in the form of an artificially inflated or deflated price—and the plaintiff's decision to trade at a market price untainted by fraud.

Although a plaintiff can rely on the market price without relying on the *integrity* of the market price, the converse does not hold true; relying on the market price operates as a prerequisite to relying on the integrity of the market price. Thus, when a defendant can show that the plaintiff relied solely on factors extraneous to the market or did not consider a security's price at all, the FOM presumption is rebutted because the plaintiff cannot claim reliance.

96. *Id.* at 255 (White, J., dissenting) ("For in adopting a 'presumption of reliance,' the Court also assumes that buyers and sellers rely—not just on the market price—but on the 'integrity' of that price.").

97. *See id.* at 248-49 (majority opinion).

98. Some courts have argued that an investor can rely on the integrity of the market price without relying on the market price at all. Such a conclusion is illogical and the facts of those cases undermine the reasoning of these courts. In *Cheney v. Cyberguard Corp.*, 213 F.R.D. 484, 492 (S.D. Fla. 2003), the plaintiff testified that after receiving his analyst's recommendation, "he probably would have purchased the stock without regard to the price at the time." Because the plaintiff also testified that if aware of the company's fraud at the time of purchase he would not have purchased the stock, the court held that although the plaintiff did not rely on the market price, he relied on the integrity of the market price and thus should benefit from the FOM presumption. *Id.* The plaintiff, however, did rely on the market price because the analyst, acting as the plaintiff's agent, presumably relied on the market price in making his buy recommendation to the plaintiff. The analyst's reliance on the price should thus be imputed to the plaintiff. *See Grossman v. Waste Mgmt., Inc.*, 589 F. Supp. 395, 405-06 (N.D. Ill. 1984). In formulating its holding, the *Cheney* court relied on *HSL, Inc. v. Daniels*, No. 81 C 7117, 1983 WL 1385, at *11 (N.D. Ill. Aug. 25, 1983), for the proposition that the FOM presumption is not rebutted if the defendant shows that the plaintiff did not rely on the market price at all. *Cheney*, 213 F.R.D. at 492-93. Not only was *HSL* decided before *Basic*, but it also involved a plaintiff who at least considered price, but who ultimately decided that price should be an "insignificant factor" in his purchase decision. *HSL*, 1983 WL 1385, at *11. Moreover, the *HSL* court also held that the FOM presumption could be rebutted if the investor "relied on matters wholly extraneous to the market" or, in other words, that the investor did not consider market price whatsoever. *Id.*
on the \textit{integrity} of a market price that the investor never even considered.\footnote{Basic, 485 U.S. at 251 (White, J., dissenting) (noting that "one who buys or sells a stock for reasons unrelated to its price" cannot state a valid claim under the fraud-on-the-market theory).}

The rationale for requiring a plaintiff to rely on the market price itself is that Rule 10b-5 should not operate as a scheme of investor's insurance whereby a plaintiff, who does not consider price at all and would have traded at any price level, could later disingenuously claim reliance on the \textit{integrity} of the market price by claiming that but for the fraud, he would not have traded at a fraudulently affected price.\footnote{See, e.g., List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965).} For example, if a plaintiff buys or sells stock solely based on astrology, the plaintiff cannot claim to have relied on the market price he never considered and \textit{a fortiori} on the integrity of that price.\footnote{See Abelson v. Strong, No. 85-0592-S, 1987 WL 15872, at *6 (D. Mass. July 30, 1987).} Likewise, as noted in Basic, if the defendant can show that the plaintiff investor bought or sold stock because of factors completely unrelated to price, such as antitrust or political concerns, the FOM presumption is rebutted.\footnote{See Basic, 485 U.S. at 248-49; see also Semerenko v. Cendant Corp., 223 F.3d 165, 179 n.7 (3d Cir. 2000) (noting that the defendant may rebut the presumption by showing that the "investor's decision to trade was based on some factor other than the market price").} In each of these examples, the plaintiff would have bought or sold his shares without regard to the price level at all, even if the price was artificially inflated or deflated because of fraud. Because the artificially inflated or deflated price level resulting from the defendant's misrepresentations or omissions in such situations does not cause the plaintiff to buy or sell, the "but for" test necessary to prove transaction causation is not met.\footnote{See, e.g., Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005).}

Short sellers, however, typically take price into consideration when determining whether a given security is overvalued.\footnote{GRAHAM \& DODD, \textit{supra} note 1, at 22 ("In that portion of the analyst's activities which relates to the discovery of undervalued, and possibly of overvalued securities, he is more directly concerned with market prices.").} Short sellers who believe in market price overvaluation\footnote{An investor may engage in a short sale for a reason other than a belief that a security is overvalued. For a discussion of how the FOM presumption applies to such short sellers, see infra Part IV.E.} either utilize market price as a reference for their personal opinion about a
security's "correct" value or as a basis for determining whether the market price does not accurately reflect all publicly available information and is therefore overvalued by $X$ dollars.\textsuperscript{106} By relying on the market price itself, short sellers meet the prerequisite to reliance on the integrity of the market price. Unlike an investor who engages in a securities transaction solely because of an alignment of stars or planets, a plaintiff short seller considers price when deciding to buy or sell.

Even if a plaintiff relies on the market price when buying or selling, this does not automatically mean that the investor has relied on the integrity of the market price.\textsuperscript{107} For example, a plaintiff who actually knew of the fraudulent misrepresentation cannot be said to have relied on the integrity of the market price to reflect truthful information, even if the plaintiff considered the security's price level when deciding whether to buy or sell.\textsuperscript{108} To determine whether a plaintiff relies on the integrity of the market price and thus whether transaction causation is met, courts must again question whether the plaintiff, after becoming aware of the fraud, would in hindsight still have engaged in the securities transaction.\textsuperscript{109} In other words, after determining that a plaintiff relied on the market price itself, the court must again question whether "but for" the claimed fraudulent misrepresentation, the plaintiff would not have entered into the security transaction.\textsuperscript{110}

1. Deciding To Engage in a Securities Transaction at a Fraudulently Affected Price Versus Trading at a Fraudulently Affected Price

Applying the "but for" test in the FOM context allows a plaintiff who takes price into consideration to claim reliance on the integrity of the market price in one of two ways, or both. First, as in non-FOM cases that require the plaintiff to have directly relied on

\textsuperscript{106} See STALEY, supra note 8, at 7-8; see also infra notes 116-18 and accompanying text.
\textsuperscript{107} See HSL, Inc. v. Daniels, No. 81 C 7117, 1983 WL 1385, at *11 (N.D. Ill. Aug. 25, 1983) (recognizing that even if an investor considers price in making an investment decision, "price per se is not the determinative factor in the fraud on the market theory. Rather it is the integrity of the market price").
\textsuperscript{109} See Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005).
\textsuperscript{110} See id.
either the defendant who had a duty to disclose or the defendant's misrepresentations, the plaintiff could claim that the fraudulent misrepresentation or omission caused him to enter into a transaction that he otherwise would not have if aware of the fraud. The claim would be that but for the defendant's fraudulent misrepresentation or omission that artificially inflated or deflated the security's price, the plaintiff would not have decided to engage in the transaction at the fraudulently affected price level. In this case, the plaintiff relies on the integrity of the market price to reflect truthful information when making his decision to buy or sell.

Second, because the FOM presumption assumes that the market price incorporates fraudulent misrepresentations or omissions, the plaintiff could claim that the fraudulent misrepresentation or omission caused him to trade at a particular price that was tainted by fraud. The claim would be that but for the defendant's fraudulent misrepresentation or omission, the plaintiff would not have bought or sold at the artificially inflated or depressed price, but rather would have sold at a price untainted by fraud. A plaintiff in this case relies on the integrity of the market price by assuming that he is trading at a price untainted by fraud. Importantly, the plaintiff could always make this claim if the FOM presumption's predicate facts are proven and regardless of whether the fraudulent misrepresentation or omission influenced his decision to buy or sell.

Courts do not distinguish between the two ways a plaintiff can claim reliance on the integrity of the market price and consequently ignore the possibility that more than one way exists for a defendant to rebut the plaintiff's reliance on the integrity of the market price. Indeed, in typical FOM cases that do not involve short sellers, courts primarily focus on whether a plaintiff would have traded at a fraudulently affected price without inquiring into whether the plaintiff would have decided to trade at that price notwithstanding the fraud. When courts consider a plaintiff's investment strategy, such as in cases involving short sellers, however, courts are more likely to inquire into whether the short seller would have decided to engage in the transaction at the fraudulently affected price. The split among district courts regarding whether short sellers can

111. See, e.g., Basic, 485 U.S. at 243-47.
112. Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975).
benefit from the FOM presumption exists partly because courts undertake different inquiries. Some courts, as in typical FOM cases not involving short sellers, generally only ask whether the plaintiff short seller would have *traded* at the fraudulently affected price, while other courts only ask whether the plaintiff short seller would have *decided* to engage in the transaction at the fraudulently affected price.

