

LIABILITY UNDER RULES 10b-5(a) & (c)

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ABSTRACT

Some recent decisions have treated the issue of liability under Securities Exchange Act Rule 10b-5(a) or Rule 10b-5(c) as if it were a novel or unsettled question of federal securities law. At this writing, a pending appeal in the Ninth Circuit is considering a standard proposed by the SEC for "scheme" liability under those subparts of Rule 10b-5 where the defendant neither spoke nor owed a duty to speak but instead engaged in business transactions that were misreported by the issuer. Similar theories of liability have already been rejected by the Second and Eighth Circuits. This article draws on the U.S. Supreme Court's Section 10(b) cases, recent federal appellate decisions, and precedents involving other rules adopted under Section 10(b) to explain that existing precedent already compels the conclusion that liability under any subpart of Rule 10b-5 requires a misrepresentation, a duty to disclose, or a manipulative transaction in the issuer's securities.

I. INTRODUCTION

With a declining stock market and the exposure of a number of far-reaching corporate scandals, plaintiffs' counsel in recent years have understandably sought to cast a broad net in the search for solvent defendants in securities fraud actions. In particular, plaintiffs increasingly invoke subsections (a) and (c) of Rule 10b-5, contending that these longstanding rules permit the maintenance of novel causes of action that are otherwise barred by the traditional barriers to reaching remote defendants in private actions under section 10(b). Specifically, plaintiffs' counsel often seek to use Rules 10b-5(a) and (c) to impose liability for misrepresentations or omissions on defendants who neither made the misrepresentation nor had a duty to disclose any omitted facts, often on the theory that such defendants participated in a "scheme" to cause misrepresentations to be made by another defendant.

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In a number of recent cases, district courts have accepted plaintiffs' novel readings of these subsections, treating Rules 10b-5(a) and 10b-5(c) as if they were separate and independent sources of liability from the traditional securities fraud claim brought under Rule 10b-5(b), and further assuming that the contours of such actions were unsettled. More recently, the Securities and Exchange Commission (SEC) has weighed in with *amicus curiae* briefs filed in the Ninth Circuit supporting this view of "scheme" liability under Rule 10b-5(a). In fact, however, this reading of Rules 10b-5(a) and 10b-5(c) is flatly inconsistent with settled U.S. Supreme Court precedents that draw on the text of the enabling statute, section 10(b) of the Securities Exchange Act of 1934, as well as with Circuit-level precedents regarding causes of action asserted under other "10b"-series rules. Moreover, the Second, Seventh, and Eighth Circuits, as well as a number of federal district courts, have recently reaffirmed that Rules 10b-5(a) and (c) do not alter the longstanding requirements of the implied private right of action under section 10(b) and Rule 10b-5: the defendant must make a misrepresentation, owe the plaintiff a duty to disclose, or carry out a manipulative transaction in the subject security.

II. THE STATUTE AND THE RULE

Section 10(b), enacted in 1934 as part of the original Securities Exchange Act, makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . *any manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe."¹ As the Supreme Court has observed, in holding that aiders and abettors are not liable for violations of section 10(b), "[T]he statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. . . . We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute."² "[T]he statutory text controls the definition of conduct covered by § 10(b). . . . It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text."³

Rule 10b-5, hastily promulgated in 1942 to give the SEC express authority over fraudulent purchases (as well as sales) of securities,⁴ is

¹15 U.S.C. § 78j(b) (2005) (emphasis added).

²Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177-78 (1994).

³*Id.* at 175, 177.

⁴*See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 n.32 (1976).

divided into three subsections, which (with exceptions not relevant here) track the language of section 17(a) of the Securities Act of 1933:

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.⁵

Plaintiffs' counsel, seizing upon the absence of any reference to a misrepresentation or omission in subsections (a) and (c) of Rule 10b-5, increasingly seek to use those subsections as a means to plead a cause of action against defendants who have neither made any false or misleading public statement nor owed the plaintiffs any duty of disclosure. But the basic elements—a misrepresentation, duty to disclose or the execution of a manipulative transaction—are required by section 10(b) itself, as the Supreme Court has made clear.

III. THE SUPREME COURT DEFINES "DECEPTION" AND "MANIPULATION"

The Supreme Court, in *Ernst & Ernst v. Hochfelder*,⁶ expressly held that the subsections of Rule 10b-5 cannot create liabilities beyond those imposed by the statutory text. *Hochfelder* is remembered today mostly for its bottom-line holding: scienter, i.e., an "intent to deceive, manipulate, or defraud," is an element of the section 10(b) cause of action.⁷ The Court

⁵17 C.F.R. § 240.10b-5 (2005).

⁶425 U.S. 185 (1976).

⁷*Id.* at 193.

drew this requirement from the common law of fraud, which was imported into section 10(b) by the use of "commonly understood terminology of intentional wrongdoing"⁸ such as the terms "manipulative," "device," and "contrivance"⁹ in the statute.

But the Court's holding in *Hochfelder* also required it to resolve an issue raised in that case by the SEC: the contention that scienter is not a requirement of a claim under Rule 10b-5 because only one of the three subparts of Rule 10b-5, on its face, requires proof of scienter. Specifically, the SEC argued, and the Court agreed, that the express terms of Rules 10b-5(b) and 10b-5(c) "could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, *whether the wrongdoing was intentional or not*."¹⁰ Nonetheless, the *Hochfelder* Court emphasized that the reach of Rule 10b-5 was limited by the scope of section 10(b):

The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law Thus, despite the broad view of the Rule advanced by the [SEC] in this case, *its scope can not exceed the power granted the [SEC] by Congress under § 10(b)*.¹¹

A year later, in *Santa Fe Industries v. Green*,¹² the Court was called upon to define the phrase "manipulative or deceptive device or contrivance"

⁸*Id.* at 214.

⁹*Id.* at 199. The Court recently reaffirmed the significance of "the common-law roots of the securities fraud action" in addition to the express statutory requirements. *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1632 (2005).

¹⁰*Hochfelder*, 425 U.S. at 212 (emphasis added). The Court subsequently confirmed this reading of Rules 10b-5(b) and (c) in *Aaron v. SEC*, 446 U.S. 680 (1980). In *Aaron*, the Court—while reaffirming that scienter was required by the "plain meaning of the language of [s]ection 10(b)," as well as by section 17(a)(1) of the 1933 Act (which uses language identical to Rule 10b-5(a))—held that there is no scienter requirement in sections 17(a)(2) and (a)(3) of the 1933 Act, which use language identical to Rules 10b-5(b) and (c), respectively. *Id.* at 690, 697. The different outcomes in *Aaron* and *Hochfelder* can only be explained by the conclusion that the language of Rule 10b-5 goes beyond the SEC's delegated rulemaking authority derived from section 10(b).

¹¹*Hochfelder*, 425 U.S. at 13-14 (emphasis added). The Court's subsequent statements that Rule 10b-5 is coextensive with section 10(b), see *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002) (referencing *United States v. O'Hagan*, 521 U.S. 642, 651 (1997); *Hochfelder*, 425 U.S. at 214), must be read in this light: not to suggest that the subsections of Rule 10b-5 can add to or define the scope of the section 10(b) cause of action, but simply to recognize that the SEC, in enacting the Rule, took the full measure of rulemaking authority granted it under the statute.

¹²430 U.S. 462 (1977).

in section 10(b) in the context of a private action under Rules 10b-5(a) and (c). The plaintiffs in *Santa Fe* challenged a "short-form" merger, which under Delaware law permitted a parent company to compel the plaintiff minority shareholders to accept cash in exchange for their shares.¹³ Although the plaintiffs alleged affirmative and intentional misrepresentations, they conceded that they had not relied on them, and thus the Court assumed that the defendants had not made an actionable misrepresentation or nondisclosure.¹⁴ The Second Circuit, in an opinion predating *Hochfelder*, had found—quoting the text of Rule 10b-5(a)—that the plaintiffs had stated the following claim: "that the Delaware procedure as applied to the facts of this case constitutes a 'device, scheme, or artifice to defraud' because of the gross undervaluation by defendants of the shares the minority shareholders are forced to sell."¹⁵ The Second Circuit explicitly rested its decision on Rules 10b-5(a) and (c):

[An] erroneous assumption is that in order to allege a claim under Rule 10b-5 there must be some showing of misrepresentation or lack of disclosure. . . . But only subdivision [b] of 10b-5 deals with nondisclosure and misrepresentation. The Rule contains two other subdivisions which state explicitly that fraud other than and in addition to a failure to disclose or truthfully represent is also actionable It must be that the failure to observe this broader scope of Rule 10b-5 led the court below to dismiss the complaint . . . lest there be any lingering doubt on this point, we now hold that in such cases, including the one now before us, no allegation or proof of misrepresentation or nondisclosure is necessary.¹⁶

Before the Supreme Court, the plaintiffs' "principal argument" was that the merger violated Rules 10b-5(a) and (c).¹⁷ The Court explained, citing *Hochfelder*, that the statute's requirements were controlling:

The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or

¹³*Id.* at 465-67.

