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MITIGATION OF DAMAGES THROUGH THE USE OF STOCK MARKET INDICATORS

A unique method of measuring damages under § 11 of the Securities Act of 1933¹ was introduced in *Feit v. Leasco Data Processing Equipment Corp.*² The essence of the complaint was the defendant's failure to disclose material information in its registration statement. In an attempt to acquire Reliance Company, Leasco had offered to exchange its stock for the shares held by that company's shareholders.³ The registration statement failed to disclose the fact that Reliance owned a large amount of "surplus surplus."⁴ The court found that this constituted a material omission and, therefore, damages were allowed under § 11.⁵

The usual measure of damages is either the difference between the price paid and the value at time of suit or, if the stock was sold, the difference between the price paid and the amount realized from the sale.⁶ In *Feit*, however, a general downward trend in the stock market, reflected by a decline in the Standard and Poor Index, was found to be proof that a particular and identifiable amount of loss was attributable to market trends rather than to the defendant's omission.⁷ *Feit* represents the first judicial use of a market indicator for determining damages.⁸

Essentially, the court took judicial notice of the 1969 stock market decline.⁹ The court concluded that a portion of Leasco's price diminution was due to this decline rather than to the defendant's material omission.¹⁰ That portion of the total loss which was attributable to the market decline

1. 15 U.S.C. § 77k (1970).

2. CCH FED. SEC. L. REP. ¶ 93,163, at 91,167.

3. The exact offer was one share of Leasco preferred stock plus one-half warrant to purchase Leasco's common stock in exchange for one share of Reliance stock. CCH FED. SEC. L. REP. at 91,168-69.

4. "Surplus surplus" is that portion of the assets of an insurer in excess of the potential claims of its policy holders and the other reasonable needs of its insurance business. Surplus surplus consists of cash or near-cash items. The existence of surplus surplus constituted the major impetus for the takeover attempt. CCH FED. SEC. L. REP. at 91,169.

5. Suit was actually brought under §§ 11, 12(2), and 17(a) of the Securities Act of 1933 [15 U.S.C. §§ 77(k)(2), 77q(a) (1970)], §§ 10(b) and 14(e) of the Securities Exchange Act of 1934 [15 U.S.C. §§ 78j(b), 78n(e) (1970)] and SEC Rule X-10B-5 [17 C.F.R. 240.10b-5 (1970)]. The court based its decision exclusively on § 11.

6. § 11(e), 15 U.S.C. § 77k(e) (1970).

7. CCH FED. SEC. L. REP. at 91,203.

8. In *Fox v. Glickman*, 253 F. Supp. 1005 (S.D.N.Y. 1966), the court approved a settlement which took account of a general decline in the market.

9. CCH FED. SEC. L. REP. at 91,202.

10. CCH FED. SEC. L. REP. at 91,203.

was disallowed. Specifically, the court found that the difference between the adjusted purchase price and the sale price constituted the recoverable damages.¹¹ The adjusted purchase price was computed by multiplying the actual price paid by the market decline quotient.¹² The sale price consisted of the combined values of the Leasco stock and the warrant on the day the stock was sold.¹³ If the stock had not been sold, its value on the day the lawsuit was initiated would have been used in the computation.

Statutory authority for this method of damage ascertainment was derived from § 11(e),¹⁴ which allows the defendant to prove that part

11. The basic method of using market indicators to reduce damages can be illustrated by assuming the following hypothetical facts:

Index at time of purchase	100
Index at time of sale	85
Purchase price of security	\$50.00
Sale price of security	\$35.00

Using the *Feit* method, 85 is divided by 100 to produce a market decline quotient of .85. The quotient is multiplied by the price paid (fifty dollars) to reach the price paid adjusted for the market decline, or \$42.50. The difference between \$42.50 and the sale price (35 dollars) represents the recoverable damages of \$7.50 per share.

