THE TRUTH-ON-THE-MARKET
DEFENSE AND ITS RELEVANCE IN SEC
ENFORCEMENT ACTIONS

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I
INTRODUCTION

The efficient capital market hypothesis— a financial theory that posits that
security prices reflect all relevant information available to the market—first
found its way into Supreme Court jurisprudence in Basic Inc. v. Levinson. In
that case, the Court adopted a new framework within which to evaluate
securities-fraud claims. Subsequent cases recognized logical extensions of the
efficient market hypothesis in the context of securities fraud, including fraud-
on-the-market reliance and the truth-on-the-market defense against materiality.

Two recent district-court cases, however, indicate that the hypothesis itself and,
consequently, the legal theories based upon that hypothesis, are not well
understood: These courts rejected the use of the truth-on-the-market defense
based on logic inconsistent with the efficient market hypothesis.3

The securities antifraud provisions of the Securities Exchange Act have long
been recognized to authorize both official SEC enforcement as well as private
litigation. Although key elements of a successful cause of action under the
securities antifraud provisions—such as material misrepresentation, a
connection between the misrepresentation and the purchase or sale of a
security, and scienter—remain the same, the full requirements for SEC
enforcement actions and private suits differ in certain aspects. Notably,
although private litigants are required to demonstrate reliance, causation, and
injury, the SEC is not. This difference lies in the original basis and purposes of
private litigation versus SEC enforcement: Broad SEC authority is statutorily
granted by Congress to preserve the integrity of the capital markets, while

1. This is also referred to in this note as the “efficient market hypothesis.”
Reys, 712 F. Supp. 2d 1170 (W.D. Wash. 2010). In both cases, the parties reached joint settlement
agreements, and the defendants consented to entry of final judgments. (See, e.g., Final Judgment as to
Defendant Gary A. Reys, No. 09-cv-1262-RSM (W.D. Wash. Oct. 26, 2010), ECF No. 25; Final
487.)
private litigation emerged in a form similar to the common-law tort of misrepresentation and deceit. Therefore, the SEC enjoys the ability to seek remedies under its broad statutory authority that are unavailable to private litigants.4

In private suits, one way for defendants to rebut allegations of material misrepresentations in securities offerings is the truth-on-the-market defense. Grounded in the efficient capital market hypothesis,5 the truth-on-the-market defense essentially claims that, in light of corrective information credibly entering the market and being reflected in the price of a security, an alleged misstatement or omission is rendered immaterial and cannot mislead investors. Thus, a successful truth-on-the-market defense rebuts assertions of the materiality of the misstatement or omission in question—an element required of both SEC enforcement actions and private suits. However, the frequent use of this defense in fraud-on-the-market cases has perhaps clouded the grounding of the truth-on-the-market defense in the materiality inquiry. Such confusion is demonstrated by two recent district-court cases in the Ninth Circuit—SEC v. Reys6 and SEC v. Mozilo7—in which defendants were denied access to the truth-on-the-market defense based on imperfect understandings of its underlying basis. Although the truth-on-the-market defense has clearly been recognized by federal courts in private suits, it has rarely been asserted in SEC enforcement actions. Hence, it remains of questionable application in SEC enforcement actions.

In this note I consider the efficient market hypothesis as adopted by the Court and its application in the securities-fraud context, particularly through the development and application of the truth-on-the-market defense. Part II discusses the basic principles of the efficient market hypothesis. Part III then looks to section 10(b) of the Exchange Act and Rule 10b–5 and the basic elements required under these causes of action for securities fraud. Part IV continues with a discussion of the truth-on-the-market defense, while Part V considers the rationales of two recent Ninth Circuit cases foreclosing that defense in SEC actions. Part VI then considers whether any intrinsic difference between the SEC and private litigants warrants limitation of the truth-on-the-market defense to only private suits, ultimately finding no reasonable basis for such a limitation. Although in both SEC v. Reys and SEC v. Mozilo the court considered the truth-on-the-market defense as solely a defense to the reliance element of a private action pursuant to section 10(b) of the Exchange Act and Rule 10b–5, the truth-on-the-market defense also bears upon the materiality of the alleged misstatement. Because materiality remains an essential element to

5. Under the efficient capital market hypothesis, all relevant material known to the market is reflected in the security’s price, including both the original misstatement and its correction.
7. 2010 WL 3656068.
an SEC enforcement action, defendants in section 10(b) and Rule 10b–5 actions should be permitted to raise the truth-on-the-market defense in SEC enforcement actions as well as private actions.

II

THE EFFICIENT CAPITAL MARKET HYPOTHESIS

The efficient capital market hypothesis contains two basic premises: (1) a security’s price encapsulates all publicly available information about the firm, and (2) security prices “react almost instantaneously and in an unbiased manner to any new information.” The theory presupposes that the market in question is “efficient” or “well-developed.” Further, the source of public information does not matter for efficient markets: All public information that could affect securities’ prices will be digested by market participants and reflected in securities’ prices. In the legal context, however, the source of public information matters: The Supreme Court’s adoption of the efficient market theory insists upon dissemination of information by a credible source for correction of a misrepresentation.

Correct application of the efficient capital market hypothesis necessarily begins with a definition of an efficient market. Eugene Fama, whose scholarship strongly supported the wide acceptance of the efficient market hypothesis, defined an efficient market as “a market where there are large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants.” Unfortunately, this definition does not provide a specific baseline to evaluate whether a market is indeed efficient. Courts have considered many factors in determining whether a given security trades on an efficient market, including:

- the average weekly trading volume expressed as a percentage of total outstanding shares;
- the number of securities analysts following and reporting on the stock;

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10. Basic Inc. v. Levinson, 485 U.S. 224, 229 (1988). For further information, see discussion infra Part IV.

11. Eugene F. Fama, Random Walks in Stock Market Prices, in ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 156, 157 (Richard A. Posner & Kenneth E. Scott eds., 1980). This definition will be referenced throughout the remainder of this article. Although other definitions of an efficient market have been presented, these definitions are not useful, because they merely define the term in a circular fashion by stating that a market is efficient if prices fully reflect all public information. See, e.g., Asher v. Baxter Int’l, Inc., 377 F.3d 727, 731 (7th Cir. 2004) (“In an efficient capital market, all information known to the public affects the price”); William H. Beaver, The Nature of Mandated Disclosure, in ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION, supra, at 317, 328 (defining an efficient market as one where “with respect to some defined information . . . the security prices in that market ‘fully reflect’ that information” and “prices act as if everyone possessed that information and were able to interpret its implications for security prices” (emphasis in original)).
the extent to which market makers and arbitrageurs trade in the stock; (4) the company's eligibility to file SEC registration Form S-3 . . . ; (5) the existence of empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the market price; (6) the company's market capitalization; (7) the bid-ask spread for stock sales; and (8) float, the stock’s trading volume without counting insider-owned stock.

In accordance with the Supreme Court’s acceptance of the efficient market hypothesis in its jurisprudence, SEC rules explicitly endorse the efficient market hypothesis with respect to large issuers. In permitting short-form registration, the SEC stated its belief “that larger seasoned issuers attract a large market following and operate in an efficient market.” The agency noted that these issuers “are followed by sophisticated institutional and retail investors, members of the financial press, and numerous sell-side and buy-side analysts that actively seek new information on a continual basis.” Therefore, the SEC permits these issuers to issue securities under abbreviated registration Form S-3, fulfilling disclosure requirements through prior SEC filings.