¹⁴*Id.* at 467-69, 474.

¹⁵*Green v. Santa Fe Indus.*, 533 F.2d 1283, 1285 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

¹⁶*Id.* at 1286-87.

¹⁷*Santa Fe*, 430 U.S. at 474 n.14.

deception. . . . Thus the . . . complaint states a cause of action *under any part of Rule 10b-5* only if the conduct alleged can be fairly viewed as "*manipulative or deceptive*" within the meaning of the statute.¹⁸

Finding no actionable "deception, misrepresentation, or nondisclosure," the Court defined the remaining statutory term—"manipulative"—as follows: manipulative conduct "is 'virtually a term of art when used in connection with securities markets' . . . [which] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."¹⁹ As discussed in more detail below, courts have followed this definition of "manipulative" as referring to similar types of artificial market activity (i.e., the execution of securities transactions designed to simulate genuine interest in buying or selling at an artificial price). As a result, unless such undisclosed artificial market activity is pleaded and proved, claims under section 10(b) necessarily turn on "deceptive . . . devices or contrivances."²⁰

Following the rejection of Rules 10b-5(a) and (c) as sources for liability in the absence of deception or manipulation, the Court went on to clarify the scope of "decept[ion]" under section 10(b) in *Chiarella v. United States*.²¹ *Chiarella*, involving trading on material non-public information by an employee of a financial printer, was brought as a criminal action under Rules 10b-5(a) and (c), not 10b-5(b).²² Even though *Chiarella* unquestionably involved a dishonest and deliberate attempt to trade on information that was unavailable to the market at large, the Court refused to extend the concept of "deception" beyond the basic common law categories of misrepresentation or a duty to disclose, holding that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak . . . premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction."²³ The Court found that the following jury instructions, quoting Rules 10b-5(a) and (c), mischaracterized the requirements of a section 10(b) violation, resulting in reversible error:

¹⁸*Id.* at 473-74 (emphasis added).

¹⁹*Id.* at 476 (quoting *Hochfelder*, 425 U.S. at 199).

²⁰See *infra* Part V.

²¹445 U.S. 222 (1980).

²²*Id.* at 225 n.5 ("Only Rules 10b-5(a) and (c) are at issue here.").

²³*Id.* at 235, 230.

The jury was told, in the language of Rule 10b-5, that it could convict the petitioner if it concluded that he either (i) employed a device, scheme, or artifice to defraud or (ii) engaged in an act, practice, or course of business which operated or would operate as a fraud or deceit upon any person. The trial judge stated that a "scheme to defraud" is a plan to obtain money by trick or deceit and that "a failure by Chiarella to disclose material, non-public information in connection with his purchase of stock would constitute deceit." Accordingly, the jury was instructed that the petitioner employed a scheme to defraud if he "did not disclose . . . material non-public information in connection with the purchases of the stock."

Alternatively, the jury was instructed that it could convict if "Chiarella's alleged conduct of having purchased securities without disclosing material, non-public information would have or did have the effect of operating as a fraud upon a seller." The judge earlier had stated that fraud "embraces all the means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false misrepresentation, suggestions or by suppression of the truth."²⁴

In short, the *Chiarella* Court expressly held that the need for either a misrepresentation or a duty to disclose is an essential element of liability under Rules 10b-5(a) or (c).²⁵

The Court recounted these decisions when it held, in *Central Bank*, that because section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," and "does not include giving aid to a person who commits a manipulative or deceptive act," the statute does not reach aiders and abettors.²⁶ After *Central Bank*, litigation has focused on what types of acts fit the definition of "the making of a material misstatement (or omission)" and "the commission of a manipulative act," mostly with regard to the issue of what

²⁴*Id.* at 236 (citations omitted).

²⁵The Third Circuit, citing *Chiarella*, required proof of a duty to disclose on the part of corporate directors in finding liability for the loss of conversion rights by holders of convertible bonds in *Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co.*, 680 F.2d 933, 940-42 (3d Cir.), *cert. denied*, 459 U.S. 1056 (1982).

²⁶*Cent. Bank*, 511 U.S. at 177-78.

constitutes "making" a misrepresentation.²⁷ In light of the Court's clear and unambiguous holdings in *Santa Fe* and *Chiarella*, however, it is already clear that—under Rules 10b-5(a) and (c), just as under Rule 10b-5(b)—liability under section 10(b) does not extend beyond those three categories: (1) the making of a misrepresentation, (2) an omission or non-disclosure coupled with a duty to speak, and (3) the commission of a manipulative act.

IV. THE STATUTE AND THE RULE IN THE LOWER COURTS

Both before and after *Central Bank*, the district and circuit courts had numerous occasions to consider whether rules promulgated under section 10(b) created causes of action not bounded by the traditional elements of a section 10(b) claim. One context in which this question has arisen is the other "10b" series rules, including Rules 10b-10 (governing required disclosures on trade confirmations) and 10b-16 (governing advance disclosures of the terms of margin loans). Consistent with the Supreme Court's direction in *Hochfelder*, the courts have uniformly recognized that, to the extent that a private cause of action could be asserted under any of these rules, the claim must nonetheless satisfy the same statutorily-derived elements as any other section 10(b) claim.²⁸

²⁷The Second Circuit, for example, follows a "bright line" approach to claims involving reliance on a misrepresentation made by an issuer of securities, under which "a secondary actor cannot incur primary liability . . . for a statement not attributed . . . to that specific actor at the time of public dissemination, that is, in advance of the investment decision." *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999) (citations omitted). *Accord* *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997). Several other circuits have taken similar approaches. *See, e.g.*, *Fidel v. Farley*, 392 F.3d 220, 234-36 (6th Cir. 2004) (following *Wright*); *Ziembra v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205-06 (11th Cir. 2001) (same). *See also* *Gariety v. Grant Thornton LLP*, 368 F.3d 356, 369 (4th Cir. 2004); *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 246 (3d Cir. 2004). The proper standards for "making" a misrepresentation, however, are outside the scope of this article.

²⁸*See, e.g.*, *Arst v. Stifel, Nicolaus & Co.*, 86 F.3d 973, 977 (10th Cir. 1996) (claim under Rule 10b-10 dismissed for failure to meet statutory "in connection with" requirement); *Angelastro v. Prudential-Bache Secs., Inc.*, 764 F.2d 939, 946 (3d Cir. 1985) (Rule 10b-16 claim must meet statutory "in connection with" requirement); *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530, 540 (9th Cir. 1984) (claim under Rule 10b-16 must satisfy statutory scienter requirement). *See also* *Morris v. Wachovia Secs., Inc.*, 277 F. Supp. 2d 622, 638 n.9 (E.D. Va. 2003) (dismissing Rule 10b-10 claim for failure to allege statutory elements of reliance and loss causation); *Bissell v. Merrill Lynch & Co.*, 937 F. Supp. 237, 244-45 (S.D.N.Y. 1996) (dismissing Rule 10b-16 claim for failure to allege statutory "in connection with" requirement and statute of limitations), *aff'd on other grounds*, 157 F.3d 138 (2d Cir. 1998), *cert. denied*, 525 U.S. 1144 (1999); *Levitin v. PaineWebber, Inc.*, 933 F. Supp. 325, 330-31 (S.D.N.Y. 1996) (dismissing Rule 10b-10 and 10b-16 claims for failure to allege statutory "in connection with" requirement), *aff'd on other grounds*, 159 F.3d 698, 707 (2d Cir. 1998), *cert. denied*, 525 U.S. 1144 (1999). *Cf.* *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1358 n.8 (11th Cir. 1985) (noting

Several district courts have applied the same reasoning to claims under Rules 10b-5(a) and (c). For example, in *In re Towers Financial Corp. Noteholders Litigation*,²⁹ the court dismissed claims against an outside law firm that, *inter alia*, assisted in the preparation of offering documents, holding that the plaintiffs must "prove all of the established elements of a rule 10b-5 claim even when proceeding under Rule 10b-5(a) & (c)," rather than Rule 10b-5(b).³⁰ In *In re Dynege, Inc. Securities Litigation*,³¹ the court dismissed claims against an outside bank that had engaged in transactions that the issuer misrepresented in its financial statements, concluding that

Central Bank precludes liability based on allegations that a group of defendants acted together to violate the securities laws unless each defendant committed a manipulative or deceptive act in furtherance of the scheme. . . . Plaintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent *Central Bank's* limitations on liability for a secondary actor's involvement in the preparation of false and misleading statements.³²

that any cause of action under Rule 10b-16 would need to meet the statutory elements of § 10(b)).