12. The market decline quotient is the reciprocal of the decline in the Standard and Poor's Index from August 16, 1968 (date of purchase) to the day on which a particular member of the class sold his Leasco securities. Since Standard and Poor's Index was 98.68 on August 16, 1968, the value of the index on the date of sale is divided by 98.68 to obtain the market decline quotient. CCH FED. SEC. L. REP. at 91,203. The court refused to use a quotient which exceeded 1.00. A quotient in excess of 1.00 would mean the market indicator rose during the period. The effect of using the actual purchase price when the market quotient exceeds 1.00 is to disallow damages in excess of the investor's out-of-pocket loss. An argument could be made that an index should be allowed to increase a recovery as well as to diminish damages. This approach would be based on the assumption that the fraud prevented the security from increasing in price and would compensate the investor for the unrealized appreciation. The court rejected this approach without comment. The rejection can be justified on the basis that § 11(e) provides recovery only for the actual difference between the price paid and the value at the time of sale or lawsuit.

13. The price of the warrant was multiplied by 1.25 to eliminate the price reduction caused by a five-for-two split on February 12, 1969. The value of the warrant was computed as of the day the preferred stock was sold even if the warrant was not sold at that time. The court recognized that this method of computing the warrant's value was arbitrary and provided for independent valuation of the warrant if this method proved unduly harsh in a particular case. *Id.*

14. The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security . . . and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security . . . and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, . . . such portion of all such damages shall not be recoverable.

15 U.S.C. § 77k(e) (1970).

or all of the damages were caused by forces independent from the misleading registration statement. The method adopted by the court is based upon the assumption that a market index can accurately isolate the degree of price depreciation caused by general market forces. Thus, it is necessary to examine the various market indicators and to discuss their accuracy in reflecting price changes in the general market and in specific securities.

MARKET INDICATORS

A market index attempts to quantify in a single figure the price level of all securities traded in a particular market. Such an index is usually based upon a sample of stocks selected either by scientific sampling techniques, or by a conscious effort to choose those which are representative of the entire market.¹⁵ The actual mechanics of computing the index range from simple averages to averages weighted by the number of shares outstanding and adjusted for stock splits and dividends. Although a variety of indicators were available, the *Feit* court considered only the Dow Jones Averages and the Standard and Poor Index.¹⁶ These two indexes will be analyzed along with the New York Stock Exchange Average, since they are the most widely used by financial analysts.¹⁷

The Dow Jones Average¹⁸ is computed by adding the individual prices of 65 securities, representing ten industries,¹⁹ and dividing by a figure which is adjusted to promote continuity in the average.²⁰ Actually, the term "average" is a misnomer because the failure of this computation to consider a company's capital structure results in distortion.²¹ In the final "average," the higher priced shares carry proportionately greater

15. Morgan, *Stock Market Indices—From Dow to NQB*, THE COM. & FIN. CHRON., Apr. 9, 1970, at 1 [hereinafter cited as Morgan].

16. CCH FED. SEC. L. REP. at 91,203.

17. Morgan, *supra* note 15, at 1.

18. The Dow Jones Average includes four separate indexes consisting of thirty industrial companies, twenty transportation stocks, fifteen utility stocks and a composite average of all 65 companies. The companies that compose the average are listed in every Monday issue of the *Wall Street Journal*.

19. Butler & Decker, *A Security Check on the Dow Jones Industrial Average*, in READINGS IN FINANCIAL ANALYSIS AND INVESTMENT MANAGEMENT 85 (E. Lerner ed. 1963) [hereinafter cited as READING]. The classification by industry included the broad category of consumer durables. *Id.*

20. The divisors as of October 15, 1971, are 9.153 for the composite average, 3.912 for utilities, 3.500 for the transportation and 1.712 for the industrial average. *Wall Street Journal*, Oct. 15, 1971, at 27, col. 1.