The efficient capital market hypothesis is not without its critics, particularly in financial circles. However, such criticism has not altered either the courts’ or the SEC’s legal analysis.

12. Unger v. Amedisys Inc., 401 F.3d 316, 323 (5th Cir. 2005) (listing factors previously considered by other courts). The Fifth Circuit noted that this list was not exhaustive and further cautioned that courts should consider these factors “analytically, . . . as each of them represents a distinct facet of market efficiency” and that “not all cases will require all of these factors.” Id.


15. 17 C.F.R. § 239.13 (2013). Following rules promulgated in accordance with the Dodd-Frank Act, one of the following criteria must be met for an issuer to be eligible to file securities using Form S-3: (1) the aggregate market value of the voting and nonvoting common equity held by nonaffiliates of the registrant must be $75 million of more; (2) the issuer must have issued at least $1 billion in nonconvertible registered securities within the three years prior; (3) the issuer must have at least $750 million of nonconvertible registered securities outstanding; (4) the issuer must be a “wholly-owned subsidiary of a well-known seasoned issuer as defined in” 17 C.F.R. § 230.405 (2013); (5) the issuer must be a “majority-owned operating partnership of a real estate investment trust that qualifies as a well-known seasoned issuer”; or (5) the issuer must state both its “reasonable belief that it would have been eligible” to register the proposed securities under Form S-3 as existed before the new rules and the basis for its reasonable belief while also filing within three years of the effective date of the new regulations. 17 C.F.R. § 239.13(b)(1)–(2) (2013).

III

EXCHANGE ACT SECTION 10(B) AND RULE 10B–5 CAUSES OF ACTION

Exchange Act section 10(b), which is codified at 15 U.S.C. § 78j(b), states,

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.17

Pursuant to its authority under the Exchange Act, the SEC adopted Rule 10b–5, which corresponds to section 10(b) and is codified at 17 C.F.R. § 240.10b–5. Rule 10b–5 states,

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.18

It is well-settled that the Exchange Act and its corresponding rules permit both SEC enforcement action and private suits.19 However, the elements required for a private suit differ from those required for SEC enforcement actions.20 The basic elements of a private suit are: “(1) a material misrepresentation (or omission); (2) scienter . . . ; (3) a connection with the purchase or sale of a security; (4) reliance . . . ; (5) economic loss; [and] (6) loss causation.”21 The SEC, on the other hand, must demonstrate that the defendant “(1) made a misrepresentation or omission (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, and (5) by virtue of the requisite jurisdictional means.”22 Notably, unlike private litigants alleging

20. Note that the SEC may choose among several alternative remedies, including cease-and-desist orders and monetary penalties, which are unavailable to private litigants, due to its broader authority to protect investors. Regardless of the remedies sought, however, the SEC must demonstrate the same elements to establish a violation of section 10(b) of the Exchange Act and Rule 10b–5.
22. SEC v. Wolfson, 539 F. 3d 1249, 1256 (10th Cir. 2008) (quoting Geman v. SEC, 334 F. 3d 1183,
section 10(b) or Rule 10b–5 claims, the SEC need not demonstrate reliance or injury.\footnote{Id. Multiple circuit and district courts have announced similar exceptions. See also SEC v. Rana Research, Inc., 8 F.3d 1358, 1363–64 (9th Cir. 1993) (joining the Sixth and Second Circuits in holding the SEC is not required to prove reliance in its seeking injunctive relief based on violations of section 10(b) and Rule 10b–5); SEC v. Reys, 712 F. Supp. 2d 1170, 1173 (W.D. Wash. 2010) (requiring only that the SEC demonstrate misstatement or omission of material fact made with scienter); SEC v. Kearns, 691 F. Supp. 2d 601, 614 (D.N.J. 2010) (finding that, unlike private litigants, the SEC “need not prove either reliance or damages”); SEC v. Prater, 296 F. Supp. 2d 210, 215 (D. Conn. 2003) (holding the SEC is not required to either allege or prove investor reliance on misrepresentations).}

This difference is historically based. Originally, private actions and SEC enforcement actions served different purposes: SEC actions served “to deter securities fraud in order to promote society’s collective interest in the integrity and efficiency of the capital markets,” while private action aimed “to compensate defrauded investors for their discrete losses—much like a common law claim for misrepresentation and deceit.”\footnote{Rose, supra note 19, at 1310 (citing Kardon v. Nat’l Gypsum Co., 69 F.Supp. 512, 513 (E.D. Pa. 1946)); see also Dura Pharm., 544 U.S. at 341 (commenting that “[t]he courts have implied from these statutes and Rule [10b–5] a private damages action, which resembles, but is not identical to, common-law tort actions for deceit and misrepresentation.” (citations omitted)).} Thus, successful private suits naturally continue to require a direct causal link to a discrete injury suffered by the private investor. In contrast, the SEC’s authority stems from statutory recognition of the social benefits of well-ordered capital markets and the potential harm to society posed by threats to these markets’ integrity—such as misrepresentations—regardless of actual reliance or injury.

Because the truth-on-the-market defense to a 10b–5 claim was first recognized in the private-suit context, it may be helpful to discuss two key elements of a private cause of action: (1) the materiality of a misstatement or omission and (2) reliance on such misstatement or omission.

A. Materiality

In \textit{TSC Industries, Inc. v. Northway, Inc.}, the Supreme Court announced a new test for materiality known as the “total mix” standard, whereby a statement or omission was deemed material if “a substantial likelihood [exists] that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”\footnote{TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).} The total-mix standard is objective: “Investors are not entitled to all of the information they would like to have about a company,” and a particular investor’s specific preferences do not establish materiality.\footnote{Sobol, supra note 9, at 89.} Rather, the inquiry focuses on a “reasonable investor” with knowledge of “information available in the public domain.”\footnote{Whirlpool Fin. Corp. v. GN Holdings, Inc., 67 F.3d 605, 610 (7th Cir. 1995).} The presumption that an investor has knowledge of public information is consistent with the efficient market
hypothesis, which states that a security’s price reflects all relevant material information. The *Basic* Court further clarified that, for “contingent” or “speculative” events, “materiality will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”  

Notwithstanding its acceptance of the efficient market hypothesis, the Court has emphasized that price movement alone is insufficient to establish or rebut materiality. The materiality inquiry is truly “fact-specific” and “depends on the significance the reasonable investor would place on the withheld or misrepresented information” in light of all information.

B. Reliance

To prevail on a 10b–5 claim, private plaintiffs must also demonstrate causation and injury resulting from the misstatement or omission in question. In *Basic*, the Supreme Court noted that “[r]eliance provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”

Citing Congress’s belief that information affects securities markets and empirical support for that belief, the Court concluded that class-action plaintiffs could establish 10b–5 violations through either direct reliance or its newly recognized “fraud-on-the-market” presumption of reliance.

In fraud-on-the-market pleadings, plaintiffs assert reliance only upon the traded prices of securities. Because “in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business,” misstatements impact a security’s price and therefore may “defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.” Thus, “[r]eliance may be presumed when a fraudulent misrepresentation or omission impairs the

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29. *Dura Pharm.*, 544 U.S. at 343 (“[A] lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. . . . Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will sometimes play a role in bringing about a future loss.” (emphasis in original)); see also *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) (finding that, at the summary-judgment stage of the litigation, the district court erred in deeming the misstatements immaterial based on lack of movement in the stock’s price following disclosure of corrective information).