*a. Deciding To Engage in a Securities Transaction at a Fraudulently Affected Price*

In FOM cases, a “defendant may ... rebut the [FOM] presumption by showing that the investor would have purchased or sold the securities at *that price* [i.e., the fraudulently affected market price] even with full knowledge of the misrepresentation.”\(^{113}\) Generally, this inquiry is not difficult because common sense dictates that an investor “does not ordinarily [decide] to purchase a loss in the form of artificially inflated [or deflated] stock.”\(^{114}\) Indeed, “‘[w]ho would knowingly roll the dice in a crooked crap game?’”\(^{115}\) A court’s focus on whether the plaintiff would have *traded* at the fraudulently affected price to the exclusion of considering whether the plaintiff would have *decided* to engage in the transaction at such a price is therefore largely irrelevant if common sense holds true. In the case of short sellers, however, common sense does not always hold true, and the inquiry of whether the short seller would have bought or sold at the fraudulently affected price becomes more difficult.

Under certain factual scenarios that give rise to Rule 10b-5 securities fraud cases, a short seller would indeed knowingly roll the dice in a crooked craps game because of his investment strategy. A short seller believes that a security’s market price is overvalued in one of two ways.\(^{116}\) First, a short seller could have an opinion as

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114. *Blackie*, 524 F.2d at 908.
116. A short seller could also simply speculate or gamble on a general price decline. Speculation on a price decline, however, does not mean that the short seller believes the security's current price to be overvalued. The short seller simply hopes that unfavorable events will transpire in the future that will drive the security’s price downward. For example, even if a short seller does not believe airline stocks to be currently overvalued, the short
to what the security's "correct" value should be, such as $20 rather than the market price of $35.\footnote{117} Second, a short seller could believe that the security's price does not accurately reflect one or more pieces of information and is therefore overvalued by $X$ dollars per share.\footnote{118}

If the short seller believes the security has some "correct" value, a short seller in certain factual scenarios would still have engaged in the securities transaction despite knowing of the defendant's fraud.\footnote{119} For example, suppose a stock is trading at $15 per share and that the stock is artificially depressed by $5 because the corporation's CEO fraudulently claims that the corporation is not engaged in merger discussions. The stock's price absent the fraud would thus equal $20 per share. Now consider a short seller who, according to his analysis, believes that the stock's "correct" market price should be $10 per share for reasons unrelated to the merger discussions. When the short seller decides to sell short at the prevailing market price of $15 per share, he does not rely on the integrity of the market price because the short seller would still sell short even if aware that fraud had tainted the market price by artificially depressing it. This is so because the short seller's motivation to sell short would actually be strengthened if aware of the fraud. Believing that the security's correct price should be $10 per share, the short seller would have a greater reason to sell short if he knew the price should have been $20 rather than $15 per share. At $20 per share, the short seller's potential profit would be greater; a potential profit of $10 would exist rather than only a potential profit of $5.

\footnote{117} See STALEY, supra note 8, at 7-8 (noting that a short seller may sell short if a company's stock is overvalued relative to the present value of the company's potential stream of income).

\footnote{118} See id. (noting that a short seller may sell short if the short seller believes that a stock's market price does not accurately reflect a company's impending bankruptcy or major income reversal).

\footnote{119} See Martin, supra note 19, at 431.
The short seller would thus have entered into the short sale transaction despite knowing of the artificially depressed stock price. In short, the CEO’s fraud does not affect the short seller’s decision to engage in a short sale, but rather only affects the short seller’s potential profit size, if any. Because an opportunity to profit would still exist, the fraud cannot be said to be the “but for” cause for the short seller deciding to enter into the short sell transaction at the fraudulently affected market price.

Similar logic applies when determining whether the FOM presumption is rebutted when a short seller believes a security to be overvalued by X dollars. Such a short seller still would have traded at a fraudulently affected price if the fraud’s impact on the market price in dollar terms were less than the amount the short seller believed the stock to be overvalued. For example, suppose

120. Admittedly, fraud may discourage the short seller from engaging in the short sale at all. This would occur if the fraud deflated the stock’s price below or equal to what the short seller believed to be the stock’s “correct” price. In such a case, engaging in a short sale would be illogical. Courts, however, have precluded a plaintiff from recovering under Rule 10b-5 based on the claim that the fraud discouraged the plaintiff from entering into a transaction. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751-52 (1975). A plaintiff must have bought or sold a security to have standing. Id. at 754-55. To allow all those investors who would have bought or sold “but for” the fraud to recover would result in speculative claims. Because a plaintiff cannot recover based on the claim that the fraud discouraged him from entering into a transaction, this Note disregards the fact that the fraud may have discouraged a short seller from consummating a short sale. Instead, this Note focuses on a short seller who bought or sold securities and therefore has standing to sue under Rule 10b-5.

121. Note that a plaintiff can recover for a reduction in profits due to a defendant’s fraudulent misrepresentation or omission, although calculation of such damages may be difficult. Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344-46 (9th Cir. 1976) (Sneed, J., concurring).

122. Admittedly, when deciding to sell short, a short seller does not know of the fraud’s effect on the market. In this situation, a short seller would only rely on the integrity of the market price to the extent that the fraud’s effect exceeds in dollar terms the amount that the short seller believed the security to be overvalued. Ultimately, this can only be proven after the fraud’s disclosure and after a determination of its effect on the market price is made. According to the Private Securities Litigation Reform Act of 1995 (PSLRA), a plaintiff’s damages cannot exceed the difference “between the purchase or sale price paid or received ... for the subject security and the mean trading price of that security during the 90-day period” following the dissemination of the corrected information. 15 U.S.C. § 78u-4(e)(1) (2000). An exception occurs if the plaintiff covers or divests himself of the securities prior to the ninety-day period, in which case the mean trading price is taken between the date the correction was first disseminated and the date of the plaintiff’s covering or divesting transaction. Id. § 78u-4(e)(2). If a defendant can produce evidence of the dollar amount by which the plaintiff believed the security to be overvalued, the damage calculations provided for by the PSLRA can be used to determine whether the plaintiff relied on the integrity of
again that a stock's prevailing market price of $15 is artificially depressed by $5 because the corporation's CEO fraudulently claims that the corporation is not engaged in merger discussions. Now consider a short seller who believes that the market price of $15 overvalues the stock by $10 for a reason unrelated to the CEO's misrepresentation. Even if the short seller knew of the CEO's misrepresentation, the short seller would still sell short because an opportunity to profit from the short sale would still exist. Absent the CEO's misrepresentation, the stock price would equal $20 per share. If the short seller discounts the $20 per share by the $10 the short seller believes the stock to be overvalued, the stock's prevailing market price of $15 would still be $5 above the price at which the short seller believes the stock should trade. The short seller would engage in the short sale with the expectation that the stock price would fall to $10 per share, thereby earning the short seller a $5 profit once the short seller covered. In sum, the short seller would engage in the short sale despite knowledge of the CEO's misrepresentations because an opportunity to make a profit would still exist notwithstanding the fraud.

These two examples illustrate that in some factual scenarios it cannot be said that "but for" the fraud, the plaintiff short seller would not have engaged in the short sell transaction at all and, consequently, that the short seller relied on the integrity of the market price when deciding to enter into the short sell transaction at the fraudulently affected price level. Because an opportunity to profit still existed, albeit a more risky one, the short seller still would have engaged in the transaction at the fraudulently affected market price despite knowledge that the defendant's fraud had tainted the price. Simply because one rolls dice in a crooked craps game does not mean that one cannot win against the odds. The link between the defendant's fraudulent misrepresentation and the plaintiff's decision to trade at a fair market price is thus severed; the defendant has met the rebuttal test outlined in Basic, which only requires the defendant to make "any showing" that severs the market price and thus would not have engaged in the transaction if aware of the fraud. *Id.* The mere fact that the defendant can make a "showing" that the plaintiff may not have relied on the integrity of the market price should be sufficient to rebut the FOM presumption and to require the plaintiff to prove actual reliance.
link between the fraud and the plaintiff's "decision to trade at a fair market price."\footnote{123}

\textit{b. Trading at a Fraudulently Affected Price}

Although a short seller in the above scenarios does not rely on the integrity of the market price when \textit{deciding} to enter into the transaction, the short seller arguably relies on the integrity of the market price when \textit{trading} at the fraudulently affected price. Absent the defendant's fraudulent misrepresentation, the plaintiff would not have bought or sold at the artificially inflated or deflated price, but rather would have sold at a price untainted by fraud. Because of the plaintiff's reliance on the integrity of the market price, the plaintiff suffered a loss or a reduction in profit. Suppose again that a stock's prevailing market price of $15 is artificially deflated by $5 because of the CEO's fraudulent misrepresentations, and that the short seller believed the stock's "correct" value should be $10 per share for a reason unrelated to a CEO's misrepresentations. If the short seller's valuation proves true and the short seller covers after the fraud's disclosure, the short seller would realize $5 in profits; that is, the short seller would have sold at $15 and repurchased at $10, thereby earning a $5 profit. Absent the fraud, however, the short seller would have profited by $10 because the stock price would have fallen from $20 to $10 per share.\footnote{124} Because a short seller desires the full realization of his profit, the short seller relies on the integrity of the market price when \textit{trading} at the market price.\footnote{125} As one commentator noted, a short seller's belief in market price overvaluation should not rebut the FOM presumption.\footnote{126}

