Shareholder actions arising from misstatements and nondisclosure have been part of the legal landscape in the United States for some time. The Wall Street stock market crash of the 1920s saw the early development in the United States of strong laws for the protection of investors in the stock market, and the mechanism of the class action meant that large numbers of investors were able to seek remedies for loss caused by fraud, deceit, untrue statements and nondisclosures. This article examines the approach of United States courts to the problems of proving that breaches of the law identified are responsible for losses claimed, and the presumptions that those courts have used to establish this requisite element of causation — principally the ‘fraud on the market’ theory of presumed reliance adopted in 1988 by the Supreme Court of the United States in Basic Inc v Levinson. The treatment of the ‘fraud on the market’ theory by Canadian courts — which have rejected the theory as a presumption of law but have been open to presumptions of fact in particular cases — is also examined. Finally, there is an examination of causation and loss in shareholder actions for misleading and deceptive conduct in Australia. The effect of the introduction of laws giving statutory force to the continuous disclosure rules of the Australian Stock Exchange is also noted, and the author examines whether recognition of losses from such claims will lead to the adoption of a ‘fraud on the market’ analysis in Australia.

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I INTRODUCTION

The issue of information disclosure by publicly-listed companies looms as large as ever for the 21st century corporation. The consequences of improper or inaccurate disclosure were illustrated by the collapses of Enron, Worldcom and others in the United States, alongside HIH and One.Tel in Australia. More recent Australian failures have also highlighted the issue, including Harris Scarfe Ltd, Sons of Gwalia Ltd, Pasminco Ltd, Media World Communications Ltd and ION Ltd. In the wake of these corporate failures, legislatures have refocused on the need for proper, accurate and continuous disclosure in financial reporting.1

Regulation of the United States stock market to this end has a long history extending back to the enactment of the Securities Exchange Act of 19342 in response to the calamities of the 1929 stock market crash and the ensuing Great Depression. As a result of this long history, the United States is the pioneering jurisdiction in the development of the law in relation to corporate disclosure and particularly in the development of civil remedies for fraud, misleading statements and nondisclosure.

In Parts II and III of this article, I review the development of corporate fraud, misstatement and nondisclosure laws in the United States, primarily in relation to civil recovery class actions by stockholders. Against this background, I discuss in Part IV the ‘fraud on the market’ theory of causation and its theoretical underpinnings. In Part V, I review the attempts to apply the ‘fraud on the market’

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1 In Australia, this produced amendments to the Corporations Act 2001 (Cth) (‘Corporations Act’), contained in the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (Cth) (‘CLERP 9’). In the United States, it produced the Sarbanes-Oxley Act of 2002, Pub L No 107-204, 116 Stat 745.

2 Ch 404, 48 Stat 881.
2005] ‘Fraud on the Market’: Securities Nondisclosure

doctrine in Canadian class proceedings. In Part VI, securities nondisclosure will be considered in the Australian context, including an analysis of the extent to which the ‘fraud on the market’ theory is compatible with the development of Australian law.

II THE SOCIAL AND LEGISLATIVE BACKGROUND TO UNITED STATES SECURITIES REGULATION

A The 1929 Stock Market Crash

During the 1920s approximately 20 million large and small shareholders purchased securities on the United States stock market, with some $50 billion in new securities offered during this period. Following the stock market crash of October 1929, it is estimated that approximately half of the $50 billion became worthless.3 The crash had an adverse impact on the savings and livelihoods of millions. Losses by banks which had also invested heavily in the stock market saw ‘runs’ on the banking system, causing bank failures.4 The worst economic depression in history ensued, with mass unemployment and a widespread loss of faith in the capitalist economic system.5 Public confidence in the share markets evaporated, and ultimately led to a political consensus that, for private capitalism to recover, strong measures were necessary to restore the public’s faith in the stock market.6

Hearings by Congress as to the problems and possible solutions ultimately resulted in Congress passing the Securities Act of 19337 and the Securities Exchange Act of 1934.8 The laws were designed to restore investor confidence in capital markets by proscribing certain practices and introducing greater levels of government oversight, particularly through the establishment of the Securities and Exchange Commission.9

7 15 USC §§ 77a–77aa (2000).
9 Ellenberger and Mahar, above n 8, xiii–xv. According to the US Securities and Exchange Commission, two commonsense notions underlie these laws. The first is that companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling and the risks involved in investing. The second is that people and entities who sell and trade securities — brokers, dealers, and exchanges — must treat investors fairly and honestly, thereby putting investors’ interests first. US Securities and Exchange Commission, above n 3.
B Rule 10b-5

In 1942, r 10b-5 was promulgated under the Securities Exchange Act of 1934. It provided:

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.\(^{10}\)

In the 1947 case of Kardon v National Gypsum Co,\(^{11}\) it was held for the first time that r 10b-5 implied a private right of action so that investors who suffered loss as a result of a breach of that rule could sue those who caused their losses.\(^{12}\)

In the United States, the procedural mechanisms for class (or group) actions have also existed since at least 1938 (under r 23 of the Federal Equity Rules and the Federal Rules of Civil Procedure)\(^{13}\) and, in a modern form, since 1966.\(^{14}\) In cases of fraud, misstatements, omissions or inadequate disclosure, the latter procedures have meant that large numbers of shareholders have been able to seek redress from those who have caused their losses.

It was also relatively early on that the United States courts accepted that the purpose of securities regulation was to go further than traditional common law concepts in both fostering disclosure and protecting investors. In Securities and Exchange Commission v Capital Gains Research Bureau Inc, the Supreme Court of the United States stated:

A fundamental purpose, common to these [securities regulation] statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.\(^{15}\)

Thus, to the extent that traditional common law principles were not conducive to the purposes of the statute, they could be modified or even discarded. The early social backdrop of the 1929 Wall Street crash and the powerful legislative response to those events saw shareholder remedies develop in the United States with a strong emphasis on the rights of stockholders. As will be seen, the

\(^{10}\) 17 CFR § 240 (2005).
\(^{11}\) 73 F Supp 798, 800, 802–3 (Kirkpatrick J) (ED Pa, 1947).
\(^{13}\) See Alba Conte and Herbert B Newberg, Newberg on Class Actions (3rd ed, 1992) [1.09].
\(^{14}\) Federal Equity Rules rr 23, 26; ibid [1.10].
\(^{15}\) 375 US 180, 186 (Goldberg J) (1963).
momentum of that emphasis would catalyse innovative judicial approaches to the procedural question of the onus of proof, with an eventual resolution of that issue to the benefit of investors.\textsuperscript{16}

\section*{III \hspace{1em} \textbf{Causation of Loss: The Early United States Cases}}

\subsection*{A Untrue Statements and Causation}

As noted, an untrue statement of a material fact will give a private right of action under r 10b-5 of the \textit{Securities Exchange Act of 1934}. A fundamental element of any such action will be proof that the untrue statement was at law the cause of the plaintiff's loss. 'Reliance' by the plaintiff on the defendant's statements is said to provide the traditional causal nexus between the defendant's conduct and the plaintiff's injury.\textsuperscript{17} Thus, where there is an affirmative misrepresentation, causation can be met by satisfying the traditional reliance requirement.\textsuperscript{18}

\subsection*{B Omissions and Causation}

The situation is more complicated, however, where the impugned conduct is not a directly untrue statement of material fact or an affirmative misrepresentation, but is an omission of a material fact.

As has been seen, r 10b-5 also applies to an omission of a material fact where the omitted statement is 'necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading'.\textsuperscript{19}

In relation to causation in nondisclosure cases, proof of reliance is clearly more problematic — it is obvious that there can be no reliance on matters that are not stated. This, however, does not address the causation requirement. As noted in an article on the issue of reliance in r 10b-5 actions in the \textit{Harvard Law Review} in 1975:

\begin{quote}
Since nothing is affirmatively represented in a nondisclosure case, demanding proof of reliance would require the plaintiff to demonstrate that he had in mind
\end{quote}

\textsuperscript{16} Though beginning in the mid-1970s there was admittedly a trend in the opposite direction with the courts tending to restrict the plaintiff class and the range of conduct resulting in liability. By the mid-1990s, the legislature had also intervened to limit shareholder actions through the \textit{Private Securities Litigation Reform Act of 1995}, Pub L No 104-67, 109 Stat 737.

\textsuperscript{17} Note, ‘The Fraud on the Market Theory’ (1982) 95 \textit{Harvard Law Review} 1143, 1144, citing William L Prosser, \textit{Handbook of the Law of Torts} (4\textsuperscript{th} ed, 1971) 714, which stated: The false representation must have played a material and substantial part in leading the plaintiff to adopt his particular course; and when he was unaware of it at the time he acted, or it is clear that he was not in any way influenced by it, and would have done the same thing without it for other reasons, his loss was not attributed to the defendant.

\textsuperscript{18} Mitchell v Texas Gulf Sulphur Company, 446 F 2d 90, 102 (Hill J) (10\textsuperscript{th} Cir, 1971), citing \textit{List v Fashion Park Inc}, 340 F 2d 457, 462 (Waterman J) (2\textsuperscript{nd} Cir, 1965), cert denied 382 US 811 (1965).

\textsuperscript{19} \textit{Securities Exchange Act of 1934}, Ch 404, 48 Stat 881.
the converse of the omitted facts, which would be virtually impossible to demonstrate in most cases.20

One approach of United States courts in the 1960s was to require not so much a belief in or reliance upon the opposite of the nondisclosed information, but to look at ‘whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.’21 This test required proof that the investor would have acted otherwise had he or she known the omitted facts.

In 1972, the United States Supreme Court in the case of Affiliated Ute Citizens of Utah v United States22 softened the reliance test for nondisclosure cases. In that proceeding, a bank and its employees purchased stocks from a group of American Indians in their tribal corporation. The bank did not disclose that those stocks were trading at a higher price on a secondary market fostered by the bank itself.

The Court of Appeals for the Tenth Circuit initially held that absence of proof of reliance upon the defendant’s fraudulent conduct by the plaintiffs meant that there could be no recovery.23 On appeal however, the Supreme Court held that proof of reliance on the nondisclosure was not necessary for recovery. Instead, where there is an obligation to disclose, the withholding of material information establishes ‘the requisite element of causation in fact’.24 The Court said:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. … This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact …25

The Affiliated Ute decision thus focused on the ‘materiality’ requirement in r 10b-5 as the critical factor, at least in cases of nondisclosure, and identified the reasonable investor as the judge of what is material. The Supreme Court adopted a similar formulation in TSC Industries Inc v Northway Inc when it stated that information was material ‘if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.’26

As can be seen, the Affiliated Ute decision deals with the presumption of reliance when the plaintiff relies directly on the defendant who completely withholds material information.

22 406 US 128 (1972) (‘Affiliated Ute’).
25 Ibid (citations omitted).
C. The Post-Affiliated Ute Cases

In the cases that followed, at least two issues continued to arise as the courts sought to deal with the Affiliated Ute authority. First, there was the question of the degree to which the Affiliated Ute authority — which arose out of a face-to-face transaction — applied to impersonal settings or markets. Second, there was the issue of how, where the presumption of reliance arose, it could be rebutted by defendants. The gradual acceptance of the ‘fraud on the market’ theory would see the first issue ultimately decided expansively in favour of plaintiffs. The second issue remained somewhat contentious. One of the reasons for this may have been that any final determination required a prior definitive choice between a traditional legal analysis and a market-based economic analysis.

1 Impersonal Settings

After Affiliated Ute, there was some uncertainty as to the extent to which the Affiliated Ute presumption of reliance could or should be applied in settings where the plaintiff and the defendant never meet. As noted in the Harvard Law Review at the time, there had always been a reluctance by the common law to allow an action for deceit based on a failure to disclose. There was no analogue in common law deceit to open market deception alleged to violate Rule 10b-5.

Open market deception cases were said to involve an allegation by the plaintiff that the reliance of third parties on the defendant’s deception affected a securities market in a way that injured the plaintiff. As common law deceit required a misrepresentation made to the plaintiff with the intention of inducing the plaintiff to act or refrain from acting in reliance on the fraud, a complaint alleging harm through the reliance of third parties would not satisfy the requirements of the common law action. Thus, the common law, to the extent it was relevant at all, appeared to suggest that the presumption of reliance should not be extended to impersonal situations.

Nevertheless, after Affiliated Ute, a number of decisions adopted the presumption of reliance in the case of impersonal market transactions lacking the face-to-face aspect of the facts in Affiliated Ute.