31. Id. at 243 (citations omitted).

32. Id. at 245–46. Specifically, the Court noted that “[r]ecent empirical studies have tended to confirm Congress’ premise that the market price of shares traded on well-developed markets reflects all publicly available information, and hence any material misrepresentations. Id.

33. Id. at 241–42 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).
value of a security traded in an efficient market,“ although this presumption is rebuttable. However, this presumption of reliance is only reasonable if markets are indeed efficient.

Fraud-on-the-market reliance and the truth-on-the-market defense both find initial recognition in Basic. This simultaneous recognition may cloud the fact that these two doctrines impact different elements of securities-fraud claims. Confusion is further compounded by case law, because the truth-on-the-market doctrine has most commonly been asserted when private plaintiffs assert fraud-on-the-market reliance. This difference, however, is crucial to understanding the role the truth-in-the-market defense plays in securities-fraud suits, particularly in SEC enforcement actions where reliance need not be demonstrated.

IV
THE TRUTH-ON-THE-MARKET DEFENSE

Under the efficient market hypothesis adopted by the courts, a security’s price reflects the total mix of all material information that credibly enters the market. In asserting the judicially created truth-on-the-market defense, a defendant claims that, according to the efficient market hypothesis, even if a particular statement would have been misleading on its own, corrective information credibly entered the market to counteract any misleading effect. As such, the market is not misled. In other words, if a misrepresentation and its correction “are transmitted to the market with roughly equal intensity and credibility, the market will receive complete and accurate information” and the

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34. Malack v. BDO Seidman, LLP, 617 F.3d 743, 747 (3d Cir. 2010) (quoting Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 175 (3d Cir. 2001)); see also In re Apple Computer Sec. Litig., 886 F.2d 1109, 1113–14 (9th Cir. 1989) (noting plaintiff is presumed to have indirectly relied on the misstatement “by relying on the integrity of the stock price established by the market.”) The fraud-on-the-market presumption facilitates class-action suits by permitting reliance to be demonstrated on behalf of the entire class, rather than on an individual plaintiff basis: Requiring individual plaintiffs to demonstrate reliance would essentially prevent a class-action suit under Federal Rule of Civil Procedure 23, because individual issues would then predominate over common questions of law or fact. Basic, 485 U.S. 224, 242 (1988). See generally, James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 ARIZ. L. REV. 497 (1997) (providing further insight into the use of class-action suits in securities regulation).

35. Sobol, supra note 9, at 89.

36. Asher v. Baxter Int'l, Inc., 377 F.3d 727, 731–32 (7th Cir. 2004); see also Unger v. Amedisys Inc., 401 F.3d 316, 322 (5th Cir. 2005) (citing Basic, 485 U.S. at 248–49); Dennis, supra note 8, at 406 (“The doctrine of market reliance depends on a belief in the efficient market model.”). As discussed in part I, demonstrating that a market is efficient may prove problematic; however, the Fifth Circuit has noted that “[i]n many cases, where heavily-traded or well known stocks are the targets of suits, market efficiency will not even be an issue.” Unger, 401 F.3d at 322.

37. Basic, 485 U.S. at 247–49 (permitting reliance to be shown under a fraud-on-the-market theory and indicating, as examples, that a showing that “market makers’ were privy to the truth” or that “news . . . credibly entered the market and dissipated the effects of the misstatements” may break causation under that theory because no fraud was transmitted through the market price).

38. In re Stac Elecs. Sec. Litig., 89 F.3d 1399, 1409 (9th Cir. 1996) (citing Kaplan v. Rose, 49 F.3d 1363, 1376 (9th Cir. 1994)).
security’s price “will accurately reflect all relevant information,” including both the misrepresentation and the correction.\(^{39}\)

At first glance, the case law seems to suggest two possible bases for the truth-on-the-market defense, both stemming from the efficient market hypothesis. The first is that the defense rebuts the materiality of the misstatement or omission: Through the dissemination of corrective information, the misstatement or omission is rendered immaterial. The second is that the defense negates reliance: Credibly disseminated corrective information is reflected in the security’s price and, as such, the plaintiff cannot have relied on the misstatement or omission in purchasing the security. Closer investigation of the case law, however, indicates that the truth-on-the-market defense is properly grounded in the materiality inquiry, not the reliance inquiry.

As mentioned above, the truth-on-the-market defense finds its roots in Basic. In that case, the Court specifically noted that the case required application of the materiality requirement of section 10(b) of the Exchange Act and Rule 10b–5.\(^{40}\) Thus, the Court’s dicta in Basic opening the door to the truth-on-the-market defense suggests the defense rebuts the materiality element of a section 10(b) and Rule 10b–5 cause of action. Perhaps confusingly, however, the Court also stated that “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.”\(^{41}\) Thus, “if despite [the] allegedly fraudulent attempt to manipulate market price, new information . . . 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.”\(^{42}\) Although the Court’s phrasing may suggest the truth-on-the-market defense breaks causation, when considered in the context of the efficient market hypothesis, its statement is properly understood as being grounded in the materiality inquiry. Truth-on-the-market “severs the link between the alleged misrepresentation and . . . the price” because the market price reflects both the misstatement and the corrective information. In other words, credible corrective information renders the misstatement immaterial because the market has the full picture of that security and further disclosure will not affect the total mix of available information.

Several circuit-court decisions applying the efficient market hypothesis employ reasoning consistent with this understanding. Although not a section 10(b) and Rule 10b–5 case, the Seventh Circuit’s decision in Wielgos v. Commonwealth Edison Co. provides an example of reasoning consistent with the efficient market hypothesis. In that case, a private plaintiff alleged that Commonwealth Edison violated section 11 of the Securities Act of 1933 by

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39. In re Apple Computer, 886 F.2d at 1114.
40. Basic, 485 U.S. at 226 (emphasis added).
41. Id. at 248–49 (dicta).
42. Id.
fraudulently “underestimat[ing] the completion costs of [nuclear] reactors” because cost projections were inaccurate and internal cost estimates already exceeded the projections at the time the shares were issued.\(^{43}\) The Seventh Circuit held that a dated projection was not misleading in light of corrective information known to market professionals.\(^{44}\) Correctly analyzing the case under the efficient market hypothesis, the court found that “[k]nowledge abroad in the market moderated . . . likely eliminated, the potential of a dated projection to mislead.”\(^{45}\) The Seventh Circuit considered the corrective information to be a rebuttal to the \textit{materiality} of the projection and considered the substance of the alleged misstatement.\(^{46}\) Although the court later states, somewhat confusingly, that the case “may be decided . . . without regard to materiality,”\(^{47}\) that statement’s context does not suggest that corrective information fails to rebut materiality, but rather indicates the court’s belief that the corporation’s disclosures were not misleading and thus required no rebuttal.