21. Kirk, *What Good is The Dow?*, BANKING, Jan., 1970, at 24. The author quotes Professor Lorie of Chicago University as saying, "We know that the Dow Jones is theoretically a bad way to construct an average and in practice we don't know how far it departs from an ideal average. Its great value is its familiarity. On any other grounds, it's ridiculous." *Id.* at 26.

weight than do lower priced ones, regardless of each company's aggregate value.²² This failure to consider aggregate value also produces distortion whenever a stock in the sample undergoes a split. The lower price per share caused by the split diminishes the stock's relative weight in the Average and allows non-split shares to dominate the final result. This produces an anomaly. Despite the fact that split shares usually represent companies with substantial growth, their influence on the Average decreases after each stock split.²³

The Dow Jones Average is further distorted by the dominance of non-representative, high quality "Blue Chip" stocks in the sample.²⁴ Dow Jones also exaggerates price since a change in the average is not reflective of a similar dollar change in price. Consequently, the 20-point increase on October 12, 1971, represented an increase of only \$.75 in the average price of the securities comprising the index.²⁵ These deficiencies are partially offset, however, by the fact that the notoriety of the Dow Jones increases the Average's accuracy in measuring price movements. Short term price fluctuations are partially caused by investor perception of the direction of the general market.²⁶ Thus, a change in the Dow Jones can cause price fluctuations in other securities. The net effect is a tendency for other securities to follow the movement of the Dow.²⁷

Construction of the Standard and Poor Index eliminates many of the distortions inherent in the Dow Jones Averages. This index consists of a highly diversified list of 500 companies.²⁸ Substantial coverage is provided since the index includes ninety per cent of the market value²⁹ of all companies listed on the New York Stock Exchange.³⁰ Additionally, the

22. For example, a company with a capital structure of one million dollars whose shares sell for 100 dollars will have four times the influence of a company with a capital structure of 100 million dollars but whose stock sells for 25 dollars.

23. Carter & Cohen, *Bias in the DJIA Caused by Stock Splits*, FIN. ANALYSTS J., Nov., 1966, at 90.

24. Shaw, *Appraising the Companies That Make the Dow Jones I.A. to Show Lack of Realism in This Average*, 117 MAGAZINE OF WALL STREET 524 (1966).

25. This computation was based on the closing price of each stock composing the Dow Jones Industrial Average. The closing price was obtained from the October 11, 1971, *Wall Street Journal* listing of stock transactions. *Wall Street Journal*, Oct. 11, 1971, at 18.

26. F. AMLING, INVESTMENTS: AN INTRODUCTION TO ANALYSIS AND MANAGEMENT 444 (1954) [hereinafter cited as AMLING].

27. *Id.*

28. The composite average is divided into smaller indexes representing 425 industrial stocks, twenty railroad stocks and 55 utility companies. STANDARD AND POOR, TRADE AND SECURITY STATISTICS 2 (1962).

29. The index does not represent ninety per cent of the number of stocks listed on the exchange, but ninety per cent of the aggregate market value (price times number of shares outstanding) of all stocks listed on the exchange. Morgan, *supra* note 15, at 19.

30. *Id.*

Standard and Poor has the advantage of being expressed in terms which closely approximate the average price of all listed stocks. Since the index is based on aggregate market value, stock splits and dividends do not affect the average.³¹ While the Standard and Poor does represent a broader spectrum than the Dow Jones, its method of computation arguably allows the largest issues (size measured in terms of price times the number of shares traded) to carry the greatest weight.³² Thus, the ten largest issues account for 1/3 of the total Standard and Poor Index.³³ However, this may not cause distortion since these companies generate the greatest activity in the market. In fact, the index may accurately reflect the effect of these transactions on the entire stock market. Whatever its shortcomings, the superiority of the method of computing this average is widely recognized by financial writers.³⁴

The most comprehensive market indicator is the New York Stock Exchange Index. The Exchange Index measures the amount of change in the aggregate market value of all common stocks listed on the New York Stock Exchange.³⁵ The computation is similar to that used by Standard and Poor. The aggregate market value of each stock is obtained by multiplying its price per share by the number of shares which are listed on the exchange. The sum of the individual aggregate market values is then divided into the adjusted base market value. The resulting quotient is multiplied by \$50.00, which is the market value during the base period.³⁶ Since the final figure is based on aggregate market value, stock splits and stock dividends do not require adjustments. Continuity of the average is provided by changing the adjusted base value whenever a new stock is listed on the exchange or an old stock is withdrawn.³⁷ The major