It seems also that some of the early ‘fraud on the market’ cases in the United States in the late 1960s related to decisions by the issuer of a security which artificially inflated that security’s price. These early decisions, which then spoke in terms of the ‘artificially inflated market price theory’, found a sufficient

27 The theory was formally accepted by the Supreme Court in Basic Inc v Levinson, 485 US 224 (1988). For an overview, see below Part IV.
30 Ibid (note that this, in a nutshell, is the ‘fraud on the market’ argument).
31 Ibid.
causal nexus if the defendant’s deception was material. An unstated assumption in such cases may have been a heightened responsibility or onus cast on the issuer of the securities; a responsibility which could be seen to be something analogous to the imposition of heightened responsibilities in a ‘personal’ context. Nevertheless, by 1973 the Second Circuit, speaking in terms of ‘constructive reliance’, had widened this approach to apply to deceptions by someone other than the issuer.

In 1976 came the case of Blackie v Barrack. In that case, a Ninth Circuit panel granted class certification to investors who purchased a company’s stock between the release of allegedly misleading financial statements and disclosure of the company’s actual condition two years later. The court found that ‘causation [as to each class member] is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of the misrepresentations.’ This was based on the rationale that material misrepresentations influence enough trading to affect the security’s market price. This was effectively the emergence of a true ‘fraud on the market’ approach. It also appeared to extend presumed reliance beyond the case of omissions and established it in the case of positive untrue statements. The latter could not have occurred without the utilisation of the ‘fraud on the market’ approach, which provided a form of causation whereby affirmative misrepresentations fed into the market price and therefore impacted on anyone who purchased a security.

A slightly different approach was taken in the 1977 decision of Arthur Young & Co v United States District Court, which spoke in terms of reliance on ‘the integrity of the regulatory process’. In that case, Lucas J focused on a deception within a registration statement filed with the Securities and Exchange Commission and dispensed with the requirement of individual reliance, stating:

Just as the open market purchaser relies on the integrity of the market and the price of the security traded on the open market to reflect the true value of the securities in which he invests, so the purchaser of an original issue of a security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies and the investors at the time of the original issue.

2 Rebutting the Presumption of Reliance

In Blackie v Barrack, it was said to be open to the defendant to rebut the ‘fraud on the market’ ‘presumption of reliance’ by proving that an insufficient number of shares was traded in reliance on the misrepresentation to have actually inflated the price. It was also said to be open to a defendant to rebut the presumption in relation to an individual plaintiff by showing that they purchased

36 Blackie v Barrack, 524 F 2d 891, 906 (Koelsch J) (9th Cir, 1975).
38 Ibid 695.
39 524 F 2d 891, 906 (Koelsch J) (9th Cir, 1975).
despite knowledge of the falsity of the representation or that the person would have purchased in any event, even if he or she had known about the misrepresentation.\(^{40}\)

The two arguments fairly neatly encapsulate the dichotomy between the traditional legal analysis and a market-based economic analysis that I have already mentioned.\(^{41}\) The first approach seeks to rebut reliance by rebutting the ‘fraud on the market’ theory itself. It does this by showing that certain assumptions underlying the theory are not present. Proving that an insufficient number of shares was traded in reliance on the misrepresentation seems to amount, as we shall see, to rebutting the application to the market in question of the ‘efficient capital markets’ hypothesis\(^{42}\) — on which the ‘fraud on the market’ theory is based — to the market in question. It is submitted that the ‘efficient capital markets’ hypothesis would suggest that an efficient market will see the share price affected exactly to the degree that the misrepresentation is price sensitive.

The second approach goes to the traditional concern of the law with the facts of the individual case but, as we shall see, also seems effectively to ignore the implications of the ‘fraud on the market’ theory. Thus, where a shareholder intends to purchase or sell regardless of the fraud, there is the issue of whether the existence of such an intention rebuts the presumption of reliance. That person may seek to transact for a variety of reasons, none of which seem to be related to the fraud.\(^{43}\) The ‘fraud on the market’ theory would suggest, however, that knowledge of misrepresentations or omissions is irrelevant.

Thus, in Panzirer v Wolf,\(^{44}\) the Second Circuit reversed a district court decision which had rejected the ‘fraud on the market’ argument of a plaintiff purchaser misled by misrepresentations in an annual report. The lower court found that the plaintiff never saw the annual report, and had relied primarily upon a newspaper article and advice from her broker.\(^{45}\) Reversing this decision, however, the Second Circuit court stated that: ‘If plaintiff can link her injury to defendant’s fraud by showing the fraud was a “substantial” or “significant contributing cause”, plaintiff has shown sufficient reliance to support her 10b-5 claim.’\(^{46}\)

In an article in the Harvard Law Review in 1982, it was noted that the ‘significant contributing cause’ concept in Panzirer v Wolf did not describe how the defendant might have rebutted the presumption of reliance, but merely made it clear that active ‘reliance on the market’ in terms of knowledge of price trends was not necessary.\(^{47}\) The reasoning in the Court’s judgment was not so much a ‘fraud on the market’ analysis as an ‘indirect reliance through the agency of a

\(^{40}\) Ibid.

\(^{41}\) See above n 28 and accompanying text.

\(^{42}\) See below Part IV(A).

\(^{43}\) For example, a person may transact because they are relying primarily on another information source, such as a trusted investment adviser, and would rely on that source regardless of knowledge about misrepresentations or omissions.

\(^{44}\) 663 F 2d 365 (2nd Cir, 1981).

\(^{45}\) Panzirer v Wolf, 79 Civ 3445 (SDNY, 21 April 1980).


\(^{47}\) Note, ‘The Fraud on the Market Theory’, above n 17, 1151.
third party’ analysis. (The two approaches have similarities, but the latter is differentiated by limits to the length of the causal chain.) Lumbard J’s reasoning included the following passages:

the plaintiff argues that if Allied’s report had been accurate, the stock analysts interviewed by the [Wall Street] Journal would not have mentioned the company favourably, the Journal would not have devoted two paragraphs to Allied’s prospects in the video cassette market, and [the] plaintiff would not have been led by the article to buy her stock.48

Lumbard J further noted:

[The plaintiff] Zelda Panzirer did not rely on the integrity of the market price because she did not rely on price, but she did rely on the integrity of the market in producing information reported in The Wall Street Journal. Just as a material misrepresentation or omission is presumed to affect the price of the stock, so it should be presumed to affect the information ‘heard on the street’ which led Zelda Panzirer to make her losing investment.49

In the 1988 decision of Basic Inc v Levinson,50 the Supreme Court of the United States formally endorsed the ‘fraud on the market’ theory of reliance in cases of securities fraud. The Court also found that the presumption of reliance may be rebutted by the defendant showing that the price was not affected by their misrepresentation, or that the plaintiff did not trade in reliance on the integrity of the market price. Before analysing that case and its implications, however, it is appropriate to review briefly the economic arguments and model on which the theory rests.

IV The ‘Fraud on the Market’ Doctrine

Part III illustrates that there are a large number of decisions by United States courts which predate the acceptance of the pure ‘fraud on the market’ theory and which are in one sense softer versions of that theory. On another view, the decisions may be seen simply as findings or inferences of fact that reliance existed in the circumstances of the case, with the practical effect of shifting the burden onto defendants to rebut those findings. Those circumstances principally included the materiality of the omissions, but also in certain cases:

- a heightened responsibility expected of the issuer of securities;
- the apparent conveyance of misleading conduct to the plaintiff by a third party (indirect or third party reliance); and
- preservation of the integrity of the regulatory process by presuming reliance on Securities and Exchange Commission (public regulatory) filings.

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49 Ibid 368.
What should be noted is that courts would seem to be entitled to arrive at these decisions by reference to traditional legal reasoning, including what can fairly be inferred on the facts of the case, rather than by a presumption of law based on economic theory.

By contrast, the ‘fraud on the market’ theory should be recognised as a presumption of law grounded in economic theory in general, and in particular on the ‘efficient capital markets’ hypothesis.\textsuperscript{51} The significance of the economic basis of the ‘fraud on the market’ theory to its application by courts will be considered later.\textsuperscript{52}

A. *The ‘Efficient Capital Markets’ Hypothesis*

The ‘efficient capital markets’ hypothesis is based on the theory that, in developed securities markets, share prices fully reflect available information.\textsuperscript{53} This also means that a current share price constitutes ‘an unbiased estimate of its future price’.\textsuperscript{54} In economic terms, this means that the markets are ‘efficient’. The theory incorporates the implicit assumption of competitive general equilibrium models: that buyers and sellers act in an economically self-interested manner and are assumed to have regard to the information of which they are aware in making self-interested decisions to buy and sell securities. In one sense, based on the first assumption, the proposition is almost tautologically true, as the market price is itself the result of the aggregate or mean result of investors’ decisions based on the aggregate total of that available information.\textsuperscript{55}

The ‘efficient capital markets’ hypothesis extrapolates from this theory to suggest that no investor using information which is generally available to other investors can systematically identify and acquire undervalued securities. It is said that this does not mean that undervalued securities do not exist, but merely that it is not possible to identify them.\textsuperscript{56} Ironically, it is the fact that traders in the market assume exactly the opposite — that they as individuals can identify underpriced securities using available information — that leads them to compete to earn superior returns by identifying mispriced securities.\textsuperscript{57} This competitive analysis of the available information leads to all public information feeding into the market price, which makes the market efficient.

An acceptance of the ‘efficient capital markets’ hypothesis leads to the conclusion that misrepresentations or omissions will affect the market price of a security and will artificially inflate or reduce it (depending upon the nature of the misrepresentation or omission). In the case of an artificial inflation of the share price, it follows that anyone who has purchased shares between the time that the


\textsuperscript{52} See below Part IV(D).


\textsuperscript{54} Ibid 72.

\textsuperscript{55} This is not to deny the possibility that a substantial number of trades will actually take place in a relative vacuum of hard information.

\textsuperscript{56} Saari, above n 51, 1035 fn 23.

misinformation became available and the time that it was corrected has pur-
chased those shares at an artificially-inflated price. When the misinformation is
corrected, the share price will fall, returning to its true or intrinsic value and the
purchaser’s loss or damage resulting from that misinformation will be realised.58

B Basic Inc v Levinson

As we have seen, there were varying degrees of acceptance of the ‘fraud on the
market’ theory in lower United States courts in the 1970s, though with a trend
towards greater acceptance.59 In 1988, however, the Supreme Court gave
decisive support to the theory in Basic Inc v Levinson. In that proceeding, the
corporate officers of Basic Inc made three public denials during 1977 and 1978
of the existence of ongoing merger negotiations with Combustion Industrial. In
fact, both companies had been engaged in merger negotiations since October
1976. The plaintiffs sold their share in Basic Inc after the first denial and prior to
Basic Inc’s later announcement in December 1978 that it would merge with
Combustion Industrial (which saw its share price rise).

The plaintiffs alleged a violation of r 10b-5 of the Securities Exchange Act of
1934, arguing that the public statements denying merger negotiations were
misleading and had artificially depressed the stock price, causing loss to the
plaintiffs when they sold their shares. The defendant alleged that no premature
disclosure of merger negotiations was mandated under the rule and that such
information only became material when an agreement-in-principle had been
reached. Blackmun J, delivering the opinion of the Court, began his judgment by
stating the purpose of the Securities Exchange Act of 1934:

The 1934 Act was designed to protect investors against manipulation of stock
prices. … Underlying the adoption of extensive disclosure requirements was a
legislative philosophy: ‘There cannot be honest markets without honest public-
ity. Manipulations and dishonest practices of the market place thrive upon mys-
tery and secrecy.’ … This Court ‘repeatedly has described the “fundamental
purpose” of the Act as implementing a “philosophy of full disclosure.”’60

Restating the significance of the materiality requirement, the Court held that
disclosure was mandated when the information became material for a reasonable
investor’s decision.61 Regarding the meaning of the materiality requirement, the
Court applied the definition found in TSC Industries Inc v Northway
Inc.62 — that materiality was to be determined by the ‘reasonable investor’
test — and confirmed its applicability to claims based on rr 10(b) and 10b-5,
respectively:

The Court also explicitly has defined a standard of materiality under the securi-
ties laws, see TSC Industries Inc v Northway Inc, concluding in the

58 Admittedly, of course, the same misinformation will also have led to windfall gains by other
players in the market who will have sold at an artificially-inflated price. However, unless these
are ‘insiders’, then their gains will have been innocently acquired.
59 See above Part III.
61 Ibid 231–2.
62 See above n 26 and accompanying text.
proxy-solicitation context that ‘an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.’ Acknowledging that certain information concerning corporate developments could well be of ‘dubious significance’, the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management ‘simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decisionmaking.’ It further explained that to fulfil the materiality requirement ‘there must be a substantial likelihood 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.’ We now expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context.63

However, the Court found that preliminary merger discussions did not constitute material facts for investors’ decision-making on the facts of the case before it:

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target’s fortune is certain and clear, the TSC Industries materiality admits straightforward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the ‘reasonable investor’ would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.64

The Court then turned to the question of reliance and the ‘fraud on the market’ theory:

The fraud on the market theory is based on the hypothesis that, 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. … Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. … The causal connection between the defendants’ fraud and the plaintiffs’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Our task, of course, is not to assess the general validity of the theory, but to consider whether it was proper for the courts below to apply a rebuttable presumption of reliance, supported in part by the fraud-on-the-market theory.65

Noting that individual reliance had traditionally been a necessary element of common law fraud claims, the Court nonetheless affirmed the application of a rebuttable presumption in favour of plaintiff investors:

The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5’s reliance requirement must encompass these differences. … Requiring a plaintiff to show a speculative state

64 Ibid 232.
65 Ibid 241–2 (citations omitted).
of facts, ie, how he would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made, would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.