²⁹No. 93 Civ. 0810, 1995 U.S. Dist. LEXIS 221147 (S.D.N.Y. Sept. 20, 1995) (Peck, M.J.), *aff'd*, 936 F. Supp. 126 (S.D.N.Y. 1996).

³⁰*Id.* at *46. In response to this decision, the plaintiffs in *Towers* attempted to replead their Rule 10b-5(a) and (c) claims as conspiracy claims, an effort that was rejected by the Second Circuit. *See* *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 839-41 (2d Cir. 1998).

³¹339 F. Supp. 2d 804, 914-16 (S.D. Tex. 2004).

³²*Id.* at 914-16. *Accord In re Charter Commc'ns, Inc., Sec. Litig.*, No. 05-1974 (8th Cir. Apr. 11, 2006), <http://www.ca8.uscourts.gov/opndir/06/04/051974P.pdf> (discussed below); *Filler v. Hanvit Bank*, Nos. 04-6295-CV, 04-6719-CV, 2005 U.S. App. LEXIS 26443, at *10-12 (2d Cir. Dec. 2, 2005) (discussed below); *Elan Corp. Secs. Litig.*, No. 02 Civ. 865, 2004 U.S. Dist. LEXIS 9913, at *71-77 (S.D.N.Y. May 18, 2004) (Maas, M.J.) (dismissing Rule 10b-5(a) and (c) claims against outside auditor that had not made a statement under the Second Circuit's interpretation of *Central Bank*); *In re Lake States Commodities*, 936 F. Supp. 1461, 1471-72 (N.D. Ill. 1996) (rejecting Rule 10b-5(a) & (c) liability in absence of misrepresentation, duty to disclose or claim of manipulation), *abrogated on other grounds*, *Damato v. Hermanson*, 153 F.3d 464 (7th Cir. 1998). *See also Garcia v. Cordova*, 930 F.2d 826, 832 & n.3 (10th Cir. 1991) (reversing jury verdict for plaintiff sellers on Rule 10b-5(a) and (c) claims based upon nondisclosure of information by insider/purchaser, where information was not material); *SEC v. Coffey*, 493 F.2d 1304, 1313 (6th Cir. 1974) (defendants did not violate Rule 10b-5(a) or (c) in selling notes to state government, where defendants' disclosures literally complied with state statute; "[t]here is no duty to disclose information to one who reasonably should already be aware of it," and state government was "held to the knowledge" of the limits of the disclosures required by the statute), *cert. denied*, 420 U.S. 908 (1975); *In re Rent-Way Secs. Litig.*, 209 F. Supp. 2d 493, 500, 505 (W.D. Pa. 2002) (rejecting Rule 10b-5(a) & (c) liability against auditor that "improperly reviewed and approved of" quarterly financial statements, where "misstatements are

V. THE MEANING OF "MANIPULATIVE"

One argument made by plaintiffs' attorneys in seeking to use Rules 10b-5(a) and (c) to evade the requirement of pleading and proving a misrepresentation or duty to disclose is to contend that the term "manipulation" can extend to false statements that "manipulate" the market for a security. While some district courts have accepted variants on this argument, recent decisions by the Second, Seventh, and Eighth Circuits have squarely rejected efforts to redefine "manipulation" to cover conduct not involving the use of manipulative securities trades.

*In re Global Crossing, Ltd. Securities Litigation*³³ involved an effort to hold an outside auditor liable for statements made by the issuer, including some made without specific mention of the auditor. *Global Crossing* was thus, at its core, a garden-variety false statement case (albeit one involving very large losses), in which the plaintiffs sought to attribute issuer statements to the auditor. The court accepted the premise that involvement in the issuance of false financial statements could constitute "manipulation":

Andersen argues that because plaintiffs failed to allege "tie-in agreements, wash sales, matched orders or rigged prices," they have failed to state [a market manipulation] claim. It is true that plaintiffs fail to assert a market manipulation claim, as those claims are technically understood—they have alleged no illegal *trading* activity that would artificially cause stock prices to rise. But subsections (a) and (c) encompass much more than illegal trading activity

The use of the term "manipulative" in section 10(b) itself "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or *artificially affecting* the

what the Plaintiffs allegedly relied upon to their detriment, and the allegations simply do not permit an inference that Plaintiffs relied upon any 'device,' 'scheme,' 'artifice,' 'act,' 'practice' or 'course of business' employed or engaged in by [the auditor] such that a Rule 10b-5 claim could be established."); *Charal Inv. Co. v. Rockefeller*, 131 F. Supp. 2d 593, 603 (D. Del. 2001) ("Plaintiffs' claim pursuant to Rule 10b-5(a) requires a demonstration of materiality even though it is not expressly required in the language of the rule"), *aff'd on other grounds*, 311 F.3d 198 (3d Cir. 2002). Cf. *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1160 n.10 (9th Cir. 1996) (granting summary judgment on claims against lender in private placement; noting that the "viability of [Rules 10b-5(a) and (c)] claims independent of [plaintiffs'] Rule 10b-5(b) claims is questionable," and finding no claim arising from lender's knowledge that undisclosed business problems of issuer could have caused cancellation of offering).

³³322 F. Supp. 2d 319 (S.D.N.Y. 2004).

price of securities." Plaintiffs allege precisely such manipulative conduct, with precisely such a result. Schemes used to artificially inflate the price of stocks by creating phantom revenue fall squarely within both the language of section 10(b) and its broad purpose, to "prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded."³⁴

The Second Circuit, in *Lentell v. Merrill Lynch & Co.*,³⁵ a case involving a brokerage firm's liability for its analyst reports, explicitly rejected this position, holding that claims sounding in misrepresentation or omission are not actionable as "manipulation":

[P]laintiffs cast their claims in terms of market manipulation, pursuant to Rule 10b-5(a) and (c). We hold that *where the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a market manipulation claim under Rule 10b-5(a) and (c)*, and remain subject to the heightened pleading requirements of the PSLRA.³⁶

³⁴*Id.* at 336-37 (citations omitted). *Accord In re AOL Time Warner, Inc. Secs. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 217 (S.D.N.Y. 2004) ("[B]oth 10b-5 and *Santa Fe* contemplate manipulation of the securities markets to be practices, acts, misstatements or omissions designed to mislead investors."). The *AOL Time Warner* court's discussion is *dicta*, as the court did not sustain any claim under Rules 10b-5(a) or (c) separate from the main Rule 10b-5(b) claims against an issuer for its own alleged false statements. A number of other decisions have similarly permitted Rule 10b-5(a) and (c) liability either in tandem with Rule 10b-5(b) liability or otherwise in circumstances that could support traditional liability for a misrepresentation or duty to disclose. *See, e.g., In re Qwest Commc'ns Int'l, Inc. Sec. Litig.*, 387 F. Supp. 2d 1130, 1146-47 (D. Colo. 2005); *SEC v. Santos*, 355 F. Supp. 2d 917, 919-20 (N.D. Ill. 2003) (denying motion to dismiss where brokerage firm failed to disclose, in reports to city, its improper payments made to city official in exchange for business); *In re Royal Ahold N.V. Secs. & ERISA Litig.*, 351 F. Supp. 2d 334, 371-72, 377-84 (D. Md. 2004) (holding corporate insiders liable for "manipulation" of financial statements); *In re Salomon Analyst AT&T Litig.*, 350 F. Supp. 2d 455, 472-74 (S.D.N.Y. 2004) (denying motion to dismiss by CEO for public statements made by an employee allegedly at his direction).