An investor with an opinion regarding whether the market has incorrectly determined the price of a stock still relies on the fact

\footnote{123. \textit{See} Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988).}

\footnote{124. A plaintiff can still recover damages for securities fraud even if the investor earns a profit from engaging in a transaction that the plaintiff claims was affected by fraud. \textit{Green}, 541 F.2d at 1344-46 (holding that even when a plaintiff resells at a price greater than his cost, a plaintiff can still recover from the corporate wrongdoing any reduction in the plaintiff's profits caused by the fraud).}

\footnote{125. \textit{See} Martin, \textit{supra} note 19, at 431.}

\footnote{126. \textit{Id}.}
that there has been no fraudulent manipulation of that stock. An investor who sells short may simply disagree with the market concerning future events affecting the company, or whether the company will remain solvent, while still relying that no hidden factors are influencing the market.\textsuperscript{127}

Denying short sellers the FOM presumption also seems justified, however, if one considers that a short seller, under some scenarios, would still have bought or sold a security despite being aware that the market price was fraudulently inflated or deflated.\textsuperscript{128}

Thus, in some factual situations, a paradox results whereby the defendant's fraudulent misrepresentation is not the "but for" cause for the short seller \textit{deciding} to enter into a securities transaction at a fraudulently affected price but is the "but for" cause for the short seller \textit{trading} at a fraudulently affected price that ultimately results in a short seller's loss or reduction in profit. In other words, a short seller can be seen as simultaneously relying and not relying on the integrity of the market price.

\textbf{2. Resolving the "Deciding" Versus "Trading" Paradox}

Because of the competing conclusions regarding whether a short seller relied on the integrity of the market price, the question remains whether the link is severed between the defendant's misrepresentation or omission and the short seller's decision to buy or sell at a market price untainted by fraud. Arguably, the link should remain intact and the FOM presumption should not be rebutted if one considers that a short seller would not willingly seek a reduction in profit or expose himself to a loss resulting from a fraudulently affected market price. From a policy standpoint, this would further Congress's and the SEC's broad remedial purpose in enacting Section 10(b) and Rule 10b-5 respectively, and would allow a plaintiff to recover damages attributable to the defendant's fraud.\textsuperscript{129} Conversely, the link should be severed—and the presump-
tion rebutted—if one considers that short sellers in some factual scenarios would have sold short despite knowledge of the fraud, and that Rule 10b-5 should not be used as a scheme of investor’s insurance, whereby those who made poor investment decisions can escape the consequences by suing under federal securities fraud laws. This would occur if a short seller did not rely on the integrity of the market price when deciding to sell short but later covered after a fraud that depressed the market price was revealed and the security price rose. Such a short seller could conveniently claim reliance on the integrity of the market price when trading at the fraudulently affected market price, recover his losses, and escape an ill-conceived short sale relatively unscathed.

As of yet, no court has directly addressed the question of whether the FOM presumption is rebutted when the plaintiff did not rely on the integrity of the market price when deciding whether to engage in a securities transaction but did rely on the integrity of the market price when trading at the market price so as not to suffer a loss or a reduction in profit. This question, however, underlies courts attempting to apply the FOM presumption to short sellers and possibly explains the confusion among federal district courts as to whether short sellers can benefit from the FOM presumption.

The question could be resolved, however, if one considers that pursuant to Federal Rule of Evidence 301, the FOM presumption is a Thayer presumption. Under a Thayer presumption, “[i]f the party against whom the presumption operates produces evidence challenging the presumed fact, the presumption simply disappears from the case.” To rebut the FOM presumption and make it disappear, the defendant would need to produce evidence of the nonexistence of the presumed fact of reliance sufficient to allow a reasonable jury

404 U.S. 6, 12 (1971)).

130. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975) (cautioning that Rule 10b-5 should not result in “unduly expansive imposition of civil liability [because it] ‘will lead to large judgments, payable ... by innocent investors, for the benefit of speculators and their lawyers’” (quoting SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring))); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965) (noting that Rule 10b-5 should not be used to create a scheme of investor’s insurance).

to be convinced of the presumed fact's nonexistence.\textsuperscript{132} If the defendant produced evidence that an investor was indeed a short seller who sold short because of a belief in market price overvaluation, this should be sufficient evidence for a reasonable jury to be convinced of the nonexistence of the presumed fact of reliance in certain factual scenarios. As noted above, under certain factual scenarios, conflicting conclusions about a short seller's reliance on the integrity of the market price are possible.\textsuperscript{133} In those cases, a jury could reasonably be convinced of the nonexistence of the presumed fact of reliance. Although courts at the class certification stage should not address the case's merits and thus whether the defendant actually rebutted the FOM presumption,\textsuperscript{134} courts could logically conclude in some factual scenarios that a short seller class representative would be atypical or that the existence of short sellers in the class would result in individual issues of reliance predominating over common questions of law and fact.

Because the FOM presumption should be rebutted in some factual scenarios, \textit{Zlotnick} was not completely incorrect if the court's holding is interpreted to mean that a defendant can rebut the FOM presumption by showing that the plaintiff short seller believed in market price overvaluation.\textsuperscript{135} A defendant, however, will not be able to rebut the FOM presumption in all factual scenarios giving rise to Rule 10b-5 securities fraud claims involving short sellers.\textsuperscript{136} As developed in Part IV, the factual scenarios in which a defendant can logically rebut the FOM presumption are limited.

\begin{itemize}
\item \textsuperscript{132} See United States v. Bailey, 707 F.2d 19, 22 (1st Cir. 1983); see also Grossman v. Waste Mgmt., Inc., 589 F. Supp. 395, 406 (N.D. Ill. 1984) (noting that the FOM presumption of reliance would be rebutted by showing "some evidence" of the nonexistence of the presumed fact of reliance).
\item \textsuperscript{133} See supra text following note 128.
\item \textsuperscript{134} Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177-78 (1974) (holding that under Federal Rule of Civil Procedure 23, a court should not make a determination as to the merits of the case; rather the court should only ensure that the necessary requirements for class certification are met).
\item \textsuperscript{135} See Zlotnick v. TIE Commc'ns, 836 F.2d 818, 823 (3d Cir. 1988).
\item \textsuperscript{136} See infra Part IV.
\end{itemize}
III. MISAPPLYING THE FRAUD-ON-THE-MARKET PRESUMPTION TO SHORT SELLERS

The issue of whether short sellers can benefit from the FOM presumption generally arises in pretrial class certifications at which the defendant contests the maintenance of the proposed class or the class representative’s claim as being atypical of other class members’ claims. Specifically, if a proposed class contains short sellers, defendants contest the maintenance of the class on the ground that individual questions of reliance will predominate over common questions because short sellers cannot benefit from the FOM presumption and, therefore must prove actual individual reliance on either the defendant who had a duty to disclose or the defendant’s misrepresentations. Additionally, defendants contest a class representative’s claim as being atypical of the claims of other class members, either because the class includes short sellers or because the class representative engaged in short sales.

Because of the substantial split among federal district courts regarding whether short sellers can benefit from the FOM presumption, divergent class certification decisions have resulted. These

137. E.g., Ganesh, L.L.C. v. Computer Learning Ctrs., 183 F.R.D. 487, 491 (E.D. Va. 1998). After denying short sellers the benefit of the FOM presumption, the Ganesh court concluded that because one-third of the proposed class consisted of short sellers, the predominance and superiority requirements in Federal Rule of Civil Procedure 23(b)(3) were not met. Id.

As many as one-third of the Proposed Class consists of these short-sellers, and each of them would have to present positive proof of individual reliance and damages in order to recover. The managerial burden of conducting thousands of mini-trials on these two issues would overwhelm any common questions of law or fact and eviscerate the efficiencies that classwide adjudication might otherwise afford.

Id. See generally Fed. R. Civ. P. 23(b)(3) (listing requirements for class certification). The court then noted that plaintiffs could amend their complaint and bring a securities fraud class action lawsuit by excluding short sellers from the class. Id. at 491-92.


