S. HRG. 111–369

EVALUATING S. 1551: THE LIABILITY FOR AIDING AND ABETTING SECURITIES VIOLATIONS ACT OF 2009

HEARING

BEFORE THE

SUBCOMMITTEE ON CRIME AND DRUGS

OF THE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 17, 2009

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THURSDAY, SEPTEMBER 17, 2009

U.S. SENATE,
SUBCOMMITTEE ON CRIME AND DRUGS,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 5 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Subcommittee, presiding.

Present: Senator Specter.

OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. Good afternoon, ladies and gentlemen. The hearing will proceed.

I regret the delay in beginning this hearing, but I know you are fully aware of the circumstances which delayed it, circumstances which made the delay unavoidable. The Senate has its own tempo, and we have just finished a series of votes. And this is a very important hearing, and I would like to see legislation result from the hearing and think it important to establish a record which can be reviewed by other Committee members who are not here and by other Senators to establish a basis for legislative action.

When I noted the decision in *Stoneridge*, I was more than surprised; I was shocked. From my own experience as a district attorney, knowing aiders and abetters are co-conspirators and are liable, hard to understand. And in the context where the circuits until 1994 were unanimous, with the arguable exception of the Seventh Circuit, imposing such liability, two Supreme Court decisions, really makes me wonder what the court is up to. And there have been commentaries about this Court being partial to big business. Hard to understand how aiders and abetters are not liable. And in light of some of the recent developments, consideration perhaps should be given to some modification of our standards on the confirmation process.

The tradition has been that nominees are never asked how they are going to decide cases. And when Chief Justice Roberts testified that it was a matter for Congress to decide the factual basis for decisions under the Supreme Court standard of proportionate—proportionate and what? Very hard to remember proportionate and congruent because it makes little sense. Then the voting rights

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came up, and he appeared to disregard a very extensive congressional record. And now we are looking at a decision on corporate contributions which, if reversed, is going to set the electoral process on its head in this country if corporations can make contributions in political campaigns.

We would not countenance someone who would overturn Brown v. Board of Education, and maybe we have to look beyond. This issue raises in a sense that question.

Well, there is a lot that I have on my mind in this and related subjects, but that has been about as brief as I can be. I intend to make an extended floor statement on the subject next week, if I can get to it. But we are going to proceed now with the bare bones, with no introductions, which is something I would like to take time to elaborate upon, but in view of the hour, I am just going to turn to our first witness, Professor John C. Coffee, Adolf A. Berle Professor of Law at Columbia, the author of a textbook way back when I went to law school.

Professor Coffee, the floor is yours.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY SCHOOL OF LAW, NEW YORK, NEW YORK

Mr. COFFEE. Thank you very much, and I am honored to be here, and I will try to be quite concise.

You focused on an anomaly, Chairman Specter, and it is an anomaly. For over a century, there has been criminal liability for anyone who aids and abets a Federal violation of law. For about a half-century, the Restatement of Torts, written by the American Law Institute, has stated the rule that private liability exists and a victim can sue not only the primary violator but a secondary violator who provides substantial assistance.

Many Federal statutes, including the Commodities Exchange Act, which is something that closely parallels the Securities Exchange Act, does provide for private actions against aiders and abetters. But we have the Federal securities laws which, since 1994, do not permit the victim to sue the aider and abetter even if there is conscious, knowing assistance given to the primary violation.

Now, it is time to reevaluate that. There are many—and I fully acknowledge that in 1995, Congress, in passing the Private Securities Litigation Reform Act, accepted the Supreme Court's decision in *Central Bank*, but we have seen a lot of water go over the dam since then. We have seen serious developments and maybe some deterioration in the discipline and our capital markets. Just thinking back over the last decade, we have had the IPO bubble in 2000, Enron and WorldCom in 2001 and 2002; we have had the securities analyst scandals; we have had the market timing abuses. And now we have this huge credit crisis that dwarfs everything else.

All of this suggests that the critical gatekeepers in our financial markets, the financial intermediaries, on whom investors rely to do things that they cannot do for themselves, such as the accountants, such as the credit rating agencies, may be under-deterred, and if they are under-deterred, we cannot expect to get back to equilibrium without some discipline on actors whose role is absolutely essential in the financial markets.

Now, from a policy perspective, I would suggest this entire debate comes down to one critical issue: Do we think that public enforcement standing alone can do the job of deterring, disciplining, and obtaining compensation for victims from these secondary participants? I am going to suggest to you that there are at least three reasons why public enforcement, although very important, is not sufficient to do that job by itself.

Public enforcement in the context of securities violations means enforcement by the Securities and Exchange Commission. I am an admirer of that body, for all of its recent problems, but it has got at least three fundamental problems that I think we have to recognize.

The SEC is authorized to sue aiders and abetters for knowing violations, but it can only seek relatively modest civil penalties plus disgorgement of ill-gotten gains. It cannot sue for restitution on behalf of all the victims, and that is the huge difference between disgorgement and restitution.

Next, the SEC always has been, is now, and always will be cost constrained and logistically underfunded, and they will be the first to say that. The SEC is also not administratively capable of handling the equivalent of a large class action in terms of settling claims, dealing with all the class members, and disbursing the proceeds. It would be an administrative nightmare for them if they were to try to deal with the issue of handling restitution.

Finally, the last point I would say about the Securities and Exchange Commission is a sensitive one, and I do not want to overstate it. Recent scandals—Mr. Madoff, the current Bank of America issue—suggest that the SEC does not proceed quite as zealously and vigorously against prominent figures and established firms as they do against the outcasts and the out-and-out crooks. But if we are going to have discipline in the capital markets, there has to be someone who will take serious disciplinary action, seek serious penalties against the major gatekeepers. And I think private enforcement can do that better than can public enforcement.

We have already seen that private enforcement. Look at the Enron class action or the WorldCom class action. They both settled for $7.5 billion and $6.5 billion, respectively. Those are numbers that dwarf anything the SEC has ever received in the way of penalties or in the way of class action recoveries. The point here is really that the private enforcement bar can chase the money, can get significant claims, and it is not interested in simply getting headlines. For better or worse, they do go where the money is, and that is what is needed if we are going to get compensation for victims.

Let me make two last points in just a second or two. One is that you are going to hear an awful lot about how authorizing liability against aiders and abetters will open the floodgates for frivolous and extortionate litigation. That might have been true, arguably, once. But since the Private Securities Litigation Reform Act of 1995, secondary participants are not only protected, they are virtually insulated because of the pleading rules under that act, because you cannot get discovery unless you can plead with particularity facts giving rise to a strong inference of fraud.

There is no realistic prospect of frivolous, extortionate litigation brought against secondary participants. They can have that action dismissed without discovery unless at the outset you can show a very strong case that gives rise to a strong inference of fraud.

And last, in just a sentence, in my proposal I suggest to you that you couple restoring private liability with a ceiling on damages. That is because the real goal here should be to create a penalty that deters but does not destroy. We do not want to see the loss of one more accounting firm like Arthur Andersen or one credit rating agency, because they are both in very concentrated markets. So I would suggest to you that the Solomonic compromise here—and I try to give you a possible model—is to restore aiding and abetting liability with a realistic ceiling on damages for secondary participants in securities violations.

Thank you very much.

[The prepared statement of Mr. Coffee appears as a submission for the record.]

Chairman SPECTER. Thank you, Professor Coffee.

We turn now to Robert Giuffra—how do you pronounce that?

Mr. GIUFFRA. Giuffra. We met before, Senator. Giuffra.

Chairman SPECTER. Thank you. Partner of the prestigious law firm Sullivan & Cromwell.

STATEMENT OF ROBERT J. GIUFFRA, JR., PARTNER, SULLIVAN & CROMWELL LLP, NEW YORK, NEW YORK

Mr. GIUFFRA. Mr. Chairman, in 1995, the PSLRA was passed with broad bipartisan support, including of Senators Dodd, Kennedy, and Reed, and then-Representative Schumer. As chief counsel to the Senate Banking Committee when Senator D'Amato chaired it, I worked closely with Republicans, Democrats, and then-SEC Chairman Arthur Levitt to develop a balanced law.

Congress should not revisit the bipartisan judgment made in 1995 in the PSLRA. That judgment was that the SEC and the Justice Department are best suited to prosecute aiders and abetters of securities fraud.

S. 1551 would greatly expand the existing securities class action system, but this system benefits lawyers, often does not help investors, and often is not fair.

Now, in the real world, where I practice law, motions to dismiss and summary judgment do not weed out baseless claims. In fact, less than 40 percent of all securities class action cases are ever dismissed on a motion. Less than 40 percent. More than 60 percent are settled, and, you know, one or two a year are ever tried. Less than 30 percent are ever dismissed on a motion to dismiss. In other words, by bringing a securities class action lawsuit, a lawyer has a better than 60 percent chance of getting fees through a settlement. Great odds.

Now, juries can be unpredictable. There is on deep-pocket third party that wants to risk losing a multi-billion-dollar jury verdict. And even where a case has no merit, companies have to spend tens of millions of dollars defending those cases, reviewing millions of e-mails.

Now, to eliminate settlements because a judge did not dismiss a baseless securities case, what Congress should do, as Senator Schumer has suggested, is permit parties as a right to appeal lower-court decisions denying motions to dismiss. If S. 1551 is enacted, the plaintiffs' bar will routinely name defendants all deep pockets who did business with a company. Plaintiffs' lawyers do not need documentary evidence to survive a motion to dismiss. They just need to cut a deal with one criminal insider who will point the finger at a banker or a lawyer. And today, when bankers, accountants, and lawyers receive hundreds of e-mails a day, it is very easy for a lawyer to blow one e-mail out of proportion.

Now, S. 1551 would hurt the competitiveness of U.S. capital markets. In Europe and Asia, there are no securities class actions. Non-U.S. companies do not think that our system is fair, and they are leaving our markets.

I live and work in New York City. Enactment of this proposal would be good for the city of London, but it would not be good for New York, Philadelphia, or other U.S. financial centers.

Now, since 1995, the SEC, the Justice Department, and State Attorney Generals have investigated the banks, the accountants, and the lawyers who provided services to Enron, WorldCom, Tyco, Refco, and the other companies that suffered major frauds and, when appropriate, they have taken action. Federal prosecutors convicted the law firm partner involved in the Refco matter and several Enron bankers, and the SEC obtained $50 million from the cable box providers involved in the *Stoneridge* case.

Now, SEC lawyers and DOJ lawyers serve the public interest. They have no incentive to bring strike suits. The SEC and the DOJ are far better than private lawyers to exercise the discretion and judgment that is needed to decide when a banker's conduct crossed the line.

By contrast, plaintiffs' lawyers have every incentive to sue deep-pocket third parties. The SEC can recover and the DOJ can recover damages from wrongdoers. Since 2002, the SEC has recovered more than a billion dollars and the DOJ billions more. And the SEC and the DOJ do not have to pay as much as a third of any recovery to lawyers, and there is no risk that SEC or DOJ lawyers will pay kickbacks to plaintiffs or make political contributions to pension fund administrators to get control of cases. And the threat of 20 years in prison is a far greater deterrent to securities fraud than civil litigation.

Finally, "fraud" is a very loose term. When a murder occurs, we can all agree that a crime has been committed. Not so with securities fraud. Prior to *Central Bank*, courts required plaintiffs to prove that secondary actors actually knew that the fraud they allegedly were assisting as going on. In this proposal, Senator, by adopting an open-ended definition of "recklessness," this would force many companies to settle baseless cases. The proposal of just pure recklessness without any definition would be far more lenient than the existing standard that judges across the United States have adopted.

So, to sum up, Congress should continue to rely on the SEC and the Department of Justice to prosecute aiders and abetters. The benefits of private enforcement are few, and the costs to our economy was potentially very great.

Thank you.

[The prepared statement of Mr. Giuffra appears as a submission for the record.]

Chairman SPECTER. Thank you very much.

I have to take a 2-minute break.

[Recess 5:19 p.m. to 5:22 p.m.]

Chairman SPECTER. Our next witness is Professor Adam Pritchard, Frances and George Skestos Professor of Law at the University of Michigan.

Professor Pritchard.

STATEMENT OF ADAM C. PRITCHARD, FRANCES AND GEORGE SKESTOS PROFESSOR OF LAW, DIRECTOR, EMPIRICAL LEGAL STUDIES CENTER, UNIVERSITY OF MICHIGAN LAW SCHOOL, ANN ARBOR, MICHIGAN

Mr. PRITCHARD. I want to thank you, Chairman Specter, for inviting me to testify today.

There are two possible justifications for imposing liability for securities fraud: compensation and deterrence. Neither one of those rationales supports the extension of liability to accountants, bankers, and lawyers that is proposed in this bill.

To put it bluntly, the compensation rationale for securities class actions is nonsense. Class actions provide about 3 to 10 cents on the dollar of the losses that investors have sustained, and that is a good thing. If we were to actually provide compensation for the full losses that investors suffered in securities class actions, it would be an economic disaster. Shareholders are paying the compensation that is paid out in securities class actions because the settlement dollars come from the corporation itself or the directors and officers' insurance that is paid for by the corporation.

So we have an insurance scheme—an insurance scheme that protects against fraud, but it is an insurance scheme in which we have to pay 50 cents on every premium dollar for administrative costs. Plaintiffs' lawyers get paid, the defense lawyers get paid, and the shareholders get their own money back, with a big haircut for the lawyers.

If you tried to sell this sort of insurance policy to a shareholder, you would not be able to find anyone who would buy it. If you tried to get an insurance commissioner to approve it, you would not find any insurance commissioner in the United States who would let you sell it.

Aiding and abetting liability would not change that calculus. Shareholders are effectively paying the fees that go to accountants, lawyers, and investment banks, and any liability costs that we impose on those professionals are going to be passed back to the shareholders in the form of higher fees. There is no free lunch in adding new deep pockets. We just will be able to employ more lawyers. As an educator of future lawyers, I want to say that is a good thing, but it is not enough to justify the bill. The only effective protection against secondary market fraud is diversification.

The second rationale for imposing securities fraud liability is deterrence. Given what we know about securities fraud class actions based on the studies that have been done over the last 10 years since the Private Securities Litigation Reform Act was adopted, it is implausible that securities class actions have any important deterrent impact at the margin above and beyond reputational effects in the market and Government enforcement efforts.

If you want to know what the predictors are of securities fraud class actions—how can you predict who is going to be sued—the relevant criteria are market capitalization, share turnover, stock price drop, Government investigations, and restatements of accounting statements. The class action bar does not uncover fraud. It follows these very public indicators. The stock price drop occurs. The class action bar responds.

Secondary defendants are sued when the corporation is bankrupt. The corporation is the easy settlement target. Ordinarily, the plaintiffs' lawyers are happy to go after them. That would not change if aiding and abetting liability were to be introduced. If we protect shareholders against the effects of bankruptcy by giving them a deep pocket to sue in the case when the corporation has gone bankrupt, it is going to further undermine the deterrent effect of securities class actions.

The problem with securities class actions is that the individuals who commit fraud—the officers who lie—do not pay in these class actions. If we take away the incentive to go after those officers in bankruptcy, which is the only time that the officers and directors pay, the plaintiffs' lawyers will pursue the investment bankers and the accountants because they can pay a lot more than the individual officers can.

If we want to reform securities fraud class actions, we need to begin with the fundamental economic problem. We need to fix the damages measure. There are two ways to do this. Congress could reform the damages measure directly, or we could allow shareholders to adopt the appropriate damages measure through the company's articles of incorporation.

The appropriate measure is disgorgement. If you have committed fraud, give back the benefits of the fraud, perhaps with a multiplier to reflect the probability that not all fraud would be detected. Maybe we would need to have attorney fee shifting. If the corporation has not benefited from the fraud, which is the overwhelming case, then there would be no damages. If the officer has benefited in the form of bonuses or stock options, the officer would have to pay. Apply the same rule to the secondary defendants.

In conclusion, the capital markets and the U.S. Treasury would be the victims if liability bankrupts an accounting firm or a TARP recipient. Without reforming the damages measure, it would be reckless to adopt aiding and abetting liability.

[The prepared statement of Mr. Pritchard appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Professor Pritchard.

Our next witness is Ms. Tanya Solov, Director of the Securities Department of the Office of the Illinois Secretary of State. Welcome and we look forward to your testimony.

STATEMENT OF TANYA SOLOV, DIRECTOR, ILLINOIS SECURITIES DEPARTMENT, OFFICE OF THE ILLINOIS SECRETARY OF STATE, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, WASHINGTON, D.C.

Ms. SOLOV. Thank you, Chairman Specter. I am honored to convey the support of the North American Securities Administrators Association for S. 1551, the Liability for Aiding and Abetting Securities Violations Act.

NASAA is the member association of State and provincial securities regulators and maintains a corporate office in Washington, D.C. State securities regulators, license broker-dealers, and investment advisers, register local securities offerings and conduct compliance examinations. Especially important is their enforcement role: protecting the Nation's investors by bringing thousands of actions every year against the firms and individuals who have committed securities fraud. In certain cases, regulators seek restitution or rescission on behalf of investors. However, given the large number of investors in the market today, private civil cases are a necessary and important complement to State and Federal actions. S. 1551 would restore the ability of defrauded investors to seek damages from all of the entities that substantially participated in the fraud.

My colleagues and I have witnessed firsthand the devastation of financial fraud on victims and their families. Investor education materials teach investors to conduct research on companies prior to investing, but no amount of research will allow investors to make appropriate decisions if the financial and other public information provided by companies is false or misleading. The integrity of the U.S. markets depends on accurate information, and our laws must send the message to corporate management, as well as their lawyers, accountants, investment bankers, and other so-called secondary actors, that they will be held accountable for aiding and abetting in deception and fraud.

In passing the Securities Exchange Act, Congress implicitly authorized a private right of action, and for decades thereafter courts allowed private suits. As Professor Coffee stated, the right to bring a private suit for aiding and abetting has been severely restricted by the Supreme Court and other courts. The decisions in these cases favor big business over innocent investors. Corporations and secondary actors often seek short-term profits, big bonuses, and large fees, and many times these goals can be achieved by cooking the books or engaging in sham transactions. Sham transactions are fraudulent, and even the majority in *Stoneridge* acknowledged that they are not baseless. If secondary actors are permitted to avoid liability, there will be no deterrent to prevent them from engaging in fraudulent schemes.

State and Federal regulators filed numerous cases against corporations and secondary actors in the past decade. However, many more cases of fraud were not pursued by regulators due to resource limitations. The majority in *Stoneridge* contends that aiding and abetting actions can be brought by the SEC on behalf of shareholders. While it is true that Federal regulators can pursue such cases, Chairman Mary Schapiro stated that the agency's enforcement and examination resources have been severely constrained in recent years. The SEC's immediate agenda includes proxy access, compensation disclosure, hedge funds, and others that need regulatory attention. Significant SEC resources will be expended working on these priorities as well as large Ponzi scheme cases and fraudulent activity having national impact. Cases involving a limited number of shareholders are less likely to be addressed.

Critics of private securities actions claim that such cases provide little benefit to victims, they punish innocent shareholders, and unjustly reward plaintiffs' lawyers. In reality, over the years private actions resulted in greater recoveries for shareholders than the compensation from regulatory actions. The fact that victims were not able to recover full damages is the result of a number of factors including the shareholders' desire to settle for less rather than to spend more time in litigation. The contention that paying defrauded investors harms innocent, current shareholders is not really applicable in cases involving secondary actors such as accountants. The vast majority of shareholders want accountability and the right to seek redress for wrongdoing. If management is concerned about current shareholders, it might strip away the bonuses, high salaries, and stock options awarded to those who participated in the fraud and place those assets in the victim restitution fund. With regard to plaintiffs' lawyers' fees, it is important to remember that class action settlements, including attorneys' fees, are reviewed and approved by judges. The recent *Bank of America* case is an example of a case where the judge refused to approve a negotiated settlement.

Allowing investors to file aiding and abetting cases will not open the floodgates of litigation and stifle business development. Private suits were allowed prior to the *Central Bank* and *Stoneridge* decisions, and businesses grew and flourished during those years. Congress enacted Section 10(b) of the Securities Exchange Act with the understanding that Federal courts respected the principle that every wrong would have a remedy. S. 1551 recognizes the right of defrauded shareholders to bring private actions against aiders and abetters and to seek remedies from wrongdoers.

In the interest of investor protection and market integrity, NASAA supports S. 1551. Thank you.

[The prepared statement of Ms. Solov appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Ms. Solov.

Our final witness is the general counsel of Change to Win, Patrick—Szymanski?

Mr. SZYMANSKI. Szymanski, Your Honor—Senator Specter. I think I am back in the court of appeals someplace.

Chairman SPECTER. Mr. Szymanski, I am not a "Your Honor."

[Laughter.]

Chairman SPECTER. Thank you for joining us.

STATEMENT OF PATRICK J. SZYMANSKI, GENERAL COUNSEL, CHANGE TO WIN, WASHINGTON, D.C.

Mr. SZYMANSKI. Thank you, Senator. And, again, thanks to you for the invitation to testify. Let me confess at the outset that, unlike the other people sitting up here, I have not spent my career involved in securities litigation. I am a union lawyer, and I spent a lot of time talking to workers, and I have got to disagree with Mr. Giuffra when he basically says we ought to leave things the way they are. I do not think what we have seen since the mid–1990's indicates in anybody's mind that things ought to stay where they were back then.

Professor Coffee catalogued very briefly and succinctly many of the things that have happened since then that indicate that it is time for a reexamination. And whether it is the result of my talking to workers or just my own natural bias, I have always thought that the law ought to make sense. I have always thought that you ought to be able to explain things so that a reasonably intelligent person can understand them. And as far as I am concerned, any rule of law that does not make sense has got a problem. And *Stoneridge* does not make any sense.

In *Stoneridge*, two providers of cable TV converters—Scientific Atlanta and Motorola—entered into sham contracts with a cable TV service provider, Charter Communications, to artificially inflate Charter's assets. There was no economic reason for the contracts. They had a perfectly fine relationship before these changes happened. The contracts were back-dated to fool Charter's outside audit firm, and Scientific Atlanta and Motorola knew that the additional fictional income would be used to artificially inflate Charter's assets. In short, the fraud on shareholders could not have been accomplished in that case without the willing participation and knowing participation of Scientific Atlanta and Motorola. But the Supreme Court in *Stoneridge* held that because Scientific Atlanta and Motorola had no duty to the shareholders and made no public statements, they are not responsible for any of the losses that were suffered by the Charter Communications shareholders.

Now, my written testimony describes similar cases involving Enron, Refco, Homestore.com, *Pugh* v. *Tribune*. Interestingly, the judge in Refco is Judge Lynch. And in some of these cases, the wrongdoing participants were convicted or pled guilty to criminal charges, and they still completely escaped any civil liability or responsibility for the losses suffered by the innocent shareholders. Now, you just try explaining that to a worker, someone who goes out every day and makes money, as John Houseman used to say, "the old-fashioned way." He and she "earn it."

This makes no sense. It does not make sense to me, and it does not make sense to hard-working Americans who invest their own funds in 401(k)s and IRAs and in pension funds in which they participate. And let me make that point. We sometimes talk about institutional investors as though they are something different. They are not different than workers. They are simply holding the funds that those workers earned in trust for a purpose: to pay pensions that those workers are relying on when it comes time for them to retire. And when they are injured, the workers are injured, and that is worker money, not money that belongs to anybody else. And the Government, their Government, should be protecting them, not the wrongdoers who are responsible for defrauding them. People ought to be responsible for their actions, and the idea that these third-party people are immune from liability is ridiculous.

So I am here to tell you that the organizations who represent workers, who brought America the weekend, holidays, the 40-hour work week, employer-paid health care, pensions, and health and safety standards and more, and who are still fighting to keep those standards on behalf of working people in this country, support Senate bill 1551, which tries to bring some common sense back into this area of the law.

I look forward to your questions, Senator. Thank you.

[The prepared statement of Mr. Szymanski appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Szymanski.

Professor Pritchard, in looking for deterrence, what would you think about an active role by the Department of Justice to utilize 18 U.S.C. Section 2 to send people to jail because the Federal criminal law makes it a criminal violation to aid and abet somebody who commits a crime? Fraud is a crime.

Mr. PRITCHARD. I think criminal enforcement is essential to deterring fraud, and I have no complaint about it being applied against third parties who have assisted, aided, facilitated the fraud. As long as their guilt is determined beyond a reasonable doubt to a jury and the standards for fraudulent intent are met, then I think that is an excellent deterrent to fraud.

Chairman SPECTER. But proving that you think should be insufficient for damages for the shareholder?

Mr. PRITCHARD. Insofar as the third party may have received benefits from participating in the fraud, I think they definitely should be made to pay those back.

Chairman SPECTER. Well, you have testified about disgorgement, but you think even though their conduct is sufficient to send them to jail, it is not sufficient to compensate the party who has been injured by that conduct.

Mr. PRITCHARD. I think the compensation is irrelevant. What is important is sending them to jail. Sending people to jail is a very strong message that you should not do that.

Chairman SPECTER. There is some thinking on cases like *Pinto* that it is insufficient to have the tortfeasor pay damages. *Pinto* is a good illustration of the document showing that Ford executives knew that putting the gas tank at the rear to save money from putting it in a less exposed spot constituted malice, supports a conviction for murder in the second degree, and that that would be the way to really deal with corporate executives who knowingly put into the stream of commerce items which are reasonably expected to cause serious bodily injury or death. Do you think that would be a collaterally good approach?

Mr. PRITCHARD. A what kind of approach? I am sorry?

Chairman SPECTER. Well, a better approach than damages.

Mr. PRITCHARD. Sending people to jail if they——

Chairman SPECTER. I am calling it a "collateral" approach.

Mr. PRITCHARD [continuing].—Are knowingly trying to kill people? Yes.

Chairman SPECTER. Well, they are not trying to kill people. They are recklessly indifferent to it.

Ms. Solov, you talked about favoring big business, and in the *Stoneridge* case the Court lined up 5–3—Justice Breyer recused himself—which has all the contours of a traditional ideological battle. Do you think that in favoring big business this is a part of the liberal-conservative split on the Supreme Court in the matter of ideology as opposed to justice, to pick an abstract term?

Ms. SOLOV. *Stoneridge* is just one of several, of many cases. *Tellabs* was another case, and there are many lower-court cases where I think the courts are coming down in favor of big business.

Chairman SPECTER. Never mind the lower courts. There are many cases where, as the commentators have said, the Supreme Court is favoring big business. But dealing with the Supreme Court, do you think it is ideological?

Ms. SOLOV. Well, it is hard to say. I did find it interesting in *Stoneridge* that, unlike the testimony that we've heard about baseless cases, the Court did not say that these transactions were baseless. I think in this case they were saying that they are somehow constrained by the Private Securities Litigation Reform Act from awarding damages and looking to Congress. I think they are inviting Congress to make some changes to allow for aiding and abetting liability. And throughout the case, they write that Congress knew to include the SEC as a party that can bring aiding and abetting actions, but Congress did not include private rights of action. So it is difficult——

Chairman SPECTER. You think they were really inviting Congress to do something? To say that Congress could have done it differently, do you really think it is an invitation?

Ms. SOLOV. Well, I think that they——

Chairman SPECTER. You think they would like to see Congress change their decision?

I am coming back to my question on ideology, which you have not answered yet. Yes or no?

Ms. SOLOV. I think that there seems to be a split with the Justices, yes.

Chairman SPECTER. Mr. Giuffra, when you talk about the SEC being the better agency to deal with it, Senator Grassley and I, when he chaired the Finance Committee and I chaired the Judiciary Committee, went after the SEC on failure to deal with insider trading. And we had very much the same view that was stated by Judge Rakoff in the celebrated refusal to accept the settlement this week, castigating the SEC. I will not ask you if you thought Senator Grassley and I were wrong. Let me ask you if you think Judge Rakoff was wrong.

Mr. GIUFFRA. Senator, I respect all of you and I know Judge Rakoff quite well. The SEC does a very good job. The SEC in these big cases—the WorldComs, the Enrons—in those cases they take a lot of testimony, and they would love to make a case against a wealthy lawyer, a wealthy banker, and, in fact, they do when the facts and circumstances warrant it.

The problem is what I am concerned about is the innocent banker and the innocent lawyer and the innocent accountant in the case that is not the high-profile case, but where a plaintiff's lawyer names everyone who touched a company that has a stock drop and essentially seeks hundreds of millions of dollars in damages. The legal fees can be in the tens of millions of dollars. And what happens is that third party has no choice but to settle the case.

As I mentioned in my testimony, 60-plus percent of these cases are settled; less than 40 percent are dismissed on either a motion to dismiss or on summary judgment.

Chairman SPECTER. I recall your testimony. It was only a few minutes ago.

Mr. GIUFFRA. Yes, I understand.

Chairman SPECTER. My memory is good for about 40 minutes.

Now, do you remember my question?

Mr. GIUFFRA. Yes, I think the SEC—we have an excellent SEC enforcement person, Robert Khuzami. He is going to try to do things to even strengthen the SEC further. Obviously, Congress can give more money to the SEC. There are a lot of really competent lawyers at the SEC, and those lawyers do not have a conflict of interest. They are doing the public's work.

Class action lawyers are obviously motivated by getting attorneys' fees, and so the problem becomes that they will bring cases that do not have merit.

Chairman SPECTER. You have said that before several times, but I would like to come back to my question. My question was: Do you think Judge Rakoff was wrong?

Mr. GIUFFRA. I think in that particular case, what Judge Rakoff was concerned about was the problem of the current shareholders of Bank of America paying money to settle this matter, and he thought that perhaps other people should pay the money. And that is one of the problems with class actions generally, because what happens with class actions is the shareholders pay the money.

Chairman SPECTER. I will only ask it one more time.

Mr. GIUFFRA. Okay.

Chairman SPECTER. Was Judge Rakoff wrong?

Mr. GIUFFRA. I think that he identified an issue, but I still think that the SEC does a very good job. And, in fact, the point that was made——

Chairman SPECTER. Let the record show you have not answered my question unless you want to dispute my conclusion.

Mr. GIUFFRA. I think the concern that he has focused on, though, is the concern about these cases, which is the pocket-shifting problem, which is that the shareholders essentially pay the damages, as opposed to the people who did something wrong. And I fully support criminal—if someone engages in—if it is a banker or a lawyer or an accountant, if they engage in real securities fraud, put them in jail. The SEC and the Department of Justice can do that. The problem is the cases that are far from the line, where people are innocent and maybe they dealt with a company that was full of fraudsters and they were lied to, and then what happens is the plaintiffs' lawyers will do a deal with the fraudsters and have the fraudsters blame the lawyers and blame the accountants.

Chairman SPECTER. OK, that is fine. I understand your points made repetitively. But I would just have liked to have had an answer to the question.

Mr. Szymanski, is the Court ideological? Is this another aspect of the ideology which permeates the Court with all these 5–4 decisions?

Mr. SZYMANSKI. I cannot help but think that it is. I see decisions that are customarily with a bloc of voters on one side and a bloc of voters on the other side, and it is the same bloc. And you can have your viewpoint about who you agree with and who you disagree with, but it seems to be the same bloc ruling the same way every time.

Chairman SPECTER. What do you think about the conventional wisdom of deference to the President as the appointing authority? There are some Senators who will apply an ideological test. I think most do not. Do you think Senators should?

Mr. SZYMANSKI. I think, unfortunately, we have had a series of judges nominated by Presidents, and I would say Republican Presidents, who are much more, I think, ideological than some of the judges appointed otherwise or nominated otherwise. I think, unfortunately, the initial obligation ought to be for the President of the United States to appoint good, fair judges to begin with.

Chairman SPECTER. Does empathy suggest an ideology?

Mr. SZYMANSKI. I am sorry?

Chairman SPECTER. Does empathy suggest an ideology?

Mr. SZYMANSKI. Empathy does not suggest ideology to me. The difficulty—when you talk about ideology, I think you are talking about ideology that overrules adherence to the law and the Constitution.

We all know that there is interpretation to be done, and interpretation is always done with a point of view. And as good as people try to be honest to the law, there are going to be judgments that are going to be made, and those judgments are colored by somebody's viewpoint about how things ought to operate.

You know, the Supreme Court listens to the election returns, one famous wag used to say. And I think that is true, although I think that most of the judges honestly try to do their best in reaching their decisions.

Chairman SPECTER. Do you think the judicial appointments, the appointments to the Supreme Court are appropriate for Presidential campaigning, as a Presidential campaign issue?

Mr. SZYMANSKI. If the President would say that he is interested in appointing certain people to the Court for certain reasons? I honestly do not think that that ought to be something that is there, that they ought to be saying that they are going to appoint good judges who are fair judges to——

Chairman SPECTER. Nominees have been doing that at least since Nixon, haven't they?

Mr. SZYMANSKI. And I think that is unfortunate, Senator. I really think that that is where it begins. It would be much easier for the Senate and these nominations would be much easier for the Senate to address if they began from a point that was more neutral than they have been.

Chairman SPECTER. If they all had the sterling academic and professional qualifications like Chief Justice Roberts?

Mr. SZYMANSKI. I cannot say that when I saw Chief Justice Roberts' nomination that I had a sense about how I thought he would rule in certain cases like these, if he had the opportunity, if the law allowed him the ability to go one way or another, how he would rule.

Chairman SPECTER. What do you think of his definition of stare decisis that the Court should be modest, should not shock the system, should consider the length of the decision, how many times it had been reaffirmed, how much reliance there was, whether a contrary decision would reflect on the integrity of the Court? Do you think those are pretty good standards?

Mr. SZYMANSKI. I think those are very good standards.

Chairman SPECTER. How do you think those standards would apply if objectively applied to letting corporations engage in campaign—make campaign contributions?

Mr. SZYMANSKI. I would think that the Supreme Court ought to leave the law the way it is instead of all of a sudden finding that the First Amendment permits corporations to do these——

Chairman SPECTER. Leave the law the way it is, but how would you think those standards for stare decisis would apply to that issue?

Mr. SZYMANSKI. That is the way I think that those standards would apply. I mean, that is the way the law has been.

I will tell you personally my gripe with the whole thing about corporations are decisions that were done in the mid-1800's that found that corporations were people with the rights of people. I think, frankly, although there is a lot of stare decisis since the mid-1800's, finding that corporations are people and should be treated as though they have the rights of people, I do not think they should, frankly. Corporations are legal fictions, and I do not think they should have the rights of people. And that is where I think we went wrong.

But if you are talking about overturning stare decisis, I am talking about overturning now 150 years of it rather than just 35 or 40 years of it.

And, by the way, Senator, let me say I think that Judge Rakoff was right, and I do not think he was worried about who was going to pay the money. I think what he was concerned about was that the amount of the settlement did not come anywhere near the size of the $3.5 billion of the violation that was involved.

Chairman SPECTER. Let me thank you for answering the Rakoff question.

Professor Coffee, do you think the securities laws are fairly well balanced at the present time, if we move ahead and enact S. 1551, would be pretty well balanced?

Mr. COFFEE. I think 1551 does fill the void. I do think—and you have heard this debate between myself and Mr. Giuffra—that public enforcement cannot do it all by itself. We need private enforcement to supplement public enforcement, and 1551 is directing private enforcement at secondary participants and what I will call the "gatekeepers of our capital markets."

Chairman SPECTER. What do you think of the recent——

Mr. COFFEE. What do I think what?

Chairman SPECTER. What do you think of the recent Supreme Court decision, opinion by Justice Kennedy changing the pleading rules?

Mr. COFFEE. Which rules—I am just not hearing fully.

Chairman SPECTER. The recent Supreme Court decision, opinion by Justice Kennedy requiring a lot more specificity on pleading in——

Mr. COFFEE. Well, that is going to weed out some meritorious cases. It is going to weed out some frivolous cases. I think on balance it is probably going to go in the direction of making it much harder to get access to the Court.

Chairman SPECTER. What happened to notice pleading, Professor Charles E. Clark and *Dioguardi* v. *Durning* and all that sort of thing?

Mr. COFFEE. I remember both Professor and Judge Clark from a long time ago, and he had a very liberalized pleading rule. I do think that there has been some evidence that we needed to cut back on frivolous litigation. I think there were some provisions in the PSLRA that were justified and were desirable. But precisely because we have those protections, I now think 1551 is particularly justified because you are not turning loose a huge litigation engine on innocent secondary participants. They have great protection—great protection under the PSLRA.

And let me point out we are talking about a world in which there was obvious under-deterrence in some fields. To my knowledge, no credit rating agency has ever been held liable for damages for securities fraud. And I think they have made some very serious errors.

I think your 1551 would greatly increase the possibility of holding accountable some of the critical gatekeepers who today are not deterred.

Chairman SPECTER. Do you think the 1995 legislation established an appropriate balance in the necessity of pleading?

Mr. COFFEE. I think it went a little too far. I think there were abuses that needed to be curbed. I think it went a little too far. If it was up to me and I ruled the world, I would correct the balance 10 or 15 degrees back in the direction of making it slightly more pro-plaintiff. But I would not try to simply reverse or throw out the PSLRA. I think it has a number of provisions that should be retained.

Chairman SPECTER. My recollection is I offered an amendment which would have struck a little different balance, which passed the Senate 57–42. Do you remember——

Mr. GIUFFRA. I actually do remember that. I remember being on the floor, Senator, when you made——

Chairman SPECTER. I tried to talk Senator D'Amato into holding it in conference. He probably was listening more closely to you than to me.

[Laughter.]

Chairman SPECTER. What did you think of that amendment? Probably not much because it went down in conference and you were counsel.

Mr. GIUFFRA. Respectfully, Senator, I think the problem is that what was going on in those cases was that the plaintiffs' lawyers would see a company's stock price drop; they would go into their support system, literally, change the names on the form complaints, and file them the next day. They did no investigation, no consideration of actually whether fraud had occurred.

Chairman SPECTER. Why not put some teeth into Rule 11 on penalties for frivolous lawsuits, to deal with frivolous lawsuits?

Mr. GIUFFRA. We tried to do that in the PSLRA, and there was a lot of discussion about it. And, in fact, the House bill had much tougher provisions to sanction lawyers. The Senate bill reduced those provisions, and there is a provision in the PSLRA that says that at the end of every case the judge should consider whether Rule 11 sanctions should be imposed.

Typically, since most of these cases settle or are dismissed, the defense lawyers do not want to really fight with the plaintiffs' lawyers, and the cases where they are dismissed, everybody just wants it to go away. And I, in fact, was involved in a case recently where the judge basically said it was a baseless complaint. We said let us try to see if the judge will look and see whether Rule 11 sanctions should be filed. And in that particular case, the plaintiff's lawyer and I had a conversation, and the plaintiff's lawyer had filed a motion to dismiss, and I decided it was better for my client, rather than to litigate about sanctions, to just have the case be dropped.

So sanctions are—you know, courts are not in the United States very pro-sanctions. It is much more of a U.K. concept.

Chairman SPECTER. Yes, but you are a fellow who likes deterrence. Wouldn't that have been a deterrent to some lawyers?

Mr. GIUFFRA. Absolutely, but at least in the United States we do not have a loser-pay rule, and that is one of the issues. You can——

Chairman SPECTER. Well, it is not loser pay if you can prove sanctions under Rule 11.

Mr. GIUFFRA. Absolutely. But there are so few cases where lawyers are actually ever sanctioned, notwithstanding the——

Chairman SPECTER. It seems to me like you have one, as you describe it, where it could have been done.

Mr. GIUFFRA. And I decided it was better for my client not to pursue the sanctions because they would appeal, it would be more money being spent on the case, and so it was better just to have it end.

Chairman SPECTER. We are now at the 1-hour mark, and thank you very much for staying. This is a very, very distinguished panel. You are even more erudite than you are patient, which is going some, on a 2 o'clock hearing which was rescheduled for 3, then for 4, and started at 5. So thank you all very much for coming.

[Whereupon, at 6:02 p.m., the Subcommittee was adjourned.]

[Questions and answers and submission for the record follow.]

QUESTIONS AND ANSWERS

ARLEN SPECTER
PENNSYLVANIA

United States Senate
WASHINGTON, DC 20510–3802
specter.senate.gov

COMMITTEES:
JUDICIARY
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VETERANS' AFFAIRS
AGING

September 29, 2009

Professor John C. Coffee
Adolf A. Berle Professor of Law
Columbia Law School
435 West 116th Street
New York, NY 10027

Dear Professor Coffee:

Thank you for your testimony at the United States Senate Committee on the Judiciary, Subcommittee on Crime and Drugs hearing on S.1551, the Liability for Aiding and Abetting Securities Violations Act of 2009, on Thursday, September 17, 2009.

Enclosed are written questions from Committee members. We look forward to including your answers to these questions, along with your hearing testimony, in the formal Committee record concerning the important issues addressed at the hearing.

Please help us complete a timely and accurate hearing record by sending your written responses no later than Tuesday, October 13, 2009 to the Judiciary Committee office, attention Sarah Guerrieri, Hearing Clerk, Senate Judiciary Committee, 224 Dirksen Senate Office Building, Washington, D.C., 20510. Please also send an electronic version of your responses to Sarah_Guerrieri@Judiciary-dem.senate.gov and Matt_Wiener@Judiciary-dem.senate.gov.

Where circumstances make it impossible to comply with the two-week period provided for submission of answers, witnesses may explain in writing and request an extension of time to reply. Where witnesses fail to answer on time, the Committee may note that failure in the official Committee record.

Again, thank you for your participation. If you have any questions, please contact Matt Wiener of my staff at (202) 224-6598.

Sincerely,

Arlen Specter

Arlen Specter

AS/mw
Enclosure

Questions from Senator Specter:

In his prepared statement (at 10-11), Mr. Giuffra enlists your 2008 article in *The New York Law Journal* ("Securities Policeman for the World") to support his argument that securities litigation drives private issuers from U.S. markets and that enactment of S. 1551 would make matters worse. What is your response?

Are there are any additional points you wish to make by way of response to testimony of the other witnesses? If so, please briefly set them forth.

more than $8 billion from securities law violators. The SEC obviously doesn't have to pay as much as one-third of any recovery to lawyers, so that greater reliance on the SEC can result in larger recoveries for innocent investors.

In addition, the Department of Justice can pursue third parties that aid and abet securities fraud. If the threat of a long prison sentence doesn't deter aiding and abetting, it's highly doubtful that the risk of a class action lawsuit is going to stop such conduct.

3. **S. 1551 Would Hurt the Competitiveness of U.S. Capital Markets.** In considering S. 1551, Congress should consider the widely acknowledged concern that foreign private issuers are being driven from U.S. markets by fear that listing shares on the U.S. exchanges will expose them to worldwide securities class actions brought on behalf of shareholders who purchased their shares outside the United States.

In Europe and Asia, there are no U.S.-style securities class actions. Non-U.S. companies fear the U.S. legal system. They don't think it's fair, and they are utterly shocked by the enormous expense involved in U.S. discovery. As a result, many non-U.S. companies are delisting from our capital markets.

As a study commissioned by Senator Schumer and Mayor Bloomberg found: "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business—and driven away potential investors." (McKinsey & Company, Report Commissioned by Mayor Michael R. Bloomberg and Senator Charles E. Schumer, *Sustaining New York's and the U.S.' Global Financial Leadership* ii (2007)).

Indeed, as Professor John Coffee has written: "while the press and others attribute the growing concern of foreign issuers with the U.S. market to the Sarbanes-Oxley Act, closer analysis and interview data suggest that fear of U.S. private antifraud litigation may be the

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better explanation [for the flight of foreign private issuers from U.S. markets]." (John C. Coffee, Jr., Securities Policeman to the World? The Cost of Global Class Actions, N.Y.L.J., Sept. 18, 2008).

4. **S. 1551 Would Hurt New York and Other U.S. Financial Centers.** I live and work in New York City. There is no more important industry to New York than the financial services industry. Although it's fashionable now to attack banks and bankers, the financial services industry is critical to the economic health of our Nation. Enactment of S. 1551 would be good for the City of London, but it would be bad for New York, Chicago, Charlotte, Boston, Philadelphia, San Francisco and other U.S. financial centers.

Prior to the Supreme Court's decision in *Stoneridge*, financial institutions were the targets of so-called "scheme" liability claims. Thus, S. 1551 would expand the risk of liability for the very businesses that Congress has supported under the TARP program. As a result, instead of spending their capital making loans and thereby growing our economy, these financial institutions would be faced with having to foot an even bigger bill for expanded securities litigation, including tens of millions for both plaintiffs' and defense lawyers and potentially billions for settlements.

S. 1551's "Recklessness" Standard Is Too Vague and Amorphous

In the PSLRA, Congress did not expressly establish a substantive standard of fraudulent intent or scienter. As matters now stand, Federal Courts of Appeal have required proof of a high degree of recklessness to constitute fraudulent intent. For example, in the Second Circuit, a plaintiff must allege reckless conduct that "is highly unreasonable and . . . represents an extreme departure from the standards of ordinary care . . . to the extent that the danger was

ROBERT J. GIUFFRA, JR.
125 BROAD STREET
NEW YORK, N.Y. 10004-2498

February 3, 2010

The Honorable Arlen Specter
Chairman
United States Senate Committee on the Judiciary
Subcommittee on Crime and Drugs
United States Senate
Washington, D.C. 20510-3802

Re: Hearing on S. 1551, the Liability for Aiding and Abetting Securities Violations Act of 2009, September 17, 2009

Dear Chairman Specter:

This responds to the Committee's written questions to me.

1. You and lawyers at your firm have derived substantial revenues from representing defendants in securities fraud cases, haven't you? Your firm represented, among others, Conrad Black, the CEO of Hollinger International, didn't it? Mr. Hollinger received a jail sentence for engaging in fraudulent accounting manipulations, didn't he?

As discussed during my testimony, I served as Chief Counsel of the Senate Banking Committee during 1995 to 1996. As Chief Counsel, I participated in the drafting of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). The PSLRA was enacted with substantial bi-partisan support, and I worked closely with Senator Dodd's staff on this important legislation. I am now a partner of Sullivan & Cromwell LLP. As stated during my written testimony, I've spent much of my professional career litigating securities class action cases. My firm and I represent defendants in such actions. My firm represented Conrad Black, although I had no role in his representation. The Supreme Court recently heard oral argument in connection with Mr. Black's appeal of his criminal conviction.

2. You note in your prepared statement (at 9) that in the Sarbanes-Oxley Act, Congress "gave the SEC the power to require wrongdoers (including aiders and abettors) to make payments into a 'Fair Fund' to compensate injured investors." But the SEC cannot recover any compensatory damages against aiders or abettors on behalf of injured investors, can it?

The SEC can take action against aiders and abettors of securities fraud and can require such wrongdoers to make payments into a "Fair Fund" to provide compensation to injured investors. *See* 15 U.S.C. § 7246(a). Under its Fair Funds authority, the SEC can take steps to ensure that the actual victims of fraud receive the lion's share of compensation—*without* taking a significant part of any recovery for attorneys' fees. Since 2002, the SEC has distributed $6.6 billion to investors, including more than $2 billion in 2009 alone.[1]

3. You note in your prepared statement (at 9-10) that "since 2002 the SEC has recovered more than $8 billion from securities law violators." Didn't private lawyers recover approximately $8 billion from secondary actors on behalf of the defrauded investors in the Enron litigation alone? Didn't the plaintiffs' lawyers in that case receive less than 10% of the total settlement?

It is my understanding that the Enron litigation—the largest securities class action settlement in history—resulted in a recovery of approximately $7.2 billion from various defendants, and plaintiffs' lawyers obtained fees of over $650 million from that recovery. The amount of these fees was obviously quite large, and plaintiffs' counsel sometimes request fees of one third or more of the settlement amount in securities class actions.[2] Indeed, one recent study showed that the average hourly rate charged by plaintiffs' attorneys in securities class actions was $1370/hour.[3] By increasing the role of institutional plaintiffs, such as public pension funds, the PSLRA has improved oversight of plaintiffs' attorneys in securities class actions. This oversight role is threatened when plaintiffs' lawyers make substantial campaign contributions to elected officials who

[1] SEC, 2009 Performance and Accountability Report, at 11.

[2] John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1546 (2006).

[3] Institute for Legal Reform, *Securities Class Action Litigation: The Problem, Its Impact, and the Path to Reform*, at 20 (July 2008).

control public pension funds, including the appointment of lead counsel in securities class actions.[4]

Sincerely yours,

Robert J. Giuffra, Jr.

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4 Choi, Skinner, & Pritchard, *The Price of Pay to Play in Securities Class Actions*, U of Michigan Law & Econ, Empirical Legal Studies Center Paper No. 09-025, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1527047; see also accompanying articles.

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12 October 2009

Sarah Guerrieri
Hearing Clerk
Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510

RE: Hearing on S. 1551, Liability for Aiding and Abetting Securities Violations Act of 2009

Dear Ms. Guerrieri:

Here is my response to Senator Specter's question:

Absolutely. As I wrote in my article, it would have made more doctrinal sense to reject the plaintiff's claim in *Stoneridge* on the basis of the "in connection with" requirement of Section 10(b). Unfortunately, that would have had the collateral effect of limiting the SEC's ability to bring enforcement actions in such cases, which the Court rejected, presumably on policy grounds. I think those policy grounds make sense – aiding and abetting liability is a dangerous tool, best wielded by the SEC and the Justice Department.

Please let me know if you have any questions. Thank you for your attention to this matter.

Sincerely yours,

s / Adam C. Pritchard

Enc.

SUBMISSIONS FOR THE RECORD

American Federation of Labor and Congress of Industrial Organizations

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September 8, 2009

The Honorable Patrick Leahy, Chairman
The Honorable Jeff Sessions, Ranking Member
Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Leahy and Ranking Member Sessions:

On behalf of the AFL-CIO, I would like to take this opportunity to express our strong support for S. 1551, "Liability for Aiding and Abetting Securities Violation Act of 2009." The proposed legislation would close gaps in the legal system that currently hinder the abilities of the SEC and investors to obtain judgments against people involved in an act of fraud.

The Tenth Circuit's 1994 Central Bank of Denver decision and the Stoneridge decision issued by the Supreme Court last year left a glaring hole in the fabric of investor protection that the AFL-CIO believes must be addressed by Congress.[1] These cases effectively granted immunity from civil liability to investors for parties such as investment banks and law firms that are co-conspirators in securities frauds. The issue here of course is not merely fairness to the investors defrauded in a particular case—it is the incentives for financial institutions to police their own conduct.

Investment banks and commercial banks were key actors in the Enron fraud, constructing derivative trades that hid Enron's real liabilities. Ultimately, Enron employees and other investors were unable to make their case against these institutions in court because of the Stoneridge decision. The law today appears to give workers no recourse when they are the victims of a conspiracy to commit fraud undertaken by banks and the corporate customers. S. 1551 would correct this injustice.

[1] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

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Letter to The Honorable Patrick Leahy
and The Honorable Jeff Sessions
September 8, 2009
Page Two

The AFL-CIO is the federation of America's labor unions, representing more than 10 million working men and women. The labor movement is interested in protecting the rights of defrauded investors because union members are investors. Union members participate in benefit plans with more than $5 trillion in assets. Union-sponsored pension plans hold approximately $491 billion in assets, and union members participate in the capital markets as individual shareholders.

We believe that S. 1551, "Liability for Aiding and Abetting Securities Violation Act of 2009," will provide necessary opportunities for the SEC and investors to pursue appropriate litigation against fraudsters. We strongly support S. 1551. If we can be of further assistance, please do not hesitate to contact Damon Silvers at 202-637-3953.

Sincerely,

Richard L. Trumka

RLT/ms
opeiu #2, afl-cio

No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR BUSINESS ROUNDTABLE AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

ROBERT B. MCCAW
CHRISTOPHER J. MEADE
ANNE K. SMALL
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LEGISLATIVE MATERIALS

IN THE

Supreme Court of the United States

No. 06-43

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR BUSINESS ROUNDTABLE AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

INTEREST OF AMICUS CURIAE[1]

Business Roundtable is an association of chief executive officers of leading U.S. companies. The companies represented have $4.5 trillion in annual revenues and more than 10 million employees and comprise nearly one third of the total value of the U.S. stock market. Business Roundtable was founded in 1972 to increase the role of business execu-

[1] Pursuant to Rule 37.6 of the Rules of this Court, amicus states that no counsel for a party authored this brief in whole or in part. No person or entity, other than amicus or its members, made any monetary contribution to the preparation or submission of this brief. Petitioner has filed a letter with the Clerk of Court giving blanket consent to the filing of all amicus curiae briefs in this case. A letter of consent from respondents has been filed in the Court with this brief.

tives in public policy debates and to advance the goals of economic growth, a dynamic global economy, and a workforce capable of future competitiveness. Since its founding, Business Roundtable has conducted research, authored numerous white papers addressing a range of significant corporate matters, and lobbied Congress on such issues. It regularly files amicus curiae briefs in cases raising legal issues of significance to its members.

The question presented in this case is of great importance to Business Roundtable. The Court is asked to determine whether there is a private right of action under § 10(b) of the Securities Exchange Act of 1934 for "scheme liability." By extending the reach of liability to companies that made no misstatement (or omission) on which the plaintiffs relied, "scheme liability" would be a broad expansion of the private right of action under § 10(b). Because it is a particularly uncabined form of liability, it would increase the risk of frivolous lawsuits aimed at extracting settlements—a form of vexatious litigation against which Congress and this Court have sought to guard. The increased scope of liability and the threat of meritless suits threaten the interests of Business Roundtable, its members, and the companies that its members lead.

SUMMARY OF ARGUMENT

Neither § 10(b) of the Securities Exchange Act of 1934 nor SEC Rule 10b-5 promulgated thereunder explicitly mentions private civil liability, and this Court has often stated that neither Congress nor the Commission intended to create a right of action for private litigants. Nevertheless, decades ago, the courts implied such a right of action for material misstatements or omissions on which a plaintiff investor relied, provided that the plaintiff can establish that the misstatement or omission caused a loss. In this case, petitioner asks this Court to extend the § 10(b) private right of action to reach a new set of defendants: participants in a "scheme to defraud." Under petitioner's view, persons who themselves did not employ a deceptive device on which a plaintiff relied could be held liable if they knowingly contributed to another person's violation. This broad expansion should be rejected because it would extend liability beyond the persons and conduct covered by the text of the statute and would substantially increase the dangers of vexatious litigation.

This brief will not make all of the arguments in opposition to petitioner's proposed new form of § 10(b) liability but will instead focus on two issues.

1. The courts created the § 10(b) private right of action without any consideration, or evidence, of congressional intent to authorize private enforcement of this antifraud provision. The Court has long since acquiesced in the existence of the private right, even as it has repeated that the right of action would not be "implied" today if the question were presented now for the first time. The Court should not extend the private right into new territory without any indication that Congress has authorized or approved such an extension. In practice, this Court has repeatedly declined to expand the private right of action, stressing both its nonstatutory origins and the high potential for vexatious litigation that Rule 10b-5 actions present. Expansion of the private right of action to reach the boundless class of "scheme" participants that did not themselves engage in any deceptive device would seriously exacerbate that risk.

Petitioner's suggestion that § 10(b) be read to authorize private actions for "scheme" liability is inconsistent with the securities laws as written by Congress and prior decisions of this Court. The text of § 10(b) describes persons who engage in deceptive devices on which investors rely. But petitioner here seeks to hold liable entities that concededly did not engage in any deceptive device—*i.e.*, made no misrepresentation (by words or actions) or omission—on which petitioner relied. *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994), rejected a similar extension of the private right of action to aiders and abettors, "conclud[ing] that the statute prohibits only the making of a material misstatement." *Id.* at 177.

Moreover, Congress, in response to *Central Bank*, made clear that it did not want to provide a § 10(b) private right of action against persons that did not themselves make misstatements or omissions on which investors relied. After *Central Bank*, the SEC and certain professional groups urged Congress to extend the § 10(b) private right of action to reach aiders and abettors. Congress refused but gave the SEC public enforcement authority against aiders and abettors. At the same time, Congress also placed additional limits on private § 10(b) suits in an effort to mitigate the risks of abusive litigation.

The "schemers" covered by petitioner's theory would include most or all of the aiders and abettors that this Court and Congress already found beyond the reach of § 10(b) and would also include a limitless range of additional persons who dealt with the person making the misstatement or omission in any way that a plaintiff can allege knowingly advanced the "scheme." Moreover, "scheme liability" as a legal concept is largely undefined; current requirements to state a cause of action under § 10(b)—including concrete allegations of materiality, reliance, and causation—would not translate to the "scheme" context, and the concept of a "scheme" is less well defined in the law than aiding and abetting. The courts would thus be required to create a new framework of requirements. In the meantime, the uncertainty as to the scope of liability would aggravate litigation abuses, increasing the pressure to settle. Congress's rejection of the request by the SEC and others to extend private liability to aiders and abettors forecloses the even broader judicial expansion sought here.

Finally, creation of private "scheme liability" would also be inconsistent with the express causes of action in the securities laws to which the Court has looked for guidance in defining the contours of the § 10(b) private right of action. In particular, each of the express causes of action carefully limits the scope of persons subject to liability and none would extend so broadly to reach those who participated in an ill-defined way in the illegal conduct at issue.

2. Petitioner and certain amici have argued that the SEC's support for "scheme liability"—as expressed in amicus briefs in other cases—should play a major role in this Court's determination of the question presented. Contrary to these suggestions, the Court does not owe deference to the SEC's amicus positions on this legal issue.

First, deference to agency views is appropriate only where Congress has not spoken to the precise question at issue. Here, Congress has made its intent clear: in the wake of *Central Bank*, Congress rejected the SEC's request to extend private liability beyond those who themselves engaged in deceptive devices on which plaintiff investors relied. Second, agency deference is predicated on the delegation of authority to the agency to interpret the statute on the point at issue. Here, Congress has plainly given no such authority to the SEC: since Congress never intended the private right of action, it certainly did not give the SEC the authority to determine its contours. And this Court has made clear that it will not infer a congressional delegation of authority to an agency to create or extend a judicial cause of action not created or extended by the statute itself.

ARGUMENT

I. THE PRIVATE RIGHT OF ACTION UNDER § 10(b) IS A JUDICIAL CREATION THAT SHOULD BE NARROWLY CONSTRUED TO REJECT "SCHEME LIABILITY"

A. The Implied Private Right Of Action Was Created Under A Practice The Court Has Since Abandoned

Petitioner asks the Court to extend the private right of action under § 10(b) of the Securities Exchange Act and Rule 10b-5 to reach participants in a "scheme to defraud," *i.e.*, persons who did not themselves employ a deceptive device on which plaintiff relied. But the private right of action under this antifraud provision is itself a judicial creation of a kind the courts would not engage in today, and for the same reasons the courts would not today create the right of action from scratch, they should not now extend it into new territory.

This Court has detailed the origins of the implied right of action under § 10(b) and Rule 10b-5. *See, e.g., Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 (1983). Neither the statute nor the Commission's rule makes any mention of actions by private parties. A district court first found an implied private right of action in 1946. *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). Many other courts followed, and this Court ultimately endorsed the approach in *Superintendent of Ins. of N.Y.* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). But the Court has repeatedly recognized that the private right of action was solely the creation of the Judicial Branch: "[W]e have made no pretense that it was Congress' design to provide the remedy afforded." *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350, 358-359 (1991). The Court has repeatedly described the private right of action as a "'judicial oak which ha[d] grown from little more than a legislative acorn.'" *Merrill Lynch, Pierce, Fenner & Smith* v. *Dabit*, 547 U.S. 71, 126 S. Ct. 1503, 1510 (2006) (quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975)) (alteration in original); *see also Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988) (explaining that the Court continued the private right of action because of "legislative acquiescence and the passage of time"); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 196 (1976) ("[T]here is no indication that Congress or the Commission, when adopting Rule 10b-5, contemplated such a remedy." (footnotes omitted)).

If the question whether to imply a private right of action under § 10(b) were to arise from scratch today, it is clear that the Court's answer would be "no," and it is inconceivable that the Court would "confirm[] with virtually no discussion ... that such a right of action did exist." *Blue Chip Stamps*, 421 U.S. at 730 (citing *Superintendent of Ins.*, 404 U.S. at 13 n.9; *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 150-154 (1972)). As Justice Scalia has put it, "[T]he contours of a Rule 10b-5 action" were initially "'implied' (*i.e.*, created) by the Court itself—a practice we have since happily abandoned[.]" *Holmes* v. *Securities Investor*

Protection Corp., 503 U.S. 258, 289 (1992) (Scalia, J., concurring in judgment) (citing *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 568-571, 575-576 (1979)).

This Court's more recent cases have consistently held that "any private right of action for violating a federal statute must ultimately rest on congressional intent to provide a private remedy." *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1102 (1991) (citing *Redington*, 442 U.S. at 575). In *Alexander* v. *Sandoval*, 532 U.S. 275 (2001), the Court found no private right of action under § 602 of Title VI of the Civil Rights Act of 1964, 78 Stat. 252, as amended, 42 U.S.C. § 2000d *et seq.*, to enforce regulations promulgated by the Department of Justice pursuant to that section. The Court said:

> Like substantive federal law itself, private rights of action to enforce federal law must be created by Congress . . . . The judicial task is to interpret the statute Congress has passed to determine whether it displays an intent to create not just a private right but also a private remedy. Statutory intent on this latter point is determinative. Without it, a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute.

Sandoval, 532 U.S. at 286-287 (citations omitted); *see also California* v. *Sierra Club*, 451 U.S. 287, 297 (1981) ("The federal judiciary will not engraft a remedy on a statute, no matter how salutary, that Congress did not intend to provide."); *Pharmaceutical Research & Mfrs. of Am.* v. *Walsh*, 538 U.S. 644, 683 (2003) (Thomas, J., concurring in judgment) ("[P]rivate parties may employ . . . an implied private right of action only if they demonstrate an 'unambiguously conferred right.'") (quoting *Gonzaga Univ.* v. *Doe*, 536 U.S. 273, 283 (2002)); *Redington*, 442 U.S. at 578 ("The ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme.").

It follows directly from this abandonment of the practice of implying rights of action Congress itself has never authorized, that the Court should not *extend* a right of action into new territory without any indication that Congress wished to go there. "Scheme liability" represents just such an extension, to persons and actions that are not mentioned in the statute.

B. While Never Abandoning The § 10(b) Implied Private Right Of Action, The Court Has Repeatedly Declined To Extend It

Prior to the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 ("PLSRA"), "Congress . . . had no occasion to provide guidance about the elements of a private liability scheme [under § 10(b)]," *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994), so the particular features and contours of the § 10(b) right of action had been almost entirely "of judicial creation," *Lampf*, 501 U.S. at 358. As this Court explained, "[w]e are dealing with a private right of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." *Blue Chip Stamps*, 421 U.S. at 748-749. The Court has approached this task cautiously, noting that it is ultimately not the Court's, but rather "the federal lawmaker's prerogative ... to allow, disallow, or shape the contours of—including the pleading and proof requirements for—§ 10(b) private actions." *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

The Court has therefore noted that "the breadth of [a] right once recognized should not, as a general matter, grow beyond the scope congressionally intended." *Sandberg*, 501 U.S. at 1102. In the context of a right of action entirely lacking a foundation in congressional intent, such as the § 10(b) private right of action, *any* expansion of the claim is necessarily beyond the scope that Congress intended. As a practical matter, of course, the courts must fill the interstices of a previously recognized right of action. *See, e.g., Lampf*, 501 U.S. at 359 (selecting a statute of limitations for actions brought under § 10(b)). But when asked to endorse attempts to expand the class of persons and conduct for which judicially-implied causes of action are available, the answer must be "no."

In fact, the Court has repeatedly cabined the implied private right of action under § 10(b) since first recognizing it. *See, e.g., Blue Chip Stamps*, 421 U.S. at 737 (limiting the private right to purchasers and sellers); *Ernst & Ernst*, 425 U.S. at 193 (requiring that private actions brought under Rule 10b-5 require "'scienter' . . . intent to deceive, manipulate, or defraud"); *Sandberg*, 501 U.S. at 1104-1105 (rejecting respondents' theory of causation and noting that "[t]his is not the first effort in recent years to expand the scope of an action originally inferred from the Act without conclusive guidance from Congress."); *Central Bank*, 511 U.S. at 188-189 (concluding that Rule 10b-5 does not provide a private right of action against aiders and abettors).

The Court has read the § 10(b) right of action narrowly not only because of the lack of congressional authorization but also out of concern "that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. As the Court explained, "in this type of litigation ... the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits ... but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial[.]" *Id.* at 742-743.

These policy considerations underlie many other decisions of this Court concerning the scope of conduct actionable under § 10(b) and the elements of such claims. In holding that a Rule 10b-5 private plaintiff must allege scienter, "a mental state embracing intent to deceive, manipulate or defraud," the Court pointed to the procedural restrictions on the express civil remedies in the 1933 Act that allowed for recovery for negligent conduct and explained that "one of

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the purposes" of those restrictions "was to deter actions brought solely for their potential settlement value." *Ernst & Ernst*, 425 U.S. at 210 n.30. More recently, the Court explained that a private plaintiff's expansive approach to allegations of loss causation under Rule 10b-5 "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the discovery process will reveal relevant evidence.'" *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 347 (2005) (quoting *Blue Chip Stamps*, 421 U.S. at 741) (alteration incorporated); *see also Sandberg*, 501 U.S. at 1104-1105 (rejecting respondents' theory of causation after recalling *Blue Chip Stamps* and expressing concern about "the same threats of speculative claims"); *Piper* v. *Chris-Craft Indus., Inc.*, 430 U.S. 1, 40 (1977) ("More likely is the prospect that shareholders may be prejudiced because some tender offers may never be made if there is a possibility of massive damages claims for what courts subsequently hold to be an actionable violation."); *TSC Indus., Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976) (rejecting the materiality standard petitioner urged because it was "too suggestive of mere possibilty" and might force management to make decisions out of "fear of exposing itself to substantial liability" "for insignificant omissions or misstatements").