³⁵396 F.3d 161 (2d Cir.), *cert. denied*, 126 S. Ct. 421 (2005).

³⁶*Lentell*, 396 F.3d at 177-78 (citing *Schnell v. Consecro, Inc.*, 43 F. Supp. 2d 438, 447-48 (S.D.N.Y. 1999) (B.D. Parker, J.) (stating that the *Schnell* court "refus[ed] to characterize allegations as market manipulation claims where alleged 'schemes to defraud' consisted largely of an aggregation of material misrepresentations to inflate stock, such as research reports containing misrepresentations of the underlying facts and use of false names to solicit investors")). *Accord In re Yukos Oil Co. Secs. Litig.*, No. 04 Civ. 5243, 2006 WL 800736, at *17-18 (S.D.N.Y. Mar. 30, 2006); *In re Nat'l Century Fin. Enters., Inc. Inv. Litig.*, No. 2:03-MD-1565, 2006 WL 469468, at *21 (S.D. Ohio Feb. 27, 2006); *SEC v. KPMG LLP*, No. 03 Civ. 671, 2006

A similar conclusion was reached by the Seventh Circuit. The district court in *Foss v. Bear, Stearns & Co.*, rejected an attempt to impose Rule 10b-5(a) and (c) liability on a brokerage firm whose employee opened accounts with securities he allegedly knew to be stolen from the plaintiff estate by its prior administrator.³⁷ On appeal, the Seventh Circuit affirmed, refusing to apply the label of "manipulation" and instead holding that the absence of a misrepresentation made, or duty to disclose owed, by the brokerage firm to the estate was fatal to the claim: "Foss wants us to call the conduct 'manipulation' rather than 'fraud,' but this is a distinction without a difference. In securities law, manipulation is a *kind* of fraud; deceit remains essential."³⁸

The Eighth Circuit, in a decision discussed in more detail below,³⁹ likewise rejected a definition of "manipulative" conduct that would swallow the definition of "deceptive" conduct:

The term "manipulative" in § 10(b) has the limited contextual meaning ascribed in *Santa Fe*. Thus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in

U.S. Dist. LEXIS 1283, at *76-77 (S.D.N.Y. Jan. 13, 2006); *Catton v. Defense Technology Sys., Inc.*, No. 05 Civ. 6954, 2006 U.S. Dist. LEXIS 205, at *16-17 (S.D.N.Y. Jan. 3, 2006); *JHW Greentree Capital, L.P. v. Whittier Trust Co.*, No. 05 Civ. 2985, 2005 U.S. Dist. LEXIS 27156, at *25-26 & n.11 (S.D.N.Y. Nov. 10, 2005); *Collier v. Aksys Ltd.*, No. 3:04CV1232, 2005 U.S. Dist. LEXIS 20300, at *49-54 (D. Conn. Aug. 15, 2005); *In re Recoton Corp. Secs. Litig.*, 358 F. Supp. 2d 1130, 1138 n.4 (M.D. Fla. 2005). The plaintiffs in *Lentell* argued that their claims, premised upon misleading analyst reports, were properly pleaded as Rule 10b-5(a) and (c) claims under *In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 235 F.Supp. 2d 549 (S.D. Tex. 2002), discussed below. See Joint Brief of Plaintiffs-Appellant at 68-76, *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005) (No. 03-7948); Joint Reply Brief of Plaintiffs-Appellant at 31-33, *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005) (No. 03-7948).

³⁷No. 03 C 8338, 2004 U.S. Dist. LEXIS 9304, at *7-10 (N.D. Ill. May 17, 2004), *aff'd*, 394 F.3d 540 (7th Cir. 2005).

³⁸*Foss v. Bear, Stearns & Co.*, 394 F.3d 540, 542 (7th Cir. 2005) (citing *Schreiber v. Burlington N., Inc.*, 472 U.S. 1 (1985); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977)). Despite the discussion of Rule 10b-5(a) and (c) in the various cases cited herein, including its own prior precedent in *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), the Sixth Circuit recently concluded that there was "very little case law explaining more specifically what types of claims are actionable under these provisions." *Benzon v. Morgan Stanley Distribs., Inc.*, 420 F.3d 598, 611 (6th Cir. 2005). The court in *Benzon*, relying solely upon *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the district court decision in *Scholnick v. Schechter*, 752 F. Supp. 1317 (E.D. Mich. 1990), and "[a] plain-language reading of the Rule," concluded that a brokerage firm's compliance with its disclosure obligations did not necessarily dispose of Rule 10b-5(a) and (c) claims arising from mutual fund sales practices, but nonetheless affirmed the dismissal of those claims in the absence of clear authority on the matter. *Benzon*, 420 F.3d at 610-11.

³⁹See *infra* Part VII.B.

manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.⁴⁰

The position of the Second, Seventh, and Eighth Circuits is the only sensible reading of the Supreme Court's repeated emphasis on defining "manipulative" practices to include types of conduct—"wash sales, matched orders, or rigged prices"—in which the common element is the execution of transactions that upset *the market mechanism itself*, rather than just the universe of information about the issuer. As the Second Circuit put it in *Gurary v. Winehouse*, "The gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities *are determined by the natural interplay of supply and demand*, not rigged by manipulators."⁴¹ The Court in *Santa Fe*, in limiting the definition of "manipulative," left little room to doubt that it regarded the term as having a specific meaning:

Section 10(b)'s general prohibition of practices deemed by the SEC to be "manipulative"—in this *technical sense of artificially affecting market activity in order to mislead investors*—is fully consistent with the fundamental purpose of the 1934 Act No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But *we do not think it would have chosen this "term of art" if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary.*⁴²

The Court cited back to its interpretation of the former Rule 10b-6, which it had described just a month earlier as "an antimanipulative provision designed . . . to prevent stimulative trading by an issuer in its own securities in order to create an unnatural and unwarranted appearance of market activity."⁴³

This reading of section 10(b)'s use of the term "manipulative" is consistent with the commonly understood meaning of the term, and with

⁴⁰*In re Charter Commc'ns, Inc., Sec. Litig.*, No. 05-1974, slip op. at 7 (8th Cir. Apr. 11, 2006), <http://www.ca8.uscourts.gov/opndir/06/04/051974P.pdf> (citations omitted).

⁴¹190 F.3d 37, 45 (2d Cir. 1999) (emphasis added).

⁴²*Santa Fe*, 430 U.S. at 476-77 (emphasis added).

⁴³*Id.* at 476 (quoting *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 43 (1977)).

the reasons why the requirements of pleading and proving market manipulation have always been distinct from misrepresentation or omission cases.⁴⁴ It is also consistent with Congress' use of the term elsewhere in the securities laws, such as section 9 of the Exchange Act, which is captioned "Prohibition Against Manipulation of Security Prices" and makes it unlawful to "effect any transaction" or "enter an order or orders" in certain circumstances "[f]or the purpose of creating a false or misleading appearance of active trading in any security . . . , or a false or misleading appearance with respect to the market for any such security."⁴⁵ It is thus unsurprising that few courts have been willing to create a new class of "manipulation" claims that are little more than "deception lite," alleging damages from reliance on misrepresentations or omissions but satisfying less than all of the required elements of a misrepresentation or omission claim.

VI. ENRON AND "SCHEME" LIABILITY

Aside from recasting the definition of "manipulative" conduct, the main argument made in favor of liability under Rule 10b-5(a) in misrepresentation or omission cases is that a secondary actor can be liable for an issuer's statements by virtue of having participated in a "scheme" to issue such statements. In general, "scheme" liability has been urged in two contexts. First, plaintiffs have sought to impose liability on parties that did business with the issuer, often in ways characterized as "sham" transactions. Sham transactions are those having no other economic purpose or are accompanied by non-public misrepresentations, where the issuer then improperly accounted for the transaction. Second, plaintiffs have sought to impose liability on accountants who were not mentioned in a public statement reporting financial results on the theory that their involvement in the underlying accounting decisions constituted an unlawful accounting scheme resulting in the issuance of false financial information.