Arising out of considerations of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between the parties. The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act. …

The presumption is also supported by common sense and probability. Recent 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. It has been noted that ‘it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?’ … Because most publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.66

The case approved the formulation of the Court of Appeals that, in order to invoke the presumption, a plaintiff must allege and prove that:

1. the defendant made public misrepresentations;
2. the misrepresentations were material;
3. the shares were traded on an efficient market;
4. the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and
5. the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.67

C Criticisms of the Doctrine

In an influential article, published in *Business Lawyer* in 1982, Daniel R Fischel argued for a wholesale adoption of the implications of the ‘fraud on the market’ theory in securities class actions.68 In doing so, he argued that the traditional approach should be discarded, including the traditional enquiries into reliance, causation and damages.69 Interestingly, he also argued for modification of the conventional enquiry into materiality — whether the misinformation or omission was material to the decision to buy or sell the securities.70 The materiality enquiry, he argued, should be an enquiry into whether the information actually did cause the security to trade at an artificially high or low price, rather

66 Ibid 243–7 (citations omitted).
67 Ibid 248.
69 Ibid 8.
70 Ibid 6–7.
than whether the information would be material to the ‘reasonable investor’.\(^{71}\) As we have seen, this was not the test that was to be adopted by the Supreme Court in *Basic Inc v Levinson*, which continued to rely on the ‘reasonable investor’.\(^{72}\)

Fischel criticised the ‘reasonable investor’ standard as containing ‘no tools for resolving the materiality problem’ apart from an ‘I know it when I see it’ test.\(^{73}\) He argued that this lack of precision led to a danger that a piece of information may appear to be important and material to investors when in fact it was not.\(^{74}\) This could occur, where the misinformation lacked credibility so that the market in fact had no regard to it (in other words, the market was not misled).\(^{75}\) Likewise, an omission to state facts may seem to be material but, because the information was available from other sources, the market may not in fact be deceived.\(^{76}\) Thus, Fischel argued that it was a contradiction for a statement to be material yet not affect enough traders to influence the market price. The meaning of materiality under the market model, therefore, was that there had to be an effect on the market price.\(^{77}\)

In the same article, Fischel noted and sought to deal with some of the possible arguments against adopting the pure ‘fraud on the market’ model. These arguments included:

1. It would create an incentive for investors to remain uninformed. Fischel dismissed this argument as based on the misconception that it was possible for an individual investor to acquire more information from Securities and Exchange Commission filings than was already incorporated in the market price (effectively this argument was itself a version of the ‘efficient capital markets’ hypothesis).\(^{78}\)

   It is submitted that a more obvious point may be that investors are unlikely in reality to trade in wilful ignorance of relevant information simply because of the prospect of a lighter burden of proof in later litigation to recover their loss. To suggest otherwise seems to assume that investors will be happier to sue for losses rather than to make profits.

2. Such an incentive to remain ignorant would create a less efficient market. In addition to the above points, Fischel noted in reply that, in an inefficient market, mispriced securities could in fact be identified, which would create an incentive for the acquisition of information to identify such securities.\(^{79}\) This would quickly correct the inefficiency and bring the market back to (an efficient) equilibrium.

\(^{71}\) Ibid 5–7.

\(^{72}\) See above nn 61–3 and accompanying text.


\(^{74}\) Ibid.

\(^{75}\) Ibid.

\(^{76}\) Ibid 6, 7.

\(^{77}\) Ibid 11.

\(^{78}\) Ibid 13.

\(^{79}\) Ibid 14.
The approach would be unfair to investors who clearly did rely on a false statement in circumstances where the market ignored the false statement. Fischel here argued that if the market ignored the statement, then there would be no ‘fraud on the market’ and, significantly, suggested that ‘the law has never compensated for injury where the so-called reasonable man — in this case the market — has not been misled’. This sentence suggests clearly that what he was really arguing for was the replacement of the ‘reasonable investor’ as the determinant of materiality with ‘the market’.

However, it is submitted that this course is likely to lead to reduced flexibility and greater chance of injustice. Clearly, the ‘reasonable investor’ test can already integrate the aggregate judgement of the market as an important factor in determining what the reasonable investor may have regard to. Yet at the same time, it is not limited to the market and may incorporate other more subjective factors, including the differing types of investors that may exist. It may be, for instance, that the majority of shareholders are unsophisticated investors, yet hold only a minority of the shares. The sophistication of the fewer larger shareholders will be more prominently reflected in the market price than the relative lack of sophistication of the more numerous smaller investors because of the weight of the former’s overall shareholding. The reasonable investor, properly hypothesised, however, is likely to more accurately take account of the knowledge profile of the more numerous small and unsophisticated investors.

The approach was unfair where investors suffered losses which were unrelated to the alleged wrongful conduct. Fischel noted that traditional causation tests would prevent recovery in this situation, but argued that the ‘fraud on the market’ approach would also deny recovery since later calculation of loss will require an inquiry into what part of the share price slump was caused by the misinformation. This calculation would presumably eliminate that part of the share price fall that was caused by the general slump.

The approach was inconsistent with the then restrictive trend of Supreme Court decisions on r 10b-5. Fischel argued that the ‘fraud on the market’ approach has no bias towards success for plaintiffs since it was based on the assumption that the investment community is not easily fooled. Thus, plaintiffs, who may have succeeded under the traditional approach, may not succeed at all under the ‘fraud on the market’ approach because the market as a whole was not fooled.

Lastly, Fischel noted the formidable objection that, because trading losses of one group are offset by the (often innocent) trading gains of others, then al-

81 In relation to the interdependence between the ‘reasonable investor’ test, the market impact test and a third variation, being the probability/magnitude test, see Mark L Mitchell and Jeffrey M Netter, ‘The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission’ (1994) 49 Business Lawyer 545, 548–9.
83 Ibid 16.
lowing the losing traders to recover their losses exceeds the net social costs of the conduct. On this view, the proper remedy is disgorgement of the gains (if any) of the wrongdoers, rather than making those wrongdoers liable for all the losses of the losing traders. Fischel confronted the argument in economic terms, noting that the social costs of fraudulent conduct are substantial in misallocating investment dollars in both primary and secondary capital markets. He noted that preventing recovery would necessitate increased investment in resources to distinguish correct from incorrect information, itself a social cost. He rejected disgorgement because of the difficulty or impossibility of measuring the wrongdoers’ gains.

Perhaps the most significant problem for the ‘fraud on the market’ model is the uncertainty in determining the actual effect of the unlawful conduct on the market price of a security. This amount, after all, will form the quantum of investors’ loss and damage per share. This quantum will also itself, under Fischel’s pure market approach, provide a yardstick for determining materiality (or perhaps the degree of materiality). One of the practical implications of the theory in courts is that the determination of such an effect is likely to involve economic analysis rather than legal theory, so that quantum of damages will be the subject of expert economic evidence and debate (particularly statistical material) rather than legal argument.

Fischel noted that the determination will require the removal of all other factors from the share price, such as the effects of an overall market downturn, to arrive at a calculation of what the share price would have been but for the fraudulent conduct or misrepresentations. The answer, he suggested, was the use of modelling based on ‘the observable correlation between the return on a particular security and the return on the entire market when viewed over time’. He noted that ‘once this historically observable correlation is determined, it is possible to predict what the return of a given security should be on a certain date given the return for the market as a whole’. A similar attempt to remove market-wide influences has also been described as an ‘event study methodology’, designed to ‘disentangle the effects of two types of information on stock prices — information that is specific to the firm under question and information that is likely to affect stock prices marketwide’. Such techniques have in fact been applied in cases brought by the Securities and Exchange Commission.

One criticism of this historical approach, however, is its inability to draw useful conclusions in the case of securities that have little or no price histories, such as newly-issued securities. It must follow that the method will decrease in

84 Ibid.
85 Ibid.
86 Ibid.
87 Ibid.
88 Ibid 17.
89 Ibid 18.
90 Ibid.
91 Mitchell and Netter, above n 81, 556–7.
92 Ibid 572–84.
accuracy as the price history shortens. For newly-issued securities, which by definition have no price history, the next best approach will presumably be to use data from closely similar types of securities. However, this will be far from ideal. Historical extrapolations can only provide so much information on the future. Social, technological, regulatory, demographic, geopolitical and a host of other possible developments can create one-off changes that can render historical share price data unhelpful or even redundant.

The ‘fraud on the market’ theory has been described as providing the ‘reliance’ element required under r 10b-5. However, on one view, this somewhat strains the meaning of the word ‘reliance’. Clearly, the ‘fraud on the market’ theory can be said to provide the causation element on a ‘but for’ basis — ie, but for the misstatements, the securities would have traded at a different price. Whether it is true to assert that investors truly ‘relied’ on the integrity of the market price is debatable given that (a) if they wished to purchase the shares, they had no choice but to purchase at the market price, and (b) the ‘reliance’ will often have been unconscious at best.

D The Differing Approaches of Law and Economics

The ‘fraud on the market’ theory in its pure economic form is also something more akin to a theory of misallocation of investment resources than one of compensation for loss caused by unlawful conduct. To the lawyer, it is the unlawfulness of the conduct causing loss that is the ill to be remedied, but to the economist, it is the misallocation of resources caused by incorrect information in the market. The distinction will in many cases be of no practical significance, but it is a subtext that may, to some degree, explain the reluctance of Canada — the other jurisdiction where the theory has been advanced — to embrace it. Apart from specially-created economic jurisdictions such as competition law, it can hardly be said that issues of allocative efficiency are traditional concerns of law. The jurisprudential underpinnings of common law actions in relation to securities nondisclosure are drawn rather from the law’s desire to provide a remedy to those injured by conduct that is negligent or deceitful.

As I have observed, the courts also show a natural reluctance to limit their flexibility by subscribing to an economic theoretical approach, given that the theory is based on a model which is built on assumptions. The latter will generally but not universally hold true (for example, people will usually, but not always, act in an economically self-interested manner) so that the possibility of injustice in an individual case can arise. Even in the United States, where the ‘fraud on the market’ theory has been accepted, the Supreme Court in Basic Inc v Levinson did not fully accept its implications in determining materiality solely through market impact. Rather, the Court maintained the ‘reasonable investor’ test which, as I have observed, appears to offer the prospect of a fairer hearing for small and unsophisticated investors than would an approach based on the mean effect of conduct on the market as a whole.93

93 See above n 81 and accompanying text.
I turn now to the approach of Canadian courts when asked to apply the ‘fraud on the market’ doctrine.94

V  The Approach of Canadian Courts to the ‘Fraud on the Market’ Doctrine

Attempts to apply the pure ‘fraud on the market’ doctrine in Canadian class actions have not met with success.95 Nevertheless, the Canadian courts have accepted that there may be an inference of reliance from facts or circumstances and that this inference could then become one requiring rebuttal by the representor.96 Further, under Ontario’s Securities Act, there is also a statutory presumption of reliance in relation to particular forms of disclosure documents including prospectuses and information memoranda relating to takeover bids and share buybacks.97

A Carom v Bre-X Minerals Ltd

In Carom v Bre-X Minerals Ltd,98 the plaintiff shareholders and former shareholders of Bre-X Minerals Ltd (‘Bre-X’), a Canadian mining company operating in Indonesia, sought to amend their statements of claim brought under the Ontario Class Proceedings Act.99 Bre-X had made a series of announcements in the mid-1990s describing the level of gold deposits in Busang in East Kalimantan province in Indonesia. This caused the Bre-X share price to rise from C$0.50 in May 1993 to C$228.00 in May 1996. The share price later plummeted, following an independent discovery that the size of the deposits was significantly less than that which was represented.