Similar concerns animated this Court's decision in *Central Bank*. There, the Court considered petitioner's request to extend the reach of the § 10(b) private right of action to aiders and abettors. Rejecting that invitation, the Court repeated that "litigation under 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." 511 U.S. at 189. The Court cautioned, moreover, that such litigation "requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Id.*; *see also Tellabs, Inc.*, 127 S. Ct. at 2509 (explaining that "[p]rivate securities fraud actions, if not adequately contained, can be employed abusively to impose substantial cost on companies and individuals whose conduct conforms to the law").

This concern over vexatious litigation is also consistent with the Court's more limited views of private securities actions as compared to SEC enforcement actions, in which abuse is much less of a concern. In *Aaron* v. *SEC*, 446 U.S. 680 (1980), the Court addressed SEC enforcement authority under § 10(b) as well as § 17(a) of the 1933 Act. Notwithstanding that the language of § 17(a) is almost identical to that of Rule 10b-5, and the Court's conclusion that all claims under § 10(b) require an allegation of scienter, the Court determined that the SEC could premise an enforcement action under subsections § 17(a)(2) and § 17(a)(3) based on negligence. *Id.* at 697. Although the SEC may bring claims under § 17(a) based on mere negligence, the Court has refused to permit private claims under § 17(a). *See Redington*, 442 U.S. at 578.

These cases reflect the Court's conclusion that the dangers of vexatiousness inherent in § 10(b) litigation necessitate particular judicial vigilance in crafting the contours of § 10(b) liability. Petitioner's "scheme liability" would substantially increase the risk of vexatious litigation that has previously concerned this Court.

C. "Scheme Liability" Would Reach Beyond The Classes Of Persons And Conduct Covered By The Statute And Prior Decisions Of This Court

The reasons for this Court's refusal to expand the § 10(b) private cause of action that the courts created are particularly powerful here, given that "scheme liability" would expand liability beyond the classes of persons and conduct covered by the text of the statute. Section 10(b) is concerned with intentional deception of investors who rely on the deception, and the Court has recognized an implied private right of action by such investors against the deceivers on whom they relied. But when litigants have attempted to extend the reach of § 10(b) liability beyond that core—whether to negligent actors, *see Ernst & Ernst*, or to aiders and abettors, *see Central Bank*—this Court has repeatedly rejected their claims.

A "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)," *Central Bank*, 511 U.S. at 173, which makes it unlawful "[t]o use or employ, in connection with the sale of any security . . . any manipulative or deceptive device or contrivance." As this Court described in *Central Bank*, the implied private civil liability under § 10(b) for "those who commit a manipulative or deceptive act in connection with the purchase or sale of securities" has never been extended to allow suit where the plaintiff cannot "show reliance on the defendant's misstatement or omission." *Id.* at 167, 179; *see also Lampf*, 501 U.S. at 376-377 (noting that a private action under § 10(b) requires proof of a false or misleading statement, reliance, and causation).

Although petitioner has packaged its claim artfully, the type of conduct of which it complains cannot fit within the bounds of the present § 10(b) right of action. Instead, by asking this Court to extend liability to parties who "themselves made no public statements [or omissions and engaged in no expressive conduct] concerning those transactions," Pet. Br. i., and therefore to parties on whom petitioner cannot have relied, petitioner requests a judicial expansion of private liability to parties and conduct never intended by Congress. In *Central Bank*, the Court refused to recognize a similar extension after looking to "earlier cases considering conduct prohibited by § 10(b)" and "again conclud[ing] that the statute prohibits *only* the making of a material misstatement." 511 U.S. at 177 (emphasis added). The Court also explained that its "reasoning [was] confirmed by the fact that [plaintiffs'] argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance." *Id.* at 180. After all, a private plaintiff bringing claims for aiding and abetting under § 10(b) could not meet the requirement of demonstrating "reliance on *the defendant's* misstatement or omission to recover under 10b-5." *Id.* at 180. "Having sworn off the habit of venturing beyond Congress's intent," this Court should not accept petitioner's "invitation to have one last drink." *Sandoval*, 532 U.S. at 287.

D. Congress's Response To *Central Bank* Also Supports A Narrow Interpretation Of The Implied Private Right Of Action Under § 10(b) To Exclude "Scheme Liability"

Legislation in the wake of *Central Bank* reinforces the conclusion that the private right of action under § 10(b) should not be extended to "scheme liability." After *Central Bank*, Congress considered proposals to override that decision and expand the private right of action by adding private liability for aiding and abetting. In enacting the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 ("PSLRA"), however, Congress rejected those proposals and chose to authorize only *SEC* enforcement against aiders and abettors and not private claims, *see id.* § 78t(e). Far from expanding the private right of action, the PSLRA and legislation that followed recognized the same concerns expressed by this Court about abusive § 10(b) litigation and took steps to restrict private suits under the statute. *See, e.g., id.* § 78u-4(b). On the question presented here, the Court need not "attempt to infer 'how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.'" *Central Bank*, 511 U.S. at 178 (quoting *Musick, Peeler, & Garret* v. *Employers Ins. of Wasau*, 508 U.S. 286, 294 (1993)). Congress has confirmed that *private claims* (as opposed to civil enforcement actions by the SEC) should not extend to persons who did not themselves engage in the deception on which the plaintiff investors relied.

Following *Central Bank*, the SEC argued to Congress that private liability under § 10(b) should be extended to aiders and abettors. Chairman Arthur Levitt testified to Congress that, in light of *Central Bank*:

> Persons who knowingly or recklessly assist the perpetration of a fraud may be insulated from liability to private parties if they act behind the scenes

> and do not themselves make statements, directly or indirectly, that are relied upon by investors. Because this is conduct that should be deterred, Congress should enact legislation to restore aiding and abetting liability in private actions.

S. Rep. No. 104-98, at 49 (1995). Groups including the North American Securities Administrators Association and the Association of the Bar of the City of New York agreed with the SEC that Congress should create private aiding and abetting liability. *See id.* The Senate Report on the PSLRA noted that when Congress chose not to add private aiding and abetting liability to the draft bill, Chairman Levitt submitted a letter "express[ing] his disappointment" that such liability was not added. *Id.* at 48.

Notwithstanding the SEC's urgings, Congress chose not to expand the scope of the private right of action under § 10(b). Congress recognized the role of private suits in complementing SEC enforcement as ensuring the "integrity and efficiency of our markets," S. Rep. No. 104-98, at 8, but the PSLRA rejected "the recommendation made by the SEC, the State securities regulators and the bar association that aiding and abetting liability be fully restored for the SEC and private litigants as well," *id.* at 48. It did so because "private aiding and abetting liability actions under Section 10(b) would be contrary to [the PSLRA's] goal of reducing meritless securities litigation." *Id.* at 8, 19.

The Senate Report recognized the coercive effects of such suits:

> The dynamics of private securities litigation create powerful incentives to settle, causing securities class actions to have a much higher settlement rate than other types of class actions. Many such actions are brought on the basis of their settlement value. The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim.

S. Rep. No. 104-98, at 6. Even Chairman Levitt conceded that "investors and markets are being hurt by litigation excesses." *Id.* at 5.

Motivated by the same concerns about vexatious litigation that this Court has identified, *see supra* pp. 9-11, Congress took other steps in the PSLRA "to curb frivolous, lawyer-driven litigation," *Tellabs*, 127 S. Ct. at 2509. Not only did Congress refuse to extend the private right of action under § 10(b), but it also imposed several additional "requirements for securities fraud actions," 15 U.S.C. § 78u-4(b). In particular, the PSLRA imposed heightened pleading requirements for the allegations of misstatements and omissions and allegations of the required state of mind. *Id.*

The PSLRA did, however, grant enforcement authority against aiders and abettors to the SEC. S. Rep. No. 104-98, at 48. Section 20(e) of the Securities Exchange Act, 15 U.S.C. 78t(e), now provides:

> Prosecution of persons who aid and abet violations
>
> For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

Congress's chosen approach balances competing interests, giving the SEC but not private plaintiffs the power to act against parties who did not themselves make a material misrepresentation or omission on which investors relied, so that—in cases deemed appropriate by the expert agency—action can be taken to deter and compensate for fraudulent conduct, but there is no encouragement to private, lawyer-driven, and often meritless litigation. The PSLRA thus reflects Congress's own determination that concerns about abusive litigation outweighed the benefits of allowing private claims against aiders and abettors and that SEC enforcement is sufficient. As this Court has explained, "[t]he express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others." *Sandoval*, 532 U.S. at 290; *see also Massachusetts Mut. Life Ins. Co.* v. *Russell*, 473 U.S. 134, 147 (1985) (when "a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it" (internal quotation marks omitted)).

When Congress has revisited the issues implicated by the PSLRA, moreover, it has declined to expand the scope of the private right of action under § 10(b).[2] To the contrary, in the period since the PSLRA's enactment, legislation regarding private actions under § 10(b) has focused on shoring up the protections against vexatious litigation. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227; *Dabit*, 126 S. Ct. at 1510-1512 (detailing Congress's response through SLUSA to litigants' efforts to frustrate the goals of the PSLRA).

Allowing an expansion of private rights of action under a "scheme liability" theory would disrupt the balance that Congress has struck. Petitioner seeks the creation of a private right of action to remedy respondents' alleged acts; the acts alleged, however, do not include misstatements or omissions on which petitioner relied, but merely actions that allegedly had "the purpose and effect of furthering the fraudulent scheme." Pet. Br. 14; *see id.* at 12. The "schemers" that

[2] In 2002, Congress again considered and rejected efforts to extend the private right of action to reach aiders and abettors. Senator Shelby proposed an amendment to the bill that became the Sarbanes-Oxley Act of 2002 that would have added a "private litigation" provision stating that "persons that aid or abet violations . . . shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." 148 Cong. Rec. S6584 (daily ed. July 10, 2002). No such provision appears in the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. *See also* H.R. Rep. No. 107-414, at 54 (2002) (minority views observing that the SEC and others had urged Congress to overturn *Central Bank*'s bar on private suits against aiders and abettors and lamenting that Congress did not "now heed these recommendations" and expand the private right of action).

petitioner's theory would reach include most if not all the aiders and abettors that Congress dealt with in a different manner, plus an unbounded set of other persons who dealt with the primary violator in any way that a plaintiff can allege furthered the fraudulent scheme.

To the extent that the "scheme liability" alleged in this case can be distinguished at all from the aiding and abetting liability rejected in *Central Bank*, it poses even more serious dangers of vexatious litigation. "Aiding and abetting" is at least a legal category with a long history and extensive statutory and common law definitions in various contexts. *See, e.g., Central Bank*, 511 U.S. at 180-183 (describing history of aiding and abetting liability). "Scheme liability" would, presumably, potentially reach anyone who dealt in any pertinent way with the person who is alleged to have engaged in the fraud, a much wider range of potential defendants. Since defendants are jointly and severally liable, *see* 15 U.S.C. § 78u-4(f)(2), the plaintiff can threaten any person with an assertable connection to the "scheme" with the massive damages often involved in securities fraud cases.

Moreover, the scope of "scheme liability," like the aiding and abetting liability at issue in *Central Bank*, is "unclear, in an area that demands certainty and predictability." *Central Bank*, 511 U.S. at 188 (internal quotation marks omitted). A "scheme liability" theory would be untethered to the accepted elements of § 10(b) actions—particularly reliance, loss causation, and materiality. The courts would need to develop a whole new body of law to determine how Rule 10b-5 will work with respect to individuals and entities, such as suppliers, lenders, and professional advisers, with even simple and peripheral relationships with the entity making the misstatements or omissions. In the meantime, market participants will have inadequate guidance regarding the legality of a variety of conduct. "[S]uch a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5 is not a satisfactory basis for a rule of liability imposed on the conduct of business transactions." *Id.* (internal quotation marks omitted) (alterations in original). And this sort of amorphous liability threat and disproportionate exposure will not only aggravate the dangers of vexatious litigation but also cannot help but distort business relations.

The PSLRA's particular steps to deter vexatious private suits are also inconsistent with a private "scheme liability" theory. Key among the constraints placed on private suits were heightened pleading requirements in § 78u-4(b)(1) for claims involving "misleading statements and omissions." A complaint must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). A suit based on "scheme liability," however, would evade these requirements. The defendant may, as in this case, never have deceived anyone with whom it dealt, and never have made any statement or omission on which any relevant investor relied. Accordingly, these additional requirements—Congress's chosen protections against frivolous suits—would have no deterrent effect on such suits.[3] Permitting private suits based on "scheme liability" would circumvent protections against abuse established by the PSLRA while greatly expanding the scope of potential defendants.

E. The Statutory Limitations On The Express Causes Of Action In The Securities Laws Support A Narrow Reading Of The Implied Right Of Action Under § 10(b) That Does Not Extend To "Scheme Liability"

As part of its analysis of the scope of private rights of action under § 10(b), this Court has considered "the express causes of action in the securities Acts as the primary model

[3] The pleading requirements of Fed. R. Civ. P. 9(b), including the requirement to plead fraud with particularity, would apply to "scheme" liability claims, but as the Conference Report on the PSLRA recognized, "[t]he Rule has not prevented abuse of the securities laws by private litigants." H.R. Conf. Rep. No. 104-369, at 41 (1995).

for the 10(b) action," on the theory that "[h]ad the 73rd Congress enacted a private § 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the Securities Acts." *Central Bank*, 511 U.S. at 178. Using that mode of analysis and recognizing the care with which Congress delineated the express causes of action, this Court has repeatedly refused to expand implied rights of action in a way that would effectively override the limits on the express remedies. *See, e.g., id.*; *Ernst & Ernst*, 425 U.S. at 200-201; *Lampf*, 501 U.S. at 359-360. After all, it would be "anomalous to impute to Congress an intention in effect to expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action." *Central Bank*, 511 U.S. at 180. An analysis of the express causes of action confirms that the private right of action under § 10(b) should not be extended to "scheme liability."

It is apparent from the careful crafting of the express causes of action that the 1933 and 1934 Congresses did not intend to give investors wide open private rights of action against indirect participants in an alleged fraud. The express causes of action each strictly cabins the scope of potential defendants or the unlawful conduct, and some of the express causes of action do both. For example, only persons who sign the registration statement, express an expert opinion on the statement, or served as a director of the issuer or underwriter in the offering may be liable under Section 11 of the 1933 Act. 15 U.S.C. § 77k. Likewise, Section 12(2) of the 1933 Act extends liability only to persons who utilize a false or misleading prospectus to "offer[] or sell[] a security." *Id.* § 77*l*. In *Pinter* v. *Dahl*, 486 U.S. 622 (1988), the Court found no textual basis or "congressional intent to incorporate tort law doctrines," *id.* at 652, and rejected arguments that parties should be liable "whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place," *id.* at 649 (footnote and citation omitted). The Court also refused to extend the reach of the statute to "persons who 'participate in soliciting the purchase.'" *Id.* at 651 n.27. Similarly, persons are liable under Section 18 of the 1934 Act only if the plaintiff actually relied on the person's false statements in documents filed with the Commission. Significantly, Section 18 also reaches only persons "who shall make or cause to be made" a false or misleading statement in an SEC filing.

The petitioner in this case has requested an expansion of the § 10(b) implied right of action to a nebulous category of conduct and an undefined class of parties. Just as this Court rejected the invitation in *Pinter* to extend liability to a indirect participants, it should refuse to endorse petitioner's theory of "scheme liability," which would render liable actors only obliquely connected to allegedly fraudulent schemes. This Court should continue to take guidance from the approach that Congress chose of precisely delineating the scope of the express causes of action under the federal securities laws.

II. THE SEC LACKS AUTHORITY TO DETERMINE THAT THERE IS A PRIVATE RIGHT OF ACTION FOR "SCHEME LIABILITY"

The Petition for a Writ of Certiorari and Amici Former SEC Commissioners make much of the SEC's support, expressed in other courts, for a private right of action for "scheme liability," implying a major role for the SEC in assessing the scope of the § 10(b) private right of action. *See* Pet. 23-24; Br. of Former SEC Comm'rs 2, 6-7. Contrary to this suggestion, the SEC's views on private rights of action for "scheme liability" are due no deference from this Court.

First, the SEC's requests for judicial extension of the private right of action to "scheme liability" run contrary to Congress's judgments on the matter. In the legislation following *Central Bank*, Congress considered and rejected SEC proposals to extend private rights of action beyond claims of misstatements and omissions on which a plaintiff relied to actions that merely had the goal and effect of advancing the fraudulent scheme. Accordingly, the SEC's expressions of support for private "scheme liability" are contrary to a clear congressional determination. Second, regardless of the particulars of the SEC's views, the SEC is not entitled to deference on this question because Congress has not delegated authority to the SEC to resolve questions concerning the existence or scope of private rights of action under § 10(b).

A. SEC Support For An Extension Of The § 10(b) Private Right Of Action Is Contrary To Congressional Intent

In amicus briefs filed in other courts, the SEC has supported the expansion of the § 10(b) private right of action to include "scheme liability." Br. of Amicus Curiae the Securities Exchange Commission 16, *Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006) (No. 04-55665) (SEC *Simpson* Amicus Br.); *see also* Reply Br. of Amicus Curiae the Securities Exchange Commission 5, *Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006) (No. 04-55665) (SEC *Simpson* Amicus Reply). The SEC opined that private liability should apply to "[a]ny person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud." SEC *Simpson* Amicus Br. 16. The Commission's proposed test transparently "include[d] conduct beyond the making of false statements or misleading omissions" and contemplated that "[t]he reliance element should be viewed as satisfied whenever a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction." *Id.* at 8. The Court need not defer to the SEC's views.

The familiar two-part test of *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), provides that a court must first ask whether "Congress has directly spoken to the precise question at issue" and, if not, whether the agency's view "is based on a permissible construction of the statute." *Id.* at 842-843. The SEC's views in *Simpson*, however, do not satisfy the first step of the *Chevron* analysis.

Under *Chevron* step one, Congress has "directly spoken to the question at issue." As the SEC itself and Congress both acknowledged, in enacting the PSLRA Congress rejected the SEC's efforts to extend private liability beyond those making misstatements and omissions on which a plaintiff relied to include aiders and abettors. *See supra* pp. 13-15. In the PSLRA and ensuing legislation, Congress has focused on limiting private suits not expanding them; the limits placed on private suits, moreover, operate on the assumption that such suits are limited to claims of misstatements or omissions on which the plaintiff relied. *See supra* p. 18.

When applying the first step of the *Chevron* analysis, this Court has looked to the "plain language of the statute," *HUD* v. *Rucker*, 535 U.S. 125, 130 (2002), and has also considered the broader context of Congress's legislation in the area, *see, e.g., FDA* v. *Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160-161 (2000) (rejecting the FDA's view that it had the authority to regulate tobacco on the ground that it required a "strained" reading of the statute and would "ignore the plain implication of Congress's tobacco-specific legislation"). When the 1934 Act is coupled with Congress's more recent legislation, "the intent of Congress is clear"—to limit private rights of action to persons making the misstatements or omissions on which the plaintiff relied.

"Scheme liability," like aiding and abetting, does not involve misstatements or omissions on which the plaintiff relied. Rather, it concerns actions that had "the purpose and effect of furthering the fraudulent scheme." Pet. Br. 14; *id.* at 12. As noted above, the "schemers" would include most if not all the aiders and abettors that Congress has already determined should not be subject to § 10(b) private liability, plus a potentially limitless group of additional persons who acted with the primary violator in a way that a plaintiff might argue advanced the "scheme." Congress's rejection of the SEC's request to extend private liability to aiders and abettors must therefore foreclose any deference to the SEC's efforts to obtain in the courts even broader private enforcement than the aiding and abetting cause of action that Congress would not provide.[4]

B. Principles Of Deference To Administrative Agencies Do Not Apply To The Question Whether To Extend The § 10(b) Private Right Of Action To "Scheme Liability"

The SEC's views on the question whether to extend the § 10(b) private right of action to "scheme liability" are not due any deference under traditional administrative law principles for an additional reason: *Chevron* provides deference to an agency's reasonable interpretation of a statute, but only where Congress has delegated authority to the agency to interpret the statute. "A precondition to deference under *Chevron* is a congressional delegation of administrative authority." *Adams Fruit Co.* v. *Barrett*, 494 U.S. 638, 649 (1990).

There is plainly no express delegation of authority to the SEC on the present issue. *See supra* pp. 5-8; *cf. Lampf*, 501 U.S. at 359 ("[W]e have made no pretense that it was Congress' design to provide the remedy afforded."). Nor can there be any implicit delegation of authority on this question. While administrative law recognizes that Congress can delegate authority to an agency implicitly as well as explic-

[4] These arguments based on congressional intent should not be discounted as resting on congressional inaction. Congress did act upon the question of liability for aiding and abetting, giving the SEC enforcement authority but declining to give private litigants a complementary right of action. *Cf. Sandoval*, 532 U.S. at 290 ("The express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others."). Given *Central Bank* and the purposes of the PSLRA, moreover, Congress plainly did not decline to create private liability for aiding and abetting because it deemed such liability already fairly included in the statute. In any event, although this Court has cautioned against reliance on congressional inaction in discerning Congress's intent, it has nonetheless cited "legislative acquiescence" in cases concerning the private right of action under § 10(b). *See, e.g., Basic Inc.*, 485 U.S. at 230-231 (1988); *Central Bank*, 511 U.S. at 186-187.

itly,[5] this Court has made clear that it will not infer Congress's delegation of authority to an agency, such as the SEC, to create or extend a judicial cause of action not created or extended by the statute itself, at least where such delegation is not Congress's own discernible intent. *See, e.g.*, *Piper*, 430 U.S. at 41 n.27, 43 (1977) (explaining that "administrative deference" was inappropriate on the question of the availability of a private right of action under § 14(e) of the Securities Exchange Act because the SEC's "presumed 'expertise' in the securities-law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution"); *Adams Fruit*, 494 U.S. at 649-650 (rejecting *Chevron* deference to agency views on the availability of a private right of action under the Migrant and Seasonal Agricultural Worker Protection Act (AWPA), 29 U.S.C. §§ 1801 *et seq.*, on the ground that "[n]o such delegation regarding AWPA's enforcement provisions is evident in the statute").[6]

Even where the agency has been authorized to administer the statute, the Court will not infer a delegation of authority over questions regarding the existence of a private right of action. *See, e.g.*, *Adams Fruit*, 494 U.S. at 649 (observing that Congress "expressly mandated a role for the Department of Labor in administering the statute ... [but] [t]his delegation, ... does not empower the Secretary to regulate the scope of the judicial power.")[7]

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[5] *See, e.g.*, *United States* v. *Mead Corp.*, 533 U.S. 218, 229 (2001).

[6] *See also Sandoval*, 532 U.S. at 291 (rejecting agency efforts to create a private right of action under § 602 of the Civil Rights Act by regulation and noting that it "is most certainly incorrect to say that language in a regulation can conjure up a private cause of action that has not been authorized by Congress [because] [a]gencies may play the sorcerer's apprentice but not the sorcerer himself."); *Redington*, 442 at 577 n.18 ("SIPC and the Trustee also appear to suggest that the rules adopted under § 17(a) can themselves provide the source of an implied damages remedy even if § 17(a) itself cannot. It suffices to say, however, that the language of the statute and not the rules must control." (citations omitted)).

[7] Lower courts have followed the Supreme Court's lead and declined to defer to agency positions on questions regarding private rights of ac-

In resolving the various questions regarding private actions under § 10(b), this Court has consistently held that the judiciary has the responsibility for defining the contours of the right of action, *see, e.g., Musick*, 508 U.S. at 292-293 ("[t]he federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes"), and demonstrated that it will not defer to the SEC on questions regarding private rights of action under § 10(b). In *Blue Chip Stamps*, 421 U.S. at 738, 743, 746 n.10, for example, the Court emphasized the "judicial role of interpreting" the implied private right of action under § 10(b), and held that the cause of action under § 10(b) was limited to "purchasers" or "sellers" of securities. In so holding, the Court acknowledged that "a great majority of the many commentators on the issue" including the SEC (in an amicus brief), supported a more expansive private liability scheme. The Court described the SEC's views but treated them no differently from the other commentators' opinions, not according the SEC's position any particular deference.

Likewise, in *Ernst & Ernst*, 425 U.S. at 193, 197-198, 207-208, the Court acknowledged the SEC's arguments in an amicus brief in support of permitting a private right of ac-

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tion or to permit agencies to manufacture causes of action. In *Murphy Exploration & Production Co.* v. *Department of Interior*, 252 F.3d 473 (D.C. Cir. 2001), the D.C. Circuit determined that "*Chevron* deference was inappropriate" on the question of what may trigger a statute of limitations on a judicial remedy provided by Congress. *Id.* at 478. The court explained that a "principal reason" for the lack of deference is that the statutory provisions establishing the remedy "do not grant powers to agencies": "Unless the agency is the recipient of congressionally delegated power, there is no reason to defer to its interpretations of the statute that does the delegating." *Id.* at 478-479. The court further remarked that "administrative agencies have no particular expertise" in questions of the scope of judicial authority over private claims. *Id.* at 479; *see also Iverson* v. *City of Boston*, 452 F.3d 94, 100 (1st Cir. 2006) (rejecting the suggestion that an agency regulation may give rise to a private right of action and observing that "the power to create a private cause of action, like the power to create a positive federal law itself, lies exclusively with Congress").

tion under § 10(b) "in the absence of any allegation of 'scienter,'" but rejected the arguments without any suggestion that it might defer to the SEC view. *See also Central Bank*, 511 U.S. at 188-191 (dismissing SEC arguments in support of an implied private right of action over aiding and abetting without discussion of any deference due); *Lampf*, 501 U.S. at 361 (rejecting SEC view regarding statute of limitations for private right of action).[8]

The Court has explicitly rejected deference to the SEC on questions concerning the existence of private rights of action under parallel provisions of the securities laws. In *Piper*, 430 U.S. at 43, the Court declined to create an implied right of action for tender offerors under § 14(e) of the Securities Exchange Act. In so doing, the Court rejected the SEC's support for this right of action, finding that the SEC's view was due no deference: "[T]he narrow legal issue is one peculiarly reserved for judicial resolution, namely whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants." *Id.* at 41 n.27; *see also id.* ("[I]n our prior cases relating to implied causes of action, the Court has understandably not invoked the 'administrative deference' rule, even when the SEC supported the result reached in the particular case."); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 23 (1979) (re-

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[8] This is not to suggest that the Court never affords the SEC's views deference on questions concerning § 10(b) or Rule 10b-5. For example, in *Basic Inc.*, 485 U.S. 224, the Court addressed the materiality requirement of Rule 10b-5. There, the Court explained the SEC's view and stated: "The SEC's insights are helpful, and we accord them due deference." *Id.* at 239 n.16. *Basic* did not address the proposition that the Court determines the existence of private rights of action. Section 10(b) makes certain acts unlawful only to the extent that they violate SEC rules and regulations. Giving "due deference" to "helpful" SEC views on questions of the meaning of certain terms in the Commission's own rules, as the Court did in *Basic*, is not the same as deferring on the question whether there is a private right of action available under the statute; as explained in *Sandoval*, the regulation itself cannot give rise to a cause of action not created by Congress.

jecting SEC views on whether a private right of action should be implied under the Investment Advisers Act).

CONCLUSION

For these reasons, the decision below should be affirmed.

Respectfully submitted.

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AUGUST 2007

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

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September 16, 2009

The Honorable Patrick J. Leahy
Chairman
Committee on the Judiciary
United States Senate
Washington, DC 20510

The Honorable Jeff Sessions
Ranking Member
Committee on the Judiciary
United States Senate
Washington, DC 20510

Dear Chairman Leahy and Ranking Member Sessions:

The U.S. Chamber of Commerce, the world's largest business federation representing more than three million businesses and organizations of every size, sector, and region, is strongly opposed to S. 1551, the "Liability for Aiding and Abetting Securities Violations Act of 2009." Included with this letter is a copy of the Chamber's Supreme Court amicus brief in the *Stoneridge v. Scientific-Atlanta* case.

The Supreme Court in *Stoneridge v. Scientific-Atlanta* refused to permit private securities class actions based on "scheme liability"—a theory of liability that, if adopted, would have dire consequences for investors and the economy. S. 1551 is explicitly designed to overturn *Stoneridge*, as well as a predecessor decision, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* This legislation would allow the securities class action plaintiffs' bar to impose liability under a theory of "guilt by association." The result would be to possibly ensnare in litigation nearly any business that has a commercial relationship with a public company simply alleged to have engaged in fraud. Because securities class actions tend to seek massive damage awards, many companies—even those bearing no culpability whatsoever—would feel compelled to settle rather than going to trial and risk losing a "bet the company" case.

S. 1551 is not needed because genuine bad actors do not receive a free pass under current law. The SEC and the Department of Justice are both able to bring enforcement actions and criminal prosecutions against true "aiders and abettors" of securities violations. Neither the Commission nor DOJ are reticent about exercising this authority. In addition, the SEC has significantly ramped up its enforcement efforts and has returned billions to investors through its Fair Funds program without any diversion of funds to plaintiffs' attorneys, which is unlike what would happen under the private litigation regime in this legislation.

Enacting S. 1551 would only exacerbate a private litigation system that is rife with abuse. For example, two of the most notable securities plaintiffs' lawyers, William Lerach and Mel Weiss, are currently incarcerated in federal prison after pleading guilty to a criminal conspiracy that involved lying to judges and payment of kickbacks to named plaintiffs and experts, a scheme that corrupted the legal system "in the most evil way." Those who stand to benefit from expanded liability the most are plaintiffs' lawyers who understand that more lawsuits mean more fees. Moreover, it must be noted that the securities litigation system is plagued by a "pay to play" culture of corruption in which plaintiffs' law firms ensure their status as lead counsel—which carries the right to the largest share of millions of dollars in attorneys' fees—through contributions to the campaigns of officials who control the public pension funds that often serve as lead plaintiffs in securities class actions.

Accordingly, the Chamber strongly opposes S. 1551 and urges you to oppose this unnecessary and harmful legislation. The Chamber respectfully requests this letter and a copy of the enclosed amicus brief be included in the hearing record for tomorrow's Crime Subcommittee hearing on securities litigation and S. 1551.

Sincerely,

R. Bruce Josten

R. Bruce Josten

Cc: The Members of the Committee on the Judiciary

Enclosure

No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICUS CURIAE*[1]

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. The Chamber's underlying membership includes more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files *amicus curiae* briefs in cases that raise issues of concern to the nation's business community, such as cases involving the federal securities laws, including *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), and *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336 (2005).

"Scheme" liability is nothing but a label in search of a cause of action. In reality, it is aiding and abetting liability disguised behind a new name. The Chamber has a vital interest in the "scheme" liability theory. The "scheme" liability label, which emerged after this Court and Congress rejected aiding and abetting liability in private § 10(b) actions, has been extended to commercial counterparties involved with an issuer merely through a commercial or financial transaction. It has no effective limiting principle, which is reason enough to reject the theory. *Santa Fe Indus.*,

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[1] Pursuant to this Court's Rule 37.6, *amicus curiae* states that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amicus curiae* made a monetary contribution to the preparation or submission of the brief.

Pursuant to Rule 37.3, *amicus curiae* states that petitioner and respondents have consented to the filing of this brief. Petitioner has filed with the Clerk of the Court a letter granting blanket consent to the filing of amicus briefs, and a letter reflecting the consent of respondents to the filing of this brief has been filed with the Clerk.

Inc. v. *Green*, 430 U.S. 462, 478 (1977) (rejecting § 10(b) claims that "could not be easily contained").

"Scheme" liability would put American companies, including the Chamber's members, at two tremendous competitive disadvantages. First, American issuers of securities would have to price their commercial transactions to reflect the substantial added risk of liability for their counterparties. Second, and even more important, to avoid litigation risk, both domestic and foreign companies would have significant incentives to do business with companies listed on foreign exchanges, or with private companies. The Chamber's members would prefer that business choices be based on factors like price, efficiency, quality, and service, rather than litigation risk.

INTRODUCTION AND SUMMARY OF ARGUMENT

Although expanding the implied § 10(b) action to cover "scheme" liability suffers from an aggregation of flaws, this brief focuses on two points of particular concern to the business community. First, the standard of liability under § 10(b) should be workable, predictable, and consistently applied so that businesses can plan their affairs with reasonable certainty. "Scheme" liability is wholly unworkable in implied § 10(b) actions. Accordingly, the Chamber submits that the proper standard is as follows: a commercial counterparty is liable under § 10(b) for deceptive "conduct" only when it has a duty to disclose to the issuer's shareholders. This standard follows this Court's precedent and is based on well-understood, time-honored concepts that lower courts can readily apply in a predictable manner.

Second, in order to provide much-needed guidance to lower courts and the business community, the Court should not merely decide the narrow question of the proper definition of the term "deceptive," but instead should recognize that the "scheme" liability theory would fundamentally alter many traditional elements of the implied cause of action in ways that contradict both the statute and this Court's precedent. Implied causes of action should not be interpreted in ways that contradict or nullify legislative decisions. The expansion of the § 10(b) implied cause of action through "scheme" liability would both override limits on the express causes of action that Congress created and nullify Congress's repeated decisions that only the SEC can sue for the conduct covered by "scheme" liability.

Moreover, "scheme" liability contradicts *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), on reliance and contradicts the Private Securities Litigation Reform Act of 1995 ("PSLRA") on loss causation. These doctrines are essential means of providing reasonable limitations on liability and the Court should make clear that the "scheme" liability theory is simply untenable because it eviscerates such limitations.

ARGUMENT

I. "SCHEME" LIABILITY IS IMPROPERLY DERIVATIVE AND UNWORKABLE.

The question before this Court is whether to recognize "scheme" liability as a legitimate implied private cause of action under § 10(b). The question presented in the *amici* brief of 32 state attorneys general offers a representative definition of "scheme" liability as a theory, *i.e.*,

> *shareholders can recover damages* from actors who, acting with the requisite intent to deceive, actively engage in conduct that has the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud the securities market, *even when the actor has made no false statement or omission and otherwise owes no fiduciary duty to the shareholders.*

Brief of Ohio, et al. ("Ohio Br."), at iii (emphasis added).

Petitioner, its amici, and lower courts have proposed an array of "scheme" liability standards, all of which share three common threads: the use of verbs that are synonymous with aiding and abetting or conspiracy; the intervening steps between the defendant's conduct and the issuer's statements that harmed the plaintiff; and the complete absence of a workable limiting principle. By contrast, the test this Court has repeatedly announced for § 10(b) liability for conduct—the existence of a duty to disclose by the specific defendant—has well-established contours and a fixed relationship to the existing elements of the private right of action.

A. Like Aiding-And-Abetting, "Scheme" Liability Is Derivative Of The Issuer's Conduct.

Petitioner asks this Court to find liability where defendants

> engaged in their own deceptive conduct in transactions with a public corporation *for the purpose and effect* of *creating* a false appearance of material fact that *enabled* the publication of artificially inflated *financial statements by the public corporation.*

Pet. Br. at *i* (emphases added). "Scheme" liability for a non-speaking defendant, like aiding-and-abetting, is purely derivative from the issuer's statements. Consider the words used by petitioner and *amici* to describe the conduct giving rise to "scheme" liability: "causing false financial statements to be published," *id.* at 22; *see also id.* at 30; Ark. Br. at 13, 14, "furthering the fraudulent scheme," Pet. Br. at 14, "participation" in a "scheme," *id.* at 14, 15, and "conspir[ing]" or "inducing" wrongdoing by the issuer, Prof. Adams Br. at 11, 17. These are simply ways of saying "aiding and abetting" or "conspiring" without using those words. *See Central Bank*, 511 U.S. at 181, 184 ("substantial assistance" or "knowing participation"); 15 U.S.C. § 78t(e). *See also Salinas* v. *United States*, 522 U.S. 52, 65 (1997) (conspiracy requires "adopt[ing] the goal of furthering or facilitating the criminal endeavor"). "Allegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms . . . all fall within the prohibitive bar of *Central Bank.*" *Shapiro* v. *Cantor*, 123 F.3d 717, 720 (2d Cir. 1997). If anything, "scheme" liability is more expansive than aiding and abetting. Mere "participation" in a scheme that has some "effect" is easier to plead and prove than "substantial assistance."

Petitioner and its *amici* effectively admit the derivative essence of "scheme" liability. They admit that reliance and causation are satisfied in "scheme" cases not by reference to the conduct of a commercial counterparty such as respondents—whose conduct was unknown to the market—but rather because the issuer's "financial statements caused the price of [its] stock to be inflated and the purchasers of the stock were accordingly damaged." Pet. Br. at 38. *See also* Regents Br. at 16 (seeking damages for "falsifying the financial statements of a public company"). Decisions adopting "scheme" liability also have necessarily premised reliance and causation on the statements of the issuer rather than the unreported conduct of the counterparty. *See, e.g.*, *Simpson* v. *AOL TimeWarner Inc.*, 452 F.3d 1040, 1050-52 (9th Cir. 2006) ("the scheme [to defraud would not] be complete until the misleading information is disseminated into the securities market"), *petition for cert. filed*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 509-10 (S.D.N.Y. 2005) (purpose and effect of scheme was "to allow Parmalat to make such misrepresentations").

The very "purpose and effect" test is derivative. To avoid liability for acting recklessly, the counterparty is expected to investigate the "purpose" and accounting policies of the issuer. Moreover, the "effect" also depends on further action by an issuer: if the issuer has a change of heart and accounts correctly for the transaction, the conduct and intent of the commercial counterparty are precisely the same—but there would be no improper effect and thus no "scheme" liability.

B. Scheme Liability Is Unworkable And Uncertain.

Central Bank held that liability under § 10(b) is "'an area that demands certainty and predictability.'" 511 U.S. at 188 (quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988)). "Scheme" liability, however, would create a vague and unprincipled standard of private civil liability easily manipulated by plaintiffs' counsel with the benefit of hindsight. Every case of "scheme" liability would turn on post-hoc allegations of scienter, here called "purpose." As *Central Bank* held, the uncertainty created when a claim can be based entirely on alleged scienter drives up the costs of numerous legitimate transactions, and eliminates some altogether. *See* 511 U.S. at 188-89. Courts that have embraced "scheme" liability have inevitably allowed claims based on transactions that may well be legitimate. *See*, *e.g.*, *Parmalat*, 376 F. Supp. 2d at 504 n.160 (deceptive act allegation sustained even though bank merely may have accepted "valid receivables"); *In re Parmalat Secs. Litig.*, 414 F. Supp. 2d 428, 435 n.31 (S.D.N.Y. 2006) (deceptive act allegation sustained even though bank legitimately may have been exposed to "significant risk"). "Scheme" liability thus fosters judicial "decisions 'made on an ad hoc basis, offering little predictive value.'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652).

The goals of the securities laws are ill served when large settlements are paid because of uncertainty. Rather, businesses need clear and understandable rules to follow. *See Pinter*, 486 U.S. at 654 n.29 (rejecting liability for "those who are only tangentially involved with" a securities transaction, because if "the test produces unpredictable results, it risks over-deterring" lawful activities). "Scheme" liability is the antithesis of certainty. Among other things, a counterparty has no ability to audit or dictate accounting decisions made by the issuer's management and auditors. Moreover, business transactions are often subject to complex, changing, or inherently subjective accounting rules.[2] In hindsight, it is easy to use labels such as "round-tripping" to suggest that a transaction had no proper purpose, even though "[t]he mere existence of reciprocal dealing does not suggest 'round-tripping.' Indeed, it is a common, legitimate, and perhaps useful business practice . . . ." *Teachers Ret. Sys.* v. *Hunter*, 477 F.3d 162, 178 (4th Cir. 2007). *See also Tellabs*, 127 S. Ct. at 2511 (noting distinction between legitimate and illegitimate forms of "channel stuffing").[3]

Unlike a company's own securities disclosures, even large commercial transactions may often be negotiated by personnel who are not versed in accounting principles. *See Nordstrom, Inc.* v. *Chubb & Son, Inc.*, 54 F.3d 1424, 1435-36 (9th Cir. 1995) (distinguishing between "directors and officers, who – unlike the public relations or personnel departments – are necessarily aware of the requirements of SEC regulations and state law and the 'danger[s] of misleading buyers and sellers'"). Requiring a business to monitor its counterparty's accounting in every commercial transaction will greatly expand costs and litigation risk. "'The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.'" *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 748 (1975) (quoting *Ultramares Corp.* v. *Touche*, 174 N.E. 441, 444 (N.Y. 1931) (Cardozo, J.)).

As Treasury Secretary Paulson testified, private civil "scheme" liability "would create a very uncertain legal environment for all the individuals and all the public

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[2] "GAAP is not a set of rigid rules ensuring identical treatment of identical transactions, but rather characterizes the range of reasonable alternatives that management can use." *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1421 n.10 (3d Cir. 1997) (Alito, J.).

[3] Similarly, "certain contracts may be legitimately backdated." *SEC* v. *Solucorp Indus., Ltd.*, 197 F. Supp. 2d 4, 11 (S.D.N.Y. 2002).

companies that deal with public companies" and would be "ultimately harmful to our economy." *The State of the International Financial Services System: Hearing Before the H. Fin. Servs. Comm.*, 110th Cong. (2007), *reprinted by* Fed. News Serv. *See also* Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, *Report and Recommendations* 90-91 (Mar. 2007) ("*Final Report*") (opposing "scheme" liability).[4] In particular, foreign companies would have a strong reason not to do business with American public companies. As *The Economist* stated: "An unfavorable ruling [in *Stoneridge*] would send a chill through boardrooms, and not only in America . . . [because] it would no longer even be necessary to issue shares in the United States to incur securities liability . . . . Any firm, anywhere, doing business with American companies would have to live with the risk that the transaction could later be portrayed as fraudulent or deceptive. And painting such pictures is what trial lawyers do best." *The Stoneridge Showdown*, Economist, Jun. 14, 2007, at 84.[5]

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[4] Indeed, two current SEC Commissioners have opposed "scheme" liability in public testimony because it has proved unworkable, creates "a real danger in chilling ongoing transactions," and will harm the "competitiveness of our economy." *A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007), *reprinted by* Fed. News Serv. (Statements of Paul S. Atkins and Kathleen L. Casey, Commissioners of the Securities Exchange Commission).

[5] *See also* Professor Rüdiger von Rosen, *Transatlantic Relations in Danger*, Boersenzeitung, June 28, 2007, at 14 (The President of the Deutsches Aktieninstitut, a business organization of German companies, explaining that "legal certainty and forseeability in transatlantic business could suffer a severe setback if [Petitioners are] successful," and could lead to a "wave of lawsuits" and "incalculable risks of class actions in the United States" that would require German companies doing business with listed companies in the U.S. "to examine the possibility of a false booking in every transaction, which is practically impossible." This could result in "transatlantic business relations [being] burdened by significant additional

C. Deceptive Conduct By A Commercial Counterparty Requires A Duty To Disclose.

As we have shown, "scheme" liability attempts to hold one defendant that did not speak to investors, often a commercial counterparty, liable for the issuer's misstatement. *Supra*, at 4-5. A well-developed body of law already exists, however, under which a defendant who engages in conduct, but neither makes a false or misleading statement to the market nor engages in market manipulation, can be sued for conduct "*only* where [a] duty to disclose arises from [a] specific relationship between two parties." *Central Bank*, 511 U.S. at

costs from misunderstood investor protection."); Astrid Maier, *German Companies Threatened By New Risks in the United States*, Fin. Times Deutchland, June 8, 2007, at 10m ("there will be a whole new door opened for damages actions" that "'would mean that each and every engagement must be thoroughly examined' . . . In particular small and medium sized companies would be burdened with significant legal costs"); *Interim Report of the Committee on Capital Markets Regulation* 11, 71 (Nov. 30, 2006) ("*Interim Report*") ("Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market."); Michael Bloomberg & Charles Schumer, *Sustaining New York's and the US' Global Financial Services Leadership* ii (Jan. 2007) ("the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation" while "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors"); Jonathan Macey, *What Sarbox Wrought*, Wall St. J., Apr. 7, 2007, at A9 ("All of a sudden it is no longer fashionable to be a U.S. public company: It's for suckers who can't access the piles of sophisticated 'global' capital available elsewhere. . . . If the U.S. is to regain its former position in the world capital market, much more will have to be done. Massive litigation risk remains . . . .") Ian Swanson, *Foreign Executives Press For Reform Of Litigation in United States*, The Hill, May 17, 2007, at 11; ("litigation is a greater disincentive to doing business in the U.S. than fears that a protectionist Congress might impose new barriers to foreign trade and investment"); Alan Beattie, *London Named Top Financial Centre*, Fin. Times, June 12, 2007, at 6 (the United States has been disadvantaged because of its "litigious and apparently arbitrary culture of regulation and policy").

180 (emphasis added) (citing *Chiarella* v. *United States*, 445 U.S. 222, 228 (1980)). *See Chiarella*, 445 U.S. at 230 (liability for nondisclosure "is premised upon *a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction.*") (emphasis added); *id.* at 233 ("Formulation of such a broad duty, which *departs radically from the established doctrine that duty arises from a specific relationship between two parties*, should not be undertaken absent some explicit evidence of congressional intent") (emphasis added).

Unlike "scheme" liability, a duty to disclose is individual, not derivative, and provides an objective, workable, bright-line standard that looks at the relationship between the parties rather than the defendant's subjective intent. *See, e.g., id.* at 232-33 ("No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger . . . [to] the sellers."). Duty to disclose is a legal question, and there is well-developed law to guide businesses concerning when such a duty exists. *Id.* at 227 (duty to disclose standard "is not a novel twist of the law").

Petitioner and its *amici* incorrectly argue that there is no requirement of a duty to disclose when a non-speaking defendant engages in affirmative "conduct." Pet. Br. at 28; Brief of Change to Win & the CtW Inv. Group ("CTW Br."), at 16, 18-23; Brief of N. Am. Sec. Adm'rs Ass'n, Inc. ("NASAA Br."), at 13-17 & n.2. This argument has already been rejected by *Central Bank* and this Court's insider trading cases. In *Central Bank*, the Tenth Circuit had held that "the lack of a duty to disclose is not dispositive in this case." *First Interstate Bank of Denver, N.A.* v. *Pring*, 969 F.2d 891, 901 (10th Cir. 1992). The plaintiffs in *Central Bank* argued to this Court that the defendant could be liable without "a preexisting duty to the victims of the fraud" because of "its participation in a concealed side agreement with the developer" to use an outdated appraisal in bringing a new bond offering to market. Brief for Respondents, No. 92-854, *available at* 1993 WL 407323, at *1-2, 7-8. Likewise, the SEC, as *amicus* in support of the *Central Bank* plaintiffs, said that the defendant engaged in "affirmative action, not merely silence or inaction." Brief for the United States as *Amicus Curiae*, No. 92-854 *available at* 1992 WL 12006433, at *5. This Court reversed, holding that "[a]s in earlier cases considering *conduct prohibited by § 10(b)*, we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Central Bank*, 511 U.S. at 177 (emphasis added).

Likewise in *O'Hagan*, this Court made clear that *conduct* by a defendant who did not speak to the market—trading on inside information—was "deceptive" under § 10(b) only when that defendant breached a duty to disclose. *See United States* v. *O'Hagan*, 521 U.S. 642, 660 (1997) ("[I]t was O'Hagan's failure to disclose his personal trading to [his client and law firm], *in breach of his duty to do so*, that made his *conduct* 'deceptive' within the meaning of § 10(b).") (emphasis added; alterations in original omitted).[6]

Petitioner incorrectly argues that a duty to disclose requirement would exclude "conduct" from § 10(b) and

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[6] This Court also has held that common law concealment and suppression require a duty to disclose. *Strong* v. *Repide*, 213 U.S. 419, 430 (1909) ("concealment is equivalent to misrepresentation" by insider purchasing stock from minority shareholder where "it was the *duty* of the party who obtained the consent, acting in good faith, *to have disclosed* the facts which he concealed") (emphasis added), *cited in Chiarella*, 445 U.S. at 228 n.10; *Stewart* v. *Wyoming Cattle-Ranche Co.*, 128 U.S. 383, 388 (1888) ("if, with intent to deceive, either party to a contract of sale conceals or suppresses a material fact which he is in good faith *bound to disclose*, this is evidence of and equivalent to a false representation") (emphasis added).

render subsections (a) and (c) of Rule 10b-5 a nullity. *See, e.g.*, Pet. Br. at 24. Liability when a silent defendant breaches a duty to disclose does not arise under Rule 10b-5(b) because that subpart addresses only speaking defendants. Specifically, Rule 10b-5(b) applies only when a defendant "make[s] any untrue *statement* of material fact" and "omit[s] to state a material fact necessary in order to make *the statements made*, in light of the circumstances under which they were made, not misleading," *i.e.*, half-truths. (Emphasis added.) In contrast, Rule 10b-5(a) and (c) apply to at least four kinds of actionable conduct by non-speaking defendants—demonstrative conduct (*e.g.*, nodding assent at a press conference), omitting to disclose conduct by a party with a duty to disclose, insider trading, and market manipulation. Indeed, this Court's cases dealing with breach of a duty to disclose and insider trading have frequently arisen under Rule 10b-5(a) and (c). *See, e.g., O'Hagan*, 521 U.S. at 651; *SEC* v. *Zandford*, 535 U.S. 813, 819 (2002); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 152-53 (1972).

Section 10(b) does not proscribe deceptive conduct in the abstract, however. To "use or employ" a deceptive device within the meaning of § 10(b), a defendant must actually mislead someone. *See O'Hagan*, 521 U.S. at 655, 659 n.9, 660. In a private civil case, that someone must be the plaintiff. Private civil liability statutes, including the implied cause of action under § 10(b), incorporate the general principle that a plaintiff must show not merely a violation of law, but breach of a legal duty owed *to that specific plaintiff*. *See, e.g., Bangor Punta Operations, Inc.* v. *Bangor & Aroostook R.R.*, 417 U.S. 703, 716 n.13 (1974) ("the recovery provided is intended to compensate, not the public generally, but those who have been injured by a breach of *duty owed to them*") (emphasis added); *Foss* v. *Bear, Stearns & Co.*, 394 F.3d 540, 541 (7th Cir. 2005) (Easterbrook, J.) (§ 10(b) private civil claim requires deceit against the plaintiff); *Moss* v. *Morgan Stanley, Inc.*, 719 F.2d 5, 13, 16 (2d Cir. 1983) (although investment bank employee was criminally convicted for § 10(b) insider trading because of breach of duty to his employer and its client, a tender offeror, shareholders in target company had no § 10(b) claim because "'[t]here is no "duty in the air" to which any plaintiff can attach his claim.'") (citation omitted); *see also Cipollone* v. *Liggett Group, Inc.*, 505 U.S. 504, 522 (1992) (plurality opinion) (citing *Black's Law Dictionary* 1489 (6th ed. 1990) as "defining 'tort' as 'always [involving] a violation of some duty *owing to plaintiff*'") (emphasis added; alteration in original).

Commercial counterparties do not have or breach any duty to the issuer's investors. Any deception used or employed against those shareholders comes from the accounting of the issuer (which has a duty to disclose), not from the transaction of the counterparty (which does not). If Charter's accounting had expensed rather than capitalized the increase in the prices for set-top boxes, there would be no alleged deception. A commercial counterparty has no relationship with the issuer's investors and thus no duty to disclose. In those circumstances, there is no implied private civil liability under § 10(b).

II. THE IMPLIED CAUSE OF ACTION UNDER § 10(b) SHOULD NOT BE EXTENDED TO ENCOMPASS "SCHEME" LIABILITY.

The Petitioner's question presented broadly asks whether *Central Bank* "forecloses claims under § 10(b)" and merely assumes that "Respondents engaged in their own deceptive conduct." Pet. Br. at *i*. Indeed, Petitioner expressly asks the Court to decide whether "scheme" liability satisfies the elements of reliance and causation necessary for private civil claims under § 10(b). *Id.* at 37-40. The Court should address the broader question of whether "scheme" liability is a basis for primary liability under the § 10(b) implied cause of action, and not only whether a commercial counterparty's participation in a commercial transaction could constitute "deceptive" conduct in the abstract. Rejection of the broader argument is vital to the competitiveness of American businesses. *See supra*, at 6-8. *Central Bank* itself addressed reliance, which is an element of only the implied cause of action. *See* 511 U.S. at 180.[7]

Of course, if the statutory language precludes "scheme" liability, that is the end of the matter. But when the statutory language is not dispositive, the Court should limit the implied § 10(b) action to ensure that this "judicial oak" does not grow even further afield from the "legislative acorn." *Blue Chip*, 421 U.S. at 737; *see also Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1102 (1991) ("the breadth of the [implied private] right once recognized should not, as a general matter, grow beyond the scope congressionally intended").[8] As *Blue Chip* held: "We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited . . . ." 421 U.S. at 749. Thus, even assuming that the SEC or Justice Department could bring a claim that a "sham" transaction by a commercial counterparty was a "deceptive" act, § 10(b) has no language suggesting that private plaintiffs could sue that commercial counterparty. *Id.* ("No language in either of [§ 10(b) or Rule 10b-5] speaks at all to the contours of a private cause of action . . . ."); *see Lampf, Pleva, Lipkin, Prupis & Pettigrow* v. *Gilbertson*, 501 U.S. 350, 359 (1991) ("We have made no pretense that it was Congress's design to provide the remedy afforded.").

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[7] The reliance holding in *Central Bank* reflects "a longstanding limitation on private § 10(b) suits" that does not apply to "criminal liability." *O'Hagan*, 521 U.S. at 664. Similarly, reliance need not be proven in SEC administrative actions under § 10(b). *See, e.g., SEC* v. *Credit Bancorp, Ltd.*, 195 F. Supp. 2d 475, 490-91 (S.D.N.Y. 2002).

[8] *Cf.* 501 U.S. at 1110 (Scalia, J., concurring) (when "the federal cause of action at issue here was never enacted by Congress . . . the more narrow we make it (within the bounds of rationality) the more faithful we are to our task") (citation omitted).

Moreover, this Court's approach is "to construe statutes, not isolated provisions." *Gustafson* v. *Alloyd Co.*, 513 U.S. 561, 568 (1995). In particular, the Court has cabined the implied § 10(b) cause of action so that it does not render superfluous the restrictions in other provisions of the 1933 and 1934 Acts. *See, e.g., Central Bank*, 511 U.S. at 178-79 ("we use the express causes of action in the Securities Acts as the primary model for the § 10(b) action"); *id.* at 182-83; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 206-10 (1976); *Blue Chip*, 421 U.S. at 736. Examination of the provisions of the 1933 and 1934 Acts shows that the § 10(b) implied action should not be extended to create private civil claims for "scheme" liability. First, it would improperly override the limits on the express civil claims created by Congress. Second, it would undo Congressional decisions that only the SEC and the Justice Department may sue defendants for participating in a scheme. "The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere." *Central Bank*, 511 U.S. at 184. Third, "scheme" liability does not satisfy the established reliance and loss causation elements necessary for primary liability in a § 10(b) private cause of action.

A. "Scheme" Liability Would Nullify Statutory Restrictions On The Express Private Rights Of Action In The 1933 And 1934 Acts.

One statutory provision should not be interpreted to render another provision a "practical nullity." *United Sav. Ass'n* v. *Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 375 (1988). Thus, this Court will not "expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action." *Central Bank*, 511 U.S. at 180; *see also Virginia Bankshares*, 501 U.S. at 1104 ("we would have trouble inferring any congressional urgency to depend on implied private actions to deter violations of § 14(a), when Congress expressly provided private rights of action in

§§ 9(e), 16(b), and 18(a) of the same Act"). Private civil "scheme" liability under § 10(b) violates this principle.

1. § **18(a):** Congress addressed in § 18(a) of the 1934 Act, not § 10(b), when a silent defendant should face private civil liability based on another defendant's misstatement or omission. Ignoring § 18(a), however, the proponents of "scheme" liability seek to imply into § 10(b) a cause of action that holds one defendant, usually a commercial counterparty, liable because another defendant, usually the issuer, makes a misstatement or material omission to the market.

Section 18(a) imposes liability on a defendant who "shall make *or cause to be made*" a statement that is "false or misleading with respect to any material fact" in "any application, report or document filed" pursuant to the 1934 Act, including the financial statements at issue here. 15 U.S.C. § 78r(a). In contrast, in § 10(b), Congress did not prohibit "causing" a deceptive device—*e.g.*, causing an issuer's misrepresentation in its financial statements—but instead stopped at the defendant who actually "use[s] or employ[s]" the deceptive device in connection with a purchase or sale of securities.

Although § 18(a) reaches a broader array of defendants than § 10(b), Congress imposed a critical limitation to preclude open-ended damages awards to the market as a whole: the plaintiff must have actually read and relied upon the misstatement. Section 18(a) limits potential plaintiffs to "any person . . . who, *in reliance upon such statement*, shall have purchased or sold a security at a price which was affected by such statement, for damages *caused by such reliance*." *Id.* (emphasis added). Because the statute expressly refers to the plaintiff's reliance on the specific statement – in addition to the requirement of an effect on the market price – it can be satisfied only by proof of individual reliance, rather than by the fraud-on-the-market presumption. *See, e.g., In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d

256, 283-84 (3d Cir. 2006); *Heit* v. *Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968).[9]

By contrast, in private § 10(b) actions, the reliance requirement is not a statutory creation but rather was judicially implied to delimit the implied cause of action. *See Basic, Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988). Allowing fraud on the market to satisfy reliance in a § 10(b) action does not render § 18(a) a practical nullity *only* because the class of defendants that can be sued in a § 10(b) private civil action is narrower than the group that can be sued in the express § 18(a) action. "Scheme" liability obliterates that essential limitation. No private plaintiff would sue a secondary actor under § 18(a), which requires actual reliance, if "scheme" liability allows a § 10(b) claim against the same defendant for causing a misstatement *without* proving actual reliance. Indeed, this is why petitioner, like all other plaintiffs alleging scheme liability, did not sue under § 18(a), even though petitioner describes "[t]he scheme to defraud here" as "causing false financial statements to be published." Pet. Br. 21-22. That fact speaks volumes about the improper nullifying impact petitioner's § 10(b) theory would have on § 18(a). *See United Sav.*, 484 U.S. at 375.

2. § 9(e): Like § 18(a), § 9(e) reaches beyond defendants who use or employ the specified unlawful devices. Section 9(a)-(c) prohibits certain enumerated forms of market manipulation, and § 9(a)(4) also prohibits false or misleading statements by a dealer, broker, "or the person selling or

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[9] An earlier proposed version of § 18(a) required only that the market price of the security be affected by the misstatement. That provision was amended to add the additional requirement of "eyeball" reliance in response to criticism of the potentially sweeping liabilities under the earlier proposal. *See* Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. Rev. 435, 464-65 & nn.191 & 192 (1984). *Accord In re MDC Holdings Sec. Litig.*, 754 F. Supp. 785, 798 (S.D. Cal. 1990); *Hoover* v. *Allen*, 241 F. Supp. 213, 221-23 (S.D.N.Y. 1965).

offering [a security] for sale" made "for the purpose of inducing the purchase or sale" of that security. 15 U.S.C. § 78i(a)-(c). Unlike § 10(b), § 9(e) creates additional express private civil liability for "[a]ny person who *willfully participates in* any act or transaction" prohibited by §§ 9(a)-(c). 15 U.S.C. § 78i(e) (emphasis added). As *Pinter*, 486 U.S. at 650 n.26, held, § 9(e) shows "Congress knew of the collateral participation concept" and thus that concept should not be implied into other civil liability provisions. Nonetheless, even the class of defendants under § 9(e) does not include "one who aids or abets a violation." *See Central Bank*, 511 U.S. at 179.

"Scheme liability" would improperly render important restrictions on the express § 9(e) action meaningless, by creating instead a more easily satisfied § 10(b) implied action. For example, § 9 is limited to specified manipulative practices and a narrow class of false or misleading statements made directly between buyers and sellers of securities, *see, e.g., Robbins* v. *Banner Indus., Inc.*, 285 F. Supp. 758, 761 (S.D.N.Y. 1966), for the specific "purpose of inducing the purchase or sale" of the specific security purchased or sold by the defendant. 15 U.S.C. § 78i(a)(4). Thus, unlike § 10(b), a purchaser in the secondary market could not sue even an issuer under § 9 over its periodic financial reports. *See Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 788 (2d Cir. 1951) (§ 9(a)(4) "impose[s] restrictions somewhat like those imposed on a suit under § 11 of the 1933 Act").

3. §§ **11 and 12 of the 1933 Act:** Section 11 of the 1933 Act creates a claim against only enumerated defendants – directors of the issuer, underwriters, and those who sign or consent to be named in a registration statement – for misrepresentations or omissions in a registration statement for an offering of new securities. *See* 15 U.S.C. § 77k(a). It does not apply to others who cause or assist misstatements by the enumerated defendants. *See Central Bank*, 511 U.S. at 179.

Sections 12(a)(1) and 12(a)(2) claims are directed against anyone who "[o]ffers or sells a security . . . by means of a prospectus or oral communication" that is false or misleading, or in violation of registration requirements, to be sued by "the person purchasing such security from him." 15 U.S.C. § 77*l*(a)(1)-(2). The class of defendants is again limited, to those in privity with the plaintiff or who directly solicit the plaintiff's purchase at least in part for their own financial gain. This Court rejected extending § 12 liability to someone "'whose participation in the buy-sell [securities] transaction is a substantial factor in causing the transaction to take place.'" *Pinter*, 486 U.S. at 649; *see Central Bank*, 511 U.S. at 179. An implied cause of action for "scheme" liability under § 10(b) against companies engaged in commercial transactions with the issuer or seller would undo Congress's policy choices limiting §§ 11 and 12 claims.[10]

B. "Scheme" Liability Would Nullify Statutory Provisions Intended To Be Enforceable Only By The Government.

In stark contrast, other provisions of the 1933 and 1934 Acts allow *only* the SEC and the Justice Department, *not* private litigants, to sue the very defendants targeted by private "scheme" liability. Petitioner's argument would obliterate these policy decisions made by Congress.

[10] *Herman & MacLean* v. *Huddleston*, 459 U.S. 375 (1983), does not suggest otherwise. That case involved a § 10(b) claim against an accounting firm for its own allegedly false statements. *See id.* at 377. In a footnote, dictum suggests that § 10(b) may apply to "*certain* individuals who play a part in *preparing* the registration statement." *Id.* at 386 n.22 (emphases added). A person that plays a "part in preparing" a false registration statement may arguably be "using or employing" that false statement under § 10(b). But commercial counterparties play no "part in *preparing*" the issuer's financial statements, and that is not the theory of "scheme" liability. Rather, "scheme" liability rests on the assertion that the implied § 10(b) action extends to the commercial counterparty's undisclosed transaction itself. Nothing in *Herman & MacLean* remotely supports that.

1. Provisions Of The Original 1933 And 1934 Acts: When Congress wanted to create liability for employing fraudulent "schemes," it did so expressly. Section 17(a) of the 1933 Act thus renders it unlawful "to employ any device, *scheme*, or artifice to defraud, or . . . to engage in any *transaction*, practice, or *course of business* which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a)(1), (3) (emphasis added). Thus, unlike § 10(b), subparts (1) and (3) of § 17(a) expressly cover defendants who employ a scheme or engage in a course of business, rather than use or employ a deceptive device itself.[11]

Section 17(a) reaches any sale in the primary and secondary markets. *See Gustafson*, 513 U.S. at 577-78; *United States* v. *Naftalin*, 441 U.S. 768, 777-78 (1979). The SEC has regularly used § 17(a) against secondary actors, *see, e.g.*,

[11] It is particularly inappropriate to construe § 10(b) or Rule 10b-5 as if § 10(b) had used language included in § 17(a) but *omitted* from § 10(b). *See Central Bank*, 511 U.S. at 179-80, 184. The reach of Rule 10b-5 is limited by § 10(b). *See, e.g., Santa Fe Indus.*, 430 U.S. at 473-74 (a "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") (emphasis added); *Hochfelder*, 425 U.S. at 213-14 (Rule 10b-5's "scope cannot exceed the power granted the [SEC] by Congress under § 10(b)"). This limit applies even when Rule 10b-5 uses the same language as § 17(a). *Compare Aaron* v. *SEC*, 446 U.S. 680, 695-97 (1980) (scienter not required under §§ 17(a)(2) & (3)), *with Hochfelder*, 425 U.S. at 212-14 (scienter required for all § 10(b) actions despite use of same language in Rule 10b-5(b) & (c) as in §§ 17(a)(2) & (3)). Moreover, the administrative history of Rule 10b-5 shows that it was promulgated merely to clarify that the SEC could sue defrauding purchasers in addition to defrauding sellers of stock. *See Hochfelder*, 425 U.S. at 212 n.32; *Blue Chip Stamps*, 421 U.S. at 766-67 (Blackmun, J., dissenting); Milton V. Freeman, *Administrative Procedures*, 22 Bus. Law. 891, 922 (1967); Milton V. Freeman, *Foreword*, 61 Fordham L. Rev. S1, S1-S2 (1993). There was no intent to create a private cause of action, much less one against secondary actors. *See Hochfelder*, 425 U.S. at 196 ("there is no indication that Congress or the Commission when adopting Rule 10b-5, contemplated such a remedy").

Weiss v. *SEC*, 468 F.3d 849, 855-56 (D.C. Cir. 2006), and against fraudulent schemes. *See, e.g., In re Schmidt*, Rel. No. 8061, 2002 WL 89028, at *7-8 (S.E.C. Jan. 24, 2002).