In the same year, the Ninth Circuit, in \textit{In re Apple Computer Securities Litigation}, found that corrective information provided to the market through intense press scrutiny negated alleged misstatements.\(^{48}\) Private plaintiffs claimed fraud-on-the-market, alleging that defendants’ “unqualified optimism” regarding the prospects of its new computer, “Lisa,” and compatible disk-drive, “Twiggy,” was “false and misleading” and thereby defrauded investors in violation of section 10(b) of the Exchange Act and Rule 10b–5.\(^{49}\)

The Ninth Circuit first distinguished between assertions of actual reliance and fraud-on-the-market reliance. Although in cases of actual reliance, “it does not matter that the market is aware of the facts necessary to make the statement not misleading,” because that plaintiff may have been misled to believe the market incorrectly valued the security, in fraud-on-the-market cases, plaintiffs concede that their purchases were induced by the “artificial stock price set by the market in light of statements made by the insiders as well as all other material public information.”\(^{50}\) Thus, for fraud-on-the-market cases, the court reasoned that “[p]rovided that they have credibly entered the market through other means, the facts allegedly omitted by the defendant would already be reflected in the stock’s price.”\(^{51}\) This reasoning is consistent with the efficient

\(^{43}\) Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 511–12 (7th Cir. 1989).
\(^{44}\) \textit{Id.} at 516.
\(^{45}\) \textit{Id.}
\(^{46}\) \textit{Id.} at 516 (dicta).
\(^{47}\) \textit{Id.} at 517.
\(^{48}\) \textit{In re Apple Computer Sec. Litig.}, 886 F.2d 1109, 1115 (9th Cir. 1989). Note that the Ninth Circuit stressed the limits of its holding that intense press scrutiny was sufficient in this case to counteract the misrepresentations of corporate insiders. \textit{Id.} at 1116. (“Scrutiny by the press will not ordinarily excuse [this] type of unqualified exuberance.”).
\(^{49}\) \textit{Id.} at 1112. Although “Lisa contained a number of technological innovations which later proved to be commercially viable when incorporated into the ‘Macintosh’ home computer,” Lisa and Twiggy themselves were not commercial successes. \textit{Id.} at 1111.
\(^{50}\) \textit{Id.} at 1114.
\(^{51}\) \textit{Id.}
market hypothesis.

The Ninth Circuit remanded the Twiggy claims for presentation to a jury because the evidence suggested “genuine issues of material fact” with respect to two statements, but upheld a grant of summary judgment for claims involving Lisa and Apple generally because no such issues existed for these claims. The Ninth Circuit found that, “[a]lthough plaintiffs allege that Apple did not fairly and adequately inform the market about Lisa’s prospects, many of the risks and underlying problems were widely publicized.” The court summarized:

The press portrayed Lisa as a gamble, with the potential for either enormous success or enormous failure. At least twenty articles stressed the risks Apple was taking, and detailed the underlying problems producing those risks. Many of the optimistic statements challenged by plaintiffs appeared in those same articles, essentially bracketed by the facts which plaintiffs claim Apple wrongfully failed to disclose. The market could not have been made more aware of Lisa’s risks.

The Ninth Circuit cited as one example a Business Week article which quoted Steven Jobs, Apple’s former Chairman of the Board, as believing “Apple would have little trouble selling Lisa,” while also noting the wide variance of expert estimates of Lisa sales (“from 2,000 to 30,000”), indicating the uncertainty of the venture. The Ninth Circuit also noted a Wall Street Journal article which “detail[ed] Apple’s difficulties in achieving IBM-compatibility, in attracting independent software suppliers, and in raising consumer interest at $9,995” while including Jobs’s prediction that “Lisa [would] be ‘phenomenally successful.’”

In finding this evidence sufficient to counteract Apple’s optimistic statements, the Ninth Circuit cautioned, “[s]crutiny by the press will not ordinarily excuse the type of unqualified exuberance expressed by Apple and its officers in this case” because of the “heavy reliance” investors “justifiably” place on the views of corporate insiders. Thus, “[i]n order to avoid Rule 10b–5 liability, any material information which insiders fail to disclose must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by the insiders’ one-sided representations.” The Ninth Circuit summarized the central issue as “whether, in light of the press’ documentation of Lisa’s risks, a rational jury could nonetheless find a ‘substantial likelihood’ that full disclosures by Apple would have ‘significantly altered the “total mix” of information made available.’”

52. Id. at 1116, 1119.
53. Id. at 1112.
54. Id. at 1116.
55. Id. at 1112.
56. Id.
57. Id. at 1116.
58. Id.
59. Id. at 1115 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).
In so defining the issue, the Ninth Circuit clearly viewed the truth-on-the-
market defense as grounded in materiality. By requiring that corrective
information be of “a degree of intensity and credibility sufficient to effectively
counterbalance” insider misrepresentations, however, the Ninth Circuit
somewhat confusingly referred to investor “reliance.” But understood in
context, the use of the term “reliance” does not refer to the reliance element
of the claim, but merely underscores defendants’ heavy burden in showing the
requisite intensity and credibility.

Subsequent cases similarly find a basis for the truth-on-the-market defense
in the materiality inquiry. In In re Stac Electronics Securities Litigation, the
Ninth Circuit again found that information in the public domain corrected an
alleged misstatement by the defendants. In that case, private plaintiffs claimed
that defendants “made material misrepresentations or omissions regarding
Stac’s initial public offering,” in violation of sections 11 and 15 of the 1933
Securities Act and sections 10(b) and 20 of the Exchange Act. Specifically,
plaintiffs alleged that defendants (1) “failed to disclose imminent competition
from Microsoft and deliberately stalled licensing negotiations with Microsoft in
order to delay Microsoft’s market entry,” and (2) “did not disclose Stac’s
‘inevitable’ impending decline.” In dismissing plaintiffs’ sections 11 and 15
claims, the district court held that “all of the [alleged] omissions . . . were
either actually disclosed, or need not have been disclosed in Stac’s prospectus,”
and focused its attention on the “gravamen” of the representative plaintiff’s
complaint—namely “Stac’s alleged failure to disclose its knowledge of
Microsoft’s plans” to create a competing product. Plaintiff stressed that Stac
“knew that Microsoft was going to come out with a competitive product, but
masked this knowledge as a contingency”; however, the district court noted
that the prospectus “ma[de] detailed disclosures concerning the risk of
competition”:

60. Id.
61. Id. at 1116.
62. 89 F.3d 1399, 1410 (9th Cir. 1996).
63. Id. at 1401.
64. Id. at 1403. Plaintiffs also alleged Stac falsified financial statements “by artificially inflating
reported results.” Id. The district court found that the prospectus adequately described the alleged
mechanisms of “artificial inflat[ion]” and their risks and further “advise[d] investors not to predict
future returns on the basis of the results of any single quarter.” Id. at 1407. The Ninth Circuit affirmed
and held that any such misstatements were “more than adequately covered by the bespeaks caution
doctrine.” Id. at 1409. The bespeaks-caution doctrine is a separate defense whereby the presence of
“enough cautionary language or risk disclosure . . . may protect the defendant against claims of
securities fraud.” Id. (citing Fecht v. Price Co., 70 F.3d 1078, 1081 (9th Cir. 1995)).
65. Id. at 1404. The district court had dismissed plaintiffs’ section 10(b) claim due to a “failure to
plead scienter with particularity,” as required by Federal Rule of Civil Procedure 9(b), and this decision
was later affirmed by the Ninth Circuit. The district court had dismissed plaintiffs’ section 11 claim, not
under rule 9(b) but rather under Federal Rule of Civil Procedure 12(b)(6), “[a]lthough it applied
similar standards and reasoning” to both the § 10(b) and § 11 claims.” Id. at 1404.
66. Id. at 1405.
67. Id. at 1406 (emphasis in original).
One developer of a compatible operating system has licensed a competitive data compression product for incorporation into the latest version of the operating system.\footnote{68} There can be no assurance that Microsoft . . . will not incorporate a competitive data compression technology in their products.\footnote{69}

The Ninth Circuit affirmed the district court’s finding, noting its prior holding that “multiple [no-assurance] warnings in . . . [a] prospectus” were sufficient to prevent the misleading of investors.\footnote{69} Further, because “the market already knew of the potential for Microsoft’s inclusion of data compression technology,”\footnote{69} the statements could not have been misleading.\footnote{70}