140. For federal district courts holding or suggesting that short sellers cannot benefit from the FOM presumption, see Rocker Mgmt., L.L.C. v. Lernout & Hauspie Speech Prods. N.V., No. Civ. A. 00-5965 (JCL), slip op. at 7-8 (D.N.J. June 7, 2005); In re PolyMedica Corp. Sec. Litig., 224 F.R.D. 27, 44 (D. Mass. 2004); In re Terayon, 2004 WL 413277, at *7-8; In re WorldCom, Inc. Sec. Litig., 219 F.R.D. 267, 296 (S.D.N.Y. 2003) (noting that because short sellers were betting that WorldCom would default on its bond obligations, the short sellers
FRAUD ON THE MARKET AND SHORT SELLERS

divergent holdings, however, generally escape review at the trial or appellate levels because securities fraud cases typically settle after the pretrial class certification.\(^{141}\)

Once certified as class actions, such suits expose corporate defendants and their officers and directors to potentially huge damage awards, and, not surprisingly, many defendants settle rather than face the risk, however small, of huge joint and several liability. Decisions granting or denying class certification occur before trial and are not reviewable until judgment is entered following trial, absent summary judgment (which occurs infrequently) or absent extraordinary permission for interlocutory appeal under 28 U.S.C. § 1292(b) (which occurs very rarely indeed). Most cases settle before trial or appeal. \textit{De facto} then, the vast majority of class certification decisions in securities fraud on the market class actions have been unreviewed and, yet are hugely important in their potential impact.\(^{142}\)

Indeed, only the Third Circuit has considered whether short sellers can benefit from the FOM presumption, and in \textit{Zlotnick v. TIE Communications}, the court held that short sellers cannot benefit from the presumption.\(^{143}\) Although \textit{Zlotnick}'s holding may provide the grounds for a 12(b)(6) motion to dismiss,\(^{144}\) federal district courts generally examine the decision to determine class

\begin{footnotesize}
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\item \[45x586\]
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\item made their investment decisions without relying on the integrity of the market price); \textit{In re Critical Path, Inc. Sec. Litig.}, 156 F. Supp. 2d 1102, 1110 (N.D. Cal. 2001) (holding that because short sales raise the question of whether the seller actually relied on the integrity of the market price, a short seller is not a suitable class representative); \textit{Ganesh}, 183 F.R.D. at 491; \textit{Weikel v. Tower Semiconductor Ltd.}, 183 F.R.D. 377, 392 (D.N.J. 1998). For federal district court decisions holding or suggesting that short sellers can benefit from the FOM presumption, see \textit{In re Initial Pub. Offering Sec. Litig.}, 227 F.R.D. 65, 109 (S.D.N.Y. 2004); \textit{Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.}, 315 F. Supp. 2d 666, 676 (E.D. Pa. 2004) (holding that short sellers are only entitled to the FOM presumption if the reason for the short sale was to hedge another market position or another reason unrelated to a short seller's general belief in market price overvaluation); \textit{In re Sunbeam Sec. Litig.}, No. 98-8258-CIV, 2001 WL 899658, at *1 (S.D. Fla. July 3, 2001); \textit{Danis v. USN Commc'ns, Inc.}, 189 F.R.D. 391, 396-97 (N.D. Ill. 1999); \textit{Moskowitz}, 128 F.R.D. at 631; \textit{Fausett v. Am. Res. Mgmt. Corp.}, 542 F. Supp. 1234, 1238-39 (D. Utah 1982) (holding that short sellers should benefit from a presumption of reliance similar to the FOM presumption).

\item \[141.\] \textit{Buckberg et al.}, \textit{supra} note 16, at 304-07.
\item \[142.\] \textit{Dougherty, supra} note 41, at 20.
\item \[143.\] \textit{Zlotnick v. TIE Commc'ns}, 836 F.2d 818, 822-23 (3d Cir. 1988).
\item \[144.\] \textit{E.g., Rocker}, No. Civ. A. 00-5965, slip op. at 6-8; \textit{Argent}, 315 F. Supp. 2d at 674-77.
\end{enumerate}
\end{footnotesize}
certification matters. In 2004 alone, one federal district court followed Zlotnick, one found Zlotnick’s reasoning wholly unpersuasive, and one bound by precedent to follow Zlotnick severely questioned its holding. In *In re PolyMedica Corp. Securities Litigation*, the court followed Zlotnick and held that short sellers are not entitled to the FOM presumption because rather than relying on the integrity of the market price, short sellers “believe that the market price is somehow mistaken[ly]” overvalued. In *In re Initial Public Offering*, the court found Zlotnick’s reasoning wholly unpersuasive and held that short sellers should benefit from the FOM presumption unless price played no part whatsoever in their decision making. Although bound by the Third Circuit’s precedent, the court in *Argent Classic Convertible Arbitrage Fund* severely questioned Zlotnick’s holding and noted that the “reasoning of Zlotnick ... would effectively eviscerate the fraud on the market theory of presumptive indirect reliance.”

Although the Zlotnick holding could be interpreted as correctly concluding that a defendant can rebut the FOM presumption by showing a short seller’s belief in overvaluation, the Zlotnick court’s application of the FOM presumption to short sellers was not entirely correct. As a consequence of relying on the incorrect aspects of the Zlotnick holding and the difficulty of applying the FOM presumption to an investor who believes in market price overvaluation, federal district courts have incorrectly denied or granted short sellers the presumption’s benefit. Specifically, in applying the FOM presumption, courts have (1) ignored the presumptions’ capability of being rebutted, (2) incorrectly assumed that short sellers do not rely on the integrity of the market price because disclosure of the fraud would in some instances achieve a short seller’s investment goals, or (3) inappropriately applied a per se rule against short sellers without regard to the factual scenario that gave rise to the securities fraud claim.

145. *In re PolyMedica*, 224 F.R.D. at 44.
147. *Argent*, 315 F. Supp. 2d at 676 n.13 (“[O]f course, we are bound to follow a Court of Appeals decision, even if we believe it is wrongly decided ....”).
148. *In re PolyMedica*, 224 F.R.D. at 44.
A. Courts Effectively Make the Fraud-on-the-Market Presumption's Presumed Fact of Reliance Unrebuttable

As discussed in Part II.B, Zlotnick can be interpreted as holding that the defendant may rebut the presumed fact of reliance because the plaintiff was a short seller who believed the security's price to be overvalued. Zlotnick could therefore be interpreted as holding that a defendant can rebut the FOM presumption because short sellers, given their investment strategy, do not rely on the market price itself. Because short sellers believe a security to be overvalued, the Zlotnick court arguably concluded that short sellers do not rely on the market price when making investment decisions. In other words, the court concluded that a short seller could not rely on the integrity of the market price because short sellers do not meet the prerequisite of relying on the market price itself. A short seller, however, unlike an astrological investor, does not make his investment decision without regard to price at all. Although a short seller may believe a security to be overvalued, the short seller makes that determination by using the current market price as a reference.

Understanding that the FOM presumption should not be automatically rebutted simply because an investor believes a stock price to be overvalued or undervalued, the court in Moskowitz v. Lopp held that an investor's belief in overvaluation or undervaluation does not rebut the FOM presumption unless price played "no part whatsoever" in the investor’s decision making.

It can be stated without fear of gainsay that the shareholders of every large, publicly traded corporation include institutional investors, short-sellers, arbitrages etc. The fact that these

151. Zlotnick v. TIE Commc’ns, 836 F.2d 818, 823 (3d Cir. 1988) ("A presumption that Zlotnick relied on the price of the stock in making his investment decision is also unwarranted. An investor like Zlotnick sells short because he believes the price of a stock overestimates its true value."); see also In re W. Union Sec. Litig., 120 F.R.D. 629, 637 (D.N.J. 1988); supra Part II.B (noting that a defendant can rebut the FOM presumption by showing that the plaintiff actually knew of the fraud, did not rely at all on the security’s market price, or did not rely on the integrity of the security’s market price).
152. Zlotnick, 836 F.2d at 823-24.
153. See supra note 104 and accompanying text.
154. See supra notes 104-06 and accompanying text.
traders have divergent motivations in purchasing shares should not defeat the fraud-on-the-market presumption absent convincing proof that price played no part whatsoever in their decision making.\textsuperscript{156}

Finding the \textit{Moskowitz} reasoning “far more persuasive than [the] application of the \textit{Zlotnick} exception [to the FOM presumption],”\textsuperscript{157} the Federal District Court for the Southern District of New York adopted this reasoning in \textit{In re Initial Public Offering Securities Litigation} and held that a short seller’s belief in market price overvaluation does not rebut the FOM presumption unless price played “no part whatsoever” in the short seller’s investment decision.\textsuperscript{158} Although the \textit{Moskowitz} court acknowledged the breadth of its holding, the court stated that “[i]f defendants believe that this [reasoning] stretches the concept of reliance beyond the intent of [10b-5], their course of attack is to overrule \textit{Basic}, not render its holding meaningless.”\textsuperscript{159} Such reasoning, however, would create a presumption that is de facto unrebuttable.\textsuperscript{160} Only trades made with knowledge of the fraud or based on factors completely unrelated to price would rebut the presumption:\textsuperscript{161}

\textit{[O]ther courts, mistakenly assum[e] that only knowledge of non-public information or reliance on factors wholly extraneous to the market (e.g., astrology) would defeat the presumption .... Yet, fraud on the market would create a presumption that is unrebuttable de facto if that were the case. It was never the theory, it was not the standard set by the Supreme Court, and, nevertheless, it constitutes the unreviewed law ... across an increasing number of class certification decisions.}\textsuperscript{162}

Limiting a defendant’s ability to rebut the FOM presumption to only those two situations ignores the fact that the FOM presump-

\textsuperscript{156} Id.
\textsuperscript{157} In re Initial Pub. Offering Sec. Litig., 227 F.R.D. 65, 109 (S.D.N.Y. 2004). The exception that the court refers to is that short sellers should not benefit from the FOM presumption. See id.
\textsuperscript{158} Id. (quoting Moskowitz, 128 F.R.D. at 631).
\textsuperscript{159} Moskowitz, 128 F.R.D. at 631.
\textsuperscript{160} Dougherty, supra note 41, at 23.
\textsuperscript{161} Id.
\textsuperscript{162} Id. (footnote omitted).
tion can be rebutted if the plaintiff did not rely on the integrity of the market price when deciding to engage in the securities transaction. The Moskowitz reasoning focuses only on whether the plaintiff would have traded at the fraudulently affected price, which would automatically be the case if the FOM presumption's predicate facts exist.