Most important for this case, § 17(a) does *not* create a private right of action. *See, e.g., Finkel* v. *Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992) (citing cases). If Congress wanted private civil claims for "scheme" liability, it would have provided an express cause of action for § 17(a) claims, just as it did for the express but narrower §§ 11 and 12 claims. It did not. Instead, § 17(a)'s sweeping prohibitions are bounded by the SEC's and the Justice Department's sound prosecutorial discretion, which ensures a focus on genuinely serious wrongdoing and the public interest. This is in marked contrast to the pursuit of private remedies, where the private plaintiffs' bar has a powerful economic incentive to sue everyone. The detrimental effect of those incentives on the competitiveness of American business is obvious: in the last decade, even *after* the PSLRA, 2,465 issuers have been named as defendants in securities fraud class actions out of approximately 6000 companies listed on the major U.S. exchanges. *See Final Report*, at 30. "Scheme" liability would cause those already astounding numbers to multiply, given that all companies do business with other companies.[12]

[12] Like § 17(a), other provisions of the 1933 and 1934 Acts also expressly authorize the government, but *not* private civil plaintiffs, to pursue a variety of secondary actors. The 1934 Act grants the SEC express statutory authority to pursue registered broker-dealers and their "associated persons" who "willfully aided, abetted, counseled, commanded, induced, or procured" violations of the securities laws. 15 U.S.C. §§ 78o(b)(4)(E), 78u-2(a)(2). *See also Central Bank*, 511 U.S. at 183. The SEC also can sue ongoing and future violators of the securities laws "and any other person that is, was, or would be *a cause* of the violation, due to an act or omission the person knew or should have known would *contribute* to such violation." 15 U.S.C. § 78u-3(a) (emphasis added). The SEC and Justice Department also can pursue those who "made or caused to be made" false statements in required filings or

2. § **20(e):** In the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress rejected proposals to overrule *Central Bank* and expand the scope of private civil liability under § 10(b) to secondary actors. Instead, in enacting § 20(e) of the 1934 Act, 15 U.S.C. § 78t(e), Congress expressly provided that *only* in actions brought by the SEC, "any person who knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." Thus, Congress gave the SEC, but *not* private plaintiffs, an express claim for conduct ("substantial assistance") against defendants who had no duty to disclose.

This congressional decision has only one of two meanings. Either Congress chose to ratify the *Central Bank* holding, *supra*, at 9-11, that *private* plaintiffs could not sue defendants under § 10(b) for conduct when those defendants had no duty to disclose. Or, as petitioner and its amici would have it, Congress believed that what was called "aiding-and-abetting" conduct before *Central Bank* would be called "primary" conduct thereafter, so that there was no need to overrule *Central Bank* for private plaintiffs. The latter view is nonsensical and contradicts the PSLRA's drafting history.

If the scope of primary liability under § 10(b) were as broad as petitioner contends, then § 20(e) would be at best surplusage. The SEC would always sue for "scheme" liability under § 10(b) because § 20(e) has additional requirements of "knowingly providing substantial assistance."

Moreover, as the Senate Report states, Congress made a deliberate policy decision to deny private plaintiffs the authority to bring suits for conduct against secondary actors who had no duty to disclose because "amending the 1934 Act

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broker-dealer registrations. *See* 15 U.S.C. §§ 78o(b)(4)(A), 78u-2(a)(3), 78ff(a). None of these provisions creates a private right of action.

to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to [the] goal of reducing meritless securities litigation." S. Rep. No. 104-98, at 19 (1995). There is no hint that the same claims could proceed simply by relabelling them as claims for primary conduct. To the contrary, in the PSLRA, Congress sought to avoid the kinds of chilling effects caused by litigation risk that "scheme" liability claims in private class actions would create. *See* H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets."); *see also* 143 Cong. Rec. S10475, S10477 (daily ed. Oct. 7, 1997) ("if our markets are to remain ahead of those in London, Frankfurt, Tokyo, or Hong Kong, we must create uniformity and certainty"); *supra*, at 6-8.

More generally, Congress is presumed to know the law when it legislates. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 379 (1982). Thus, Congress knows that "[a]s a general rule, the principle of *stare decisis* directs [this Court] to adhere not only to the holdings of [its] prior cases, but also their explications of the governing rules of law." *County of Allegheny* v. *ACLU*, 492 U.S. 573, 668 (1989) (Kennedy, J., concurring); *see also Carey* v. *Musladin*, 127 S. Ct. 649, 655 (2006) (Stevens, J., concurring) (*stare decisis* includes "explanatory language" for the Court's ruling even if "such guidance . . . may not have been strictly necessary as an explanation of the Court's specific holding").

Central Bank explicated why aiding-and-abetting was inconsistent with the necessary elements for primary liability. First, *Central Bank* held: "As in earlier cases considering *conduct* prohibited by § 10(b), we again conclude that the statute prohibits *only* the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177 (emphasis added). Commercial counterparties do not make statements to the market about the issuer or have the duty to disclose necessary for liability for a material omission.

Second, *Central Bank* held that defendant-by-defendant reliance is an essential element of primary liability:

> [R]espondents' argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance. A plaintiff must show reliance on *the defendant's misstatement or omission* to recover under 10b-5. Were we to allow the aiding and abetting action proposed in this case, *the defendant* could be liable without any showing that the plaintiff relied upon *the aider and abettor's* statements or actions. Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.

Id. at 180 (emphasis added; citations omitted). As we show *infra*, at 28-29, "scheme" liability cannot be reconciled with the defendant-by-defendant reliance required by *Central Bank*.

Less than a month after *Central Bank* was issued on April 19, 1994, then-SEC Chairman Levitt told Congress that *Central Bank* required defendant-by-defendant reliance under § 10(b): "As the Supreme Court emphasized in *Central Bank of Denver*, a private plaintiff under Rule 10b-5 must show, *defendant by defendant*, that the plaintiff reasonably relied on the defendant's misstatement or omission." *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs*, 103d Cong. 51 (1994) (statement of Arthur Levitt, Chairman, SEC) (emphasis added). And, former SEC Chairman David Ruder told Congress that "[a]ctive assistance to securities law fraud by accountants, banks, lawyers and others who cannot be classified as participants or controlling persons would no longer be actionable." *Id.* at 107. Congress chose not to overrule either *Central Bank*'s definition of the scope of § 10(b) liability or its requirement of defendant-by-defendant reliance.

To the contrary, in the PSLRA, Congress adopted the principle of *Central Bank* that elements of § 10(b) primary liability must be satisfied by reference to the conduct of the particular defendant. Specifically, the PSLRA required that "the act or omission *of the defendant* alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (emphasis added). As we show *infra*, at 29-30, "scheme" liability cannot be reconciled with defendant-by-defendant loss causation.

3. Sarbanes-Oxley: In the Sarbanes-Oxley Act enacted in 2002, Congress again rejected allowing private civil plaintiffs to use § 10(b) to sue secondary actors. Members of Congress proposed "to give the victims of fraud the right to sue those who aid issuers in misleading and defrauding the public." H.R. Rep. No. 107-414, at 53 (2002). Congress was urged to "undo the Central Bank case and bring back aiding and abetting." *Hearing on H.R. 3763 Before the H. Comm. on Fin. Servs.*, 107th Cong. 63 (2002).[13] It was broadly asserted that "when a person adds substantial value to a fraudulent course of conduct—in other words, contributes in a substantive way to its success—then liability is necessary and appropriate to achieve both deterrence and compensation." *Id.* at 485-86. Congress rejected these proposals for expanding the § 10(b) implied private cause of action. Instead, Congress empowered *the SEC* to direct to shareholders any proceeds it obtained from the secondary actors it sued under § 20(e). 15 U.S.C. § 7246(a). From 2002 to 2006, the SEC recovered $8 billion, including from aiders

[13] Former Senator Metzenbaum proposed "to restore aiding and abetting liability for those who contribute to fraud but are not the primary culprit." *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. 1037 (2002). Senators Shelby and Durbin proposed to create express private liability against "persons that aid or abet violations" of § 10(b) of the 1934 Act. 148 Cong. Rec. S6584 (daily ed. July 10, 2002).

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and abettors, for distribution to shareholders. See SEC, *2006 Performance and Accountability Report* 23 (Nov. 2006), *available at* http://www.sec.gov/about/secpar2006.shtml. *See also Interim Report*, at 71 ("The United States has the toughest administrative enforcement of securities laws in the world.")[14]

Congress's repeated decisions not to modify *Central Bank* in private civil suits is at least "entitled to a good deal of weight." *Blue Chip*, 421 U.S. at 749. Indeed, "[i]t is the federal lawmaker's prerogative . . . to . . . shape the contours of . . . § 10(b) private actions." *Tellabs,* 127 S. Ct. at 2512. Legislative acquiescence is particularly strong here because, "[o]nly one month after" *Central Bank* was decided "Congress held its first hearings on this precise issue. Exhaustive hearings have been held on the issue at various times since then[;]" and Congress has rejected various bills to overrule *Central Bank. Bob Jones Univ.* v. *United States*, 461 U.S. 574, 600-01 (1983). "In view of its prolonged and acute awareness of so important an issue," *id.*, Congress has decided that *Central Bank* provides the proper rule of decision in § 10(b) private actions.

[14] As petitioner and its *amici* note, the 1933 and 1934 Acts refer in several places explicitly to misrepresentations, omissions, conduct, and acts rather than to a "manipulative or deceptive device or contrivance." Petitioner and its *amici* incorrectly contend that these references prove that Congress intended the language of § 10(b) to cover "scheme" liability. Pet. Br. at 18-21; Regents Br. at 17-20, 24; Ohio Br. at 15-20; Ark. Br. at 12-14. This argument is a red herring. No one disputes that § 10(b) applies to "conduct." But for a § 10(b) private civil claim to be based on conduct, the conduct must itself be "deceptive or manipulative" and satisfy "*all* of the requirements for primary liability under Rule 10b-5." *Central Bank*, 511 U.S. at 191. Petitioner and its *amici* contend that participating in a "scheme" is "deceptive" conduct. Nothing in any of the statutory provisions cited by petitioner or its *amici* addresses, expressly or implicitly, whether participating in a "scheme" constitutes "deceptive" conduct under § 10(b), or satisfies the other requirements for primary liability, such as reliance and loss causation. Those provisions are therefore irrelevant.

C. "Scheme" Liability Cannot Be Reconciled With The Elements Of Primary Liability In A § 10(b) Cause Of Action.

Central Bank holds: "Any person or entity, including a lawyer, accountant, or bank, *who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies* may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191 (first emphasis added). As *Central Bank* describes, the line between private primary liability and aiding-and-abetting requires that the deceptive "device or contrivance" used or employed by the particular defendant itself satisfy *all* of the requirements for § 10(b) primary liability. A plaintiff cannot mix and match (1) one device or contrivance used or employed by defendant A to satisfy the deception element against defendant A with (2) defendant B's different device or contrivance to satisfy the *other* elements of primary liability against defendant A, including reliance.

In particular, when a commercial counterparty's allegedly deceptive conduct or statements to third parties other than investors merely assist, enable, or otherwise cause an issuer's misstatement, and the reliance, causation, and other elements are satisfied only by the issuer's misstatement, the defendant has committed only aiding and abetting. *See Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 173-76 (2d Cir. 1998) (because investors did not rely on auditor's false but undisclosed statement to issuer that issuer's financial results were accurate, auditor's statement constituted aiding and abetting, not primary liability); *Filler* v. *Hanvit Bank*, 156 F. App'x 413, 415-16 (2d Cir. 2005) (summary order) (although banks sent "false loan confirmations" to auditor, investors did not rely on these).

1. "Scheme" Liability Is Incompatible With *Central Bank*'s Reliance Requirement.

Even when a defendant has used or employed a deceptive device, such as a misstatement, but that statement is *not* disclosed to investors, the defendant itself has not made "a material misstatement (or omission) *on which a purchaser or seller of securities relies.*" *Central Bank*, 511 U.S. at 191 (emphasis added). Under *Central Bank*, reliance upon the public statements of issuers and auditors is insufficient to satisfy the reliance element to hold a different, silent defendant liable as a primary violator. *See id.* at 180 ("A plaintiff must show reliance on *the defendant's misstatement or omission* to recover under 10b-5."). Lack of reliance on a secondary actor is no different just because the defendant is relabeled from an aider and abettor to a schemer. Such a defendant's conduct or statements are still unknown to the plaintiff and the market and that defendant still has no relationship that creates a duty to disclose.[15]

The fraud on the market doctrine is of no assistance in establishing reliance against "scheme" liability defendants. That doctrine applies only to "publicly available information" from the defendant. *Basic*, 485 U.S. at 247; *see Dinsmore* v. *Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 843 (2d Cir. 1998) (investors did not rely on attorneys' misrepresentations to SEC that were not public). The

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[15] As *Central Bank* recognized, 511 U.S. at 177, 180, it would be particularly inappropriate to apply the word "indirectly" from the preamble to § 10 to make the reliance requirement easier to satisfy in a § 10(b) private damages action. The reliance requirement does not arise from the language of § 10(b) and thus does not apply when the SEC sues. *Supra*, at 14 & n.17. Rather, the courts created a reliance requirement to keep the judicially implied private damages action within "careful limits." *Central Bank*, 511 U.S. at 180. It would be improper to apply the "indirectly" language of § 10(b) to weaken the important reliance limit on the private damages action when the language of § 10(b) does not itself create a private damages action in the first place.

transactions of commercial counterparties would normally not be publicly available information. *Stoneridge* illustrates this. The market knew about Charter's financial statements but was unaware of any conduct by respondents.

2. "Scheme" Liability Is Incompatible With The PSLRA's Loss Causation Requirement.

As noted above, the PSLRA requires that the plaintiff allege and prove that "the *act or omission of the defendant* alleged to violate this chapter caused the loss." 15 U.S.C. § 78u-4(b)(4). Loss causation is satisfied only when the issuer's stock price declined because of the particular defendant's deceptive act or omission. *Dura*, 544 U.S. at 344; *see also Lattanzio* v. *Deloitte & Touche LLP*, 476 F.3d 147, 158 (2d Cir. 2007) (plaintiffs "have not alleged facts to show that *Deloitte's misstatements*, among others (made by Warnaco) that were much more consequential and numerous, were the proximate cause of plaintiffs' loss") (emphasis added).

In this case, as in other commercial counterparty cases, the "act or omission of the defendant" vendors was never disclosed to either inflate or deflate the market price of the issuer's stock. Nonetheless, petitioner alleges that *Charter's* much broader "*financial statements* caused the price of Charter's stock to be inflated" and that respondents should be held responsible for all $7 billion in damages flowing from Charter's financial statements, Pet. Br. at 38, even though respondents' transactions allegedly increased operating cash flow by only $17 million. Scientific-Atlanta Cert. Opp. App. at 33 (Am. Cmpl. ¶ 79.) Because Charter's statements and omissions were not "the act or omission *of the defendant*" respondents, the PSLRA loss causation requirement is not satisfied.

This is confirmed by *Dura*, which held that loss causation is at least as demanding as common law proximate cause. *See*

544 U.S. at 343-44. The common law requires "a direct causal connection." *Anza* v. *Ideal Steel Supply Corp.*, 126 S. Ct. 1991, 1996-98 (2006). "Scheme" liability, however, seeks to hold a commercial counterparty liable because (a) its commercial transaction was (b) improperly accounted for by the issuer in (c) the issuer's much broader financial statements, and (d) those broader financial statements inflated the issuer's stock price. That is the antithesis of "a direct causal connection." *Cf. Holmes* v. *SIPC*, 503 U.S. 258, 287 (1992) (Scalia, J., concurring) ("'for want of a nail, a kingdom was lost' is a commentary on fate, not the statement of a major cause of action against a blacksmith"). Rather, it is classic aiding-and-abetting. Thus, under *Central Bank*, it provides no basis for a claim under the § 10(b) implied action.

CONCLUSION

The decision of the court of appeals should be affirmed.

Respectfully submitted,

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August 15, 2007

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Testimony of Professor John C. Coffee, Jr.

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Before the Subcommittee on Crime and Drugs of the
United States Senate Committee on the Judiciary

September 17, 2009

Hearing on
"Evaluating S.1551: The Liability for Aiding and Abetting Securities Violations Act of 2009"

226 Dirksen Senate Office Building

Chairman Specter, and Fellow Senators:

I am honored to be before this Committee to discuss the proposed "Liability for Aiding and Abetting Securities Violations Act of 2009." I support the concept but urge that it be coupled with a ceiling on damages for such secondary defendants.

Introduction

For a century (since 1909), it has been a criminal offense under federal law to knowingly aid or abet persons committing a federal crime with the intent to facilitate that crime.[1] Indeed, aiding and abetting can be traced back to the English criminal law of the 1700s.[2] In the civil law, the Restatement of Torts has long provided to similar effect that an actor is liable for harm resulting to a third person as a result of the tortous conduct of another "if he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other."[3]

In the securities law context, the idea also has a considerable history. Prior to the Supreme Court's decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994), Justice Stevens observed (in his dissenting opinion in that case) that:

> "In hundreds of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under §10(b) and Rule 10b-5."[4]

Thus, we are not dealing with a novel concept where there has been no prior experience. Civil liability for aiding and abetting securities violations was well established prior to 1994, and securities class actions were by then already well developed. No evidence suggests that such

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[1] See 18 U.S.C. §2, 35 Stat. 1152 (Act of March 4, 1909).
[2] See 1 M. Hale, Pleas of the Crown, 615 (1736); for a general discussion, see United States v. Peoni, 100 F.2d 401, 402 (2d Cir. 1938).
[3] See Restatement (Second) of Torts, §876(b) (1977). See also 1 T. Cooley, Law of Torts, 244 (3d ed. 1906) ("All who actively participate in any manner in the commission of a tort, or who command, direct, advise, encourage, aid or abet its commission, are jointly and severally liable therefor"). To be sure, not every state follows the Restatement of Torts, but many do.
[4] 511 U.S. 164, 192.

liability resulted in major failures or bankruptcies or that it drove firms out of the industry. This is not to say that safeguards are not needed (and I will suggest one shortly), but predictions of doom and disaster from restoring private civil liability seem unfounded given the considerable prior experience with aiding and abetting actions against secondary participants in securities transactions.

Nor, if it restored aiding and abetting liability, would Congress be challenging the Supreme Court with respect to a matter primarily reserved to it by the Constitution. This is not a Constitutional issue, and the Supreme Court in Central Bank was only interpreting the intent of Congress with respect to the implied private cause of action under Rule 10b-5.

Thus, the real issue is not whether Congress can restore aiding and abetting liability but whether it should. In this brief memorandum, I will address (1) the arguments for restoring aiding and abetting liability; (2) the claim that it will open the floodgates to frivolous or abusive litigation; (3) the case for a ceiling on the damages applicable to secondary defendants; and (4) a modest drafting revision that I would recommend so that the intent of the proposed statute is better realized.

I. The Case for Aiding and Abetting Liability

To say the least, it is anomalous that one could be criminally liable for aiding a securities law violation, but not civilly liable for the same conduct in a private suit. Yet, that has been the state of the law since 1994. The consequences need to be assessed along two different dimensions: deterrence and compensation.

a. Compensation. Frequently, the primary violator in a securities case will become bankrupt at or about the time the fraud is discovered. This is often the case in initial public offerings ("IPOs"), but it was also true in Enron and WorldCom. In those two cases, the settling secondary participants (primarily investment banks) contributed approximately $7.3 billion and $6.5 billion, respectively, to fund the settlements (these cases remain the record securities class action settlements). However, in the case of Enron, this liability was based on a "scheme" theory of liability that was subsequently overturned in Stoneridge Investment Partners LLC v. Scientific Atlanta, 552 U.S. 148 (2008), and the remaining Enron defendants who had not settled escaped liability when the class action was decertified. The point here is simply that secondary defendants do represent a significant source of compensation for injured investors if a cause of action for aiding and abetting is recognized.

Many commentators (including this author[5]) have criticized the typical securities class action as being incapable of achieving compensatory relief because of its circularity. That is, when the corporation pays damages in a secondary market case (which is the typical securities class action), this payment is borne by its shareholders. Thus, shareholders who purchased or sold within the class period win (at least if they file claims), whereas those shareholders who fall outside the class period lose. But because most shareholders are diversified, they fall into both camps, sometimes winning and sometimes losing. The net result is a series of pocket-shifting wealth transfers that in the aggregate leave shareholders worse off (particularly after the deduction of the legal costs of both sides).

Valid as this critique may sometimes be, it does not apply to litigation against secondary participants. Recoveries obtained from secondary participants do not come from the issuer corporation and thus are not indirectly borne by its shareholders. Pocket-shifting wealth transfers do not occur. Thus, in a very real sense, recoveries from secondary participants uniquely provide compensation to shareholders, while recoveries from issuer corporations may seldom do so.

[5] See Coffee, Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 Colum. L. Rev. 1534 (2006).

b. Deterrence. Most recent academic commentary has viewed deterrence as the best rationale for the securities class action. From this perspective, restoring private liability for aiding and abetting violations makes sense because (1) the critical gatekeepers of the capital markets – accountants, investment banks, securities analysts, credit rating agencies, and sometimes law firms – will not otherwise face liability and will remain underdeterred in most instances, and (2) these gatekeepers can be more easily deterred than the primary violator because they do not stand to receive the same gain as the primary violator. In contrast, the primary violator may be essentially undeterrable by civil penalties. To visualize this point, recall Enron and Arthur Andersen. Because Arthur Andersen received only accounting fees and consulting income from Enron, it did not share in the massive stock price inflation or in the proceeds of numerous offerings that benefitted Enron and its officers. Thus, it can be more easily deterred. But Enron and its officers were virtually beyond deterrence through civil penalties.

Moreover, gatekeepers are critical actors without whom many corporate and securities transactions cannot be completed unless they do give their approval (for example, the law firm's opinion, the accountant's certification or the credit rating agency's investment grade rating may be a legal precondition to the transaction). Hence, if the gatekeepers are adequately deterred, they will block transactions, even though the primary violator would willingly proceed with them. Thus, to give these gatekeepers immunity from private liability is to abandon what logically is the most efficient technique for deterrence: namely, to focus on the party who has both the ability to block the illicit transaction and the weakest incentive to engage in it. This was precisely the strategy that Congress adopted in Section 11 of the Securities Act of 1933 when it imposed a form of negligence liability on both accountants and other experts in connection with registered public offerings of securities.

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Put differently, it may not always be possible to deter the primary violator because it regularly may face a choice between bankruptcy or engaging in a fraud. In these circumstances, the most realistic means to prevent misconduct may be to seek to deter those who have less to gain and also the ability to block the transaction by withholding their consent. It was precisely this more feasible form of deterrence that the Central Bank decision denied investors.

If we look at the last decade's experience in the U.S. capital markets, it is difficult to avoid the conclusion that there has been inadequate deterrence. A high-tech bubble burst in 2000; a wave of accounting restatements (which began in the late 1990s) peaked in 2001-2002 with the collapse of both Enron and WorldCom amidst egregious accounting irregularities; and, in 2007-2008, the principal gatekeeper of the debt markets – the credit rating agencies – clearly failed investors and deserve much of the blame for the collapse of asset-backed securitizations. In response to these evident gatekeeper failures, Congress passed the Sarbanes-Oxley Act in 2002, and a year later a global settlement was reached between regulators and securities analysts. Basically, these reforms increased criminal penalties, administrative controls, and the SEC's powers. But the one obvious step that has not been taken was to focus private enforcement on delinquent gatekeepers. Although private enforcement has its flaws, it is entrepreneurially motivated and thus will pursue secondary participants with predictable zeal.

Given the severity of the current financial crisis, the only possible justification for not unleashing private enforcement is the belief that adequate deterrence can come from public enforcement alone. But can it? To pose this question in a more pointed fashion, does anyone really believe today, in this post-Madoff world, that the SEC, by itself, can adequately deter most secondary participants in securities frauds? As the Madoff debacle, itself, shows, the SEC has been reluctant (at least in the recent past) to pursue prominent persons aggressively and has

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rarely sued major accounting or law firms (arguably both because of cost considerations and because of fears of political retaliation). Nor has it sued any of the credit rating agencies for their failures. This week, a federal court in New York criticized the SEC for its illusory settlement in the SEC's action against the Bank of America and suggested that too often the SEC enters into weak settlements that penalize the shareholders, rather than protecting them. Against this backdrop, adding private enforcement to backstop public enforcement is a failsafe protection. The plaintiff's bar would not be similarly constrained by the desire to obtain public relations victories; it wants money.

Recently, in the Stoneridge decision, which found "scheme to defraud" liability to be outside the scope of Rule 10b-5, the Court's majority wrote that it would not extend Rule 10b-5 to reach secondary participants because this "would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."[6] The "class of defendants" here referred to were essentially those secondary participants who had not themselves made public attributed statements upon which the market had relied. Today, it seems less likely that Congress really wants to rely exclusively on the SEC to police misconduct by such a broad class of persons. Inevitably, the SEC is cost constrained, has limited personnel and a large backload of cases, and sometimes it misses for years frauds (such as the Madoff and Stanford Ponzi schemes) that others had begun to suspect and would have been motivated to pursue if they could.

My sense that it no longer seems wise to rely exclusively upon the SEC has been recently confirmed by the comments of a prominent federal judge (who has been recently nominated by the President for appointment to the Second Circuit). In In re Refco Securities Litigation,[7] United

[6] Stoneridge Investment Partners LLC v. Scientific Atlanta, 128 S. Ct. 761, 771.
[7] 609 F. Supp. 2d 304 (S.D.N.Y. 2009).

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States District Judge Gerald Lynch was confronted with a case in which it appeared that a law firm, which was highly familiar with the company's operations, had participated in 17 rounds of "round-trip" loan transactions pursuant to which certain "receivables were periodically made to disappear from Refco's books."[8] The partner at the law firm supervising the client was later criminally convicted of securities fraud. Yet, Judge Lynch concluded that he had no choice but to dismiss the case against the law firm in light of Central Bank and its progeny of follow-up decisions in the Second Circuit. In dicta, he observed:

> "It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable to the victims of the fraud . . . In 1995, in reaction to the Supreme Court's decision in Central Bank, Congress authorized the SEC – but not private parties – to bring enforcement actions against those who "knowingly provide . . . substantial assistance to another person in violation of the federal securities laws . . ." This choice may be ripe for legislative re-examination. While the impulse to protect professionals and other marginal actors who may too easily be drawn into securities litigation may well be sound, a bright line between principals and accomplices may not be approximate."[9]

Essentially, I agree with the judge that the time has come for legislative re-examination of the immunity given secondary participants; a balance needs to be struck. As I suggest below, this balance is best struck by restoring private aiding and abetting liability, but with a ceiling on damages.

II. The Open Floodgates Argument: Will Secondary Participants Be Exposed to a Flood of Frivolous Litigation?

The predictable response to any proposal to restore aiding and abetting liability will be that it would expose professionals to frivolous litigation. Once, back at the time that Central Bank was decided in 1994, this might have been a valid concern. But the next year, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"), and its reforms have

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[8] 609 F. Supp. 2d at 307.
[9] Id. at 318 n. 15.

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amply protected – indeed, insulated – secondary participants. The key PSLRA safeguard is a pleading requirement: under §21D(b)(2) ("Required State of Mind") of the Securities Exchange Act of 1934, the action cannot go forward, and the plaintiff cannot obtain discovery, unless and until the plaintiff can plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" (i.e., an intent to defraud in the case of Rule 10b-5 cases). In the case of the primary violator, this requisite level of intent can often be shown without the benefit of discovery (for example, the CEO may have suddenly sold most of his stock after he learned of undisclosed negative information). But in the case of a secondary participant (such as accountant or law firm), it is extremely difficult to plead such facts without discovery. A plaintiff cannot simply allege that the lawyer or investment banker serving as an advisor to the CEO counseled fraud or illegality; rather, the plaintiff must plead such a claim with particularity before it can obtain any discovery. This is one of the primary reasons that credit rating agencies have never been held liable for securities fraud. Erroneous and inflated as some of their ratings may have been, such errors do not by themselves show with particularity an intent to defraud.

Other PSLRA provisions also provide protections that uniquely shelter secondary defendants. For example, the proportionate liability provision of Section 21D(f) of the Securities Exchange Act replaces the traditional "joint and several" liability rule with a proportionate liability rule that is designed to reduce the liability that can be imposed on less culpable defendants (such as secondary defendants).

The net result is that secondary defendants in most cases will be able to obtain early dismissals at the motion to dismiss stage and will be protected by the proportionate liability standard so that they can settle well within their insurance coverage.

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III. Aiding and Abetting Liability Should Be Accompanied By a Ceiling on Damages for Secondary Defendants

Restoring aiding and abetting liability will be controversial. A solid phalanx of professions – law firms, accounting firms, investment banks, and the credit rating agencies – will unite to oppose such a restoration. Although I am hardly an expert on the political odds on its passage, those odds would be improved if restoration of aiding and abetting liability were packaged with a ceiling on liability for secondary defendants. Independently, such a ceiling, particularly for gatekeepers, makes good sense for a number of reasons:

(1) Because secondary defendants typically stand to make only a small portion of the gain that the primary defendant expects, they can be deterred more easily and do not need to face exposure to multi-billion dollar liabilities;

(2) A number of markets for gatekeeper services are highly concentrated (for example, there are only four major accounting firms and three major credit rating agencies). The failure of one of these firms would be as disruptive to the capital markets as that of Arthur Andersen.

(3) A ceiling on damages would permit professional firms that cannot now obtain liability insurance to obtain such coverage, thus averting their potential collapse.

(4) It is fundamentally unfair and undesirable that any professional firm become insolvent and fail because of the conduct of just one individual. Essentially, this is the Arthur Andersen scenario, and it could reoccur; and

(5) A ceiling on liability would mean that professional firms could not be extorted into settling by the threat of potential billion dollar liability.

What would a reasonable ceiling on damages for secondary defendants look like? Because secondary participants come in all sizes and shapes, neither a fixed dollar amount nor a

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fixed percentage (whether of net worth or market capitalization or income) will work well. The goal should be to devise a penalty that is sufficiently painful to deter, but not so large as to threaten insolvency. Because some secondary participants are publicly held and some are not, one must use a variety of measures: e.g., market capitalization or net worth for public companies, revenues or income for private ones. Some outer fixed ceiling seems necessary so that a billion dollar penalty is not within the ceiling in the case of public company. Hence, on this basis, I would propose a ceiling as set forth below:

> "The maximum penalty that may be imposed in one or more actions (whether filed in state or federal court and whether the result of a judgment or a settlement in a filed action) relating to the same transaction or conduct shall not exceed the greater of:
>
> (A) in the case of a defendant who is not a natural person,
>
> (1)[10]% of the defendant's average annual income over its last three fiscal years;
>
> (2) [10]% of the defendant's net worth (as determined by its latest audited financial statements);
>
> (3) [10%] of the defendant's market capitalization at the close of its latest fiscal year if its securities are traded in a securities exchange;
>
> (B) in the case of a defendant who is a natural person, $2,000,000;
> but in no event shall any such defendant be liable for an amount greater than $[50,000,000]."

In the case of a natural person, the ceiling would thus be $2,000,000; in the case of a public corporation (such as an investment bank or a rating agency), the maximum ceiling would be $50,000,000. If this latter maximum ceiling seems high at first glance, it should be understood that accounting firms have recently settled securities fraud class actions for amounts in excess of $300 million. Moreover, the real impact of a ceiling is to induce the parties to settle for an amount beneath the ceiling (because few, if any, will settle for an amount equal of their maximum exposure to liability).

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IV. A Drafting Suggestion

Proposed Section 20(e)(2) follows the existing language of §20(e) of the Securities Exchange Act of 1934. But there is a problem with that language. Its key limiting phrase – "any person that knowingly or recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title" (emphasis added) – probably requires that the secondary participant have itself engaged in a deceitful or manipulative act that would violate an SEC rule (most likely, Rule 10b-5). Thus, this language would not reach persons who provide substantial assistance without themselves engaging in a deceit or manipulation. Consider the lawyer in the earlier noted Refco case who knowingly advises his client on how to structure a transaction to avoid disclosure of material information. Hence, to remove this ambiguity, I would suggest redrafting Section 20(e)(2) to read as follows:

> "For purposes of any private civil action implied under this title, any person who knowingly or recklessly provides substantial assistance to another person enabling such person to violate this title, or any rule or regulation issued under this title, shall be deemed to be in violation of this title to the same extent as the person to whom such assistance is provided."

Use of the word "enabling" also connotes that some causal linkage is required (i.e., helping to incorporate a subsidiary or assisting on an unrelated matter is not sufficient). Finally, the legislative history should make clear that when the proposed language uses the phrase "to the same extent as the person to whom such assistance is provided," it does not seek to overrule the proportionate liability damages rule of §21D(f) of the Securities Exchange Act. That is, the secondary participant would be liable, but the measure of damages to be awarded against such person would be determined under §21D(f).

United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

August 13, 2007

The Honorable Paul D. Clement
Solicitor General
United States Department of Justice
950 Pennsylvania Avenue, N. W.
Washington, D.C. 20530

Dear Mr. Clement:

I am writing to express my disappointment that you have not filed an amicus brief with the Supreme Court expressing the views of the United States Securities and Exchange Commission in a case on appeal from the Eighth Circuit, *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted*, 127 S.Ct. 1873, (U.S. Mar. 26, 2007) (No. 06-43). Since you have not filed as of today such a brief, I urge that you not file an amicus brief advocating any position other than the well-established position of the Commission that parties who contribute to defrauding investors should be held accountable.

The *Stoneridge* case raises a significant issue affecting private rights of action and civil liability under Section 10(b) of the Securities Exchange Act of 1934 ("the Act") and Rule 10b-5 thereunder. This case is particularly important because the Supreme Court's decision could resolve differences among the Fifth, Eighth and Ninth Circuits regarding the application of Section 10(b) of the Act.

The Commission has analyzed issues raised by *Stoneridge* and, earlier this year, voted that, under Section 10(b) of the Act and Rule 10b-5 thereunder, a deceptive act is not limited to making false or misleading statements or failing to speak when there is a duty to speak, but includes non-verbal conduct that creates a false or misleading appearance. The Commission also voted that a person uses or employs a deceptive device or contrivance within the meaning of Section 10(b) of the Act if, in a transaction with an issuer of securities, the person engages in conduct that has the principal purpose and effect of conveying a false appearance of material fact about the transaction.

These votes were consistent with the positions that the Commission unanimously took in 2004 in the amicus curiae briefs it filed in *Simpson v. AOL Time Warner, Inc. (In re Homestore.com, Inc., Sec. Litig.)*, 452 F. 3d 1040 (9^{th} Cir. 2006), petition for *cert. filed sub nom. Avis Budget Group, Inc. v. California State Teachers'*

Retirement System, 75 U.S.L.W. 3236 (U.S. Oct. 29, 2006) (No.06-560) (Chairman Donaldson not participating).

These standards, and similar standards that the SEC has advocated in amicus briefs filed in other cases, are, in my view, meritorious. As a co-author of the Private Securities Litigation Reform Act, I have worked to protect businesses from frivolous and meritless lawsuits. At the same time, I have supported efforts to protect the rights of investors who have been defrauded.

The position of the Commission has strong support. The view is shared or supported by former SEC chairmen, law professors, institutional investors, and numerous others who have filed amicus briefs with the Supreme Court in this case.

Your decision thus far to not advocate the Commission's position has in effect deprived the Commission of the opportunity to participate in an important securities case. It has also prevented the Supreme Court from receiving views from the Commission as the Court interprets the Federal securities laws in *Stoneridge*.

It is my view that when the Supreme Court considers a case involving securities law, it should have the views of the Federal regulatory agency with expertise in securities law and practice. The SEC has built its expertise on decades of interpreting and administering the Exchange Act along with other statutes to protect investors and maintain fair and efficient markets.

It has been reported that your office may file an amicus brief advocating views inconsistent with the views of the SEC. If this occurs, it would In my view compound the damage already caused to the investing public by the failure thus far to advocate the views of the Commission in the *Stoneridge* case. I would encourage the rejection of any such plan.

Thank you for your attention to these views.

Sincerely,

Chris Dodd

Christopher J. Dodd
Chairman

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510–6075

May 25, 2007

The Honorable Christopher Cox
Chairman
U. S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D. C. 20549

Dear Chairman Cox:

The U.S. Securities and Exchange Commission has vital responsibilities to protect investors and to promote fair and efficient securities markets. The Commission's successful performance of these responsibilities has promoted investor confidence and made our markets the envy of the world. I compliment you on recent initiatives which have furthered the role of the Commission as "the investor's advocate."

Recently, the United States Supreme Court accepted for review a case on appeal from the Eighth Circuit, *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted*, 127 S.Ct. 1873, (U.S. Mar. 26, 2007) (No. 06-43). The *Stoneridge* case raises a significant issue affecting private rights of action and civil liability under the Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder that some have called "scheme liability." The case is particularly important because its decision could resolve differences among the Fifth, Eighth and Ninth Circuits regarding the application of Exchange Act Section 10(b).

It is my understanding that in the past, the Commission has filed some amicus briefs with courts that were considering cases that raised similar issues. The preparation of such amicus briefs has been an important activity of the Commission and has provided the courts with the Commission's expert analysis of the statutes it administers. In some instances, the courts have embraced the Commission's reasoning or a variant thereof.

The Commission in its amicus briefs has recommended standards for interpreting these anti-fraud provisions of the Exchange Act. The Commission has said, for example, that:

- 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 Section 10(b) and Rule 10b-5(a)." Brief of the Securities and Exchange Commission as Amicus Curiae at 16, *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, (9th Cir. 2006) (No. 04-55665). The SEC explained that "deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words." *Id.* at 8.

- "A person who creates a misrepresentation, but takes care not to be identified publicly with it, 'indirectly' uses or employs a deceptive device or contrivance and should be liable . . . In sum, by providing a safe harbor for anonymous creators of misrepresentations, a rule that imposes liability only when a person is identified with a misrepresentation would place a premium on concealment and subterfuge rather than on compliance with the federal securities laws." Brief of the Securities and Exchange Commission as Amicus Curiae at 10-11, *Klein v. Boyd*, 1998 WL 55245 (3d Cir. 1997) (No. 97-1143).

- "Section 10(b)'s coverage of 'deceptive device[s],' however, reaches deceptive *acts* as well as statements and omissions, and such acts have long been understood to constitute fraud . . . Section 10(b)'s prohibition of any 'deceptive device or contrivance' thus implies coverage of the full range of schemes to deceive, not just statements or omissions." Brief of the United States at 19, 20, n. 10, *United States v. O'Hagan*, 139 F.3d 641 (8th Cir. 1998) (Nos. 94-3714, 94-3856).

These standards have, in my view, been meritorious. As a co-author of the Private Securities Litigation Reform Act, I have worked to protect business from frivolous and meritless lawsuits. At the same time, I have supported efforts to protect the rights of investors who have been defrauded.

I understand that the Commission is considering whether to file an amicus brief in the *Stoneridge* case. I would appreciate knowing whether the Commission plans to file or intends to ask the Solicitor General to file an amicus brief in that case. If the Commission so intends, I would appreciate knowing whether it plans to advocate to the Court arguments consistent with its past positions in "scheme liability" cases. If it intends to file an amicus brief in *Stoneridge* that differs from past positions, I am interested to learn the reasons supporting this in order to better understand Commission policy.

Sincerely,

Chris Dodd

Christopher J. Dodd
Chairman

United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

August 13, 2007

The President
The White House
Washington, D. C. 20500

Dear President Bush:

I am writing to express my disappointment that the Solicitor General has chosen not to file an amicus brief with the Supreme Court that was recommended by the United States Securities and Exchange Commission in a case on appeal from the Eighth Circuit, *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted*, 127 S.Ct. 1873, (U.S. Mar. 26, 2007) (No. 06-43), and to urge that he not file an amicus brief advocating any position other than the well-established position of the Commission that parties who contribute to defrauding investors should be held accountable.

The *Stoneridge* case raises a significant issue affecting private rights of action and civil liability under Section 10(b) of the Securities Exchange Act of 1934 ("the Act") and Rule 10b-5 thereunder. This case is particularly important because the Supreme Court's decision could resolve differences among the Fifth, Eighth and Ninth Circuits regarding the application of Section 10(b) of the Act.

The Commission has analyzed issues raised by *Stoneridge* and, earlier this year, voted that, under Section 10(b) of the Act and Rule 10b-5 thereunder, a deceptive act is not limited to making false or misleading statements or failing to speak when there is a duty to speak, but includes non-verbal conduct that creates a false or misleading appearance. The Commission also voted that a person uses or employs a deceptive device or contrivance within the meaning of Section 10(b) of the Act if, in a transaction with an issuer of securities, the person engages in conduct that has the principal purpose and effect of conveying a false appearance of material fact about the transaction.

These votes are consistent with the positions that the Commission unanimously took in 2004 in the amicus curiae briefs it filed in *Simpson v. AOL Time Warner, Inc. (In re Homestore.com, Inc., Sec. Litig.)*, 452 F. 3d 1040 (9th Cir. 2006), petition for *cert. filed sub nom. Avis Budget Group, Inc. v. California State Teachers' Retirement System*, 75 U.S.L.W. 3236 (U.S. Oct. 29, 2006) (No.06-560) (Chairman Donaldson not participating).

These standards, and similar standards that the SEC has adopted in amicus briefs filed in other cases, are , in my view, meritorious. As a co-author of the Private Securities Litigation Reform Act, I have worked to protect businesses from frivolous and meritless lawsuits. At the same time, I have supported efforts to protect the rights of investors who have been defrauded.

The position of the Commission has strong support. Its view is shared or supported by former SEC chairmen, law professors, institutional investors, and numerous others who have filed amicus briefs with the Supreme Court in this case.

The Solicitor General, by declining to advocate the position of the SEC in this case, has deprived the Commission of the opportunity to participate in an important securities case and prevented the Supreme Court from receiving views from the Commission as the Court interprets the Federal securities laws in *Stoneridge*.

It is my view that when the Supreme Court considers a case involving securities law, it should have the benefit of the views of the Federal regulatory agency with expertise in securities law and practice. The SEC has built its expertise on decades of interpreting and administering the Exchange Act and other statutes with a view to protecting investors and maintaining fair and efficient markets.

It has been reported that the Solicitor General plans to file an amicus brief advocating views inconsistent with the views of the SEC. If this occurs, it would compound the damage already caused by the Solicitor in declining to advocate a position consistent with the SEC's. I urge you to take appropriate steps to discourage any such plans.

Sincerely,

Chris Dodd

Christopher J. Dodd
Chairman

Testimony of Robert J. Giuffra, Jr.
Partner, Sullivan & Cromwell LLP
Former Chief Counsel, U.S. Senate Banking Committee (1995-1996)

Before the U.S. Senate Committee on the Judiciary
Subcommittee on Crime and Drugs
"Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009"

September 17, 2009

Chairman Specter, Senator Graham, members of the Subcommittee, it is a privilege to testify on this important topic. The views that I'm expressing today are my own and do not reflect the views of my law firm or clients.

I've spent much of my professional career litigating securities class action cases. I've been involved in many significant cases. During 1995 and 1996, I served as Chief Counsel of the Senate Banking Committee. I spent many hours participating in the drafting of the Private Securities Litigation Reform Act of 1995 (the "PSLRA" or "Reform Act"). We worked very hard – Republicans and Democrats alike – to enact balanced legislation that would stop real abuses, but not prevent the bringing of meritorious securities cases.

I'm going to speak about several topics:

First, why I think Congress made the right decision in the 1995 Reform Act to permit only the SEC – and the Department of Justice in criminal cases – to bring so-called "aiding and abetting" securities claims against third parties – banks, accountants, vendors or lawyers – that have a business relationship with a public company alleged to have engaged in securities fraud. I believe that Congress acted wisely in entrusting the responsibility for deciding when to prosecute alleged aiders and abettors of securities fraud to the expert judgment of the SEC and the Department of Justice. Obviously, those agencies don't have the same incentives as the plaintiffs' bar to bring strike suits against deep-pocket defendants.

Second, I'd like to provide some perspective on how securities class actions are actually litigated and settled in the real world, and why I think Congress should not enact S. 1551. In my view, S. 1551 would hurt the competitiveness of U.S. capital markets and financial centers and vastly expand the potential liability and defense costs of innocent third parties that do business with public companies.

Third, I'd like to offer some practical suggestions for reforming securities class actions to address pressing issues that have arisen since the passage of the PSLRA.

The 1995 Reform Act

The 1995 Private Securities Litigation Reform Act was passed with broad bi-partisan support, including of Senators Bradley, Dodd, Feinstein, Kennedy, Kerry. Harkin, Mikulski, Murray, Reid, and Rockefeller. Senator Schumer supported the Reform Act when he was in the House. I worked very closely with Senator Dodd and his staff to pass the Reform Act.

It's important to remember why the Reform Act was enacted. This law addressed the serious problem of frivolous and abusive securities strike suits, while being careful not to impose significant burdens on meritorious fraud cases. Congressional hearings demonstrated that a small coterie of strike suit lawyers, some now in prison, were suing public companies whenever their stock price fell for any reason, claiming that securities fraud was responsible for the price decline.

To serve as their supposed "clients," these strike suit lawyers recruited professional – indeed, figurehead – plaintiffs who owned only a few shares of stock in dozens of companies for the sole purpose of bringing a securities class action the day after a company's stock price dropped. The lawyers would file a boilerplate complaint, with the same named "plaintiffs," in case after case. The selection of the lead plaintiff turned on the speed with which a plaintiffs' lawyer could file a complaint, not on the care that they took to investigate the facts and to draft that complaint or the claimed financial losses of the named plaintiff.

These abusive practices permitted the strike suit lawyers to exact hefty attorneys' fees from companies that couldn't afford years of expensive litigation – inevitably paid by the shareholders of those companies. As a result, many cases settled for token payments for shareholders and large fees for plaintiffs' and defense lawyers. This system didn't benefit stockholders because stockholders had to bear the cost of these strike suits.

In the PSLRA, Congress enacted a balanced set of reforms. The Senate played a critical role in adding balance to the House bill. I worked closely with representatives of the SEC, including then-Chairman Arthur Levitt, in drafting legislation that would address the problem of strike suits and at the same time protect investors. In fact, the Senate introduced some revisions to the House bill that were suggested by representatives of the plaintiffs' bar.

To address lawyer-driven litigation and to slow the race to the courthouse, Congress barred suits by professional plaintiffs and created a rebuttable presumption that the lead plaintiff would be the plaintiff – typically an institutional investor such as a public pension fund – with the biggest loss. Today, large institutional investors are almost always the lead plaintiffs in big securities class actions.

To reduce the number of frivolous strike suits, Congress enacted a uniform pleading standard, based on the Second Circuit's pleading standard, requiring the plaintiff to state some facts (as opposed to mere allegations) supporting the existence of the claimed misstatement and the charge that the defendant acted with fraudulent intent. The Reform Act also requires that each defendant in a multi-defendant lawsuit usually pay only that portion of the judgment for which the jury finds that defendant responsible, rather than the entire judgment, except where the defendant had actual knowledge that its statements were false.

And, to strengthen investor protections, the Reform Act confirmed the SEC's power to take action against third parties – such as a public company's bankers, accountants, customers and lawyers – who aid and abet securities fraud.

The PSLRA Worked and We Should Not Go Back

Back in 1995, when Congress was debating the Reform act, Bill Lerach, then probably the best known securities class action lawyer, came to see me in my Senate office. Bill knew that I had defended securities class actions. At the end of the meeting, Bill – frustrated because I didn't see the light – said: "You're going to put me out of business, and that won't be good for your law firm."

Now, Bill Lerach was eventually put out of business, but not by the PSLRA. Bill was put out of business and sent to jail, because he and his partner, Mel Weiss, were lying to investors and courts and paying kickbacks to plaintiffs and experts for many years.

Despite the fears of some, the PSLRA has not kept meritorious claims out of court. Post-PSLRA, the number of true strike suits is down, while the settlement value of claims is up substantially. More than 250 securities class actions were filed in 2008, and at least that many suits may be filed in 2009. Since 1995, there have been many settlements in the hundreds of millions of dollars, and some billion-dollar settlements in cases involving Worldcom and Enron.

But, as I'll discuss, significant changes in the real-world litigation environment since the PSLRA have permitted the return of some of the very same abuses that Congress sought to address in 1995. Rather than adding a new form of open-ended liability to a system

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that is being abused in ways that hurt investors and our capital markets, Congress should enact legislation that stops the abuse.

Some Practical Aspects of Securities Class Actions

Securities class actions are almost always settled or dismissed. In the last ten years, only a handful of these cases actually have gone to trial. The PSLRA tried to address this issue by heightening pleading standards, but the massive growth in damages claims since 1995 has changed the game.

Back in 1995, plaintiffs in a "big" securities case sought hundreds of millions of dollars in damages. Today, plaintiffs seek *billions* of dollars in damages. According to one estimate, the claimed damages in the hundreds of putative securities class actions filed in 2008 exceeded an average of $1.6 billion.

As a result, now more than ever, settlement often is the only realistic option for a deep-pocket defendant. Very few defendants can afford the risk of a lengthy and complex trial where the price of losing can be hundreds of millions in damages, and no board of directors will let its executive roll the dice in even the most meritorious case.

When securities class actions are settled, a company's present shareholders effectively pay money to its past shareholders. Given the size of the claimed damages, it's rare for a company's executives to pay a meaningful part of the settlement out of their own pockets, and, if those executives have engaged in actual fraud, they rarely have enough money to make a serious contribution to a settlement. Most settlements are covered by D&O insurance and direct payments from companies – costs, ultimately, borne by their shareholders.

The defense of a securities class action (even a meritless claim) often can cost tens of millions of dollars. A huge part of the bill is the skyrocketing cost of e-discovery –

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another important change since the enactment of the PSLRA. The cost of reviewing the millions of emails generated today by big public companies alone can cost many millions of dollars. In some of the larger cases, like Enron and Worldcom, the document discovery exceeded well in excess of 100 million pages documents and email.

In considering the reform of securities class actions, Congress should consider that companies and their executive make innocent mistakes. Bankers make innocent mistakes. Accountants make innocent mistakes. Vendors make innocent mistakes. And, yes, even lawyers make innocent mistakes.

It's easy to allege fraud by hindsight. Sometimes executives are too optimistic. In retrospect, sometimes disclosures arguably are not as full and complete as they might have been. It's easy to allege that an executive, banker, accountant, vendor or lawyer missed a red flag. Today, when executives, bankers, accountants, vendors and lawyers sometimes receive hundreds of emails a day, it's easy to find an email with loose language, to blow something out of proportion, and to allege that the services provided aided in the issuer's fraud.

Fraud is a very loose term, particularly when fraud is defined, as S. 1551 would do, to include "recklessness." When a murder occurs, we can all agree that a crime has been committed. Not so with securities fraud. The difference between an innocent mistake and fraud often turns on a jury's hindsight judgment about a defendant's state of mind years after the fact. This line-drawing will become an even more vexing issue if civil aider and abettor liability is revived.

**The Case Against Deputizing the Plaintiffs' Bar
To Bring "Aiding and Abetting" Claims Against Third Parties**

If Congress permits "aiding and abetting" claims, plaintiffs' lawyers will be able once again to extract millions of dollar from innocent banks, accountants, vendors and lawyers whenever a company's stock price drops. The creation of aiding and abetting liability would generate lots of fees for lawyers. But, in long run, such liability would severely hurt U.S. capital markets and our broader economy.

1. S. 1551 would vastly expand the potential liability of innocent bankers, accountants, vendors, lawyers and other third parties. Under current law, liability under the securities laws is premised on a misstatement or misleading statement by the defendant to investors. Thus, if an accounting firm provides an audit opinion, the firm can be sued for making a false statement, assuming all the other elements of Section 10(b) liability are met. When accountants issue audit opinions, they recognize that this risk exists.

Here are some real-world examples of why S. 1551, however well-intentioned, almost certainly would have serious unintended consequences for innocent third parties.

Almost every public company faces business risks that even the most diligent banker, accountant or lawyer may not spot. Company executives routinely make decisions that turn out poorly in retrospect. Perhaps, the company lost money because a product didn't sell or the company's competitors made better products. Or, the economy suffered an unexpected downturn that caused the company to suffer significant losses. This happens every day in America.

As matters now stand, if the company's stock has fallen significantly, the plaintiffs' bar may sue the company and its executives charging that they were reckless in not disclosing the business risks that caused the company's stock to drop. If S. 1551 is enacted, the plaintiffs' bar almost certainly will name as defendants all of the third parties – particularly

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bankers – who provided lending or financing to the company, claiming that those loans funded the "fraud."

Even if the case is weak, the third parties will have to spend hundreds of thousands of dollars moving to dismiss the complaint. If they fail to do so, then those third parties will have to spend millions in defense costs. As result, as before the PSLRA, the plaintiffs' bar will have the unjustified power to exact big settlements from innocent third parties.

Here's another real-world example. Let's suppose a company's executives lie to the company's bankers, accountants, vendors and lawyers. Assume that the executives are really good liars. Great con artists. I have deposed some pretty well-known con artists, and the best con artists could sell ice to eskimos.

Also assume that the company's bankers, accountants, vendors and lawyers reasonably believe the lies that they are told by the company's executives. The bankers agree to provide loans putting the bank's money at risk. The accountants provide audit opinions. The vendors engage in transactions with the company. And, the lawyers help the company draft SEC filings or provide opinion letters that are necessary for capital-raising or other corporate transactions to be completed.

At some point, the company's fraud is revealed. Maybe one of the company's bankers, accountants, vendors or lawyers figures out that something is wrong and blows the whistle to the Department of Justice or the SEC. The company's stock collapses. The executives plead guilty and go to jail.

A plaintiffs' lawyer doesn't need documentary proof to survive a motion to dismiss or even summary judgment. Sometimes, a criminal executive of a company will try to

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cut a deal with the plaintiffs' lawyers: " Drop your case against me, and I'll testify against the deep-pocket banker." It's enough that one corrupt executive charges that a third party knew about the company's fraud, for example, the claim that a banker made a loan to prop up a company's fraud. There may be no other proof, but the mere allegation of an insider, even if a convicted felon, is enough to create an issue of fact for the jury.

Juries can be unpredictable. Some third parties, like Wall Street bankers, are not particularly popular with the typical juror. No deep-pocket third party wants to risk a catastrophic jury verdict or even the massive expense of defending a securities class action. So, fearful of a runaway jury, companies settle, with the settlement amount often turning on the size of the potential damages more than any notion of culpability. And, the cost of settling and defending securities class action is passed on to shareholders through higher D&O insurance premiums.

2. The SEC and DOJ Are Best Suited To Prosecute Aiders and Abettors. In the PSLRA, Congress wisely decided that the SEC and Department of Justice (and not the plaintiffs' bar) should have the power to prosecute third parties – from banks to accountants to vendors – that aid and abet securities fraud. The SEC and Department of Justice should (and do) take action against real aiders and abettors of securities fraud. But, clearly, Congress did not want to give the plaintiffs' bar the enormous leverage of an open-ended theory of liability to extract huge settlements from the supposedly deep pockets of those who deal with public companies.

In 2002, in Sarbanes-Oxley, Congress gave the SEC the power to require wrongdoers (including aiders and abettors) to make payments into a "Fair Fund" to provide compensation to injured investors. Since 2002, the SEC has set up 115 Fair Funds and recovered more than $8 billion from securities law violators. The SEC obviously doesn't have to pay as much as one-third of any recovery to lawyers, so that greater reliance on the SEC can result in larger recoveries for innocent investors.

In addition, the Department of Justice can pursue third parties that aid and abet securities fraud. If the threat of a long prison sentence doesn't deter aiding and abetting, it's highly doubtful that the risk of a class action lawsuit is going to stop such conduct.

3. **S. 1551 Would Hurt the Competitiveness of U.S. Capital Markets.** In considering S. 1551, Congress should consider the widely acknowledged concern that foreign private issuers are being driven from U.S. markets by fear that listing shares on the U.S. exchanges will expose them to worldwide securities class actions brought on behalf of shareholders who purchased their shares outside the United States.

In Europe and Asia, there are no U.S.-style securities class actions. Non-U.S. companies fear the U.S. legal system. They don't think it's fair, and they are utterly shocked by the enormous expense involved in U.S. discovery. As a result, many non-U.S. companies are delisting from our capital markets.

As a study commissioned by Senator Schumer and Mayor Bloomberg found: "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business—and driven away potential investors." (McKinsey & Company, Report Commissioned by Mayor Michael R. Bloomberg and Senator Charles E. Schumer, *Sustaining New York's and the U.S.' Global Financial Leadership* ii (2007)).

Indeed, as Professor John Coffee has written: "while the press and others attribute the growing concern of foreign issuers with the U.S. market to the Sarbanes-Oxley Act, closer analysis and interview data suggest that fear of U.S. private antifraud litigation may be the

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better explanation [for the flight of foreign private issuers from U.S. markets]." (John C. Coffee, Jr., Securities Policeman to the World? The Cost of Global Class Actions, N.Y.L.J., Sept. 18, 2008).

4. **S. 1551 Would Hurt New York and Other U.S. Financial Centers.** I live and work in New York City. There is no more important industry to New York than the financial services industry. Although it's fashionable now to attack banks and bankers, the financial services industry is critical to the economic health of our Nation. Enactment of S. 1551 would be good for the City of London, but it would be bad for New York, Chicago, Charlotte, Boston, Philadelphia, San Francisco and other U.S. financial centers.

Prior to the Supreme Court's decision in *Stoneridge*, financial institutions were the targets of so-called "scheme" liability claims. Thus, S. 1551 would expand the risk of liability for the very businesses that Congress has supported under the TARP program. As a result, instead of spending their capital making loans and thereby growing our economy, these financial institutions would be faced with having to foot an even bigger bill for expanded securities litigation, including tens of millions for both plaintiffs' and defense lawyers and potentially billions for settlements.

S. 1551's "Recklessness" Standard Is Too Vague and Amorphous

In the PSLRA, Congress did not expressly establish a substantive standard of fraudulent intent or scienter. As matters now stand, Federal Courts of Appeal have required proof of a high degree of recklessness to constitute fraudulent intent. For example, in the Second Circuit, a plaintiff must allege reckless conduct that "is highly unreasonable and . . . represents an extreme departure from the standards of ordinary care . . . to the extent that the danger was

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either known to the defendant or so obvious that the defendant must have been aware of it." *Chill* v. *General Electric*, 101 F.3d 263, 269 (2d Cir. 1996).

S. 1551 would impose liability on any third party that "recklessly provides substantial assistance to another person" in violation of the Securities Exchange Act. By not at least adopting a strict definition of "recklessness," courts likely would view S. 1551 as watering down the current standard for alleging fraudulent intent to something approximating negligence or, at best, gross negligence. As a result, many cases that now do not survive motions to dismiss would pass this lower pleading threshold, and more companies would have no choice but to settle weak securities cases to avoid the risk of a large judgment. In addition, S. 1551 does not define "substantial assistance," leaving that term to be defined by courts and juries on an ad hoc basis, creating more uncertainty and pressure to settle cases.

The combination of an undefined "substantial assistance" – conduct that in itself may be perfectly legal – and a nebulous "recklessness" standard that does not require that the accused party have any actual knowledge that its conduct in some way assisted a fraud not only gives plaintiffs' lawyers a broad "hunting license," but creates such uncertainty about the legal standard that the pressure to settle cases (rather than risk a jury trial in which the damages could be billions of dollars) will be overwhelming. Indeed, even before the Supreme Court in *Central Bank* held that aiding and abetting claims are not authorized by the securities laws, many of the lower courts that permitted such claims had adopted strict limits on the circumstances in which such claims could be brought, including requiring proof that the accused party had knowledge of the fraud it allegedly was assisting.

Some Reforms of Securities Litigation That Congress Should Consider

The PSLRA improved securities class actions, but as I've explained the system is still far from perfect. While benefiting lawyers, the current system typically requires innocent shareholders to bear the cost of litigating and settling securities class actions – particularly when claims lack merit.

1. **Eliminating Settlements Based on Legal Error.** As I mentioned, unless dismissed on a motion, virtually all securities class actions settle. Many of these settlements are based on district court rulings denying motions to dismiss or for summary judgment, and granting motions for class certification. To avoid the risk that settlements are based on legal error by lower courts, Congress should permit parties to appeal immediately as of right lower court decisions on motions to dismiss, for summary judgment and for class certification. In their report, Senator Schumer and Mayor Bloomberg urged adoption of this needed reform.

Alternatively, Congress could provide parties with the right to petition appellate courts for interlocutory review of decisions on motions to dismiss and for summary judgment. These appellate rights could be limited to cases where plaintiffs seek damages of more than $50 million or do not specify an amount of alleged damages. Under the Federal Rules of Civil Procedure, parties presently can petition for interlocutory review of decisions on class certification.

2. **Improving the Lead Plaintiff Selection Process.** In the PSLRA, Congress adopted the presumption that the largest interested shareholder should, as lead plaintiff, control the conduct of securities class actions. This provision was intended to eliminate so-called captive plaintiffs in major securities class actions.

The recent revelations about "pay-to-play" relationships between plaintiffs' firms and the public officials who control public pension funds indicate that some lawyers may have found a way to circumvent these provisions, returning to plaintiffs' lawyers the control that the PSLRA was designed to eliminate. Many prominent observers, including the late Judge Edward Becker and Professor Coffee, have criticized this practice. To eliminate any risk of "pay to play," Congress should require that plaintiffs' lawyers disclose to the court any political contributions made to elected officials who manage public pension funds when those funds seek to become lead plaintiffs in securities class actions.

Moreover, in order to eliminate the risk that lead plaintiffs will not effectively control securities class actions, Congress should bar plaintiffs' lawyers from aggregating unrelated plaintiffs as a single lead plaintiff group to seize control of a securities class action from the largest interested shareholder.

In some cases, plaintiffs (and their counsel) have unfairly secured the lead plaintiff role by submitting inflated calculations of their clients' alleged losses. To address this abuse, Congress could amend the PSLRA's lead plaintiff provision to require detailed submission of information about shareholder loss in connection with the lead plaintiff selection process.

3. Eliminating Coercive Settlements by Reforming the Calculation of Damages. Most securities class actions settle because defendants cannot afford the risk of a judgment based on a jury's acceptance of the grossly inflated theories of damages of plaintiffs. In some cases, district courts do not sufficiently scrutinize the damages theories of plaintiffs' experts.

At the pleading stage, Congress could require that plaintiffs plead loss causation with the particularity required for fraud claims. Courts presently are divided over whether such heightened pleading standards apply to loss causation.

To eliminate speculative theories of damages, Congress could expressly require that damages in securities class actions be based solely on losses caused by the fraud, and not from general market or industry factors, or from non-fraudulent company-specific factors, such as poor business performance.

In any securities class action, some members of the plaintiff class receive a "windfall," because they sold some shares at a fraudulently inflated profit before the disclosure of the fraud. Congress could require that, in the event of a judgment, any calculation of damages include a netting of any such gains from the calculation of individual class member's losses.

In an effort to inflate settlements, plaintiffs typically request that juries be permitted to award damages on an aggregate basis to a class of plaintiffs of largely unknown size. Congress could bar jury awards based on aggregate theories of damages. Instead, juries should award damages based on the damages per share, with the total amount of damages to be determined based on the number of shareholders who actually submit valid claims. In many cases, substantially less than 50% of affected shareholders even submit claims.

Under current law, the risk exists that a deep-pocket defendant might be liable for 100% of the damages caused by a securities fraud, even if that defendant bore only 1% of the responsibility for those damages. To avoid the coercive impact of this risk on settlements, Congress could eliminate joint and several liability in securities class actions.

4. Eliminating Speculative Theories of Reliance. In *Basic* v. *Levinson*, 485 U.S. 224 (1988), a divided Supreme Court effectively eliminated the requirement that plaintiffs in securities class actions plead a basic requirement of fraud – that the plaintiff relied on a misstatement of the defendant. Instead, the Supreme Court adopted a rebuttable presumption that all public statements about a company are reflected in the company's stock

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price, including statements that not read by many shareholders, much less relied on, such as statements by third parties like stock analysts. One thing we've learned from the recent financial crisis is that markets are far from perfect. But the Supreme Court decision in *Basic* rests entirely on the notion that markets perfectly reflect all available information. Thus, Congress could limit application of the so-called "fraud on the market" theory to cases against issuers in which plaintiffs allege that the SEC filings of the issuer were false, as opposed to statements made by company officials reported in the press or that are not widely disseminated to the market.

* * *

In sum, I urge the Committee to continue to rely on the SEC and DOJ to prosecute aiders and abettors of securities fraud. The benefits of allowing the plaintiffs' bar to assume this mantle are few and the costs are likely to be great. Congress should consider other reforms of securities class actions, but not revisit the balanced approach struck in the PSLRA to aiding and abetting liability.

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S. Hrg. 107–618

THE ROLE OF THE FINANCIAL INSTITUTIONS IN ENRON'S COLLAPSE—VOLUME 2

HEARINGS

BEFORE THE

PERMANENT SUBCOMMITTEE OF INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

JULY 23 AND 30, 2002

Printed for the use of the Committee on Governmental Affairs

2079

DEC-21-1999 10:57 MERRILL LYNCH 214 849 5399 P.01

Merrill Lynch

Investment Banking Group
200 Crescent Court
Suite 550
Dallas, Texas 75201

Facsimile Cover Sheet

Don Boyle

To: Jim Brown
Company: ML
Phone:
Fax: 212-449-1787
From: Rob Furst
Phone: (214) 849-5350
Fax: (214) 849-5399

Date: December 21, 1999

26 pages including this cover page.

Message

Paul Wood
2-6318

[illegible] — foreign tax (income, w/h, VAT, etc.)
MAYBE — environmental
RISK — operating performance
RISK — failure to complete
YES NOT SURE HOW — expropriation
— failure to pay under IIA (no IIA signed yet?)
— No repurchase obligation from Enron
— foreign currency risk
— Enron credit/performance risk
— reputational risk in default [illegible]

Permanent Subcommittee on Investigations
EXHIBIT #212

MS 06518

2080

Handwritten note at bottom of Merrill Lynch Facsimile Cover Sheet:

"... reputational risk i.e. aid/abet Enron income stmt [statement] manipulation ..."