Regarding plaintiffs’ allegation of a failure to disclose the company’s “inevitable’ impending decline”\footnote{71} based on weakened product demand due to customer anticipation of a new product that would render its service redundant—information unknown to the public—the Ninth Circuit notably responded that such “customer resistance . . . [was] precisely the sort of market awareness that . . . [had been] held to defeat claims of fraud on the market.”\footnote{72} Specifically, the Ninth Circuit reiterated that “investors know of the risk of obsolescence posed by older products forced to compete with more advanced rivals” and that “technical obsolescence . . . in a field marked by rapid technological advances is information within the public domain.”\footnote{73} Although the prospectus “clearly acknowledge[d]” Stac’s “dependence” on the product, the Ninth Circuit held that, “[e]ven without such disclosures . . . investors could easily have predicted that if Stac’s key product were to lose its market share, the company would be in serious trouble.”\footnote{74} Thus, corrective information “had entered the market through other channels” and the “market [was] not . . . misled.”\footnote{75} Consistent with the efficient market hypothesis, the Ninth Circuit considered the allegedly misleading statements in the context of market knowledge and determined corrective information rendered them immaterial in the total mix of information.

In \textit{Ganino v. Citizens Utilities Company}, private plaintiffs alleged that the defendants had misstated earnings by improperly reporting approximately $10 million of 1995 income as 1996 income.\footnote{76} They sought to “meet and exceed[]” analyst’s projections and thereby artificially inflate the stock price, in violation of sections 10(b) and 20(a) of the Exchange Act and Rule 10b–5.\footnote{77} Defendants moved to dismiss plaintiffs’ claims on various grounds, including that “the
nondisclosures at issue were immaterial because the information was already publicly available”—that is, defendants asserted the truth-on-the-market defense. On appeal, the Second Circuit described truth-on-the-market defense in terms of materiality: “[A] misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market.” Citing In re Apple Computer, the court reaffirmed the requirement that corrective information be transmitted “with a degree of intensity and credibility sufficient to counter-balance effectively any misleading information created by” the alleged misstatements.

In support of its truth-on-the-market defense, defendants argued that the alleged misstatements were immaterial because Citizen had already disclosed all the relevant information about the fees in question before the class period. They pointed to the absence of price movement following filing of its 1997 Second Quarter Form 10-Q for support, which the district court had taken as “significant evidence” of immateriality. The defendants also argued that other SEC filings submitted during the class period “contained sufficient accurate information to neutralize any misleading impressions created by Citizens’ financial reports.” The Second Circuit rejected this defense based in part on the “dispute” surrounding the alleged lack of price movement and the inadequacy of the record regarding “whether [defendants’] disclosures were conveyed with sufficient ‘intensity and credibility.’” Thus, although the Second Circuit rejected the defense in this case due to insufficiency of the record, its analysis accorded with the efficient market hypothesis and squarely viewed the defense as a way to rebut materiality.

Because the truth-on-the-market defense is frequently asserted in fraud-on-the-market cases and the fraud-on-the-market theory is a vehicle for plaintiffs to demonstrate reliance, it is unsurprising that courts deciding such cases comment extensively on whether the facts support a plaintiff’s allegation of reliance on a particular misstatement or omission—even when courts find the facts do not support such allegations in light of corrective information in the market. For instance, the Ninth Circuit in In re Apple Computer extensively discussed “reliance” in describing the fraud-on-the-market theory and the reliance investors place on insider statements, even though its ultimate decision

78. Id. at 160 (emphasis in original). Note that the district court rendered its decision based solely on their agreement with defendants’ alternate defense that the allegedly “deceptively stored” fees were immaterial as a matter of law since they represented only 1.7% of the company’s pretax revenues. The Second Circuit subsequently rejected the court’s adoption of a numerical benchmark in evaluating materiality. Id. at 163–64.
79. Id. at 167 (citations omitted).
80. Id. (citing In re Apple Computer Sec. Litig., 886 F.2d 1109, 1116 (9th Cir. 1989))
81. Id. at 167–68. In this filing, Citizens “first publicly acknowledged that the reported income for the first and second quarters of 1996 included substantial payments from [Hungarian Telephone & Cable Corporation].” Id.
82. Id. at 167.
83. Id. at 168.
did not rest on the reliance element. The language used by particular courts should not overshadow the true grounding of the truth-on-the-market defense in the materiality inquiry: Credible corrective information renders a misrepresentation or omission immaterial, in which case it “cannot be the basis of liability.”

V


Two recent district-court decisions in the Ninth Circuit—SEC v. Reys in the Western District of Washington and SEC v. Mozilo in the Central District of California—suggest misunderstandings of the efficient market hypothesis and, consequently, the grounding of the truth-on-the-market defense in the materiality inquiry. Because the SEC is not required to demonstrate reliance, the SEC did not invoke a fraud-on-the-market theory of reliance in either case.

A. SEC v. Reys

In SEC v. Reys, Gary Reys, the Chairman and CEO of CellCyte Genetics Corporation, allegedly violated Exchange Act section 10(b) and Rule 10b–5 by “repeatedly misle[a]d[ing] the investing public about CellCyte’s key product, a purported stem cell therapy to treat and repair damaged organs.” The SEC based its allegations on eight alleged misstatements and omissions “that individually and collectively amounted to numerous counts of securities fraud.”

The court started its analysis in the materiality inquiry, noting that “[t]o constitute a violation of the antifraud provisions, the statements or omissions in question must be material.” The standard for determining the materiality of a misrepresentation or omission was presented as follows: “A misrepresentation or omission is material if there is a substantial likelihood that a reasonable investor would have acted differently if the misrepresentation had not been made or the truth had been disclosed.”

Of the eight alleged misstatements and omissions, Reys asserted the truth-on-the-market defense for only two statements, referred to as Statements 1 and 2. Statement 1 was that “CellCyte’s discoveries ‘are the first stem cell enabling drugs to enter Investigational New Drug (“IND”) supported by the United

84. In re Apple Computer, 886 F.2d at 1113–16.
86. 712 F. Supp. 2d 1170, 1173 (W.D. Wash. 2010). The SEC also alleged violations of the “obligation to file accurate quarterly and current reports” under Exchange Act section 13(a) and Rules 12b–20, 13a–11, and 13a–13. Id.
87. Id. at 1173–74.
88. Id. at 1174 (citing Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988)).
89. Id. (citing Livid Holdings Ltd. v. Salomon Smith Barney, Inc., 416 F.3d 940 (9th Cir. 2004)).
States Food and Drug Administration ("FDA") clinical trials. However, CellCyte had neither filed an IND application nor received any sort of approval from the FDA to begin clinical trials, and Reys knew or should have known this when making the statement. Reys claimed this statement was corrected by additional disclosures that (1) the IND had not yet begun and (2) "an IND submission was scheduled for the second half of 2007."

Statement 2 was that "CellCyte's stem cell research had 'been proven in extensive late-stage animal studies.'" Actually, Reys "knew that the preliminary experiments years earlier had achieved positive results in a small number of mice and that no additional research had been conducted using the special compound since 2002." Reys claimed this statement was corrected by a clarification that the company's "technology [was] at an early stage of development." With respect to these statements, the court noted that the truth-on-the-market defense "probably . . . is not available at the pleadings stage," and that, "in any case[,] Reys ha[d] cited no published in-circuit case for the proposition that the truth on the market doctrine applies to an SEC enforcement action as opposed to a private securities action based [on] a theory of 'fraud on the market.'" The court thus characterized the truth-on-the-market defense as merely "a response to [the] very particular theory of liability in private securities actions" of fraud-on-the-market and declared it inapplicable to SEC actions such as the one at bar.