The plaintiffs, who sued on behalf of purchasers of Bre-X shares who had suffered loss after purchasing at the inflated price caused by the announcements, asserted causes of action in negligence, negligent and fraudulent misrepresentation, conspiracy, breach of fiduciary duty and breach of the Canadian Competition Act.100 In 1998, the plaintiffs sought to amend their claims to integrate the United States ‘fraud on the market’ doctrine. On 4 November 1998, Winkler J of the Ontario Court (General Division) gave judgment refusing the proposed amendments.101

94 There do not appear to have been any attempts to apply the theory in litigation in the United Kingdom. This is probably due to the lack of comprehensive procedural provisions facilitating class actions in that country.
95 Carom v Bre-X Minerals Ltd (1998) 41 OR (3d) 780 (‘Bre-X’).
96 See, eg, CC&L Dedicated Enterprise Fund (Trustee of) v Fisherman (2001) 8 CCLT (3d) 240 (‘Fisherman’).
100 RSC 1985, c C-34.
The plaintiffs had argued that whether the ‘fraud on the market’ theory could be invoked in Ontario was a ‘novel point’ and an ‘open question’. Winkler J disagreed with this. His Honour noted that reliance was an essential element of their claims in negligent and fraudulent misrepresentation and said:

The theory is advanced out of the statutory context in which it was developed. It is put forward absent the surrounding qualifications and conditions with which it is circumscribed in the United States. Moreover, the plaintiffs’ submission would require a redefinition of the common law torts of fraudulent and negligent misrepresentation as developed by the Supreme Court of Canada.

Winkler J reviewed the decision of the Supreme Court of the United States in Basic Inc v Levinson and, in particular, noted the statement by Blackmun J that 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.

Winkler J then stated: ‘It must be noted that the “predominance of common issues” test does not pertain to class proceedings under the [Class Proceedings Act] in Ontario.’ Thus, refusing the amendments would not necessarily have been fatal to certification of the class action in the manner it may have been in the United States.

Winkler J went on to note the distinction between r 10b-5 actions and common law claims in the United States, noting that United States courts had rejected the ‘fraud on the market’ theory in common law misrepresentation or deceit claims. His Honour noted that he was being asked to adopt the presumption of reliance under the ‘fraud on the market’ theory to satisfy the requirement of actual reliance in fraudulent and negligent misrepresentation claims.

Winkler J conceded that a presumption of reliance might arise as an inference of fact, though not as an inference of law. This concession was based on the 1884 English case of Smith v Chadwick. His Honour concluded that ‘there...

102 Ibid 786.
103 Ibid.
104 Ibid.
I must respectfully disagree with [the] statement that the Act was not intended to be used in circumstances where the individual issues to be determined could be said to predominate the common issues … I cannot accept that the legislature intended to incorporate the predominate issue test into the Act.
108 Ibid 792.
109 (1884) 9 App Cas 187. Lord Blackburn said at 196:
I think that if it is proved that the defendants with a view to induce the plaintiff to enter into a contract made a statement to the plaintiff of such a nature as would be likely to induce a person to enter into a contract, and it is proved that the plaintiff did enter into the contract, it is a fair inference of fact that he was induced to do so by the statement.
is no support in the common law for the plaintiffs’ assertion that a presumption of reliance may arise as a matter of law.\textsuperscript{110}

The significance of the distinction between inferring reliance as a matter of law and making the inference as a matter of fact was not discussed by Winkler J. Lord Blackburn in \textit{Smith v Chadwick}, however, indicated that an inference of fact will require evidence of the relevant circumstances.\textsuperscript{111} Thus, if no evidence was given as to reliance in fact, then that would be ground for not drawing the inference. Winkler J concluded:

In the United States the fraud on the market theory has one application: it is asserted in a cause of action founded on a breach of a statutory duty. Here, the plaintiffs seek to apply the fraud on the market theory and the resulting presumption to common law causes of action. They also seek to apply the theory in these actions without the limitations which circumscribe its application in the United States. However, the nexus, between the plaintiffs’ claims and the theory, is absent without the necessary statutory framework from which it emanated. Moreover, attempts to advance the theory in common law actions in the United States have been almost unanimously rejected, and no appellate court there has approved of the theory in the context of such actions. The theory was developed in support of a legislative objective directed at securities fraud and the cause of action is accordingly circumscribed by two important limitations of the statute, as judicially interpreted, specifically the unavailability of punitive damages and a shortened limitation period. In contrast, punitive damages are available under the common law torts, are claimed in the instant proceedings and the limitations periods here are significantly longer than under the US statute.\textsuperscript{112}

His Honour also noted that fraud was not an element of all the causes of action before him as it was in the United States under s 10(b) and r 10b-5,\textsuperscript{113} and repeated his observation that there was no requirement of a ‘predominance of common issues’ under the Ontario \textit{Class Proceedings Act} as there was in the United States. His Honour concluded that the proposed amendments to the statements of claim disclosed no reasonable cause of action and should not be allowed.

\section*{B Subsequent Decisions}

A slightly different approach was adopted by the Ontario Superior Court of Justice in \textit{Fisherman}. This case involved a complicated factual situation entailing the issue of securities in a corporation (YBM) in the mid-1990s, pursuant to an alleged criminal conspiracy involving Canadian, Channel Islands and Hungarian companies, and alleged members or associates of Russian organised crime. The plaintiffs alleged fraud and conspiracies to launder money and market securities

\textsuperscript{110} \textit{Bre-X} (1998) 41 OR (3d) 780, 793.
\textsuperscript{111} (1884) 9 App Cas 187, 196.
\textsuperscript{112} \textit{Bre-X} (1998) 41 OR (3d) 780, 793.
\textsuperscript{113} Ibid 793–4. It must respectfully be doubted whether this is correct — especially in relation to para (b) of Rule 10b-5. However, fraud does not have precisely the same meaning under United States law as it has in the Commonwealth common law countries.
on the basis of a ‘pervasive’ false representation that YBM was a legitimate business with legitimate business income.

YBM shares ceased to trade in May 1998 after it became the subject of a criminal fraud investigation in the United States. The shares became valueless after a receiver was appointed in December 1998, and YBM pleaded guilty to a charge of conspiracy to commit mail and securities fraud in June 1999. The plaintiff group were purchasers of shares on a secondary market prior to the revelations of the wrongdoing. The defendants included company insiders, the company’s auditors, its lawyers and a financial adviser.

The auditor defendants sought to strike out the statement of claim as disclosing no reasonable cause of action against them. One of the issues that arose was the requirement that the plaintiffs plead and prove reliance as a necessary element of the action of negligent misrepresentation. The plaintiffs had argued that the question of reliance was a matter of fact and the market price of the shares reflected the ‘representation’ contained in certain audit opinions. They therefore argued that a court could conclude that, by purchasing YBM shares, each class member relied upon the misrepresentation.

The auditor defendants argued that the plaintiffs’ argument was, in reality, advancing the ‘fraud on the market’ theory of reliance, which was not part of Canadian law and had been rejected in *Bre-X*\(^{114}\) and *Kripps v Touche Ross & Co*.\(^{115}\)

The plaintiffs accepted that the ‘fraud on the market’ theory and an inference of reliance as a matter of law was not available to them under Canadian common law. They argued that their pleading alleged actual reliance, which was a matter of fact, and that it was therefore open to the court to conclude, as a matter of fact, that each putative class member relied upon the ‘representation’ in purchasing shares in the secondary market. They argued that the court in *Bre-X* did not decide this issue as Winkler J dealt only with the proposition that there should be an inference of reliance as a matter of law based specifically on the ‘fraud on the market’ theory.

In his judgment, Cumming J expressed the view that whether a plaintiff has actually relied upon a misrepresentation was a question of fact and may be inferred from all the circumstances. He quoted from Finch JA of the British Columbia Court of Appeal noted in *Kripps v Touche Ross & Co*:\(^{116}\)

> Whether a plaintiff has actually relied upon a misrepresentation is a question of fact and may be inferred from all the circumstances. As Finch JA of the British Columbia Court of Appeal noted in *Kripps v Touche Ross & Co* …

Whether a representation was made negligently or fraudulently, reliance upon that representation is an issue of fact as to the representee’s state of mind. There are cases where the representee may be able to give direct evidence as to what, in fact, induced him to act as he did. Where such evidence is available, its weight is a question for the trier of fact. In many cases,

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114 (1998) 41 OR (3d) 780, 793 (Winkler J).
116 (1997) 35 CCLT (2d) 60, 89.
however, as the authorities point out, it would be unreasonable to expect such evidence to be given, and if it were it might well be suspect as self-serving.

Finch JA had further held that

where the misrepresentation in question is one which was calculated or which would naturally tend to induce the plaintiff to act upon it, the plaintiff’s reliance may be inferred. The inference of reliance is one which may be rebutted but the onus of doing so rests on the representor.

Cumming J’s conclusion was:

To foreclose the consideration of an arguable issue past the pleading stage, a moving party must show that there is an existing bar in the form of a decided case directly on point from the same jurisdiction demonstrating that the very issue has been squarely dealt with and rejected: Dalex Co v Schwartz Levitsky Feldman … Had the plaintiffs simply pleaded the ‘fraud on the market theory’ I would have foreclosed that consideration. Given, however, that the case law recognizes that a person’s reliance upon a representation may be inferred from all the circumstances, in my view it would be premature to foreclose the consideration of this issue in the case at hand beyond the pleading stage.117

This approach may suggest that, despite the rejection of the pure ‘fraud on the market’ theory in Canada, the courts have subsequently entertained the possibility of a softer version of presumed reliance based on inferences of fact that may be drawn in particular cases. Such facts might, for instance, establish that a misrepresentation was one which was calculated or would naturally tend to induce the plaintiff to act upon it. How far such inferences will be drawn remains to be seen, particularly in circumstances where there may be little or no evidence available from individual claimants.118

Other recent Canadian decisions have produced differing results. In Yves Beaudoin c Avantage Link Inc,119 Viau J in the Quebec Superior Court certified a class proceeding based on loss through alleged false and misleading press

117 Fisherman (2001) 8 CCLT (3d) 240, 256–7. Note the reference to the judgment of the Ontario Court of Appeal in NBD Bank Canada v Dofasco Inc (2000) 181 DLR (4th) 37. That proceeding was not a class action, but one of the points on appeal was that there was no evidence from a representee as to what he thought a comment by the representor actually meant. The appellant argued it was therefore not open to the trial judge to infer that the representee relied on that statement. In that regard, Rosenberg JA said at 70:

Whether or not Mr Nicholas’ statements were misrepresentations and whether or not the respondent reasonably relied upon them are findings of fact. These findings turned upon the trial judge’s assessment of the credibility of the many witnesses and the inferences to be drawn from the evidence. … It was not necessary, for example, for Mr Hynes to testify that he relied upon the statements by Nicholas on the morning of January 11th. That reliance could be inferred from all the circumstances. The fact that after the conversation, Mr Hynes took no steps to stop the cheques from clearing, notwithstanding he did not have a reply from Mr Melville, is compelling evidence that Mr Hynes must have relied upon the assurances he received from Mr Nicholas. As indicated above, it was not necessary for the respondent to prove that the statements by Mr Nicholas were the only factors that induced the respondent to act to its detriment: Kripps v Touche Ross & Co …

118 The situation of a claimant being unable to give evidence may arise in an absolute sense where a shareholder is deceased but the cause of action for economic loss survives and is pursued by the deceased’s estate. It will arise in a relative or practical sense if the number of shareholder group members is too vast for court resources to allow the admission of detailed evidence from all.

releases causing artificial inflation of the share price. Damages were claimed by secondary market investors so that, though the ‘fraud on the market’ theory was not addressed, there being some doubt as to how causation might have been found other than through ‘fraud on the market’ type reliance on the market price. The certification decision might suggest that such a method of proving causation was at least arguable.

In *Shaw v BCE Inc*., however, a statement of claim was struck out by Farley J in the Ontario Superior Court of Justice for failure to disclose a reasonable cause of action in negligent misrepresentation, given the failure to allege that the plaintiff had relied on the misrepresentation. In a similar vein, Macauley J of the British Columbia Supreme Court in *Collette v Great Pacific Management Co* dismissed a claim for certification based on a failure to establish individual reliance on alleged misrepresentations. This decision was reversed by the Court of Appeal for British Columbia, based on a finding that there was a two-stage process for the sale to the investors of the relevant investments (mortgage units). It found that although the second stage of that process involved individual sales to investors by advisors (which did require proof of reliance), the first stage of the process involved a due diligence process where there were sufficient common issues to allow certification. An argument that, but for the negligent due diligence process, no units would ever have been sold, appears to have been accepted as an arguable form of causation.