–Handwritten note of Merrill employee on Merrill document dated 12/21/99, MS 06518

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Jim Brown
1-212-449-1787

Confidential Memorandum

Preferred Stock Representing a Set Duration 90% Economic Interest in

ENRON NIGERIA BARGE LTD.

IMPORTANT NOTICE TO RECIPIENT

The information contained in this Preliminary information Memorandum (this "Information Memorandum") is being furnished by Enron Nigeria Barge Holdings Ltd., a Cayman Islands company ("Enron"), to a limited number of selected persons who have expressed interest in acquiring redeemable preference shares (the "Shares") of Enron Nigeria Barge Ltd. (the "Company") entitled, subject to the terms of the Share Purchase Agreement (as hereinafter defined), to a distribution of 90% of the Cash Flows of the Company, a private, limited liability company incorporated under the laws of the Federal Republic of Nigeria and a wholly owned subsidiary of Enron.

The sole purpose of this Information Memorandum is to provide preliminary background information on a confidential basis to assist the recipient in deciding whether to proceed with an investment in the Company and the Shares. This Information Memorandum is not an offer, nor is it intended to provide the basis of any credit or any other evaluation and is not to be considered as a recommendation by the Company or any other person that any recipient of this Information Memorandum should purchase the Shares or provide loans or other credit to the Company or any of its affiliates. Each recipient of this Information Memorandum contemplating purchasing shares of, or otherwise investing in, the Company must make (and will be deemed to have made) its own independent investigation and appraisal of the operations, financial condition, prospects, creditworthiness, status and affairs of the Company, the Project and any other matter it considers relevant to a decision to purchase the Shares, or to provide loans or other credit to the Company, including, without limitation, its own independent investigation and appraisal of the risks.

This Information Memorandum is directed at persons whose ordinary activities involve them, as principal or as agent, in acquiring, holding, managing or disposing of investments of this nature. It would be imprudent for other persons to respond to this Information Memorandum.

No representation or warranty (express or implied) regarding the accuracy or completeness of the information contained in this Information Memorandum is hereby made by the Company or any of its shareholders or its or their affiliates or advisors. The only representations or warranties that will be made in connection with the proposed financing will be such representations and warranties, if any, set forth in the definitive, written Share Purchase Agreement for the sale and purchase of the Shares.

The information contained in this Information Memorandum, except where the context expressly states otherwise, has been based on the assumption that the Project is implemented as described herein. Any financial projections in this Information Memorandum are estimates prepared and set out for illustrative purposes only, have been prepared using data available to date and do not constitute a forecast. Such financial projections may be affected by changes in economic and other circumstances and the reliance, if any, that the recipient of this Information Memorandum places upon such projections is a matter for its own commercial judgment. No representation or warranty

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(expressed or implied) is made about the accuracy or completeness of any of the information contained in this Information Memorandum or any other written or oral information, including, without limitation, any projection, forecast, opinion, information, advice, assumption or estimate. **THEREFORE, NOTHING CONTAINED IN THIS INFORMATION MEMORANDUM IS, OR SHOULD BE RELIED ON BY ANY INTERESTED PERSON OR RECEPIENT AS, A REPRESENTATION AS TO THE FUTURE PERFORMANCE OF THE COMPANY, ANY OF ITS RESPECTIVE AFFILAITES, THE PROJECT OR THE SHARES, OR AS A REPRESENTATION THAT ANY PROJECTION, FORECAST, ASSUMPTION OR ESTIMATE WILL BE ACHIEVED. RECIPIENT AND ITS RESPECTIVE REPRESENTATIVES EACH HEREBY AGREES THAT BY ACCEPTING THIS INFORMATION MEMORANDUM NEITHER THE COMPANY, ITS RESPECTIVE AFFILIATES, NOR ANY OF THEIR REPRESENTATIVES SHALL HAVE ANY LIABILITY TO RECEPIENT OR ANY OF ITS REPRESENTATIVES RESULTING FROM THE USE OF ANY SUCH INFORMATION BY RECIPIENT OR ITS REPRESENTATIVES AND NO PERSON WILL HAVE ANY LIABILITY RELATING TO SUCH INFORMATION OR FOR ANY ERRORS THEREIN OR OMISSIONS THEREFROM. NEITHER THE COMPANY, ITS RESPECTIVE AFFILIATES, NOR ANY OF THEIR REPRESENTATIVES MAKE ANY REPRESENTATION OR WARRANTY ABOUT THE TAX EFFECT OR THE LEGAL EFFECT OF ANY ARRANGEMENT DESCRIBED IN THIS INFORMATION MEMORANDUM OR ANY OTHER INFORMATION GIVEN TO ANY INTERESTED PERSONS OR RECIPIENTS, EXCEPT FOR PARTICULAR REPRESENTATIONS AND WARRANTIES, IF ANY, WHICH MAY BE MADE BY THE SELLER IN THE SHARE PURCHASE AGREEMENT WHEN, AS AND IF EXECUTED, AND SUBJECT TO THE LIMITATIONS AND RESTRICTIONS SPECIFIED IN THE SHARE PURCHASE AGREEMENT. EACH INTERESTED PERSON SHOULD CONDUCT ITS OWN INDEPENDENT INVESTIGATION AND ANALYSIS OF THE COMPANY AND THE SHARES AND THE INFORMATION SET FORTH IN THIS INFORMATION MEMORANDUM OR OTHERWISE SUPPLIED BY ENRON, THE COMPANY OR ANY OF THEIR REPRESENTATIVES AND AFFILIATES.** As used above, "representatives" shall include, without limitation, such person's employees, agents and attorneys, accountants, financial advisors, potential financing sources, or any employees, agents and attorneys of the foregoing.

Certain documents and agreements are described herein in summary form and, in the case of agreements or amendments to agreements not yet executed, are described based on drafts of such agreements or amendments as proposed by the Company. The summaries do not purport to be complete descriptions of such documents and agreements. They are intended only to assist in a reading of such documents and agreements, are qualified in their entirety by reference to the actual documents and agreements and should not be relied on as a basis for contracting. With respect to the discussions herein concerning the development, financing, construction and operation of the Project, the Company has not yet finalized (or in certain cases commenced) negotiation of the documents and agreements that will be required in connection therewith; consequently, said discussions merely reflect the Company's assumptions and current expectations concerning the manner in which the Project will be developed, financed, constructed and operated and should in no event be viewed as either (i) a final, complete or accurate description as to how such matters will ultimately be resolved or (ii) a representation or warranty (expressed or implied) from the Company that such matters will be resolved as discussed herein.

This Information Memorandum contains descriptions and other information believed to be accurate as of the date hereof. The delivery of this Information Memorandum at any time does not

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imply that the information in it is correct as of any time after the date set out on the cover hereof, or that there has been no change in the operations, financial condition, prospects, creditworthiness, status or affairs of the Company or the Project, or of any other person since that date.

The information contained herein is proprietary to the Company and its shareholders. By accepting delivery of this Information Memorandum and any other information concurrently or separately submitted in conjunction herewith, the recipient agrees not to permit its duplication, dissemination or disclosure, in whole or in part, and, if the recipient is not interested in purchasing the Shares or any portion thereof, the recipient agrees to return the same to the Company.

Unless prior written consent has been obtained from the Company or unless disclosure of specific information is required by law, the recipient agrees not to divulge to any person any information about the Project, the Company or its shareholders or affiliates, or the fact that such information has been made available to the recipient. In no event shall the recipient divulge any such information without giving the Company advance notice and an opportunity to take any action the Company deems reasonable under the circumstances.

Additional information about the contents of this Memorandum may be obtained from the following persons:

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333 Clay Street, Suite 1800
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Facsimile: 713 646 7433

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Table of Contents

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Abbreviations

EE&CC -	Enron Engineering & Construction Company
ENBL -	Enron Nigeria Barge Ltd. or "the Company"
ENPH -	Enron Nigeria Power Holdings Ltd.
EPC -	Engineering, Procurement and Construction
FSA -	Fuel Supply Agreement
IPP -	Independent Power Producer
LSG -	Lagos State Government of Nigeria
NEPA -	Nigeria Electric Power Authority
O&M -	Operation and Management
PPA -	Power Purchase Agreement
TDA -	Transmission and Distribution Agreement
YFP -	Y.F. Power

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1. EXECUTIVE SUMMARY

1.1 Introduction

Enron, its affiliates and Y.F.Power ("YFP"), an affiliate of Yinka Folawiyo and Sons Ltd. ("Yinka Folawiyo") have nearly completed development of a 3 x 30 MW emergency power barge mounted gas turbine electric power facility (the "Barges") to be located in Ijara, Lagos, Nigeria and are developing a 548MW long term power generation facility, both with electrical capacity and energy sales to the National Electric Power Authority ("NEPA") as directed by the Lagos State Government of Nigeria ("LSG"). Enron affiliate, Enron Nigeria Power Holdings Ltd. ("ENPH") is expected to enter into a Power Purchase Agreement (the "PPA") with NEPA as purchaser, the Federal Republic of Nigeria ("FRN") as guarantor and NEPA as transmission and distribution provider to provide a combination of emergency and long term electrical energy and capacity. In turn, LSG is expected to have first right to direct the transmission and distribution of the power sold under the PPA.

Under the PPA, Phase I covers the thirteen (13) year three (3) month operating period for the Barges and Phase II covers a 20 year operating period for the 548 MW gas fired power plant (the "Power Plant") Phase III covers the thirteen (13) year three (3) month operating period for 180MW of additional barge mounted power generation.

Phase I, Phase II and Phase III of the Project are being developed by Enron affiliates and YFP, an affiliate of Yinka Folawiyo, a Nigerian holding company with interests in shipping, cement, construction, agriculture, fishing, energy and banking. During Phase I of the Project, Yinka Folawiyo is to receive an annual fee for their participation and during Phase II, an equity ownership position.

Enron desires to sell Shares in the Company entitled to distribution of 90% of the net cash flow expected to be generated by the Company over the initial three years of operations of the Barges in the form of preferred and common shares. Enron currently holds 100% of the preferred and common shares of the Company. Finally, an affiliate of Enron is available to provide up to 75% of the purchase price with seller financed debt.

Figure No.1 shows the contractual structure for the Project and the relationship of the various Enron entities involved in the Project as of the date of signing the PPA. Figure No. 2 shows the Preferred Share Structure.

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Figure No. 1

Nigerian Power Barge, Power Plant & Additional Power Ownership Structure

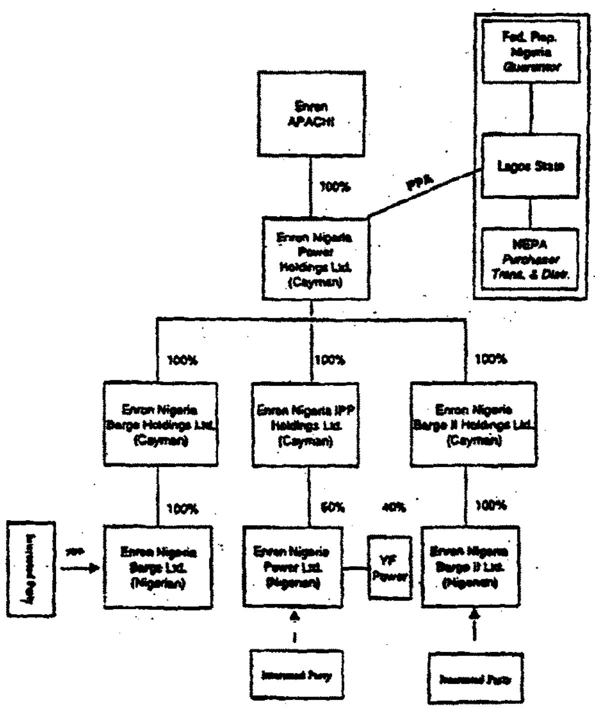

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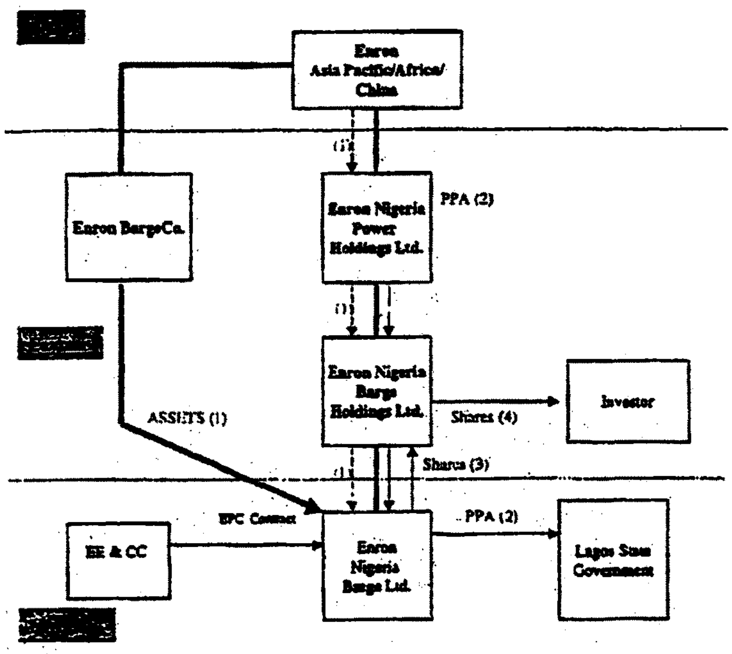
Figure No. 2

Preferred Share Structure



(1) Assets (barges) are sold to Enron Nigeria Barge Ltd. at fair market value. Cash to finance the purchase is [illegible] from Enron Corp. and relayed to Enron BargeCo.

(2) The rights to the PPA (Phase I barge activities only) are passed down to Enron Nigeria Barge Ltd.

(3) Enron Nigeria Barge Ltd. Preferred Stock is issued to Enron Nigeria Barge Holdings Ltd. Preferred A and Common shares are entitled to cash flows from operations based on their equity stake.

(4) Preferred A and Common Shares are sold to the Investor.

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1.2 Project Description

1.2.1 Phase I – The Barges

Under the PPA, ENPH will provide power for thirteen (13) years three (3) months from commercial operations of the Barges. The Barges shall be initially fired on No. 2 Diesel Fuel with an expectation to convert them to gas within 15 months of the commercial operations date. First power is expected by the end of February 2000. The pricing for Phase I under the PPA is based on the following:

- 13 years 3 months of capacity and energy with payment in US$
- Capacity Payment of $20.04 per KW-Month (approx. $0.029/kWh)
- Fuel Cost will be a pass-through (approx. $0.056/kWh on No.2 Diesel Fuel); substantially less on gas.

LSG will provide to Enron a Standby Letter of Credit ("Standby L/C") in the amount of US$31,000,000. The Standby L/C is expected to be issued by Citibank London. LSG will also establish for Enron an Escrow Account for the term of the project, whereby electricity sales proceeds from a select group of commercial and industrial customers shall be collected and held to ensure payment to ENPH under the terms of the PPA.

ENPH is indirectly 100% owned by Enron Corp., a Delaware corporation. Affiliates of Enron have provided procurement and technical services during the construction of the Barges and will provide technical assistance and operation services for the Barges. A consortium of three local diesel fuel oil suppliers have been contracted to supply the 690 metric tons of fuel per day required by the three Barges. Arrangements to secure gas from existing and planned production is underway.

1.2.2 Phase II – The Power Plant

In addition to the Power Barges, ENPH may provide long term electrical energy and capacity to LSG over a 20 year period. Under the PPA, ENPH expects to finance, build, own, operate and maintain a Power Plant, to be located near Agbara, Lagos State, Nigeria – near the Benin border. The Power Plant is to be owned by Enron Nigeria Power Ltd. which is expected to be 60% owned by Enron Nigeria IPP Holdings Ltd. and 40% by YFP.

In respect of the Power Plant, LSG and the FRN are to provide Enron Nigeria IPP Holdings Ltd. an additional Standby L/C in the amount of US$76,000,000, as well as, rights to an Escrow Account for the term of the project. First power from the Power Plant is expected by the end of December 2002. The pricing for Phase II of the PPA is based on the following:

- 20 years of capacity and energy with payment in US$
- Capacity Payment of $20.23 per KW-Month
- Fuel Cost is a pass-through with per kwh price based on delivered gas cost

Whereas the PPA also contemplates the construction of an offshore gas pipeline from the Delta Region of Nigeria to the Power Plant, ENPH is reviewing a number of alternatives including the use of the existing Escravos to Lagos Pipeline.

MS 06527

1.2.3 Phase III Emergency Power

In addition to the Power Barges, ENPH shall have the option to provide at least 180MW of additional emergency power ("Additional Power") under substantially the same terms as the Power Barge. Enron currently owns an additional 6 power barges of approximately 180 MW. Subject to further due diligence and completion of the terms related to the Additional Power, Enron expects to install such power barges as soon as practicable. The additional power barges may initially use distillate fuel. However, Enron expects to convert such barges to gas as soon as commercially reasonable.

1.3 Project Status

On August 13, 1999, an affiliate of ENPH signed a Memorandum of Understanding ("MOU") with LSG in connection with the Barges and the Power Plant. Under the MOU, Enron was granted a 90 day exclusive negotiation period with LSG, and the PPA was required to be executed within 90 days of LSG issuing a notice to ship order ("NTS") for the Barges.

LSG issued the NTS order on September 6, 1999 and committed to pay transportation charges in the event the PPA is not concluded within the 90 day period. The Barges are presently in Lagos, Nigeria following delivery from Cebu, Philippines.

With respect to the Power Plant, a site has been identified and rights to the site are provided under the PPA. The PPA also grants all permits and approvals for the Barges, the Power Plant and the Pipeline.

Enron has identified a consortium of three local distributors for the fuel supply and is presently negotiating the Fuel Supply Agreement ("FSA") is nearly ready for execution. Discussions with potential gas suppliers is also underway

Outstanding conditions for the projects include finalizing the Standby L/C, the Escrow Account, the FSA and environmental approvals. Additionally, the Power Plant requires securing of third party debt financing for at least 70% of the project.

1.4 Barge Project Economic Summary

Cost Summary (US$000)

Power Barges	$25,000
Barge Upgrades and Onshore Cost	15,800
Total EPC	40,800
Mobilization	1,014
Development Costs	1,500
Working Capital and Spares	2,119
Contingency	181
Total Costs	$45,614

Projection of 90% of Net Cash Flow (US$000)

Year 2000	Year 2001	Year 2002	Year 2003	Total
$9,213	$13,362	$13,706	$3,410	$39,691

The $45.6 million project costs are to be paid by Enron. The net cash flow projected over the three year Phase I project life is $44.1 million, and 90% of the three year cash flow is $39.7 million.

It is the intention of Enron to provide to the Investor monthly distributions of net cash flow, and to have an Enron affiliate provide up to 75% of seller financed debt. The proposed debt period is three years with an interest rate of 12% per year.

17 million

4 — 13

$70 million

45

28

13.

28

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2. Facilities Description

2.1 The Barges

The project consists of three Power Barges with a combined nominal net output of approximately 90 MW and certain ancillary systems and facilities located on-shore. The Power Barges are moored in Lagos Lagoon in close proximity to the National Electric Power Authority's (NEPA) 132/33/11 kV Ijora substation on Iddo Island in Lagos.

Mitsui manufactured the Power Barges, which are not self-propelled. Each Barge has one General Electric (GE) PG6531 gas turbine and an Ahlstrom air to air cooled generator installed on board for the generation of electricity. Control of the gas turbine generator is provided by a GE Mark IV Speedtronic control system located in an in-line control cab onboard the Barge.

Approximately 30 MW of 50 Hz power at 11.5 kV is generated on each Barge by its gas turbine generator operating in open cycle on light distillate fuel. The output of each generator is stepped up to 132 kV through its own 45 MVA transformer at which voltage is evacuated from the Barges, combined with the output of the other Barges, and delivered to NEPA's Ijora substation. These Barges, which were originally designed by GEC Ahlstrom to generate 60 Hz power at 13.8 kV and step up to 69 kV or 138 kV, have been converted to produce 50 Hz power at 11.5 kV.

Each Power Barge has an essentially self-contained power plant. In addition to the gas turbine generator, control system and step-up transformer mentioned above, other electrical equipment on each Barge includes a generator circuit breaker, a unit auxiliary transformer, switch gear and overhead connection to shore. Gas turbine support systems on board each Barge include: a standard type, three stage, non-self-cleaning inlet air filtration system, a diesel engine generator gas turbine starting (including black start) system, oil lubrication and cooling system, exhaust gas stack, fuel storage, treating, handling and forwarding equipment, an off-line water wash system, and CO_2 and sea water fire protection systems.

Each Barge has 2.5 million liters of fuel oil storage capability (approximately 9.5 days supply at a 90%-100%-100%-100% load factor) on board. The Power Barges are refueled by fuel Barges that operate in Lagos harbor. Since none was originally provided, each gas turbine has been modified with a water injection skid for NOx abatement.

The raw water storage and treatment facilities and the de-mineralized water storage and forwarding systems required for gas turbine water injection are located on-shore. Additional on-shore facilities include the electrical dead end structure from which the single circuit 132 kV transmission line to the Ijora substation runs, roads, parking facilities, fencing, lighting and buildings for maintenance, warehousing and administrative offices.

Barge dimensions are as follows:

- Length 46 meters
- Width 22 meters
- Depth 4.4 meters
- Draft (when loaded) 3.5 meters
- Gross Weight 3,646 tons

MS 06530

These Power Barges are three of the nine that Enron recently acquired from NAPOCOR, an electric utility company in the Philippines. NAPOCOR employed the Barges in peaking service since about the 1990 time frame. Since acquiring them, Enron has refurbished both the gas turbines and the Barge hulls to address areas requiring attention as identified by the inspection that Enron conducted prior to the acquisition.

The actual fired hours, equivalent operating hours, starts, and fired hours since last overhaul of each of these gas turbines are as follows:

Barge Number	Actual Fired Hours	Equivalent Op Hours	Starts	Fired Hours Since Last Overhaul
207	31,800	47,692	2,465	11,800
208	23,300	34,866	1,705	3,800
209	27,500	41,223	1,945	10,625

2.1.1 The Barges Site

As mentioned above, the three Power Barges are to be moored in Lagos Lagoon adjacent to the south side of NEPA's Ijora substation on Iddo Island in Lagos. The on-shore facilities are located on property to be leased by the Company adjacent to the barge jetty and the Ijora substation.

2.1.2 Fuel Supply

A consortium of three local diesel fuel oil suppliers are expected to supply the 690 metric tons of fuel per day required by the 3 x 30 MW Power Barges under a three year FSA. Each barge has 2,100 mt of fuel storage capacity on board. The consortium has local storage of approximately 45,000 mt of fuel, 30,000 mt, which will be dedicated to the Barges. Every third day, a fuel barge will re-supply the Power Barges with 2,000 mt, topping them off. Two of the local suppliers receive their fuel from local refineries and the third has a contract with a Dutch company, Chimimex, which has an arrangement with a Balkan refinery. Two of the three have extensive operations in the Lagos area, owning and operating transport vessels and refueling Barges. All three suppliers have extensive contracts and operations in place with most of the major oil companies in Nigeria (Chevron, Shell, Total, Elf, etc). Specific logistics and the interaction between the three suppliers are being finalized.

Enron shall use commercially reasonable efforts to convert the Barges, including the Additional Power, to gas as soon as practicable. The target conversion date is fifteen months after commercial operations of the Barges. Enron is currently conducting due diligence as to the appropriate site for gas based generation for the barges as well as the most appropriate source of gas supply and transportation.

2.1.3 Engineering, Procurement and Construction

Enron Engineering & Construction Company ("EE&CC") has been engaged by the Company to perform the turnkey engineering, procurement and construction ("EPC") for the Project. In its capacity as turnkey EPC Contractor, EE&CC will have total responsibility managing the project and for

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providing a completely operational power facility. EPC for the project includes development engineering, detailed engineering and construction management.

Development engineering consisted of developing preliminary design specifications, geotechnical analysis, environmental considerations, design schematics, right of ways, project cost estimates, schedules, quality assurance and the process control plan.

The detailed design work consisted of developing detailed engineering and design, bid and construction drawings, bid specifications, material procurement, job books, expediting, shop inspection, project management, cost control, permits and other detailed activities.

The construction management effort consists of field inspection, mechanical completion, commissioning, start-up, facility turnover, completion of as-built drawings, final project documentation, and post completion review.

2.1.4 Operations and Maintenance

Figure No. 3 outlines the operations and maintenance and administrative services arrangements for the Project.

Operational Energy Corp. ("OEC"), a subsidiary of Enron Corp., will provide technical, operations and maintenance services to the Company in exchange for a fee under the Operations and Maintenance Agreement (the "O&M Agreement"). The O&M Agreement allows for adjustments to the OEC fee, should the plant operate below agreed performance levels. OEC will be responsible for providing a budget and maintenance schedule for the Company's approval on an annual basis as well as meeting the operating requirements stipulated in the PPA.

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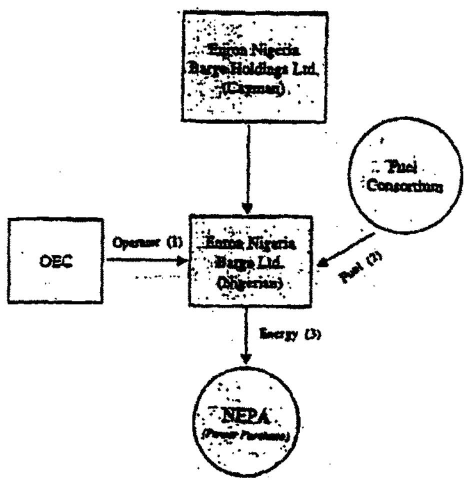
Figure No. 3

Operations and Maintenance Diagram

Phase I - Barges Project



(1) Operations and Maintenance Agreement
(2) Fuel Supply and Management Agreement
(3) Power Purchase Agreement

MS 06533

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2.2 Additional Emergency Power

In addition to the Power Barges, ENPH shall have the option to provide at least 180MW of additional emergency power ("Additional Power") under substantially the same terms of the PPA. Enron currently owns an additional 6 power barges of approximately 180 MW. Subject to further due diligence and completion of the terms related to the Additional Power Enron expects to install such power barges as soon as practicable. The additional power barges will initially use distillate fuel. However, Enron expects to convert such barges to gas as soon as commercially reasonable.

2.3 The Power Plant

The Power Plant is expected to consist of five General Electric PG9171E combustion turbine generators ("CTGs") (or similar technology from another vendor) operating in open cycle. It will have a nominal, net new and clean output of approximately 548,000 kW (approximately 110 MW per turbine) at the site average ambient (design) conditions of 27.2° C (81°F), 82.5% relative humidity, and an atmospheric pressure of 14.696 psia. The CTGs are to be configured to burn natural gas using Dry Low NO_x ("DLN") combustors to reduce NO_x pollutant discharge at the stack to 25 ppm.

3. CONTRACTUAL ARRANGEMENTS

Figure No. 1 outlines the contract structure for the Barges. The following summaries provide additional information on the contracts. The actual contracts are provided in the Appendices.

3.1 Power Purchase Agreement

The PPA is to be entered into by and between ENPH and LSG, NEPA and the FRN and covers the sale and purchase of 90MW of capacity and energy from the Barges over a thirteen year three month term (Phase I) and the subsequent sale and purchase of 548MW of capacity and energy from the Power Plant over a 20 year period (Phase II). ENPH is expected to assign its Phase I PPA rights and obligations to the Company and its Phase II PPA rights and obligations to Enron Nigeria Power Ltd.

LSG is the power purchaser and is responsible for making the capacity and energy payments under the PPA. NEPA is responsible for transmission and distribution of the power to end users and the FRN guarantees the obligations of LSG and NEPA. However, it is anticipated that the LSG rights and obligations as purchaser under the PPA will be assigned to NEPA, resulting in NEPA serving as purchaser and the party responsible for transmission and distribution.

Several noteworthy aspects of the PPA are further addressed below. The full PPA is provided as an appendix.

3.1.1 Letter of Credit

The letter of credit is to be a standby letter of credit (the "Standby L/C") issued by a minimum A-rated offshore financial institution. Citibank London is expected to be the offshore Standby L/C bank. ENPH will be entitled to draw upon the Standby L/C in the event that LSG, NEPA or the FRN fail to meet their obligations under the PPA, particularly their payment obligations. The Standby L/C will be $31 million – equal to approximately six months worth of projected revenues for the Barges and $76 million for the Power Plant. If at any time the Standby L/C is drawn upon, it must be immediately replenished to the initial amount. The Standby L/C is revolving, meaning it must always be in place, and replenished if drawn.

Figure No. 4 provides a summary of the Standby L/C and Escrow Account Structure.

3.1.2 Escrow Account

Under the terms of the PPA, NEPA and LSG are required to establish an escrow account into which revenues from electricity sales to a select group of industrial and commercial customers will be paid. During Phase I, the minimum balance in the Escrow Account is to be $7.5 million and $18.0 million in Phase II. Escrow funds above the minimum level are subject to periodic release after the Company (or in the case of the Power Plant, Enron Nigeria Power Ltd.) is paid for the electrical capacity and energy. In the event electrical capacity and energy payments are not paid as agreed, the funds in the escrow account may be released to the Company (and to Enron Nigeria Power Ltd. in the case of the Power Plant).

Figure No. 4 provides a summary of the Standby L/C and Escrow Account Structure.

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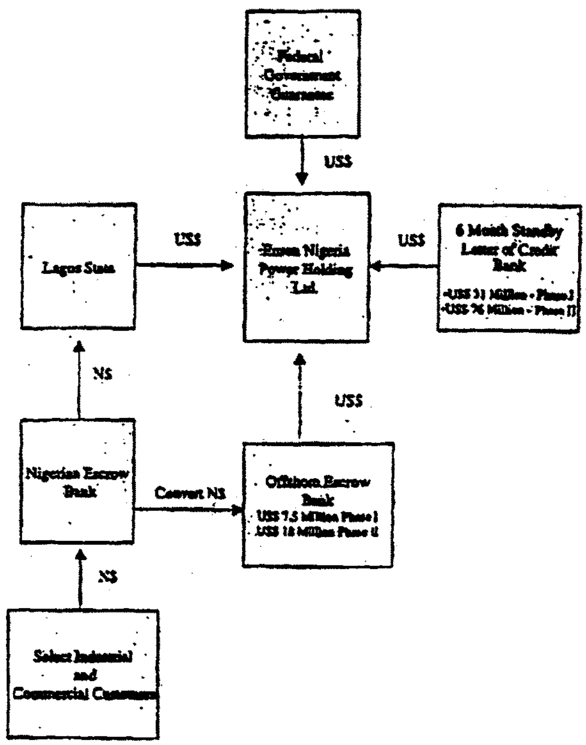
Figure No. 4

Escrow Account & Letter of Credit Structure



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3.2 Fuel Supply Contract

The FSA is expected to be entered into with a consortium of three local fuel suppliers. The fuel will be required to meet designated quality standards and will be tested regularly. The fuel supplier will be required to provide a performance letter of credit of $3 million issued by an A-rated financial institution that can be drawn upon by the Company in the event of fuel supplier non performance.

Under the PPA, the cost of fuel is a past through to the electricity purchaser. Within 15 months of the commercial operations date, the Company shall have converted the Barges to gas fuel and commercial operations on gas. Otherwise the Company shall have the right to invoke the buyout provisions under the PPA. In any event, the Company has commercial discussions with potential gas suppliers and early indications are that the 15 month schedule to conversion is achievable.

The FSA is provided as an appendix.

3.3 Engineering Procurement and Construction

EE&CC is the EPC Contractor. A lump sum, turnkey EPC Agreement is expected to be executed between the Company and EE&CC. All project EPC activities performed by EE&CC or its subcontractors are to be performed by qualified companies and individuals experienced in the required work. The contracts shall be in writing and approved in accordance with EE&CC requirements. EE&CC will identify the required contract activities, determine responsibility and assure bid and approval requirements are met.

The EPC Agreement provides guarantees, on EE&CC's part, for first power from the first barge and for project completion. Commensurate Liquidated Damages (LDs) associated with not meeting these guaranteed first power and project completion dates, due strictly to the fault of EE&CC, are also provided for in the Agreement.

Inasmuch as the project is employing "used" equipment, the EPC Agreement does not provide for either performance or availability guarantees or LDs associated with such guarantees.

3.4 Operations and Maintenance

OEC is the O&M Contractor for the Project, and is expected to provide the expertise and management resources necessary to ensure that the operations and maintenance activities are carried out in accordance with the Company's objective of obtaining maximum availability with minimal capital expenditures during the three year term of the O&M Agreement. For this purpose, the O&M activities will be carried out on a "conditions based maintenance" basis. Barge operations and maintenance staff will be employed by OEC, or its designee, and shall have the authority to plan and direct the activities required to execute OEC's responsibilities under the O&M Agreement.

The O&M Agreement is provided as an appendix.

4. PROJECT ECONOMICS

4.1 Assumptions

The economic assumptions are provided in the Financial Model.

MS 06538

APPENDICES

See attached files.

MS 06539

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Nigeria Barge Project Sell Down
Transaction and Shareholder Structure

17 December 1999

The following transaction structure has been developed to allow the Purchaser to purchase 90% of the projected after tax cash flow to be generated over three (3) years by the 90 MW Nigeria Barge Project (the "Barge Project") while 1) funding the purchase price with 25% equity and 75% seller financed debt, 2) basing the purchase price on the net present value of such cash flow and providing a projected yield to purchaser of approximately 25% on invested equity and 3) allowing Enron to book a gain based on the sale of such cash flows.

Following extensive review and discussion with Enron accounting staff and outside auditors, the following structure has been developed and approved to ensure the desired accounting treatment for the transaction. Whereas the structure is more complex than desired and originally envisaged, it is necessary to meet all of the objectives for the transaction.

<u>A Few Definitions</u>
Cash Flow: The operating distributable cash flow generated by the Barge Project from all revenues less all expenditures including but not limited to operating and administrative costs, fuel, all taxes and debt service; and as further delineated in the Financial Model.

Cumulative Cash Flow: The aggregate monthly cumulative Cash Flow commencing on the commercial operations of the Barge Project and ending on the Trigger Date (as defined below).

Early Liquidation: The termination of the Power Purchase Agreement or the otherwise winding up of Enron Nigeria Barge Ltd. prior to the Trigger Date.

Liquidation Proceeds: The cash proceeds from the Early Liquidation of the Barge Project excluding proceeds (if any) from the sale or disposition of the barges.

Trigger Cash Flow: The projected Cash Flow (approximately $44.1 million) to be generated by the Barge Project during its first 3 years of operations.

Trigger Date: The date upon which the Cumulative Cash Flow equals the Trigger Cash Flow.

<u>Transaction Structure</u>

Purchaser Equity Contribution	$ 7.00 Million
Acquisition Loan (from Enron to Purchaser)	21.00 Million
Total Purchase Price	$28.00 Million

Basis: 25% Internal Rate of Return on invested equity for Purchaser.
Acquisition Loan Terms: 12% Interest Rate, 24 Month Term, Amortization to be Agreed
Loan secured by Purchaser's interest in the Barge Project

<u>Shareholder Structure</u>
There will be three classes of stock, two preferred and one common. The Purchaser will purchase the Preferred A Shares and the Common Shares. Enron will own the Preferred B shares. The summary below indicates the economic interests before and after the Trigger Date. In each case, the table indicates the Cash Flow rights of each shareholder class after the previous class shareholder has received their percentage share of the Cash Flow.

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Economic Interest (Percent of Cash Flow ("CF"))

Stock Class	Pre Trigger Date	Post Trigger Date
Preferred A (Purchaser)	0.1% of CF	0.1% of CF
Preferred B (Enron)	9.9% of CF After Pref A	99.0% of CF After Pref A
Common Stock (Purchaser)	100.00% of CF After Pref A & B	100.00% of CF After Pref A & B

Before the Trigger Date, the Purchaser is expected to receive approximately 90% the Cash Flow via the Common Stock and a small percentage from the Preferred A. After the Trigger Date, the Enron Preferred B Shares receive approximately 99.0% of the Cash Flow and after distribution to the Preferred A and Preferred B, the Common receives the residual distribution of the Cash Flow.

Early Liquidation
In the event of an Early Liquidation, the Purchaser shall receive via the Preferred A Shares an amount stipulated in an appendix to be attached to the Share Purchase Agreement. Generally, the Early Liquidation proceeds payable to Purchaser via the Preferred A Shares and included in the appendix shall be designed to ensure the Purchaser a 25% internal rate of return on invested equity. Upon an Early Liquidation, The Preferred B Shares shall then receive 99.0% of the remaining Liquidation Proceeds after the liquidation payment to the Preferred A shares and all Phase I Facilities (as defined in the Power Purchase Agreement). The Common shares shall receive 100.00% of the remaining Liquidation Proceeds after the payments to the Preferred A and Preferred B Shares.

Return Considerations
If the Cumulative Cash Flow equals the Trigger Cash Flow at the end of 3 years of operations, the return to the Purchaser would be approximately 25%.

If the Cumulative Cash Flow equals the Trigger Cash Flow before the end of 3 years, then the return to the Purchaser would exceed 25%. If the Trigger Cash Flow level is reached after the end of 3 years, the Purchaser's return may be below 25%. It is intended for the Purchaser to take this risk and upside opportunity.

If there is an early liquidation, and there are sufficient liquidation proceeds (which the letter of credit shall ensure) the liquidation payment schedule is designed to ensure the Purchaser an approximate 25% return on invested equity.

Voting Rights
Each share class shall have the following number of shareholder votes and shall also appoint the same number of directors to the Board of Directors. This structure is necessary to ensure conformity to Nigerian law.

Share Class	Votes	Directors
Preferred A	1	1
Preferred B	8	8
Common	1	1

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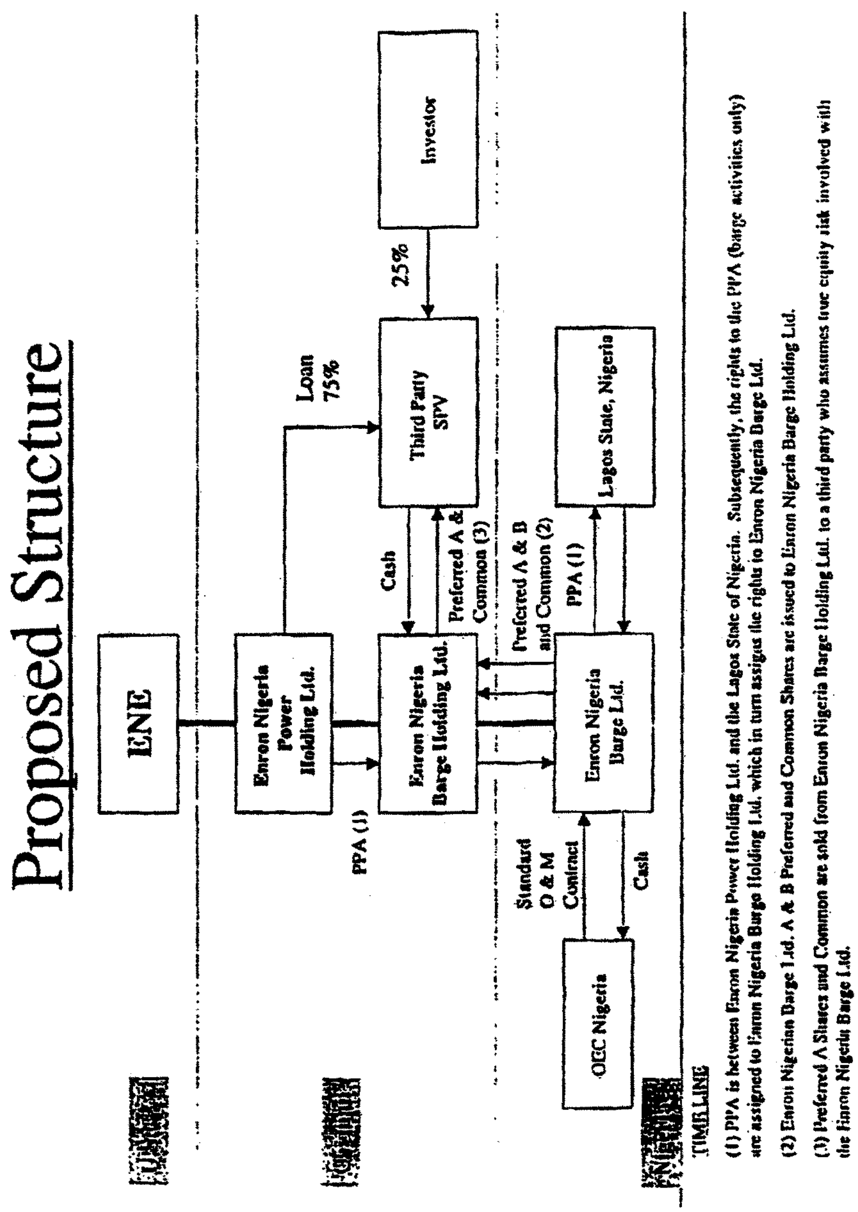

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09/17/2009 5:30PM (GMT-04:00)

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September 15, 2009

Senator Charles Schumer
United State Senate
Washington, DC 20510

Dear Senator Schumer:

I understand the Judiciary Committee will hold a hearing Thursday on S.1551. I respectfully request that this letter be entered into the record.

In addition to my pubic duties, I serve as the principal in a wealth management firm. These dual roles give me a unique perspective on the interaction between public policy and the realities of the marketplace. It is from that vantage point that I opine on this legislation.

Public, transparent markets are a fundamental of the American economy. There is no doubt that the excesses of the past few years merit a strong regulatory response by the Congress. I believe it would be unwieldy and unwise to turn this responsibility over to various courts in different jurisdiction across the country.

The scheme liability contemplated by this legislation will have federal judges supplant legislators and regulators as arbiters of appropriate market conduct while casting a large net that will inevitably envelop innocent actors. Lawsuits, by their nature, seek to rope in the largest number of potential defendants. In contrast, policymakers need to carefully weigh the broader social and economic consequences of over-regulation.

I support President Obama's efforts to dramatically ramp up staffing at the SEC and am pleased that more investigations are in the offing. But scheme liability—roping in vendors, accountants, law firms and others—will open the door to unprecedented litigation-style discovery in every sector. Present improvements to the regulatory regime, including a variety of measures to strengthen the SEC being considered by Congress, is a more appropriate vehicle to address concerns about market excess.

I appreciate the opportunity to present my views.

Sincerely yours,

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Statement of Senator Patrick Leahy (D-VT),
Chairman, Senate Committee on the Judiciary,
Hearing On "Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009"
Before the Subcommittee on Crime and Drugs
September 17, 2009

Today's hearing focuses on yet another case where the Supreme Court has misinterpreted the clear intent of Congress. This important hearing will examine laws designed to deter and punish those who assist and participate in fraud schemes. In the wake of scandals like Enron, the Madoff case, and the widespread financial fraud that contributed to our current economic crisis, we need to start holding those who take part in fraud accountable. I have long supported efforts to ensure that we give our Federal agencies the tools they need to help address fraud. The Supreme Court has made this issue more difficult to address in the wake of their divided decision in *Stoneridge v. Scientific Atlanta*.

Last year, I chaired a Senate Judiciary Committee hearing where we examined corporate misconduct and fraud. One of the cases we examined was *Stoneridge*. The court held that pension funds and other investors in companies ruined by fraudulent managers cannot recoup the money they lost from those who knowingly facilitated the fraud. Justice Stevens' dissent criticized the majority for thwarting the intent of Congress because it passed the law "with the understanding that Federal courts respected the principle that every wrong would have a remedy." With this ruling, the Supreme Court has left everyday Americans with nowhere to go for redress. I believe Justice Stevens was correct in his dissent. The decision would allow enablers of fraud, such as the accountants who were involved in the Enron scandal, to escape any responsibility. We cannot tolerate such actions, and we cannot deny those who deserve their day in court their constitutional right.

This Supreme Court decision has real world consequences on the livelihoods and lives of thousands of Americans. Unfortunately, it will not have any impact on the corporation that should be punished. I believe that this hearing will allow us to begin doing what is necessary to address the issues of fraud. In just this Congress, I introduced several pieces of legislation, among them the Fraud Enforcement and Recovery Act, which gives our Federal Government important new tools to combat fraud and which the President signed into law this spring, but much more still remains to be done. We should continue to act and make sure that those who aid in fraudulent behavior are caught and held fully accountable and that individuals are not held to a lower standard than corporations. I thank Senator Specter for holding this hearing today and look forward to consideration of his proposed legislation to hold those who participate in fraud accountable.

#####

No. 06-43

In The
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., *et al.*,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

MOTION FOR LEAVE TO FILE BRIEF OUT OF TIME AND BRIEF *AMICI CURIAE* OF FORMER SEC COMMISSIONERS IN SUPPORT OF PETITIONER

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OR CALL COLLECT (402) 342-2831

MOTION FOR LEAVE TO FILE BRIEF OUT OF TIME OF *AMICI CURIAE* FORMER SEC COMMISSIONERS IN SUPPORT OF PETITIONER

Pursuant to Supreme Court Rule 37.3, William H. Donaldson and Arthur Levitt, Jr., former Chairmen of the Securities and Exchange Commission, and Harvey J. Goldschmid, former Commissioner of the SEC, respectfully move for leave to file a brief *amici curiae* out of time, and to file the accompanying brief in support of the petitioner.

Amici regret missing the deadline for filing. This is one of the most important securities cases to be heard by this Court in many years. As former Chairmen and Commissioners of the Securities and Exchange Commission, *amici* have been involved extensively in securities law policy and enforcement and respectfully believe they have a perspective that might assist in the Supreme Court's consideration of the issue now pending before the Court.

Amici expected that the Solicitor General would support the past and current position of the Securities and Exchange Commission on the issue presented and file an *amicus curiae* brief on behalf of the United States in support of petitioner. *Amici* apologize for the late motion, but saw no need to file this brief until after June 11, 2007, when petitioner's brief was filed and an *amicus* brief of the United States supporting petitioner was not. Plaintiffs consent to the filing of this *amici* brief; Defendants do not. Since Defendants have been granted an extension of time

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to file their brief until August 15, 2007, the granting of this motion would not prejudice them.

Respectfully submitted,

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No. 06-43

In The
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., *et al.*,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

BRIEF *AMICI CURIAE* OF FORMER SEC COMMISSIONERS IN SUPPORT OF PETITIONER

INTEREST OF *AMICI*[1]

This *amici curiae* brief is submitted by William H. Donaldson, former Chairman of the Securities and Exchange Commission (2/18/03 – 6/30/05, appointed by President George W. Bush), Arthur Levitt, Jr., former Chairman of the

[1] This brief was not authored in whole or in part by counsel for a party. No person or entity other than *amici curiae* or their counsel made a monetary contribution to the preparation or submission of this brief. Plaintiffs' blanket letter of consent to the filing of this brief is on file with the Court. Defendants do not consent to the filing of this brief.

SEC (7/27/93 – 2/9/01, appointed by President William J. Clinton), and Harvey J. Goldschmid, former Commissioner of the SEC (7/31/02 – 7/31/05, appointed by President George W. Bush) in support of Petitioner. Throughout our tenure of service at the SEC, during Administrations of both political parties, we have been involved in Commission policy and enforcement regarding so-called "fraudulent scheme liability." We believe the continued viability of private actions based on such liability is essential for the protection of the nation's investors and the integrity of our financial markets.

This is one of the most important securities cases to be heard by this Court in many years. It is critical to the antifraud purposes of the federal securities laws that actors, other than issuers and their officers and directors, who actively engage in deceptive conduct – for the purpose and with the effect of creating a false statement of material fact in the disclosure of a public corporation – continue to be held liable in private actions.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, as the SEC explained recently, include "conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words." *Amicus Curiae* Brief of the SEC filed October 22, 2004 in *Simpson v. AOL Time Warner, Inc.* (*Cal. St. Teachers Ret. Sys. v. Homestore.com, Inc.*, No. 04-55665 (9th Cir.), at 8 (quoted in *In re Enron Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 43146, at *165 (S.D. Tex. June 5, 2006), *rev'd, Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372 (2007)). We believe that this Court's resolution of the issue of fraudulent scheme liability in the instant case will have a profound effect on the continued deterrence of fraud, the ability of defrauded investors to recover their losses, and the overall fairness and effectiveness of our securities markets. We urge this Court to reaffirm liability for actors who actively engage in deceptive conduct as part of a fraudulent scheme.

INTRODUCTION

The federal securities laws reflect Congress' broad purpose to protect investors and preserve the integrity of the markets by deterring, punishing, and allowing civil remedies for manipulative and deceptive conduct. In particular, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), prohibits "any manipulative or deceptive device or contrivance" and provides a broad grant of authority to the Commission to enact rules "in the public interest or for the protection of investors." The Commission promulgated Rule 10b-5, 17 C.F.R. §240.10b-5, to deter and prevent fraud.

Together Section 10(b) and Rule 10b-5 are the chief weapons in the SEC's arsenal against securities fraud and the principal means by which defrauded investors recover their losses from those who perpetrate frauds. If allowed to stand, the decision below would make virtually invulnerable those who actively, purposely, and with market effect, engage in deceptive conduct and would cause grave harm. The decision conflicts with the language and purposes of Section 10(b), the historical position of the Commission, and well-grounded judicial precedent.

The decision below immunizes non-issuers who commit securities fraud from private liability merely because they were cunning enough to avoid making a public statement. Those who – with purpose and effect – actively engage in fraudulent acts as part of a scheme with the issuer to defraud investors should be held primarily liable, regardless of whether they speak to the market, assuming all the other requirements to plead and prove a claim under Section 10(b) and Rule 10b-5 are met.

Fraudulent scheme liability neither results in undue liability exposure for non-issuers, nor an undue burden upon capital formation. Holding liable wrongdoers who actively engage in fraudulent conduct that lacks a legitimate business purpose does not hinder, but rather enhances, the integrity of our markets and our economy. We believe that the integrity of our securities markets is their strength. Investors, both domestic and foreign, trust that fraud is not tolerated in our nation's securities markets and that strong remedies exist to deter and protect against fraud and to recompense investors when it occurs. The decision below, if left standing, would dramatically undermine private enforcement of our securities laws and investor confidence in our securities markets.

SUMMARY OF ARGUMENT

Meritorious private actions to enforce the federal antifraud securities laws are an essential supplement to government actions. Private actions are the principal means by which defrauded investors recover their losses due to the Commission's limited resources and powers. The Commission's traditional position has been that a party commits a primary securities fraud violation for which it may be held liable in a private action by actively engaging in fraudulent conduct as part of a scheme to defraud investors, even if it does not make a public statement. Such "fraudulent scheme liability" is consistent with the purposes of the federal securities laws and essential to the protection of investors, the integrity of the securities markets, and the ability of America to remain the world's leader in capital formation. The Court should reverse the decision below and reaffirm the availability of fraudulent scheme liability.

ARGUMENT

The broad antifraud purposes of Section 10(b) of the Securities Exchange Act of 1934, have long been fully recognized by this Court. *See, e.g., SEC v. Zandford*, 535 U.S. 813, 821 (2002) (noting statute's broad language and interpretation); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (noting Congress' intention "to insure honest securities markets and thereby promote investor confidence"); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices"); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972) (noting statute's broad language accords with Congress' "fundamental purpose . . . to achieve a high standard of business ethics in the securities industry") (internal quotation marks omitted).

This Court and the SEC have also "long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)." *Tellabs*, *Inc. v. Makor Issues & Rights, Ltd.*, 2007 U.S. LEXIS 8270, *9 (June 21, 2007). "[P]rivate securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses – a matter crucial to the integrity of domestic capital markets." *Id.* at *24 n.4 (internal quotation marks omitted).

The Commission's traditional position has been that a person may commit a "manipulative or deceptive" act constituting a primary violation of Section 10(b) without making a public statement. The SEC consistently has expressed this position through rulemaking,[2] *amicus* briefs in private litigation,[3] civil actions brought by the

[2] *See, e.g.*, Rule 10b-5(a) and (c), and many other rules promulgated by the Commission under Section 10(b) prohibiting manipulative or deceptive acts without requiring misstatements or omissions. Rule 10b-1, 17 C.F.R. §240.10b-1; Rule 10b-3, 17 C.F.R. §240.10b-3; Rule 10b-5-1, 17 C.F.R. §240.10b-5-1; Rule 10b-5-2, 17 C.F.R. §240.10b-5-2; Rule 10b-10, 17 C.F.R. §240.10b-10; Rule 10b-16, 17 C.F.R. §240.10b-16; Rule 10b-17, 17 C.F.R. §240.10b-17.

[3] *See, e.g., Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) ("We agree with the SEC that engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact, constitutes a 'deceptive act' "), *petition for cert. filed sub nom. Cal. St. Teachers Ret. Sys. v. Homestore.com, Inc.*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560); *In re Enron Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 43146, at *165 (S.D. Tex. June 5, 2006) (noting Commission's argument "deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words. For example, if an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding the company debt, it has achieved the same deception, and liability should be equally available"), *rev'd, Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372 (2007); *Amicus Curiae* Brief of the SEC filed April, 1998 in *Klein v. Boyd*, No. 97-1142 (3d Cir.).

Commission,[4] and the Commission's own administrative adjudications.[5]

The SEC's position is both reasonable and necessary for the protection of investors. An intentional scheme to engage in sham transactions for the purpose of artificially inflating a public corporation's financial statements, as alleged in the instant case, is anathema to what Congress sought to accomplish by enacting Section 10(b).

Although the Commission has the authority to proceed against aiders and abettors, 15 U.S.C. §78t(e), private litigants do not. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Investors must rely primarily on private actions to recover when

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[4] *See, e.g., SEC v. Dibella*, 2005 U.S. Dist. LEXIS 31762, *11 (D. Conn. Nov. 29, 2005) (noting Commission's position subsections (a) and (c) prohibit schemes to defraud regardless whether any material statements or omissions were made).

[5] *See, e.g., In re Robert W. Armstrong, III*, 2005 SEC LEXIS 1497, *23 (June 24, 2005) (misstatement or omission not required for liability under subsection (a) or (c) of Rule 10b-5: "A person's conduct as part of a scheme constitutes a primary violation when the person directly or indirectly engages in a manipulative or deceptive act as part of the scheme.... 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, and nothing in the language of Section 10(b) or Rule 10b-5 or in the case law interpreting them shields a defendant from liability for direct participation in such a scheme") (internal quotation marks omitted); *In re Cady, Roberts & Co.*, 1961 SEC LEXIS 386, *9, 40 S.E.C. 907, 911 (Nov. 8, 1961) ("These anti-fraud provisions are not intended as a specification of specific acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others").

defrauded. The SEC's disgorgement and civil money penalty powers, although enhanced by the Sarbanes-Oxley Act, are limited, and will generally cover only a fraction of the damage done to investors by serious securities fraud. Moreover, the SEC with limited resources cannot possibly undertake to bring actions in every one or even most of the financial fraud cases that have proliferated over the past few years.

Thus, the elimination of fraudulent scheme liability would mean, in practical terms, that defrauded investors would not be able to recover their losses from any party other than the public company that issued the financial or other public statements. But in many fraud cases, the issuer becomes bankrupt or unable to satisfy a judgment once the fraud is exposed. If the only party investors could proceed against were the issuer (and its directors and officers), defrauded investors would be unable to recover much of their losses and public confidence in the markets would surely suffer. Private cases, so long as they are well-grounded, are an important enforcement mechanism supplementing the SEC in the policing of our markets.[6] Most often, the larger the frauds, the greater investors must rely on private cases to recover their losses. In the *Enron* case, for example, the Commission and the Department of Justice were able to obtain only $440 million for investors (*see* http://www.sec.gov/divisions/enforce/claims/enron.htm) out of total claimed losses of approximately $40 billion (*see* Petition for Writ of Certiorari at 5 n.8, *The*

[6] In enacting the Private Securities Litigation Reform Act of 1995, 109 Stat. 737, Congress "installed both substantive and procedural controls" designed to ensure private cases are well-grounded. *Tellabs*, 2007 U.S. LEXIS, at *23.

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Regents of the Univ. of Cal. v. Merrill Lynch Pierce Fenner & Smith, Inc., (No. 06-1341)).

The most serious effect of the elimination of fraudulent scheme liability would be on deterrence and the integrity of the markets – the foundations of public confidence and trust in the markets. *See Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005) ("The securities statutes seek to maintain public confidence in the marketplace. . . . by deterring fraud, in part, through the availability of private securities fraud actions"); *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (private securities fraud actions provide "a most effective weapon in the enforcement" of securities law and are "a necessary supplement to Commission action"). What signal would it send to banks, broker-dealers, accountants, and lawyers to relieve them of all possibility of private liability so long as they do not speak publicly about the transactions with respect to which they perform their essential services? What signal would it send to investors to deprive them of the ability to recover significant parts of their losses in cases where actors actively and purposefully engaged in a fraudulent scheme?

The continuation of fraudulent scheme liability will not harm American competitiveness; in fact, investor faith in the safety and integrity of our markets *is* their strength. The fact that our markets are the safest in the world has helped make them the strongest in the world. Capital formation through the United States securities markets since the enactment of the federal securities laws has been a resounding success.

CONCLUSION

We respectfully urge this Court to reverse the decision of the court below and to reaffirm the availability of fraudulent scheme liability under Section 10(b) and Rule 10b-5.

Respectfully submitted,

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Testimony by

BRENDEL LOGAN

ON BEHALF OF HUDSON VALLEY ENVIRONMENTAL ACTION FUND

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Distinguished Members of the Judiciary Committee:

On behalf of the Hudson Valley Environmental Action Fund, I urge your strong opposition to S.1551, which would overturn the Supreme Court's recent Stoneridge decision.

Our concern emerges from the impact this expansion of securities litigation could have on emerging technologies in the green jobs and clean energy areas. As you know, the 2009 Omnibus Appropriations Act allocates $82 billion for spending on clean energy, energy efficiency, public transit, transportation infrastructure and research.

A recent front page story in the New York Times focused on China's effort to become a clean energy leader. Taking new clean energy products to market, despite substantial public investment, requires significant participation by venture capital and other entrepreneurial funds. Because some of these technologies are new and experimental, there is potential stock price volatility for any public company taking these products to market. Stock volatility is generally the foundation for securities suits.

The expansion of scheme liability would further depress incentives for new and innovative products by introducing new litigation risks to an expanded roster of potential defendants. This is precisely the wrong direction, particularly in a period of economic volatility.

Expanded litigation risks is at counterpoint for Congressional efforts to stimulate private investment in new technology and I respectfully urge a second look at this bill and its impact on the issues outlined above.

The **National Law Journal**
Vol. 30, No. 4

September 24, 2007

Opinion
The 'Stoneridge' Case

KEEPING MARKETS HONEST

Arthur R. **Miller**
Special to The **National Law Journal**

During the summer, a high drama played out within the Bush administration involving the U.S. Securities and Exchange Commission (SEC), the U.S. Department of Justice, Congress, Wall Street banks and victims of securities fraud -- with a spotlight on the Enron meltdown. The underlying battle, now before the U.S. Supreme Court, concerns whether investment banks and other third parties that work hand-in-glove with the WorldComs of the world -- creating sham loans and cooking books -- can be brought to justice by their victims. The result, in a case called Stoneridge, will have enormous consequences for investors' ability to recover monies against those who purposefully enable others to lie to the markets -- the silent partners in corporate fraud, insider trading and stock manipulation.

Although so far these events have been relegated to the financial pages, this is not just some legal technicality. With the Dow Jones Industrial Average bouncing like a pingpong ball, the integrity of the American markets has taken on even greater importance. Volatility begets fraud, as when the tech bubble burst. That is why the inside-the-Beltway battle was so fierce over whether the White House and its lawyer, Solicitor General Paul Clement, would come down on the side of the victims or of Wall Street. That is why, when Clement declined to file the brief recommended by the SEC, others were not so reticent, including past SEC chairmen, heads of the House banking and judiciary committees and 35 state attorneys general, Republican and Democrat, all filing briefs in support of investors and 'scheme liability' -- holding accountable liars and enablers alike.

And that is why it was more than just an unfavorable judgment call when the Bush administration, rejecting the advice of senators like Arlen Specter, R-Pa., and Christopher Dodd, D-Conn., and ignoring the formal vote of its own SEC and its Republican chairman, Chris Cox, recently chose to support those who commit fraud from behind the curtain. Indeed, just how and why that decision was reached presents a cautionary tale. It reflects the serious threat posed to the rule of law by what historian Kevin Phillips has described as 'the fusion of money and government.'

Among those closely watching this case are victims of the greatest 'Ponzi scheme' in history, the Enron fraud. Tens of billions of dollars were lost by millions of Americans from just such illegal schemes concocted by Enron executives but with enablers, like Merrill Lynch, acting from behind the scenes and garnering large fortunes as a result. The Enron trial against those banks was stopped dead in its tracks when the 5th U.S. Circuit Court of Appeals found there should be no liability for those who knowingly empower others to lie to an unsuspecting public.

This country is blessed with the world's toughest securities fraud laws. Like our Bill of Rights, their genius is their simplicity. For example, the law prohibits anyone from engaging in 'any manipulative or deceptive device or contrivance.' Therefore those who create deceptive devices, as the banks did in Enron through sham loans and falsified balance sheets, have commit fraud and should be held accountable. But that principle is now in jeopardy.

In years past, shareholders took on these third-party fraudsters in private litigation for 'aiding and abetting' others that spoke falsely. But a few years ago, in Central Bank, the Supreme Court ruled that only the government and not private victims of fraud could contest aiding and abetting. So shareholders now typically sue the third parties for directly engaging in the illegal scheme. It is their ability to do so that is now squarely before the Supreme Court.

We all benefit from the truth about a company's financial condition; we all suffer from falsehood. And as our laws are now structured, a victim of fraud can get his money back only through a private lawsuit since the SEC is limited by law to imposing penalties. Thus, to deny such private enforcement would dramatically undermine the fundamental purposes of our securities laws -- recovering losses, deterring fraud and promoting honest dealings.

Initially, the SEC actually voted to file its own brief in support of victims of fraud, whether committed by the liar or the enabler. But enter Henry Paulson, the past chairman of Goldman Sachs (an Enron defendant), who is now Treasury secretary. On a conference call with President Bush and Clement, Paulson is said to have argued that holding third-party schemers liable would be bad for business -- by making U.S. markets less competitive against their foreign counterparts. He won the argument; the SEC was prohibited from filing its brief. The American people lost. And now, your government filed a brief supporting Wall Street and opposing you.

As more power is vested in corporations, banks, insurance companies and business generally, the 'little guy' is left in greater jeopardy of being trampled. The only recourse for such victims of greed and abuse is the government; it is the essence of the social contract. But that contract has repeatedly been breached of late: when government regulators come from the very industries they are supposed to regulate, when U.S. attorneys become political pawns instead of champions of justice -- and when big business uses the backdoor to the White House to get its views heard in the Supreme Court.

Arthur R. **Miller**, past Bruce Bromley professor at Harvard Law School, and now university professor at New York University School of Law, co-authored the U.S. Supreme Court brief in Stoneridge on behalf of the past SEC commissioners.

9/24/2007 NLJ 26, (Col. 1)

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September 16, 2009

By Email/Pdf and FedEx

The Honorable Arlen Specter
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Re: Hearing on S. 1551 and Request for Inclusion in the Record

Dear Chairman Specter:

We are following with interest your introduction of S. 1551. As you may know, NYSE Euronext and Nasdaq jointly filed an amicus brief in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. and Motorola, Inc.* on behalf of the Respondents. We argued then, and we reiterate now, that current and potential issuers (whether located in the U.S. or abroad) should not be dissuaded from using the U.S. capital markets by unreasonable extensions of securities fraud liability to third parties providing services to issuers.

Attached to this letter is a copy of our amicus brief noted above. In our brief, we argued that if the liability rules were to shift, it was for the legislature to do so, not the courts. We maintain that stance, yet do not believe that Congress should exercise its authority and extend liability to third parties who conduct business with U.S. issuers. Such a liability regime would impose unnecessary, inefficient and inequitable costs on U.S. issuers.

We ask that you include this letter and our brief in the record of Thursday's Subcommittee hearing on S. 1551.

Respectfully,

John K. Halvey

John K. Halvey

Enclosure

JKH/wpc

No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR THE NASDAQ STOCK MARKET, INC. AND NYSE EURONEXT AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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IN THE

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On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR THE NASDAQ STOCK MARKET, INC. AND NYSE EURONEXT AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

INTERESTS OF *AMICI CURIAE* [1]

The Nasdaq Stock Market, Inc., operates The NASDAQ Stock Market LLC (collectively "Nasdaq"), the largest electronic equity securities market in the United States, which lists more companies than any other U.S. market. Nasdaq is a leading provider of securities listing, trading, and information products and services. It is home to approximately 3,200

[1] The parties have consented to the filing of this brief and their letters of consent have been filed with the Clerk. In accordance with Rule 37.6, *Amici* state that this brief was not written in whole or in part by counsel for any party, and no persons other than *Amici* have made a monetary contribution to the preparation or submission of this brief.

listed companies, domestic and foreign, with a combined market capitalization of over $4.6 trillion. Its listed companies represent a diverse array of industries, including information technology, financial services, healthcare, consumer products and industrials. Nasdaq pioneered electronic equities trading more than thirty-five years ago, creating the most replicated market model among global exchanges.

NYSE Euronext, the world's largest exchange group, operates cash equities and derivatives exchanges in the United States and Europe. It is a global leader for listings, equities trading, derivatives, bonds and the distribution of market data. As of June 2007, the total market capitalization of NYSE Euronext's approximately 3,900 listed companies was $30.8 trillion. In the United States, NYSE Euronext operates the markets known as the New York Stock Exchange LLC, the world's largest cash equities exchange based on market capitalization, and NYSE Arca, the first open, all-electronic stock exchange in the United States (collectively, for purposes of this brief, "the NYSE"). For over 200 years, the NYSE has provided a reliable, orderly, and efficient marketplace for investors and traders to buy and sell securities. The NYSE also performs regulatory functions relating to its exchanges and their participants.