Such a focus not only allows plaintiffs to benefit from the presumption in illogical situations but also results in Rule 10b-5 acting as a scheme of investor's insurance. As noted in Part II.B, under certain factual scenarios, a short seller would have entered into a short sell transaction despite knowing of the fraud because an opportunity to profit would still exist. In such instances, however, the Moskowitz reasoning would not allow a defendant to rebut the presumption because a short seller's belief in overvaluation indeed requires price to play a part in the short seller's investment decision. Applying the FOM presumption to these illogical situations allows Rule 10b-5 to become tantamount to a scheme of investor's insurance. For example, consider the situation in which a defendant's misrepresentation deflates the security price and the short seller would have traded anyway—despite knowledge of the fraudulent misrepresentation—because an opportunity to profit still existed. Once the fraud is disclosed and the stock price rises, the short seller could escape relatively unscathed from what the short seller later concluded, for reasons unrelated to the fraud, to be an ill-conceived short sale. The short seller would take advantage of the fraud by covering and then suing under Rule 10b-5, claiming reliance on the integrity of the market price by stating that, but for the fraud, he would have traded at a price untainted by fraud. A short seller can thus roll his dice in a game that the short seller believes to have a high potential payout while allowing Rule 10b-5 to pay the short seller money if the potential payout goes

163. For examples of when an investor would not rely on the integrity of the market price when deciding to engage in a securities transaction, see supra Part II.B.1.a.
164. See supra Part II.B.
165. See supra notes 104-06 and accompanying text.
166. See supra Part II.B and infra Part IV for situations in which a short seller would still have engaged in a securities transaction at a fraudulently affected price level even if aware of the fraud.
unrealized for a reason unrelated to the fraud, such as the short seller's ill-conceived overvaluation analysis.

Perhaps aware of the possibility of this perverse outcome, the Supreme Court in Basic held that "[a]ny showing that severs the link between the alleged misrepresentation and ... [the plaintiff's] decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." 167 Although the Supreme Court gave examples of how the presumption could be rebutted, courts have mistakenly treated these examples as exhaustive. 168 Courts should not ignore the fact that an investor's belief in overvaluation or undervaluation could result in the FOM presumption of reliance being rebutted in certain factual scenarios. As discussed in Part IV, allowing a defendant to rebut the presumption of reliance in such scenarios will not render Basic's holding meaningless, as the factual scenarios in which the FOM presumption should logically be rebutted are limited.

B. Courts Incorrectly Assume that Short Sellers Do Not Rely on the Integrity of the Market Price Because Disclosure of the Fraud Would in Some Cases Achieve the Short Sellers' Investment Goals

Attempts to apply the FOM presumption to short sellers, the federal district court in Ganesh v. Computer Learning Centers, Inc. noted that the "logic of the fraud on the market theory is that a 'stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock.'" 169 The court held that because "gambling on a predicted loss is precisely what a short-seller seeks to do," a short seller cannot "logically use a fraud on the market theory to obviate the need for positive proof of individual reliance." 170 Implicitly, the court reasoned that a short seller does not rely on the integrity of the market price when selling short at a fraudulently inflated price because the short seller is indifferent to such a price. 171 If the security price is artificially inflated, the

168. Dougherty, supra note 41, at 23.
170. Id. at 491 (citing Zlotnick v. TIE Commc'ns, 836 F.2d 818, 823-24 (3d Cir. 1988)).
171. See id.
fraud's disclosure will cause the price to decline, which is exactly what the short seller hopes will happen. For this reason, the Ganesh court, citing Zlotnick, reasoned that it could not "presume that a short-seller who discounted the market price at the time of his short sale later reversed his strategy and relied on the market price when the time to [purchase the security back and return it to the lender] arrived." Imputing a short seller's reliance on the integrity of the market price from the short sale transaction to the covering transaction will be argued against in Part III.C, but for now, ignore this fact and simply consider the Ganesh court's logic.

The Ganesh court's logic simply asks whether the fraud's disclosure would be aligned with the short seller's reason for entering into the transaction. If so, the short seller should not benefit from the FOM presumption. For example, if the short seller covered at a fraudulently inflated price, the fraud's disclosure would work against the short seller's reason for entering into the covering transaction. If aware of the fraud, the short seller presumably would not have covered, would have waited for the stock price to decline upon the fraud's disclosure, and consequently either would have reduced his losses or reaped the profits resulting from the security price's decline. After applying this logic to all potential factual scenarios that could give rise to Rule 10b-5 claims in which the fraud's effect remained constant between the fraud's perpetration and disclosure, one realizes that a short seller would only benefit from the FOM presumption when the plaintiff incurred damages attributable to the fraud. The Ganesh court's logic thus inappropriately conflates the reliance and damage element in Rule 10b-5 cases in which the fraud's effect on the market price remained constant. An investor, however, may indeed incur damages without relying on the integrity of the market price in such scenarios.

172. See STALEY, supra note 8, at 4.
174. See id.
175. For the factual scenarios that could give rise to a Rule 10b-5 claim, see infra Part IV. For an explanation on when a fraud's effect on the market price would not remain constant due to market forces acting on the fraud, see Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344-46 & nn.6-7 (9th Cir. 1976) (Sneed, J., concurring).
C. Courts Inappropriately Apply a Per Se Rule Against Short Sellers No Matter the Factual Situation Supporting the Claim

As cited in Ganesh,176 the Zlotnick court held that because Zlotnick did not rely on the integrity of the market price when selling short, the court could not presume that Zlotnick had a fundamental change in investment strategy when deciding to cover.177 This per se rule not only ignores the relevant transaction in securities fraud cases, but also ignores that a change in investment strategy often provides the rationale for purchasing or divesting securities.178

The following factual sequence gave rise to Zlotnick's claim: short sale; fraud that artificially inflated the security's price; covering transaction; disclosure.179 In all securities fraud cases, the only relevant transactions are the ones occurring between the fraud and its disclosure,180 which in Zlotnick's case was only the covering transaction. All other transactions cannot be said to have been caused by the fraud and thus fall outside the scope of the plaintiff's fraud claim.181 To determine if Zlotnick relied on the integrity of the market price, the court should not have focused on Zlotnick's short sale but rather on his covering transaction. Although a court could arguably use an investor's initial transaction as evidence of whether the plaintiff likely relied on the integrity of the market price when undertaking the relevant transaction—if different from the initial transaction—a per se rule should not be applied whereby the investor's reliance (or lack thereof) on the integrity of the market price in the initial transaction determines whether an investor relied in the relevant transaction. If courts apply a per se rule, they would ignore the fact that investors undergo fundamental shifts in investment strategy when divesting their securities holdings. Indeed, a fundamental change in one's investment strategy often provides the rationale for divesting oneself of their securities

177. *Zlotnick* v. TIE Comm'n's, 836 F.2d 818, 823 (3d Cir. 1988).
178. See *GRAHAM & DODD*, supra note 1, at 22.
179. *Zlotnick*, 836 F.2d at 819.
180. See *Basic Inc. v. Levinson*, 485 U.S. 224, 248 n.27 (1988) (noting that for a FOM case the threshold fact "that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed" must be met).
181. See *id.*
After undertaking a valuation analysis, a short seller may believe that the current market price grossly overvalues the security, and thus sells short. After the fraud artificially inflates the security’s price, the short seller may deem his analysis ill conceived and cut his losses by covering. When covering, the short seller has changed his investment strategy by concluding that the current market price no longer overvalues the security, for if the short seller still believed the security to be overvalued, he would have maintained his position rather than covering. The short seller should therefore benefit from the FOM presumption in this factual scenario because “but for” the fraud the short seller would not have decided to enter into the covering transaction at a fraudulently tainted price.\(^1\)

A per se rule should also not be applied to factual scenarios in which both the short sale and covering transaction occur between the fraud’s perpetration and disclosure. In these scenarios, both the short sale and covering transaction are theoretically relevant, unless the class action is defined to include only purchasers or sellers.\(^2\) A short seller could theoretically rely on the integrity of the market price when engaging in the covering transaction but not when engaging in the short sale, and vice versa. Although both transactions are theoretically relevant, Part IV.C argues that only the second transaction, the covering transaction, is relevant for determining whether the short seller relied on the integrity of the market price in this factual scenario. As such, imputing a short

182. See GRAHAM & DODD, supra note 1, at 22.

Undervaluations caused by neglect or prejudice may persist for an inconveniently long time, and the same applies to inflated prices caused by overenthusiasm or artificial stimulants. The particular danger to the analyst is that, because of such delay, new determining factors may supervene before the market price adjusts itself to the value as he found it. In other words, by the time the price finally does reflect the value, this value may have changed considerably and the facts and reasoning on which his decision was based may no longer be applicable.

