In Malack v. BDO Seidman, LLP, No. 09-4475, 2010 WL 3211088 (3d Cir. Aug. 16, 2010), the Third Circuit refused to endorse the "fraud created the market" theory.

Fraud requires the plaintiff to prove a (1) misrepresentation or omission by the defendant, (2) of a material fact, (3) scienter of defendant, (4) defendant's intent to induce reliance, (5) reasonable reliance by the plaintiff, (6) causation, and (7) plaintiff's damages.

Plaintiff attorneys argued that reasonable reliance is presumed when the defendants are selling a security that shouldn't be sold because it's totally worthless or unmarketability. To be unmarketable, the securities must be "so lacking in basic requirements that [they] would never have been approved by the [issuing entity] nor presented by the underwriters had any one of the participants in the scheme not acted with intent to defraud or in reckless disregard of whether the other defendants were perpetrating a fraud." *Id.* at 468. The theory is that the security market should only present marketable securities that have investment value. While I think most everyone likes the tone of this theory, the court didn't and reasoned that investors still have to do their due diligence when determining what to invest in. Ultimately, the court is saying that while it would be nice not have to deal with scammers selling you crap, the reality is they are here to stay.

Reliance is an essential element to proving fraud and getting a presumption for one of your elements can save much time. The plaintiff's reliance must be reasonable which means that the plaintiff has some burden to act responsibly in making his investment decisions. Ultimately, this decision only hurts plaintiff attorneys slightly because they still have two more accepted theories that give a presumption of reasonable reliance.

The first was set forth in Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972), where the Supreme Court held that proof that a material fact was omitted created a presumption of reliance. These cases would involve failing to disclose material facts, i.e. someone knows something, and he should tell you so that you can make the most informed decision, but he doesn't tell you, and this affects your decision.

Second, in Basic Inc. v. Levinson, 485 U.S. 224 (1988), the Supreme Court also recognized the "fraud on the market" theory. This legal argument can be raised when a fraudulent misrepresentation affects the price of the security being traded on the market. The theory is that, absent the fraud, the market operates efficiently. Introduce the fraud and the market then reacts negatively and the investor is harmed.

While it isn't highly likely that this "fraud created the market" theory will gain much greater acceptance in other federal court districts (only the Fifth accepts it and the Seventh agrees with the Third Circuit, discussed currently), there are still two accepted arguments that can create a presumption of reasonable reliance.

Currently, the Fifth Circuit has accepted the "fraud created the market" theory and the Third and Seventh Circuits take the opposite stance. Because there is a split of opinion among the circuits, this issue is now ripe for the U.S. Supreme Court.