Nasdaq and the NYSE are registered with the U.S. Securities and Exchange Commission ("SEC") as national securities exchanges and self-regulatory organizations ("SROs") within the meaning of Section 3 of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(26). The Exchange Act both authorizes and requires SROs to promulgate and enforce rules governing their membership and the conduct of members, member organizations and their employees, 15 U.S.C. §§ 78f(b)(1)-(9), 78s(g), as well as "to remove impediments to and perfect the mechanism of a free and open market . . . and, in general, to protect investors and the public interest." 15 U.S.C. § 78f(b)(5).

SROs in the securities industry are an essential component of the regulatory scheme for providing fair and orderly markets and protecting investors. The Exchange Act imposes on SROs multiple regulatory and operational responsibilities, including day-to-day market and broker-dealer oversight, as well as compliance-monitoring and enforcement of listing standards for listed companies. Virtually all aspects of Nasdaq's and the NYSE's operations are subject to oversight by the SEC.

The rules enforced by Nasdaq and the NYSE as SROs, and those to which they are subject, are focused on safeguarding the integrity of the securities markets and protecting market participants and investors. Nasdaq and the NYSE believe that quality regulation enables them to better serve listed companies, market participants and investors in providing high quality cash equities markets, access to deep pools of liquidity, and fast and transparent trading data and execution. This in turn enables the corporate growth, entrepreneurship, and innovation that are the hallmarks of the U.S. capital markets.

Nasdaq and the NYSE are acutely aware that the globalization of world markets and an increasingly competitive global environment for equity capital are challenging the United States' historical dominance in capital markets. Companies worldwide, with newly viable alternative venues for listing, launching IPOs, investing, and doing business, have voiced concerns to Nasdaq and the NYSE regarding the litigation climate generally in the United States and the potential expansion of third-party liability.

Nasdaq and the NYSE share an interest in an application of the securities laws that is faithful to the limitations imposed by Congress and this Court's prior decisions. In particular, Nasdaq and the NYSE believe that current and potential issuers (whether located in the United States or abroad) must not be dissuaded or inhibited from utilizing the U.S. capital markets by unreasonable and unpredictable extensions of securities fraud liability to third parties providing services to such issuers. Nasdaq and the NYSE believe that the boundaries of who might be held potentially liable under the antifraud provisions of the Securities Exchange Act of 1934 should be clear and unambiguous, and that interpretations of those provisions that risk unbounded expansion of potential liability inhibit growth of and access to the U.S. capital markets.

For the reasons discussed more fully in this brief, Nasdaq and the NYSE respectfully urge the Court to affirm the decision below.[2]

SUMMARY OF ARGUMENT

The United States public equity markets have long offered the most liquid, most competitive and best regulated pools of equity capital in the world. Public listing of companies on U.S. stock exchanges, under the regulatory mechanisms created by U.S. securities law, has greatly benefited U.S. investors and contributed to U.S. economic growth. But the globalization of world markets and an increasingly competitive global environment for equity capital are challenging the United States' historical dominance in capital markets. Companies worldwide, with newly viable alternative venues for listing, are increasingly launching IPOs, investing, and doing business outside the United States.

In this environment, increasing the costs of doing business with U.S. public companies weakens the competitiveness of the U.S. public equity capital markets and thus harms U.S.

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[2] NYSE Euronext is one of several defendants in a pending purported class action litigation asserting securities and antitrust law violations, styled *Sea Carriers, LP I et al. v. NYSE Euronext et al.*, No. 07 Civ. 4658 (S.D.N.Y.) (filed June 1, 2007). Although that complaint does not relate to NYSE Euronext's role as an issuer, an affirmance of the Eighth Circuit's decision below could benefit NYSE Euronext and other defendants in that matter.

investors and the U.S. economy. Petitioner's novel theory would impose such costs by extending private Section 10(b) liability to manufacturers, vendors and suppliers who merely do business with a publicly traded company that later makes a misstatement or material omission to its investors. Such a novel theory of liability would make one company responsible for another company's accurate accounting and reporting, thus converting business counterparties effectively into auditors and insurers of compliance with the securities laws. Counterparties thus will either avoid doing business with publicly traded companies or charge them more for doing so.

This approach is highly inefficient, and the costs it imposes are likely to discourage companies from listing or remaining on U.S. public stock exchanges and encourage their relocation to increasingly competitive foreign markets. Thus, far from increasing enforcement of the U.S. securities laws, Petitioner's theory, if adopted, would have the perverse effect of shrinking the scope of their coverage.

Such increased costs and their attendant harms to U.S. public equity markets, U.S. investors and the U.S. economy are unnecessary. Congress has created and periodically enhances a complex and overlapping set of protections for investors in U.S. publicly traded companies that provides adequate protection without need for new, judicially fashioned private causes of action.

Congress knows well how to add aiding-and-abetting or participant liability to this enforcement mosaic, and has done so in several narrowly defined circumstances. But Congress has never enacted the expansive, unlimited participant liability sought by Petitioner, even when specifically urged to do so by the SEC and others. Against this legislative backdrop, judicial creation of such liability would be inappropriate. The complex weighing of any marginal gain in deterrence from such new private Section 10(b) liability against the costs to U.S. public companies, their counterparties, and the competitiveness of the U.S. public equity capital markets is quintessentially a matter of policy that should be left, if at all, to Congress and not the courts.

ARGUMENT

I. CREATING NEW PRIVATE SECTION 10(b) LIABILITY FOR ENTITIES THAT DO BUSINESS WITH PUBLICLY TRADED COMPANIES WOULD RAISE THE COST OF LISTING ON U.S. EXCHANGES, WEAKENING THE GLOBAL COMPETITIVENESS OF THE NATION'S PUBLIC EQUITY CAPITAL MARKETS

The United States has long been recognized as having the world's largest, most liquid, and until recently, most competitive public equity capital markets. Both American and foreign corporations historically have turned to these markets as principal sources for raising and pricing capital. Strong public equity capital markets stimulate other sources of capital formation; the venture capital industry, for example, invests in start-up companies based on the prospect that the most successful of them may be taken public.[3] And the contribution of strong capital markets to overall economic growth is well documented.[4]

The historical success of the nation's public equity capital markets has depended greatly on a strong system of securities regulation and self-regulation. "Tough enforcement is essential for a strong securities market," and "[t]he United States has the toughest administrative enforcement of securities laws

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[3] *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

[4] *See* Ross Levine & Sara Zervos, *Stock Markets, Banks and Economic Growth*, 88 AM. ECON. REV. 537 (1998).

in the world."[5] The securities laws adopted by Congress in the wake of the market crash of 1929 represent a remarkable regulatory success story. The Securities Act of 1933 increased disclosure of the financial conditions of publicly traded corporations, making the public securities markets much more transparent. The Securities Exchange Act of 1934, and in particular, Section 10(b) of that Act, were aimed at preventing unfair conduct in the trading of public securities.

Section 10(b) was *not* aimed, however, at regulating the conduct of those who merely conduct commercial transactions with companies listed on public equity capital markets. To the contrary, the Exchange Act sought in a targeted way "to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges." H.R. REP. NO. 73-1383, at 2 (1934). Congress aimed to prevent, for example, securities price manipulation by market actors such as brokers, dealers, syndicates, financial writers, and insiders. Nothing in the Exchange Act's enactment reflected a concern with regulating commercial transactions in which securities issuers engaged in the ordinary course of their businesses. As this Court has often reiterated, the securities laws are not a general code of corporate conduct. *See, e.g.*, ***Marine Bank v. Weaver***, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.").

Disregarding this history and these principles, Petitioners seek here to establish a private right of action under Section 10(b) against those who do business with a publicly traded

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[5] COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 71-72 (2006) ("INTERIM REPORT"), *available at* http://www.capmktsreg.org/research.html.

corporation that misrepresents the parties' transaction to its shareholders—even where the issuer's counterparty makes no misstatement itself, and violates no fiduciary duty to the public issuer or its investors. Such a theory has twice been definitively rejected—once by this Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which held that a private plaintiff may not maintain an aiding and abetting action under Section 10(b), and once by Congress, which pointedly declined to create such private liability despite the SEC's express recommendation that it overturn *Central Bank* by doing so. Congress instead granted the SEC, and only the SEC, authority to prosecute aiding and abetting of Section 10(b) violations in Section 20(e), 15 U.S.C. § 78t(e), a provision added by the Private Securities Litigation Reform Act (PSLRA).[6] The theory of private liability sought here and correctly rejected by the decision below is a transparent end run around these considered decisions by two branches of government.

Among the many reasons to reject Petitioner's argument is the significant harm its novel private liability theory would cause to publicly traded companies. Public listing of companies on stock exchanges like Nasdaq and the NYSE has benefited the nation's economy by enabling a high volume of securities trading within a sophisticated legal structure that

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[6] After *Central Bank* was decided, the SEC and others called for legislation overturning the decision, and Congress held several hearings on the subject. *See Aiding and Abetting Liability under the Federal Securities Laws: The Impact of the Supreme Court's Decision in Central Bank: Hearing Before Subcomm. on Securities of the Sen. Banking, Housing, and Urban Affairs Comm.*, 103rd Cong. (1994); *Private Securities Litigation Revision: Hearing on H.R. 10 Before Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 104th Cong. (1994). Congress, however, determined that "amending the 1934 Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to [the PSLRA's] goal of reducing meritless securities litigation," S. REP. NO. 104-98, at 19 (1995).

protects investors and businesses alike through administrative enforcement by the SEC and self-regulation by the SROs. The benefit of listing on U.S. exchanges also includes the periodic and offering disclosure obligations established and reviewed by the SEC. Imposition of inefficient and inappropriate costs on publicly traded companies through adoption of Petitioner's theory would diminish these benefits by discouraging companies from listing or remaining on U.S. public stock exchanges.

Thus, ironically, Petitioner's purported effort to increase the private enforcement of the securities laws might well have the perverse effect of decreasing the volume of securities business subject to those laws as companies seek to raise capital through public listings abroad or private alternatives.

A. Petitioner's Theory Would Impose Costly Audit or Insurance Obligations on Those Who Do Business with Publicly Traded Companies

As the complaint in this case illustrates, Petitioner's theory of implied participant liability under Section 10(b) would greatly increase the risk that accompanies doing business with companies traded on U.S. public stock exchanges. Petitioner, an investor in publicly traded securities issued by Charter Communications, does not allege that Motorola or Scientific-Atlanta made any misstatements or omissions upon which it relied in connection with the purchase or sale of those securities, nor that Motorola or Scientific-Atlanta owed Charter or its investors any fiduciary duty of disclosure. Petitioner does not allege that Motorola or Scientific-Atlanta improperly accounted for or misreported the supposedly "sham" transactions. Petitioner alleges only that it relied upon false statements by Charter concerning its financial performance, which Charter was able to report because of its previous commercial transactions with Motorola and Scientific-Atlanta.

Petitioner thus seeks to impose private liability on Respondents solely for another company's failure to account for and report their mutual commercial transactions properly. Such liability would add a burdensome obligation in addition to those already imposed by the securities laws. Under existing Section 10(b) rules, a public company may engage in a wide range of transactions with counterparties based solely on business considerations, so long as those transactions are properly accounted for and accurately reported by the company to the investing public. Under Petitioner's theory, however, counterparties would risk civil damages liability if they failed to ensure that the publicly traded company with whom they were doing business was also properly accounting for and accurately reporting those transactions. Such potential liability could lack any proportion to the business transaction at issue.

Faced with such potential liability, a commercial vendor or purchaser has three choices. *First*, it can increase its due diligence with respect to its commercial transactions with a publicly traded company in order to decrease its risk of exposure if that company later fraudulently accounts for those transactions. Implementing this due diligence would effectively transform a business relationship into an auditing relationship.

This approach is likely to be highly inefficient. By analogy, firms that are already subject to the reach of securities liability, such as underwriters for a newly offered company, engage in a significant, costly and time-consuming legal and financial due diligence review of the company, its management and its statements in the offering document. Even a pared-down version of this diligence review would take time, slowing the ability of public companies to sign contracts and making them less competitive with their private and foreign counterparts. On Petitioner's theory, a business transaction would not be complete when a contract is performed but would require ongoing surveillance until the public company's quarterly or annual reports were filed. Such an approach would also undermine the division of labor within corporations. Sales employees, acting in a non-accounting role and without expertise in the preparation or issuance of financial statements, could subject their companies to litigation risk merely by engaging in a business transaction that was later improperly accounted for or reported by the financial employees of a public company with whom they did business—employees wholly uninvolved in the underlying sales transaction.

Second, a commercial vendor or purchaser that does business with publicly traded companies can insure against the risk that those companies will fraudulently report transactions. It can do so by increasing formal insurance coverage. Or it can self-insure by charging higher prices to do business with publicly traded companies.

The cost of such insurance or self-insurance could well be significant given the litigation features of Petitioner's theory. This Court has acknowledged in general "that 'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 80 (2006) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). The risk of vexatiousness is likely to be especially high on the theory urged here. "Participation" with a supposed "purpose and effect" to advance a fraud is easy to allege and difficult to dismiss without factual development, increasing incentives to settle even the most baseless or attenuated participation claims. Moreover, awards risk being dramatically disproportionate to the economic value of the transaction. In these circumstances, the cost of insurance is necessarily increased because it is difficult to price such broad and unrelated risks.

The *third* alternative for commercial counterparties fearing liability from their transactions with publicly traded U.S. companies is to shift their business away from publicly traded U.S. companies altogether. This alternative would reduce the profitability and competitiveness of publicly traded U.S. companies. For example, if a producer of a component who could sell to either a U.S. or a foreign manufacturer chooses to avoid Section 10(b) participant liability risk by choosing the foreign manufacturer, the foreign manufacturer will gain a competitive advantage over the U.S. manufacturer in selling the finished product back into the United States. Even if they do not take their business overseas, vendors might forego otherwise efficient transactions because the litigation risk is too great in relation to the small size of the contract or the contract too likely to be deemed material to the issuer.

Under all three of these scenarios, adoption of Petitioner's theory would increase the cost of doing business with publicly traded U.S. companies. These costs in turn increase the cost of *being* a publicly traded U.S. company. Service providers will charge more for their services; margins will be lower; and business will be lost. In short, the economic effect of turning commercial counterparties into auditors or insurers of a publicly traded U.S. company's securities compliance would be to decrease the incentive to remain or list on a U.S. public exchange in the first place.

B. Increasing the Cost of Doing Business with Publicly Traded U.S. Companies Encourages Flight to Foreign Equity Markets, Which Offer Increasingly Competitive Alternatives

In a closed system, increasing the cost of listing on a U.S. public stock exchange might leave companies with little alternative but to list there anyway and absorb the increased cost. But the global environment for equity capital has become increasingly competitive. As governments in Europe and Asia have liberalized and modernized their capital markets, foreign markets are becoming robust alternatives to public exchanges based in the United States. Hong Kong, Singapore and Europe now have highly competitive stock exchanges. This new environment poses greater risk that increasing the cost of a U.S. public listing—as Petitioner's theory would entail—will encourage companies to raise capital abroad instead.

For example, U.S. capital markets are now growing at just over half the rate of foreign markets, with overall market capitalization in major foreign markets growing at ten percent a year, compared with a growth rate of six percent in the United States.

The United States is also now lagging foreign markets in the creation of new companies. In the 1990s, the number of foreign companies choosing to list on the NYSE and Nasdaq increased roughly fourfold, while European exchanges lost market share. Over the past decade, however, "the trend seems to have reversed."[7] Initial public offerings (IPOs) on U.S. exchanges have fallen from over forty percent of global capital to just seventeen percent. In 2006, twenty-three of the largest twenty-five IPOs chose to list outside the United States, meaning that only two of the top twenty-five IPOs listed on U.S. exchanges; in 2005, the number was one. Companies seeking access to U.S. investors have increasingly done so through non-U.S. capital pools; for example, U.S. institutional and retail investors have recently been increasing their holdings of non-U.S. investments by fourteen percent annually while increasing holdings of U.S. investments by only eight percent.

[7] INTERIM REPORT, *supra* note 5, at 29.

In light of these trends, several recent major studies have concluded that the U.S. public equity market is losing competitiveness with foreign markets.[8] As countries compete with one another for pools of capital, one dimension of their relative competitiveness is litigation risk and the perception of such risk. As one study summarized, "certainly one important factor contributing to this trend is the growth of U.S. regulatory compliance costs *and liability risks* compared to other developed and respected market centers."[9]

While these concerns should not be overstated, and the $20 trillion U.S. equity capital pool remains the largest in the world, the growth of competition from foreign stock exchanges means that new litigation exposure that increases the cost of being a U.S. publicly traded company may tip the balance in a company's choice of where to list.[10] Such disincentives to public listing of equities on U.S. exchanges risk harming U.S. investors and the U.S. economy.

* * *

In sum, while it might seem at first glance that Petitioner's theory would increase enforcement in the public securities markets, imposing some increased cost on counterparties of public issuers but neutral in its effects on public issuers themselves,[11] such a view would be mistaken. Adoption of Peti-

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[8] *See id.*; MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP ii, 5, 12, 43-54 (2006), *available at* http://www.tinyurl.com/ 2fhyuf.

[9] INTERIM REPORT, *supra* note 5, at x (emphasis added).

[10] *See* BLOOMBERG & SCHUMER, *supra* note 8, at 16-17 (noting that "legal environment" and "regulatory balance" are the key factors after workforce quality in determining a financial center's competitiveness).

[11] Many counterparties on whom Petitioner's theory would impose new liability are in any event, as here, publicly traded companies, so that the costs would be borne by public investors either way.

tioner's novel private liability theory would impose increased costs on publicly traded companies and thus would encourage shifts at the margin to foreign (and private) alternatives. The net effect would be perversely to reduce the scope of coverage of U.S. securities laws rather than to improve their enforcement, risking harm to U.S. investors and the U.S. economy.

II. CREATION OF ANY NEW PRIVATE SECTION 10(b) "PARTICIPANT" LIABILITY SHOULD BE LEFT TO CONGRESS

As this Court recently stated, "it is the federal lawmaker's prerogative . . . to allow, disallow, or shape the contours of . . . § 10(b) private actions." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2512 (2007). Private liability under the securities laws is "'an area that demands certainty and predictability,'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)), and clear statements by Congress serve these important values better than judicial creation of any new "complex, sinuous line separating securities-permitted from securities-forbidden conduct," *Credit Suisse Sec. (USA) LLC v. Billing*, 127 S. Ct. 2383, 2397 (2007).

It is especially appropriate to leave undisturbed Congress's decision not to create new private Section 10(b) liability for commercial participants in transactions with publicly traded companies, for three reasons:

First, as this Court noted in *Central Bank*, Congress knows how to impose aiding-and-abetting liability when it wishes to. Because Congress pointedly declined to provide for private aiding-and-abetting liability in the wake of *Central Bank*, judicial implication of such a claim here would be inappropriate. Judicial creation of a new private right of action under the label of "participant" scheme liability would be similarly inappropriate, for Congress has provided for "participant" liability in several narrowly defined circumstances in the securities laws while pointedly omitting it from Section 10(b).

Second, Congress's institutional fact-finding capacity makes it better suited than the courts to weigh the complex economic tradeoffs involved in extending private Section 10(b) liability to remote actors who are merely commercial counterparties. *Third*, securities fraud is policed by various mechanisms other than private lawsuits under Section 10(b) that obviate the need for any judicial implication of new civil remedies pending any future congressional action.

A. By Providing for Specific "Participant" Liability in Other Securities Laws But Not in Section 10(b), Congress Has Precluded Implied Section 10(b) Participant Liability

The text and structure of the federal securities laws resist judicial implication of a private cause of action for "participation" in a commercial transaction that later results in securities fraud by a public company. Congress in the 1930s was well aware of the concept of participant liability and employed it selectively in parts of the securities laws while contemporaneously omitting it from Section 10(b). Where Congress has expressly provided for something in one provision of the securities laws and omitted it in another, that omission generally is considered intentional. *See, e.g., Touche Ross & Co. v. Redington*, 442 U.S. 560, 571-72 (1982).

Before the enactment of federal securities laws in the 1930s, state "blue sky" laws recognized narrow variants of participant liability. Section 16 of the Model Uniform Sale of Securities Act, for example, authorized suit against any "director, officer, or agent" of a seller who "personally participated in or aided in any way" a fraudulent security sale.[12]

[12] *See* Douglas E. Abrams, *The Scope of Liability under Section 12 of the Securities Act of 1933: 'Participation' and Pertinent Legislative Materials*, 15 FORDHAM URB. L.J. 877, 926 (1987). By the time that the

Section 15 of the Uniform Act also authorized injunctive relief against any "person or persons . . . in any way participating in . . . fraudulent practices or acting in violation" of the Act.[13]

Against this state-law backdrop, Congress authorized several specific, narrow versions of participant liability in both the 1933 Act and the 1934 Act. For example, the 1933 Act allows liability against an underwriter involved with a security for which a false registration is issued, *see* 15 U.S.C. § 77k(a)(4), and defines the term "underwriter" to include anyone who "participates or has a direct or indirect participation" in the distribution of a security, *id.* § 77b(a)(11). Similarly, Section 9 of the 1934 Act imposes liability upon "[a]ny person who willfully participates in any act or omission" that violates that section, which prohibits certain types of market manipulation. 15 U.S.C. § 78i(e). Various other provisions of the securities laws also impose liability for participation in certain specific and narrowly defined circumstances.[14]

By contrast, there is nothing in Section 10(b) that provides for participant liability. The section does not impose liability upon "participants" in underlying commercial transactions or other activities remote from the securities market. Instead, Section 10(b) makes it unlawful to "use or employ" any deceptive or manipulative device "in connection with" the purchase or sale of a security. 15 U.S.C. § 78j(b). As this Court has recognized, these elements require that the deceptive or manipulative device "coincide" with the purchase or

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Exchange Act was enacted in 1934, at least twelve states and Hawaii had adopted such participant liability. *See id.* at 926-27.

[13] By early 1933, this provision had been adopted verbatim by at least three states and Hawaii. *See id.* at 926 n.292.

[14] *See id.* at 932-34 (Trust Indenture Act); *id.* at 934-36 (Investment Company Act); *id.* at 936-37 (Investment Advisers Act); *id.* at 937-40 (Section 11 of the 1933 Act).

sale of securities. *SEC v. Zandford*, 535 U.S. 813, 822 (2002). Participation that merely facilitates fraudulent statements by another party concerning that party's securities at some point in the future cannot fit this legislative text or structure.

Where Congress has so carefully picked and chosen its spots in the securities law to impose narrow and carefully specified participant liability, judicial implication of newly expanded participant liability Congress has not chosen would be inappropriate. This Court recognized as much in *Pinter v. Dahl*, 486 U.S. 622 (1988), where it rejected the petitioner's contention that Section 12 of the 1933 Act imposed liability on any individual whose participation in the sale of securities was a substantial factor in causing the fraudulent sale to occur. The Court observed that Congress was aware of collateral participation concepts but had not chosen to implement them in Section 12. *See id.* at 650-51. *Pinter* thus supports the idea that it is only the participants specified in the statute that are covered.

Here, too, it should not be assumed that Congress simply forgot to mention in Section 10(b) that it had intended to permit a broad private cause of action for participant liability. Because Congress included narrowly defined participant liability in Section 9, an adjacent statutory provision, it is more plausibly concluded that Congress considered and rejected such liability under Section 10(b).

B. Congress Is Better Suited than the Courts to Weigh the Costs and Benefits of Creating Section 10(b) "Participant" Liability

Whether Petitioner's proposed private right of action will, as argued above, invite wasteful strategic litigation, increase the cost of doing business with publicly traded companies and endanger the competitiveness of U.S. public equity capital markets are quintessential policy questions best suited for careful fact-finding and systematic review. So is the question whether any possible marginal gains to deterrence could justify such costs. Such tasks are best assigned to Congress, whose broad oversight of the national economy allows it to assess the facts and make the relevant tradeoffs.

C. Existing Regulatory Mechanisms Established and Enhanced Periodically By Congress Make Implication of Expansive Private "Participant" Liability under Section 10(b) Unnecessary

Congress has provided an extensive regulatory system that obviates the need for judicially created "participant" scheme liability such as Petitioner seeks here. That structure has an array of protections beyond private lawsuits, including administrative enforcement by the SEC, criminal enforcement by the Department of Justice, and self-regulation by the SROs. Congress has regularly supplemented these regulatory powers when needed, and can specify new forms of participant liability if it sees fit in the future.

For example, federal criminal prosecution of securities law violations has increased markedly since the 2002 creation of the Corporate Fraud Task Force within the Department of Justice. Moreover, the SEC's administrative enforcement power has been increased by recent legislation, most notably by the FAIR Funds Act's establishment of a fund through which over $8 billion has been collected for the purpose of disgorgement to investors and payment of civil penalties. *See* 15 U.S.C. § 7246. Regulation may be extended where appropriate beyond immediate securities market actors; as noted above, the PSLRA conferred upon the SEC the authority to prosecute aiding and abetting of Section 10(b) violations.

The authorities exercised by private SROs are another component of the complex, overlapping mosaic of protection that investors enjoy under the federal securities laws. The concept of self-regulation was, from its inception, a cornerstone of federal oversight of the securities and futures industries. The Securities Exchange Act of 1934 authorizes SROs to promulgate and enforce rules governing their membership and the conduct of members, member organizations and their employees, 15 U.S.C. §§ 78f(b)(1)-(9), 78s(g). SROs are also required "to remove impediments to and perfect the mechanism of a free and open market . . . and, in general, to protect investors and the public interest." 15 U.S.C. § 78f(b)(5). Congress's delegation of authority to SROs creates an overlapping system of market protection that uses valuable, expert, front-line oversight by industry-dedicated professionals to supplement regulatory enforcement and help meet the challenges posed by the size, complexity and pace of the public equities markets.

Other advantages of self-regulatory authority are the flexibility to address new unfair or manipulative trading practices and the ability to set standards that exceed those imposed by the SEC—for example, to preclude conduct detrimental to the market and contrary to equitable principles of trade.[15]

SROs such as Nasdaq and the NYSE provide several forms of self-regulation. They regulate the conduct of their members through an independent non-governmental body, the Financial Industry Regulatory Authority (FINRA), formed in 2007 through the consolidation of the National Association of Securities Dealers (NASD) and certain regulatory functions of the NYSE, including its enforcement arm. In addition, the SROs themselves, with the approval and oversight of the SEC, set standards and ascertain eligibility for companies listing on their exchanges. While they do not duplicate the audit function, they regularly review their listed companies' compliance with financial and governance listing standards. This monitoring function also enables the enforcement of the

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[15] *See generally* S. REP. NO. 73-1455 (1934); H.R. DOC. NO. 73-1383, 2d Sess. (1934).

exchanges' disclosure obligations and early detection of issues that might give rise to a public interest concern.

SROs wield enforcement authority including the ability to halt trading and the ultimate sanction of delisting public companies from their exchanges. Delisting may occur for several reasons, including the failure to maintain the quantitative standards required by rule, timely file periodic reports, or meet required corporate governance standards such as obtaining requisite shareholder approvals or maintaining audit committee independence. An issuer may also be delisted when the exchange determines it has acted contrary to the public interest, even if the issuer meets all enumerated criteria for listing.

Congressional support for the SRO system is evident in its periodic reexamination of SRO powers, reaffirmation of the system, and expansion of SRO authority when needed.[16] For example, the Sarbanes-Oxley Act of 2002 mandated stricter audit committee corporate governance listing standards. Congress has determined these expansions of authority to be appropriate because SROs, like the SEC, have a comparative advantage over private securities plaintiffs in expertise and systematic knowledge of the markets.

This complex and overlapping set of protections, subject to periodic congressional review and enhancement, needs no supplement from new and unbounded private rights of action for "participant" liability.

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[16] *See, e.g.*, U.S. SEC. EXCH. COMM'N REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95 1st Sess. (1963); U.S. SEC. EXCH. COMM'N, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS, Division of Market Regulation, U.S. Securities and Exchange Commission (1994).

CONCLUSION

The decision below should be affirmed.

Respectfully submitted,

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A $2.2 Trillion Temptation

The nation's public employees have a very large pool of money — about $2.3 trillion — that must be invested wisely to cover their retirement. So it makes sense that anybody who wants to help invest that money — and make the fabulous profits that go along with such assistance — should not be writing campaign checks to state treasurers or comptrollers or other officials who manage the funds.

In its crudest form, the transaction is called "pay to play" — or give to get — and it is an unspoken arrangement that often means investors are chosen not for their low fees and high skills but for their connections.

The Securities and Exchange Commission long ago barred underwriters of municipal bonds from contributing to candidates and then doing business with them. But 10 years ago, the commission balked at expanding that order to pension funds.

Finally, last week the commissioners unanimously proposed excellent new rules to end pay to play for public pension funds and 529 college savings funds invested by states.

The proposed rules cannot be enacted too soon for New York State's pensioners. The state's fund, which has dropped from $154 billion to $110 billion in a year, has been the source of great concern after three people were arrested in a recent scandal. They allegedly participated in a kickback scheme involving pension investments under the control of Alan Hevesi, the former comptroller.

His replacement, Comptroller Thomas DiNapoli, who has instituted a number of reforms as a result of the scandal, has not agreed to refuse campaign contributions from those doing business with his office. He has asked the Legislature to create a public-financing system for the comptroller's race next year.

There is also another very large loophole that needs to be closed: lawyers make huge fees negotiating contracts for the state and the S.E.C. has no control over lawyers unless they are fronting for investors. So campaign finance experts fear that law firms will become the newest fertile ground for finance officials looking for campaign money.

That exception needs to be fixed. Until then, the S.E.C. should give final approval to these excellent new rules for investors. They could help level the playing field for candidates and remove the corruption of contributions by investors who later want to do business.

STATEMENT OF

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BEFORE THE
COMMITTEE ON THE JUDICIARY, SUBCOMMITTEE ON CRIME AND DRUGS
UNITED STATES SENATE

EVALUATING S. 1551: THE LIABILITY FOR AIDING AND ABETTING SECURITIES VIOLATIONS ACT OF 2009

SEPTEMBER 17, 2009

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Mr. Chairman and members of the Committee, thank you for inviting me to this hearing. Securities class actions are the principal focus of my academic research and I welcome the opportunity to share my views with the Committee as it considers this legislation, which would extend securities fraud liability in private class actions to secondary actors.

Stoneridge* and *Central Bank

S. 1551 would reverse two Supreme Court decisions interpreting Section 10(b) and Rule 10b-5 of the Exchange Act. In *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*,[1] the Court rejected "scheme" liability in private causes of action. *Stoneridge* followed an earlier decision by the Court, *Central Bank of Denver v. First Interstate Bank of Denver*,[2] in which the Court rejected "aiding and abetting" liability. In both cases, the Court rejected attempts by the plaintiffs' bar to bring in third parties as defendants in securities class actions.

The Court's principal concern in these cases was the specter of unlimited liability. As Justice Kennedy wrote for the Court in *Stoneridge*, "[w]ere [the plaintiffs'] concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business." If accepted, the plaintiff's theory in *Stoneridge* threatened to inject the § 10(b) cause of action into "the realm of ordinary business operations."

S. 1551 would tear down the safeguards that the Court adopted in *Stoneridge* and *Central Bank*, creating the potential for the securities laws to be injected into a wide range of ordinary commercial transactions. As Justice Kennedy recognized in *Stoneridge*, expanding liability to secondary actors would undermine the United State's international competitiveness and raise the cost of capital because companies would be reluctant to do business with American issuers. Issuers might list their shares elsewhere to avoid these burdens, thereby further fueling the flight from America's securities markets.

Commercial counterparties of the sort named as defendants in *Stoneridge* and *Central Bank* are just a sideshow to S. 1551I's real purpose. The goal of the bill is to rope in more "deep pocket" defendants to feed the plaintiffs' bar's lucrative class action machine. That class action machine generates enormous fees that support the "pay to play" political contributions that plaintiffs' lawyers use to persuade state pension funds to bring the lawsuits that help keep the machine rolling.

By offering up additional targets to the class action bar, S. 1551 promises to worsen the fundamental problems that make America's securities class action regime so dysfunctional and destructive of shareholder wealth. Securities class actions are already an enormous drain on America's capital markets. S. 1551 would make a bad situation worse.

The Economics of Securities Fraud Class Actions

No other nation has adopted the open-ended private liability for misrepresentations affecting the secondary market price of corporate securities that we have in the United States, and for good reason. Our current regime is not the product of congressional action, but rather, judicial happenstance. In *Basic, Inc.* v. *Levinson*[3] the Supreme Court – in a 4-2 decision – unleashed an avalanche of securities fraud class actions under Rule 10b-5. The Court did this by creating a presumption of reliance for lawsuits involving securities traded in the secondary public markets – the fraud on the market theory (FOTM). The FOTM presumption greatly expands the size of the class, and

[1] 128 S. Ct. 761 (2008).
[2] 511 U.S. 164 (1994).
[3] 485 U.S. 224 (1988).

thus, the potential amount of damages. Every investor who purchased stock during the time that a misrepresentation was affecting the company's stock price—and did not sell it before the truth was revealed—has a cause of action under Rule 10b-5. In the overwhelming majority of securities fraud class actions, plaintiffs' attorneys sue the corporation for misrepresenting the company's operations, financial performance, or future prospects that inflate the price of the company's stock in secondary trading markets. Although these misrepresentations may have a material effect on a company's stock price, in the aggregate there is no net wealth transfer away from investors. For every shareholder who *bought* at a fraudulently inflated price, another shareholder has *sold*: The buyer's individual loss is offset by the seller's gain, investors can expect to win as often as lose from fraudulently distorted prices. With no expected loss from fraud on the market, shareholders do not need to take precautions against the fraud; they can protect themselves against fraud much more cheaply through diversification. Losses from the few fraudulent bad apples will be offset by the gains from the honest companies.

Despite the ability of shareholders to protect themselves against secondary market fraud cheaply through diversification, the FOTM presumption puts the corporation on the hook to compensate investors who come out on the losing end of a trade at a price distorted by misrepresentation. Corporations are held responsible for the entire loss of all of the shareholders who paid too much for their shares as a result of fraudulent misrepresentations. Critically, there is no offset for the windfall gain on the other side of the trade. The investors lucky enough to have been selling during the period of the fraud do not have to disgorge their profits. Given the trading volume in secondary markets, the potential recoverable damages in securities class actions can be a substantial percentage of the corporation's total capitalization, easily reaching hundreds of millions of dollars, and sometimes billions.

The size of the damages becomes a cause for concern when we factor in the inevitably scattershot nature of securities fraud class actions. Distinguishing fraud from mere business reversals is difficult. As a result, a substantial drop in stock price following news that contradicts a previous optimistic statement may well produce a lawsuit. Courts face the difficult task of sorting the meritorious cases from those with weak evidence of fraud (so-called "strike suits"). If plaintiffs can withstand a motion to dismiss, defendants generally will find settlement more attractive than litigating to a jury verdict, even if the defendants believe that a jury would share their view of the facts. From the company's perspective, the enormous potential damages make the merits of the suit a secondary consideration in deciding whether or not to settle. The math is straightforward: A ten percent chance of a $2 billion judgment means that a settlement for $199.9 million makes sense. For many companies facing a securities fraud class action, the choice is settle or risk the very real possibility of a bankruptcy-inducing jury verdict.

If the threat of bankruptcy-inducing damages were not enough, any case plausible enough to get past a motion to dismiss may be worth settling just to avoid the costs of discovery and attorneys' fees, which can be enormous in these cases. The recent experience of JDS Uniphase is illustrative.[4] After five years of litigation, the company was eventually exonerated by a jury after a trial—one of only four securities class actions to go to verdict out of 2,105 suits filed since 1995. The company knew that it was risking bankruptcy if it lost, but it gambled and won—after paying a reported $50 million in legal fees. Even if JDS had been *certain* that it would prevail at trial, it would have been economically rational to settle the case for $49 million when it was filed. Combine this calculus with one other data point—NERA reports that median settlement in securities fraud class actions was $6.4 million from 2002 to

[4] Ashby Jones, JDS Wins Investor Lawsuit, Bucking a Trend, Wall Street Journal, June 2, 2008, at B4.

2007.[5] Given JDS's experience, it is difficult to argue that any suit likely to be filed that gets past a motion to dismiss can be defended for less than $6.4 million. This means that *at least* half of the suits that produce a settlement are settling for essentially nuisance value.

The deterrent value of securities class actions is further diluted by the fact that the measure of damages currently used encourages plaintiffs' lawyers to pursue the wrong party—the corporation. The current regime for secondary-market class actions largely produces an exercise in "pocket shifting." Traditionally, class action settlements have not included a contribution from corporate officers individually. Plaintiffs' lawyers forgo that source of recovery because they can reach a settlement much more quickly if they do not insist on a contribution from the individual defendants. The big money for plaintiffs' attorneys is in pursuing the corporation and its insurers, and the officers and directors are happy to buy peace for themselves with the corporation's money. The dirty secret of securities class actions is that companies and their insurers pay the costs of settlement, which effectively means that shareholders are paying the costs of settlements to shareholders.

In sum, the combination of the potential for enormous judgments and the cost of litigating securities class actions means that even weak cases may produce a settlement if they are not dismissed at the complaint stage. Paying a settlement is a perfectly rational response in the face of the threat of bankrupting liability. If the question is "Your money or your life?," the answer is always the money, unless you are Jack Benny. The deterrent effect of class actions is diluted by this settlement imperative because both wrongful and innocent conduct is punished. Settlement is all the more attractive because the individual defendants can use the shareholders' money to make the suit go away. Consequently, securities class actions punish the wrong party; it is the innocent shareholders who pay, with the wrongdoers generally walking away unscathed. Rule 10b-5 actions sometimes target fraud, but more frequently they are simply legalized extortion at shareholders' expense.

The Effect of S. 1551

Giving the plaintiffs' bar aiding-and-abetting authority would offer class action lawyers one more weapon with which to shake down settlements.[6] Here the obvious targets would be available deep pockets with some contractual connection to the corporation, such as accountants, lawyers, and banks. The demise of Arthur Andersen suggests that increasing the liability burden of these third party professionals is fraught with risks for the capital markets. Aside from the threat of bankruptcy, shifting liability from the corporation to these third parties only puts an additional link in the chain of the pocket shifting problem. Professionals providing services to public corporations will demand compensation for bearing the risks of liability. Moreover, these advisors will begin more aggressively monitoring statements in order to protect themselves from litigation risk. The additional time spent on monitoring will not only duplicate the corporation's efforts to ensure accuracy; it will also be redundant across the multiple advisors working on a common document. Shareholders will bear those costs; securities class actions are not a free lunch.

The burden imposed by extortionate settlements drove Congress's previous response to the question of aiding and abetting liability. In the wake of *Central Bank*, a bill was introduced to extend aiding-and-abetting authority to private litigants. The argument was that expanded liability would encourage accountants and lawyers to be more vigorous "gatekeepers," denying defrauders access to

[5] NERA Economic Consulting, Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High–But Are These Trends Reversing? (September 2007).

[6] Secondary defendants might be afforded some protection by proportionate liability, 15 U.S.C. § 21D(f), but the effect of that provision is reduced substantially by the exceptions for intentional fraud and the insolvency of other defendants.

the financial markets. Congress rejected those arguments in 1995 when it adopted the Private Securities Litigation Reform Act ("PSLRA"), instead giving aiding-and-abetting authority only to the SEC.[7]

The balance struck by the PSRLA is a sensible compromise. The SEC has the authority to pursue secondary defendants with knowledge of the fraud, and unlike plaintiffs' lawyers, the agency is not driven by its financial incentives in using its aiding-and-abetting authority. Facing the knowledge standard, the SEC is forced to pursue secondary defendants only when there is clear evidence of wrongdoing. By vesting authority to pursue aiders-and-abettors in the SEC, Congress recognized that securities class actions are not the primary vehicle for deterring fraud. Civil sanctions imposed by the SEC, criminal prosecution by the Justice Department, and both civil and criminal cases brought by state attorneys general are the primary deterrent of fraud in the securities markets. Private class actions move a lot of money around, but add little to deterrence at the margin.

Moreover, even in private actions, secondary defendants do not enjoy immunity from liability under current law. If they make misrepresentations upon which investors rely (such as certifying false financial statements or hyping a security with inflated prospects), secondary defendants can and will be held liable. *Central Bank* and *Stoneridge* only exclude liability when secondary defendants have made no false statement themselves. That is hardly a startling principle. The basic purpose of securities law is to protect investors who reasonably rely on information. If the accountant, investment banker, or lawyer has made no statement, then investors have not relied on that person in making their investment decisions. On the other hand, current law already provides that if the secondary defendants have induced reliance by investors, they will be on the hook.

The purported benefits of expanded liability – a nebulous increase in marginal deterrence beyond that afford by SEC enforcement and criminal punishment – are unlikely to be worth the costs – a sharp spike in securities class actions, with a corresponding increase in strike suit settlements. In the hands of plaintiffs' lawyers, aiding-and-abetting liability transforms the law of fraud from a sanction for misleading people into a sanction for failing to uncover fraud committed by others.

Such a regime might make sense if we thought it would be proper to transform professionals into quasi-fraud police. But there are good reasons why audits of public companies are not full-scale investigations for fraud. A forensic audit to uncover fraud requires an enormous investment of time and resources and therefore costs a multiple of the typical charge for an annual audit. A forensic audit is a huge waste for the overwhelming majority of public companies that are not engaged in fraud. And it is not as if public accountants are lacking in leverage over their clients; the Sarbanes-Oxley Act has already given accountants the whip hand in that relationship. A chief financial officer disagrees with his independent auditor's interpretation of the sometimes open-ended provisions of GAAP at his peril. Terminating your auditor because of an accounting disagreement assures a steep drop in the stock price. Internal controls? Public accountants love 'em; they come at the company's expense. The Sarbanes-Oxley Act has sent audit fees skyrocketing; introducing aiding-and-abetting liability would send them higher still.

Perhaps more expensive would be the cost of training lawyers to uncover fraud. As an educator of future lawyers, I know first-hand that the average corporate lawyer is doing well to understand the transactions that he is asked to document, much less look behind them for nefarious purposes. Uncovering fraud requires specialized expertise that can only be developed through extensive and expensive training. Law schools do not provide it, nor could they on any cost-effective basis.

[7] PSLRA § 104, 109 Stat. 757 (codified at 15 U.S.C. § 78t(e)).

Imposing liability on the banks raises different concerns. Already a big target for the class action bar before the financial crisis, financial institutions were named as defendants in half of the securities class actions filed last year. In the post-bailout world, suing the large banks that dominate the financial services industry effectively means suing the U.S. Treasury. Almost 80% of the TARP funds have gone to financial institutions that have been named as defendants in recent securities class actions. The pocket-shifting problem of shareholders paying themselves in securities class actions takes on a whole new dimension when we start taking the money out of the pocket of the U.S. taxpayer. S. 1551 would increase the windfall that the plaintiffs' bar has received from the TARP program.

Perhaps the worst consequence of introducing aiding-and-abetting liability, however, would be to further diminish the incentive of plaintiffs' lawyers to pursue the corporate executives who are responsible for the fraud. Under the current scheme, plaintiffs' lawyers extract settlements from the corporation because it is the easiest target and companies fear bankruptcy if they gamble on a trial and lose. The third-party defendants that would be targeted under aiding-and-abetting liability face a similar calculus: even a weak lawsuit poses *some* chance of bankrupting liability. Better to pay up than to become extinct. The costs can always be passed along to the shareholders of the client firms

A Better Solution

Basic economics teaches that deterrence is maximized by sanctioning the person who is most at fault for the fraud. Congress can encourage plaintiffs' lawyers to go after the real wrongdoers in every fraud case by altering the damages remedy for Rule 10b-5 fraud on the market cases. The current rule holds corporations responsible for the entire loss of all of the shareholders who paid too much for their shares as a result of fraudulent misrepresentations. But that measure exaggerates the social harm caused by fraud on the market because it fails to account for the gains of equally innocent shareholders who sold at the inflated price. In most cases, the losses and gains will be a wash for shareholders in the aggregate: some individual shareholders will have suffered losses, others will have reaped windfall gains.

A better damages rule would focus on deterrence rather than compensation.[8] Instead of making defendants liable for all losses resulting from misstatements, we should instead force defendants to disgorge their gains (or expected gains, for those who fail in their scheme) from the fraud. So if a corporation were issuing securities at the time it was distorting the market price of its stock, it would be required to disgorge the amount by which it inflated the price of the securities that it sold to the investors who bought them. In most fraud on the market cases, however, the corporation has not benefited from the misrepresentation that is the basis of the class action. Indeed, the corporation is usually the *victim* of the fraud. The corporation is victimized when an executive is awarded a bonus that is undeserved because he creates the appearance of having met the target stock price. The corporation is also victimized when a chief executive officer keeps his job for a bit longer because he creates the appearance of adequate performance. The proper remedy in such cases is for the executive to return the bonus or salary earned from the fraud to the corporation. If the executive benefits from the fraud by cashing out stock options at an inflated price, those profits can be paid over to the corporation. The Sarbanes-Oxley Act makes a beginning toward making executives pay for their fraud by requiring them to reimburse the corporation for any incentive compensation (as well as profits from any stock sales) if the corporation is required to restate its financial results.[9] The big money for plaintiffs' attorneys, however, remains in pursuing the corporation and its insurers. If we took away the corporation's

[8] I develop these ideas further in a recent article, Stoneridge Investment Partners v. Scientific Atlanta, 2007-2008 Cato Sup. Ct. Rev. 217.
[9] 15 U.S.C. § 78t-1(b)(1).

exposure when it did not benefit from the fraud, we would substantially increase the attorneys' incentive to pursue the executives responsible for the fraud.

If Congress were to adopt a disgorgement measure of damages for Rule 10b-5 class actions, plaintiffs' lawyers would have to extract settlements from executives' bonuses and stock options instead of relying on the corporation's coffers for their payday or targeting deep-pocketed secondary defendants. Deterrence is maximized by sanctioning the person who is most at fault for the fraud, so turning the sights of the class action bar on the culpable individuals would give us substantially more deterrent bang for our class action buck. And reducing the potential dollar figures involved would eliminate the ability of plaintiffs' lawyers to extract nuisance settlements in weak cases. If defendants believe they can prevail at trial, a small probability of losing an enormous judgment will no longer tip the balance in favor of settlement. Fraud should should not pay, but neither should strike suits.

How would the principle apply to aiding-and-abetting liability? Accountants, lawyers, and investment bankers who are complicit in the corporation's fraud should be forced to give up their fees (or some multiple thereof) earned during the fraud period. Canada uses a version of this remedy in its recently adopted securities class action legislation. Under that legislation, the liability cap for experts is $1 million or the revenue that the expert and its affiliates have earned from the issuer and its affiliates during the 12-month period immediately preceding the day on which the misrepresentation or the failure to make timely disclosure occurred.[10] Those limits are inapplicable if the fraud is done knowingly.

The desire to enlist secondary parties in rooting out fraud does not require us to expose them to extortionate settlements in securities class actions. The objective here should be to ensure that fraud does not pay, not to enrich the class action bar. Until Congress reforms the damages measure for Rule 10b-5 class actions, private aiding-and-abetting liability will only serve to fuel the plaintiffs' lawyers' class action machine.

Summing Up

Securities class actions are a big stick to wield against corporate fraud. Unfortunately, they are also all too prone to abuse. Under the damages measure currently used in such actions, corporations are coerced into paying settlements even in weak cases. Expanding liability to "aiders-and-abettors" of securities fraud would expand the potential range of victims for this extortion. Moreover, bringing accountants, attorneys, and banks into the crosshairs further distracts the plaintiffs' bar from going after the real culprits, the corporate executives who commit fraud. If Congress wants to make securities fraud class actions a more effective deterrent, it needs to fix the Rule 10b-5 damages formula first.

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[10] Ontario Securities Act, s. 138.1. Liability can be proportionately allocated in respect of each defendant's responsibility for the damages assessed. Ontario Securities Act s. 138.6. Janis Sarra and I discuss the Canadian securities class action regime at greater length in *Securities Class Actions Move North: A Doctrinal and Empirical Analysis of Securities Class Actions in Canada*, which is forthcoming in the Alberta Law Review.

Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform

*A. C. Pritchard**

I. Introduction

Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.[1] is the latest in a series of recent Supreme Court decisions restricting securities class actions. The Court's holding in *Stoneridge*—rejecting scheme liability that would have roped in third party defendants—is of a piece with the Court's recent skepticism toward securities class actions. The Court's recent decisions reflect a retrenchment from a two-decade-old decision by the Court, *Basic, Inc.* v. *Levinson*,[2] which was the high-water mark for the implied cause of action the courts have found in the Securities Exchange Act § 10(b) and its implementing Rule 10b-5.[3] *Basic* opened the doors wide to securities fraud class actions under Rule 10b-5 by creating a presumption of reliance for lawsuits involving securities traded in the secondary public markets—the fraud on the market theory (FOTM). The result of the *Basic* decision was an upsurge in securities class actions.

That upsurge was met by a predictable backlash from the targets of those suits: public companies and their officers and directors, accountants, and investment bankers. Those potential defendants complained that companies were unfairly targeted by securities class actions based on no more than a drop in the stock price, with the plaintiffs' bar looking to extort settlements based on frivolous suits.

*Professor, University of Michigan Law School. Thanks to Alicia Davis Evans, Nico Howson, and Bob Thompson for helpful comments and suggestions.

[1] 552 U.S. ____, 128 S.Ct. 761 (2008).

[2] 485 U.S. 224 (1988).

[3] 15 U.S.C. § 78j and 17 C.F.R. § 240.10b-5.

And their complaints were heard by Congress and the Court, both of which have taken steps to rein in securities class actions. Congress enacted the Private Securities Litigation Reform Act,[4] which imposes a series of procedural barriers for securities fraud class actions, and the Securities Litigation Uniform Standards Act,[5] which checks efforts to evade the PSLRA's barriers by resort to state court.[6] The Court's interpretations of those statutes have generally been considered defendant-friendly.[7]

Stoneridge is certainly defendant-friendly; the Court put itself through serious intellectual contortions to get to its goal of exculpating secondary actors. *Stoneridge*'s interpretation of the reliance element, however, suggests that while the Court will resist expansion of the Rule 10b-5 cause of action, we cannot expect more fundamental reform from that quarter. In this essay, I compare the institutions and actors that might change how securities class actions work: the Court, Congress, the SEC, and shareholders.

I begin in Part II by explaining the wrong turn that the Court took in *Basic*. The *Basic* Court misunderstood the function of the reliance element and its relation to the question of damages. As a result, the securities class action regime established in *Basic* threatens draconian sanctions with limited deterrent benefit. Part III then summarizes the cases leading up to *Stoneridge* and analyzes the Court's reasoning in that case. In *Stoneridge*, like the decisions interpreting the reliance requirement of Rule 10b-5 that came before it, the Court emphasized policy implications. Sometimes policy implications are invoked to broaden the reach of the Rule 10b-5 cause of action. More recently, policy implications have been invoked to narrow its reach. Part IV explores the policy choices made by Congress in the express private

[4] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in part at 15 U.S.C. §§ 77z-1, 78u-4).

[5] Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified at 15 U.S.C. §77p, 78bb(f)).

[6] See David M. Levine and Adam C. Pritchard, The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws, 54 Bus. Law. 1 (1998).

[7] See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007); Merrill Lynch, Perce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006); Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005). My own view is that *Tellabs* was as generous to plaintiffs as the text of the PSLRA would allow. The opinion did, however, reverse a more generous, but implausible, interpretation from the Seventh Circuit.

causes of action in the securities laws, and the implications of those choices for securities fraud class actions under Rule 10b-5. The choices reflected in those explicit causes of action suggest that the *Basic* Court erred by failing to calibrate the damages measure in Rule 10b-5 class actions to accord with the attenuated version of reliance that it adopted. In secondary-market class actions, I argue, damages should be measured by disgorgement of unlawful gains rather than compensation of defrauded shareholders. Doing so would bring damages closer in line with social costs; more importantly, such a reform promises to make securities fraud class actions a more cost-effective mechanism for deterring fraud.

I then turn in Part V to the question of *who* can reform securities class actions. Which institution—the Court, Congress, the SEC, or shareholders—is most likely to bring about the needed changes to the damages measure? The available evidence suggests that the three government actors in this list are largely paralyzed from overhauling securities class actions in a meaningful way. I argue that shareholders, the parties who bear the costs of the current regime, must take matters into their own hands. I briefly outline the path by which shareholders could opt out of the current dysfunctional class action regime, replacing it with a more precisely targeted deterrent scheme focused on disgorgement. Part VI concludes.

II. The *Basic* Mistake

Congress did not create a private right of action when it enacted the anti-fraud provision in Exchange Act § 10(b). The courts, left to their own imagination in implying a cause of action under Rule 10b-5, have relied heavily on the requirements of the common law action for deceit.[8] Reliance under the common law required the plaintiffs to allege that they had relied on the misstatement and that it affected their decision to purchase. Applying that model to the Rule 10b-5 cause of action, plaintiffs were required to allege that they read the misstatements that they claimed were distorting the price of a company's stock before purchasing or selling that security.

[8] Dura Pharmaceuticals, 544 U.S. at 341 (2005) (private right of action under § 10(b) "resembles, but is not identical to, common-law tort actions for deceit and misrepresentation.").

The Supreme Court, in a 4-2 vote with Justice Harry Blackmun writing for the majority, adopted a "fraud on the market" presumption of reliance in *Basic*.[9] In *Basic*, the defendant company repeatedly denied that it was in merger negotiations. When the company eventually announced a merger at a substantial premium to its prevailing market price, disappointed shareholders who had sold during the time that the company was denying the merger negotiations brought suit. The Court (in another opinion by Justice Blackmun) had excused the reliance requirement in an earlier case, *Affiliated Ute Citizens of Utah v. United States*, in which the gravamen of the fraud had been deceptive nondisclosure in breach of a fiduciary duty.[10] In that case, it was obviously impossible for the plaintiffs to plead actual reliance because the violation was a failure to speak, rather than a misstatement, so the Court concluded that materiality of the omission would "establish the requisite element of causation in fact."[11] The Court treated reliance as simply a subset of the tort concept of proximate causation (that is, whether the defendant's conduct is sufficiently close to the plaintiff's harm).

Affiliated Ute's presumption of reliance did not extend, however, to affirmative misstatements. The reliance requirement for misstatements posed two obstacles to certifying a class of securities purchasers under Rule 10b-5, one rooted in the law and the other rooted in investor behavior. The legal obstacle lies in the standards for certifying a class action. If each member of the plaintiff class were required to allege that he had read and relied on the misstatement in making her decision to purchase, it would defeat the commonality requirement for class actions.[12] The obstacle posed by investor behavior is that most purchasers of the company's stock would not have read or heard the alleged misstatement, which would substantially limit

[9] Anthony Kennedy had not yet taken his seat as Lewis Powell's replacement; Chief Justice William Rehnquist and Antonin Scalia recused themselves. Given their votes in other securities cases, it seems likely that the result would have been reversed if Kennedy, Rehnquist, and Scalia had participated.

[10] 406 U.S. 128 (1972) (fraudulent non-disclosure of certain conditions attaching to the transfer of commercial paper related to tribal trust assets).

[11] *Id.* at 154.

[12] Fed.R.Civ.P. 23(b)(3) (class action maintainable if "the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting individual class members").

the size of the class. The FOTM presumption allows plaintiffs to skip the step of alleging personal reliance on the misstatement, instead allowing them to allege that the *market* relied on the misrepresentation in valuing the security. The plaintiffs in turn are deemed to have relied upon the distorted price produced by a deceived market. The empirical premise underlying the FOTM presumption is the efficient capital market hypothesis, which holds that efficient markets rapidly incorporate information—true or false—into the market price of a security. Thus, the price paid by the plaintiffs would have been inflated by the fraud, rendering the misstatement the cause in fact of the fraudulently induced purchase. The FOTM presumption assumes that purchasers would not have paid the prevailing market price if they knew the truth.[13]

The FOTM presumption avoids the evidentiary difficulties of showing actual reliance and, as a by-product, greatly expands the size of the class, thus increasing the potential amount of damages. Herein lies the problem: Once the FOTM presumption is in play, the potential damages available under Rule 10b-5 become enormous. Every investor who purchased during the time that a misrepresentation was affecting the company's stock price—and did not sell it before the truth was revealed—has a cause of action and potential remedies under Rule 10b-5.[14] As a result, the question of damages takes on vital importance.

Blackmun and the Supreme Court punted on this question in *Basic*, brushing the point off in a footnote. Blackmun ducked the issue of damages at the insistence of Justice John Paul Stevens, who wanted it left for another day.[15] This is perhaps fortunate, because Blackmun might well have made things worse. He was focused solely on compensation; there is no evidence that he even considered disgorgement.[16] The elements of reliance and damages, however,

[13] The presumption also applies if the misstatement has depressed the price of the stock, although this scenario is much less common.

[14] Shareholders who purchased before the fraud are excluded by the "purchase or sale" requirement announced in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[15] Harry Blackmun, Conference Notes, Basic v. Levinson, No. 86-279 (November 4, 1987) (Harry A. Blackmun Collection, Library of Congress).

[16] Letter from Harry A. Blackmun to William J. Brennan, Jr., No. 86-279, *Basic v. Levinson* (January 15, 1988) (Thurgood Marshall Collection, Library of Congress) ("there are at least two theories of damages that a plaintiff could propose, and this opinion does not lend particular support to either. . . . [T]he plaintiff could argue that

are not so easily severed. In adopting the FOTM presumption, Blackmun followed his earlier opinion in *Affiliated Ute*, which Blackmun characterized as holding that reliance was satisfied as long as "the necessary nexus between the plaintiff's injury and the defendant's wrongful conduct had been established."[17]

In *Affiliated Ute*, the connection between reliance and damages was self evident. The fraudulent transaction at issue fit neatly into the tort action for deceit. The plaintiffs' losses corresponded to the defendants' gains; the defendants had withheld material information about the value of the securities that they were purchasing from the plaintiffs. The ordinary "out of pocket" measure of tort damages—the difference between the price paid to the victim and the security's "true" value—makes sense in this context. In this scenario, requiring that the defendant compensate the plaintiff for her losses corrects the distortions caused by fraud in two ways. First, requiring compensation to the victim discourages the defendant from committing fraud. Second, compensation discourages investors from spending resources trying to avoid fraud.[18]

Expenditures on committing fraud and avoiding fraud are the real social costs that the anti-fraud cause of action is trying to prevent, and they underlie the reliance element of the tort action for deceit. Expenditures by both the perpetrator and the victim due to fraud are a social waste, so discouraging those expenditures by requiring compensation makes sense when the corporation is benefiting from the fraud. Indeed, fraud may influence how investors direct their capital. Firms selling securities in the primary market disclose more information in an effort to attract investors. If those disclosures are fraudulent, investors will pay an inflated price for those securities and companies will invest in projects that are not cost-justified. That risk of fraud will lead investors to discount the value of securities,

he would not have sold had he known about the merger discussion, and thus that he should receive the difference between the price at which he sold ($18) and the eventual merger price ($42). Alternatively, one could argue that a plaintiff should recover the difference between the price he sold ($18) and what the price would have been had defendants not misrepresented the facts ($20).").

[17] Basic, 485 U.S. at 243.

[18] Paul G. Mahoney, Precaution Costs and the Law of Fraud in Impersonal Markets, 78 Va. L. Rev. 623, 630 (1992) ("If fraud is not deterred, market participants will take expensive precautions to uncover fraud so as to avoid entering into bargains they would not have concluded in an honest market.").

thus raising the cost of capital for publicly traded firms. Fraud is worth deterring when the defendant is a party to the securities transaction, and requiring compensation ensures that fraud does not pay.

Basic's FOTM presumption, however, does not require that the defendant have purchased or sold the security whose price was allegedly affected by the misstatement. In fact, in the overwhelming majority of securities fraud class actions, plaintiffs' attorneys sue the corporation and its officers for misrepresenting the company's operations, financial performance, or future prospects that inflate the price of the company's stock in secondary trading markets. Because the corporation has not sold securities (and thereby transferred wealth to itself), it has no institutional incentive to spend real resources in executing the fraud—and thus no reason to encourage investor reliance.

On the other side of the equation, secondary-market fraud does not create a net wealth transfer away from investors, at least in the aggregate. For every shareholder who *bought* at a fraudulently inflated price, another shareholder has *sold*: The buyer's individual loss is offset by the seller's gain.[19] If we assume all traders are ignorant of the fraud, we can expect them to win as often as lose from fraudulently distorted prices.[20] With no expected loss from fraud on the market, shareholders do not need to take precautions against the fraud. Thus, secondary-market fraud fits awkwardly in the confines of a tort action for deceit, which is premised on misrepresentation in a face-to-face transaction. In face-to-face transactions, parties naturally take precautions to manage the risk of fraud.

Oddly enough, the status of many shareholders as passive price takers in the secondary market was one of the rationales offered by the *Basic* Court for adopting the FOTM presumption. The Court has it exactly backwards: Because these shareholders are passive, they are not relying in the economically relevant sense, which is to say, they are not making a choice to forego verification. Verification is not an option for the passive investor; checking the accuracy of a

[19] Frank Easterbrook & Daniel Fischel, Optimal Damages in Securities Cases, 62 U. Chi. L. Rev. 607, 611 (1985).

[20] Alicia Davis Evans, Are Investors' Gains and Losses from Securities Fraud Equal Over Time? Some Preliminary Evidence, Working Paper, University of Michigan (2008) (demonstrating that diversified traders' gains and losses from securities fraud average out to essentially zero).

corporation's statements is a task that can be taken on only by an investment professional, and even these sophisticated actors are unlikely to succeed in uncovering fraud. Passive investors can protect themselves against fraud much more cheaply through diversification. Fraud, like other business reversals, is a firm-specific risk, so assembling a broad portfolio of companies essentially eliminates its effect on an investor's portfolio. The few bad apples will be offset by the gains from the honest companies. The irony of the FOTM presumption, intended to protect passive investors, is that the ultimate passive investors—holders of index funds—have already protected themselves against fraud in the secondary market, and at a very low cost.

Notwithstanding the ability of shareholders to protect themselves through diversification, the FOTM presumption, when coupled with the "out of pocket" tort measure of damages, puts the corporation on the hook to compensate investors who come out on the losing end of a trade at a price distorted by misrepresentation.[21] The current rule applied by the lower courts holds corporations responsible for the entire loss of all of the shareholders who paid too much for their shares as a result of fraudulent misrepresentations. Critically, the "out of pocket" measure of damages provides no offset for the windfall gain on the other side of the trade. The investors lucky enough to have been selling during the period of the fraud do not have to give their profits back. Given the trading volume in secondary markets, the potential recoverable damages in securities class actions can be a substantial percentage of the corporation's total capitalization, easily reaching hundreds of millions of dollars, and sometimes billions. With potential damages in this range, class actions are a big stick to wield against fraud. More importantly, the "out of pocket" measure exaggerates the social harm caused by FOTM because it fails to account for the windfall gains of equally innocent shareholders who sold at the inflated price. Absent insider trading, the losses and gains will be a wash for shareholders in the aggregate, even though some individual shareholders will have suffered substantial losses.

[21] For a thorough discussion of damages issues under Rule 10b-5, see Robert B. Thompson, "Simplicity and Certainty" in the Measure of Recovery Under Rule 10b-5, 51 Bus. Law. 1177 (1996).

The case for deterring fraud with enormous damages is weaker when the corporation does not benefit from the fraud. The standard argument for vicarious liability in this context is that it will encourage the company to take precautions to prevent the fraud. A similar argument applies to third parties, such as accountants and investment banks. This argument, however, assumes that fraud sanctions are being imposed accurately. Securities fraud class actions are inevitably scattershot. Distinguishing fraud from mere business reversals is difficult. The external observer may not know whether a drop in a company's stock price is attributable to a prior intentional misstatement about its prospects (i.e., fraud) or a result of risky business decisions that did not pan out (i.e., misjudgment or bad luck). Unable to distinguish the two, plaintiffs' lawyers must rely on limited publicly available indicia (SEC filings, press releases from the company, evidence of insider trading by the managers alleged to be responsible for the fraud, the rare instance of a public revelation by a whistleblower, etc.) when deciding whom to sue. Thus, a substantial drop in stock price following news that contradicts a previous optimistic statement may well produce a lawsuit.

That leaves courts with the difficult task of sorting the meritorious cases from those with weak evidence of fraud (so-called strike suits). Courts and jurors, with hindsight, may have difficulty distinguishing false statements (which were known to be false at the time) from unfortunate business decisions. Both create a risk of liability and thus provide a basis for filing suit. If plaintiffs can withstand a motion to dismiss, defendants generally will find settlement more attractive than litigating to a jury verdict, even if the defendants believe that a jury would share their view of the facts. From the company's perspective, the enormous potential damages make the merits of the suit a secondary consideration in the decision of whether or not to settle. The math is straightforward: A 10 percent chance of a $250 million judgment means that a settlement for $24.9 million makes sense.[22] For many companies facing a securities fraud class action, the choice is settle or risk the very real possibility of a jury verdict that threatens bankruptcy.

[22] *See* Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 Stan. L. Rev. 1487, 1511 (1996) ("The class-based compensatory damages regime in theory imposes remedies that are so catastrophically large that defendants are unwilling to go to trial even if they believe the chance of being found liable is small.").