31. *Id.*

32. *Id.*

33. *Id.*

34. Smerling, *Found: A Realistic Measure*, in READINGS, *supra* note 19, at 97; Gaubis, *Which is the Best Stock Average from a Practical Standpoint?*, in READINGS, *supra* note 19, at 103.

35. The New York Stock Exchange is divided into indexes representing industrial, transportation, utility, and finance companies. Morgan, *supra* note 15, at 21.

36. The base is the average market value on December 31, 1965, which was fifty dollars. An illustration of the computation of the New York Stock Exchange Average can be provided by assuming the following facts:

Current aggregate market value\$500 billion

Adjusted base market value\$550 billion.

The adjusted value (550 billion dollars) is divided by the actual aggregate value (500 billion dollars), which produces a quotient of 1.10. This is multiplied by the base amount (fifty dollars) to produce the current index value of 55.00. Morgan, *supra* note 15, at 21.

37. Assume the hypothetical facts in note 36 *supra*. In addition, assume that one billion dollars of new stock was listed on the exchange and no transactions occurred in

advantage of this index is the fact that it represents every common stock listed on the exchange.

The Exchange Index does, however, have several disadvantages. The breadth of the index may cause contradictory market trends to offset each other. Furthermore, unrepresentative stocks, such as those which are infrequently traded, are included in the average. Trends unique to such atypical stocks may, to some extent, offset differing trends in more representative stocks. This can serve to render the index less sensitive to the changes in the general market.³⁸

While each index has its own unique advantages and limitations, comparison of long term price movements suggests a high degree of similarity in the indexes.³⁹ There is general agreement among the indexes as to the direction of the stock market, the magnitude of change in stock prices, and their high and low levels in a given year. The only variations occur on a monthly basis.⁴⁰ Financial writers generally conclude that such indicators are an accurate reflection of average price behavior in the market.⁴¹

RELATIONSHIP OF INDEXES TO SPECIFIC STOCKS

While an index generally provides a rough measurement of activity in stock prices, the indicator will not necessarily reflect the price activity of a particular stock. Any attempt to use an average of stock prices to ascertain the normal market activity of a particular stock is based on the erroneous assumption that the prices of all stocks are similarly affected by the same forces.⁴² Thus, before an indicator is used to mitigate

these shares. Since there was no change in stock price activity except for the new listing, continuity of the index would require that the index remain the same. This is achieved by changing the adjusted base market value to 555.1 billion. The computation now involves dividing the 551.1 billion by 501 billion dollars (500 billion dollars current market value plus the newly added 1 billion dollars of stock). The resulting quotient is 1.10. The quotient is multiplied by the base value (fifty dollars) to achieve the current index value of 55 dollars.

38. Cf. Smerling, *Found: A Realistic Market Measure*, in READINGS, *supra* note 19, at 101.

39. Gaubis, *Which is the Best Stock Average from a Practical Standpoint?*, in READINGS, *supra* note 19, at 107-10. The author conducted a comparison of market indicators from 1936 to 1963. His conclusion was that the averages do move in unison and comprise a rough measure of the industrial stock market as a whole. The few deviations occurring during this time were on a short-term basis. *Id.*

40. AMLING, *supra* note 26, at 453.

41. See AMLING, *supra* note 26; B. GRAHAM, D. DODD & S. COTTLE, *SECURITY ANALYSIS PRINCIPLES AND TECHNIQUE* (4th ed. 1962); Markstein, *How Do You Measure the Stock Market?*, BURROUGHS CLEARING HOUSE, Mar., 1969, at 14; Morgan, *supra* note 15, at 21.