Id.

183. By covering at the fraudulently affected price, the short seller also trades at the fraudulently affected price. The “deciding” versus “trading” paradox noted in Part II.B does not arise and therefore the FOM presumption should not be rebutted in this scenario.

184. For an example of a class consisting of only purchases and thus short sellers who covered between the fraud’s perpetration and disclosure, see Ganesh, L.L.C. v. Computer Learning Ctrs., Inc., 183 F.R.D. 487, 488 (E.D. Va. 1998).
seller’s reliance on the integrity of the market price from the short sale transaction to the covering transaction would be inappropriate.

IV. WHEN SHORT SELLERS SHOULD BENEFIT FROM THE FRAUD-ON-THE-MARKET PRESUMPTION OF RELIANCE

As discussed in Part II.A, short sellers should be entitled to the FOM presumption of reliance despite their belief in the fundamental inefficiency of financial markets, which leads short sellers to believe in market price overvaluation. Such a belief, however, enables a defendant to successfully rebut the FOM presumption in certain factual scenarios. This Part presents a matrix of factual scenarios that give rise to securities fraud cases and details whether a short seller’s belief in overvaluation will enable a defendant to rebut the FOM presumption of reliance.\textsuperscript{185} Additionally, the short seller’s counterpart—an investor who purchases with the belief that a security is undervalued—will be considered. Interestingly, courts have also reached divergent holdings as to whether a long investor, who believes in market price undervaluation, should benefit from the FOM presumption or from similar theories extant before the Supreme Court’s adoption of the FOM presumption in \textit{Basic}.\textsuperscript{186} Typically, these cases involve an investment strategy known as “averaging down.”\textsuperscript{187} If a stock’s price declines after an investor’s initial investment, this strategy requires the investor to continue purchasing additional shares of the stock at the lower

\textsuperscript{185} For purposes of this Part, two assumptions are made. First, a short seller and a long investor are both assumed to have considered the security’s market price when deciding whether to engage in an investing or divesting transaction. Both therefore meet the prerequisite to relying on the integrity of the market price. Second, both types of investors are assumed to have no actual knowledge of the fraud.

\textsuperscript{186} \textit{Compare} Malone v. Microdyne Corp., 148 F.R.D. 153, 159 (E.D. Va. 1993) (holding in a class certification that individual issues of reliance would not predominate over common issues because although the class comprised long investors who believed the security price to be undervalued, this did not prevent them from benefiting from the FOM presumption), \textit{with} Lewis v. Johnson, 92 F.R.D. 758, 760 (E.D.N.Y. 1981) (holding that a class representative’s claim was atypical of absent class members’ claims because the investor’s “averaging down” theory suggested that the class representative, unlike the rest of the class, did not rely on the integrity of the market). \textit{See also In re} Bally Mfg. Sec. Corp. Litig., 141 F.R.D. 262, 268-69 & n.6 (N.D. Ill. 1992) (holding that the fact that certain named plaintiffs had engaged in “averaging down” did not undermine the typicality requirement of class certification).

\textsuperscript{187} Malone, 148 F.R.D. at 158.
price to reduce the average price per share of the investor's total investment.\textsuperscript{188} Presumably, the investor purchases the additional shares because of a belief in market price undervaluation.\textsuperscript{189}

Even if courts correctly realize that a defendant could rebut the FOM presumption by showing an investor's belief in market price overvaluation or undervaluation, such a holding will not render \textit{Basic} meaningless because the factual scenarios in which the FOM presumption should logically be rebutted are limited. In these factual scenarios, however, the possibility of rebuttal may substantially impact class certification decisions, as it may render a class representative atypical or cause individual questions of reliance to predominate over common questions. Because most securities fraud cases settle prior to trial,\textsuperscript{190} whether an investor's belief in overvaluation or undervaluation will enable the defendant to rebut the FOM presumption could have a substantial impact on settlement values.

\textbf{A. The Factual Scenario in Which the Fraud Inflates or Deflates the Security's Price Before the Investing Transaction and Disclosure Occurs Before the Divesting Transaction}

In cases in which a fraudulent misrepresentation or omission deflates a security's price prior to the investing transaction, a defendant who can show the short seller's belief in market price overvaluation will rebut the FOM presumption. A long investor, on the other hand, would incur no damages and would not be included in a lawsuit arising from these facts. The following factual sequence gives rise to this scenario: the defendant perpetrates a fraud that deflates the security price; an investor engages in a short sale or buy transaction; the fraud is disclosed; the investor engages in a covering or sell transaction. The short sale—or in the case of a long investor, the purchase transaction—are the only relevant transactions because these transactions occur between the fraud's perpetration and its disclosure. Moreover, whether the security's price fluctuates due to market forces acting on the fraud and whether the

\textsuperscript{188} Id.
\textsuperscript{189} Id.
\textsuperscript{190} Buckberg et al., supra note 16, at 304-07.
short seller would rely on the integrity of the market price because of this possibility do not matter.\textsuperscript{191}

Under this factual scenario, a long investor incurs no damages attributable to the fraud because the long investor does not sell until after the fraud's disclosure increases the security's price. In contrast, a short seller—who believes the security to be overvalued when selling short—incurs damages when the fraud's disclosure increases the security's price. As discussed above, a paradox results whereby a court could logically conclude that a short seller simultaneously relies and does not rely on the integrity of the market price.\textsuperscript{192} In accord with Federal Rule of Evidence 301, the occurrence of these competing conclusions creates a jury issue, which "bursts" the FOM presumption.\textsuperscript{193} The short seller must then prove actual reliance either on the defendant who had a duty to disclose or on the defendant's misrepresentation.\textsuperscript{194}

In cases in which a fraudulent misrepresentation or omission seeks to inflate a security's price prior to the investing transaction, a defendant who can show a long investor's belief in market price undervaluation will rebut the FOM presumption of reliance. A short seller, on the other hand, will incur no damages. This scenario simply presents the reverse of the factual scenario directly above in which the fraud deflated the security's price. Like the long investor above, a short seller suffers no damages attributable to the fraud because the fraud's disclosure decreases the stock price, thereby benefiting the short seller when covering. A long investor, however, suffers damages, but should not benefit from the FOM presumption because the presumption is rebutted for the same reasons cited in Part II.B for why the presumption is rebutted in the case of short sellers.

\textsuperscript{191} See infra Part IV.D.
\textsuperscript{192} See supra Part II.B.1.a-b.
\textsuperscript{193} See supra Part II.B.2.
\textsuperscript{194} As noted in Zlotnick, an investor can prove actual, albeit indirect, reliance on the defendant's misrepresentation or omission by making use of the efficient market hypothesis. See Zlotnick v. TIE Commc'n s, 836 F.2d 818, 824 (1988). Specifically, a plaintiff could still claim actual reliance on the integrity of the market price that incorporated the fraudulent misrepresentation or omission; the plaintiff investor, however, would not be entitled to a presumption of reliance. E.g., id.; Rocker Mgmt., L.L.C. v. Lernout & Hauspie Speech Prods. N.V., No. Civ. A. 00-5965 (JCL), slip op. at 7-8 (D. N.J. June 7, 2005).
Is the FOM Presumption Rebutted in Cases in Which the Fraud Is Perpetrated Before the Investing Transaction and Disclosure Is Made Before the Divesting Transaction?

<table>
<thead>
<tr>
<th>Scenario: (1) Fraud that Inflates or Deflates the Security Price, (2) Short Sale or Buy Transaction, (3) Disclosure of the Fraud, (4) Covering or Sell Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of Investor</td>
</tr>
<tr>
<td>Long Investor (believed security price to be under-valued)</td>
</tr>
<tr>
<td>Short Seller (believed security price to be over-valued)</td>
</tr>
</tbody>
</table>

B. The Factual Scenario in Which the Fraud Inflates or Deflates the Security's Price After the Investing Transaction and Disclosure Occurs After the Divesting Transaction

In cases in which the fraudulent misrepresentation or omission occurs after the investing transaction, the relevant transaction for the short seller becomes the covering transaction and for the long investor, the sell transaction. The following factual sequence gives rise to this scenario: an investor engages in a short sale or buy transaction; the defendant perpetrates a fraud that inflates or deflates the security price; the investor engages in a covering or sell transaction; the fraud is disclosed. Because the investing transaction occurs before the fraud's disclosure, the fact that the fraud's effect may fluctuate due to market forces is relevant in that it may cause the investor to cover or sell, but is irrelevant for determining whether an investor relied on the integrity of the

195. See Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344-46 (9th Cir. 1976) (Sneed, J., concurring).
market price when covering or selling. When covering or selling, the investor is only concerned about whether the current market price incorporates undisclosed fraud, and not whether the fraud's effect on the price may increase or decrease in the future.