⁴⁴See, e.g., *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 112 (2d Cir. 1998); *United States v. Russo*, 74 F.3d 1383, 1391-92 (2d Cir. 1996) (noting distinction between manipulation and cases requiring a misrepresentation or duty to disclose); *United States v. Regan*, 937 F.2d 823, 829 (2d Cir.) (same), *amended*, 946 F.2d 188 (2d Cir. 1991), *cert. denied*, 504 U.S. 940 (1992); *Catton*, 2006 U.S. Dist. LEXIS 205, at *16-17; *In re Initial Pub. Offering Secs. Litig.*, 383 F. Supp. 2d 566, 577 (S.D.N.Y. 2005) ("In market manipulation cases, . . . the plaintiff's burden [of pleading loss causation] is somewhat different [from cases involving false statements], because of the nature of the artificial inflation caused by manipulative conduct."). See also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 460-63 (1976) (discussing absence of duty of corporation to disclose its transactions in its own stock in absence of actual "market manipulation").

⁴⁵15 U.S.C. § 78i(a)(1) (2005).

As discussed above, the problem with "scheme" liability under Rule 10b-5(a)—and with similar efforts under Rule 10b-5(c)—is that it is inconsistent with the Supreme Court's reading of the language of section 10(b) itself.⁴⁶ The opinions accepting "scheme" liability have generally not grappled with the leading Supreme Court cases: few of them cite *Chiarella* at all, and none mention the fact that *Santa Fe* and *Chiarella* have already decided the scope of "deception" under Rules 10b-5(a) and (c). Several of these opinions have also placed undue reliance on *dicta* in other Supreme Court opinions that found liability under the traditional categories of misrepresentation or duty to disclose. The Second Circuit, in a recent unpublished opinion, and the Eighth Circuit, in a published opinion, both rejected this theory of liability, and at this writing, an appeal is pending in the Ninth Circuit addressing the question.⁴⁷

The case that has served as a template for theories of "scheme" liability is *In re Enron Corp. Securities, Derivative & ERISA Litigation*,⁴⁸ which arose from perhaps the most sensational corporate accounting scandal in American history.⁴⁹ The court in *Enron*, in an opinion of extraordinary length recounting facts of dizzying complexity, denied motions to dismiss brought by, *inter alia*, several broker-dealers, investment banks and banks, as well as one of Enron's law firms. Each of these defendants was alleged to have been involved in various ways in structuring and financing transactions between Enron and various "special purpose" entities under Enron's control and, in the case of the law firm, drafting legal opinions, giving advice, and co-authoring disclosure documents.⁵⁰

⁴⁶There are also a number of practical objections to "scheme" liability, particularly in the context of private litigation, including the difficulty of translating the requirements of reliance, materiality, loss causation, and compliance with the statute of limitations and the pleading requirements of Rule 9(b) and the Private Securities Litigation Reform Act into cases where the plaintiff may have been entirely unaware of the conduct and even the existence of the defendant at the time of the plaintiff's investment. These objections are outside the scope of this article.

⁴⁷See *infra* Part VII.

⁴⁸235 F. Supp. 2d 549 (S.D. Tex. 2002).

⁴⁹Some district courts have relied on *Enron* as authority for finding liability under Rule 10b-5(a) and (c). See, e.g., *Swack v. Credit Suisse First Boston*, 383 F. Supp. 2d 223, 238-39 (D. Mass. 2004). As noted above, however, there has been disagreement even among courts in the same district as to the *Enron* court's analysis. See *Dynegy*, 339 F. Supp. 2d at 914-16. In light of the split with the *Dynegy* court, the defendants in the *Enron* litigation have made several efforts to place the issue before the Fifth Circuit, but at this writing have not yet succeeded in finding a procedural vehicle to get the issue on the Fifth Circuit's docket.

⁵⁰The court's decision also denied various of the broker-dealer defendants' motions to dismiss based on misleading analyst reports, as well as the motion to dismiss of Enron's auditor for publicly certifying its financial statements, conclusions that do not implicate *Central Bank* or Rules 10b-5(a) or (c). See *Enron*, 235 F. Supp. 2d at 688-89, 706-07.

The *Enron* court concluded that "liability is not limited to the making of a material misstatement or omission, nor to a few very technical forms of manipulation," and thus that "in addition to claims under Rule 10b-5(b), plaintiffs may sue for securities law violations under Rule 10b-5(a) and (c) for conduct other than material misrepresentations or omissions."⁵¹ Therefore, the court permitted claims to go forward without any analysis of whether particular defendants had made a misrepresentation, owed a duty to disclose, or carried out manipulative transactions in Enron securities. The court appears to have relied in part on the redefinition of "manipulative" conduct discussed above.⁵² But the court also read passages from three Supreme Court cases as permitting Rule 10b-5(a) and (c) liability without satisfaction of the traditional section 10(b) elements. First, the court quoted *Affiliated Ute Citizens v. United States*:⁵³

While subsection (b) of Rule 10b-5 provides a cause of action based on the "making of an untrue statement of a material fact and the omission to state a material fact," subsections (a) and (c) "are not so restricted" and allow suit against defendants who, with scienter, participated in "a 'course of business' or a 'device, scheme or artifice' that operated as a fraud" on sellers or purchasers of stock even if these defendants did not make a materially false or misleading statement or omission.⁵⁴

Affiliated Ute, however, was the original duty to disclose case: the defendant market-makers, who purchased securities from the plaintiffs unsophisticated investors *in face-to-face transactions*, failed to disclose to the plaintiffs: (1) the existence of a secondary market, (2) the defendants' market maker status in that market, or (3) the fact that the securities were selling for higher prices in the secondary market.⁵⁵ The Court held that the market maker defendants "possessed the *affirmative duty* under [Rule 10b-

⁵¹*Id.* at 589 n.31, 687.

⁵²For example, the court characterized the law firm's legal advice and structuring of transactions between Enron and an offshore entity ("Mahonia") as the law firm "'effect[ing] the very' deceptive devices and contrivances that were the heart of the alleged Ponzi scheme." *Id.* at 704 (quoting *U.S. Envtl.*, 155 F.3d at 112). But unlike *U.S. Environmental*, which involved a broker executing manipulative trades in the issuer's stock, the connection alleged between the Mahonia transactions and the plaintiffs' claims was that Enron subsequently accounted for them in a way that avoided reporting debt. *Enron*, 235 F. Supp. 2d at 627-28.

⁵³406 U.S. 128, 152-53 (1972).

⁵⁴*Enron*, 235 F. Supp. 2d at 577.

⁵⁵*Affiliated Ute*, 406 U.S. 145-48, 151-54.

5] to disclose [the fact that they were market makers] to the . . . sellers."⁵⁶ Indeed, it was the existence of an "obligation to disclose" arising from this relationship that led the Court to hold that "positive proof of reliance is not a prerequisite to recovery."⁵⁷

The *Enron* court also distinguished much of the caselaw construing *Central Bank* on the theory that the Supreme Court's decision in *SEC v. Zandford*,⁵⁸ "made crystal clear that a misrepresentation need not be involved and that a suit could be based on Rule 10b-5(a) or (c)."⁵⁹ But *Zandford*, like *Affiliated Ute*, involved an affirmative duty to disclose on the part of the defendant. *Zandford* was an SEC civil action against a securities broker who stole client funds, in some cases by liquidating mutual fund securities in an account under his control by writing checks to himself against the account, and in other cases by selling securities in a discretionary account and later transferring the funds to his own bank accounts.⁶⁰ Nothing in *Zandford* changed the meaning of section 10(b)'s requirement of a "manipulative or deceptive device or contrivance"; the Court granted *certiorari* solely to decide whether concededly fraudulent conduct was "in connection with" a purchase or sale of securities. A unanimous Court concluded that the defendant's conduct was so connected, rejecting a requirement imposed by the Fourth Circuit that the fraud bear "some 'relationship to market integrity or investor understanding.'"⁶¹ Instead, the Court observed, "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act."⁶²

The *Enron* court noted that *Zandford* invoked Rule 10b-5(c), in a passage stating that the defendant "broker's 'continuous series of unauthorized' sales of securities and personal retention of the proceeds without his client's knowledge to further his fraudulent scheme 'are properly viewed' as a 'course of business' that operated as a fraud or deceit on a stockbroker's customer."⁶³ But the *Zandford* Court's discussion of the nature of the fraud and its connection to the customers' grant of investment discretion makes clear that liability turned on a nondisclosure in violation of a fiduciary duty:

⁵⁶*Id.* at 153 (emphasis added).

⁵⁷*Id.* at 153-54.

⁵⁸535 U.S. 813 (2002).

⁵⁹*Enron*, 235 F. Supp. 2d at 585.