In response to all of the alleged misstatements, Reys presented another defense based on stock-price fluctuation, citing out-of-circuit cases. Reys had originally argued that "a misstatement or omission is immaterial as a matter of law where a corrective disclosure has no material effect on the company's stock price." The court rejected this argument as having been "roundly rejected by the Ninth Circuit" because "the market is subject to distortions that prevent the ideal of 'a free and open public market' from occurring." Reys then argued that "stock prices are just a factor to be considered in assessing the materiality of certain public statements, and that the price fluctuations in this case indicate that the immateriality of the statements was so obvious that reasonable minds..."
This argument was similarly rejected by the court, which found that “stock price fluctuations surrounding purportedly corrective disclosures” could not form the basis for a finding of immateriality of alleged misstatements or omissions. Although not stated in the specific context of the truth-on-the-market defense, this reasoning suggests a possible misunderstanding of the efficient market hypothesis and the defense itself.

As discussed in part II, the efficient market hypothesis states that, if a security is traded on an efficient market, all relevant public information is captured in the security’s price. Although the Reys court states that the disclosures cited by Reys did not provide the requisite “intensity and credibility” to counteract Reys’s statements, this was merely dicta: The court’s holding was that the truth-on-the-market defense did not apply because this was not a private fraud-on-the-market action. Note that the district court’s determination that the disclosures in this case did not rise to the level of “intensity and credibility” required to successfully assert the truth-on-the-market defense is likely correct in light of Ninth Circuit precedent. As such, the court’s rejection of the truth-on-the-market defense in all SEC enforcement actions was unnecessary. If a defendant can demonstrate the required level of corrective information, then the efficient market hypothesis states that the market will reflect that information in the share price.

The court’s rejection of Reys’s argument regarding share-price fluctuations also suggests a misunderstanding of the efficient market hypothesis. In its outright refusal to consider share-price fluctuations in its materiality inquiry, the Reys court ignores the efficient market hypothesis’s key implication that, in an efficient market, all relevant material information is reflected in the share price. Thus, share-price fluctuations are a relevant consideration in determining materiality, although not dispositive on the issue.

In refusing consideration of share-price fluctuations, the Reys court expressed concern that “distortions . . . prevent[ed] the ideal of a free and open public market,” citing the Ninth Circuit’s decision in No. 84 Employer-Teamster Joint Council Pension Trust Fund. However, the Reys court did not properly consider the context of the Ninth Circuit’s statement. No. 84 Employer-Teamster was a private suit in which investors alleged that America West

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101. Id. at 1174–75.
102. Id. at 1175.
103. See In re Apple Computer Sec. Litig., 886 F.2d 1109, 1116 (9th Cir. 1989) (“In order to avoid Rule 10b–5 liability, any material information which insiders fail to disclose must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by the insiders’ one-sided representations,” bearing in mind that “[t]he investing public justifiably places heavy reliance on the statements and opinions of corporate insiders.”).
104. The efficient capital market hypothesis does not itself require that share-price fluctuations be dispositive in a materiality inquiry; however, the hypothesis states that all material and relevant information will be reflected in the share price of an efficiently traded security.
106. 712 F. Supp. 2d 1170, 1174 (W.D. Wash. 2010) (quoting No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 934 (9th Cir. 2003)).
Holding and its subsidiary (1) failed to inform investors of its “fail[ure] to perform . . . required inspections and routine maintenance” and ongoing FAA investigations of such failures in an effort to overstate income and (2) engaged in a significant stock-repurchase plan as a “manipulative device designed to further inflate its [stock] price” to benefit controlling shareholders. The district court dismissed plaintiffs’ claims, finding the misrepresentations “immaterial as a matter of law because the market did not immediately react” to disclosures by the Wall Street Journal and the company of the FAA’s potential and final imposed fines.

In reversing the district court, the Ninth Circuit, citing Basic, made the statement cited by the Reys court—namely, that “distortions . . . prevent[ed] the ideal of a free and open public market.” However, its next sentence clarifies that these distortions may simply prevent immediate correction. The Ninth Circuit rejected adoption of a “bright-line” rule, but did not challenge the idea that the stock price reflects all material information. In that context, the Ninth Circuit’s holding is consistent with the efficient market hypothesis’s principle that information is captured almost instantaneously in the share price. If the Reys court was merely concerned that immediate correction did not occur and thus was not captured in the share price, then the court should have expanded the examined time period, rather than rejecting outright Reys’s argument. If the Reys court was instead concerned that all relevant market information was not captured in the share price, the court should have questioned whether the shares were offered on an efficient market—an inquiry the court never conducted—rather than simply rejecting Reys’s argument.

The Reys court’s rejection of the truth-on-the-market defense to SEC enforcement actions demonstrates a misunderstanding of the defense. As suggested in part IV, the truth-on-the-market defense is properly grounded in the materiality inquiry: Successful use of the defense requires the defendant to show corrective information rendered the otherwise material misrepresentation or omission immaterial. Although the SEC is not required to demonstrate reliance or injury in enforcement actions, the SEC is required to demonstrate materiality. Should a defendant demonstrate that the market had the full picture of an issuer through corrective information of an “intensity and credibility” equal to the alleged material misstatement or omission, the efficient market hypothesis implies that the misstatement and corrective information cancel each other out. By adopting a bright-line rule precluding the truth-on-the-market defense in SEC enforcement actions, the Reys court eliminated an important vehicle for challenging the materiality of a misstatement without any basis in precedent and in direct contravention of the efficient market hypothesis.

107. No. 84 Employer-Teamster Joint Council Pension Trust Fund, 320 F.3d at 928, 930.
108. Id. at 934.
109. Id.
110. Id.
B. SEC v. Mozilo

In SEC v. Mozilo, the SEC alleged that three senior executives of Countrywide Financial Corporation (Countrywide) fraudulently made “misleading statements in periodic filings and during earnings calls, conferences, and investor presentations” regarding “the quality of Countrywide’s underwriting guidelines and loan production,” its pay-option ARM loans, and descriptions of its loans as “prime” or “nonprime.” The SEC alleged violations of numerous securities laws and regulations, including section 10(b) of the Exchange Act and Rule 10b–5.

With respect to Countrywide’s underwriting guidelines and loan production, the SEC alleged that the executives “made numerous public statements from 2005 through 2007, praising the quality of Countrywide’s underwriting and distinguishing Countrywide from subprime lenders.” These statements included affirmative representations that (1) they were unaware of changes in protocols or underwriting policies, (2) the company had “not taken any steps to reduce the quality of its underwriting regimen,” and (3) Countrywide was not involved in making subprime loans. The SEC alleged that defendants made these statements while aware that “Countrywide was originating increasing percentages of poor quality, subprime loans that did not comply with [its] already lax underwriting guidelines.” Regarding pay-option ARM loans, the SEC pointed to former CEO and Chairman of the Board Mozilo’s public statements in 2005 and 2006 that “pay option loan quality remains extremely high” and the product was a “sound investment” because loans were made only to consumers “capable of making a higher payment, should that be required, when they reach their reset period.” At the same time, Mozilo “expressed grave concerns about the quality or viability of these loans” in internal correspondence. Regarding Countrywide’s categorization of loans as “prime” in public filings, the SEC alleged failure to “inform investors that it included loans within its ‘prime’ category with increasing amounts of credit risk.”