In cases in which the fraud inflates the security's price after the investing transaction, the long investor has no damages because he divests himself of his shares either at a higher price than that at which he bought or at a lower price not attributable to the fraud. As to the short seller who has damages attributable to the fraud, a defendant should not be able to rebut the FOM presumption. Regardless of whether the short seller relied on the integrity of the market price when deciding to sell short, the short seller relies on the integrity of the market price when covering—the only relevant transaction. The short seller relies on the integrity of the market price when covering because, by covering, the short seller abandons his investment strategy, thereby admitting that the security is not overvalued and that his investment strategy was ill conceived. If the short seller still believed the security to be overvalued, the short seller would have continued to hold the investment, waiting patiently for his prognostication to come true. Because the short seller no longer believes the stock price to be overvalued, the paradox described in Part II.B does not arise. Employing the "but for" test, the short seller would not have engaged in the covering transaction because if aware of the fraud, the short seller would have presumably held his position, waited for the fraud's disclosure to decrease the security's price, and ultimately profited or reduced his loss. Thus, in this factual scenario, the FOM presumption should not be rebutted as to a short seller unless the short seller did not consider price at all or actually knew of the defendant's fraud.

In the converse situation in which the fraud deflates the security's price, the positions of the short seller and long investor are reversed. The short seller does not incur any damages because the short seller covers at a lower price than which he sold, thereby securing a profit. Because the long investor no longer believes the security to be undervalued when selling the security, a defendant should not be able to rebut the FOM presumption for the reasons discussed above in regard to a short seller. For the long investor, a

defendant should only be able to rebut the FOM presumption if the investor did not consider price at all or actually knew of the defendant's fraud.

Admittedly, a short seller or a long investor may have respectively covered or sold without abandoning his position that the market price was overvalued or undervalued. For example, an investor may have abandoned his position for a reason unrelated to his valuation analysis. However, this does not change the analysis. To determine if an investor relies on the integrity of the market price, the relevant inquiry is to look at the motivating factor behind the transaction relevant to the securities fraud claim. Because the valuation analysis no longer drove the investor to engage in the transaction, a separate rebuttal analysis would need to be conducted to determine if the investor's motivating factor required the investor to rely on the integrity of the market price. The rebuttal analysis outlined here, which is applicable to investors who were motivated to buy or sell by a belief in market price overvaluation or undervaluation, would be inapplicable.

| Scenario: (1) Short Sale or Buy Transaction, (2) Fraud that Inflates or Deflates the Security Price, (3) Covering or Sell Transaction, (4) Disclosure of the Fraud |
|-------------------------------------------------|-------------------------------------------------|-------------------------------------------------|
| Type of Investor | Misrepresentation or Omission that Artificially Inflates the Security Price | Misrepresentation or Omission that Artificially Deflates the Security Price |
| Long Investor (believed security price to be undervalued) | NO DAMAGES | NO |
| Short Seller (believed security price to be overvalued) | NO | NO DAMAGES |
C. The Factual Scenario in Which Both the Investing and Divesting Transactions Occur Between the Fraud's Perpetration and Disclosure

A short seller or long investor who engaged in both the buy and sell transactions between the fraud's perpetration and disclosure would have incurred damages only if the fraud's effect fluctuated due to market forces acting on the fraud. If the fraud's effect remained constant, "class member purchasers [or short sellers] who sold [or covered] before disclosure [would] have recovered from the open market the 'cost' of the misrepresentations [or omissions]." If the fraud's effect on the market price may fluctuate if the fraud is of the type that is susceptible to market forces.

To illustrate, a false representation that the corporation has discovered oil will increase in value if the price of oil goes up subsequent to the misrepresentation. Expressed in terms of [the fraudulently affected price] and [the stock's true price], the spread between the [prices] increases .... A decline in the price of oil, on the other hand, will reduce the value of the misrepresentation and cause the [stock's true price and fraudulently inflated price] to converge.

The following factual sequence gives rise to scenarios in which an investor could be damaged by market forces acting on the fraud incorporated into a security's price: the defendant perpetrates a fraud that inflates or deflates the security price; an investor engages in a short sale or buy transaction; the investor engages in a covering or sell transaction; the fraud is disclosed. Because market forces can both inflate or deflate the fraud's effect on the market price, both the long investor and short seller could suffer damages resulting from the fraud, regardless of whether the fraud initially sought to inflate or deflate the security's price.

Two relevant transactions exist under this scenario because both the buy and sell transactions take place between the fraud's perpetration and disclosure. The plaintiff need not have relied on

197. See Green, 541 F.2d at 1344-46 & nn.6-7.
198. Id. at 1345.
199. Id.
the integrity of the market price in both transactions but only in the second or divesting transaction. If, after the investing transaction, the fraud's effect fluctuated because of market forces, the change in the security's value can be understood as a new fraud being perpetrated on the market. For example, consider the following scenario: the defendant perpetrates a fraud that initially inflates a security's price; a long investor buys the security; market forces diminish the fraud's effect; the long investor sells; the fraud is disclosed. If all else remains constant, the long investor suffers a loss from the fraud's effect, which, because of market forces, has decreased the security's value. Although the fraud initially sought to inflate the price, this scenario is largely analogous to the factual scenario in Part IV.B: investing transaction; fraud that deflates the security price; divesting transaction; disclosure of the fraud. The only difference between the factual scenario in Part IV.B and this scenario, however, is that both types of investors can potentially incur damages regardless of whether the fraud initially sought to inflate or deflate the security's price. Note, however, that this analysis only applies if the proposed class action consists of both purchasers and sellers.
TABLE 3

Is the FOM Presumption Rebutted in Cases in Which Both the Investing and Divesting Transactions Occur Between the Fraud’s Perpetration and Disclosure? (Assumes Fraud’s Effect on the Market Price Does Not Remain Constant)

Scenario: (1) Fraud that Inflates or Deflates the Security Price, (2) Short Sale or Buy Transaction, (3) Covering or Sell Transaction, (4) Disclosure of the Fraud

<table>
<thead>
<tr>
<th>Type of Investor</th>
<th>Misrepresentation or Omission that Artificially Inflates the Security Price</th>
<th>Misrepresentation or Omission that Artificially Deflates the Security Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long Investor (believed security price to be under-valued)</td>
<td>No damages if fraud’s effect further inflates security price. No, if fraud’s effect dissipates.</td>
<td>No, if fraud’s effect further deflates security price. No damages if fraud’s effect dissipates.</td>
</tr>
<tr>
<td>Short Seller (believed security price to be over-valued)</td>
<td>No, if fraud’s effect further inflates security price. No damages if fraud’s effect dissipates.</td>
<td>No damages if fraud’s effect further deflates security price. No, if fraud’s effect dissipates.</td>
</tr>
</tbody>
</table>

D. The Factual Scenario in Which the Class Action Includes Only Purchasers or Sellers

If a proposed class is defined as only purchasers or sellers, the class could include investors who made their investing or divesting transaction, or both, between the fraud’s perpetration and disclosure. For example, a class defined as only purchasers would include long investors who bought, short sellers who covered, or both long investors and short sellers who both bought and sold between the fraud’s perpetration and disclosure. Because of the limitation on the class definition, the inquiry into whether an investor relied on the

integrity of the market price must focus on the transaction that entitles the investor to be included in the class. For investors only engaging in either their investing or divesting transaction, the analysis in Parts IV.A-B would govern whether a defendant could rebut the FOM presumption by showing an investor's belief in market price overvaluation or undervaluation.

For investors—who both bought and sold between the fraud's perpetration and disclosure—the analysis in Part IV.C needs to be modified if the class definition includes only purchasers or sellers. As argued in Part IV.C, an investor who bought and sold between the fraud's perpetration and disclosure need only to rely on the integrity of the market price when deciding to engage in one of the transactions because both transactions are relevant to the fraud claim. Because an investor relies on the integrity of the market price when engaging in a divesting transaction, a defendant cannot rebut the FOM presumption in the factual scenario outlined in Part IV.C. As argued in Part IV.B, when an investor engages in a divesting transaction, he no longer logically believes the market price to be overvalued or undervalued. However, if a class includes only an investor's investing transaction, namely the long investor's buy transaction or the short seller's short sale, that transaction needs to be analyzed without regard to the divesting transaction.

In the factual scenario in which the fraud's effect remains constant, the long investor who buys and the short seller who sells short after the fraud's perpetration incur no damages because they will have engaged in their respective divesting transactions before the fraud's disclosure. If the fraud's effect fluctuates however, these investors could incur damages. For example, if a short seller sells short at a fraudulently inflated price, that price could further increase because of market forces operating on the fraud incorporated in the price. A short seller may then be forced to cover at a higher price, thereby suffering a loss attributable to the fraud. Note that if the fraud's effect dissipated, that is, if the fraud's inflation effect on the market price declined, the short seller would not incur a loss attributable to the fraud when he covered. Because a short seller does not know whether the fraud's effect would dissipate to his benefit or would hurt him by being further augmented by market forces, the short seller arguably relies on the integrity of the market price to reflect truthful information. On the other hand, the
risk that the security’s price would further increase is offset by the equal possibility that the fraud’s effect on the market price would dissipate, thereby benefiting the short seller. Because the upside and downside potentials are equal, a short seller arguably is indifferent to whether the market price incorporates fraud, and therefore does not rely on the integrity of the market price to guard against a loss resulting from market forces acting on the fraud.