⁶⁰*Zandford*, 535 U.S. at 815-16.

⁶¹*Id.* at 818 (citation omitted).

⁶²*Id.* at 820 (emphasis added).

⁶³*Enron*, 235 F. Supp. 2d at 577 (quoting *Zandford*, 535 U.S. at 821).

[E]ach sale was made to further respondent's fraudulent scheme; *each was deceptive because it was neither authorized by, nor disclosed to, the [customers].*

....

Respondent was only able to carry out his fraudulent scheme without making an affirmative misrepresentation because the [customers] had trusted him to make transactions in their best interest without prior approval. . . . Not only does such a fraud prevent investors from trusting that their brokers are executing transactions for their benefit, but it undermines the value of a discretionary account like that held by the [customers]. The benefit of a discretionary account is that it enables individuals, like the [customers], who lack the time, capacity, or know-how to supervise investment decisions, to delegate authority to a broker who will make decisions in their best interests without prior approval. If such individuals cannot rely on a broker to exercise that discretion for their benefit, then the account loses its added value. Moreover, *any distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients.*⁶⁴

Indeed, to underline the point that a "course of business" alone did not give rise to liability, the Court emphasized, as it had in past decisions, that an omission and a duty were necessary to convert outright theft into securities fraud: "if the broker told his client he was stealing the client's assets, that

⁶⁴*Zandford*, 535 U.S. at 821, 822-23 (citing *Chiarella*, 445 U.S. at 230 (stating that "silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b)' when there is 'a duty to disclose arising from a relationship of trust and confidence between parties to a transaction'"); *Affiliated Ute*, 406 U.S. at 153). The *Zandford* Court's emphasis on the discretionary nature of the accounts is consistent with "[t]he general [common law] rule . . . that a broker is not the fiduciary of his customer unless the customer entrusts him with discretion to select the customer's investments." *Carr v. CIGNA Sec., Inc.*, 95 F.3d 544, 547 (7th Cir. 1996) (Posner, J.). An exercise of discretion or control over a brokerage account was also held to be an element of a claim for the sale of unsuitable securities on a theory of "fraud by conduct" under Rules 10b-5(a) and (c) in *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992).

breach of fiduciary duty might be in connection with a sale of securities, but it would not involve a deceptive device or fraud."⁶⁵

The third Supreme Court case cited by the *Enron* court as supportive of its reading of Rules 10b-5(a) and (c) was *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*⁶⁶ But *Bankers Life* expressly declined to decide issues of secondary actor liability in a misrepresentation case. The Supreme Court in *Bankers Life* held that an alleged fraud was "in connection with" a corporation's sale of U.S. Treasury bonds, in exchange for a worthless certificate of deposit, where the corporation's "Board of Directors was allegedly deceived into authorizing this sale by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value."⁶⁷ The Court concluded, unsurprisingly, that an affirmative misrepresentation to the plaintiff was a "deceptive device" within the meaning of section 10(b).⁶⁸ In remanding, however, the Court expressly declined to rule on either (1) the liability of Bankers Life, one of the defendants, which argued that "the complaint did not allege, and discovery failed to disclose, any connection between it and the fraud,"⁶⁹ or (2) potential liability of any defendant for other legs of the complex set of transactions besides the misrepresentation.⁷⁰

Two subsequent opinions have sought to elaborate on the theory of "scheme" liability set forth in *Enron*. The first, *In re Lernout & Hauspie Securities Litigation*,⁷¹ observed that the defendants in that case conceded that "the post-*Central Bank* caselaw on fraudulent schemes is slender"⁷² and proceeded to fashion a rule for such cases:

[Section 10(b) and Rule 10b-5] impose primary liability on any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a

⁶⁵*Zandford*, 535 U.S. at 825 n.4 (citing *Santa Fe*, 430 U.S. at 474-76). *Accord* United States v. O'Hagan, 521 U.S. 642 (1997). In insider trading cases:

[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the source of information, *if the fiduciary discloses* to the source that he plans to trade on the nonpublic information, *there is no "deceptive device" and thus no § 10(b) violation*—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.

Id. at 655 (emphasis added) (footnote omitted).

⁶⁶404 U.S. 6 (1971).

⁶⁷*Id.* at 8 n.1.

⁶⁸*Id.* at 9-12.

⁶⁹*Id.* at 13.

⁷⁰*Bankers Life*, 404 U.S. at 13 n.10.

⁷¹236 F. Supp. 2d 161 (D. Mass. 2003).

⁷²*Id.* at 171-72.

manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, *even if a material misstatement by another person creates the nexus between the scheme and the securities market.*⁷³

The second, *Global Crossing* (discussed above), relied heavily on the language of Rule 10b-5(a) and (c) as well as its discussion of the term "manipulative." Neither case, however, even cited *Chiarella* or gave any discussion to the Supreme Court's requirement of a duty to disclose in the absence of a misrepresentation by the defendant.⁷⁴

In short, none of the cases adopting "scheme" liability for misrepresentations made by others have offered any substantial justification for departing from the consistent holdings of the Supreme Court regarding the essential elements of section 10(b) liability, nor even acknowledged those holdings. As the Supreme Court recently observed in rejecting another effort to alter the longstanding elements of a section 10(b) claim, "the uniqueness of [this] perspective argues against the validity of its approach in a case like this one where we consider the contours of a judicially implied cause of action with roots in the common law."⁷⁵

VII. RECENT AND PENDING APPEALS

A. *Filler v. Hanvit Bank*

The Second Circuit, in an opinion that it designated as unpublished, rejected an effort to impose liability on similar factual allegations to those in *Enron*, *Lernout & Hauspie*, and *Global Crossing*, based on at least some of the same arguments in *Filler v. Hanvit Bank*.⁷⁶

Filler, like *Lernout & Hauspie*, arose out of the collapse of Lernout & Hauspie, N.V., a Belgian multinational corporation (L&H Belgium). The plaintiffs in *Filler*, investors who obtained L&H Belgium stock in stock-for-stock mergers, brought claims against three banks in Korea that allegedly engaged in "sham transactions with L&H Belgium's wholly

⁷³*Id.* at 173 (emphasis added).

⁷⁴See also *In re Parmalat Secs. Litig.*, 376 F. Supp. 2d 472, 491-92, 497-503 (S.D.N.Y. 2005) (discussing the requirements of a Rule 10b-5(a) and (c) violation and the implications of *Lernout* and *Global Crossing*); *WM High Yield Fund v. O'Hanlon*, No. Civ. A. 04-3423, 2005 WL 1017811, at *7-8 (E.D. Pa. Apr. 29, 2005) (sustaining Rule 10b-5(a) and (c) claims against entities that did business with issuer in action arising from issuer's misrepresentations; court relied on *Global Crossing* and did not discuss Supreme Court section 10(b) cases or *Lentell*).

⁷⁵*Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1633 (2005).

⁷⁶Nos. 04-6295-CV, 04-6719-CV, 2005 U.S. App. LEXIS 26443 (2d Cir. Dec. 2, 2005).

owned subsidiary, Lernout & Hauspie Korea ('L&H Korea'), [that] enabled L&H Belgium falsely to inflate its earnings and revenues."⁷⁷ The plaintiffs also alleged that the banks made misrepresentations by falsely confirming, "to KPMG, L&H Belgium's outside auditor," certain facts about the alleged "sham" transactions that caused "L&H Belgium's fraudulently inflated financials [to be] based on, and justified by, the information the defendant banks provided to KPMG."⁷⁸

Much as in *Lentell*, the plaintiffs cited Rules 10b-5(a) and (c) and the *Enron* and *Global Crossing* cases on appeal.⁷⁹ The Second Circuit, however, found that the plaintiffs failed to state a claim because their allegations, even if pleaded with particularity, failed to satisfy the traditional elements of a section 10(b) claim under the Second Circuit's interpretation of Central Bank:

[P]laintiffs' federal claim fails because none of the alleged false statements relied upon by plaintiffs were attributed to the defendant banks. . . . Secondary actors, such as accountants, lawyers, or in this case, banks, may still be held liable as primary violators after Central Bank, but only "if *all* the requirements for primary liability are met, including a 'material misstatement (or omission) on which a purchaser or seller of securities relies.'"⁸⁰

Plaintiffs assert that they exchanged their stock shares in reliance on L&H Belgium's financial statements, L&H Belgium's earnings releases dated February 9, 2000 and May 9, 2000, and representations made to them by KPMG. None of these statements, however, mention the defendant banks, much less discuss their allegedly false loan confirmations. Accordingly, we must conclude, as the district court did, that plaintiffs failed to allege an actionable

⁷⁷*Id.* at *3.