C Presumed Reliance under the Ontario Securities Act

The importance of the ‘fraud on the market’ theory, and the case for Canadian courts to consider its adoption in order to do justice to investors and to reduce securities fraud, is lessened at least in the province of Ontario by the existence of statutory deemed reliance in relation to certain key documents circulated by corporations. Thus, shareholders will be presumed to have relied on any misrepresentations made in a prospectus, takeover bid or issuer bid (share buyback) circular.

Section 130 of the Ontario *Securities Act* provides that, where a prospectus contains a misrepresentation, a purchaser who purchases a security offered thereby during the period of distribution to the public shall be deemed to have relied on such a misrepresentation if it was a misrepresentation at the time of the purchase. They will have a right of action for damages against directors and various other persons specified in the section.

Section 131 of that Act also provides that, where a takeover bid circular sent to security holders or any notice of variation in respect thereof contains a misrepresentation, every such security holder shall be deemed to have relied on the misrepresentation and may elect to exercise a right of action for rescission or damages against persons specified in the section.

120 (Unreported, Ontario Superior Court of Justice, Farley J, 14 May 2003); (2004) 42 BLR (3d) 107.
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Thus, reliance is presumed under ss 130 and 131 of the Ontario Securities Act, and the evidentiary burden of rebutting the presumption is on the defendants. This is essentially the same situation as that created by the ‘fraud on the market’ doctrine, though limited to prospectuses, and takeover and buyback circulars.123

VI THE APPROACH OF AUSTRALIAN COURTS TO CAUSATION AND COMPATIBILITY OF THE ‘FRAUD ON THE MARKET’ DOCTRINE WITH AUSTRALIAN LAW

A Securities Nondisclosure in Australia

Securities nondisclosure in Australia is now regulated primarily by provisions in the Corporations Act and the Australian Securities and Investments Commission Act 2001 (Cth) (‘ASIC Act’). These Acts create numerous specific offences124 as well as adopting the civil misleading and deceptive conduct provisions originally contained in the Trade Practices Act 1974 (Cth) (‘TPA’).125 In more recent times, the Corporations Act has been amended to incorporate continuous disclosure obligations which give legislative force to the Australian Stock Exchange Listing Rules.126

1 Misleading and Deceptive Conduct

The Australian provisions that deal most closely with the matters covered by the United States r 10b-5 in relation to misleading statements and omissions generally are s 1041H of the Corporations Act (misleading and deceptive conduct in relation to a financial product or financial service — civil liability only) and s 12DA of the ASIC Act (misleading and deceptive conduct in relation to financial services).127

Section 1041H(1) provides that ‘a person must not, in this jurisdiction, engage in conduct, in relation to a financial product or a financial service, that is misleading or deceptive or is likely to mislead or deceive.’

123 At least one Ontario class action has been certified under the deemed reliance provisions of the Ontario Securities Act, RSO 1990, c S-5: see Maxwell v MLG Ventures Ltd (Unreported, Ontario Superior Court of Justice, Ground J, 27 April 1995). In that case, the defendant corporation made an offer in an issuer bid (share buyback) to purchase all outstanding shares of Maple Leaf Gardens Ltd. As required under the Securities Act, RSO 1990, c S-5, Maple Leaf Gardens Ltd included an information circular with the distribution of its issuer bid. The class action was commenced on the basis of misrepresentations in the information circular. The deemed reliance provision of the Securities Act, RSO 1990, c S-5, s 131 saw the plaintiffs easily overcome the common hurdle to class action certification.

124 See, eg, Corporations Act ss 1041A, 1041B, 1041C, 1041E, which created the offences of stock market manipulation; false trading and market rigging transactions; false or misleading statements in relation to securities; and fraudulently inducing persons to deal in securities.

125 See Corporations Act s 1041H. Misleading and deceptive conduct continues to be dealt with by s 52 of the TPA.

126 See Corporations Act s 674.

127 However, since being amended in 2000 and 2002, neither of these sections deal with misleading or deceptive conduct in relation to a takeover document or a disclosure document. This is dealt with separately by ss 670A and 728 of the Corporations Act, respectively. Nor do they deal with misleading statements or omissions in disclosure documents, such as financial services guides, statements of advice, and product disclosure statements. These are regulated by, respectively, ss 953A and 1022A of the Corporations Act.
Section 1041H(2) goes on to define ‘engaging in conduct in relation to a financial product’ (a ‘financial product’ is stated in s 764A(1)(a) to include a security) as including ‘dealing in a financial product’ as well as a range of other acts, including ‘issuing a financial product’, ‘publishing a notice in relation to a financial product’, ‘making, or making an evaluation of, an offer under a takeover bid or a recommendation relating to such an offer’, and a range of other activities under the *Superannuation Industry (Supervision) Act 1993* (Cth) and the *Retirement Savings Accounts Act 1997* (Cth).

Section 12DA of the *ASIC Act* is in similar terms, and provides that ‘a person must not, in trade or commerce, engage in conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive.’

2 *Continuous Disclosure*

As well as the prohibition on misleading and deceptive conduct, there are positive requirements of continuous disclosure of materially price-sensitive information. These were first inserted into the *Corporations Law* in 1994 by the *Corporate Law Reform Act 1994* (Cth) and commenced on 4 September 1994. The provisions were redrafted, relocated and strengthened with the introduction of ch 6CA (continuous disclosure) into the Act by the *Financial Services Reform Act 2001* (Cth) effective from 11 March 2002.

Section 674 of the *Corporations Act* gives legislative force to the *Listing Rules* and goes further than earlier provisions in applying the requirement to unlisted disclosing entities and listed disclosing entities where their listing rules do not have disclosure obligations. The provisions are marked as civil penalty provisions, allowing a civil standard of proof in actions by the Australian Securities and Investments Commission (‘ASIC’) and, as noted by Lindgren J, an important difference between the present ch 6CA and the former ss 1001A–1001D is that ‘the requirement of intentionality, recklessness or negligence has not been retained.’

The requirements of continuous disclosure under r 3.1 of the *Listing Rules* are that: ‘Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity’s securities, the entity must immediately tell ASX that information.’

Rule 3.1A of the *Listing Rules* provides a carve out where the above will not apply. Rule 3.1 of the *Listing Rules* does not apply to particular information where all of the following are satisfied:

3.1A.1 A reasonable person would not expect the information to be disclosed.
3.1A.2 The information is confidential and ASX has not formed the view that the information has ceased to be confidential.
3.1A.3 One or more of the following applies:
   - It would be a breach of a law to disclose the information.

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128 *Australian Securities and Investments Commission v Southcorp Ltd* (2003) 130 FCR 406, 409 (though an element of knowledge is still likely to be required for persons ‘involved’ in the contravention).

The information concerns an incomplete proposal or negotiation.
- The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
- The information is generated for the internal management purposes of the entity.
- The information is a trade secret.

Section 674(2)(c)(ii) of the Corporations Act establishes the requirement of materiality based on the reasonable person as part of the overall test in s 674(2). The section provides:

If:
(a) this subsection applies to a listed disclosing entity; and
(b) the entity has information that those provisions require the entity to notify to the market operator; and
(c) that information:
   (i) is not generally available; and
   (ii) is information that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of ED securities of the entity;

the entity must notify the market operator of that information in accordance with those provisions.

The standard for disclosure set by s 674 of the Corporations Act may, however, be lower than that established for misleading and deceptive conduct because there is no requirement to disclose information that is ‘generally available’, a phrase which has been interpreted broadly in the insider trading cases.130

3 Silence, Misleading Conduct and Nondisclosure

The law of misleading conduct in Australia has developed doctrines of nondisclosure in situations where there is a combination of silence and positive averments, or where silence gives rise to a misleading representation in the absence of better disclosure. In Rhone-Poulenc Agrochimie SA v UIM Chemical Services Pty Ltd, Bowen CJ discussed the issue of misrepresentation by silence or concealment:

Dealing with the question of misrepresentation constituted by silence, there are cases which show, for example, that an omission to mention a qualification, in the absence of which some absolute statement is rendered misleading, is conduct which should be regarded as misleading. So too is the omission to mention a subsequent change which has occurred after some statement which is correct at the time has been made where the result of the change is to render the statement incorrect so that thereafter it becomes misleading. This also may be regarded as constituting misleading conduct.131

130 See, eg, R v Firns (2001) 51 NSWLR 548.
In Demagogue Pty Ltd v Ramensky, Black CJ noted that a party’s reasonable expectations are relevant to the question of disclosure:

Silence is to be assessed as a circumstance like any other. To say this is certainly not to impose any general duty of disclosure; the question is simply whether, having regard to all the relevant circumstances, there has been conduct, that is misleading or deceptive or that is likely to mislead or deceive. To speak of ‘mere silence’ or of a duty of disclosure can divert attention from that primary question. Although ‘mere silence’ is a convenient way of describing some fact situations, there is in truth no such thing as ‘mere silence’ because the significance of silence always falls to be considered in the context in which it occurs. That context may or may not include facts giving rise to a reasonable expectation, in the circumstances of the case, that if particular matters exist they will be disclosed.132

The case of GPG (Australia Trading) Pty Ltd v GIO Australia Holdings Ltd133 involved non-disclosure to the stock market. Allegations were made based on both misleading and deceptive conduct, and non-disclosure contrary to s 674 of the Corporations Act. Gyles J found there was misleading and deceptive conduct in an announcement to the market which omitted reference to, and which was not appropriately qualified to reflect the substance of, an internal report that had been relayed to the directors of the company. Having found there was misleading conduct on the basis of a combination of express statements and non-disclosures, Gyles J found no need to consider the issues of ‘pure non-disclosure’:

I need not deal with these issues in view of my conclusion as to the misleading nature of the 24 September 1999 statement and the continuing effect of it. That case must be stronger than the case of non-disclosure. The non-disclosure case, even if established, would not lead to any different result.134

The standard applied in relation to breaches of s 674 of the Corporations Act will be different in some cases from the standard in relation to misleading and deceptive conduct. In the former, a court can have regard to information generally available which, as I have noted, has been interpreted widely in the insider trading cases.135 This may be less helpful to the unsophisticated investor as he or she will be presumed to have access to all publicly-available information, even though it has not been announced to the Australian Stock Exchange, may not be widely circulated or easily available, and even though in practice he or she may not have such knowledge. With misleading conduct, however, a court will look at the ‘implied representation’136 — the implication drawn by combination of statements and silences. Whether this will be misleading and deceptive will be an objective test and will be judged by reference to the class of persons to whom the

134 Ibid 72.
135 See above n 130 and accompanying text.
136 For an illustration of the use of implied representations, see Clyde Industries Pty Ltd v Golden West Refining Corp Ltd (1996) 18 ATPR (Digest) ¶46-160. In their application to cases involving securities non-disclosure, see King v GIO Australia Holdings Ltd (2001) 184 ALR 98. See also Dorajay Pty Ltd v Aristocrat Leisure Ltd [2004] FCA 634 (Unreported, Stone J, 20 May 2004).
representation is addressed. Thus, the court will need to postulate a reasonable member of the class: in a securities nondisclosure case this may be the ‘reasonable shareholder’ or ‘reasonable retail investor’. Whilst the putative ordinary investor may be expected to have some knowledge of publicly-available information, it seems likely that the assumed level of knowledge would not be as high as that implied by the continuous disclosure laws (where a disclosing entity has no obligation to disclose information that is ‘generally’, though perhaps not easily, available).

B Action for Compensation or Loss

1 Private Actions

Section 1041I of the Corporations Act provides a right of civil recovery to ‘a person who suffers loss or damage by conduct of another person that was engaged in, in contravention of’ (inter alia) s 1041H of that Act. Rights of recovery are also provided under s 1317H for damage that ‘resulted’ from the contravention of civil penalty provisions including s 674(2).

Section 12GF of the ASIC Act also provides for a right of civil recovery for ‘[a] person who suffers loss or damage by conduct of another person that contravenes a provision of’, inter alia, s 12DA of the Act. Section 12GM(2) in turn provides for compensation as well as other orders designed to prevent or reduce such loss. Such actions may be brought by ASIC on behalf of individuals or by individuals on their own behalf. In the latter situation, individuals might also utilise the procedural machinery for the commencement of representative proceedings (class actions), such as that contained in pt IVA of the Federal Court of Australia Act 1976 (Cth).