If the threat of bankruptcy-inducing damages were not enough, any case plausible enough to get past a judge may be worth settling just to avoid the costs of discovery and attorneys' fees, which can be enormous in these cases. Securities fraud class actions are expensive to defend because the focus of litigation will often be scienter: What did the defendants know, and when did they know it? The most helpful source for uncovering those facts will be the documents in the company's possession. Producing all documents relevant to the knowledge of senior executives over many months or even years—for example, all email sent or received by the top management team—can be a massive undertaking for a corporate defendant. Having produced the documents, the company can then anticipate a seemingly endless series of depositions, as plaintiffs' counsel investigates whether the executives' recollections square with the documents. Beyond the cost in executives' time, the mere existence of the class action may disrupt relationships with suppliers and customers, who will be understandably leery of dealing with a business accused of fraud.[23]

The recent experience of JDS Uniphase is illustrative.[24] After five years of litigation, the company was eventually exonerated by a jury after a trial—one of only four securities class actions to go to verdict out of 2,105 suits filed since 1995. The company knew that it was risking bankruptcy if it lost, but was unable to come to terms with the plaintiffs. JDS gambled and won—but only after paying a reported $50 million in legal fees. Even if JDS had been *certain* that it would prevail at trial, it would have been economically rational to settle the case when it was filed for $49 million. Combine this calculus with one other data point: The median settlement in securities fraud class actions was $6.4 million from 2002 to 2007.[25] Given JDS's experience, it is difficult to argue that any suit likely to be

[23] See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742–43 (1975). The cost of discovery has been ameliorated somewhat by the PSLRA, which limits discovery while a motion to dismiss is pending. 15 U.S.C. § 78u-4(b)(3)(B).

[24] Ashby Jones, JDS Wins Investor Lawsuit, Bucking a Trend, Wall Street Journal, June 2, 2008, at B4.

[25] NERA Economic Consulting, Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But Are These Trends Reversing? (September 2007). The average settlement was $23.2 million during that period.

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filed that gets past a motion to dismiss can be defended for less than $6.4 million. This means that *at least* half of the suits that produce a settlement are settling for essentially nuisance value.

In sum, the combination of the potential for enormous judgments and the cost of litigating securities class actions means that even weak cases may produce a settlement if they are not dismissed at the complaint stage. The deterrent effect of class actions is thus diluted, because both wrongful and innocent conduct is punished. This possibility of extracting multimillion dollar settlements from strike suits has driven post-*Basic* efforts to rein in securities class actions. I turn now to the Court's part in those efforts.

III. *Stoneridge*

As noted above, *Stoneridge* is the latest salvo in the Court's efforts to combat strike suits. The Court's most controversial post-*Basic* effort to curtail securities class actions also happens to be the precursor to *Stoneridge*: *Central Bank of Denver v. First Interstate Bank of Denver*.[26] *Central Bank*, like *Stoneridge*, was written by Justice Anthony Kennedy. The issue presented in *Central Bank* was whether private civil liability under § 10(b) (the authorizing statute for Rule 10b-5) extends to aiders and abettors of the violation.[27] The issuer of the securities in the case was the Public Building Authority, which raised $26 million in bonds to finance public improvements at planned residential/commercial development in Colorado. Central Bank acted as indenture trustee for the bonds. The bonds were secured by liens on real property, with a covenant requiring that the assessed value of that land must be at least 160 percent of the bonds' outstanding principal and interest. Additional covenants required AmWest Development—the developer—to give annual reports showing that the 160 percent test was being met.

Before an issue of the bonds in 1988 (but after a previous issue in 1986), AmWest gave Central Bank an updated appraisal showing no change in value of land from 1986. But the senior underwriter of the 1986 bond issue sent Central Bank notice questioning the 1986 valuation because property values had dropped in the region.

[26] 511 U.S. 164 (1994).

[27] See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (holding that Rule 10b-5's "scope cannot exceed the power granted the Commission by Congress under § 10(b)").

Central Bank asked its in-house appraiser to review the 1988 appraisal, who concluded that it was too optimistic. Instead of insisting on a new independent appraisal, Central Bank agreed to delay the outside full appraisal until after the 1988 bond offering. The building authority later defaulted and the bondholders filed suit against Central Bank, alleging that the bank had aided and abetted the Building Authority's Rule 10b-5 violation.

Blackmun assigned the opinion to Kennedy, who had voted at conference to uphold the aiding and abetting cause of action.[28] After further review, however, Kennedy switched his vote.[29] The open-ended nature of aiding and abetting liability clearly raised concerns about strike suits for Kennedy. He warned that uncertainty over the scope of liability could induce secondary actors to settle "to avoid the expense and risk of going to trial."[30] The risk of having to pay such settlements could cause professionals, such as accountants, to avoid newer and smaller companies, and "the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute."[31]

In an effort to increase Rule 10b-5's predictability, Kennedy's opinion adopted a two-part framework for addressing the scope of the private right of action under § 10(b), a significant departure from the free-wheeling approach of *Basic*.[32] In the first step of the inquiry,

[28] See Harry A. Blackmun, Conference Notes, No. 92-854, Central Bank of Denver v. First Interstate Bank (Dec. 3, 1993) Harry A. Blackmun Papers, Library of Congress (noting Kennedy's vote); Letter from Harry A. Blackmun to Chief Justice Rehnquist, No. 92-854, Central Bank of Denver v. First Interst. Bank, (Dec. 7, 1993) Harry A. Blackmun Papers, Library of Congress (informing the Chief that Kennedy would write for the majority).

[29] Letter from Anthony M. Kennedy to Harry A. Blackmun, Re: Central Bank v. First Interstate, No. 92-854 (February 17, 1994) Harry A. Blackmun Papers, Library of Congress. ("After working through the cases, particularly *Blue Chip Stamps, Ernst & Ernst, Pinter*, and *Musick*, I came to the conclusion that our precedents require us to confine the 10b-5 cause of action to primary violators, without extension to aiders and abettors.").

[30] Central Bank, 511 U.S. at 189.

[31] *Id.*

[32] I apply the two-step inquiry of *Central Bank* to the relationship between reliance and damages below.

Kennedy examined the text of § 10(b) to determine the scope of the conduct prohibited by the provision. He had little difficulty determining that the text of § 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[33] This, in Kennedy's view, was sufficient to resolve the question: aiding and abetting was not prohibited by § 10(b).

Nonetheless, Kennedy set forth a second-step to the inquiry:

> When the text of § 10(b) does not resolve a particular issue, we attempt to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act. For that inquiry, we use the express causes of action in the securities Acts as the primary model for the § 10(b) action. The reason is evident: Had the 73d Congress enacted a private § 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the securities Acts. . . .[34]

The plaintiffs' argument also failed under this second step, because the explicit causes of action afforded by Congress in the Securities Act and the Exchange Act were similarly silent on the question of aiding and abetting.[35]

In passing, Kennedy noted one additional problem with the plaintiffs' argument, which would have important consequences in *Stoneridge*: "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or

[33] Central Bank, 511 U.S. at 177.

[34] *Id.* at 178 (citations and internal quotation marks omitted). The Court has used the approach of looking to express causes of action to infer appropriate elements under the implied cause of action under Rule 10b-5 in other cases. Lampf, Pleva, Lipkind, Purpis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (applying statute of limitations from Securities Act claims to Rule 10b-5 claim); Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 297 (1993) (finding an implied right of contribution under Rule 10b-5 based on express right of contribution under explicit causes of action in the Exchange Act).

[35] Whether the question is resolved under the first or the second step of this inquiry has potentially significant consequences. When the Court interprets § 10(b), it is defining not only the limits of the private cause of action, but also the reach of the SEC's authority. When it constructs the hypothetical cause of action in the second step, only the private cause of action is implicated.

actions."[36] The Court left the door open for some liability for secondary participants, such as accountants, investment bankers, and lawyers, but only if they have exposed themselves to that risk by acting in a way that induces investor reliance. The bottom line after *Central Bank* is that a defendant must make a misstatement (or omission) on which a purchaser or seller of a security relies. Kennedy did not explain further the connection between reliance and the scope of Rule 10b-5; that issue would reemerge in *Stoneridge*.

If *Central Bank* was intended to enhance predictability, Kennedy's effort failed. What did it mean to "make" a misstatement? What sort of reliance was required? Not surprisingly, the lower courts arrived at different answers to these questions. The Ninth Circuit found that substantial participation in the making of a misstatement would suffice, even without public attribution of that statement to the defendant.[37] The Second Circuit adopted a narrower approach, finding participation in the making of a statement insufficient; public attribution of the statement to the defendant was required.[38]

This split over the interpretation of *Central Bank*'s holding brought the question of the scope of a primary violation of Rule 10b-5 back to the Court in *Stoneridge*. The *Stoneridge* plaintiffs attempted an end run around *Central Bank*: Instead of alleging that the secondary defendants had made or participated in the making of a misstatement, the plaintiffs alleged that the secondary defendants were part of a "scheme to defraud," thus invoking a separate provision of Rule 10b-5's anti-fraud prohibition.[39]

The scheme alleged by the plaintiffs in *Stoneridge* involved two suppliers of the cable company Charter Communications. The plaintiffs' complaint alleged that Charter engaged in a massive accounting fraud that inflated Charter's reported operating revenues and cash flow. The plaintiffs also named as defendants two equipment suppliers who provided cable set-top boxes to Charter, Scientific-Atlanta, and Motorola. The plaintiffs alleged that Charter paid the suppliers $20 extra for each set-top box in return for the supplier's agreement

[36] Central Bank, 511 U.S. at 180.

[37] In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628–629 (9th Cir. 1994).

[38] Wright v. Ernst & Young, LLP, 152 F.3d 169, 175 (2d Cir. 1998).

[39] Exchange Act Rule 10b-5(a).

to make additional payments back to Charter in the form of advertising fees. Charter then capitalized the $20 extra expense (shifting the accounting cost into the future) while treating the advertising fees as current income, artificially boosting Charter's current accounting revenues at the expense of future income. The suppliers had no direct role in preparing or disseminating the fraudulent accounting information, nor did they approve Charter's financial statements. The plaintiffs alleged, however, that the vendors facilitated Charter's deceptions by preparing false documentation and backdating contracts. The district court granted the suppliers' motion to dismiss, relying on *Central Bank* to hold that the vendors were not primary violators for Rule 10b-5 purposes. The court of appeals affirmed, concluding that the suppliers had not engaged in any deception because they had made no misstatements, had no duty to disclose to Charter's investors, and had not engaged in manipulation of Charter's shares.[40]

The Supreme Court, by a vote of 5–3 (with Justice Stephen Breyer recused), affirmed. Justice Kennedy, writing for the Court, rejected the appellate court's holding that there was no deception, noting that "[c]onduct itself can be deceptive."[41] He instead hung the affirmance on the other doctrinal point from his *Central Bank* decision, the incompatibility of aiding and abetting liability with the "essential element" of reliance.[42] He concluded that Blackmun's presumptions of reliance from *Affiliated Ute* and *Basic* did not apply because the suppliers had no fiduciary duty to Charter's shareholders and the suppliers' statements were not disseminated to the public. In this case, investors relied on Charter for its financial statements, not the cable set-top box transactions underlying those financial statements. Why did Kennedy focus on the defendants' conduct, rather than the plaintiffs, when assessing reliance? According to Kennedy, "reliance is tied to causation, leading to the inquiry whether [suppliers'] acts were immediate or remote to the injury."[43] Kennedy, following Blackmun's lead, was treating the reliance inquiry as a species of the tort concept of proximate cause.

[40] In re Charter Communications, Inc. Sec. Litig., 443 F.3d 987, 990–93 (8th Cir. 2006).

[41] Stoneridge, 128 S.Ct. at 769.

[42] *Id.*

[43] *Id.* at 770.

Like *Central Bank*, Kennedy's principal concern was the specter of unlimited liability. According to Kennedy, "[w]ere this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business."[44] If accepted, the plaintiff's theory threatened to inject the § 10(b) cause of action into "the realm of ordinary business operations."[45]

Kennedy's rationale for limiting the concept of reliance could have more naturally been put into the "in connection with the purchase or sale of any security" language from § 10(b). Kennedy pointed to that language, but said that it did not control in this case because the "in connection with" requirement goes to the "statute's coverage rather than causation."[46] Another reason for not putting the limit into that doctrinal category is that the Court had only recently affirmed a very broad scope for that requirement.[47] A more substantial reason is that cabining Rule 10b-5 through the "in connection with the purchase or sale" requirement would limit not only private plaintiffs but, potentially, the SEC, whose enforcement authority is limited by the reach of the statute. Kennedy conceded that the SEC's enforcement authority might reach commercial transactions such as those between Charter and its suppliers, but he was reluctant to grant the same freedom to the plaintiffs' bar.[48]

Given the need to cabin the plaintiffs' bar, but maintain the SEC's discretion, the reliance requirement was an attractive tool. The reliance requirement, despite being an "essential element," has no basis in the language of § 10(b), but is instead derived from the common law of deceit.[49] More importantly for Kennedy's purposes, reliance does not apply in enforcement actions brought by the SEC, or criminal prosecutions brought by the Justice Department.[50] Putting the

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] SEC v. Zandford, 535 U.S. 813 (2002).

[48] Stoneridge, 128 S.Ct. at 770–771 ("Were the implied cause of action to be extended to the practices described here . . . there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees.").

[49] See, e.g., List v. Fashion Park, Inc. 340 F.2d 457 (2d Cir. 1965).

[50] Geman v. SEC, 334 F.3d 1183, 1191 (10th Cir. 2003) ("The SEC is not required to prove reliance or injury in enforcement cases."); United States v. Haddy, 134 F.3d 542, 549–51 (3d Cir. 1998) (government need not prove reliance in criminal case).

limit on secondary party liability in the reliance element allowed the Court to have its cake—unfettered government enforcement—and eat it too—constrain the scope of private actions.

The importance of the SEC's enforcement efforts had been reinforced by Congress's response to *Central Bank*. Rebuffing calls to restore aiding-and-abetting liability, Congress instead gave that authority only to the SEC.[51] Accepting the plaintiff's argument in *Stoneridge*, Kennedy reasoned, would thus "undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."[52] The Court's rationale for the need to constrain private litigants echoed and amplified the policy concerns of *Central Bank*. Expanding liability would undermine the United States' international competitiveness and raise the cost of capital because companies would be reluctant to do business with American issuers. Issuers might list their shares elsewhere to avoid these burdens.[53]

Most telling was the Court's treatment of the basic question of the existence of the implied private right of action. Kennedy made it clear that the initial implication of a private cause of action had been a mistake; under current doctrine, private causes of action are based only on explicit instruction from Congress.[54] Having now recognized the mistake, the Court was not going to compound the error: "Concerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us. Though it remains the law, the § 10(b) private right should not be extended beyond its present boundaries."[55] Thus, *Stoneridge* stands for the proposition that the

[51] PSLRA § 104, 109 Stat. 757 (codified at 15 U.S.C. § 78t(e)).

[52] Stoneridge, 128 S.Ct. at 771.

[53] *Id.* at 772.

[54] *Id.* ("Though the rule once may have been otherwise, it is settled that there is an implied cause of action only if the underlying statute can be interpreted to disclose the intent to create one.") (citations omitted). See also *Id.* at 779 (Stevens, J., dissenting) ("A theme that underlies the Court's analysis is its mistaken hostility towards the § 10(b) private cause of action. The Court's current view of implied causes of actions is that they are merely a relic of our prior heady days.") (citations and internal quotation marks omitted).

[55] *Id.* at 773.

Rule 10b-5 cause of action is now frozen, at least when it comes to the expansion of liability.[56]

IV. Fixing the Mistake

How do we fix the problem created by *Basic*? One way of getting at this question is through revisionist history. How would the reliance question in *Basic* have come out if we applied the two-step inquiry from *Central Bank*? Step 1: What does the statutory text tell us? Nothing; Congress did not mention reliance in § 10(b), hardly a surprise given that it did not intend to create a private cause of action. That silence sends us to the second step, which attempts to glean Congress's intent with respect to the implied cause of action under Rule 10b-5 by looking to the explicit private causes of action in the securities laws. What do those explicit causes of action tell us about the appropriate relation between damages and reliance under Rule 10b-5? They tell us that the Court has made a mistake in thinking about the implied right of action under Rule 10b-5 as a species of the tort action for deceit. The focus should be deterrence; a more apt model for the FOTM action would be unjust enrichment.[57]

There are six explicit causes of action relevant to our inquiry.[58] The first two come from the Securities Act of 1933. How do these causes of action treat reliance? Section 11 of that law allows the plaintiff to sue a corporate issuer, along with its officers and directors, for damages if the company has a material misstatement in its registration statement for a public offering.[59] Section 11 has no reliance requirement. Plaintiffs do not need to have read the registration statement that is alleged to be misleading. Damages, however, are

[56] See *Id.* ("when [the aiding and abetting provision of the PSLRA] was enacted, Congress accepted the § 10(b) private cause of action as then defined but chose to extend it no further.").

[57] On the unjust enrichment measure under Rule 10b-5, see Thompson, *supra* note 21.

[58] Two other provisions, § 15 of the Securities Act, 15 U.S.C. § 77o, and § 20 of the Exchange Act, 15 U.S.C. § 78t, extend liability to control persons of violators of those laws. It seems reasonable to conclude, however, that the control person benefitted from the wrongdoing of its affiliate if the affiliate benefitted. Even then liability is excused if the control person can show that it acted in good faith and was not complicit in the wrongdoing.

[59] 15 U.S.C. § 77k.

limited to the offering price.[60] The corporate issuer's liability exposure cannot be greater than its benefit from the fraud. Section 12(a)(2) provides a parallel cause of action for material misstatements in a prospectus or an oral statement made in connection with a public offering.[61] Section 12(a)(2) also does not require reliance, but its remedy is rescission—plaintiffs who prevail are entitled to put their shares back to the seller in exchange for their purchase price (or rescissory damages, if the plaintiff has sold before bringing suit). Under either formula, damages are limited to the amount that the seller received from the investor.[62] This parallels the unjust enrichment measure, not the out-of-pocket measure from tort.

Turning to the Exchange Act private causes of action, § 28 preserves existing rights and remedies, but bars plaintiffs from recovering "a total amount in excess of his actual damages on account of the act complained of."[63] This provision clearly bars double recovery, but has also been construed to bar punitive damages.[64] It tells us nothing, however, about the relation between reliance and damages.

Section 9(e) allows for recovery in cases of market manipulation.[65] Section 9 does not require reliance, and it is silent on the measure of damages. There is little doubt, however, that the defendant in a manipulation case is benefiting from the fraud. Manipulation requires a showing of intent, and it is hard to conjure up incentives for market manipulation other than extracting profits from that market. Although reliance is not required, § 9 does impose a challenging standard requiring the plaintiff to show that his transaction "price . . . was affected by" the manipulation, a difficult task in the face of the myriad influences that can affect the price of a security. The requirement that plaintiff tie his losses to the manipulation inevitably means that there will be some correspondence between the plaintiff's losses and the defendant's gains.[66]

[60] *Id.* at § 77k(g).

[61] *Id.* at § 77*l*(a)(2).

[62] Under certain circumstances, § 12(a) allows for recovery from persons who have solicited on behalf of the seller. See Pinter v. Dahl, 486 U.S. 622 (1988).

[63] 15 U.S.C. § 78bb.

[64] See, e.g., Green v. Wolf Corp., 406 F.2d 291, 302–303 (2d Cir. 1968).

[65] 15 U.S.C. § 78i(e).

[66] There is little case law on this subject, as § 9(e) "has been virtually a dead letter so far as producing recoveries is concerned." Louis Loss & Joel Seligman, Securities Regulation 4279 (3rd Ed. 2004).

More illuminating are the two explicit causes of action allowing for recovery from insider traders. Neither cause of action requires reliance, but both limit damages to the benefit that the insider trader obtained from his violation. They are therefore modeled on unjust enrichment, and not the tort model of deceit. First, § 16(b) allows shareholders to bring derivative suits on behalf of the corporation to recover "short swing" gains made by insiders trading in the company's shares (that is, profits gained, or losses avoided, for "round trip" transactions—buy/sell or sell/buy—within six months of each other).[67] The remedy is limited to the defendant's benefit from the violation, in this case the profits the insider gained (or the losses he avoided) within the six-month period that defines the offense. Second, § 20A creates a private cause of action for insider trading, this time for conduct that violates § 10(b) because the insider has breached a duty of disclosure.[68] The provision allows investors who have traded contemporaneously with insiders to recover damages from those insider traders. Reliance is excused in such cases by *Affiliated Ute*, but damages once again are limited to "the profit gained or loss avoided in the transaction."[69] Moreover, even that measure is reduced by any disgorgement obtained by the SEC based on the same violations. Thus, where the Exchange Act excuses reliance, recovery is limited to the defendant's gain, not the plaintiff's loss.

Completing our survey of the explicit causes of action in the principal securities laws, § 18 of the Exchange Act comes closest to the Rule 10b-5 FOTM class action. Section 18 allows investors who have relied on a corporation's filings with the SEC to recover damages for misstatements in those filings.[70] Section 18 does not limit damages, thus standing in sharp contrast to the other causes of action. It is also unique in requiring that a plaintiff demonstrate that he purchased or sold "in reliance upon" the misstatement in

[67] 15 U.S.C. § 78p(b).

[68] 15 U.S.C. § 78t-1. This provision was added to the Exchange Act as an amendment in 1988. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub.L. No. 100-704, § 5 (1988).

[69] 15 U.S.C. § 78t-1(b)(1).

[70] *Id.* § 78r.

the company's filings with the SEC.[71] Damages are limited to the "damages caused by such reliance," an implicit recognition by the 1934 Congress of the connection between reliance and the social costs of fraud. Section 18 is best understood as a statutory expansion of the tort cause of action for deceit, premised on the assumption that SEC filings are in reality communications directed toward shareholders. Shareholders who rely on them have invested in information and should be compensated if the communications are false or misleading.

The basic principle that emerges from these explicit causes of action is that damages should be limited to some measure of the defendant's benefit (the disgorgement measure of unjust enrichment), unless the plaintiff can show actual reliance on the misstatement, in which case the out-of-pocket measure from the action for deceit is appropriate.[72] The choices made by Congress in these explicit causes of action are consistent with my argument in Part II that the damages measure currently used in FOTM actions is simply too large because the damages available do not track the social costs of secondary-market fraud. If we limit § 10(b) damages in the way the explicit securities causes of action do, only those plaintiffs who can show actual reliance would be entitled to recover the "out of pocket," compensatory measure of losses, assuming that they can show that the losses were proximately caused by the defendant's misstatement. This follows the pattern of § 18, but that does not render the Rule 10b-5 cause of action redundant. Rather than being limited to misstatements in SEC filings, plaintiffs could also recover if they relied on press releases or statements by company officers. Such plaintiffs are investing in information; if we believe that their investments are worthwhile, we need to compensate those plaintiffs when their reliance has been fraudulently manipulated.[73]

[71] *Id.* § 78r(a). Section 18 further stands out in allowing the court to assess reasonable attorneys' fees against the losing party, which no doubt goes a long way toward explaining the provision's disuse.

[72] The Court noted the actual reliance requirement of § 18 in *Basic*, 485 U.S. at 243, but essentially ignored it.

[73] Mahoney, *supra* note 18, at 632 (arguing that wealth transfer can serve as a proxy for investment in lying, precaution costs and allocative losses where fraud results in transfer from victim to fraudster).

For plaintiffs who cannot make a showing of actual reliance (the passive price takers), a disgorgement rule would bring about a substantial departure from current practice.[74] Under the current "out of pocket" rule, corporations are liable for all losses resulting from public misstatements by their agents. If we limited the remedy for Rule 10b-5 to a benefits rule when the plaintiffs could not demonstrate actual reliance, we would force defendants to disgorge their gains (or possibly expected gains, for those who fail in their scheme) from the fraud. So if a corporation were issuing securities while distorting the market price of its stock, it would be required to disgorge to investors the amount by which it inflated the price of the securities.

In most FOTM cases, however, the corporation has not benefited from the misrepresentation that is the basis of the class action. Indeed, the corporation is usually the victim of the fraud. The corporation is victimized when executives are awarded a bonus that is undeserved because they create the appearance of having met the target stock price. The corporation is also victimized when CEOs keep their job for a bit longer than they should because they create the appearance of adequate performance.[75] The proper remedy in such cases is for the executives to return the bonus or salary earned from the fraud. And if the executives benefit from the fraud by cashing out stock options at an inflated price, those profits also can be disgorged.

Reformulating damages under Rule 10b-5 to focus on disgorgement will sharpen the deterrent effect of securities class actions. The "out of pocket" measure of damages currently used encourages plaintiffs' lawyers to pursue the wrong party—the corporation. The current regime for secondary-market class actions largely produces an exercise in "pocket shifting."[76]

[74] I have previously proposed such a move in Should Congress Repeal Securities Class Action Reform? Cato Policy Analysis No. 471 (2003), reprinted in After Enron: Lessons for Public Policy (William A. Niskanen, ed., 2004).

[75] Jennifer H. Arlen & William J. Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. Ill. L. Rev. 691.

[76] Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 Stan. L. Rev. 1487, 1503 (1996) ("Payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up.").

Traditionally, class action settlements have not included a contribution from corporate officers individually. Plaintiffs' lawyers forgo that source of recovery because they can reach a settlement much more quickly if they do not insist on a contribution from the individual defendants. The only reason that officers and directors are named is to improve the plaintiffs' lawyers' bargaining position. The big money for plaintiffs' attorneys is in pursuing the corporation and its insurers, and the officers and directors are happy to buy peace for themselves with the corporation's money. The dirty secret of securities class actions is that companies and their insurers pay the costs of settlement, which effectively means that shareholders are paying the costs of settlements to shareholders.[77] Settlement payments and insurance premiums reduce the cash flow available for dividends and share repurchases.

A disgorgement measure of damages would take away the corporation's exposure when it did not benefit from the fraud, thereby increasing the attorneys' incentive to pursue the executives responsible for the fraud. Instead of relying on the corporation's coffers for their payday, plaintiffs' lawyers would have to extract settlements from executives' bonuses and stock options. Deterrence is maximized by sanctioning the person who is most at fault for the fraud, so turning the sights of the class action bar on the culpable individuals would give us substantially more deterrent bang for our class action buck. And reducing the potential dollar figures involved would eliminate the ability of plaintiffs' lawyers to extract nuisance settlements in weak cases. If defendants believe they can prevail at trial, a small probability of losing an enormous judgment will no longer tip the balance in favor of settlement. We can expect more cases would be tried to a jury, which would give us a much better picture of what Rule 10b-5 actually prohibits. As it stands now, we are mainly making informed guesses based on judicial resolution of motions to dismiss, which apply a standard much more generous to the plaintiffs.

[77] See Arlen & Carney, *supra* note 75, at 719 ("Although compensating victims may be a laudable goal, enterprise liability does not serve the goal of just compensation because it simply replaces one group of innocent victims with another: those who were shareholders when the fraud was revealed. Moreover, enterprise liability does not even effect a one-to-one transfer between innocent victims: a large percentage of the plaintiffs' recovery goes to their lawyers.").

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V. The Political Economy of Securities Class Action Reform

The answer to the problem created by *Basic* is straightforward—fix the damages measure. Getting to that answer in the real world, however, is considerably more complicated. How can we shift from deceit to unjust enrichment, thereby recalibrating the damages rule for § 10(b) suits to focus on deterrence? Which body—the Supreme Court, Congress, the SEC, or shareholders acting collectively—is most likely to bring about the needed reform?[78]

A. The Supreme Court?

The Court does not hear a lot of securities cases, averaging about one case per year. The Court's wariness here is not surprising, given the dearth of prior experience that the current justices have in the field. The members of the Court are all former government officials, academics, appellate advocates, etc. Simply put, they are not equipped to confront the highly technical field of securities law. It has been more than 20 years since the last justice with substantial experience as a corporate lawyer—Lewis F. Powell, Jr.—retired from the Court.[79]

Unfortunately, Powell retired before *Basic* was decided (though one of his last votes to grant certiorari in a securities case was *Basic Inc.* v. *Levinson*). The Court's efforts since his departure do not instill confidence; its forays into this area have been occasionally impenetrable[80] and sometimes bizarre.[81] The Court is at its most coherent when it simply regurgitates the SEC's party line.[82] In sum, the Court

[78] I have previously made a similar proposal for reforming securities fraud enforcement, suggesting that it could be implemented through the exchanges. See A. C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 Va. L. Rev. 925 (1999). The exchanges have not taken me up on the suggestion.

[79] The full story of Powell's influence is detailed in my article, Justice Lewis F. Powell, Jr. and the Counter-Revolution in the Federal Securities Laws, 52 DUKE L.J. 841 (2003).

[80] See Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1109 (1991) (Scalia, J., concurring) (describing the Court's opinion as a "psychic thicket").

[81] See, e.g., Gustafson v. Alloyd Co., 513 U.S. 561 (1995); see also Hillary A. Sale, Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act, 75 Wash. L. Rev. 429, 456 (2000) (criticizing *Gustafson*).

[82] See, e.g., Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005).

is essentially rudderless when it ventures into the deep waters of securities regulation.[83]

Looking at the question of reliance, it is difficult to extract any consistent guiding principle from *Affiliated Ute, Basic, Central Bank,* and *Stoneridge.* Justice Stevens, dissenting in *Stoneridge* (as he had in *Central Bank*), hammered on this point:

> *Basic* is surely a sufficient response to the argument that a complaint alleging that deceptive acts which had a material effect on the price of a listed stock should be dismissed because the plaintiffs were not subjectively aware of the deception at the time of the securities' purchase or sale. This Court has not held that investors must be aware of the specific deceptive act which violates § 10(b) to demonstrate reliance. . . .
>
> The fraud-on-the-market presumption helps investors who cannot demonstrate that they, themselves, relied on fraud that reached the market. But that presumption says nothing about causation from the other side: what an individual or corporation must do in order to have "caused" the misleading information that reached the market. The Court thus has it backwards when it first addresses the fraud-on-the-market presumption, rather than the causation required.[84]

It is fair to say that Justice Blackmun, who wrote *Affiliated Ute* and *Basic,* would have reached a different outcome in *Stoneridge.* As Blackmun noted in his memo to the file after reviewing the *Affiliated Ute* briefs, "I feel we should plump for a high standard in this area, and that this is in line with the intent of Congress in enacting the legislation."[85] Blackmun set a "high standard" in *Affiliated Ute* and *Basic;* Kennedy ratcheted it down in *Central Bank* and *Stoneridge.*

The point is not that one side or the other is correct in their divining of congressional intent. That quest seems futile. Rule 10b-5's reliance element is nowhere to be found in the language of § 10(b)

[83] See Donald C. Langevoort, Words from on High About Rule 10b-5: *Chiarella's* History, *Central Bank's* Future, 20 Del. J. Corp. L. 865, 868 (1995) ("[S]cholars and learned practitioners are giving the Court's securities law opinions low grades for logic, clarity, and usefulness in future cases.").

[84] Stoneridge, 128 S.Ct. at 776 (Stevens, J., dissenting).

[85] Harry A. Blackmun, Memo, No. 70-78—Affiliated Ute Citizens v. United States (10/18/71), Harry A. Blackmun Papers, Library of Congress.

or Rule 10b-5; the Court borrowed it from the common law of deceit. But the Court does not refer to the common law when it is interpreting the reliance requirement for the Rule 10b-5 private cause of action. In *Stoneridge*, Kennedy brusquely rejected the argument that the plaintiffs had adequately pled reliance under common law standards: "Even if the assumption is correct, it is not controlling. Section 10(b) does not incorporate common-law fraud into federal law."[86] It would seem more accurate to say that the incorporation is selective: The Court borrows the common law element of reliance, without really explaining why, but then disregards it when inconvenient, as it did in adopting the FOTM theory in *Basic* and Kennedy's rejection of common law standards in *Stoneridge*. The Court treats the reliance element as a do-it-all tool to implement its policy choices of the moment, without fully understanding the implications of those choices. It is charting its own common law course but its interventions are episodic; the Court takes an insufficient number of securities cases to develop this "common law" in any meaningful manner.

The interpretive approach of *Central Bank* purports to depart from the common law interpretation that typified Rule 10b-5 for many years. Cases like *Affiliated Ute* and *Basic* focused on assuring recovery for the plaintiffs, with little regard for the costs created by private litigation. Generally, the Court used a common law, policy-oriented approach when it was expanding Rule 10b-5, viewing the private cause of action as an "essential supplement" to the SEC's enforcement efforts.[87] *Central Bank* promised a textual, formalist approach when the Court turned to reining in the reach of the private cause of action. *Stoneridge*, with its return to a fuzzy "requisite causal connection" notion of reliance,[88] fails to deliver on that promise, instead returning to an essentially common law mode of decision-making. The opinion does little more than tell us that the defendants' conduct was "too remote" for plaintiffs to rely on.[89] The bottom line is that both factions of the Court manipulate the reliance element to achieve their preferred scope for the securities fraud cause of action.

[86] Stoneridge, 128 S.Ct. at 771.

[87] Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2504 (2007).

[88] Stoneridge, 128 S.Ct. at 769 (quoting Basic, 485 U.S. at 243).

[89] *Id.* at 770.

Moreover, the Court has offered scant guidance on Rule 10b-5 damages, addressing the issue only twice. The first time was in *Affiliated Ute*, which applied the out-of-pocket measure in the context of a face-to-face transaction involving fraudulent nondisclosure in breach of fiduciary duty. The Court said this about damages:

> In our view, the correct measure of damages under § 28 of the Act is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct, except for the situation where the defendant received more than the seller's actual loss. In the latter case, damages are the amount of the defendant's profit.[90]

In this face-to-face transaction, the Court invokes both the out-of-pocket measure and unjust enrichment. The Court's only opportunity to consider the appropriate measure of damages in a case in which the defendant did not benefit because it was not a party to the transaction (the standard scenario in FOTM class actions) was *Basic* itself, and there, as I have noted, the Court passed on the question.[91] And the Court is unlikely to ever have an opportunity to consider the damages question because companies almost invariably settle rather than risk bankruptcy.

In Part IV I argued that what was required was a fundamental rethinking of the relationship between reliance and damages. We do not know what the Court thinks about damages in FOTM cases, but it appears oblivious to the connection between precaution costs and reliance. The Court's other recent forays into securities fraud class actions have been reactions to Congress's activity in the area, generally involving interpretive questions arising under the PSLRA.[92] The Court has made it clear that it intends to defer to Congress in this area: "It is the federal lawmaker's prerogative . . . to allow, disallow, or shape the contours of—including the pleading and proof requirements for—§ 10(b) private actions."[93] Thus, we

[90] Affiliated Ute, 406 U.S. at 155.

[91] See *supra*, note 15 and accompanying text. The Court's other foray into Rule 10b-5 damages focuses on the need to deprive the defendant of his benefit from the fraud. Randall v. Loftsgaarden, 478 U.S. 647 (1986).

[92] See, e.g., Dura Pharmaceuticals, 544 U.S. 336; Tellabs, 127 S. Ct. 2499.

[93] Tellabs, 127 S. Ct. at 2512.

should not expect the Court to be anything more than a passive observer here, looking to Congress to take any bold step toward reform.

B. Congress?

Is it realistic to expect Congress to take such a step? Probably not. Congress had its opportunity to tackle the relation between reliance and damages at a moment in time when there was tremendous momentum for reform of securities class actions—and it ducked.

In 1995, Congress reacted to the flood of securities class actions that *Basic* spawned. Accountants and the high-tech sector clamored for relief from the "stock price drop" suits that were besetting them; money flowed into campaign coffers from these proponents, as well as from the opposition (plaintiffs' lawyers). High on the wish list of reforms was a reversal of *Basic.* The House of Representatives considered sweeping changes to securities class actions in the Common Sense Legal Reforms Act of 1995.[94] As originally introduced, that bill would have eliminated the FOTM presumption. The SEC opposed the provision,[95] however, and it was abandoned in favor of a codification of the doctrine that would have set forth more clearly when the presumption would apply.[96] By the time the bill came out of conference as the PSLRA, even this codification of the FOTM presumption had been abandoned.[97]

Instead of changing the FOTM presumption and out-of-pocket damages formula that create the economic incentive to bring strike suits, Congress chose to erect a series of procedural barriers to make them harder to pursue.[98] The effect of these restrictions has been to

[94] H.R. 10, 104th Cong., 1st Sess. (1995). A complete account of the legislative history of the PSLRA can be found in John W. Avery, Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995, 51 Bus. Law. 335 (1996).

[95] Testimony of Chairman Arthur Levitt Concerning Litigation Reform Proposals Before the House Subcommittee on Telecommunications and Finance, Committee on Commerce, February 10, 1995 (available at http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt).

[96] H.R. 10, 104th Cong., 1st Sess. (1995), reprinted in H.R. Rep. No. 104-50, 104th Cong., 1st Sess., pt. 1, at 2 (1995).

[97] H.R. Rep. No. 104-369, 104th Cong., 1st Sess. (1995).

[98] For a discussion of these provisions, see Marilyn F. Johnson, Karen K. Nelson, & A.C. Pritchard, Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act, 23 J. L. Econ. & Org. 627 (2007).

force plaintiffs to focus on objective evidence—such as restatements, insider trading, and SEC enforcement actions—as the basis for bringing suit.[99] This means that securities class actions are now brought when the evidence of fraud is relatively obvious. And not surprisingly, cases continue to be brought when the damages calculation is greatest, with large stock price drops and heavy trading.[100] This means that the companies punished hardest by the market are also the ones that are most likely to face a class action. If securities class actions are a "necessary supplement" to SEC enforcement,[101] Congress's reforms have ensured that the supplement is directed where it is least needed.

Why did Congress back away from undoing *Basic*'s FOTM presumption? One answer is that the original House bill offered nothing in its place. Requiring plaintiffs to plead actual reliance largely eliminates class actions, leaving fraud deterrence exclusively in the hands of the SEC and the Justice Department. Another reason may be that eliminating compensation is a political non-starter. The "pocket shifting" element of secondary-market class actions has been well known for a long time, but it does not seem to have influenced legislative thinking. Congress's latest contribution on the subject came in the Sarbanes-Oxley Act in 2002, which includes a provision requiring the SEC to use recoveries from its enforcement actions to compensate investors.[102] Providing compensation to widows and orphans sells well on the campaign trail, even if the widows and orphans can protect themselves against the risk of fraud through portfolio diversification. Compensating defrauded investors takes some of the sting out of putting all of their eggs in one basket, hardly the investment strategy that our public policy should promote. Never let it be said that Congress does not look out for the financially reckless!

[99] Stephen J. Choi, Karen K. Nelson, & A.C. Pritchard, The Screening Effect of the Private Securities Litigation Reform Act, 6 J. Empirical. Leg. Stud. ____________________ (forthcoming, 2009).

[100] Johnson et al., *supra* note 98.

[101] Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985).

[102] 15 U.S.C. § 7246(a). Under that provision, the SEC has collected at least $8 billion for distribution to harmed investors since 2002. See 2006 Performance and Accountability Report, U.S. Securities and Exchange Commission (available at http://www.sec.gov/about/secpar/secpar2006.pdf).

C. The SEC?

As noted above, the SEC opposed eliminating the FOTM presumption when Congress considered that move back in 1995. Is there any reason to think that the SEC's views have changed in the intervening years? Not really. The SEC consistently sides with the plaintiffs' bar in its amicus role,[103] and even minor deviations from that role bring a firestorm of criticism from the plaintiffs' bar and its allies.[104] The SEC's support for the plaintiffs' bar in part reflects its own institutional interests. The agency favors broad interpretations of its governing statutes; as we saw in *Stoneridge*, a narrow interpretation of § 10(b) could reduce the SEC's enforcement discretion. The SEC's commitment to the plaintiffs' bar goes beyond that interest, however, because it sides with the plaintiffs' bar even on issues that relate purely to the terms of the implied Rule 10b-5 cause of action, such as the reliance issue in *Basic*. This commitment can be ascribed only to ideology, as the agency staff views its investor protection role broadly and sees plaintiffs' lawyers as allies in that fight.

The staff's affinity for the plaintiffs' bar only rarely meets any resistance from the commissioners. The SEC has consistently supported the FOTM presumption, beginning in *Basic* and continuing to the present day.[105] The majority of the commissioners wanted to file a brief siding with the plaintiffs in *Stoneridge*,[106] but the agency

[103] And has for a long time. See Pritchard, *supra* note 78 at 923 (quoting Lewis Powell complaining that "SEC usually favors *all* π. I can't recall a case in which this was not so.")

[104] See, e.g., Stephen Labaton, S.E.C. Seeks to Curtail Investor Suits, N.Y. Times, Feb. 13, 2007, at C1; Stephen Labaton, Is the S.E.C. Changing Course? N.Y. Times, March 1, 2007, at C1. Labaton is the son of a prominent plaintiffs' lawyer, Ed Labaton.

[105] Brief of the Securities and Exchange Commission, Amicus Curiae, In re Worldcom Securities Litigation, 2nd Cir. 03-9350 (April 2004) (available at http://www.sec.gov/litigation/briefs/wchevesi_amicus.htm#summaflowry) (noting SEC's support for FOTM presumption in *Basic* and arguing for application of presumption to reports by securities analysts). See also Donald C. Langevoort, *Basic* at Twenty: Rethinking Fraud-on-the-Market, Working Paper, Georgetown University Law Center (2008) ("[T]he *Basic* opinion was for all practical purposes authored by the SEC and the Solicitor General's Office. The key arguments, analysis, quotes and citations that one finds in the Courts' holdings on both materiality and reliance come directly out of the *amicus curiae* brief filed on behalf of the SEC.").

[106] The vote was 3-2. See Paul Atkins, Just Say 'No" to the Trial Lawyers, Wall St. J., Oct. 9, 2007, at A17. Chairman Christopher Cox voted with the majority, despite having introduced the bill that in 1995 that would have reversed *Basic*. Joel Seligman, The Transformation of Wall Street 663–64 (3d Ed. 2003). The SEC had filed a brief

was overruled by the Solicitor General, who sided with the defendants.[107] The SEC has the authority to make the necessary changes to Rule 10b-5,[108] but it is unrealistic to expect reform to come from that quarter.

D. Shareholders?

That brings us to our last, best hope for reforming securities fraud class actions: shareholders. Shareholders have the right incentives for evaluating reforms because they are forced to internalize both the benefits and the costs of securities class actions. Shareholders benefit from securities class actions if those suits generate deterrence. Deterrence promotes accurate share prices and thereby reduces the cost of participation in the securities markets. These benefits flow to corporations as well because they translate into a lower cost of capital. Shareholders (at least some of them) are also the beneficiaries of the compensation paid out in securities class actions, modest though it may be. On the other side of the equation, all shareholders ultimately bear the costs of securities fraud class actions, which include the payment of attorneys' fees on both sides of the litigation, the cost of experts, and the distraction costs to executives arising from defending the lawsuit. Directors and officers (D&O) insurance will cover some of these costs, but the premiums to secure that insurance are ultimately paid by the shareholders. Less tangible, but perhaps more substantial, are costs firms incur to avoid being sued: more money spent on lawyers' fees for flyspecking disclosure documents, higher auditors' fees, new projects that are rejected because of the risk of suit, and less forthcoming disclosure. These costs are

in a Ninth Circuit case raising similar issues arguing that ""[t]he reliance requirement is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction." SEC Reply Br. at 12, Simpson v. AOL Time Warner, Inc., No. 04-55665 (Feb. 7, 2005) (available at http://www.sec.gov/litigation/briefs/homestore_020405.pdf).

[107] Brief for the United States as Amicus Curiae Supporting Affirmance, 2007 WL 2327639 (August 15, 2007). The government's argument was essentially adopted by the Court, as it frequently has been in securities cases since Powell retired.

[108] 15 U.S.C. § 78mm (granting the SEC broad exemptive authority); Joseph Grundfest, Disimplying Private Rights of Action under the Federal Securities Laws: The Commission's Authority, 107 Harv. L. Rev. 961 (1994); John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and its Implementation, 106 Columbia L. Rev. 1534, 1582–83 (2006).

not covered by insurance. How does the balance tip between these benefits and costs? Perhaps shareholders should be allowed to weigh for themselves.[109]

My suggestion is that shareholders change the damage measure in Rule 10b-5 securities fraud class actions involving the company, its officers, and directors, to focus on deterrence rather than compensation. Specifically, shareholders could adopt an unjust enrichment model by making a partial waiver of the FOTM presumption of reliance in the corporation's articles of incorporation.[110] The waiver would stipulate to a disgorgement measure of damages, requiring violators to give up the benefits of the fraud, if the FOTM presumption were invoked in a securities class action. This partial waiver would not limit shareholder-plaintiffs who could plead actual reliance on a misstatement; they could still seek the tort out-of-pocket measure of damages. Thus, in an FOTM suit, the company itself would be liable only when making an offering or repurchasing shares. It would be liable only for out-of-pocket compensation to plaintiffs who actually relied to their detriment.[111] Executives who violated Rule 10b-5 would be liable to repay their compensation tied to the stock price (bonuses, stock, and options) during the time that price was fraudulently manipulated; here the FOTM presumption could be invoked.[112]

[109] See Marilyn F. Johnson, Karen K. Nelson, & A.C. Pritchard, *In re Silicon Graphics Inc.*: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard, 73 S. Cal. L. Rev. 773 (2000) (arguing that shareholder wealth effects are relevant to design of securities class action regime).

[110] Cf. Myriam Gilles, Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action, 104 Mich. L. Rev. 373, 424 (2005) (suggesting that companies might opt out of securities class actions through their corporate charters).

[111] Cf. Donald C. Langevoort, On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Reemdies, and Debate Over Entity Versus Individual Liability, 42 Wake Forest L. Rev. 627, 656–657 (2007) (offering similar suggestion).

[112] Such cases would likely implicate the executives' duty of loyalty under state corporate law. Under state corporate law, the cause of action would be derivative, rather than direct, so the recovery would properly go to the corporation, rather than the shareholder members of the class. It is clear, however, that the federal cause of action would be direct under Rule 10b-5 because plaintiffs must have been a purchaser or seller to have standing per *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), so the disgorgement could be paid to the shareholders who purchased during the class period. For an argument that Rule 10b-5 actions should be treated as deriva-

Obviously, the damages paid under a disgorgement measure are unlikely to afford full compensation, but settlements currently compensate for only a small percentage of investor losses. More fundamentally, compensation is not the cure for securities fraud in the secondary market; diversification is. The goal of securities fraud class actions should be that of unjust enrichment: deterrence. The purpose of the FOTM version of the Rule 10b-5 cause of action should be to deprive wrongdoers of the benefits they obtained by violating Rule 10b-5.

This goal is well served by my proposal, which focuses sanctions on actual wrongdoers, unlike the current regime. In addition, the requirements for invoking the FOTM presumption could be relaxed. If we are focused on defendants' gains from the fraud, rather than shareholders' losses, the informational efficiency of the market for the security is unimportant. Under the current regime, smaller companies largely get a free pass from securities class actions because the market for their shares is not efficient enough to invoke the FOTM presumption. Relaxing the FOTM standards would widen the range of companies that could be sued in a Rule 10b-5 action—a clear gain for deterrence.

The main objection to this proposal is that it reduces the incentive to bring suit. The argument would be that if plaintiffs' lawyers cannot expect a payday in the hundreds of millions of dollars, they cannot be expected to sue. Deterrence would suffer as a result. One answer to this objection is that the average settlement is not the billion dollar payday that attracts big publicity, but much smaller, and suits nonetheless get filed. According to a leading economic consulting firm, the average settlement was $13.5 million from 1996 to 2001 and $23.6 million from 2002 to 2007.[113] More modest still are median settlements; the median settlement was $4.7 million from 1996 to 2001 and $6.4 million from 2002 to 2007.[114] These figures suggest that the lure of relatively modest settlements is sufficient incentive to bring suit in a substantial number of cases. Moreover,

tive suits, see Richard A. Booth, The End of the Securities Fraud Class Action as We Know It, 4 Berkeley Bus. L.J. 1 (2007).

[113] NERA Economic Consulting, "Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But Are These Trends Reversing?" (September 2007).

[114] *Id.*

they are not grossly out of line with typical compensation packages for CEOs these days.[115] And litigation would be less expensive if the remedy sought were disgorgement because some very expert-intensive issues, such as loss causation, would drop out, and others, such as damages, would become much simpler to calculate.

Remember, too, that out-of-pocket damages would be available to plaintiffs who could show actual reliance. Those plaintiffs are likely to be institutional investors, who may have substantial losses in a given security that is affected by fraud. Those individual actions could be consolidated with the main proceeding for disgorgement, thus economizing on discovery costs and streamlining adjudication.

The incentive to bring suit can be bolstered, however, if shareholders deem it necessary. Rather than simply having the court award attorneys' fees based on a percentage of recovery (the "common fund" doctrine currently employed), the corporation could commit to paying an hourly fee to attorneys who succeed in bringing securities claims against the corporation, its officers, or directors. The fee could be subject to a review for reasonableness by a judge or arbitrator, and perhaps include a multiplier to reflect the risk of suit. This one-way fee shifting would effectively allow the corporation to pay the plaintiffs' bar to monitor for fraud. It is surely within the corporation's power to pay for that valuable service, and those attorneys' fees could be covered by the company's D&O insurance.

Any judgments obtained by the plaintiffs' lawyers, however, are unlikely to be covered by the company's D&O policy because such policies typically exclude coverage when there has been a finding of fraud or self-dealing. A Rule 10b-5 suit seeking disgorgement involves both. Indemnification by the corporation would also be barred in the event of a judgment because indemnification requires a finding of "good faith,"[116] which is hard to square with the finding of fraudulent intent needed to establish liability under § 10(b).[117]

[115] This relatively low median has two obvious implications for the current regime: First, most suits are settling for a small percentage of investor losses; and second, half of the suits are settling for essentially nuisance value. If a suit has gotten past a motion to dismiss, it is unlikely that it could be defended for less than $6.4 million dollars.

[116] Del. Gen. Corp. L. § 145(a).

[117] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). See also Coffee, *supra* note 108, at 1567–68 (collecting cases holding that securities law liabilities cannot be indemnified).

A settlement avoids an adjudication that the officer or director acted with fraudulent intent, but it would not entitle the officer or director to automatic indemnification; the board of the company would still need to make a finding of good faith.[118] If the settlement were not covered by D&O insurance, a requirement of a finding of good faith would require a close look from the company's board of directors if it chose to indemnify an officer. Under the current regime, the corporation is typically a party to the lawsuit, so it is easy to justify a settlement as avoiding the risk of catastrophic liability to the corporation. Under a disgorgement regime, plaintiffs' lawyers will be less likely to sue the corporation because of the difficulty of showing the requisite benefit to the corporation from the fraud.

Can shareholders do this? Do legal barriers prevent shareholder-led reform of securities fraud class actions? We can test this.[119] Under Exchange Act Rule 14a-8, shareholders can make proposals to be included in the company's proxy statement, including suggestions that the directors amend the articles of incorporation.[120] The rule allows companies to exclude shareholder proposals for a variety of reasons, but they must submit their rationale for exclusion to the SEC for review.[121] If the SEC agrees with the company, the agency issues a "no action" letter allowing the proposal to be excluded. A proposal recommending that the directors amend the articles would be excludable only if it "would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject."[122]

Does the proposal violate state law? Unlikely. Delaware affords corporations broad latitude to include provisions in their articles of

[118] See Waltuch v. Conticommodity Services, Inc., 88 F.3d 87 (2d Cir. 1995) (construing Del. Gen. Corp. L. § 145(c) to require automatic indemnification only when the officer or director has avoided making a settlement payment). Jack Coffee has proposed requiring the corporation to disclose how they arrived at the determination that an officer should be indemnified. See Coffee, *supra* note 108, at 1576.

[119] The suggestion here applies to companies that are already public. Companies that are not yet public could include such a provision in their charter before making their initial public offering.

[120] Exchange Act Rule 14a-8. Any amendment approved by the board would also have to be approved by the shareholders. Del. G. Corp. L. § 241.

[121] Exchange Act Rule 14a-8(j).

[122] Exchange Act Rule 14a-8(i)(2). Rule 14a-8 provides other bases for exclusion, but none apply to the proposal here.

incorporation "creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State."[123] This language has been read to authorize provisions unless they can be said to "clash[] with fundamental policy priorities that clearly emerge from the Delaware General Corporation Law or our common law of corporations."[124] No such priorities are apparent in Delaware corporate law.[125] Delaware generally views anti-reliance clauses as enforceable as a matter of contract law.[126] Corporations adopting the proposal will need to highlight the provision in their periodic SEC filings to maximize the likelihood that a court will apply the reliance waiver. If they do so, state law is unlikely to block the adoption of the disgorgement proposal.

The more substantial argument would be that the proposal violates federal law because it runs foul of § 29 of the Exchange Act, which voids "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder." Read broadly, § 29 would bar any provision affecting a right created by the Exchange Act. And written broadly, an anti-reliance provision could arguably waive compliance with § 10(b) (although SEC and criminal enforcement would still be available).[127] The Supreme Court has not addressed

[123] Del. Gen. Corp. L. § 102(b)(1).

[124] Jones Apparel Group, Inc. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 843 (Del. Ch. 2004).

[125] Del. Gen. Corp. L. § 102(b)(7), which allows corporations to exempt their directors from paying money damages for breaches of the duty of care, would not apply to the disgorgement proposal because the provision is limited to breaches of fiduciary duty.

[126] See MBIA Insurance Corp. v. Royal Indemnity Co., 426 F.3d 204, 218 (3rd Cir. 2005) ("When sophisticated parties include a broad but unambiguous anti-reliance clause in their agreement, the Delaware Supreme Court will likely indulge the assumption that they said what they meant and meant what they said."). Cf. In re Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 974 (Del. Ch. 1997) (certificate can stipulate fair value of preferred stock for appraisal under § 262).

[127] Reliance waivers have received mixed treatment in the courts. Compare AES Corp. v. The Dow Chemical Co., 325 F.3d 174, 182 (2003) ("[T]o hold that a buyer is barred from relief under Rule 10b-5 solely by virtue of his contractual commitment not to rely would be fundamentally inconsistent with Section 29(a)."); Caiola v. Citibank, N.A., 295 F.3d 312, 330 (2d Cir. 2002) ("A disclaimer [of reliance] is generally enforceable only if it tracks the substance of the alleged misrepresentation.") (citations and internal quotations omitted); Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966) ("Were we to hold that the existence of this provision constituted the basis (or

waiver of reliance clauses; it has only interpreted § 29 in connection with mandatory arbitration clauses. After initially concluding that arbitration provisions conflicted with the anti-waiver provisions in the securities law,[128] the Court reversed course, concluding that forum selection clauses[129] and arbitration provisions[130] were enforceable.

In response to the claim that arbitration amounted to a waiver of the Exchange Act's conferral of "exclusive jurisdiction" to the federal courts in § 27, the Court declined to read § 29 so broadly:

> § 29(a) forbids . . . enforcement of agreements to waive "compliance" with the provision of the statute. But § 27 itself does not impose any duty with which persons trading in securities must "comply." By its terms, § 29(a) only prohibits waiver of the substantive obligations imposed by the Exchange Act. Because § 27 does not impose any statutory duties, its waiver does not constitute a waiver of "compliance with any provision" of the Exchange Act under § 29(a).[131]

The proposed amendment to the articles of incorporation does not excuse compliance with the anti-fraud provision—it simply alters the remedy available under certain circumstances. Indeed, by focusing on deterring the most culpable actors, the disgorgement proposal promises *greater* compliance with Rule 10b-5 without waiving claims based on actual reliance. Finally, it is difficult to see the FOTM presumption as a "substantive obligation[] imposed by the Exchange

a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating Section 29(a)."); with Rissman v. Rissman, 213 F.3d 381, 384 (7th Cir. 2000) ("[A] written anti-reliance clause precludes any claim of deceit by prior representations."); Harsco Corp. v. Segui, 91 F.3d 337, 343–344 (2nd Cir. 1996) (upholding no reliance clause in contract between sophisticated commercial parties); One-O-One Enterprises, Inc., v. Caruso, 848 F.2d 1283 (D.C. Cir. 1988) (same).

[128] Wilko v. Swan, 346 U.S. 427 (1953) (construing § 14 of the Securities Act to bar arbitration).

[129] Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974) (upholding arbitration clause in international contract between sophisticated parties).

[130] Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (Exchange Act claims arbitrable); Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (U.S. 1989) (overturning *Wilko* and holding arbitration clauses enforceable in Securities Act disputes).

[131] Shearson/American Express, 482 U.S. at 228.

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Act." It is a procedural device, created by the courts, not Congress, intended to facilitate class actions.

Will shareholders vote for such a proposal? Interests will vary. All investors have an interest in deterrence; the proposed regime compares favorably with the current system on that ground. Interests will diverge, however, in compensation, which would be reduced under the proposed regime. The relatively low rate of participation in securities class action settlements suggests that shareholders as a class do not value compensation all that highly. Shareholders who are holders, trading infrequently, are likely to favor the proposal because they are typically on the paying end of litigation and settlement. Investors who index, whether individual or institutional, are likely to see things the same way as holders. Indexers have protected themselves against the firm-specific risk of fraud; they are unlikely to favor paying large premiums to lawyers for additional insurance that they do not need. The votes of institutional investors who actively pick stocks are harder to handicap. On the one hand, they are more likely to have been trading during a fraud period, so they are more likely to be members of an FOTM class.[132] On the other, the proposed regime would still allow such investors to pursue an individual or joint action if they have relied on a misstatement.

We will get prompt feedback if investors make the wrong assessment with their vote. If waiving the FOTM presumption of reliance undermines deterrence (or signals a management likely to commit fraud), we would expect to see a stock price drop for the firm that has adopted the amendment. That will be powerful evidence for opponents who think that the proposal is misguided, which they will no doubt raise if another company proposes such an amendment. My instinct is that the market reaction will be positive for companies that opt out. My greater worry is that managers will be reluctant to opt into a disgorgement regime because it arguably increases their personal exposure. Optimistically, one could argue that refusing to adopt the disgorgement regime here would signal that a management team felt it had something to hide. Implementing the regime may require the efforts of institutional investors to press this case

[132] Of course, these investors are also more likely to have gotten a windfall gain from the fraud if they sold during the period that the stock price was inflated. This would be true regardless of the regime, however, so it is unlikely to influence their votes on the proposal raised here.

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and push outside directors to adopt the proposal over the managers' objections.

VI. Conclusion

The Supreme Court has now been struggling for 20 years with the wrong turn it took in *Basic. Stoneridge*, like the Court's earlier reliance decisions in *Affiliated Ute, Basic*, and *Central Bank*, uses the reliance element to expand or contract the private cause of action under Rule 10b-5 based on no discernible principle. The FOTM regime established in *Basic* shifts money from one shareholder pocket to another at enormous expense. *Stoneridge* limits the adverse consequences of that regime, which does provide some benefit to shareholders. The decision is a step in the right direction, but it fails to grapple with the fundamental problem: Out-of-pocket damages should be tied to actual reliance. The appropriate model for reform is found in the explicit causes of action provided by Congress, which limit plaintiffs to rescission or disgorgement if they cannot plead reliance.

The disgorgement amendment to the articles of incorporation proposed here promises greater deterrence at a lower cost. The Court, Congress, and the SEC have all had the opportunity to fix the problem created by *Basic*, but none of these institutions has risen to the occasion. Shareholders bear the costs of the FOTM regime, and shareholders fortunately have the power to fix it. Will shareholders clean up the mess that the Supreme Court has created with securities class actions? Stay tuned.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff,	:	09 Civ. 6829 (JSR)
- v -	:	MEMORANDUM ORDER
BANK OF AMERICA CORPORATION, Defendant.	:	

JED S. RAKOFF, U.S.D.J.

In the Complaint in this case, filed August 3, 2009, the Securities and Exchange Commission ("S.E.C.") alleges, in stark terms, that defendant Bank of America Corporation materially lied to its shareholders in the proxy statement of November 3, 2008 that solicited the shareholders' approval of the $50 billion acquisition of Merrill Lynch & Co. ("Merrill"). The essence of the lie, according to the Complaint, was that Bank of America "represented that Merrill had agreed not to pay year-end performance bonuses or other discretionary incentive compensation to its executives prior to the closing of the merger without Bank of America's consent [when] [i]n fact, contrary to the representation ..., Bank of America had agreed that Merrill could pay up to $5.8 billion -- nearly 12% of the total consideration to be exchanged in the merger -- in discretionary year-end and other bonuses to Merrill executives for 2008." Compl. ¶ 2. Along

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with the filing of these very serious allegations, however, the parties, on the very same day, jointly sought this Court's approval of a proposed final Consent Judgment by which Bank of America, without admitting or denying the accusations, would be enjoined from making future false statements in proxy solicitations and would pay to the S.E.C. a fine of $33 million.

In other words, the parties were proposing that the management of Bank of America - having allegedly hidden from the Bank's shareholders that as much as $5.8 billion of their money would be given as bonuses to the executives of Merrill who had run that company nearly into bankruptcy - would now settle the legal consequences of their lying by paying the S.E.C. $33 million more of their shareholders' money.

This proposal to have the victims of the violation pay an additional penalty for their own victimization was enough to give the Court pause. The Court therefore heard oral argument on August 10, 2009 and received extensive written submissions on August 24, 2009 and September 9, 2009. Having now carefully reviewed all these materials, the Court concludes that the proposed Consent Judgment must be denied.

In reaching this conclusion, the Court is very mindful of the considerable deference it must accord the parties' proposal, since it would seemingly result in the consensual resolution of

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the case. Society greatly benefits when lawsuits are amicably resolved, and, for that reason, an ordinary civil settlement that includes dismissal of the underlying action is close to unreviewable. See Hester Industries, Inc. v. Tyson Foods, Inc., 160 F.3d 911, 916 (2d Cir. 1998)(citing cases). When, however, as in the case of a typical consent judgment, a federal agency such as the S.E.C. seeks to prospectively invoke the Court's own contempt power by having the Court impose injunctive prohibitions against the defendant, the resolution has aspects of a judicial decree and the Court is therefore obliged to review the proposal a little more closely, to ascertain whether it is within the bounds of fairness, reasonableness, and adequacy - and, in certain circumstances, whether it serves the public interest. See S.E.C. v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984); see also S.E.C. v. Wang, 944 F.2d 80, 85 (2d Cir. 1991). See generally, United States v. ITT Continental Baking Co., 420 U.S. 223 (1975); United States v. North Carolina, 180 F.3d 574 (4th Cir. 1999). But even then, the review is highly deferential. S.E.C. v. Worldcom, Inc., 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003).

Here, however, the Court, even upon applying the most deferential standard of review for which the parties argue, is forced to conclude that the proposed Consent Judgment is neither fair, nor reasonable, nor adequate.

It is not fair, first and foremost, because it does not comport with the most elementary notions of justice and morality, in that it proposes that the shareholders who were the victims of the Bank's alleged misconduct now pay the penalty for that misconduct. The S.E.C. admits that the corporate penalties it here proposes will be "indirectly borne by [the] shareholders." Reply Memorandum of Plaintiff Securities and Exchange Commission in Support of Entry of the Proposed Consent Judgment ("S.E.C. Reply Mem.") at 13. But the S.E.C. argues that this is justified because "[a] corporate penalty ... sends a strong signal to shareholders that unsatisfactory corporate conduct has occurred and allows shareholders to better assess the quality and performance of management." Id. This hypothesis, however, makes no sense when applied to the facts here: for the notion that Bank of America shareholders, having been lied to blatantly in connection with the multi-billion-dollar purchase of a huge, nearly-bankrupt company, need to lose another $33 million of their money in order to "better assess the quality and performance of management" is absurd.

The S.E.C., while also conceding that its normal policy in such situations is to go after the company executives who were responsible for the lie, rather than innocent shareholders, says it cannot do so here because "[t]he uncontroverted evidence in

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the investigative record is that lawyers for Bank of America and Merrill drafted the documents at issue and made the relevant decisions concerning disclosure of the bonuses." Id. But if that is the case, why are the penalties not then sought from the lawyers? And why, in any event, does that justify imposing penalties on the victims of the lie, the shareholders?

Bank of America, for its part, having originally agreed to remain silent in the face of these charges, now, at the Court's request that it provide the Court with the underlying facts, vigorously asserts that the proxy statement, when read carefully, is neither false nor misleading, see Reply Memorandum of Law on Behalf of Bank of America Corporation ("BoA Reply Mem.")at 5, or that, even if it is false or misleading, the misstatements were immaterial because "[it] was widely acknowledged in the period leading up to the shareholder vote that Merrill Lynch intended to pay year-end incentive compensation," id. at 19. The S.E.C. responds, however, that these arguments are hollow. The Bank's argument that the proxy statement was not misleading rests in material part on reference to a schedule that was not even attached to the proxy statement, and "[s]hareholders are entitled to rely on the representations in the proxy itself, and are not required to puzzle out material information from a variety of external sources." S.E.C. Reply Mem. at 2. As for the Bank's

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argument that the investors were not materially misled because the press was already reporting the imminent payment of Merrill bonuses, "investors were not required to ignore Bank of America's express statements in the proxy materials and rely instead on media speculation that may have suggested that these statements were misleading." Id. at 9.

Moreover, it is noteworthy that, in all its voluminous papers protesting its innocence, Bank of America never actually provides the Court with the particularized facts that the Court requested, such as precisely how the proxy statement came to be prepared, exactly who made the relevant decisions as to what to include and not include so far as the Merrill bonuses were concerned, etc.

But all of this is beside the point because, if the Bank is innocent of lying to its shareholders, why is it prepared to pay $33 million of its shareholders' money as a penalty for lying to them? All the Bank offers in response to this obvious question is the statement in the last footnote of its Reply Memorandum that "Because of the SEC's decision to bring charges, Bank of America would have to spend corporate funds whether or not it settled," BofA Reply Mem. at 28, n. 20 - the implication being that the payment was simply an exercise of business judgment as to which alternative would cost more: litigating or settling.