⁷⁸*Id.* The Second Circuit found that the confirmations were not pleaded with particularity as required by Federal Rule of Civil Procedure 9(b). *Id.* at *4-5.

⁷⁹See Brief for Plaintiffs-Appellants at 33-34, *Filler v. Hanvit Bank*, 2005 U.S. App. 26443 (No. 04-6295) (2d Cir. Dec. 2, 2005); Brief for Defendant-Appellee at 33-34, *Filler v. Hanvit Bank*, 2005 U.S. App. 26443 (No. 04-6295) (2d Cir. Dec. 2, 2005). The issue of Rule 10b-5(a) and (c) liability was also raised by the Second Circuit at oral argument.

⁸⁰*Filler*, 2005 U.S. App. LEXIS 26443, at *6 (quoting *Wright v. Ernst & Young LLP*, 152 F.3d 169, 174 (2d Cir. 1998) (citing *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994))).

misrepresentation sufficient to state a claim for primary liability under [s]ection 10(b).⁸¹

The result in *Filler* is thus wholly incompatible with a theory of "scheme" liability in which plaintiffs allege that they—like the plaintiffs in *Filler*—relied only on the statements of the issuer, and allege that defendants—like the defendants in *Filler*—enabled the issuer to engage in fraudulent accounting by virtue of the structure of the defendant's transactions with the issuer.

B. *In re* Charter Communications

The second decision to address liability in this factual setting, and the first published opinion to directly address Rule 10b-5(a) and (c) liability based upon a non-speaker's transactions with the issuer, was the Eighth Circuit's opinion in *In re Charter Communications, Inc., Securities Litig. (Stoneridge Inv. Partners, LLS v. Scientific-Atlanta, Inc.)*.⁸² The plaintiffs in *Charter Communications* alleged that two vendors of digital cable "set-top boxes" entered into "sham" transactions with a cable television provider, Charter, by which,

although Charter had firm contracts with the Vendors to purchase set-top boxes at a set price sufficient for its present needs, Charter agreed to pay the Vendors an additional \$20 per set-top box in exchange for the Vendors returning the additional payments to Charter in the form of advertising fees.⁸³

The plaintiffs claimed that these transactions were used by Charter to falsely inflate its revenue and cash flow, but did not allege any role by the vendors in preparing or disseminating Charter's financial reports, nor that those reports were publicly attributed to the vendors.⁸⁴

The district court in *Charter* concluded that the absence of any public statement doomed the claims against the vendors under *Central Bank*, and that the absence of any duty to disclose precluded those claims

⁸¹*Filler*, 2005 U.S. App. LEXIS 26443, at *5-7.

⁸²No. 05-1974 (8th Cir. Apr. 11, 2006), <http://www.ca8.uscourts.gov/opndir/06/04/051974P.pdf>.

⁸³*Id.*, slip op. at 3.

⁸⁴*Id.*

under *Chiarella*.⁸⁵ On appeal, the plaintiffs relied on Rules 10b-5(a) and (c) and on the district court opinions in *Enron*, *Global Crossing*, *Lernout & Hauspie*, and *Parmalat*. The Eighth Circuit found that these efforts to evade *Central Bank* were unavailing:

Like the district court, we reject Stoneridge's narrow interpretation of *Central Bank*. We conclude that *Central Bank* and the earlier cases on which it relied stand for three governing principles: (1) The Court's categorical declaration that a private plaintiff "may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)," included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b). (2) *A device or contrivance is not "deceptive," within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose.* (3) *The term "manipulative" in § 10(b) has the limited contextual meaning ascribed in Santa Fe. Thus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.*⁸⁶

The Eighth Circuit concluded that these principles necessarily barred a claim against a non-speaking business partner of the issuer:

[The vendors] did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition. None of the alleged financial misrepresentations by Charter was made by or even with the approval of the Vendors. Accordingly, the district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs.

⁸⁵See *In re Charter Commc'ns, Inc., Sec. Litig.*, MDL Docket No. 1506 [Case No. 4:02-CV-1186(CAS)], slip op. at 9-10.

⁸⁶See *Charter*, No. 05-1974, slip op. at 6-7 (emphasis added, citations omitted).

[W]e are aware of *no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts*. The point is significant. To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock *would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.*⁸⁷

The *Charter* opinion does not address the situation—presented in some of the district court cases—where the transaction at issue itself involved securities; the court was understandably alarmed at the idea of extending potential securities fraud liability to ordinary commerce. But the logic of the *Charter* decision, like the logic of the Supreme Court's decisions in *Chiarella* and *Santa Fe*, does not permit a principled distinction between the two situations, because the involvement of a security in the transaction would not create a duty to disclose and would not amount to manipulation unless the security involved was the issuer's own security and the transaction itself affected the demand for that security.

C. Homestore

Against this backdrop, two other appeals raised the question of whether the theory of "scheme" liability should be adopted to hold non-speaking defendants primarily liable for the public statements of issuers based upon their business or financial transactions with the issuer. One was an interlocutory appeal from a denial of a motion to dismiss in *Quaak v. Dexia, S.A.*,⁸⁸ which like *Filler* arose from the collapse of Lernout & Hauspie and involved defendants who allegedly engaged in transactions with affiliates of L&H Begium that L&H Belgium misrepresented in its financial statements. The district court in *Quaak*, following its prior decision in *Lernout & Hauspie*, found a claim to be stated under Rules 10b-

⁸⁷*Id.*, slip op. at 7-8 (emphasis added).

⁸⁸357 F. Supp. 2d 330 (D. Mass. 2005), *appeal dismissed*, No. 05-2580 (1st Cir. Mar. 29, 2006), <http://pacer.ca1.gov/cgi-bin/dktrpt.pl?CASENUM=01144784168>, at 11.

5(a) and (c).⁸⁹

The second appeal, *Simpson v. Homestore.com, Inc.*,⁹⁰ was argued in the Ninth Circuit on February 6, 2006. The SEC has submitted *amicus curiae* briefs in *Homestore* urging the Ninth Circuit to adopt a theory of "scheme" liability for secondary actors under Rule 10b-5(a) in a case involving alleged misrepresentations by an issuer of securities. The case, *In re Homestore.com, Inc. Secs. Litig.*⁹¹—like many of the cases discussed above—involved allegations that a corporation (Homestore) engaged in a variety of transactions with outside "business partners" that—according to the plaintiffs—provided no benefit to Homestore but were nonetheless improperly recorded by Homestore as revenue.⁹² The district court rejected "scheme" liability for the "business partner" defendants, noting, among other things, that the "plaintiffs suffered damage through [their] reliance on false or misleading statements, not from the 'scheme' itself."⁹³

On appeal, the SEC proposes the following test for "scheme" liability for secondary actors where the alleged object of the "scheme" is the corporation's issuance of false statements:

Any person who *directly or indirectly engages in a manipulative or deceptive act* as part of a scheme to defraud can be a primary violator of [s]ection 10(b) and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.⁹⁴

⁸⁹See *id.* at 330, 332-34, 341-42. *Quaak* was fully briefed as of February 13, 2006, and argument was set for early April 2006, but the First Circuit dismissed the appeal on March 29 after the district court granted a motion to file a new third amended complaint. The First Circuit's dismissal order left to the district court's discretion "whether to certify or recertify one of its orders for interlocutory appeal." *Quaak v. Dexia, S.A.*, No. 05-2580 (1st Cir. Mar. 29, 2006), <http://pacer.ca1.gov/cgi-bin/dktrpt.pl?CASENUM=01144784168>, at 11.

⁹⁰No. 04-55,665 (9th Cir. argued Feb. 6, 2006).

⁹¹252 F. Supp. 2d 1018 (C.D. Cal. 2003).

⁹²*Id.* at 1022-23.

⁹³*Id.* at 1041.

⁹⁴Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Appellant, *Simpson v. Homestore.com, Inc.* (No. 04-5565) (9th Cir. Oct. 21, 2004), http://www.sec.gov/litigation/briefs/homestore_102104.pdf, at 16 (emphasis added) [hereinafter SEC Homestore Brief].