An example of such a representative proceeding in Australia was the action brought on behalf of former GIO shareholders against the former GIO Australia Holdings Ltd, its independent expert, Grant Samuel and Associates, and the former GIO directors. The action alleged misleading and deceptive conduct, and negligence in relation to advice about the 1998 AMP takeover offer. The Federal

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139 See King v AG Australia Holdings Ltd [2003] FCA 652 (Unreported, Allsop J, 24 June 2003). In some circumstances, there could be more than one applicable objective standard, such as for ‘the reasonable retail investor’ and the ‘reasonable institutional investor.’
140 See below Pt VI(C).
141 Victoria has similar provisions: see Supreme Court Act 1986 (Vic) pt 4A.
142 Federal Court of Australia Act 1976 (Cth) s 33C.
Court approved a settlement of that proceeding in late 2003 for damages and costs of some $112 million after the case survived a number of challenges to its representative structure.\(^{143}\)

2 *Actions Brought by ASIC*

Sections 12GM(2) and (3) of the *ASIC Act* make it clear that ASIC may make an application on behalf of one or more persons identified in the application, who have suffered, or are likely to suffer, loss or damage by the conduct of another person constituting a contravention of, inter alia, s 12DA. These persons must also have consented in writing to the application being made.

ASIC may also bring proceedings pursuant to s 1317H of the *Corporations Act*, seeking a declaration of contravention of the continuous disclosure provisions in ss 674 or 675 (or any other civil penalty provisions). ASIC would also be in a position to seek a compensation order under s 1317HA, as would a person who has suffered ‘damage’ in relation to the contravention).\(^{144}\) The CLERP 9 amendments, which became law from 1 July 2004, extend this potential liability to a person who is involved in the disclosing entity’s contravention.\(^{145}\)

ASIC can also cause a civil proceeding to be initiated on behalf of a particular person or persons (including a corporation) under s 50 of the *ASIC Act*. It is necessary that it appears to ASIC, as a result of an investigation or from a record of an examination conducted under pt 3 of the *ASIC Act*, to be in the public interest for the person to begin and carry on a proceeding. The proceeding must be for the recovery of damages for fraud, negligence, default, breach of duty, or other misconduct in connection with a matter to which the investigation or examination related or for recovery of the property of the person.

If the person is a company, then ASIC may bring proceedings in the company’s name; no consent of a corporation appears to be necessary. Otherwise, ASIC must obtain a person’s written consent to the proceedings. Section 50 would appear to give ASIC power to bring what is effectively a derivative action, even though ASIC is not one of the persons given standing to bring a statutory derivative action under the *Corporations Act*.\(^{146}\) This is because ASIC does not need the approval of the board of directors of the company to commence such proceeding. In *Australian Securities Commission v Deloitte Touche Tohmatsu*, the Federal Court rejected an argument that ASIC, when deciding whether to commence a s 50 proceeding, is required to have regard to what was referred to as the ‘Foss v Harbottle principles’ — that it is a matter for the directors to

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\(^{143}\) See *King v GIO Australia Holdings Ltd* (2000) 100 FCR 209; *King v GIO Australia Holdings Ltd* [2000] FCA 1543 (Unreported, Wilcox, Lehanne and Merkel JJ, 1 November 2000); *King v AG Australia Holdings Ltd* [2003] FCA 980 (Unreported, Moore J, 17 September 2003).

\(^{144}\) See *Corporations Act* s 1317J(3A). See generally James McConvill and Darryl Smith, ‘Can Minority Shareholders “Free Ride” on ASIC’s Civil Penalty Litigation?’ (2002) 20 *Company and Securities Law Journal* 302. However, the making of such a declaration of contravention under s 1317E is not an essential precondition to seeking such relief.

\(^{145}\) *Corporations Act* ss 674(2A), 675(2A), amended by CLERP 9.

\(^{146}\) *Corporations Act* pt 2F.1A.
decide whether proceedings should be commenced in the name of the company for the enforcement of its rights.\footnote{147}

It is untested whether proceedings under s 50 could also in appropriate cases utilise procedural machinery for the commencement of representative proceedings provided for by statute.\footnote{148} It may be that ASIC could cause a shareholder corporation (or an individual with consent) to bring proceedings under s 50 which would be both on their own behalf and as a representative of all shareholders under pt IVA, provided that all shareholders were given notice of the proceedings and an opportunity to opt out of the action.\footnote{149} Section 1325(3) of the Corporations Act suggests however that such an opt-out procedure may not be available to ASIC in relation to continuous disclosure and misleading conduct claims. Certainly, written consent of represented parties has been critical in some cases.\footnote{150} It is not clear whether the opt-out procedure would provide a solution to this problem.\footnote{151}

Proceedings by ASIC under s 50 are only one aspect of ASIC’s enforcement activities,\footnote{152} however the regulator has brought a number of successful high profile proceedings over the years in relation to securities nondisclosure. In the mid-1990s, it brought proceedings on behalf of 1400 noteholders in Farrow Finance Co Ltd to recover losses following the collapse of the Pyramid and Farrow group of companies in September 1990.\footnote{153} There were also proceedings in the late 1990s against Permanent Trustee on behalf of some 26 000 investors in the Aust-Wide trusts,\footnote{154} and actions on behalf of former shareholders in Great Central Mines against Yandal Gold Pty Ltd, Edensor Nominees and others arising out of the takeover bid for Great Central Mines in 1999.\footnote{155}

\footnote{147} (1996) 70 FCR 93, 129 (Beaumont, Drummond and Sundberg JJ).
\footnote{148} See Federal Court of Australia Act 1976 (Cth) pt IVA; Supreme Court Act 1986 (Vic) pt 4A.
\footnote{149} Federal Court of Australia Act 1976 (Cth) ss 33C, 33E, 33J.
\footnote{151} It is arguable that it might provide a solution, given that the root of the problem in Medibank Private Ltd v Cassidy was constitutional: see the comments of Hayne J in Transcript of Proceedings, Cassidy v Medibank Private Ltd (High Court of Australia, McHugh and Hayne JJ, 20 June 2003). This statement necessarily assumes the constitutional validity of pt IVA of the Federal Court of Australia Act 1976 (Cth), which has never been fully tested. See also Jeremy Cooper, ‘Corporate Wrongdoing: ASIC’s Enforcement Role’ (Paper presented at the International Class Actions Conference 2005, Melbourne, 2 December 2005) <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ICAC2005_speech_021205.pdf/$file/ICAC2005_speech_021205.pdf>.
\footnote{152} These were actions against the trustee that issued the notes, the auditors of Farrow and the investigating accountant under the issue prospectus. There are various reported and unreported judgments on the proceedings: see, eg, Meadow Gem Pty Ltd v ANZ Executors & Trustee Co Ltd [1996] 2 VR 26; Meadow Gem Pty Ltd v ANZ Executors & Trustee Co Ltd (1995) 13 ALC 1198; Meadow Gem Pty Ltd v ANZ Executors & Trustee Co Ltd (Unreported, Supreme Court of Victoria, Byrne J, 29 April 1996).
Civil proceedings against well-resourced defendants that involve potential liability for substantial sums tend to be vigorously defended with numerous challenges typically made from an early stage in proceedings. Notwithstanding ASIC’s investigative powers, which are largely unavailable to a private plaintiff, a decision by the corporate regulator to take action will still involve a commitment of substantial resources which may involve a diversion from other enforcement activities. As a public agency, ASIC has also been subject to the additional challenge of administrative review of its decision to take proceedings and its interpretation of the ‘public interest’.

It is for these reasons that there remains scope for private enforcement as advocated by a number of commentators. However, it has been suggested that there are insufficient financial incentives for such private enforcement to occur. Others have warned against the dangers of lawyer-driven United States-style ‘entrepreneurial’ litigation. The current prohibition of United States-style ‘contingency fees’ by state legislatures appears to limit the amount of such litigation, although the increased role of litigation funders may be altering this. The future status of professional prohibitions under a regime of free trade with the United States is also not entirely clear. Whilst private actions are admittedly driven by the motive of private profit for the legal and commercial entities that promote them, it is also true that such actions can, in meritorious cases (and with tight judicial supervision) incidentally serve the public interest in enforcing the law and compensating victims of unlawful conduct.

161 See, eg, Legal Practice Act 1996 (Vic) s 99.
162 On one view, such prohibitions could be viewed as an impediment to competition between Australian and United States lawyers in the trans-Pacific market for legal services. Annex 10-A of the Australia–United States Free Trade Agreement, which relates to the development of professional services, states that the parties shall encourage the relevant bodies in their respective territories to develop mutually-acceptable standards and criteria for licensing and certification of professional services supplies and to provide recommendations on mutual recognition to the Joint Committee. Such ‘standards and criteria’ are said to include, inter alia, conduct and ethics (meaning standards of professional conduct and the nature of disciplinary action for non-conformity with those standards) and scope of practice (meaning the extent of or limitations on, permissible activities). The prohibition on contingency fees arguably falls within such areas. See <http://www.dfat.gov.au/trade/negotiations/us_fta/final-text/chapter_10.html>.
3 Recent Decisions: Shareholders as Creditors

Three recent decisions in Australia have considered the status of civil damages claims arising from securities nondisclosure. I will deal only briefly with these as they go to issues outside the main focus of this article — causation and loss — and raise questions about whether there are other legal barriers to shareholders taking actions against companies which arise from the nature of their relationship with the company. The questions arose in two cases due to the insolvency of the corporation against which shareholders sought to make claims. In the other case, a question arose about whether there was a distinction between shareholders who buy securities on the market and those who are original subscribers.

The first decision was that of Finkelstein J of the Federal Court of Australia in Re Media World Communications Ltd (Administrator Appointed),163 in which his Honour found that shareholders, claiming as company creditors on the basis of securities nondisclosure by the company, could not vote as creditors in an administration order under pt 5.3A of the Corporations Act. The finding was based on the rule established in Houldsworth v City of Glasgow Bank164 that a person who has subscribed for shares in a company may not, while retaining those shares, recover damages against the company on the ground that he or she was induced to subscribe for those shares by fraud or misrepresentation. Finkelstein J further noted that, in Webb Distributors (Aust) Pty Ltd v Victoria,165 the High Court of Australia held this rule bars not only common law claims but also statutory causes of action unless the statute itself overrode the rule.166 His Honour did say by way of obiter, however, that this may not apply to shares purchased on market (transferee shareholders), as unlike subscribing shareholders they could not renounce their shareholding in order to claim damages (except in unusual circumstances).167

A similar issue came before Finkelstein J in Cadence Asset Management Pty Ltd v Concept Sports Ltd,168 and his Honour again found that Houldsworth’s Case was a bar to recovery. In particular, it prevented a claim under s 729 of the Corporations Act, which provides for a right of recovery of loss from the company (and various other persons) who contravened s 728 in issuing a prospectus that omits information required by s 710, or contains misleading or deceptive statements which are materially adverse from the point of view of an investor.169 The defendant in Concept Sports was not insolvent, so the principal rationale for the decision appears to have been Houldsworth’s Case, rather than

163 (2005) 216 ALR 105 (‘Media World’).
164 (1880) 5 App Cas 317 (‘Houldsworth’s Case’).
165 (1993) 179 CLR 15 (‘Webb’).
167 Ibid 110. 
168 (2005) 55 ACSR 145 (‘Concept Sports’).
169 Ibid 150–1 (Finkelstein J).
the application of s 563A of the Corporations Act (which was highly relevant in the Media World matter, given that the company was under administration and probably insolvent). A somewhat different approach however was taken by Emmett J, also of the Federal Court, in Sons of Gwalia Ltd (Administrator Appointed) v Margaretic. The facts were somewhat similar to Media World. The company, Sons of Gwalia Ltd, was under administration and its administrator sought a declaration that the respondent shareholder was not a creditor. (The shareholder claimed a right to damages for losses caused by alleged breaches of ss 674(2) and 1041H of the Corporations Act, s 12DA of the ASIC Act and s 52 of the TPA.)

His Honour considered Houldsworth's Case and Webb, and stated:

I do not regard Webb's Case as authority for the principle that a claim by a person who, in reliance upon conduct of a company in a contravention of a prohibition on misleading or deceptive conduct, acts to the person's detriment, albeit by buying shares in the company from a third party in a transaction that has no connection whatsoever in the company, is a claim by that person in his capacity as a member of the company. I do not consider that the Shareholder's Claim is a debt owed by the Company to the Shareholder in the Shareholder's capacity as a member of the Company. If it is a debt at all, it is a debt arising as a result of the operation of the consumer protection provisions referred to above, which prohibit misleading and deceptive conduct in various circumstances. Section 563A would not require postponement of that debt until debts owed to, or claims made by, persons otherwise than as members have been satisfied. It follows that the adoption of s 563A in the proposed deed of company arrangement would not require the postponement of the Shareholder's Claim in the course of the administration.