Defendants argued that “the alleged statements and omissions were not misleading or material as a matter of law in light of Countrywide’s extensive disclosures about the risk characteristics of its loan originations in periodic SEC filings, at investor forums, on free company-sponsored websites, and in prospectus supplements filed by . . . subsidiaries.” Invoking the truth-on-the-market defense, defendants argued that, because “all publicly available

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112. Id. at *6. The SEC also alleged violations of section 17(a) of the Securities Act of 1933 and section 13(a) of the Exchange Act and various rules thereunder. Id.
113. Id. at *4.
114. Id.
115. Id.
116. Id.
117. Id. at *5.
118. Id.
119. Id. at *8.
information is reflected in Countrywide’s stock price” — a fact conceded by the SEC’s expert — “the omitted facts were known to investors and thus immaterial as a matter of law.”

In response, the court labeled the defendant’s truth-on-the-market defense “a corollary to the fraud on the market theory of reliance” and held that defendants could not “replace the traditional analysis of materiality” with a truth-on-the-market defense in an SEC enforcement action. Because the court viewed the defense only as a corollary to the fraud-on-the-market theory of reliance, the court focused on the fact that the SEC had not asserted the fraud-on-the-market presumption of reliance. Citing the Ninth Circuit’s decision in Miller v. Thane International, Inc., the court stated that “in an action that does not involve the fraud on the market presumption, that truthful information is available elsewhere does not relieve a defendant from liability for misrepresentation in a given filing or statement.” The court then held, noting the Reys decision, that “because the SEC in an enforcement action is not required to prove reliance, the ‘fraud on the market’ presumption is not relevant.” Notably, the court explained that, in an SEC enforcement action, “omissions by corporate insiders are not rendered immaterial as a matter of law simply because the omitted facts were available to the public elsewhere” and “the ‘total mix’ of information does not encompass the total universe of information available in the public domain.” Instead, the court required that the “information [be] so readily available that a reasonable investor would consider it as part of the total mix of information,” rather than simply incorporated in the security’s price. For these reasons, the court rejected the truth-on-the-market defense in SEC enforcement actions.

The Mozilo court’s reasoning suggests a misunderstanding of the efficient market hypothesis. First, the court’s statement that not all information in the public domain is reflected in the total mix of information rejects the basic premise of the efficient market hypothesis — namely, that all material public information is reflected in the security’s price. The efficient market hypothesis does not require that corrective information be “so readily available” that reasonable investors consider it; rather, the market incorporates all material information into a security’s price, so that investors access all material information by noting the stock price.

Second, the court’s reliance on the Ninth Circuit’s decision in Miller v. Thane International and, consequently, its statement that “in an action that does not involve the fraud on the market presumption, that truthful information is

120. Id.
121. Id.
122. Id. at *9 (citing Miller v. Thane Int’l, Inc., 519 F.3d 879, 887 n.2 (9th Cir. 2008)).
123. Id. (citing SEC v. Reys, 712 F. Supp. 2d 1170, 1174 (W.D. Wash. 2010); SEC v. Rana Research, Inc., 8 F.3d 1358, 1364 (9th Cir. 1993)).
124. Id.
125. Id.
available elsewhere does not relieve a defendant from liability for misrepresentation in a given filing or statement,” also reflects a misunderstanding of the efficient market hypothesis.\textsuperscript{126} By taking the Ninth Circuit’s decision out of context and applying it to the Mozilo case, the court renders the holding incompatible with the efficient market hypothesis. The Miller case involved private plaintiffs who alleged a violation of section 12(a)(2) of the Exchange Act due to a misrepresentation that, postmerger, the company’s stock would be listed on the NASDAQ exchange.\textsuperscript{127} Defendants argued that, although earlier drafts of the prospectus stated that listing on the NASDAQ or a national securities exchange was “a condition to the merger,” the final prospectus language indicated merely that the postmerger stock had been approved for NASDAQ listing and that the merged company would not “continue as a public company.”\textsuperscript{128}

The language of section 12(a)(2) of the Exchange Act imposes different requirements than section 10 of the Exchange Act, the violation at issue in Mozilo. Section 12(a)(2) is violated if a plaintiff demonstrates that, in conjunction with an offer or sale of a security conducted “by the use of a means or instrumentality of interstate commerce” and “by means of a prospectus or oral communication,” the prospectus “includes an untrue statement of material fact or omits to state a material fact that is necessary to make the statements not misleading.”\textsuperscript{129} Thus, in evaluating the section 12(a)(2) claim, the district court and Ninth Circuit inquiries focused first on the specific language of the prospectus and then on whether the language was material according to the total-mix standard.\textsuperscript{130} Importantly, the defendants in Miller never asserted a truth-on-the-market defense; rather, they argued first that the prospectus statements were factually correct and then that the choice of market in which a security trades is not material to a security.\textsuperscript{131} As such, the Ninth Circuit comment quoted by the Mozilo court was not only dicta in the Miller case, but was also given in response to a completely different set of circumstances in which the defendants did not argue the presence of corrective information at all.

Taken in context, the Ninth Circuit’s comment in Miller is not inconsistent with the efficient market hypothesis: The Ninth Circuit was merely highlighting the different considerations involved in adjudicating section 12(a)(2) claims and section 10(b) claims. As the Ninth Circuit noted, “Section 12(a)(2) is a virtually absolute liability provision.”\textsuperscript{132} Section 12(a)(2) restricts the inquiry to the prospectus, so corrective information in another public filing cannot remove

\textsuperscript{126} Id. (citing Miller, 519 F.3d at 887 n.2).
\textsuperscript{127} Miller, 519 F.3d at 885. Plaintiffs also alleged violation of section 15 of the Exchange Act; however, the materiality inquiry discussed here only related to the section 12(a)(2) allegation. Id.
\textsuperscript{128} Id. at 882–83.
\textsuperscript{129} Id. at 885.
\textsuperscript{130} Id. at 885–92.
\textsuperscript{131} Id.
\textsuperscript{132} Id. at 886.
liability. However, section 10(b) and Rule 10b–5—the claims at issue in Mozilo—evaluate the alleged misrepresentation “in the light of the circumstances under which they were made.” Such circumstances should include corrective information disseminated in an equally credible and intense manner as the alleged misrepresentation, consistent with both the efficient market hypothesis and In Re Apple Computer.

By considering the truth-on-the-market defense solely as a corollary to the fraud-on-the-market presumption of reliance, the Mozilo court mistakenly grounded the defense in the causation inquiry rather than the materiality inquiry. Rather simplistically, the Mozilo court considered only the fact that the SEC did not invoke the fraud-on-the-market presumption of reliance and analogized the SEC to a private investor alleging actual reliance on the particular misrepresentations. The court thus confused the causation and materiality inquiries. As indicated in part IV, if a defendant successfully pleads the truth-on-the-market defense, an otherwise material misrepresentation is rendered immaterial by equally intense and credible corrective information: Because the stock price reflects both the misrepresentation and the correction, the two cancel each other out. Although this conclusion logically leads to the determination that investors cannot have relied on that misrepresentation—because investors cannot rely on immaterial information—and the chain of causation is thus broken, the causation and materiality inquiries are indeed distinct. In relegating the truth-on-the-market defense to merely a corollary of the fraud-on-the-market presumption of reliance, the Mozilo court considered the break in causation without considering the source of that break—namely, the corrective information’s impact on the statement’s materiality. As a consequence, the Mozilo court needlessly adopted a bright-line rule that bars defendants from asserting the truth-on-the-market defense in SEC enforcement actions.