42. *S&P v. DJ*, FORBES, Nov. 1, 1962, at 16.

damages, a comparison of that stock's activity to the behavior of the index is required.

Price movements in stocks are produced by a variety of stimuli. These forces are often impossible to measure. The stock market does not always reveal the current financial status of a particular company.⁴³ Psychological factors are prevalent which may have substantial impact upon the performance of any particular stock.⁴⁴ In addition, the impact of any single factor upon the price of stock varies greatly among different companies and industries. The reactions of some stocks may be exactly opposite to the trend of the general market.⁴⁵ Consequently, before an index can be used to accurately isolate declines caused by general market forces, its historical conformity to the price pattern of the stock must be established. This comparison should be conducted over a period in which prices were not influenced by violations of security regulations.

The price pattern of the Leasco stock was tested for conformity with that of the market indexes over a thirteen-month period following the initiation of the suit. The results of this comparison reveal contradictory trends in certain months. The market indicators, however, accurately reflected the general price behavior of the Leasco stock over the thirteen-month period.⁴⁶ Based on these considerations, the *Feit* court correctly concluded that an index could provide a rough measure of the decline in price attributable to general market forces. The court's method was successful not only because the Standard and Poor Index was utilized over a long time period, but also since considerable similarity historically existed between the price behavior of Leasco and the trends established by the various indexes. In future cases of a similar nature, however, courts must recognize that market indicators are limited tools and cannot always be used. The complex nature of stock price movements prevents the total elimination of arbitrariness, even when the use of market indicators is clearly appropriate. Since this method of computing damages may produce arbitrary results, it is necessary to consider § 11 of the Securities Act and the consequences which this method can produce upon the underlying policies of that statute.

43. AMLING, *supra* note 26, at 444.

44. *Id.* at 445.

45. For example, from April, 1970 to April, 1971 Standard & Poor reflected a consistently sharp increase in stock prices. Yet, during this period, stock prices in the copper, steel and aluminum industries declined sharply, and the stocks of food chains recorded almost perfectly level prices. [1971] STANDARD & POOR OUTLOOK 574-75.

46. The comparison was based on the closing price of Leasco preferred stock and each index on the last trading day of each month. Quotations were obtained from individual issues of *Barrons* and *Wall Street Journal*.

SECTION 11 OF THE SECURITIES ACT OF 1933

Section 11, as interpreted in *Escott v. BarChris*,⁴⁷ provides a useful remedy for securities buyers, by eliminating the proof of several elements which a common law action for fraud requires. Under § 11 the plaintiff need only show that a material fact was misstated or omitted and that he purchased a registered security which declined in value.⁴⁸ Normally reliance,⁴⁹ causation,⁵⁰ privity or scienter need not be shown. In addition to recovering from the issuer of the security, the buyer can hold liable several other persons.⁵¹ The liability of the issuer is nearly absolute since his only affirmative defense is proof that the buyer knew of the misstatement or omission.⁵² Other defendants can escape liability only by proving that "after reasonable investigation they had reasonable grounds to believe that the statements were true and that no material facts had been omitted."⁵³

The limited burden of proof combined with the restricted availability of affirmative defenses allows buyers considerable opportunity to establish liability. Since privity is not required, an infinite number of successive purchasers may recover their trading losses.⁵⁴ Thus, the potential liability under § 11 is substantial. To offset this harshness, Congress provided

47. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1969). The case involved a misleading registration statement, a violation of § 11. The court imposed liability on a variety of defendants, and affirmative defenses were limited. The case has been called the first significant interpretation of the civil liability provisions of § 11. Folk, *Civil Liabilities Under the Federal Securities Act: The BarChris Case*, 55 VA. L. REV. 1, 3 (1969).

48. 15 U.S.C. § 77k (1970).

49. A purchaser is required to prove that he relied upon the misleading statement or omission in the registration statement if he purchased after the issuer had distributed an earnings statement covering at least the twelve-month period from the effective date of the registration statement. Securities Act of 1933, § 11(a), 15 U.S.C. § 77k(a) (1970).