The SEC echoed this test in an opinion of the Commission in *In re Robert W. Armstrong III*, Rel. No. 34-51920, 2005 WL 1498425, at *6-8 & nn. 36-47 (S.E.C. June 24, 2005), which cited recent district court decisions such as *Global Crossing*, *Lernout & Hauspie*, and *Enron* but did not address *Chiarella*, *Santa Fe*, *Lentell*, or other authorities discussed in this article. The extent to which *Armstrong* could be read to announce a new standard is somewhat questionable, however, given that it involved a corporate insider who personally prepared misleading financial

Because it repeats the statutory terms "manipulative or deceptive" to describe the prohibited conduct, this test contributes little to understanding what conduct of the defendant would constitute a manipulative or deceptive act, the commission of which is already required by *Central Bank* for liability to attach. Thus, to apply its proposed test to the conduct at issue in *Homestore*, the SEC argues: "It is reasonable to construe [s]ection 10(b) as encompassing, within the rubric of engaging in a *deceptive* act, *engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues*."⁹⁵ Significantly, the SEC contends that acts resulting in the issuance of false or misleading financial statements should be viewed as "deceptive" rather than "manipulative" conduct.⁹⁶ Thus, the SEC does not appear to argue with the Second, Seventh, and Eighth Circuits' conclusions regarding the inapplicability of the term "manipulative" to conduct not involving manipulative transactions in the issuer's securities.⁹⁷ To the contrary, the SEC acknowledges that "market manipulation . . . typically involves conduct that creates a false appearance of trading activity."⁹⁸

As a practical matter, one problem with the SEC's application of its test is that a transaction will frequently only have the "effect" of "creat[ing] a false appearance of revenues" when the issuer itself chooses to make a statement about the transaction or about its revenues. The SEC effectively concedes this point on reply, restating its proposed application with the appended requirement that the plaintiff must show that the transaction's "purpose and effect is to create a false appearance of revenues *that will be reported falsely by the issuer*."⁹⁹ With that caveat, the SEC's test—unlike many of the "scheme" cases—explicitly recognizes that the defendant's

results in the reports of a public company, and who could therefore be covered under a reading of the traditional section 10(b) cause of action for misrepresentations. Armstrong, the chief accounting officer of a subsidiary of a public company, not only calculated and provided the subsidiary's misleading results to the parent, but also personally reviewed and approved the misleading financial results separately reported in SEC filings by a segment of the parent's operations that included the subsidiary. *Id.* at *1-4, 7. Thus, if Armstrong's conduct was not covered by section 10(b), it is difficult to imagine how any corporate officer could be primarily liable for statements made by the company.

⁹⁵SEC Homestore Brief at 18 (emphasis added).

⁹⁶*See id.* at 18; Reply Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Appellant, *Simpson v. Homestore.com, Inc.* (No. 04-55665) (9th Cir. Feb. 4, 2005), http://www.sec.gov/litigation/briefs/homestore_020405.pdf, at 1, 5 [hereinafter SEC Homestore Reply]. *See also Armstrong*, 2005 WL 1498425, at *6-8 (finding that preparing misleading financial statements constituted "deceptive acts").

⁹⁷The SEC's reply brief in *Homestore*, filed subsequent to the decisions in *Lentell* and *Foss*, does not discuss either opinion.

⁹⁸SEC Homestore Brief at 19.

⁹⁹SEC Homestore Reply at 11 (emphasis added).

liability ultimately turns on the extent to which the defendant can be said to be responsible for the making of a misrepresentation by another party. Rule 10b-5(a) is thus all but irrelevant to the application of the SEC's standard if it is read simply as a rephrasing of the test for liability for misrepresentations under *Central Bank*.¹⁰⁰ Where the SEC's arguments prove more problematic is in the Commission's insistence that "deceptive conduct can be something other than misrepresentation or nondisclosure."¹⁰¹ Pointing to the Supreme Court's statement in *Central Bank* that section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act,"¹⁰² the SEC argues that this "is *dictum*" and "best explained as an unfortunate choice of words to paraphrase the statutory language."¹⁰³ The SEC stresses that *Central Bank* "[did] not purport to explain the scope of conduct encompassed by" the statutory term "deception."¹⁰⁴

As discussed above, however, explaining the scope of conduct encompassed by the statutory term "deception" is precisely what the Court did in *Chiarella* when it held that, where claims of fraudulent conduct under Rules 10b-5(a) and (c) do not rest on manipulation and the defendant has not made a statement, "there can be no fraud absent a duty to speak . . . premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction."¹⁰⁵ In fact, the Supreme Court quoted this holding of *Chiarella* in *Central Bank* and referred repeatedly to *Chiarella* as one of its prior cases that "determined the scope of conduct prohibited by § 10(b)."¹⁰⁶ Unfortunately, however, the SEC fails to even cite *Chiarella*, let alone explain why its holding does not control. The SEC does cite *Zandford* and *O'Hagan*, in support of its

¹⁰⁰As noted above, there are other significant problems with the SEC's application, which in many respects amounts to an attempt to impose conspiracy liability under section 10(b) and would extend liability even to defendants the plaintiff had never heard of when making an investment. The SEC's application would represent a substantial expansion of the principal Ninth Circuit authority on which it relies, *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997), which permitted liability on a "scheme" theory for statements made by an issuer and its officers to analysts "with the intent that the analysts communicate those statements [about the issuer] to the market"; *Cooper*, unlike *Homestore*, involved liability of a corporation and its own officers for affirmative statements about the issuer itself. (The Commission similarly relied on *Cooper* in its opinion in *Armstrong*.) A more detailed discussion of Ninth Circuit precedents under *Central Bank* is beyond the scope of this article.

¹⁰¹SEC Homestore Reply at 3-4.

¹⁰²*Cent. Bank*, 511 U.S. at 177.

¹⁰³SEC Homestore Reply at 2, 3.

¹⁰⁴*Id.* at 3.

¹⁰⁵*Chiarella*, 445 U.S. at 230, 235.

¹⁰⁶*See Cent. Bank*, 511 U.S. at 172-74.

contention that "[s]ection 10(b) and Rule 10b-5(a) and (c) . . . cover conduct beyond the making of false statements and misleading omissions,"¹⁰⁷ but does not discuss the passages in those cases that emphasized—as in *Chiarella*—that a violation of a duty to disclose was required to convert the conduct in question (insider trading and theft) into securities fraud actionable under section 10(b).¹⁰⁸

In short, while "conduct" or "schemes" can be part of a section 10(b) violation, such conduct alone does not give rise to a "deceptive" act within the meaning of section 10(b) unless the defendant has made a misrepresentation or violated a duty to disclose. Given the SEC's failure to address the governing authority on these points, it is difficult to see how its view can be given deference by the Ninth Circuit.

VIII. CONCLUSION

Rules 10b-5(a) and (c) do not impose a different standard for liability than the longstanding standards governing any claim under section 10(b). Recent efforts to create a distinct cause of action under Rules 10b-5(a) and (c) are not supportable in light of the consistent holdings of the Supreme Court construing section 10(b) and in light of recent decisions of the Second, Seventh, and Eighth Circuits declining to apply those rules to allow liability in the absence of one of the three traditional elements of a section 10(b) claim—a misrepresentation, a duty of disclosure, or manipulative securities transactions. As a result—other than statutory methods such as "control person" liability—the sole basis for reaching remote or secondary defendants in cases involving reliance on misrepresentations by an issuer remains pleading and proof that the defendant actually "made" the misrepresentation in question within the meaning of *Central Bank*.

¹⁰⁷SEC Homestore Brief, at 13-14.

¹⁰⁸See *Zandford*, 535 U.S. at 825 n.4; *O'Hagan*, 521 U.S. at 655. See also *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8 (1985) (discussing requirement that manipulation itself be undisclosed to be actionable). The SEC likewise cites *Affiliated Ute* without discussion of the Court's holding in that case that liability was premised upon an "affirmative duty . . . to disclose." *Affiliated Ute*, 406 U.S. at 153. Instead, the SEC cites a passage from *Hochfelder* describing what 10b-5(c) "could be read" to mean if "[v]iewed in isolation," without mentioning that the passage was immediately followed by the *Hochfelder* Court's holding that such a reading would exceed the SEC's statutory authority under section 10(b). Compare SEC Homestore Reply at 4 with *Hochfelder*, 425 U.S. at 213-14.