The holdings of Reys and Mozilo highlight the potential for misunderstanding the premises of the efficient market hypothesis and therefore misapplying the truth-on-the-market defense. Because these courts misunderstood the full implications of the efficient market hypothesis, the courts were forced to resort to formalistic arguments and apply holdings outside their relevant context. By considering the defense only in reference to causation, without regard for its impact on materiality, these courts lowered the SEC’s burden of proof for materiality and unduly limited defendants’ ability to rebut allegations of materiality in SEC enforcement actions.


134. Recall that proving a truth-on-the-market defense can be difficult, because it requires demonstration of credible corrective information; therefore, it is quite possible that the defendants in Reys and Mozilo may not have been able to meet this high bar and successfully present this defense, rendering the courts’ decisions to foreclose the defense even more unnecessary.
VI

SHOULD THE TRUTH-ON-THE-MARKET DEFENSE BE PERMITTED IN SEC ENFORCEMENT ACTIONS?

As discussed in part IV, the truth-on-the-market defense is a judicially created doctrine that evaluates materiality based on the premises of the efficient market hypothesis. Because the defense is a product of judicial decisions, precedent may also limit the use of the truth-on-the-market defense. SEC v. Reys and SEC v. Mozilo apply such a limitation based on misunderstandings of the efficient market hypothesis. Although the reasoning employed in these particular cases is unpersuasive, the cases themselves raise an interesting question: Is there any difference between the SEC and a private litigant that warrants limitation of the truth-on-the-market defense to only private suits?

As discussed in part III, requirements for a successful SEC action differ from those of a private litigant. Courts base this special treatment of the SEC on the statutory authority expressly granted by Congress’s designation of the SEC “as the primary enforcement agency for the securities laws.”\(^\text{135}\) As such, the SEC “has broad authority to initiate enforcement actions when a violation of the securities laws has occurred, is occurring, or is about to occur.”\(^\text{136}\) The SEC serves as a guardian for the integrity of U.S. capital markets: It seeks to not only address injuries arising from securities fraud but also to deter actors in engaging in any future fraud. Since material misrepresentations and omissions have great potential to injure the basic integrity of securities markets, the SEC’s ability to act without evidence of actual injury enables pursuit of deterrence objectives and ensures well-functioning capital markets from which society benefits. For these same reasons, the SEC may seek remedies unavailable to private litigants.\(^\text{137}\) An SEC enforcement action is not merely “an action ‘under’ Rule 10b–5,” but rather a “creature[] of statute” granted direct authority under sections 21(d) and (e) of the Securities Exchange Act.\(^\text{138}\) As such, courts are willing to engage in somewhat expansive constructions of section 10 and Rule 10b–5, effectively affording the SEC special treatment.\(^\text{139}\)


\(^{136}\) James D. Cox & Randall S. Thomas, SEC Enforcement Heuristics: An Empirical Inquiry, 53 DUKE L.J. 737, 746 (2003). The article also provides further explanations for this special grant of authority. Id. at 743–44.

\(^{137}\) See supra note 4 and sources cited therein.

\(^{138}\) Rana Research, 8 F.3d at 1363–64 (9th Cir. 1993) (citations omitted).

\(^{139}\) See, e.g., id. at 1362 (noting meaning of “in connection with” in SEC actions “remains as broad and flexible as is necessary to accomplish the statute’s purpose of protecting investors”) (citations omitted).
However, the expansive role and authority of the SEC do not warrant special treatment with respect to the materiality element of securities-fraud claims and, therefore, do not provide a rationale for refusing the truth-on-the-market defense. Materiality remains an essential element of SEC enforcement actions pursuant to not only case precedent, but also statutory language. For instance, although the SEC is permitted by statute to issue freeze orders for “threatened violation[s],” the statutes also require that violations be “likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest.” Materiality is required to demonstrate such “significant” or “substantial” harm, because immaterial statements cannot create such harm. Further, the statute empowering the SEC to assess monetary penalties explicitly requires that the statement be material.

Although the statute permitting the SEC to seek injunctions—perhaps its broadest grant of authority—does not explicitly refer to materiality, it references federal securities law, the rules of a national securities exchange, and the rules of self-regulating organizations—which often incorporate a materiality requirement. Finally, the SEC’s authority to issue cease-and-desist orders permits the SEC to find, “after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of [Chapter 2B of the Exchange Act].” However, nothing in the statutory language removes the materiality element from a 10b–5 violation.

Further, the broader mandate of the SEC does not warrant special treatment in terms of demonstrating materiality. If a misstatement or omission is not material, it cannot endanger the integrity of the broader capital markets or harm investors. Under the efficient market hypothesis, the price of a security traded on an efficient market reflects all relevant information: Immaterial information is ignored in the price. Thus, requiring the SEC to demonstrate materiality is proper.

142. See 15 U.S.C. § 78u(d)(1) (2006) (granting authority to seek injunctions “whenever it . . . appear[s] . . . that any person is engaged or is about to engage in” violations of federal securities law, the rules of a national securities exchange, or the other rules of a self-regulating organization of which that person is a member upon a “proper showing”) (emphasis added).
143. For relevant securities-law provisions, see sources cited supra notes 140–142. See, e.g., MUN. SEC. RULEMAKING BD. R. G-21(c), available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-21.aspx (prohibiting members from “publish[ing] or disseminat[ing], or caus[ing] to be published or disseminated, any product advertisement that such broker, dealer, or municipal securities dealer knows or has reason to know is materially false or misleading”); NYSE R. 472(i), available at http://nyserules.nyse.com/NYSETools/PlatformViewer.asp?selectednode=chp_1_6&manual=%2Fnysx%2Frules%2Fnysx-rules%2F (this rule refers explicitly to “material fact[s]” and has been incorporated into FINRA rules); PUB. CO. ACCOUNTING OVERSIGHT BD. R. 3502, available at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx#rule3502 (stating responsibility of auditors to “not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation . . . of the . . . provisions of the securities laws”).
The efficient market hypothesis posits that if both a misstatement and its correction are made public, the market incorporates both, rendering the alleged misrepresentation immaterial—and liability cannot attach if the misrepresentation was immaterial. Since the SEC is required to demonstrate materiality and the efficient market hypothesis does not distinguish between the SEC or a private plaintiff, there is no reason to hold the truth-on-the-market defense strictly inapplicable in SEC enforcement proceedings, as in Reys and Mozilo. In evaluating materiality, courts should be guided by the standards of TSC Industries, Basic Inc., In re Apple Computer, Dura Pharmaceuticals, and the other cases discussed in part IV. The SEC as plaintiff should not affect the materiality inquiry.

VII
CONCLUSION

Properly understood, the truth-on-the-market defense creates a vehicle through which a defendant can rebut the alleged materiality of a misstatement or omission. Since the SEC is required to demonstrate materiality of a misrepresentation or omission and there is no theoretical or policy basis for rejecting application of the truth-on-the-market defense against materiality in SEC enforcement actions, a defendant should retain the ability to challenge such materiality through the truth-on-the-market defense. The recent district-court rulings of SEC v. Reys and SEC v. Mozilo mistakenly employed reasoning inconsistent with the efficient market hypothesis and the true grounding of the truth-on-the-market doctrine in the materiality inquiry. In so doing, these rulings needlessly constrict the value of the truth-on-the-market defense, particularly in light of the difficulty in successfully proving this defense.