50. Causation has been eliminated to the extent that the buyer does not have to prove that the misleading statement or omission caused him to purchase the security. The seller can prove, under § 11(e), that the violation did not cause the loss.

51. The buyer can recover from the issuer of the security and from everyone signing the registration statement. Securities Act of 1933, § 6(a) [15 U.S.C. § 77f(a) (1970)] requires all issuers to sign the registration statement. Section 11(a)(1) [15 U.S.C. § 77k(a)(1) (1970)] makes all signers liable. In addition, the buyer can recover from directors incumbent at the time of the filing, [§ 11(a)(3), 15 U.S.C. § 77k(a)(3) (1970)], from prospective directors named in the statement, [§ 1(a)(2), 15 U.S.C. 77k(a)(2) (1970)], from experts who consented to being named as responsible for particular parts of the registration statement, [§ 11(a)(4), 15 U.S.C. 77k(a)(4) (1970)] and from every underwriter who participated in the distribution of the security [§ 11(a)(5), 15 U.S.C. § 77k(a)(5) (1970)].

52. § 11(b), 15 U.S.C. § 77k(b) (1970).

53. § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1970).

54. The only limitation is that plaintiff's purchase price cannot exceed the public offering price of the security. § 11(e), 15 U.S.C. § 77k(e) (1970).

a short statute of limitations,⁵⁵ and allowed defendants to prove that a portion of the loss was not caused by their violation of § 11.⁵⁶

THE USE OF MARKET INDICATORS TO OFFSET DAMAGES

The major objection to the use of indexes as a means of limiting damages is the danger of arbitrary results. This problem is minimal, however, since discretion in the use of these indexes is retained by the court. While the frequently irrational behavior of stock prices prevents a guarantee of precise calculation, this problem can be partially eliminated by resolving questionable situations in favor of the plaintiff. Such an approach would be consistent with the requirement of § 11(e) that the defendant prove the portion of damages not attributable to his omissions.⁵⁷ Although the danger of an arbitrary result is not totally eliminated when an index is used, uncertainty is inherent in any determination of value.⁵⁸

The major advantage of using stock indicators is the establishment of loss causation in § 11 cases.⁵⁹ Loss causation conforms to the general tort notion that there should be a causal connection between one person's conduct and another's loss.⁶⁰ Such a connection is advantageous since it avoids insuring investors against bad market judgments.⁶¹ The Securities

55. The statute of limitations is one year after the discovery of the misleading statement and three years after the security was issued to the public. § 13, 15 U.S.C. § 77m (1970).

56. § 11(e), 15 U.S.C. § 77k(e) (1970).

57. § 11(e), 15 U.S.C. § 77k(e) (1970).

58. *Cherner v. Transiron Electronic Corp.*, 221 F. Supp. 48 (D. Mass. 1963). In determining damages for violations of §§ 11 and 12(2) [15 U.S.C. §§ 77k, 77l(2) (1970)], the court stated:

The final formula seems clearly fair in its general characteristics, even if in some aspects there are arbitrary elements. Arbitrary elements would exist in any formula for allocating damages. . . .

221 F. Supp. at 52.

59. Cf. Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1369 (1965).

60. W. PROSSER, *LAW OF TORTS* § 41, at 240 (1964); W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 41, at 236 (1971).

61. The use of market indicators will prevent insuring investors against bad market judgment only if other sections of the Securities Act of 1933 are not used to litigate alleged violations of § 11. For example, it is not clear whether a § 11 cause of action can also be tried under § 17 of the Securities Act of 1933 [15 U.S.C. § 77g(a) (1970)] or § 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j(b) (1970)]. These sections do not contain a statutory damage limitation similar to that of § 11(e). In *Feit* the plaintiffs alleged violations of §§ 11, 12(2) and 17(a) of the Securities Act of 1933 [15 U.S.C. §§ 77k, 77l(2), 77q(a) (1970)], §§ 10b-5 and 14(e) of the Securities Exchange Act of 1934 [15 U.S.C. §§ 78j(b), 78n(e) (1970)] and SEC Rule X-10B-5 [17 C.F.R. § 240.10b-5 (1970)]. The court stated that liability might attach under the other broader provisions but focused only on § 11. CCH SEC. L. REP. at 91, 167. See also *Globus v. Law Research Serv.*, 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913