Assuming, arguendo, that the short seller is not indifferent to any possible fluctuation of the fraud’s effect and therefore relies on the integrity of the market price to reflect truthful information, a defendant can defeat this conclusion by making a “showing” that the short seller believed in market price overvaluation. For example, suppose a short seller believes a security’s “correct” price should be $10 and that the security price of $20 is fraudulently inflated by $5. If the short seller knew of the fraud, the short seller would still have decided to engage in the transaction because an opportunity to profit would still exist. Because the security’s price absent the fraud would be $15, the short seller would still have considered the security overvalued by $5 and thus would logically still have decided to engage in the short sale at the fraudulently affected price level. Admittedly, the opportunity to profit would be a risky one given the risk that the fraud’s effect could further increase the price. One cannot logically conclude, however, that “but for” the fraud the short seller would not have decided to enter into the transaction at the fraudulently inflated price. Again, “[a]ny showing [by the defendant] that severs the link between the alleged misrepresentation and ... [the plaintiff’s] decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.”

A short seller’s belief in market price overvaluation would thus allow a defendant to “show” that the short seller did not rely on the integrity of the market price when deciding to engage in his short sale. The “deciding” versus “trading” paradox arises and pursuant to Federal Rule of Evidence 301, the FOM presumption should “burst” as argued in Part II.B, notwithstanding that the short seller may have relied on the integrity of the market price to reflect truthful information because he wanted to protect against a loss.

resulting from any fluctuation of the fraud's effect. The short seller, however, would still be entitled to prove actual reliance on either the defendant who had a duty to disclose or on the defendant's misrepresentations.  

202. See supra note 194.

### Table 4

<table>
<thead>
<tr>
<th>Scenario: (1) Fraud that Inflates or Deflates the Security Price, (2) Short Sale or Buy Transaction OR Covering or Sell Transaction, (3) Disclosure of the Fraud</th>
<th>Misrepresentation or Omission that Artificially Inflates Security Price</th>
<th>Misrepresentation or Omission that Artificially Deflates Security Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of Investor</td>
<td>Only Purchasers</td>
<td>Only Sellers</td>
</tr>
<tr>
<td>Long Investor (believed security price is undervalued)</td>
<td>YES</td>
<td>NO DAMAGES</td>
</tr>
<tr>
<td>Short Seller (believed security price is overvalued)</td>
<td>NO</td>
<td>NO DAMAGES</td>
</tr>
</tbody>
</table>
**Table 5**

<table>
<thead>
<tr>
<th>Type of Investor</th>
<th>Misrepresentation or Omission that Artificially Inflates Security Price</th>
<th>Misrepresentation or Omission that Artificially Deflates Security Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class Definition</td>
<td>Only Purchasers</td>
<td>Only Sellers</td>
</tr>
<tr>
<td>Long Investor (believed security price is undervalued)</td>
<td>If damages, YES</td>
<td>If damages, NO</td>
</tr>
<tr>
<td>Short Seller (believed security price is overvalued)</td>
<td>If damages, NO</td>
<td>If damages, YES</td>
</tr>
</tbody>
</table>

*Note that if the fraud's effect on the market price remains constant, an investor incurs no damages. Moreover, if the fraud's effect fluctuates in a direction that benefits the investor, then the investor will incur no damages attributable to the fraud when he divests before the fraud's disclosure.

**E. The Factual Scenario in Which a Short Seller Does Not Believe that a Security's Market Price Is Overvalued**

A short seller may not always sell short because of a belief that a security is overvalued. For example, a short seller may sell short to hedge against a decline in another market position or to merely speculate on a price decline without undertaking any sort of valuation analysis. The analysis undertaken in Parts IV.A-D

203. See, e.g., *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 296 (S.D.N.Y. 2003) (noting that short sellers sold WorldCom stock short because they were betting that WorldCom would default on its bond obligations).

204. STALEY, *supra* note 8, at 4.
applies only when the short seller believes the security to be overvalued or, conversely, when a long investor believes the security to be undervalued. It does not create per se rules for all short sellers, but rather only for those who sell short because of a belief in market price overvaluation.

A FOM analysis distinct from that described above should be employed in those cases in which the short seller merely speculates on a price decline or undertakes a short sale for hedging purposes without a belief in overvaluation. As discussed in Part II.B, such an analysis should focus on whether the FOM presumption is rebutted because the short seller either actually knew of the defendant's fraudulent misrepresentation, did not take price into consideration at all, or did not rely on the integrity of the market price.

CONCLUSION

A substantial split exists among federal district courts regarding whether short sellers can benefit from the FOM presumption to prove the reliance element in Rule 10b-5 securities fraud cases. Because the issue largely arises in pretrial class certification decisions, these decisions, although important in determining settlement values, are not reviewed at the trial and appellate levels because of the high settlement and dismissal rates for securities fraud class actions. Indeed, only the Third Circuit in Zlotnick v. TIE Communications has considered whether a short seller should benefit from the presumption. Depending on how the decision is interpreted, the Third Circuit either held that a short seller is not entitled to the FOM presumption at all, or that if entitled to the presumption, a defendant could rebut the presumption by showing that the short seller believed in market price overvaluation.

The confusion regarding whether a short seller can benefit from the FOM presumption results because of the difficulty of applying the presumption to an investor who believes that security prices are overvalued, a belief in fundamental inefficiency. In applying the FOM presumption to short sellers, a paradox results in certain

205. See, e.g., Argent Classic Convertible Arbitrage Fund v. Rite Aid Corp., 315 F. Supp. 2d 666, 676 (E.D. Pa. 2004) (holding that because short sellers sold short for hedging purposes and not because of a belief in overvaluation, the FOM presumption was not rebutted).
factual scenarios, whereby courts could logically conclude that short sellers simultaneously do and do not rely on the integrity of the market price. This raises a novel question as yet unaddressed by any court: whether transaction causation in FOM cases is met if a plaintiff does not rely on the integrity of the market price when deciding to enter into a securities transaction but does rely on the integrity of the market price when trading, so as not to suffer a loss or a reduction in profits. Although strong policy considerations exist on both sides for concluding that a short seller does or does not rely on the integrity of the market price, a logical solution can be achieved if courts conclude that these competing conclusions create a jury question regarding whether a short seller relied on the integrity of the market price. In accord with Federal Rule of Evidence 301, the existence of the jury question "bursts" the FOM presumption, thereby leaving the short seller to prove actual reliance on the defendant who had a duty to disclose or on the defendant's misrepresentations. Therefore, to the extent that Zlotnick held that a defendant who can show that a short seller's belief in overvaluation will rebut the FOM presumption, the Zlotnick holding is not entirely wrong. Rather, this holding should be limited to the factual scenarios in which the FOM presumption is logically rebutted by a short seller's belief in overvaluation.

Because courts have either attempted to fashion their own solution to the issue or unqualifiedly relied on Zlotnick, they have misapplied the FOM presumption to short sellers. Specifically, courts have (1) misunderstood the FOM's theoretical underpinnings, (2) ignored the presumption's capability of being rebutted, (3) incorrectly assumed that short sellers do not rely on the integrity of the market price because disclosure of the fraud would in some instances achieve the short seller's investment goals, or (4) inappropriately applied a per se rule against short sellers no matter the factual situation that gave rise to the securities fraud claim. In doing so, courts have incorrectly denied or granted short sellers the FOM presumption's benefit. A short seller's belief in market price overvaluation should not prevent the FOM presumption from arising but should only rebut it in some factual scenarios.

Although the Zlotnick holding is not entirely wrong depending on one's interpretation, the FOM presumption should only be rebutted when it would be illogical because of the short seller's belief in overvaluation to presume a short seller's reliance on the integrity
of the market price. When the defendant's fraudulent misrepresentation or omission deflates a security's price and the short seller sells short after the fraud's perpetration but before its disclosure, the FOM presumption should be rebutted. As a corollary, the FOM presumption should also be rebutted when a short seller's counterpart, a long investor who believes in market price undervaluation, purchases at an artificially inflated level and does not sell before the fraud's disclosure. Other than in these scenarios, the FOM presumption should also be rebutted in some instances in which both the buy and sell transactions occur between the fraud's perpetration and disclosure but the proposed class limits the relevant transaction to one or the other by including only purchasers or sellers. This can be remedied, however, by defining the class to include both purchasers and sellers. In sum, these limited factual scenarios in which the FOM presumption should be rebutted will not render Basic's holding meaningless, but will ensure that Rule 10b-5 is not used as a scheme of investor's insurance.

Douglas A. Smith*