The three decisions can seemingly be reconciled on the basis that any bar to recovery applies only to subscribing shareholders though the outcome seems somewhat anomalous (given that those who deal more directly with the wrong-doers appear to end up with lesser rights of recovery). To the extent that there is an issue of principle at stake, it might relate to the desirability of shareholders being elevated from their traditional position of residual claimants. That issue,
however, would only have practical implications in a situation of insolvency; postponement (rather than extinguishment) of shareholder rights arguably addresses it in any event. Complicating factors such as the presence of indemnifying insurance are not addressed by the decisions, but may in some cases be relevant — such sums may not be available to ordinary creditors, yet may be available to indemnify the company against tortious or statutory liability. The position of other defendants is also left somewhat unclear: the decisions do not appear to affect causes of action against other defendants such as directors. However, as discussed below, the application of proportionate liability may create complicated issues if such defendants wish to seek indemnity from, or apportion liability to, a company which is a concurrent wrongdoer but against which claims are postponed.

C Causation of Loss through Misleading Conduct and Nondisclosure in Australia

In cases where either ASIC or private individuals seek recovery of loss or a compensation order, the question of causation will inevitably arise. The question of causation may also arise even where ASIC seeks declaratory relief and civil penalties only. This is because if the court makes an order that there has been a contravention of that division, then s 12GM(2) of the ASIC Act gives scope for a private person who has suffered loss from that contravention to bring proceedings for recovery of that loss. Those proceedings might be on behalf of that person alone or other persons, and so might also take a representative form. Also, as noted, action by ASIC pursuant to s 1317HA of the Corporations Act, which results in a declaration of contravention of the continuous disclosure provisions in ss 674 or 675, will enable a person who has suffered ‘damage’ in relation to the contravention to seek a compensation order under s 1317HA.

1 Proving Reliance and Onus

There is no statutory presumption of reliance in relation to actions by shareholders for compensation in Australia. The relative newness of class action legislation in Australia also means there is no case law in Australia where shareholders have attempted to invoke the ‘fraud on the market’ theory before Australian courts.

It is not clear whether Australian courts would be prepared to accept something akin to the ‘fraud on the market’ doctrine. The acceptance of the doctrine is said to be one reason for an increase in shareholder class actions in the United States. The perception that some of those claims were frivolous appears to have been behind the intensive lobbying that resulted in the enactment by Congress of the Private Securities Litigation Reform Act of 1995. That enactment introduced a number of hurdles for shareholder action including:

173 See Corporations Act s 562.
174 See below Part VI(C)(5).
175 Spender, above n 158, 134.
stringent pleading requirements as to the nature of the intention to deceive (the United States ‘scienter’ requirement); a rebuttable presumption that the largest shareholder willing to do so should be the representative plaintiff; and a requirement that courts give additional weight to cautionary language in financial forecasts in determining the materiality of misstatements or nondisclosures (the ‘bespeaks caution’ doctrine).177

Despite introducing these new hurdles, however, the legislature did not tamper with the ‘fraud on the market’ doctrine, which remains good law in the United States.178

2 Onus where Representation Is ‘Calculated to Induce’

As has been seen,179 the approach of Canadian courts was initially to shut the door on the ‘fraud on the market’ doctrine and then to reopen it slightly. There is now an openness to the possibility of inferring (as a question of fact) from the circumstances that putative class members relied on the ‘representation’ made, casting an onus on the defendant to rebut the inference. The circumstance that the misrepresentation in question is one which was calculated or which would naturally tend to induce the plaintiff to act upon it will be critical. Further, as we have seen, in Fisherman it seems the court was prepared to entertain the possibility — at the pleading stage at least — that the market price of the shares reflected a ‘representation’ contained in certain audit opinions and that by purchasing the shares each class member had relied upon the said representation.180

In Bre-X a Canadian court went back to the early English authority of Smith v Chadwick. In that case, Lord Blackburn had noted that:

I think that if it is proved that the defendants with a view to induce the plaintiff to enter into a contract made a statement to the plaintiff of such a nature as would be likely to induce a person to enter into a contract, and it is proved that the plaintiff did enter into the contract, it is a fair inference of fact that he was induced to do so by the statement.181

This is undoubtedly the law in Australia too. A similar principle was stated by Wilson J of the High Court of Australia in 1985 in Gould v Vaggelas:

If a material representation is made which is calculated to induce the representative to enter into a contract and that person in fact enters into the contract there arises a fair inference of fact that he was induced to do so by the representation.182

178 Cf West v Prudential Securities Inc, 282 F 3d 935 (7th Cir, 2002) which refused to apply the ‘fraud on the market’ approach in the absence of evidence that a broker’s allegedly false statements to his 11 clients had leaked into the market or moved the market price. Another interpretation, however, that is consistent with the ‘fraud on the market’ approach, might simply be that there was no provable loss referable to the statements.
179 See above Part V.
181 (1884) 9 App Cas 187, 196.
Along the same lines, there is a useful discussion of causation and the onus of proof in the Full Federal Court of Australia case of Como Investments Pty Ltd (in liq) v Yenald Nominees Pty Ltd. This case was an action for damages under s 82 of the TPA — the cognate provision to s 1041I of the Corporations Act — for misleading and deceptive conduct. The conduct concerned misrepresentations by a vendor to a purchaser that a commercial property was let to ‘a good tenant’ whose rental payments provided a good return. In reality, the tenant (a restaurant) was in serious financial difficulty, and had been in default in respect of the rent over a period of several months.

The vendor appealed the trial judge’s findings on reliance emphasising evidence of extensive and detailed enquiries made by the purchaser itself and its solicitors (although these enquiries did not reveal the problems with the tenant). The vendor thus argued that the purchaser looked to the information it obtained for itself, placing no trust or reliance on the information provided by the vendor. In considering the question of causation of loss by the alleged misleading representations, the Full Court (Burchett, Ryan and R D Nicholson JJ) had this to say:

The law does not consider cause and effect in mathematical or in philosophical terms. The law looks at what influences the actions of the parties. Acknowledging that people are often swayed by several considerations, influencing them to varying extents, the law attributes causality to a single one of those considerations, provided it had some substantial rather than negligible effect. As Brennan J said in San Sebastian Proprietary Limited v Minister administering the Environmental Planning and Assessment Act 1979 (1986) 162 CLR 340 at 366: ‘The representation must be a real inducement or one of the real inducements to engage in the conduct which occasions the loss.’

Where a representation is relevant to the decision in question, and in its nature persuasive to induce the making of that decision, it accords with legal notions of causation to hold that it has a causative effect. And where a respondent, who may be taken to know his own business, has thought it was in his interests to misrepresent the situation in a particular respect, the Court may infer that the misrepresentation was persuasive. These inferences arise from the making of the representation followed by the respondent doing the thing it was calculated to induce him to do.

It is therefore clear that these principles and lines of reasoning, which have led Canadian courts to accept that reliance might, in appropriate cases, be presumed as an inference of fact, are also the law in Australia. Whether Australian courts would go further and adopt a ‘fraud on the market’ theory in cases of misleading the market generally is not clear. Certainly, causation under s 82 of the TPA and cognate provisions in the Corporations Act already extends beyond direct reliance.

184 Ibid 43 619.
3 Third Party Reliance and Alternative Approaches to Causation

In Janssen-Cilag Pty Ltd v Pfizer Pty Ltd, the question was whether s 82 of the TPA allowed a claim by a person who, although not himself misled by the representation, suffered injury as a direct result of a third party’s reliance on the misleading or deceptive representation. The case was brought by a trader who had lost business when his customers were induced by the misleading representations of a competitor to patronise the competitor. The decision of Lockhart J in that case stands strongly for the principle that entitlement to recover loss or damage under s 82 is not confined to persons who rely on the representations which constitute contraventions of the Act.

In Hayne v Top Slice Deli Pty Ltd, Einfeld J said in relation to Lockhart’s decision in Janssen: ‘At least in the area of misleading advertising, that conclusion must with respect be correct. It might also be the case that the reliance of a third person will be sufficient for causation in circumstances similar to the current case.’

Haynes concerned a claim by delicatessen purchasers in relation to misleading representations of profitability by the vendor and its accountants. The claim by the purchasers for lost profits against the vendor’s accountants was in relation to a misleading cash flow projection provided to the purchaser’s bank. Though the purchasers did not themselves rely on this document, it was alleged that the cash flow had procured for the purchaser a successful result to their loan application. It was claimed that, but for the document, they would not have been able to purchase the business and would not have incurred the trading losses. Einfeld J accepted that causation could exist without reliance but cautioned that there was still a requirement of directness or proximity:

Justice Lockhart’s recognition that there is no absolute requirement of reliance on the part of the applicant was in no sense an abandonment of the considerations of proximity or directness that lie behind reliance and have made it a decisive factor in the majority of cases. His Honour clearly recognised that, although reliance by the applicant is not a necessary element of section 82, all applicants retain the onus of proving the requisite element of directness or proximity necessary to constitute causation at law.

Thus, Australian law would appear already to accept that reliance by a shareholder on a person or persons who had themselves relied on misleading representations by a company or others may be sufficient causation in the case of corporate misstatements or nondisclosure.

Whether this chain of causation can be lengthened to the extent demanded by the ‘fraud on the market’ theory is unclear. Einfeld J’s requirement of proximity suggests that the chain of causation cannot be so lengthened. However, the implications of the ‘efficient capital markets’ hypothesis for the transmission of
information (and misinformation) through the Australian stock market might suggest a sound theoretical basis by which the proximity requirement can be satisfied.

In *McCarthy v McIntyre*,188 a case with facts similar to those in *Janssen*, a Full Federal Court, comprising Hill, Sackville and Katz JJ, agreed with Lockhart J in *Janssen* that there was nothing in s 82 of the *TPA* or s 87 or their state equivalents that required, in a case where the misleading or deceptive conduct involved a misrepresentation, that the person who alleges damage must rely on that misrepresentation. Their Honours went on to state:

All that is necessary, in our opinion, is that there be a sufficient and direct link (ie, causation) between the loss or damage alleged to have been suffered by the claimant and the misleading or deceptive conduct.

It is well established that the misleading or deceptive conduct need not be the sole cause of the loss. However, causation must be established. So much emerges from the word ‘by’ to be found in s 82 and s 87 of the *Trade Practices Act* (and their State equivalents). As was said in *Wardley Australia Ltd v Western Australia* (1992) 175 CLR 514 at 525, that word ‘clearly expresses the notion of causation without defining or elucidating it’. Precisely what test should be used to judge what constitutes the sufficient causal connection required between the misleading conduct and the outcome is the subject of some difficulty. Perhaps there is no simple test capable of formulation. It is necessary that the issue of causation be approached in what the High Court in *Wardley* called a ‘practical or commonsense’ way. In many areas, the courts have applied a ‘but for’ test of causation. As McHugh, Hayne and Callinan JJ pointed out in *Marks v GIO Australia Holdings Ltd* at 346, the idea that a ‘but for’ test is the exclusive test of causation has been found wanting in some contexts and it may yet be found to be wanting in the context of s 82 and s 87 of the *Trade Practices Act* (and their State equivalents). Whether this be the case or not, the ‘but for’ test, applied in a common sense and not a pedantic way, provides still a useful approach to the issue of causation.

Where a claimant is able to show that, but for the misleading or deceptive conduct, he or she would not have entered into a transaction, then such loss as flows directly to the claimant from the transaction will satisfy the requirement of causation. This is so where the claimant relies upon the misleading or deceptive conduct (the usual case). It is also so where a third party whose action was a *sine qua non* of the entry by the claimant into the transaction (the present case as alleged) relies upon the misleading or deceptive conduct.189

4 Causation and Loss from ‘Pure Nondisclosure’

I have focused on misrepresentations and reliance in the Australian context. As noted in Part II of this article, reliance may be a problematic tool in the context of omissions and nondisclosures, which by their nature cannot be relied upon. The early United States decisions on presuming causation in cases of material

nondisclosure illustrate this. The Janssen decision in Australia would suggest
tests of causation other than reliance are open to be considered by Australian
courts.

Certainly, the nondisclosure situation brings this question into sharp relief,
particularly where claims are for loss suffered by those who purchased ‘over-
priced’ shares.\textsuperscript{190} In such a scenario, there is a disconnection between ‘price’ and
‘value’, as nondisclosure causes the market price to be higher than it would have
been if the true facts had been known. Positive representations have no relevance
other than those earlier statements which may have been true when they were
made and which continue to artificially support the inflated share price in the
absence of the disclosure of correcting information. Those who suffer loss are
those who purchase securities during the currency of the nondisclosure and
before it is corrected by proper disclosure.