Act was not intended to prevent investors from suffering trading losses due to general declines in a stock market.⁶² It may be argued, however, that the possibility of insuring against bad judgment is justified as furthering the deterrence objective of § 11. In *Globus v. Law Research Service*,⁶³ the court stated that:

[C]ivil liability under Section 11 and similar provisions was designed not so much to compensate the defrauded purchaser as to promote enforcement of the Act and to deter negligence.⁶⁴

Thus, deterrence is a central purpose of the Securities Act. However, the fact that the Act has proven to be such an effective deterrent renders it unlikely that the use of the market index procedure will reduce its *in terrorem* effect.⁶⁵ The fear of damages, brought about by the lack of privity requirements and the near absolute liability of the issuer, historically has caused corporations to overdisclose facts in their registration statements. A corporation will not assume the risk of substantial aggregate damages merely because a market indicator might be used to offset liability.

Finally, a market decline will never eliminate a justifiable recovery. If the defendant's acts were not sufficient to create a greater decline in the stock's price than in the index, it is evident that the failure to disclose

(1970); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1968); *Fishman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Weber v. C.M.P. Corp.*, 242 F. Supp. 321 (S.D.N.Y. 1965). For a discussion of the overlapping of these sections, see 6 L. LOSS, *SECURITIES REGULATION* 3910-14 (Supp. 1969); Cohen, "*Truth in Securities*" *Revisited*, 79 HARV. L. REV. 1340 (1966). The possibility of overlap will not reduce the value of using market indicators if §§ 17 and 10b are utilized only when intentional fraud or gross negligence is proven in addition to the § 11 violations.

62. Clarifying the provisions of § 11(e), the Chief of Securities of the Federal Trade Commission (prior to the formation of the SEC) stated:

One sees immediately that trading losses as distinguished from losses due to material, misleading or inadequate statements as of the time of offering of the security, afford no ground for action.

17 C.F.R. § 231.45 (1970).

63. *Globus v. Law Research Serv.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). The case involved violation of the Securities Act of 1933. The violation consisted of a failure to disclose in a prospectus that a major contract with Sperry Rand had been terminated by Sperry.

64. *Id.* at 1288.

65. Cohen, "*Truth in Securities*" *Revisited*, 79 HARV. L. REV. 1340 (1966). Mr. Cohen is the former Director of Special Study of Securities Markets, SEC. In discussing the history of § 11, Cohen stated:

In actual experience the liability provisions have had *in terrorem* effect of creating an extraordinary high sense of care and responsibility in the preparation of registration statements.

Id. at 1355.

was immaterial.⁶⁶ Therefore, no liability should be imposed.

CONCLUSION

The use of market indexes to mitigate damages is a laudable development which will prevent inequitable results in cases involving a violation of § 11 of the Securities Act of 1933. Unless market indexes are utilized, a court must either deny recovery or assess damages equal to the security's decline in price. When the decline was caused by general economic conditions, the damages could become grossly disproportionate to the defendant's misconduct. Although the use of market indexes has disadvantages, in appropriate cases it can provide an excellent method for achieving equitable results in assessing damages for violations of § 11.

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66. 2 A. BROMBERG, *SECURITIES LAW* 199-202. The author takes an entirely different approach for establishing liability. He suggests using the price reaction of a security when fraud is disclosed as independent evidence of the existence or absence of materiality. Disclosure of the fraud may be preceded by anticipatory trading which would prevent accurate measurement of the full market reaction to the disclosure. The other objection involves the danger of an irrational price reaction to the disclosure. A reasonable market standard might provide a rough criterion to determine whether the price reaction was rational.