But, quite aside from the fact that it is difficult to believe that litigating this simple case would cost anything like $33 million, it does not appear, so far as one can tell from this single sentence in a footnote, that this decision was made by disinterested parties. It is one thing for management to exercise its business judgment to determine how much of its shareholders money should be used to settle a case brought by former shareholders or third parties. It is quite something else for the very management that is accused of having lied to its shareholders to determine how much of those victims' money should be used to make the case against the management go away.[1] And even if this decision is arguably within their purview, it calls for greater scrutiny by the Court than would otherwise be the case.

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[1] Undoubtedly, the decision to spend this money was made even easier by the fact that the U.S. Government provided the Bank of America with a $40 billion or so "bail out," of which $20 billion came after the merger. Since $3.6 billion of that money had already been spent, indirectly, to compensate the Bank for the Merrill bonuses - not to mention the $20 billion in taxpayer funds that effectively compensated the Bank for the last-minute revelations that Merrill's loss for 2008 was $27 billion instead of $7 billion - what impediment could there be to paying a mere $33 million (- or more than most people will see in their lifetimes -) to get rid of a lawsuit saying that the bonuses had been concealed from the shareholders approving the merger? To say, as the Bank now does, that the $33 million does not come directly from U.S. funds is simply to ignore the overall economics of the Bank's situation.

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Overall, indeed, the parties' submissions, when carefully read, leave the distinct impression that the proposed Consent Judgment was a contrivance designed to provide the S.E.C. with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry - all at the expense of the sole alleged victims, the shareholders. Even under the most deferential review, this proposed Consent Judgment cannot remotely be called fair.

Nor is the proposed Consent Judgment reasonable. Obviously, a proposal that asks the victims to pay a fine for their having been victimized is, for all the reasons already given, as unreasonable as it is unfair. But the proposed Consent Judgment is unreasonable in numerous other respects as well.

For example, the Consent Judgment would effectively close the case without the S.E.C. adequately accounting for why, in contravention of its own policy, see Order, 8/25/08 (quoting the policy), it did not pursue charges against either Bank management or the lawyers who allegedly were responsible for the false and misleading proxy statements. The S.E.C. says this is because charges against individuals for making false proxy statements require, at a minimum, proof that they participated in the making of the false statements knowing the statements were false or recklessly disregarding the high probability the statements were false. But how can such knowledge be lacking when, as the Complaint in effect alleges, executives at the Bank expressly approved Merrill's making year-end bonuses before they issued the proxy statement denying such approval?[2] The S.E.C. states, as noted, that culpable intent was nonetheless lacking because the lawyers made all the relevant decisions. But, if so, then how can the lawyers be said to lack intent? Under these circumstances, how can a Court find reasonable a proposed Consent Judgment that otherwise violates S.E.C. policy?[3]

[2] Lurking in the background is the suggestion, affirmed by the Bank's counsel at the August 10 hearing, that the highest executives of Bank of America, upon learning that Merrill's loss was $20 billion more than had been represented at the time the merger was negotiated, were prepared to walk away from the merger until "coerced" by the Government into going through with it, following which the Government provided the Bank with an additional $20 billion in bail-out funds. But, quite aside from the fact that none of this appears to have been revealed to the shareholders prior to the merger, neither party suggests that any such coercion played any role in the alleged decision not to reveal the Merrill bonuses. The huge increase in Merrill's losses, however, did arguably render the providing of the bonuses more material, as well as more inexplicable.

[3] The S.E.C. also claims it was stymied in determining individual liability because the Bank's executives said the lawyers made all the decisions but the Bank refused to waive attorney-client privilege. But it appears that the S.E.C. never seriously pursued whether the this constituted a waiver of the privilege, let alone whether it fit within the crime/fraud exception to the privilege. And even on its face, such testimony would seem to invite investigating the lawyers. The Bank, for its part, claims that it has not relied on a defense of advice of counsel and so no waiver has occurred. But, as noted earlier, the Bank has failed to provide its own particularized version of how the proxies came to be and how the key decisions as to what to

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To give a different example, the proposed Consent Judgment seeks injunctive relief forbidding the Bank, on pain of contempt of court, from issuing false or misleading statements in the future. On its face, the proposed injunction appears too nebulous to comply with Rule 65(d) of the Federal Rules of Civil Procedure, which requires, among other things, that an injunction "describe in reasonable detail ... the act or acts restrained ...." Moreover, since the Bank contends that it never made any false or misleading statements in the past, the Court at this point lacks a factual predicate for imposing such relief.

To be sure, the Bank's initial position was that it neither admitted nor denied the allegations, and such a position, when coupled with proof by the S.E.C. that the alleged violations have occurred, may often be sufficient to support certain forms of injunctive relief. But here the further submissions of the Bank make clear its position that the proxy statement in issue was totally in accordance with the law: meaning that, notwithstanding the injunctive relief here sought by the S.E.C., the Bank would feel free to issue exactly the same kind of proxy statement in the future. Under these circumstances, the broad but vague injunctive relief here sought would be a pointless exercise,

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include or exclude were made, so its claim of not relying on an advice of counsel is simply an evasion.

since the sanction of contempt may only be imposed for violation of a particularized provision known and reasonably understood by the contemnor, all of which would be lacking here. See, e.g., Int'l Longshoreman's Ass'n, Local 1291 v. Philadelphia Marine Trade Ass'n, 389 U.S. 64, 76 (1967); Powell v. Ward, 643 F.2d 924, 931 (2d Cir. 1981).

Without multiplying examples further, the point is that the Court finds the proposed Consent Judgment not only unfair but also unreasonable.

Finally, the proposed Consent Judgment is inadequate. The injunctive relief, as noted, is pointless. The fine, if looked at from the standpoint of the violation, is also inadequate, in that $33 million is a trivial penalty for a false statement that materially infected a multi-billion-dollar merger. But since the fine is imposed, not on the individuals putatively responsible, but on the shareholders, it is worse than pointless: it further victimizes the victims.

Oscar Wilde once famously said that a cynic is someone "who knows the price of everything and the value of nothing." Oscar Wilde, Lady Windermere's Fan (1892). The proposed Consent Judgment in this case suggests a rather cynical relationship between the parties: the S.E.C. gets to claim that it is exposing wrongdoing on the part of the Bank of America in a high-profile

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merger; the Bank's management gets to claim that they have been coerced into an onerous settlement by overzealous regulators. And all this is done at the expense, not only of the shareholders, but also of the truth.

Yet the truth may still emerge. The Bank of America states unequivocally that if the Court disapproves the Consent Judgment, it is prepared to litigate the charges. BofA Reply Mem. at 5. The S.E.C., having brought the charges, presumably is not about to drop them. Accordingly, the Court, having hereby disapproved the Consent Judgment, directs the parties to file with the Court, no later than one week from today, a jointly proposed Case Management Plan that will have this case ready to be tried on February 1, 2010.[4]

SO ORDERED

Dated: New York, N.Y. ______________________________

September 14, 2009 U.S.D.J.

[4] The trial would include both the application for permanent injunctive relief and the claim for monetary penalties. If the parties cannot jointly agree on a schedule, they should submit to the Court their competing proposals, and the Court will then resolve the differences.

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SIFMA
Securities Industry and Financial Markets Association

September 17, 2009

Chairman Arlen Specter
Subcommittee on Crime and Drugs
Senate Committee on the Judiciary
United States Senate
Washington, DC 20510

Ranking Member Lindsey Graham
Subcommittee on Crime and Drugs
Senate Committee on the Judiciary
United States Senate
Washington, DC 20510

Dear Chairman Specter and Ranking Member Graham,

In advance of the Crime and Drugs Subcommittee hearing, "Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009", we wanted to express our views on the legislation.

The Securities Industry and Financial Markets Association (SIFMA) believes the Supreme Court correctly ruled in the *Stoneridge* case that shareholders cannot sue investment banks, attorneys, accountants, or other third parties who did business with a company that engaged in fraud, where the investors did not rely upon any deceptive acts of the third parties. Had the Court ruled otherwise, innocent third-parties would be routinely joined as defendants in scores of frivolous lawsuits generating significant additional litigation, costing billions of dollars to American businesses, and putting U.S. companies at a competitive disadvantage to their foreign counterparts. S. 1551 seeks to overturn *Stoneridge*, undo decades of judicial effort to lend clarity and predictability to the law, and revert to an unworkable standard. SIFMA thus strongly opposes the bill.

Investors already receive substantial protections under the law. Federal and state prosecutors and securities regulators enforce existing laws against, and recoup lost monies from, aiders and abettors. If liability for third parties is unnecessarily and improperly expanded merely to target innocent third-party businesses as an additional source of recovery, then litigation, transaction, and compliance costs would soar – squeezing bottom lines for companies in the U.S. and deterring foreign investment – at the expense of the American economy, its workers and investors.

SIFMA's amicus brief in the *Stoneridge* case further outlines our objections to a change in the current liability standard, and it is attached. Thank you for considering our views.

Sincerely,

Scott DeFife
Senior Managing Director
Government Affairs

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No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND FUTURES INDUSTRY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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August 15, 2007

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INTERESTS OF *AMICI CURIAE*[1]

Amicus SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers that have a vital interest in the outcome of this appeal. These institutions are the gateway to the U.S. capital markets, linking thousands of companies to millions of investors. Among other things, they underwrite equity and debt offerings for domestic and foreign issuers, broker securities trades, provide financial advisory services, publish analysis, lend money to companies ranging from small start-ups to the Fortune 100, and make private-equity investments in large and small companies. In short, these financial institutions are essential to every aspect of the U.S. (and global) capital markets' function. SIFMA's mission is to promote policies and practices that expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally through offices in New York, Washington, D.C., and its associated firm, the Asia Securities Industry and Financial Markets Association, in Hong Kong.

Amicus FIA is a national trade association for the commodity futures and options industry. Its regular membership consists of 35 of the nation's largest futures brokerage firms, and its associate membership consists of approximately 150 firms involved in virtually all other segments of the industry. Many of FIA's members also are securities broker-dealers, investment banks, commercial-bank affiliates, or are otherwise extensively involved in capital market and business transactions.

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[1] Letters of consent from both parties have been filed with the clerk. The Securities Industry and Financial Markets Association ("SIFMA") and the Futures Industry Association ("FIA") state that under Rule 37.6, no counsel for a party authored this brief in whole or in part. No person or entity other than SIFMA, FIA, their members, or counsel made a monetary contribution to this brief's preparation or submission.

This case is enormously important to these financial institutions and the U.S. capital markets. Much like the vendors that petitioner Stoneridge Investment Partners ("Stoneridge") sued in this case, financial institutions routinely provide a broad range of services to and engage in counterparty transactions with public issuers. If Stoneridge's positions were accepted, these institutions would face unprecedented liability risk and litigation expense from private securities-fraud litigation brought by shareholders of issuers that later misreport those transactions in their financial statements. Nothing in the relevant statutory framework, caselaw, or public policy supports such a result.

SUMMARY OF ARGUMENT

The federal securities laws guard against fraud by imposing duties on certain parties in certain contexts to disclose material information. But those duties do not apply equally to all commercial actors. In *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*,[2] for example, the Court held that Section 10(b) does not give rise to "aiding-and-abetting" or conspiracy liability.[3] And since 1994, Congress has consistently reaffirmed *Central Bank*'s wisdom by amending the statute to empower only the SEC to sue securities-fraud aiders and abettors, while further restricting Section 10(b)'s implied private right of action.

Foreshadowing cases like this one, the *Central Bank* dissent correctly predicted that private plaintiffs would recast aiding-and-abetting allegations as primary violations:

> [M]any aiders and abettors will be subject to liability as primary violators. For example, an accountant, lawyer, or other person making oral or written misrepresentations (or omissions, *if the person owes a duty to the injured purchaser or seller*) in connection with the purchase or sale of securities

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[2] 511 U.S. 164 (1994).

[3] *See id.* at 177–78.

> may be liable for a primary violation of § 10(b) and Rule 10b-5.[4]

Thus, the dissent recognized the settled law that a silent secondary actor's failure to disclose could constitute a primary Section 10(b) violation only if the actor had a duty to disclose.

If Section 10(b) did not require that duty as a condition to liability in the nondisclosure context, every routine commercial or financial transaction with a public issuer would become a minefield of private securities-fraud liability exposure. Once an issuer misreports the transaction, shareholder-plaintiffs could sue every anonymous third party that played a role, even if that party never uttered a word publicly. The resulting specter of Rule 10b-5 liability would force every commercial actor to disclose all material information to every other counterparty and its shareholders or other constituents. In this case, the only way that Scientific-Atlanta and Motorola could have protected themselves from potential liability would have been to leapfrog Charter and make a specific disclosure (possibly violating a confidentiality agreement) to *Charter's* shareholders, complete strangers with whom Scientific-Atlanta and Motorola otherwise would never have interacted or communicated.

That is why Stoneridge's scheme-liability theory fails. The duty to make truthful disclosures to Charter's shareholders belonged exclusively to Charter, and thus only Charter could have breached that duty in violation of Section 10(b). At most, Scientific-Atlanta's and Motorola's alleged participation in sham transactions that Charter used to falsify its financials may constitute aiding and abetting securities fraud. But absent their own misstatements or a duty to speak, Scientific-Atlanta and Motorola cannot be found to have committed primary Section 10(b) violations.

Eliminating the duty requirement would especially prejudice financial institutions that routinely provide financial services to or engage in counterparty transactions with public

[4] *Id.* at 199 n.10 (citations omitted) (emphasis added).

issuers. These institutions would effectively be charged with ensuring the *issuers'* compliance with federal securities laws. Unless the financial institutions prepared their own disclosures (or closely supervised their clients' disclosures), they would regularly face exposure to classes of securities holders to whom they never made any statements or owed any duties, and with whom they never transacted business. The ripple effects of such a regime—which several lower courts adopted after *Central Bank*—are living proof of the harm to the very investor-base that Stoneridge and its *amici* claim to champion. Added transaction and compliance costs put the U.S. capital markets out of reach (or at least make them unattractive) for many issuers and increase the cost of capital prohibitively for many others, driving them to foreign markets and deterring foreign issuers from raising capital in the U.S. The result is fewer opportunities for American investors.

Contrary to Stoneridge's and its *amici*'s shrill cry, an affirmance here would not encourage financial institutions to participate in sham transactions that issuers might use to falsify their financial statements. Financial institutions already face serious consequences for aiding and abetting an issuer's securities-law violations. First and foremost, they can be put out of business as a practical consequence of criminal prosecution. They can also be sued by the SEC or self-regulatory organizations (SROs) (for aiding and abetting the issuer's fraud, or for violating other rules and regulations applicable to financial institutions), and by state regulators and attorneys general (under broad anti-fraud statutes like New York's Martin Act). There is thus no need to distort Section 10(b)'s longstanding duty requirement by recharacterizing classic aiding-and-abetting conduct as a "primary violation."

ARGUMENT

I. A NON-DUTY-BASED SCHEME-LIABILITY REGIME WOULD MULTIPLY LITIGATION EXPOSURE AND INCREASE THE COST OF CAPITAL IN U.S. MARKETS.

At bottom, Stoneridge's espoused theory of "scheme liability" is nothing more than an impermissible private right of action for aiding and abetting securities fraud. Indeed, the Tenth Circuit Court of Appeals in *Central Bank* found the bank's "affirmative" participation in the issuer's "fraudulent scheme" to constitute aiding and abetting (which the court erroneously concluded was actionable).[5] Nonetheless, Stoneridge argues that its allegations regarding Scientific-Atlanta's and Motorola's alleged affirmative participation in Charter's fraudulent scheme fit within *Central Bank*'s description of a "primary" violation. This argument fails because Stoneridge cannot allege against Scientific-Atlanta and Motorola Section 10(b)'s central requirement—a duty to disclose.

A. Section 10(b) and Rule 10b-5 address fraud by imposing disclosure duties on certain market participants.

The Court has repeatedly observed that the securities laws' "fundamental purpose" is to promote "full disclosure."[6] Section 10(b) furthers that purpose by prohibiting the use or employment of "any manipulative or deceptive device or contrivance in

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[5] *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 895, 902 (10th Cir. 1992) (sustaining aiding-and-abetting claim against Central Bank where plaintiffs had alleged that securities "were sold as part of a fraudulent scheme" that Central Bank assisted "by affirmative action, specifically by affirmatively agreeing to delay the independent review of the" property appraisal).

[6] *See, e.g.*, *Cent. Bank*, 511 U.S. at 171; *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8 (1985); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

contravention of such rules and regulations as the [SEC] may prescribe."[7]

SEC Rule 10b-5 and its three subsections effectuate this mandate. Specifically, Rule 10b-5(b) bars *incorrect* and *incomplete* disclosure by imposing a duty on speakers to be truthful and complete—it prohibits "any untrue statement of material fact" or omission "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."[8] Rules 10b-5(a) & (c), in contrast, address conduct that does not involve speaking, and thus apply even where there is *no* disclosure. They prohibit "any device, scheme, or artifice to defraud"[9] and "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[10]

The failure to disclose is essential to Rule 10b-5(a) & (c) liability because there can be no "fraud or deceit" where the nature of the "device, scheme, or artifice" is fully disclosed. In *Santa Fe Industries, Inc. v. Green*, for example, the plaintiff shareholders were "furnished with all relevant information on which to base their decision" either to approve a proposed short-form merger or reject it and exercise their share-appraisal rights.[11] Because "the complaint failed to allege a material misrepresentation or material failure to disclose," the transaction was "neither deceptive nor manipulative and therefore did not violate either § 10(b) of the Act or Rule 10b-5."[12] Just as full

[7] *See* 15 U.S.C. § 78j(b) (2007).

[8] 17 C.F.R. § 240.10b-5(b) (2007).

[9] *Id.* § 240.10b-5(a).

[10] *Id.* § 240.10b-5(c).

[11] 430 U.S. 462, 474 (1977).

[12] *Id.*; *see also United States v. O'Hagan*, 521 U.S. 642, 655 (1997) ("[F]ull disclosure forecloses liability under the misappropriation theory [of insider trading]: Because the deception essential to the (Cont'd)

disclosure precludes a fraud claim, the failure to disclose can create one. The Court first made this observation in *Affiliated Ute Citizens v. United States*, when it found that the acts of the defendants—bank employees who had contracted to facilitate Ute tribe members' stock sales to outsiders (including the defendants themselves)—"operated as a fraud . . . because the defendants devised a plan and induced the [plaintiffs] to dispose of their shares *without disclosing to them* material facts that reasonably could have been expected to influence their decisions to sell."[13] Regardless of the specific "act, practice, or course of business"[14] that brought the defendants within the rule, it was their failure to disclose that rendered their conduct fraudulent.

Nondisclosure also underlies the fraud alleged here. As Stoneridge's *amici* concede, "had the truth behind Charter's financial statements been disclosed, there would have been no injury."[15] That is, had Charter announced the terms of its transactions with Scientific-Atlanta and Motorola (rather than just Charter's revenue data), the market would have recognized the transactions for what they were.[16] Thus, the transactions

(Cont'd)

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 . . . .").

[13] 406 U.S. 128, 153 (1972) (emphasis added); *see also SEC v. Zandford*, 535 U.S. 813, 820–21 (2002) ("Taking the allegations in the complaint as true, each sale was made to further respondent's fraudulent scheme; each was *deceptive because* it was neither authorized by, *nor disclosed to*, the [client].") (emphasis added).

[14] 17 C.F.R. § 240.10b-5(c) (2007).

[15] Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 14 n.4.

[16] *See, e.g., Ganino v. Citizens Util. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) (explaining that under "truth on the market" corollary to "fraud on the market" doctrine, "a misrepresentation is immaterial (Cont'd)

themselves did not result in any fraud—rather, investors were allegedly defrauded by Charter's later misrepresentations *about* the transactions. In *amici*'s words, "the plaintiffs' injuries are ultimately traceable to the false statements that Charter issued."[17]

B. A disclosure triggers a duty to speak truthfully, but a failure to disclose gives rise to securities-fraud liability only when it breaches a duty.

Fraud thus boils down to either a knowingly false or misleading disclosure, or a failure to disclose. Charter's false statements were fraudulent because Rule 10b-5(b) imposes a duty on speakers to disclose accurately and completely.[18] In Rule 10b-5(a) and (c) cases involving conduct, not speech, fraud arises from the defendant's failure to disclose his actions.[19] But when a defendant has made no false or misleading statements to investors, silence can give rise to fraud liability only when the defendant breaches a duty to speak. Thus, in *Chiarella v. United States*, the Court found that Section 10(b) incorporated the

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if the information is already known to the market because the misrepresentation cannot then defraud the market"); *cf. Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988) (holding that presumption of reliance in a fraud-on-the-market case may be rebutted by proving that "the 'market makers' were privy to the truth"); *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1094 (N.D. Cal. 1994) (holding that defendant's truthful disclosure of its financial results relieved it of any duty to characterize those results).

[17] Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 17.

[18] *See, e.g., Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 268 (6th Cir. 1998) (holding that Rule 10b-5(b) imposes a duty "to provide complete and non-misleading information with respect to subjects on which [a speaker] undertakes to speak").

[19] *See* Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 14 n.4 ("Because the securities laws are fundamentally directed at disclosure, at bottom, every injury premised on affirmative conduct can be reduced to a failure to disclose.") (citations omitted).

common-law principle that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so."[20]

This duty is essential to any nondisclosure-based Section 10(b) claim. It renders the nondisclosure "deceptive" because the plaintiff is entitled to rely on the defendant for complete information.[21] In contrast, Stoneridge's "scheme" theory—also based on nondisclosure—would impose primary fraud liability on defendants that not only made no disclosures to shareholders, but also owed those shareholders no disclosure duty at all. As the Court has noted (and rejected), such duty-divorced liability would amount to "recognizing a general duty between all participants in market transactions" to disclose all material, nonpublic information or to forgo their transactions entirely.[22]

To say instead that the disclosure duty arises from "conduct"[23] likewise eradicates the duty requirement altogether, because an issuer's counterparties always engage in some "conduct"—whether they are buying goods, selling advertising, making loans, or structuring a transaction. By alleging undisclosed "conduct" as "primary" fraud—such as by artfully

[20] 445 U.S. 222, 228 (1980).

[21] *See id.* at 234–35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."); *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 385 (5th Cir. 2007). The court in *Regents* concluded:

> It is natural to expect a plaintiff to rely on the candor of one who owes him a duty of disclosure, and it is fair to force one who breached his duty to prove that the plaintiff did not so rely. Here, however, where the plaintiffs had no expectation that the banks would provide them with information, there is no reason to expect that the plaintiffs were relying on their candor.

Id.

[22] *Chiarella*, 445 U.S. at 233.

[23] *See* Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 19.

pleading a legitimate transaction as a pejorative "sham"—private plaintiffs simply end-run and effectively eliminate the requirement for a preexisting duty. The resulting dutiless securities-fraud regime, and the expansive liability that would follow, are precisely what the statute does not authorize and this Court has repeatedly rejected.[24]

Instead, the Court has sought only to prevent the "inherent unfairness"[25] of parties exploiting, while failing to disclose, information to which they were afforded special access. In *Chiarella*, the Court adopted the Restatement of Torts' common-law formulation that, absent any false statements, a duty to disclose exists only "when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' "[26] Thus, the duty to disclose "arises from a *specific* relationship between two parties."[27] That relationship may exist among corporate insiders and shareholders[28] or brokers and their clients,[29] but it does not exist between a corporation's shareholders and

[24] *See Dirks v. SEC*, 463 U.S. 646, 654–55 (1983) (observing that "[n]ot to require" a disclosure duty arising from a fiduciary relationship "would amount to 'recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information' ") (quoting *Chiarella*, 445 U.S. at 233); *id.* at 657 (rejecting "idea that the antifraud provisions require equal information"); *Chiarella*, 445 U.S. at 233 ("Formulation of such a broad duty . . . should not be undertaken absent some explicit evidence of congressional intent. As we have seen, no such evidence emerges from the language or legislative history of § 10(b).").

[25] *See In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968).

[26] *Chiarella*, 445 U.S. at 228 & n.9 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

[27] *Id.* at 233 (emphasis added).

[28] *See, e.g.*, *id.* at 228 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)).

[29] *See, e.g.*, *SEC v. Zandford*, 535 U.S. 813, 823 (2002).

commercial third parties, such as the corporation's financial-services providers or its third-party vendors. Like the financial-printer employee in *Chiarella*, Scientific-Atlanta and Motorola were "complete stranger[s]" who never interacted with Charter's shareholders.[30] Imposing a duty to disclose to such remote parties would "depart[] radically from the established doctrine" and "should not be undertaken absent some explicit evidence of congressional intent," which, as the Court noted in *Chiarella*, does not exist.[31]

Amici Change to Win and the CtW Investment Group incorrectly rely on the common-law general "duty not to deceive."[32] As both the Court and the Restatement have acknowledged, that duty runs at most only to counterparties in business transactions—not to unidentified third parties (like the counterparty's shareholders) with whom the defendant never interacted or communicated.[33] The Fourth Circuit in *United*

[30] *See Chiarella*, 445 U.S. at 232–33 ("[Chiarella] was not [the selling shareholders'] agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

[31] *Id.* at 233.

[32] *See* Br. for Change to Win & the CtW Inv. Group as *Amici Curiae* in Support of Petitioner at 16 ("Common law fraud also includes acts taken to conceal, create a false impression, mislead, or otherwise deceive in order to 'prevent[] the other [party] from acquiring material information,' even in the absence of a fiduciary, statutory, or other independent duty to disclose material information.") (citation omitted); Br. of the Am. Ass'n for Justice as *Amicus Curiae* in Support of Petitioner at 14.

[33] *See Stewart v. Wyo. Cattle Ranche Co., Ltd.*, 128 U.S. 383, 388 (1888) ("The gist of the action [for common-law fraud] is fraudulently producing a false impression *upon the mind of the other party* . . . .") (emphasis added); Restatement (Second) of Torts § 550 (1977) ("*One party to a transaction* who by concealment or other action intentionally prevents *the other* from acquiring material information is subject to the same liability . . . .") (emphasis added).

States v. Colton[34] reached the same result in construing the same words in the federal bank-fraud statute on which Stoneridge relies here—"scheme or artifice to defraud."[35] The court applied the common-law rule to conclude that the defendant had directly deceived his counterparty, the Resolution Trust Corporation, by failing to disclose material facts that allowed him to purchase a defaulted note at a discount.[36] Thus, contrary to *amici*'s urging,[37] *Colton*'s logic is no broader than the common law and, even if it applied to Rule 10b-5(a)'s similar language, would not reach defendants who never interacted or communicated with the complaining shareholders.

The common-law cases likewise consistently impose disclosure duties only on business adversaries.[38] Thus, under the common-law rule, Scientific-Atlanta's and Motorola's "duty not to deceive" would run to *Charter*—their business counterparty—not to anonymous Charter shareholders with whom they never interacted or communicated.[39] Even Change to Win's far-afield example of a car dealer resetting an odometer to deceive a buyer illustrates this limitation.[40] The dealer's

[34] 231 F.3d 890 (4th Cir. 2000).

[35] *See* 18 U.S.C. § 1344 (2007).

[36] *See Colton*, 231 F.3d at 896–99.

[37] *See* Br. for Change to Win & the CtW Inv. Group as *Amici Curiae* in Support of Petitioner at 5, 13, 16 & 22.

[38] *See, e.g., Salzman v. Maldaver*, 24 N.W.2d 161 (Mich. 1946) (aluminum seller concealed corroded sheets from buyer and interfered with buyer's ability to inspect); *Lindberg Cadillac Co. v. Aron*, 371 S.W.2d 651 (Mo. Ct. App. 1963) (seller painted over engine-block crack to conceal it from buyer); *Berkowitz v. Lyons*, 119 A. 20 (N.J. 1922) (seller sold buyer stolen automobile).

[39] *See, e.g., Sachs v. Blewett*, 185 N.E. 856, 858 (Ind. 1933) (dismissing fraud claim where complaint did not allege "any relationship of trust or confidence between the parties, nor are any circumstances shown which would entitle the [plaintiff] to place more than ordinary reliance in the promises of the [defendants]").

[40] *See Dist. Motor Co. v. Rodill*, 88 A.2d 489, 494 (D.C. Ct. App. 1952); Restatement (Second) of Torts § 525 cmt. b (1977).

duty—to disclose the reset odometer or abstain from selling the car—runs only to the buyer, not to the buyer's constituents or subsequent counterparties. This is similar to the duty to disclose or abstain that the Court has held must arise from a "specific relationship between two parties."[41] And of course, the odometer example is several steps removed from this case—unlike the car dealer whose conduct amounts to an affirmative representation about the car under his control, Charter's third-party vendors made no representations (through either words or conduct) to Charter's shareholders and did not control the contents of Charter's financial statements.

C. Stoneridge's non-duty-based Section 10(b) theory would create litigation exposure to anonymous third-parties, raising the cost of accessing the U.S. capital markets without benefiting investors.

Abandoning the duty to disclose as a prerequisite to Section 10(b) liability would expose literally all participants in commercial transactions with public issuers to private securities-fraud litigation—even if they never deceived anyone or uttered a word publicly. For financial institutions, which collectively do business with virtually every company seeking access to the U.S. capital markets, the consequences of Stoneridge's non-duty theory would be especially acute. It would force them to police issuers' disclosures for accuracy and completeness or, worse, implement their own disclosure regime for every transaction with a public company.[42] It would also place financial institutions in the impossible role of assessing a disclosure's materiality to their *counterparty's* shareholders while lacking

[41] *Chiarella*, 445 U.S. at 233.

[42] *See Dirks v. SEC*, 463 U.S. 646, 653 n.12 (1983) ("The SEC views the disclosure duty as requiring more than disclosure to purchasers or sellers: 'Proper and adequate disclosure . . . can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.' ") (quoting *In re Faberge, Inc.*, 45 S.E.C. 249, 256 (1973)).

complete and accurate information themselves. Setting aside the potential exposure to the counterparty that a misinformed disclosure could create, and the practical conflict if the counterparty were to insist on typical confidentiality protections, such a result would only harm investors by burying them in an avalanche of countless, potentially conflicting disclosures from an issuer's commercial counterparties. As the Court has observed, such information-overload is "hardly conducive to informed decision making."[43]

In other words, Stoneridge's non-duty-based private-right-of-action theory would lead to precisely the "ripple effects" that the Court in *Central Bank* aimed to avoid: "newer and smaller companies may find it difficult" to obtain securities and financial advice and to access the U.S. capital markets, and the financial institutions' "increased costs . . . may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute."[44] The additional compliance costs and litigation expense—not to mention liability risk—would be staggering. Every transaction for which an allegation could be constructed that passes Stoneridge's proposed "purpose and effect" test[45] could put financial institutions at risk for the entire amount of the *issuer's* fraud, as

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[43] *See Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (recognizing that the Court must be "careful not to set too low a standard of materiality" because "a minimal standard might bring an overabundance of information within its reach, and lead management simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making") (internal quotations omitted).

[44] *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994).

[45] Br. for Petitioner at 32 ("A person engages in a deceptive act as part of a scheme to defraud investors, and violates Section 10(b) and Rule 10b-5(a) and/or (c), if the purpose and effect of his conduct is to create a false appearance of material fact in furtherance of that scheme.").

the PSLRA's proportionate-liability protection does not apply to knowing violations.[46] Access to U.S. capital markets would become more expensive as investors and their companies bear the higher transaction costs to compensate financial institutions for soaring expenses. Foreign markets—which limit or prohibit private class actions—would become more attractive to both U.S. and foreign companies, depriving American investors of *bona fide* investment opportunities.[47] The end result: securities class-action litigation, which is already cited as a key deterrent to foreign issuers considering entry into U.S. markets,[48] would continue to sabotage the competitive footing of U.S. capital markets.

These consequences are not a matter of idle speculation. Securities-plaintiffs' lawyers have concocted numerous costly litigation theories post-*Central Bank*—including against SIFMA and FIA members—giving rise to the conflicting circuit rulings that precipitated this appeal.[49] And foreign commentators are

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[46] *See* 15 U.S.C. § 78u-4(f)(2)(A) (2007).

[47] *See* H.R. Rep. No. 104-50, at 20 (1995) ("Fear of [securities] litigation keeps companies out of the capital markets.").

[48] Interim Report of the Committee on Capital Markets Regulation at 11 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30 Committee_Interim_ReportREV2.pdf ("Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market.").

[49] *Compare, e.g., Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) (holding that primary liability arises from "conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme"); *and In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 504 (S.D.N.Y. 2005) (sustaining claims for primary Section 10(b) violations where complaint alleged that secondary actors had "used or employed a[] device or contrivance with the capacity or tendency to deceive"); *with Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 384 (5th Cir. 2007) (holding that " 'deception' within the meaning of § 10(b) requires that a defendant (Cont'd)

already watching this case closely for fear that Stoneridge's scheme-liability theory, if endorsed, would impose new barriers to foreign trade and investment, and damage transatlantic economic relations.[50]

These adverse consequences greatly outweigh any *de minimis* benefit that an expanded securities-fraud class-action regime might provide. While federal law authorizes appropriate securities-fraud actions, all securities class actions merely pit one group of shareholders against another—the innocent shareholders who happen to own the company when the suit is brought.[51] Indeed, many shareholders—particularly the institutional investors likely to serve as lead plaintiffs—are often on both sides and essentially end up paying themselves (minus substantial attorneys' fees).[52]

Expanding private class actions through Stoneridge's non-duty theory would only increase the likelihood of this circular wealth transfer because the issuer's and the secondary actors' respective shareholders often overlap. Common lead plaintiffs like pension funds and other diversified institutional investors typically own large stakes in the financial-services companies

(Cont'd)
fail to satisfy a duty to disclose material information to a plaintiff" and rejecting plaintiffs' theory that "[m]erely pleading that defendants failed to fulfill that duty by means of a scheme or an act" constitutes § 10(b) deception); *and In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 916 (S.D. Tex. 2004) (dismissing claims against secondary actor for "structuring, funding, and executing" transactions that issuer falsely reported because "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").

[50] *See generally* Br. of Org. for Int'l Inv. *et al.* as *Amici Curiae* in Support of Respondents.

[51] *See* Interim Report of the Committee on Capital Markets Regulation, *supra* note 48, at 11.

[52] *See id.*

that the non-duty theory would most likely affect. For example, the New York State Common Retirement Fund owns more than $2.5 billion of stock in Bank of America, Citigroup, and JPMorgan Chase & Co.[53] Even individual investors with moderately diversified portfolios or mutual-fund ownership would be on both sides in a multi-defendant scheme-liability action. For this reason, a commentator on which the Stoneridge *amici* rely concludes that "[f]rom a compensatory perspective . . . the securities class action performs poorly."[54]

Treasury Secretary Paulson has crystallized the relevant policy concerns: "Our markets are, indeed, the best in the world. Yet we must be vigilant, and we must do everything we can to ensure they stay that way. . . . [T]he fundamental question we must ask is: Have we struck the right balance between investor protection and market competitiveness . . . ?"[55] A non-duty scheme-liability regime advances neither.

D. In contrast to the clear standard that the duty requirement provides, Stoneridge's proposed "purpose and effect" test would create uncertainty and roll back Congress's consistent post-*Central Bank* efforts to limit private securities class actions.

The Court in *Central Bank* emphasized the need for certainty and predictability in Section 10(b) litigation,[56] which,

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[53] *See* N.Y. State Common Ret. Fund Asset Listing as of March 31, 2006, at 8, 14 & 30, *available at* http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/asset_listings_06.pdf.

[54] John C. Coffee, Jr., *Reforming the Securities Class Action: an Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1545 (2006).

[55] Opening Remarks by Treasury Secretary Henry M. Paulson, Jr. at Treasury's Capital Markets Competitiveness Conference (Mar. 13, 2007), http://www.ustreas.gov/press/releases/hp306.htm.

[56] *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994) (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)).

as the Court has long recognized, "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[57] Without clear standards, decisions are " 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business."[58] This uncertainty only increases the *in terrorem* effect inherent in securities-fraud class actions that lends them "a settlement value to the plaintiff out of any proportion to its chance of success at trial."[59] By adhering to the duty to disclose as a prerequisite to Rule 10b-5(a) and (c) liability, this Court would maintain the clear standard that curtails such abuse.

A looser standard—such as Stoneridge's proposed "purpose and effect" test[60]—would ensnare legitimate business conduct in private securities-fraud class-action litigation. Financial institutions design structured-finance transactions, for example, to confer legitimate legal, tax, or accounting benefits, but the complex and dynamic governing rules make such transactions particularly susceptible to securities class-action abuse.[61] Indeed, such abusive litigation has already gained traction in lower courts

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[57] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975); *see also Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007) ("Private securities fraud actions, however, if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law.").

[58] *Cent. Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652); *see also Blue Chip Stamps*, 421 U.S. at 755 ("We do not believe that such a shifting and highly fact-oriented disposition of the issue of who may bring a damages claim for violation of Rule 10b-5 is a satisfactory basis for a rule of liability imposed on the conduct of business transactions.").

[59] *Blue Chip Stamps*, 421 U.S. at 740.

[60] Br. for Petitioner at 32.

[61] *See generally* Br. of the Am. Bankers Ass'n *et al.* as *Amici Curiae* in Support of Respondents at 17–20.

that have applied vague standards similar to what Stoneridge is proposing here.[62] As one district court explained, even though the transactions depicted in the complaint may well have been legitimate, the court was bound at the pleadings stage to sustain securities-fraud claims against the financial-institution defendant.[63]

Even under the newly strengthened *scienter* pleading standard that the Court announced in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[64] Stoneridge's nebulous "purpose and effect" test would nevertheless reward plaintiffs for cherry-picking disadvantageous facts—which cannot necessarily be countered on a motion to dismiss—and ignoring legitimate business justifications. The likely outcome would be to penalize legitimate capital-raising behavior by adding the unnecessary litigation costs and coercive settlement payments that the Court has condemned.[65]

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[62] *See supra* note 49 and accompanying text.

[63] *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 504 n.160 (S.D.N.Y. 2005). The court observed:

> [I]t is possible that Parmalat never sold bad invoices to Citigroup but simply misrepresented the effect of the securitization transactions on its financial health. On this view, the relevant allegations likely would fail to state a claim against Citigroup [because] Citibank would not have committed a deceptive act but rather merely facilitated Parmalat's misstatements. At this stage, however, the Court is obliged to draw from the complaint all reasonable inferences in the plaintiffs' favor and therefore assumes for present purposes that Citigroup securitized worthless invoices.

Id.

[64] 127 S. Ct. 2499, 2513 (2007) ("A plaintiff alleging fraud in a § 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference.").

[65] *See Cent. Bank*, 511 U.S. at 189 ("Because of the uncertainty of the governing rules, [defendants] may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial.").

Stoneridge's relaxed "purpose and effect" test would thus roll back Congress's efforts to contain frivolous private securities-fraud litigation at the pleadings stage. Congress has noted the importance of a rigorous standard to prevent strike-suit plaintiffs from leveraging the burden and expense of discovery into a nuisance-value settlement.[66] To that end, Congress has legislated repeatedly over the past twelve years to restrict private securities class-action litigation. In 1995—the year after *Central Bank*—Congress enacted the PSLRA to rein in the rampant securities class actions that were "being used to injure 'the entire U.S. economy.' "[67] Consistent with that approach, Congress chose *not* to expand Section 10(b)'s private right of action to include aiding-and-abetting or conspiracy liability, even though it extended the SEC's enforcement authority to exactly that conduct.[68] Similarly in 1998, Congress enacted SLUSA to stop private plaintiffs from circumventing the PSLRA by filing the same frivolous securities lawsuits in state court.[69] And even after the highly publicized corporate scandals of 2001 and 2002, Congress responded (in the Sarbanes-Oxley Act) by legislating more stringent corporate-governance requirements and greater SEC enforcement

[66] *See* S. Rep. No. 104-98, at 7 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 686 ("If a defendant cannot win an early dismissal of the case, 'the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.' ") (quoting then-SEC Chairman Arthur Levitt); *see also Cent. Bank*, 511 U.S. at 189 (noting Congress's concern over the excessive sums that secondary actors are forced to spend "even for pretrial defense and the negotiation of settlements") (citing 138 Cong. Rec. S12605 (Aug. 12, 1992) (remarks of Sen. Sanford)).

[67] *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (quoting H.R. Rep. No. 104-369, at 31 (1995)) (discussing PSLRA's legislative history and purpose).

[68] *See* 15 U.S.C. § 78t(e) (2007).

[69] *See* 15 U.S.C. § 77p(b) (2007) (preempting any "covered class action based upon the statutory or common law of any State" that alleges securities fraud).

authority[70]—and *rejected* the expansion of private securities-fraud liability that Stoneridge urges here.[71]

II. EXISTING FEDERAL AND STATE LAWS PROVIDE ADEQUATE DETERRENCE AGAINST POTENTIAL AIDERS AND ABETTORS AND AMPLE INVESTOR PROTECTION.

Stoneridge sounds a false alarm by declaring that the Court's unwillingness to expand "scheme liability" would "create a moral hazard encouraging fraud."[72] It depicts a doomsday scenario in which secondary actors would be emboldened to aid and abet others' fraud.[73] Stoneridge's hyperbole is flatly refuted by the ample deterrence of aiding and abetting, and means for restitution, that exist from (i) numerous federal criminal, regulatory, and civil penalties; and (ii) state-law regulatory consequences.

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[70] *See, e.g.*, 15 U.S.C. § 7241(a) (2007) (requiring issuer's "principal executive officer or officers and principal financial officer or officers" to certify the "effectiveness of the issuer's internal controls"); *id.* § 7262(a) (requiring issuers' annual reports to include an "internal control report" that states management's responsibility "for establishing and maintaining an adequate internal control structure and procedures for financial reporting"); *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 3 (2002) (conferring on the SEC the power to enforce all provisions of the Act).

[71] *See* 148 Cong. Rec. S6575-02, S6584 (daily ed. July 10, 2002) (describing Senator Shelby's proposed amendment to include a "private litigation" provision that "persons that aid or abet violations . . . shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided"); *see also* H.R. Rep. No. 107-414, at 54 (2002) (lamenting that Congress did not "heed these recommendations" to expand the private right of action).

[72] Br. for Petitioner at 35.

[73] *Id.* ("[C]ompanies will quickly learn that they can get away with fraud.").

A. Federal criminal penalties are a professional death sentence for most secondary actors, including financial institutions.

The Justice Department's vigorous prosecution of securities-law violations provides a potent deterrent to aiding and abetting fraud. Since its creation in 2002, the Corporate Fraud Task Force has charged more than 1,300 defendants and secured more than a thousand corporate fraud convictions, including the convictions of a hundred CEOs or corporate presidents.[74] The Department's success is partly attributable to its broad statutory powers to punish secondary actors who assist others in committing securities fraud—the same targets of Stoneridge's suit here. That is, the United States Code criminalizes aiding and abetting violations of the securities laws and mail and wire fraud,[75] as well as conspiracy to violate those laws.[76] Prosecutors are further able to return ill-gotten gains directly to injured shareholders through restitution and forfeiture[77]—without the hefty contingency-fee payout to plaintiffs' lawyers.

The threat of a criminal indictment is a serious deterrent—because even an indictment, and certainly a conviction, would amount to a professional death sentence.[78] One need look no

[74] *See* U.S. Dep't of Justice, Fact Sheet: Corporate Fraud Task Force (Aug. 9, 2006), *available at* http://www.usdoj.gov/opa/pr/2006/August /06_odag_521.html.

[75] *See* 18 U.S.C. § 2 (2007).

[76] *See id.* § 371.

[77] *See id.* § 3572 (restitution must be paid before fines and penalties); *id.* § 981(a)(1)(D) & (E) (forfeiture of proceeds from mail and wire fraud).

[78] *See, e.g.*, Kurt Eichenwald, *Brokerage Firm Admits Crimes in Energy Deals*, N.Y. TIMES, Oct. 28, 1994, at A1 (" '[C]riminal prosecution of these types of [securities] firms can be the equivalent of the corporate death penalty . . . .' ") (quoting former SEC Commissioner Joseph Grundfest).

further for evidence than Arthur Andersen LLP, which was forced to shut its doors and terminate most of its 28,000 U.S. (and 85,000 worldwide) employees[79] after a conviction on just one obstruction-of-justice count (that was ultimately reversed).[80] Before Arthur Andersen, Drexel Burnham Lambert—once the nation's fifth largest securities firm—collapsed and laid off 5,400 employees after pleading guilty to securities charges.[81] And these existence-threatening risks are not limited to Wall Street and corporate America; they affect any business that depends on its reputation and the public's trust. For example, two major plaintiffs' law firms have recently struggled to retain clients following a criminal investigation and indictment[82] because, as one lead plaintiff declared, the "indictment so taint[s the firm] that neither it nor its attorneys—even those not specifically targeted . . . should continue to serve as class counsel."[83]

[79] Jonathan D. Glater, *Last Task at Andersen: Turning Out the Lights*, N.Y. TIMES, Aug. 30, 2002, at C3.

[80] *See Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005) (reversing obstruction-of-justice conviction).

[81] *See Key Events in the Prosecution*, N.Y. TIMES, Apr. 21, 1990, at 1; Pat Widder, *Timing Helps Salomon Beat Drexel's Fate*, CHI. TRIB., May 24, 1992, at C1 ("Drexel paid $650 million, pleaded guilty to six felonies and floundered; the firm was driven into bankruptcy.").

[82] *See, e.g.*, Order, *In re New Motor Vehicles Can. Exp. Antitrust Litig.*, 03-MDL-01532-DBH (D. Me. Dec. 18, 2006) (granting motion to remove Milberg Weiss from leadership position in multi-district litigation because of criminal indictment's taint); Order, *In re Medtronic, Inc. Implantable Defibrillator Prod. Liab. Litig.*, 05-MDL-1726-JMB-AJB (D. Minn. June 5, 2006) (ordering *sua sponte* the removal of Milberg Weiss from the Plaintiffs' Steering Committee—even though there were no allegations that the attorney handling case had violated any laws—because of firm's criminal indictment); Order, *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 02-CV-1152-M (N.D. Tex. Feb. 28, 2007) (granting lead plaintiffs' motion to replace Lerach as lead counsel).

[83] Reply Br. of Lead Pl. in Support of Mot. for Substitution of Lead Counsel at 7, *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 02-CV-1152-M (N.D. Tex. Dec. 27, 2006).

Even when corporate defendants are able to avoid criminal prosecution by cooperating with the government, they still face stiff financial penalties and reputational damage. For example, CIBC was forced to exit *entirely* the U.S. structured-finance business—a legitimate and profitable field for financial institutions—as part of its deferred-prosecution agreement arising from Enron.[84] In a similar agreement relating to its tax-shelter practice, the accounting firm KPMG agreed to pay a *$456 million* penalty and abandon three of its businesses to avoid criminal charges that KPMG "knew . . . would probably kill it."[85]

And on facts similar to *Stoneridge*, AOL/Time Warner agreed to pay $210 million in investor restitution and penalties to resolve charges of aiding and abetting PurchasePro's revenue misstatements.[86] The criminal complaint had charged AOL with entering sham transactions (in which AOL received $70 million plus stock warrants) that its counterparty, PurchasePro, later used to report inflated revenue. Illustrating the pressure that prosecutors can exert, the $210 million that AOL paid to resolve the criminal charges was *greater* than the benefit it received from the challenged transaction.

This case itself illustrates that the government can and will punish vendor conduct that aids and abets an issuer's fraud on the market. As Stoneridge notes,[87] four Charter officers were

[84] Press Release, U.S. Dep't of Justice, Canadian Imperial Bank of Commerce Agrees to Cooperate with Enron Investigation (Dec. 22, 2003), *available at* http://www.usdoj.gov/opa/pr/2003/December/03_crm_718.htm.

[85] David Reilly, *Narrow Escape: How a Chastened KPMG Got by Tax-Shelter Crisis — Boss of Just Three Days Admitted Firm's Sins, Fought to Keep Clients*, WALL ST. J., Feb. 15, 2007, at A1.

[86] *See* Press Release, U.S. Dep't of Justice, America Online Charged with Aiding and Abetting Securities Fraud (Dec. 15, 2004), *available at* http://www.fbi.gov/dojpressrel/pressrel04/aolrelease121504.htm.

[87] Br. for Petitioner at 37.

indicted for their roles in the alleged transactions on 14 counts of mail fraud,[88] wire fraud,[89] conspiracy to commit mail and wire fraud,[90] and aiding and abetting mail and wire fraud.[91] The charges led to guilty pleas, a combined 26 months of prison time, and $775,000 in personal fines.[92]

B. The SEC has responded to Congress's decision to expand its—and not private plaintiffs'—enforcement and recovery powers.

The SEC's broad powers and lengthy record of pursuing wrongdoers and returning funds to investors further belie the Stoneridge *amici*'s argument that the government is "ill-equipped" to enforce the securities laws on a large scale.[93] Indeed, Congress thought just the opposite when it expanded the SEC's mandate in 1995 to include bringing suits against secondary actors for aiding and abetting securities violations.[94] And by passing the Sarbanes-Oxley Act's FAIR Funds provision, Congress once again rejected a proposal to overrule *Central Bank* by expanding private litigation to include aiding and abetting,[95] instead favoring greater SEC enforcement authority. It directed the SEC to create a fund to collect and return to injured investors monies that the SEC recovers through disgorgement and civil penalties.[96]

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[88] *See* 18 U.S.C. § 1341 (2007).

[89] *See id.* § 1343.

[90] *See id.* § 371.

[91] *See id.* § 2.

[92] Judgment, *United States v. Barford*, No. 4:03CR00434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. Kalkwarf*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. McCall*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. Smith*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005).

[93] *See* Br. of the N. Am. Sec. Adm'rs Ass'n, Inc. as *Amicus Curiae* in Support of Petitioner at 19.

[94] *See* 15 U.S.C. § 78t(e) (2007).

[95] *See supra* note 71 and accompanying text.

[96] *See* 15 U.S.C. § 7246 (2007).

The FAIR Funds provision's sponsors sought to compensate investors without incurring the high legal fees associated with private class-action litigation and to ensure that "[t]his money is [used] for investors' retirement accounts, not oceanfront estates for ambulance-chasing trial lawyers."[97] The statute is thus designed to recapture "[n]inety percent or more of forfeited ill-gotten gains . . . [for] injured investors"[98]—a huge benefit considering that legal fees can account for a substantial portion of any private recovery, even when institutional or state plaintiffs have the leverage to " 'drive a hard[] bargain' with law firms."[99] In Ohio's securities class-action settlement with AOL, for example, $31 million of the $175 million settlement went to pay the plaintiffs' lawyers' fees and expenses.[100]

The SEC has embraced its increased authority. From 2002 to 2006, it collected more than *$8 billion* for distribution to investors through the FAIR Funds program.[101] And just as the Justice Department has used its criminal powers against vendors who aid and abet an issuer's fraud on the market, the SEC has similarly used its enforcement authority. In fact, it has already obtained large recoveries from Scientific-Atlanta and Motorola for their alleged aiding and abetting.[102] The SEC has (i) sued

[97] *See* Press Release, Office of Rep. Richard H. Baker, U.S. House of Representatives, Returning Funds to Defrauded Investors (Jul. 17, 2002) (announcing proposed FAIR Funds provision to the Sarbanes-Oxley Act) (quoting Rep. Michael G. Oxley); *see also id.* ("Unless we act on behalf of investors, this money merely will be transferred from greedy corporate executives to greedy trial lawyers.") (quoting Rep. Michael G. Oxley).

[98] *See id.*

[99] Peter Krouse, *Ohio Gains $144 Million for Pensions in Settlement*, CLEVELAND PLAIN DEALER, Mar. 8, 2007, at A1.

[100] *See id.*

[101] *See* SEC, 2006 Performance and Accountability Report at 23 (2006), *available at* http://www.sec.gov/about/secpar2006.shtml.

[102] *See* Br. for Petitioner at 37.

Scientific-Atlanta for entering transactions with another cable company that were nearly identical to those it entered with Charter; (ii) recovered $20 million in disgorgement through a settlement with Scientific-Atlanta;[103] and (iii) recovered $25 million in civil penalties from Motorola for the same conduct.[104]

Not only can the SEC sue secondary actors as aiders and abettors under Section 20(e),[105] it can also sue them for violating Section 13 (as it did Scientific-Atlanta),[106] which addresses the accuracy of corporate books and records. Rule 13b2-2(b)(1),[107] which the SEC adopted to enforce Section 303(a) of the Sarbanes-Oxley Act,[108] applies *primary liability* to customers, vendors, creditors, accountants, attorneys, securities professionals, or other advisors who, under the direction or request of an issuer's officers or directors, (i) provide false or misleading information to auditors, (ii) enter into "side agreements" that enable issuers to mislead auditors, or (iii) place pressure on auditors that compromises the audit report's integrity.[109] Accordingly, if a secondary actor provides false

[103] *See SEC v. Scientific-Atlanta, Inc.*, SEC Litig. Release No. 19735 (Jun. 22, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19735.htm.

[104] *See In re Motorola, Inc.*, SEC Exchange Act Release No. 55,725 (May 8, 2007), *available at* http://www.sec.gov/litigation/admin /2007/34-55725.pdf.

[105] *See* 15 U.S.C. § 78t(e) (2007).

[106] *See id.* § 78m(b) (2007); *see also supra* note 103 and accompanying text.

[107] *See* 17 C.F.R. § 240.13b2-2(b)(1) (2007) ("No officer or director of an issuer, or *any other person acting under the direction thereof*, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements . . . .").

[108] 15 U.S.C. § 7242(a) & (b) (2007).

[109] Improper Influence on Conduct of Audits, Exchange Act Release No. 34–47890, Investment Company Act Release No. 26,050, 68 Fed. Reg. 31820, 31821–22 (2003).

documents to an issuer's auditor—even without uttering a word publicly—the SEC also could sue it as a primary Rule 13b2-2(b)(1) violator.

In addition to the SEC's enforcement power, it also oversees self-regulatory organizations, such as the Financial Industry Regulatory Authority,[110] which can bring disciplinary actions against securities firms and their employees who aid and abet another's Section 10(b) violation.[111]

C. State penalties and recovery methods broadly encompass aiding and abetting securities-law violations.

Besides the formidable deterrence the DOJ, SEC, and SROs provide, a broad array of state-law penalties also deters secondary actors from aiding securities violations. These include state "blue sky" laws that permit attorneys general and state regulators to seek fines and obtain restitution from,[112] and impose

[110] The Financial Industry Regulatory Authority ("FINRA") is the nongovernmental regulatory body created in 2007 by the consolidation of the National Association of Securities Dealers, Inc. and the New York Stock Exchange's regulation, enforcement, and arbitration functions. FINRA currently regulates all securities firms doing business in the United States.

[111] *See Dep't of Enforcement v. Perles*, CA F980005, 2000 NASD Discip. LEXIS 9, at *20–24 (Aug. 16, 2000) (holding that *Central Bank* does not apply to NASD's interpretation of its own Conduct Rules and that aiding and abetting another's securities fraud violates NASD Conduct Rule 2110), *aff'd in relevant part*, Exchange Act Release No. 45691, 2002 SEC LEXIS 847 (Apr. 4, 2002); *see also, e.g., Dep't of Enforcement v. J. Alexander Sec., Inc.*, CA F010021, 2004 NASD Discip. LEXIS 16, at *45–46, 65–69 (Aug. 16, 2004) (holding that aiding and abetting another's securities fraud violates NASD Conduct Rule 2110, and barring aider and abettor from associating with any NASD firm).

[112] *See, e.g.*, Del. Code Ann. tit. 6, § 7325 (2007) (permitting the commissioner to fine and order restitution form any person "who aids and abets any person who wilfully violates any provision of [the

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criminal sanctions against,[113] anyone who aids state securities-law violations. For example, in recent years, the New York attorney general has successfully used New York's Martin Act to recover more than $5 billion in securities-fraud settlements.[114] And state attorneys general have actively pursued aiders and abettors.[115]

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Delaware Securities Act]"); Cal. Corp. Code §§ 25403(b), 25530–25536 (2007) (permitting the commissioner to take action against any person who knowingly provides substantial assistance to another's violation of California's securities laws); *State v. McLeod*, 12 Misc. 3d 1157(A), 2006 WL 1374014, at *11 (N.Y. Sup. Ct. 2006) (holding that a defendant's mere participation in another's stock-spinning scheme "is sufficient to subject [that defendant] to the Martin Act's reach") (citing N.Y. Gen. Bus. Law, Art. 23-A §§ 352(1) & 352-c(2)).

[113] *See, e.g.*, N.Y. Gen. Bus. Law, Art. 23-A §§ 352-c(4)–(6), 352-d, 358 (authorizing criminal penalties and prosecution for violations of Martin Act's anti-fraud provisions); Del. Code Ann. tit. 6, § 7325 (2007) (authorizing criminal prosecution of any person who willfully aids and abets a violation of securities laws); Cal. Corp. Code §§ 25540–25542 (same); 815 Ill. Comp. Stat. § 5/14 (same).

[114] Paul Davies, *Spitzer's Successor May Not Follow in His Footsteps—Cuomo Targets Medicaid Fraud, Guns, Government Corruption; Grasso Case Will Be Early Test*, WALL ST. J., Nov. 11, 2006, at B1.

[115] *See, e.g.*, Press Release, N.Y. State Att'y Gen., Former Trust Company Officials Arrested in Late Trading Fraud (Nov. 25, 2003) (announcing that the combined efforts of the New York Attorney General, SEC, and Office of the Comptroller of Currency had resulted in felony charges against three of Security Trust Co.'s executives for assisting in mutual-fund late trading and had led to the firm's dissolution), *available at* http://www.oag.state.ny.us/ press/2003/nov/nov25a_03.html; *SEC v. J.P. Morgan Chase & Co.*, SEC Litig. Release No. 18252 (Jul. 28, 2003) (announcing civil complaint and $135 million settlement achieved "in coordination with the New York County District Attorney's Office" arising from bank's aiding and abetting accounting fraud), *available at* http://www.sec.gov/litigation/litreleases/lr18252.htm; *SEC v. Southmark*

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CONCLUSION

The essence of securities fraud is making material misstatements or failing to disclose despite a duty to do so. That is fair game for private securities-fraud liability. The securities laws do not, however, allow private plaintiffs to sue third parties that owed them no duties and indeed may never have deceived them at all. Yet that is precisely what Stoneridge's scheme-liability theory would accomplish. For financial institutions that collectively do business with virtually every company seeking to access the U.S. capital markets, the consequences of applying Stoneridge's radical liability theory would be especially costly. Added litigation and compliance costs would further weigh down the U.S. capital markets in the global race to lure companies and investors. And this handicap would yield no corresponding benefits, considering the litany of other fraud deterrents and investor remedies. In the end, the only clear winners would be plaintiffs' lawyers, who would have won the right to sue additional parties for the issuer's fraud, all in pursuit of deep pockets to pay higher fees. Congress has repeatedly refused to give the lawyers that windfall, and this Court should decline that same invitation. The Court of Appeals' judgment should be affirmed.

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Advisory, Inc., SEC Litig. Release No. 17818 (Oct. 30, 2002) (acknowledging Oklahoma Department of Securities' assistance in bringing civil aiding-and-abetting action), *available at* http://www.sec.gov/litigation/litreleases/lr17818.htm; *SEC v. Christian*, SEC Litig. Release No. 19294 (Jul. 7, 2005) (acknowledging New York Attorney General's assistance in bringing civil enforcement action relating to market timing of mutual-fund trades, including for aiding and abetting Section 10(b) violations), *available at* http://www.sec.gov/litigation/litreleases/lr19294.htm.

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August 15, 2007

Testimony of Tanya Solov

Director, Illinois Securities Department
Illinois Secretary of State
On behalf of the North American Securities Administrators Association

Before the
United States Senate Committee on the Judiciary
Crime and Drugs Subcommittee

"Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009"

September 17, 2009

Chairman Specter, Ranking Member Graham, members of the Subcommittee,

I am Tanya Solov, Director of the Illinois Securities Department, and I am honored to convey the North American Securities Administrators Association's (NASAA)[1] support for S. 1551, the " Liability for Aiding and Abetting Securities Violations Act of 2009."

Background

The U.S. members of NASAA are responsible for administering state securities laws and regulations. Their activities include licensing broker-dealers, registering local securities offerings, and conducting compliance examinations. Especially important is their enforcement role: protecting the nation's investors by bringing thousands of enforcement actions every year against the firms and individuals who have committed securities fraud. State securities regulators often seek restitution to help make injured investors whole. However, given the large number of investors in the market today, private civil actions are a necessary and important complement to state and federal actions. S. 1551, is a positive step in restoring the ability of defrauded investors to seek damages from all entities that knowingly and substantially participate in the fraud.

State securities regulators have witnessed first-hand the devastation of financial fraud on victims and their families. Shareholders in the U.S., both retail and institutional, invest in the market with the assumption that the financial information provided by public companies is accurate. Investor education materials teach investors to conduct research on companies prior to investing, but no amount of research will allow investors to make appropriate decisions if the financial and other public information provided by companies is false and misleading. The integrity of the U.S. markets depends on accurate information and our laws must send the message to corporate management, as well as their lawyers, accountants, investment bankers, and other so-called "secondary actors," that they will be held accountable for aiding and abetting in deception and fraud.

Aiding and Abetting

One of the purposes of the Securities Exchange Act of 1934 was to establish higher standards of conduct in the securities industry than already existed in common-law. In passing this law, Congress implicitly authorized a private right of action and for decades thereafter, courts allowed private suits. The right to bring a private suit for aiding and abetting was restricted by the Supreme Court in *Central Bank of Denver v. First*

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

Interstate Bank of Denver and basically eliminated in *Stoneridge Investment Partners, LLC v. Scientific –Atlanta, Inc.* The decisions in these cases interpret the securities laws in a way that protects big business, emboldens secondary actors to engage in manipulative practices, and sets an extremely high bar for defrauded shareholders to seek compensation from wrongdoers. Corporations and secondary actors often seek short-term profits, big bonuses, and large fees and, many times these goals can be achieved by cooking the books or engaging in sham transactions. Given the complexity of corporate activity, secondary actors such as accountants and lawyers now play a critical role in the preparation and dissemination of public information. If they are allowed to avoid liability for their actions, there will be no deterrent to prevent them from engaging in fraudulent schemes.

State regulators and the Securities and Exchange Commission ("SEC") filed numerous cases against corporations and secondary actors in the past decade. However, many more cases of fraud were not pursued by the regulators due to their limited resources. In denying investors the right to bring private aiding and abetting actions, the majority in *Stoneridge* contends that such actions can be brought by the SEC on behalf of shareholders. While it is true that the SEC can pursue such cases, in reality, the SEC is not in the position to take on this task. In an April 2009 speech[2], Chairman Mary Schapiro stated: "Quite frankly, our enforcement and examination resources have been seriously constrained in recent years." The SEC's immediate agenda includes proxy access, compensation disclosure, credit rating agencies, money market fund liquidity, hedge funds, credit default swaps, and other projects that need regulatory attention. These priorities play an important role in restoring market integrity, and significant SEC resources will be expended working on these priorities as well as large Ponzi scheme cases and fraudulent activity having national impact. Scarce resources will remain for cases involving a limited number of shareholders in a particular company.

Critics of private securities actions claim that such cases provide little benefit to victims, punish innocent shareholders, and unjustly reward plaintiffs' lawyers. These arguments are faulty. With regard to victim compensation, over the years, private actions resulted in greater recoveries for shareholders than the compensation from regulatory actions. The fact that victims were not able to recover full damages is the result of a number of factors including the corporation's inability to pay and shareholders' desire to settle for less rather than to spend more time in litigation. The contention that paying defrauded victims harms innocent, current, shareholders is not really applicable in cases involving secondary actors such as accountants. As evidenced by the amici briefs filed in the *Stoneridge* case, shareholders want accountability and the right to sue for wrongdoing; management and secondary actors are the ones invoking shareholder harm arguments in their attempt to avoid all accountability. If management is concerned about current shareholders, it might alleviate the cost to shareholders by stripping away the bonuses, high salaries, and stock options awarded to those who participated in the fraud and place those assets in the victim restitution fund. With regard to plaintiffs' lawyers' fees, it is

[2] Mary Schapiro, Chairman, Securities and Exchange Commission, Address to the Council of Institutional Investors, (April 6, 2009).

important to understand that class action settlements, including attorneys' fees, are reviewed by the courts. Judges decide whether plaintiffs' attorneys' fees are appropriate.

Allowing investors to file aiding and abetting cases will not open the floodgates of litigation and stifle business development. Private suits were allowed prior to the *Central Bank* and *Stoneridge* decisions and businesses grew and flourished during those years. Deceptive and manipulative transactions that are intended to defraud investors cannot be classified as ordinary business decisions and do not promote economic development.

The dissent in the *Stoneridge* case noted that Congress enacted Section 10(b) of the Securities Exchange Act with the understanding that federal courts respected the principle that every wrong would have a remedy. If aiding and abetting liability is not restored by Congress, innocent victims of investment fraud will be left without a remedy against the entities that assisted in perpetrating the fraud. S. 1551 restores the right of defrauded shareholders to bring private actions against aiders and abettors. Given the recent financial scandals and corporate fraud, this legislation is a positive step in restoring accountability and the integrity of the U.S. markets.

I thank the Chairman and each member of this Subcommittee for allowing me the opportunity to appear today. I look forward to answering any questions you have and providing additional assistance to you in the future.