In a claim for loss by a purchaser of overpriced shares there may be no direct
reliance at all on the nondisclosure. The chain of causation in this situation may
be based on the market’s response to the nondisclosure rather than that of the
individual claimant. Indeed, in this type of case the claimant is assumed to be
unaffected by nondisclosure as implicit in his or her claim is the assumption that
he or she would still have purchased the shares (albeit at a lower price) if the true
facts had been known.\textsuperscript{191}

There is, of course, the possibility that the investor would not have purchased
at the lower price; his or her mood presumably becoming more bearish by the
disclosure of the bad news. Such a possibility may necessitate a discounting of
the value of the claim. This occurs because the damages in a misleading and
deceptive conduct claim may represent the value of a lost commercial opportu-
nity to buy at the lower price,\textsuperscript{192} which can be discounted based on the degree of
probability of the applicant making the purchase had he or she been given the
opportunity.\textsuperscript{193}

Alternatively, the plaintiff’s damage may be determined on the basis that he or
she would not have purchased at all had the true facts been known.\textsuperscript{194} The

\textsuperscript{190} The shares are overpriced in terms of their true current value. As the High Court has noted: ‘the
difference between price and value will often be an important element in assessing the damage
suffered by a person who, by misrepresentation, has been induced to buy an item of property’;
\textit{Murphy v Overton Investments Pty Ltd} (2004) 216 CLR 388, 403 (Gleeson CJ, McHugh, Gum-
mow, Kirby, Hayne, Callinan and Heydon JJ). See generally \textit{Potts v Miller} (1940) 64 CLR 282.

\textsuperscript{191} Interestingly, the \textit{Corporations Act} allows for a claim for compensation by a purchaser of
overvalued shares when they were purchased from an insider holding price-sensitive informa-
tion: see \textit{Corporations Act} s 1043L(4). It also appears to allow for such a claim by a purchaser of
shares which are overvalued due to a takeover announcement which does not come to fruition:
see \textit{Corporations Act} s 670E.

\textsuperscript{192} See \textit{Malec v JC Hutton Pty Ltd} (1990) 169 CLR 638, 639–40, 642–3 (Brennan and Dawson JJ);
\textit{Commonwealth v Amann Aviation Pty Ltd} (1991) 174 CLR 64, 92 (Mason and Dawson JJ),
102–4, 118–19 (Brennan J); \textit{Sellars v Adelaide Petroleum NL} (1994) 179 CLR 332, 350 (Mas-
son CJ, Dawson, Toohey and Gaudron JJ); \textit{Naxakis v Western General Hospital} (1998) 197 CLR
269, 278 (Gleeson CJ).

\textsuperscript{193} \textit{Commonwealth v Amann Aviation Pty Ltd} (1991) 174 CLR 64; \textit{Sykes v Reserve Bank of

\textsuperscript{194} Although, as noted, such claims will not lie against an insolvent company under external
administration if the claim is effectively for rescission of the contract to subscribe for shares in
the company: see \textit{Media World} (2005) 216 ALR 105. Finkelstein J found in that case that such
quantum of loss would then be based on the difference between the present value of his or her shares and the amount originally paid for them. Individual evidence from the investor would be necessary to establish their case.

A third possibility is a claim based on an opportunity to sell at the artificially high price which an individual investor forgoes because of the nondisclosure. This approach has problems, however, as that opportunity may not have existed but for the nondisclosure (i.e., if there had been proper disclosure other investors would simultaneously have also cashed in their shares, causing the market price to fall). The latter argument will, at the very least, justify a discount on damages. There is also the possibility of an illiquid market (which, as we have seen, can rebut a ‘fraud on the market’ presumption under United States law).

In some circumstances, a shareholder may fail to mitigate losses or actively contribute to its losses by its own conduct. Arguments can be made about whether losses were wholly or partly caused by the shareholder’s decision, after the nondisclosures to sell (in a situation where share prices subsequently recovered) or not to sell (in a situation where share prices further declined). Loss assessment will certainly be complicated by the fact that there is no Australian equivalent of the United States ‘90-day rule’, under which damages awards are calculated as the difference in price based on a 90-day average price after corrective information is released to the market. There are difficulties with such arguments, however, as they appear to presume that the shareholder has or should have better information than the market.

5 Law and Policy

Defendants being sued in such circumstances will no doubt point out that they are being held liable for losses which may substantially exceed their gains from the wrongdoing and in a situation where other investors will have made windfall gains by selling (albeit innocently) the overvalued shares during the currency of nondisclosure of negative news. As we have seen, this criticism has been met in the United States by the adoption of economic analysis, suggesting that:

1. there are substantial costs of nondisclosure in the resulting misallocation of investment dollars in both primary and secondary capital markets;
2. allowing recovery reduces the cost of investment in resources to distinguish correct from incorrect information; and

claimants could therefore not vote as creditors in an administration under pt 5.3A of the Corporations Act: at 111.

195 From 26 July 2004, this defence is clearly available under the Corporations Act s 1041I(1B).
197 That is, in the case of a share price recovery, if there is a better than even prospect of the share price recovering, then, according to the ‘efficient capital market’ hypothesis, it should have already recovered. Further, such arguments may be problematic for the corporation as they may raise questions of whether there has been sufficiently early disclosure of new positive news or whether the corrective disclosure that caused the price fall was in fact overstated.
198 This is different from the situation of insider trading where the amount of compensation of the victims will normally equate to the gains made by the insider — a ‘zero sum game’.
the alternative remedy of disgorgement of wrongdoer’s gains suffers from the difficulty or impossibility of measuring such gains.\textsuperscript{199}

To this might also be added the criticism that disgorgement of a profit obtained by the wrongdoer will usually be insufficient to compensate the quantum of actual loss of the innocent investor.

There is also the problem of the company being held liable to one group of current or former shareholders for nondisclosure when damages paid to that group will effectively come out of the pockets of all current shareholders.\textsuperscript{200} This problem is partly ameliorated by the possibility that other wrongdoing parties, such as directors, auditors and advisors will be joined and held partially or wholly liable, either directly or through notices for contribution, indemnity or cross-claim. The introduction of proportionate liability for misleading and deceptive conduct claims from 26 July 2004\textsuperscript{201} will also mean that successful apportionment of fault to other defendants or non-parties will have the effect of directly reducing the company’s liability even if those other defendants or non-parties are insolvent or impecunious.\textsuperscript{202}

Recent legislative developments certainly suggest that Parliament has identified nondisclosure as a matter warranting reform.\textsuperscript{203} For example, in the 1990s, provisions were introduced that gave statutory force to the Australian Stock Exchange requirement of continuous disclosure.\textsuperscript{204} These were further strengthened with the financial services reforms commencing in 2002 and the CLERP 9 reforms of 2004. Whilst some of the rationales for continuous disclosure laws relate to the need to minimise the possibility of insider trading, it cannot be denied that inaccurate or incomplete information does undermine the efficient operation of capital markets and misallocate investment dollars. It also causes some players to suffer ‘loss’ (as that expression has been interpreted by the courts).\textsuperscript{206} The legislature appears to have recognised this in establishing a right of compensation for such losses.\textsuperscript{207} If this right is to be viable, then it may

\textsuperscript{199} Fischel, ‘Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities’, above n 28, 17–19.

\textsuperscript{200} This is so, at least to the extent the payout impacts the current share price. This share price effect will also of course impact upon plaintiffs who are current shareholders. Plaintiffs who have disposed of their shares will not suffer this effect, although they will also have missed out on any share price recovery subsequent to that disposal.

\textsuperscript{201} Corporations Act pt 7.10, div 2A.


\textsuperscript{204} Sections 1001A, 1001B, 1001C, 1001D, introduced into the then Corporations Law by the Corporate Law Reform Act 1994 (Cth), since repealed from the Corporations Act by the Financial Services Reform Act 2001 (Cth).

\textsuperscript{205} See above n 192.

\textsuperscript{206} Corporations Act ss 1317HA, 1317J(3A).
be that Australian courts will need to take a wider perspective of causation than the traditional reliance nexus.\footnote{Andrew Cassidy and Larelle Chapple have indeed suggested that \textit{CLERP 9} develops the causation area of the law further to align Australia’s securities laws closer to the United States ‘fraud on the market’ concept: see Cassidy and Chapple, above n 158, 94.}

As we have seen, the utility of the ‘fraud on the market’ theory in the United States may be demonstrated in at least four ways:

1. It is generally supportive of a philosophy of full disclosure in securities markets;
2. It facilitates civil recovery by:
   i. providing a rebuttable presumption of reliance or causation, even in situations where the misleading representation may not be calculated to induce or in its nature be sufficiently persuasive to induce;
   ii. solving certain conceptual difficulties in establishing reliance on nondisclosures;\footnote{The general issue in Australian law was discussed (but not resolved) by the Full Federal Court in \textit{Aroma E Core Pty Ltd v Aromas Pty Ltd} [1999] FCA 904 (Unreported, Burchett, Kiefel and Hely JJ, 5 July 1999). The conceptual problems have caused difficulties in pleading shareholder claims for loss based on nondisclosure: see \textit{King v GIO Australia Holdings Ltd} (2000) 100 FCR 209; \textit{Johnstone v HIH Ltd} [2004] FCA 190 (Unreported, Tamberlin J, 5 March 2004); \textit{Dorajay Pty Ltd v Aristocrat Leisure Ltd} [2004] FCA 634 (Unreported, Stone J, 20 May 2004).}
   iii. providing a causal link between unlawful conduct and the mispricing of securities;
3. It creates a deterrent to nondisclosure by increasing the civil liability consequences; and
4. It goes beyond reliance and embraces the economic effects of nondisclosure on the market as a whole.

The \textit{Janssen} decision suggests that Australian courts will go beyond reliance in appropriate cases. The adoption of a ‘but for’ causation test in a case of securities nondisclosure appears to be an approach that is open to Australian courts, as is an extended chain of third party causation (where reliance of third parties on the defendant’s deception affected a securities market in a way that injured the plaintiff).\footnote{As articulated in Note, ‘The Reliance Requirement in Private Actions under Rule 10b-5’, above n 20.} The idea of ‘reliance’ on the market price as suggested by the ‘fraud on the market’ theory may indeed be merely another way of describing the same phenomenon and may ultimately be the other side of this same causal coin.

\section*{VII Conclusion}

The Wall Street stock market crash of the 1920s saw the early development in the United States of strong laws for the protection of investors in the stock market. Access to justice through the mechanism of the class action meant that large numbers of investors were able to seek remedies where they suffered loss through breaches of the law, particularly r 10b-5, which proscribed fraud, deceit, untrue statements and omissions which tended to mislead. The requirement of
proving that breaches of the law caused the loss led courts, particularly in class actions, to presume as a matter of fact that non-disclosure of material information established the requisite element of causation. With the aid of economic theory in the form of the ‘efficient capital markets’ hypothesis, courts soon developed the ‘fraud on the market’ theory of presumed reliance. This was officially adopted by the United States Supreme Court in Basic Inc v Levinson in 1988.

The ‘fraud on the market’ theory was initially rejected by Canadian courts and remains unavailable in that country as a presumption of law. However, more recent decisions by Canadian courts show some preparedness to entertain the possibility of findings consistent with the theory. The court’s entitlement to make inferences of fact about reliance will apply at least in relation to representations which are calculated to induce conduct by shareholders. In at least one Canadian jurisdiction, Ontario, there is also a statutory presumption of reliance in relation to prospectuses, takeover documents and share buyback documents.

In Australia there is no statutory presumption of reliance nor has there been an attempt to apply the ‘fraud on the market’ theory in Australian courts. Nevertheless the principles for inferring reliance as a matter of fact which have been noted in Canadian cases are also applicable in Australian law. Further, Australian case law on causation of loss from misleading and deceptive conduct has accepted that causation may not require direct reliance or reliance at all in some cases.

Laws giving statutory force to the continuous disclosure rules of the Australian Stock Exchange mean that pure nondisclosure is clearly actionable. They require courts to grapple with causation where traditional reliance may be more problematic. It is not inconceivable, therefore, that Australian courts might adopt a ‘fraud on the market’ type theory in relation to nondisclosures in the Australian stock market. This might occur by adopting a ‘but for’ test of causation, which would combine existing principles of indirect or third party reliance upon misleading or deceptive statements with recognition, in appropriate cases, of the implications of the ‘efficient capital markets’ hypothesis for the rapid transmission of information through the market — including the consequences of a failure to rectify incorrect or outdated disclosures.