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The Legislature of Rockland County

PHILIP SOSKIN
Legislator - District 7

Chair, Multi-Services Committee
Budget & Finance Committee
Government Operations Committee
Treasurer, Rockland County Solid Waste Management Authority

Senator Charles Schumer
United State Senate
Washington, DC 20510

Dear Senator Schumer:

As a public official, I want to thank you for your consistent presence in all areas of our state, particularly the often overlooked Hudson Valley. Your attentive does not go unnoticed.
I understand the Judiciary Committee will hold a hearing Thursday on S.1551. I respectfully request that this letter be entered into the record.
I'm concerned about this pending legislation offered by Senator Specter that I believe will be bad for our state and investors across the country. The legislation would expand what is commonly known as "scheme liability" and create a litigation dragnet that can ensnare small business and municipalities.
A bipartisan group of former officials and prominent academics—including 3 former SEC Chairmen and 11 former Commissioners, such as Commissioner Grundfest and Commissioner Hunt—filed an amicus brief opposing this expansion of liability.

These former officials and academics also rejected the mistaken belief that extending
the reach of private securities litigation would "promote the policy goal of investor compensation." They pointed to the "broad consensus" that the damages measures used in Rule 10b-5 class actions bear "little relation to the actual net harm suffered by
investors." Instead, settlements or judgments paid by companies only harm investors
because the costs ultimately fall on shareholders, as such payments come from the
shareholders' pockets and "insurers are funded by premiums paid by" shareholders.

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In addition to serving as a legislator, you know I am also a public accountant.

Settlements by accountants and banks also fall on shareholders' shoulders "through
increased fees due to litigation risk." They further explained that "[t]hose who aid and abet securities law violations face considerable deterrents under the existing regime"—especially the broad enforcement authority possessed by the SEC and DOJ. In fact, for individuals who actually might be involved in fraudulent activity, "[p]ublic enforcement serves as a stronger deterrent . . . than private enforcement, as individuals are rarely made to contribute to the settlement of Rule 10b-5 class actions."

I urge you to heed these voices and oppose this bill.

Sincerely yours,

PHILIP SOSKIN
Legislator – District 7

PS/cj

United States Senate

COMMITTEE ON THE JUDICIARY
WASHINGTON, DC 20510–6275

August 3, 2007

The President
1600 Pennsylvania Avenue, NW
Washington, DC 20500

Dear Mr. President:

I am writing to express my concern about the Solicitor General's failure to file a brief that was requested by the Securities and Exchange Commission in *Stoneridge Investment Partners v. Scientific Atlanta*. The outcome of *Stoneridge* will also determine whether tens of thousands of Enron investors will secure a day in court. Earlier this year, the SEC voted to file an amicus brief in *Stoneridge* in favor of scheme liability, which is the same position the Commission has previously taken in similar cases in lower courts, including the Enron case. It has been reported that the Solicitor General did not file the brief, based on your views, and that the Solicitor General may actually file an amicus brief arguing the opposite position recommended by the SEC.

The SEC is an independent agency and its attorneys can represent the agency in trial courts and courts of appeals. The SEC, however, cannot represent itself at the Supreme Court of the United States—it must convince the Solicitor General to represent the SEC's position. Independence, when used to describe an administrative agency, connotes independence from the President and the ability to take positions or engage in actions that do not necessarily reflect the policies and views of the Administration.

Chairman Cox, in response to questions about the SEC's vote to file an amicus brief in *Stoneridge*, stated at a Congressional hearing on June 26, 2007, that the "law has to have some objective meaning. It can't be just a question of how we all feel about it" and that laws should not change with the change in political composition of the Commission. He explained that he did "not think that there's anywhere where it could be more important for there to be predictability and clarity in rulemaking than when it comes to our capital markets, because so much is at stake that people have to make big bets on whether or not what they're doing is the right thing to do.... I think we do a great disservice when we are anything but clear and predictable, rule-based and law-based." I agree with Chairman Cox.

On the issue of predictability in the law, I note what happened to shareholders who were defrauded by Enron when they brought a lawsuit charging certain Enron executives and directors—along with the company's accountants, law firm and banks—with violation of federal securities laws. The alleged violations included massive insider trading while making false and misleading statements about Enron's financial performance. The shareholders reached a settlement with several financial institutions, but while claims were still pending against a number of additional institutions, in March 2007, the Court of Appeals for the Fifth Circuit granted the banks complete immunity from liability. The court acknowledged that the banks' conduct was "hardly praiseworthy," but it ruled that because the banks themselves did not make any false statements about their conduct to the shareholders they could not be held liable, even if they knowingly participated in the scheme to defraud. In an extraordinary admission, the court acknowledged that the ruling runs afoul of "justice and fair play." The ruling also is at odds with the position of the SEC, with its wealth of specialized knowledge on the issues of contention in both the Enron case and *Stoneridge*, and with rulings of other courts.

The Solicitor General is entitled to aid the Court in its interpretation of the law, and I applaud his close attention to this critical case. I am concerned, however, that he has been unable to articulate a legal position—either for or against the plaintiffs—that is independent from the Administration's policy preferences. As you have often said, substantive changes to the law should be made through the legislative process, not through the courts.

Thank you for attention to this matter.

Sincerely,

Arlen Specter

Mr. President —
The SEC is right to have
the Solicitor General
argue to reverse the
Stoneridge case where the
Court made new law
reversing what Congress
did in the statute.

Testimony of Patrick J. Szymanski

**Before the Senate Judiciary Committee,
Subcommittee on Crime and Drugs**

"Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009"

Chairman Specter, Ranking Member Graham and members of the subcommittee, thank you for inviting me to testify concerning S. 1551 which addresses liability for aiding and abetting violations of the Securities Exchange Act and, in particular, would correct the result reached by the United States Supreme Court in *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148, 128 S. Ct. 761 (2008).

My name is Patrick Szymanski, and I am General Counsel to Change to Win. Change to Win ("CtW") is an alliance of unions and six million workers, united to build a new movement of working people that can meet the challenges of the global economy and restore the American Dream: a paycheck that can support a family, affordable health care, a secure retirement and dignity on the job. Our partner unions include the International Brotherhood of Teamsters, Laborers' International Union of North America, Service Employees International Union, United Farm Workers of America, and the United Food and Commercial Workers International Union.

The CtW Investment Group was established in February 2006 to monitor corporate activity, to protect the interests of Change to Win workers in pension funds sponsored by unions affiliated with Change to Win, and, in particular, to enhance long-term shareholder returns through active ownership. Members of CtW affiliates participate in Taft-Hartley plans with more than $200 billion in assets. Because these funds are responsible for supporting the retirement benefits of their participants, they are diversified, are focused on long-term appreciation, and are particularly concerned with corporate governance issues, including the prevention of securities fraud, as a means of achieving reliable long-term results. In short, these funds are the paradigmatic "institutional investors" to whom Congress entrusted the presumptive leadership of private securities litigation.

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Change to Win and the CtW Investment Group filed amicus briefs in *Stoneridge* and *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 127 S. Ct. 2499 (2007), and have similarly supported the interests of our funds, workers, investors and shareholders before Congress and the Securities and Exchange Commission.

In recent years, and particularly as a result of last year's economic meltdown, our funds have lost tens of billions of dollars, in some cases as much as 25-30 percent of their assets. These losses were not the result of poor management by fund administrators – the vast majority of pension funds have adopted investment policies that significantly limit investments in the highly complex and poorly understood financial products at the heart of the meltdown. Rather, the losses sustained by our funds were the result of financial misconduct by firms like Enron and WorldCom and, more recently, by the 2008 economic debacle that directly resulted from the lack of meaningful regulation in the financial sector, particularly with regard to complex and poorly understood derivatives and the so-called "shadow financial markets."

While our funds' conservative investment policies thankfully prevented them from investing in such products to the degree of many Wall Street investors, pension funds have nonetheless suffered massive losses as the fallout from out-sized risks taken by Wall Street executives that rippled out into virtually every corner of the capital markets. The lack of regulation in the shadow financial markets meant that there was little to no way for the funds to determine how much risk their portfolios contained – something the banks themselves were apparently unable to accurately gauge. This was true even for pension funds' investments in publicly traded investment and commercial banks, which saw their market capitalization crash when the full extent of their exposure to unregulated and ultimately toxic investments became clear. As a result, the retirement security of millions of hard-working American families has been severely shaken due to the gambles taken by Wall Street executives.

Unfortunately, this is not new. William O. Douglas accurately described the inherent problems in the financial markets in an address delivered at the University of Chicago in 1937 ("Forces of Disorder," SEC

Historical Society, http://www.sechistorical.org/collection/ papers/1930/ 1936_1027_Douglas_Forces.pdf):

> Of the many forces which breed insecurity, perhaps the most dangerous are the exploitation and dissipation of capital at the hands of what is known as "high finance." The reality of such waste and leakage comes forcibly home when one sees the tottering ruins of industry in bankruptcy or receivership.

Then Chairman of the SEC, Mr. Douglas went on to describe "financial termites" that "destroy the legitimate function of finance and become a common enemy of investors and business."

> Enterprises ostensibly secure collapse as a consequence of their subtle operations. Their mysterious and destructive work has ruined many fine businesses. And at times the first warning which security holders have had that these termites were at work was the disastrous collapse of the company.

And Mr. Douglas well understood that the purpose of the SEC and the Government is to protect investors, both the "institutional buyer of stock" and "people of small income," from the adverse effects of these inherent problems.

The recent financial crisis has highlighted the necessity of a legal and regulatory framework that properly and adequately protects investors from corporate fraud. The Securities and Exchange Commission must of course take a leading role, as it did when Mr. Justice Douglas was its Chairman. But the markets and the problems have grown beyond what anyone imagined in the 1930s. The SEC cannot be the sole cop on the beat. It simply has not the necessary resources. As with any market system, the capital markets will function most efficiently and fairly if investors themselves have the legal tools necessary to hold accountable those who knowingly or recklessly put their investments at risk.

Nowhere could this be more true than in the case of corporate actors who make fraudulent or misleading statements to investors *and* those who would knowingly or recklessly aid in deceiving the investing public. The

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Supreme Court's ruling in *Stoneridge* insulates from accountability those who aid in the dissemination of such fraudulent or misleading statements regarding the financial health of publicly-traded companies – companies in which our funds and our workers' retirement security are heavily invested. In the wake of the scandals of the Enron and WorldCom era and following the worst financial crisis since the Great Depression, it is exactly the wrong way to protect investors in a dis-intermediated, market based financial system.

Stoneridge and other recent decisions have contributed to the problem. They are inconsistent with the fundamental purpose of protecting investors from financial misconduct. *Stoneridge* virtually immunizes banks, brokers, accountants, law firms, and others from liability in many cases. The view that those crafty enough to benefit from participating in a securities fraud can escape liability by carefully avoiding a public statement directly conflicts with the broad language and purposes of the antifraud provisions. Indeed, it is precisely with respect to such secret schemes that the antifraud provisions are needed the most. The federal securities laws cannot be allowed to reward the most cunning at the expense of the honest and hard working and the institutional investors entrusted with holding and managing their funds for their future benefit and retirement.

We need a general overhaul of federal financial regulation, and the Administration has promised to lead that effort. The overhaul must reinvigorate the private enforcement of the securities laws and, to accomplish that end, must remove two significant barriers to investor claims. The first, resulting from the Supreme Court's decision in *Tellabs*, concerns the requirement that securities fraud claims be dismissed unless investors can without discovery allege evidentiary facts demonstrating a "strong inference of scienter." The second is the *Stoneridge* rule that those who knowingly or recklessly facilitate another's fraud must be immune to liability because they are mere "aiders and abettors."

We believe that S. 1551 adequately and appropriately addresses the artificial and inexplicable result in *Stoneridge*, and we discuss below many of the cases that show the need for just such a correction. But before we address the *Stoneridge* aiding-and-abetting issue, we briefly note the need to also correct the initial barrier to legitimate claims imposed in *Tellabs*.

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Requiring Investors to Demonstrate "a Strong Inference" of Scienter

The Private Securities Litigation Reform Act of 1995 (PSLRA) requires plaintiffs in securities cases to state with particularity both the facts constituting the alleged violation and the facts establishing "scienter," i.e., the defendant's intention "to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 & n.12 (1976). In particular, PSLRA §21D(b)(2) requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u–4(b)(2). Congress left the key term "strong inference" undefined. Many courts, as did the court of appeals in *Tellabs* itself, had held that the "strong inference" standard would be met if the complaint "allege[d] facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006). But the Supreme Court ruled in *Tellabs* that courts faced with securities claims must go beyond this common sense pleading requirement to assess the defendant's state of mind by "engag[ing] in a comparative evaluation; it must consider, not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged." *Tellabs,* 551 U.S. at 314. This standard is ambiguous, subjective, unworkable and fatal to many meritorious securities actions.

WorldCom stands as one of the most notorious frauds of the past century. But when investors first filed suit against WorldCom and its top executives, CEO Bernard J. Ebbers and Scott D. Sullivan, in federal court in Mississippi, their case was dismissed – and the U.S. Court of Appeals for the Fifth Circuit affirmed on the ground that investors could not allege either Ebbers or Sullivan acted with scienter – even though Sullivan was by then under indictment. *See Goldstein v. MCI WorldCom,* 340 F.3d 238 (5th Cir. 2003). Both Ebbers and Sullivan ultimately received prison sentences. As the magnitude of their fraud became public, investors managed to plead claims that were permitted to proceed in federal court in New York. Still, the investors who first identified WorldCom as a fraudulent operation had their case thrown out of court – on account of a ridiculously demanding pleading requirement.

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Many other cases get terminated forever because plaintiffs cannot plead enough facts to demonstrate a strong inference of fraudulent intent or recklessness. Along with the correction embodied in S. 1551, Congress should also correct the *Tellabs* result by returning the law to the commonsense requirement that plaintiffs be required to "allege facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Tellabs*, 551 U.S. at 323 (quoting decision below).

Central Bank and Stoneridge: A Free Pass for Aiders and Abettors

We turn to the cases that demonstrate the need to correct the *Stoneridge* rule. Our criminal law long ago "'abolishe[d] the distinction between principals and accessories and [made] them all principals.'"[1] Indeed, the rule that one who aids and abets another's crime or fraud shall be punished as a principal has been codified in 18 U.S.C. §2, which states: "Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal."

Thus, in *Nye & Nissen v. United States,* 336 U.S. 613, 618-20 (1949), the Supreme Court held that one who aids and abets fraud is himself guilty as a principal perpetrator of that fraud. *Id.* The rule is sound. For a scheme to defraud typically involves multiple parties who conspire with, or aid and abet, one another in order to perpetrate the fraudulent scheme. "[A]ll members" of such a scheme, the Supreme Court holds without hesitation in criminal cases, "are responsible." *Pinkerton v. United States,* 328 U.S. 640, 647 (1946) (mail fraud).

When Congress enacted §10(b) it understood that such a statute, making securities fraud illegal, would also make aiding and abetting securities fraud illegal. Federal courts and the SEC readily concluded that

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1 *Standefer v. United States*, 447 U.S. 10, 19 (1980), quoting *Hammer v. United States*, 271 U.S. 620, 628 (1926) (*Standefer*'s brackets); *see United States v. Pino-Perez*, 870 F.2d 1230, 1233 (7th Cir. 1989) (en banc); *United States v. Oates*, 560 F.2d 45, 55 (2d Cir. 1977).

aiding and abetting a violation of the federal securities laws is itself a violation of those laws.[2]

From the very beginning, the same rule applied to civil liability in private actions under §10(b). The first two decisions recognizing an implied private right of action for violations of §10(b) imposed liability for conspiracy to defraud,[3] and for aiding and abetting a violation of §10(b).[4] Following those early cases, the circuit courts uniformly concluded that aiding and abetting securities fraud was a violation of §10(b) and Rule 10b-5 for which investors could sue. "Under §10(b) and Rule 10b-5 knowing assistance of or participation in a fraudulent scheme," the Tenth Circuit held in *Kerbs v. Fall River Indus.*, 502 F.2d 731, 740 (10th Cir. 1974), "gives rise to liability equal to that of the perpetrators themselves." When auditors assisted a client's fraud, the Ninth Circuit declared: "Aiding and abetting is itself a violation of section 10(b) and Rule 10b-5." *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 652 (9th Cir. 1988). The other Circuits agreed that those who aid and abet securities fraud should face liability to their foreseeable victims.[5]

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2 *See, e.g.*, *SEC v. Scott Taylor & Co.*, 183 F. Supp. 904, 909 n.12 (S.D.N.Y. 1959); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939), appeal dismissed, 118 F.2d 718 (9th Cir. 1941); *Matter of Burley & Co.*, 23 S.E.C. 461, 468 n.11 (1946) (Exchange Act Release No. 3838).

3 *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946) (Kirkpatrick, J.) (sustaining a complaint that "in substance, charges a conspiracy, participated in by the three defendants").

4 *Fry v. Schumaker*, 83 F. Supp. 476, 478 (E.D. Pa. 1947) (Kirkpatrick, J.) (recognizing liability for either "rendering service essential to or participating in a scheme to defraud").

5 *See, e.g.*, *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 772-77 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir. 1978); *Schatz v. Rosenberg*, 943 F2d 485, 496-97 (4th Cir. 1991); *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981); *Carroll v. First National Bank*, 413 F.2d 353, 357

But the Supreme Court changed the rules in *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994), by overturning many decades of settled precedent holding that aiders and abettors of a fraud may be liable under §10(b). The Court went even further in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S.Ct. 761 (2008), when it held that third parties who conspire to generate phony financial results for another company to report cannot be held liable – because they have merely aided and abetted another's fraud. The consequences for the victims of sophisticated fraudulent schemes have been disastrous.

Stoneridge: Freedom to Generate Phony Financial Results

Stoneridge itself presents a compelling example of why the proposed amendment is needed – for it exempted from liability companies that knowingly entered into sham transactions in order to generate the phony financial results that Charter Communications, a cable-television provider, wanted to report to investors.

Investors alleged that when Charter executives saw that their company would miss projected operating cash-flow numbers by $15 to $20 million, they sought the help of Scientific-Atlanta, Inc., and Motorola, Inc., to gin up the phony numbers needed to meet the projections. Scientific-Atlanta and Motorola supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. So Charter executives arranged to conceal the company's cash-flow shortfall by arranging to overpay Scientific-Atlanta and Motorola "$20 for each set top box it purchased until the end of the year, with the understanding that [they] would return the overpayment by purchasing advertising from Charter," which it would then report as revenues, while improperly capitalizing the added expense of the set-top boxes. *Stoneridge*, 128 S.Ct. at 766.

Charter investors alleged that Motorola and Scientific-Atlanta were knowing participants in this fraudulent scheme to falsify Charter's financial results by misleading both Charter's auditors and the investors who

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(7th Cir. 1969); *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985); *Little v. Valley National Bank*, 650 F.2d 218, 222-23 (9th Cir. 1981); *Woods v. Barnett Bank*, 765 F.2d 1004, 1009 (11th Cir. 1985).

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ultimately would rely upon its audited financial statements. As the Supreme Court's opinion explains:

> To return the additional money from the set top box sales, Scientific-Atlanta and Motorola signed contracts with Charter to purchase advertising time for a price higher than fair value. The new set top box agreements were backdated to make it appear that they were negotiated a month before the advertising agreements. The backdating was important to convey the impression that the negotiations were unconnected, a point Arthur Andersen considered necessary for separate treatment of the transactions. Charter recorded the advertising payments to inflate revenue and operating cash flow by approximately $17 million. The inflated number was shown on financial statements filed with the Securities and Exchange Commission (SEC) and reported to the public.

Stoneridge, 128 S. Ct. at 767.

Motorola and Scientific-Atlanta booked the transactions as a wash, given their lack of real economic substance. But by entering the transactions and backdating documents, they knowingly facilitated the generation of the phony results that Charter desired to report. In short, they participated in a scheme to defraud, that they could expect would injure investors who purchased Charter securities in reliance on the bogus financial results that they helped to generate.

The Supreme Court applied *Central Bank*, to hold them immune to liability under §10(b), on the rationale that they had merely aided and abetted Charter's fraud. "Respondents had no duty to disclose," the Supreme Court explained, "and their deceptive acts were not communicated to the public" – only the deceptive results of those acts were reported by Charter. *Stoneridge*, 128 S. Ct. at 769.

The Court wrote that "[i]n effect petitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect." *Stoneridge*, 128 S. Ct. at 770. This, the Supreme Court held, went too far. It held that "respondents' deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance," even if they knowingly entered sham transactions in order to generate the phony financial results that Charter sought to report, and backdated documents to hide the impropriety from Charter's auditors. *Id.* That Charter reported those results (as all involved surely expected) somehow constituted an intervening cause: "It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did." *Id.*

The Court cited *Central Bank,* and Congress' response to it as the basis for denying investors relief from the very entities that had worked to advance Charter's fraud. The Court explained that after *Central Bank* had done away with civil aiding-and-abetting liability,

> Congress amended the securities laws to provide for limited coverage of aiders and abettors. Aiding and abetting liability is authorized in actions brought by the SEC but not by private parties. See 15 U.S.C. §78t(e). Petitioner's view of primary liability makes any aider and abettor liable under §10(b) if he or she committed a deceptive act in the process of providing assistance. [citation omitted] Were we to adopt this construction of §10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants.

Stoneridge, 128 S. Ct. at 771. Thus, said the Court, "we give weight to Congress' amendment to the Act restoring aiding and abetting liability in certain cases but not others," by denying relief to the victims of the fraud. *Id.* at 772.

The time has come for Congress to restore to victims the right to be made whole, by restoring their right to recover from those who knowingly or recklessly facilitate financial fraud. The sad consequences of the *Central Bank/Stoneridge* rule can be seen in many cases, where investors are being denied relief from perpetrators of criminal acts.

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One such case is *In re Adelphia Communications Corp. Sec. & Deriv. Litig.*, No. 03-MDL-1523 (LMM), 2009 WL 1740035 (S.D.N.Y. June 17, 2009), where purchasers of Adelphia securities alleged that the *Stoneridge* defendants Scientific-Atlanta and Motorola had engaged in precisely the same kind of transactions to inflate Adelphia's financial results as they had with Charter. Adelphia "negotiated and entered into supplemental agreements with Motorola and Scientific-Atlanta to buy cable boxes at the original contract price plus a premium," while "Motorola and Scientific-Atlanta agreed to pay Adelphia an amount equivalent to the premium as 'marketing support payments.'" *Adelphia*, 2009 WL 1740035, at *1. As in *Stoneridge,* these "deals were in essence 'wash' transactions," whose "only impact was to make Adelphia's financial performance look better from an accounting standpoint, by artificially inflating Adelphia's" apparent financial results. *Id.* Though they were repeat players in such schemes, Motorola and Scientific-Atlanta avoided liability again, just as they had in *Stoneridge*.

As serious as these frauds may be, *Stoneridge* and *Adelphia* provide only a hint of how bad the problem is. The largest and most egregious frauds are the ones where immunity for aiders and abettors has its most serious effect.

Enron: Poster Child for Reform

The case of Enron, perhaps the most notorious of all financial frauds, starkly illustrates why aiders and abettors cannot be permitted to avoid liability under §10(b). Boiled down to its essence, Enron's financial fraud consisted of using bogus transactions to hide the company's debt and generate phony revenues. Enron's investment banks, including Credit Suisse, Merrill Lynch, and Barclays Bank, structured and executed the transactions that accomplished this – producing the raw data underlying the false financial statements on which investors and the market relied.

Yet the Fifth Circuit held that the very entities who effected the fraud – by executing the sham transactions that hid Enron's debt and generated the phony financial results that it reported – were immune to liability under §10(b). They were, the Fifth Circuit held, merely aiders and abettors of Enron's fraud, because they had no independent duty to report the bogus financial data they generated to investors, and because it was Enron, in the end, that filed the false financial statements reporting the results that they had worked to generate.

Under *Central Bank*, the Fifth Circuit ruled, "the factual probability that the market relied on the banks' behavior and/or omissions does not mean that plaintiffs are entitled to the legal presumption of reliance," when they purchased Enron securities on the basis of the false data that the banks had generated for Enron. *Regents*, 482 F.3d at 383. The banks' carefully structured bogus transactions were, the Fifth Circuit reasoned, "not misrepresentative because the market had no right to rely on them." *Id.* And reliance on Enron's financial statements, which were based upon them, did not count – because it was too remote. *Id.*

"Presuming plaintiffs' allegations to be true," the Fifth Circuit explained, "Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders." *Regents*, 482 F.3d at 386. The federal appeals court accordingly held that "what the banks are alleged to have done, namely engage in transactions elsewhere that gave a misleading impression of the value of Enron securities that were already on the market," was quite simply beyond the law's reach because, under *Central Bank*, they were merely aiders and abettors of the fraud that they had structured and executed. *Regents*, 482 F.3d at 391.

This, the Fifth Circuit acknowledged, ran contrary to common-sense constructions of §10(b) and Rule 10b-5. For §10(b) purports to reach "any person" who "directly or indirectly" employs "any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the Commission may prescribe." 15 U.S.C. §78j(b). And Rule 10b-5 says it reaches "any person" who "directly or indirectly" employs "any device, scheme, or artifice to defraud," who makes "any untrue statement of a material fact," or omits facts "necessary to make the statements made, in light of the circumstances under which they were made, not misleading," or who engages "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." 17 C.F.R. §240.10b-5.

The investment banks' conduct – structuring bogus transactions in order to mislead creditors and investors – surely seemed to fit within the

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natural meaning of the statute and rule, as deceptive contrivances designed to deceive investors as part of a clearly fraudulent scheme. But the Fifth Circuit held that it was "by ascribing natural, dictionary definitions to the words of the rule, that the district court and likeminded courts have gone awry." *Regents*, 482 F.3d at 387. The Fifth Circuit concluded that the statute's natural meaning had to fall, and that under *Central Bank* the investment banks were immune to liability as mere aiders and abettors of the fraudulent scheme that they helped to design, and in which they knowingly participated.

To be sure, Enron investors managed to collect more than $7 billion in settlements before the Fifth Circuit so ruled. But the Fifth Circuit's interpretation of *Central Bank denied* investors any further relief. And a week after issuing its opinion in *Stoneridge*, the Court denied the Enron petition for certiorari and allowed the decision to stand.[6]

Refco: Criminals Owing No Duty to Their Victims

Another egregious example of the effect of *Stoneridge* is found in the Refco securities-fraud litigation, where investor claims against Refco's outside counsel were dismissed with prejudice, despite allegations that the lawyers were intimately and knowingly involved in the company's fraud. "Although the Complaint alleges facts that, if true, would make the Mayer Brown Defendants guilty of aiding and abetting the securities fraud that harmed the plaintiffs," the district court observed in dismissing the claims, "the Supreme Court and Congress have declined to provide a private right of action for victims of securities fraud against those who merely – if otherwise substantially and culpably – aid a fraud that is executed by others." *In re Refco, Inc., Sec. Litig.*, 609 F. Supp. 2d 304, 306 (S.D.N.Y. 2009); *see also Thomas H. Lee Equity Fund V, L.P. v. Mayer Brown, Rowe & Maw LLP*, 612 F. Supp. 2d 267 (S.D.N.Y. 2009).

"Prior to Refco's spectacular collapse," the district court's opinion explains, "it was among the world's largest providers of brokerage and

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6 *Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, __ U.S. __, 128 S. Ct. 1120 (January 22, 2008) (denying petition for a writ of certiorari).

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clearing services in the international derivatives, currency, and futures markets." *Refco*, 609 F. Supp. 2d at 306. "Refco's business model involved extending credit to its customers so that they could trade on margin and leverage their capital into larger trades, for which Refco could again extend credit," thereby generating "substantial commissions, revenues, and profits." *Id.* Over time, however, "Refco began making loans without adequately assessing customers' credit-worthiness or the risks associated with trading activities," so that when customers suffered massive trading losses in the late 1990s, the loans "became 'uncollectible receivables' that Refco's customers were unwilling or unable to repay." *Id.*

"Rather than write off or disclose these uncollectible receivables – the revelation of which would have had dire financial consequences for the company – Refco's management allegedly devised a scheme to conceal them from the public and Refco's investors." *Refco*, 609 F. Supp. 2d at 306. The district court's opinion describes its operation:

> First, they transferred the loans onto the books of Refco Group Holdings, Inc. ("RGHI"), an entity owned and controlled by Phillip R. Bennett ("Bennett"), Refco's President, CEO, and Chairman. As a result of these transfers, [RGHI] owed hundreds of millions of dollars to Refco, but RGHI had no liquid assets and no operational functions, and thus it had no conceivable means of repaying the "loans."
>
> Next, to avoid the disclosure of large "related-party" receivables - the sum of which dwarfed Refco's net income – a series of fraudulent transactions were arranged by which the RGHI receivables were periodically made to disappear from Refco's books through so-called "round-trip loans" in which the receivables owed to Refco from RGHI were replaced with receivables purportedly owed by a third-party customer.
>
> These loans, which straddled the end of each fiscal year from 2000 through 2005 and at the end of several fiscal quarters as well, all worked in essentially the same way. First, several days before Refco closed its books for each financial period, Refco Capital Markets Ltd. ("RCM"), a Refco subsidiary, would loan hundreds of millions of dollars to a third-party

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> customer who then, through its account at Refco, simultaneously loaned the same amount to RGHI. The loan agreements between the third party and RCM – which were done on a book basis (the principal never changed hands) – were meticulously structured so that they were essentially risk-free to the third-party customers; the customers' loans to RGHI were guaranteed by Refco and the customers profited for their participation in the "loans" through interest earned on their loans to RGHI, which by design exceeded the interest they were charged by RCM. RGHI, in turn, used the loans from the customers to pay down the money it owed to Refco for its uncollectible receivables. The net effect of these transactions was that at the close of each reporting period, Refco's books would show "loans" to third-party customers and the RGHI receivables would be gone. Then, just days after the financial period closed, the transactions were unwound – the "loans" repaid, and the uncollectible receivables from RGHI were returned to Refco's books. Thus, these transactions enabled Refco to lend money to itself, through third parties, to conceal its grim, multi-hundred million dollar losses from the public and from its investors.

Refco, 609 F. Supp. 2d at 306-07 (citations omitted); *see id.* at 315-16.

You might imagine that lawyers were needed to structure and execute this elaborate scheme of manipulative transactions. Indeed, the law firm of "Mayer Brown was familiar with Refco's operations and finances and participated in seventeen rounds of the round-trip loan transactions between 2000 and 2005 by which Refco's uncollectible receivables were concealed." *Refco*, 609 F. Supp. 2d at 307. "Specifically, the role of the Mayer Brown Defendants was to explain the structure and terms of the transactions to potential third-party participants, negotiate the loans, draft and revise the documentation for the transactions including the relevant loan agreements, promissory notes, guarantees and indemnification letters, transmit documents to the participants, distribute executed copies of the documents, and mark the third-party customers' promissory notes to RCM as 'paid in full' when the transaction was unwound." *Id.* at 307-08.

With Refco's financial difficulties thus concealed by its attorneys, Refco insiders began to cash out of the company as they issued securities to unsuspecting public investors – beginning with a $600-million bond offering in 2004, and a $670-million initial public offering ("IPO") of stock in 2005. *Refco*, 609 F. Supp. 2d at 308. Refco's lawyers from Mayer Brown "participated in drafting the documents that were filed with the Securities and Exchange Commission ('SEC') in order to induce investors to purchase Refco's Bonds and, later, to effectuate the IPO. The lawyers took part "in drafting and disseminating the Offering Memorandum" for the bonds, "which state that Mayer Brown represented Refco in connection with the offering." *Id.* at 308. "The portions of the memorandum drafted by the Mayer Brown Defendants included the Management's Discussion & Analysis ('MD&A') and Risk Factors portions, which discussed Refco's business and financial conditions in a way that, given Mayer Brown's involvement in the round-trip loan transactions and knowledge of the RGHI receivables, the Mayer Brown Defendants knew to be false." *Id.* at 308-09.

The lawyers also "played a significant role in drafting and reviewing the IPO Registration Statement," which similarly "misrepresented Refco's financial condition and failed to disclose multi-hundred million dollar receivables that were concealed through the round-trip loans that the Mayer Brown Defendants helped facilitate." *Refco*, 609 F. Supp. 2d at 309.

The lawyers thus had "'design[ed] and implement[ed] sham transactions used by Refco to fraudulently transfer uncollectible debt and design[ed] and participat[ed] in blatantly fraudulent sham loan transactions.'" *Refco*, 609 F. Supp. 2d at 316. And these allegations raised a strong inference of the lawyers' scienter, "that is, that the Mayer Brown Defendants knew or acted in reckless disregard of Refco's intention to use the transactions to inflate its revenues, and knew or should have known that the resulting financial statements issued would be relied upon by research analysts and investors." *Refco*, 609 F. Supp. 2d at 316. The lawyers then transmitted information that they knew to be false to investors through false offering documents that they helped to draft and disseminate. *See id.*

But Judge Lynch felt compelled to dismiss the claims of the defrauded investors against the dishonest lawyers, holding that "the Supreme Court's decision in *Stoneridge* forecloses this theory of liability." *Refco*, 609 F.

Supp. 2d at 314. He explained that the allegations "if proven true, are adequate to establish liability for aiding and abetting securities fraud, but are not enough to establish civil liability as a ***primary*** actor. As was the case in Stoneridge, it was Refco, not the Mayer Brown Defendants, 'that . . . filed fraudulent financial statements; nothing [the Mayer Brown Defendants] did made it necessary or inevitable for [Refco] to record the transactions as it did.'" *Refco*, 609 F. Supp. 2d at 316 (quoting *Stoneridge*, 128 S. Ct. at 770).

The lawyers might be criminally liable – indeed, the government had indicted one of them – but their victims had no claim for relief: "However significant a role the Mayer Brown Defendants played in assisting Refco's management to engage in these transactions, and however culpable they may have been to do so with the knowledge that the transactions were ultimately designed as part of a scheme to defraud and practice a deceit upon Refco's shareholders – indeed even if the acts of Collins were, as the Government has charged, criminal – the liability that attaches to those acts is liability for aiding and abetting Refco's schemes and manipulation, not principal liability for executing schemes of the Mayer Brown Defendants' own." *Refco*, 609 F. Supp. 2d at 316.

Judge Lynch found it "perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. However, as the Court noted in *Stoneridge*, the fact that the plaintiff-investors have no claim is the result of a policy choice by Congress," in 1995, when it "authorized the SEC – but not private parties – to bring enforcement actions against those who 'knowingly provide [] substantial assistance to another person' in violation of the federal securities laws." *Refco*, 609 F. Supp. 2d at 318 n.15.

"This choice may be ripe for legislative re-examination," Judge Lynch declared, observing that "in the criminal context when the Godfather orders a hit, he is only an accomplice to murder – one who 'counsels, commands, induces or procures' but he is nonetheless liable as a principal for the commission of the crime." *Refco*, 609 F. Supp. 2d at 318 n.15 (quoting 18 U.S.C. §2).

The time is indeed ripe for legislative re-examination when the criminals who orchestrated frauds like that of Refco may face prison sentences – but are utterly immune from liability to their victims, who on account of *Central Bank* and *Stoneridge*, may never be made whole.

Homestore.com: Generating Revenues Through Sham Transactions

Litigation on behalf of investors defrauded by Homestore.com's false financial results also is instructive. *See In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003), *aff'd in part and remanded sub nom. Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), *vacated and remanded sub nom., Avis Budget Group, Inc. v. Cal. State Teacher' Ret. Sys.*, 128 S. Ct. 1119 (U.S. Jan. 22, 2008), *and vacated sub nom. Simpson v. Homestore.com*, 519 F. 3d 1041 (9th Cir. 2008).

The case involved sham transactions that had no real economic substance and whose sole purpose was to inflate the revenues of each involved company in the structured triangular wash transactions. As a duly-appointed lead plaintiff on behalf of a class of investors who had purchased Homestore stock, the California State Teachers' Retirement System ("CalSTRS") alleged that Homestore and its business partners – including AOL Time Warner – had devised and executed a scheme to mislead public investors by means of accounting contrivances that were designed to, and did, produce phony revenues. CalSTRS alleged, for example, that the structure of triangular deals entered into between Homestore and AOL in order to falsify Homestore's reported revenues was "jointly developed" and "concocted by [Homestore CEO Peter] Tafeen and [AOL's Eric] Keller, with the knowledge and approval of [AOL's David] Colburn." (Complaint ¶1, ¶¶174, 331). CalSTRS averred that further deals, with defendants L90 and Cendant, were similarly designed and executed to mislead Homestore investors by generating phony revenues. (Complaint ¶¶174, 331).

That fraud was committed was beyond dispute. Seven Homestore executives had entered guilty pleas for what they did. AOL Time Warner and Cendant's role in perpetrating financial fraud with them was plainly alleged, and in great detail. CalSTRS averred that defendant AOL, through its employees Keller and Colburn, devised and successfully executed the scheme to mislead Homestore investors. Several of Homestore's other "business partners" knowingly participated in Homestore's massive financial fraud, entering into transactions with Homestore with the very purpose of generating fabricated revenues.

In related securities-fraud litigation against AOL Time Warner, moreover, it was similarly "alleged that Keller was the architect of sixteen separate sham transactions with Homestore in which the two companies generated bogus advertising revenue through the use of three-legged 'round-trip' deals involving third parties." *AOL*, 2004 U.S. Dist. LEXIS 7917, at *80. The *AOL* plaintiffs alleged that "Keller and Colburn agreed with Homestore executives not to document the secret leg of these transactions in order to avoid detection." *Id.* If these allegations are proved, the *AOL* district court had held, then these defendants "engaged in a prohibited act as defined by Rules 10b-5(a) and (c)." *Id.* at *82-*83 (Keller); *see id.* at *89 n.38 (Colburn).

But when Homestore investors sued Homestore's partners in fraud – AOL, Cendant, and L90 – the district court held that even if they had deliberately fabricated transactions to generate Homestore's phony revenues, under *Central Bank* they could face no securities fraud liability to purchasers of Homestore's securities. Applying *Central Bank*, it held that by generating phony revenues to mislead investors, AOL and the other "third-party" defendants did not engage in any "manipulative or deceptive device or contrivance" within the meaning of §10(b), 15 U.S.C. §78j(b), or in a "scheme" to defraud prohibited by Rule 10b-5(a), or even in conduct calculated to "operate as a fraud or deceit upon any person" as prohibited by Rule 10b-5(c). 17 C.F.R. §240.10b-5(a), (c).[7]

Ruling on appeal that the investors should at least be permitted to amend their complaint, the Ninth Circuit held "that to be liable as a primary violator of §10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) Should the

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7 As originally promulgated by the SEC, Rule 10b-5's subparagraphs are numbered, (1) through (3). As codified in the C.F.R., the subparagraphs are lettered, (a)-(c). *See* 17 C.F.R. §240.10b-5(a)-(c).

plaintiff investors be able to meet this standard, the Ninth Circuit ruled, the case might proceed.

But the Supreme Court vacated the Ninth Circuit's decision just one week after it issued *Stoneridge*, remanding to the Ninth Circuit with directions to reconsider its decision "in light of *Stoneridge*." *Avis Budget Group, Inc. v. Cal. State Teachers' Ret. Sys.*, 128 S. Ct. 1119 (Jan. 22, 2008). On remand the Ninth Circuit complied by vacating its prior opinion, and remanding to the district court "for further proceedings which are consistent with the opinion of the Supreme Court." *Simpson v. AOL Time Warner Inc.*, 519 F.3d 1041, 1041 (9th Cir. 2008).

Though the fraudulent transactions had involved multiple parties, *Stoneridge* appeared to bar liability.

Pugh v. Tribune Co.: Deliberate Criminal Fraud, with No Relief to Investors

Investors value stock on the basis of the money that a company can legitimately be expected to make. Thus, even the common law recognized that a company commits securities fraud if its reported financial results come, in material part, from a fraud upon its customers. "The reasonable interpretation of a representation that a company is making dividends and profits is that it is making lawful dividends and profits; and if, instead of this, the company is stealing from some one money with which to declare fictitious dividends and profits, the representation is untrue." *Boggs v. Wann,* 58 F. 681, 686 (Cir. Ct. N.D. Ohio 1893) (Taft, Circuit Judge).

In *Pugh v. Tribune Co.,* 521 F.3d 686 (7th Cir. 2008), employees of the Tribune Co.'s *Newsday* subsidiary deliberately falsified circulation numbers for *Newsday* and *Hoy,* and reported revenues obtained by practicing a fraud upon its advertisers. "The true circulation of *Newsday* and *Hoy* was roughly 80 percent and 50 percent, respectively, of what was reported." *Id.* at 691. Investigations launched after advertisers filed suit to get their money back required the Tribune Co. to take a $90 million charge and produced legal actions – criminal prosecutions by the federal government and

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securities-fraud and ERISA class actions filed on behalf of Tribune Co. investors and pension-plan beneficiaries.

The criminal prosecutions produced "guilty pleas by nine former *Newsday* and *Hoy* employees, including four of the five *Newsday* and *Hoy* employees named as defendants in [the] securities case." *Pugh v. Tribune Co.*, 521 F.3d at 691 n.1. A Justice Department press release reported that "each defendant faces a maximum sentence of 20 years imprisonment, three years supervised release, and a $250,000 fine (or twice the gross gain or loss as a result of the offense)."[8] A subsequent Department of Justice press release "reported that *Newsday* and *Hoy* agreed to forfeit $15 million to the United States pursuant to an agreement that resolves its criminal investigation."[9]

But defrauded investors and pension funds got no relief at all, not even from the fraudulent scheme's "mastermind," Louis Sito, who at relevant times was *Newsday*'s vice president for circulation, *Hoy*'s president, publisher, and chief executive, and the Tribune Co.'s vice president for

8 *Press Release: Nine Former Employees and Contractors of* Newsday *and* Hoy *Plead Guilty to Scheme to Defraud Newspaper Advertisers* (May 30, 2006) (available online: http://www.usdoj.gov/usao/nye/pr/2006/2006may30.html). It appears that, in the end, Sito actually served no prison time, receiving instead a sentence of five years probation. *See* Stephanie Cohen, *Newsday Circ Scandal Execs Sentenced,* New York Post, August 30, 2008 ("Louis Sito, a former vice president of *Newsday* and *Hoy*'s former publisher; Robert Brennan, Newsday's former circulation director; Richard Czark, Hoy's former senior vice president for circulation; and Robert Garcia, a circulation manager at *Newsday* and *Hoy*, were each given five years probation and fined.").

9 *Pugh v. Tribune Co.,* 521 F.3d at 691 n.1; *see DOJ Press Release: Newsday and Hoy Agree to Resolve Criminal Inquiry into Scheme to Defraud Newspaper Advertisers – Newspapers Admit Responsibility for Circulation Reporting Fraud and Agree to Forfeit $15 Million* (December 18, 2007) (available online at http://www.usdoj.gov/usao/nye/pr/2007/007dec18b.html).

Hispanic Media – and whose guilty plea to criminal charges of fraud "admitted to directing *Newsday* and *Hoy* employees to falsely inflate paid circulation data." *Pugh v. Tribune Co.,* 521 F.3d at 693 n.4, 696. Even as to Sito, the Seventh Circuit held, "the plaintiff's allegations of 'scheme liability' are insufficient under the Supreme Court's recent decision in *Stoneridge.*" *Id.* at 696.

"Like the defendants in *Stoneridge,*" the Seventh Circuit explained, "Sito participated in a fraudulent scheme but had no role in preparing or disseminating Tribune's financial statements of press releases." *Pugh v. Tribune Co.,* 521 F.3d at 697. That Sito's fraudulent conduct was designed to – and in fact operated to – mislead investors was beside the point:

> Sito may have foreseen (or even intended) that the advertising scheme would result in improper revenue for Newsday and Hoy, which would eventually be reflected in Tribune's revenues and finally published in its financial statements. But *Stoneridge* indicates that an indirect chain to the contents of false public statements is too remote to establish primary liability.

Pugh v. Tribune Co., 521 F.3d at 697.

Sito, who orchestrated and executed the fraud, could not be held liable under *Stoneridge,* because he did not frame or file the Tribune Co.'s financial statements communicating to investors the fraudulently inflated revenues that his scheme was designed to produce. *Id.* The Tribune Co., in turn, was insulated from liability, because "the corporate scienter inquiry must focus on 'the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment,'" and because "misconduct of employees at a corporate subsidiary is not normally attributed to its corporate parent." *Pugh v. Tribune Co.,* 521 F.3d at 697 (citation omitted).

The Seventh Circuit thus concluded that although the Tribune's financial results had been deliberately falsified, and although investors who purchased its securities were injured, no one was accountable to them. Sito

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was accountable as a felon under criminal law, but under *Stoneridge,* his investor victims were not entitled to even a penny of relief.

Conclusion

There are other decisions that demonstrate the injustice of *Central Bank* and *Stoneridge*, but these are the principal and most egregious ones. And, if not corrected, there will be more as lawyers in accord with *Stoneridge* tell clients that they are free from liability so long as they make no public statement to investors. S. 1551 makes the appropriate and necessary correction by extending liability for violations to "any person that knowingly or recklessly provides substantial assistance to another person in violation of this title."

Thank you again for the opportunity to testify. I welcome your questions.

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WSJ LAW BLOG: SEC Says No To Law Firm 'Pay-To-Play' Probe
17 July 2009
Posted by Nathan Koppel

We've blogged before about New York Attorney General Andrew Cuomo's investigation into whether financial firms improperly shelled out payments to middlemen in exchange for the firm getting hired to manage state pension-fund investments.

In May, for example, Carlyle Group struck a deal to pay $20 million to resolve its involvement in Cuomo's pay-to-play probe.

The SEC, meanwhile, is looking into whether it can clamp down on pay-to-play practices by investment firms.

But what about law firms? Securities class action firms shell out tons in campaign contributions to state politicos who often return the favor by hiring the firms to file securities suits on behalf of state pension funds. Pro business groups, and even some plaintiffs' lawyers, have long complained about this practice.

Last week, Sen. Robert Bennett, R-Utah, took aim at pay-to-play by law firms, according to a story by Deseret News. The senator fired off a letter to SEC Chair Mary Schapiro. Campaign contributions by law firms, in exchange for business, he wrote, "is no less serious a threat to the integrity of the nation's public pension funds, and it too requires the Commission's immediate attention."

This week, Schapiro wrote back, declining Bennett's invitation. "The commission's review of play-to-play...relates to fund managers and financial firms," she wrote. "Our ongoing review necessarily focuses

THE WALL STREET JOURNAL

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The Specter of Unlimited Liability

Arlen Specter became a Democrat this year, but there's one party we're confident the Pennsylvania Senator will never abandon—the trial bar. He's recently introduced legislation to repeal two important Supreme Court business rulings in order to create a new lawsuit bonanza.

Pennsyvania's Senator has a couple of favors for the tort bar.

In *Stoneridge v. Scientific Atlanta,* five Justices ruled in 2008 that companies can't be sued merely for doing business with another firm that commits fraud. This followed the 1994 precedent in *Central Bank of Denver v. First Interstate Bank of Denver,* in which the Justices limited liability claims against alleged "aiders and abettors." Both decisions undermine "scheme liability" suits, which are the kind of elastic legal claim that gives U.S. civil justice a bad name.

Enter Mr. Specter and Rhode Island's Jack Reed, who say the decisions deny fraud victims their day in court. Their bill would amend the 1934 Securities Exchange Act specifically to authorize a private right of action for aiding-and-abetting liability. The two Supreme Court rulings interpreted the law narrowly to apply only to primary offenders, who can still be sued by genuine—and even not-so-genuine—victims of fraud.

Stoneridge is instructive on this point. In 2000, Scientific-Atlanta and Motorola agreed to sell cable boxes to Charter Communications, which was creative in booking these deals and had to restate its financial results. Scientific-Atlanta and Motorola had done nothing more than enter into contracts with its customer, Charter, on terms requested by that customer, and had accounted for the deals properly. Nonetheless, the Stoneridge investment firm sued the two suppliers, alleging a "scheme" against Charter investors.

In striking down this suit, the High Court called the case "a private cause of action against the entire marketplace in which the issuing company operates." It also pointed out that Congress decided not to provide a private cause of action against secondary parties when it passed the Private Securities Litigation Reform Act in 1995 and Sarbanes-Oxley in 2002. The Securities and Exchange Commission already has the authority to punish fraud and distribute fines to victims. Private lawsuits are about trying to use expansive liability claims that distort justice and harm the shareholders of innocent but deep-pocketed companies.

To show what a loyal tort-lobby servant he is, Mr. Specter has also introduced a bill to let attorneys claim an up-front tax deduction on expenses they incur while building contingency fee cases. Amazing but true: Mr. Specter wants to give a tax cut to sustain the likes of Mel Weiss or Dickie Scruggs in the yachts to which they have become accustomed while they await jackpot jury verdicts. Even Democrats are too embarrassed by this giveaway (estimated cost: $1.6 billion) to pass it as a stand-alone bill, so tort lobbyist Linda Lipsen recently said "we have to tuck it into something" else, such as another "tax vehicle."

Pennsylvania Congressman Joe Sestak announced last week he's going to challenge Mr. Specter in the 2010 Democratic Senate primary, so the incumbent needs all the trial-bar cash he can carry. Don't expect him to ease up on pushing either of these proposals, and with 60 Senate Democrats they might even pass.

For Opinion See 114 S.Ct. 1439

United States Supreme Court Amicus Brief.
CENTRAL BANK OF DENVER, N.A., Petitioner,
v.
FIRST INTERSTATE BANK OF DENVER, N.A., and
Jack K. Naber.
No. 92-854.
October Term, 1993.
September 10, 1993.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Respondents

Paul Gonson, Solicitor, Jacob H. Stillman, Associate General Counsel, Brian D. Bellardo, Assistant General Counsel, Brian F. McNally, Senior Litigation Counsel, Diane White, William Johnson, Attorneys, Securities and Exchange Commission, Washington D.C. 20549, Drew S. Days, III, Solicitor General, Edwin S. Kneedler, Deputy Solicitor General, Edward C. DuMont, Assistant to the Solicitor General, Department of Justice, Washington, D.C. 20530, (202) 514-2217

QUESTIONS PRESENTED

1. Whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and the Securities and Exchange Commission's Rule 10b-5, 17 C.F.R. 240.10b-5.

2. Whether recklessness, as opposed to conscious intent, is sufficient to satisfy the scienter element of aiding-and-abetting liability under Section 10(b) of the Securities Exchange Act, where the defendant's substantial assistance of the primary wrongdoing consists of affirmative action rather than silence and inaction.

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***1 INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION**

The Securities and Exchange Commission administers and enforces the federal securities laws. The questions presented in this case are whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and the Commission's Rule 10b-5, 17 C.F.R. 240.10b-5, and, if so, whether recklessness satisfies the scienter element for such liability in the circumstances of this case. Private actions under Rule 10b-5 are an essential supplement to Commission enforcement of the Exchange Act, and the Commission has a strong interest in *2 seeing that the principles applied in such actions promote the purposes of the securities laws. Aiding-and-abetting liability and the recklessness standard are also critical in the Commission's own enforcement actions. The United States filed a brief in this case at the petition stage at the invitation of the Court.

STATEMENT

Petitioner served as indenture trustee for two separate bond issues sold in 1986 and 1988 by the Colorado Springs-Stetson Hills Public Building Authority to finance public improvements to a planned community. The indenture required the bonds to be secured at all times by land having an appraised value of at least 160% of the outstanding principal and interest. Pet. App. A4-A5.

In early 1988, before the second offering, petitioner received an updated appraisal covering both the land securing the 1986 bonds and the separate parcels that were to secure the 1988 bonds. The new appraisal, prepared by the same individual who had supplied the original appraisal in 1986, showed land values essentially unchanged from 1986, even though local real estate values had declined in the interim. Pet. App. A5-A6, A7 n.6. The lead underwriter for the 1986 bonds notified petitioner that the 160% test was not being met for those bonds, and expressed concern that the 1988 appraisal was unreliable. *Id.* at A6. Petitioner's own investigation raised similar questions. *Id.* at A7.

Petitioner, as trustee for the 1986 bonds, at first directed that an independent review of the appraisal be conducted by a different appraiser. Pet. App. A7. After meetings with the issuer, the developer, and others, however, petitioner agreed to defer the independent review until late 1988, at least six months after the 1988 bonds were to be sold. As one condition for petitioner's forbearance, the developer agreed to pledge an additional $2 million in property as security for the 1986 bonds. *Id.* at A8 & n.7. No additional property was pledged as security *3 for the 1988 bonds, see *id.* at A27, which were sold as scheduled in June 1988. *Id.* at A4. Thereafter the issuer refused to complete the promised independent appraisal, and ultimately defaulted on the 1988 bonds. *Id.* at A9.

Respondents are purchasers of 1988 bonds who brought this securities fraud action against petitioner and others, alleging that the 1988 sale violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and the Commission's Rule 10b-5, 17 C.F.R. 240.10b-5. In particular, respondents alleged that petitioner knowingly or recklessly aided and abetted the fraud by withdrawing its demand for an immediate independent review of the appraisal despite serious concerns about its accuracy, and by agreeing to delay the review until after the 1988 bonds had been sold. Pet. App. A9, A20, A27 & n.19.

The district court granted summary judgment for petitioner. Pet. App. A29-A36. The court held that recklessness could not satisfy the scienter requirement for aiding-and-abetting liability absent an independent duty on petitioner's part to disclose information, and that there was no genuine issue of material fact as to petitioner's actual knowledge or its duty. *Id.* at A33. The court of appeals agreed (*id.* at A20) that petitioner had no duty to disclose, but held (*id.* at A25) that reckless action-as opposed to mere silence or inaction-that assists a fraud may satisfy the scienter requirement for aiding and abetting even absent such a duty. The court concluded that this case involved more than mere inaction, because petitioner "affirmatively agree[d] to delay the independent review of the [1988] appraisal." *Id.* at A23. Given petitioner's concerns about the appraisal and its knowledge of the upcoming bond sale, the court held that petitioner's decision to allow the delay could support a finding of recklessness, and it remanded the case for trial on that issue. *Id.* at A26-A27.

***4 SUMMARY OF ARGUMENT**

Liability for aiding and abetting is fairly encompassed within the established private cause of action under Rule 10b-5. Such liability is supported by the broad language of Section 10(b), read in its statutory and historical context. The federal courts have long and uniformly permitted private plaintiffs to sue defendants for aiding-and-abetting violations of Rule 10b-5, and the history of recent Exchange Act amendments demonstrates that Congress has approved the courts' resolution of the issue. That result is consistent with the deterrent and remedial purposes of the securities laws, and with the role of the private action as a necessary supplement to the Commission's own enforcement efforts. It should not be disturbed.

In order to establish liability for aiding and abetting, a plaintiff must generally establish that the defendant substantially assisted a third party's violation of Rule 10b-5, and did so with some degree of scienter. This case concerns only what degree of scienter is required. In our view, a recklessness standard is appropriate where the required substantial assistance is accomplished through some affirmative action on the part of the defendant, even if the defendant owes the plaintiff no independent duty.

The recklessness standard applies for purposes of primary violations of Rule 10b-5, as well as for purposes of common law fraud. In those cases it discourages deliberate ignorance and, importantly, prevents defendants from escaping liability simply because of the often prohibitive difficulty of proving knowledge or conscious intent on the basis of the circumstantial evidence frequently used in securities fraud cases. The same rationales apply equally to liability for aiding and abetting. In addition, the recklessness standard combines flexibility and predictability more effectively than the alternatives. It requires proof of a high level of culpability in order to establish liability, without limiting such liability so ***5** severely as to impede effective public and private enforcement of the law.

ARGUMENT

I. AIDERS AND ABETTORS MAY BE INCLUDED AS DEFENDANTS IN A PRIVATE ACTION UNDER SECTION 10(B) AND RULE 10B-5

This Court has recently reaffirmed that private actions under Section 10(b) and Rule 10b-5 are "an accepted feature of our securities laws," and that the federal courts have appropriately "accepted and exercised the principal responsibility for the continuing elaboration of the scope" of such actions. *Musick, Peeler & Garrett v. Employers Ins.*, 113 S. Ct. 2085, 2089 (1993); see also, *e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983). In prior cases involving such elaboration, this Court has looked to statutory language, legislative history, lower court decisions, statutory and common law when the Exchange Act was enacted, and policy considerations.[FN1] In this case, those factors all counsel confirmation by this Court of the lower courts' uniform conclusion that private actions may properly reach defendants who have aided or abetted violations of Rule 10b-5.

FN1. See, *e.g., Musick, Peeler*, 113 S. Ct. at 2090-2092 (analogous provisions, lower court decisions and policy considerations); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-206 (1976) (statutory language and legislative history); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729-749 (1975) (statutory language, judicial treatment, common law, and policy).

A. Liability For Aiding And Abetting Is Fairly Encompassed Within The Existing Private Action Under Rule 10b-5

Musick, Peeler reiterated this Court's recognition of judicial authority to define the contours of the existing private right of action under Rule 10b-5, and to "flesh out" aspects of the law on which the Act and implementing regulations do not offer conclusive guidance. *6113 S. Ct. at 2089, quoting *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 737 (1975); see also *Virginia Bankshares, Inc. v. Sandberg,* 111 S. Ct. 2749, 2764 (1991) (looking to policy considerations to evaluate "rounding out" substance of existing implied right of action). That is what the lower courts have done with respect to aider-and-abettor liability under Rule 10b-5.

In *Musick, Peeler,* this Court treated contribution rights as merely an aspect of the existing Rule 10b-5 private right of action, even though a right of contribution is typically thought to be "a separate or independent cause of action." 113 S. Ct. at 2088. The Court found the contribution action to be sufficiently aligned with the existing private right because it alleged that those from whom contribution was sought had "committed a wrong that courts have already deemed actionable under federal law." *Ibid.* Under that analysis, aider-and-abettor liability is even more clearly comprehended within the existing cause of action. As this Court has indicated in analogous contexts, for purposes of giving content to recognized private rights of action, such theories of secondary liability should not be regarded as "separate" causes of action, but rather as falling within the existing rights of action under which primary liability is imposed.[FN2]

FN2. A private plaintiff often sues the same defendant on both primary violation and aiding-and-abetting theories under Rule 10b-5. See, *e.g., Herman & MacLean,* 459 U.S. at 379 n.5. In addition, unlike a contribution claim-which will frequently be brought after conclusion of the lawsuit establishing overall liability, and which may name as defendants persons who were not parties to the original suit-an aiding-and-abetting claim will often be brought as part of the same lawsuit that alleges the primary violation, and name the same defendants. See 9 L. Loss & J. Seligman, *Securities Regulation* 4481 (3d ed. 1992).

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran,* 456 U.S. 353, 394 (1982), for example, this Court held that where an implied private right of action existed for violations of the Commodity Exchange Act, it *7 "necessarily follow[ed]" that those who conspired to violate the Act were also subject to private suit. The Court did not suggest that it was implying a new or "separate" cause of action for conspiracy, 456 U.S. at 394-395, even though, of course, a conspiracy theory might reach some defendants who had not directly violated the Act. Similarly, in *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.* (*ASME*), 456 U.S. 556, 568-574 (1982), this Court held a defendant secondarily liable for antitrust violations on the theory that its agent acted with apparent authority, analyzing the case as involving the scope of the existing express right of action.[FN3] *Id.* at 569-570.

FN3. In *ASME,* 456 U.S. at 568, the Court cited with approval two federal securities fraud cases involving secondary liability. The first, *Kerbs v. Fall River Indus., Inc.,* 502 F.2d 731 (10th Cir. 1974), which the Court cited for its discussion of apparent authority, is also the leading Tenth Circuit decision allowing private actions against aiders and abettors under Rule 10b-5. In the second case, *Holloway v. Howerdd,* 536 F.2d 690 (6th Cir. 1976), the Sixth Circuit held a brokerage firm secondarily liable on a respondeat superior theory in a private action under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2). Like *Curran* and *ASME,* each of the cases recognized a theory of secondary liability under an existing right of action, without purporting to imply a new or "separate" cause of action.

Aiding and abetting, like apparent authority and conspiracy, is a theory of secondary liability, and one properly encompassed by the existing private action under Rule 10b-5. Despite the suggestions to the contrary by petitioner and its amici (see, *e.g.*, SIA Br. 7-10), this case thus involves no more than the rounding out of the existing implied right of action under Rule 10b-5, and there is no need to take as the central inquiry whether Congress would have intended, in the first instance, to create some wholly independent implied cause of action for aiding and abetting. The result is the same, however, under either approach, because there is substantial *8 evidence of congressional intent to include aiders and abettors in private actions under Rule 10b-5.

B. The Text Of Section 10(b) Supports Imposition Of Liability On Aiders And Abettors

The broad language of Section 10(b) makes it "unlawful for *any person, directly or indirectly,* * * * [t]o use or employ * * * any manipulative or deceptive device or contrivance" "in connection with" the purchase or sale of securities. 15 U.S.C. 78j(b) (emphasis added). Congress thus intended to reach all persons who engage, even if only indirectly, in proscribed activities connected with securities transactions. Moreover, this Court has made clear that the provisions of the securities laws-and Section 10(b) in particular-are to be construed broadly to further their protective and remedial purposes. *Reves v. Ernst & Young,* 494 U.S. 56, 72-73 (1990); *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6, 12 (1971); *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 151 (1972). Although the language of Section 10(b) does not in terms mention aiding and abetting, we think that when read in context it is broad enough to encompass liability for such "indirect" violations.[FN4]

FN4. See *Geo. H. McFadden & Bro. v. Home-Stake Prod. Co.,* 295 F. Supp. 587, 589 (N.D. Okla. 1968) ("directly or indirectly" language in Section 10(b) includes aiders and abettors). See also *SEC v. Universal Major Indus. Corp.,* 546 F.2d 1044, 1046 (2d Cir. 1976), cert. denied, 434 U.S. 834 (1977) ("directly or indirectly" language in Section 5 of the Securities Act of 1933, 15 U.S.C. 77e, includes aiders and abettors); *In re Atlantic Financial Management, Inc.,* 784 F.2d 29, 31 (1st Cir. 1986) (noting that majority of courts of appeals have concluded that "any person" and "directly or indirectly" language of Section 10(b) accommodates some forms of secondary liability), cert. denied, 481 U.S. 1072 (1987); p. 11 & note 9, *infra.*

Petitioner argues, citing *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), that aiders and abettors violate Section 10(b) only if their own actions are manipulative or deceptive. Pet. Br. 10, 13-17, 34, 36, 41. That argument ignores Section 10(b)'s "any person" and "directly or *9 indirectly" language, and the fact that in *Ernst & Ernst,* 425 U.S. at 192 n.7, this Court expressly reserved the question whether aiding-and-abetting liability exists under that section. Petitioner also argues (Br. 19 & n.14) that Section 10(b) imposes no aiding-and-abetting liability because the private rights of action expressly provided by Sections 9 and 18 of the Exchange Act, 15 U.S.C. 78i, 78r, impose none. Those sections are textually similar to Section 10(b): Section 9 uses both the "any person" and "directly or indirectly" language, and Section 18 uses "any person." Moreover, Section 9(e) expressly bases liability on "participat[ion]" in prohibited acts, which plainly encompasses aiding and abetting. Contrary to the SIA's assertion (SIA Br. 12 n.9), courts have indicated that aiding-and-abetting liability is available under both sections,[FN5] and we are aware of no case in which a court has held that such liability is unavailable under either.

FN5. See *Walck v. American Stock Exchange, Inc.,* 565 F. Supp. 1051, 1064 (E.D. Pa. 1981) (Section 9), aff'd, 687 F.2d 778 (3d Cir. 1982), cert. denied, 461 U.S. 942 (1983); *In re Caesars Palace Securities Litigation,* 360 F. Supp. 366, 386 (S.D.N.Y. 1973) (Section 18); *Bloor v. Dansker,* 523 F. Supp. 533, 542 (S.D.N.Y. 1980), aff'd, 754 F.2d 57 (2d Cir. 1985) (same). See also Pet. Br. 19 n.14.

Amicus AICPA's similar reliance (Br. 15) on the lack of aiding-and-abetting liability under Sections 11 and 12 of the Securities Act of 1993, 15 U.S.C. 77k, 77*l*, is misplaced for different reasons. Each of those sections sets forth precise categories of permissible defendants; neither contains the "directly or indirectly" language of Section 10(b); and each imposes a culpability requirement (strict liability or negligence) significantly different from that applicable under Section 10(b). They are thus simply inapposite here. Likewise, petitioner and its amici assert that the "controlling person" provisions of Section 20(a) of the Exchange Act, 15 U.S.C. 78t(a) were intended to supplant all other theories of secondary liability, including aiding and abetting. But the text of the section does not support ***10** that view, and the legislative history indicates that, to the contrary, Section 20(a) was "aimed at expanding liability, rather than contracting it." *In re Atlantic Financial Management, Inc.*, 784 F.2d at 32-34. It is therefore not surprising that every court of appeals that has considered whether Section 20(a) constitutes the sole basis for secondary liability has determined that it does not.[FN6]

FN6. See, *e.g.*, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576-1577 (9th Cir. 1990) (en banc) ("§ 20(a) was intended to supplement, and not to supplant, the common law theory of respondeat superior as a basis for vicarious liability in securities cases"), cert. denied, 499 U.S. 976 (1991). Accord *In re Atlantic Financial Management*, 784 F.2d at 32-34; *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 712-716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118-1119 (5th Cir. 1980); *Holloway*, 536 F.2d at 694-695; *Fey v. Walston & Co.*, 493 F.2d 1036, 1051-1052 (7th Cir. 1974); *Commerford v. Olson*, 794 F.2d 1319, 1322-1323 (8th Cir. 1986); *Kerbs*, 502 F.2d at 740-741. See also *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 182-183 (3d Cir. 1981) (respondeat superior available against broker-dealers and accounting firms in view of "public trust of the firms involved, and the duty to supervise arising therefrom"), cert. denied, 455 U.S. 938 (1982). If Section 20(a) does not supplant respondeat superior, under which an employer may be held strictly liable for the actions of an employee, it certainly should not affect liability for aiding and abetting, which applies only when the defendant's own conduct is culpable.

Section 10(b), and particularly the term "indirectly," must also be interpreted in light of the legal environment concerning secondary liability at the time of Section 10(b)'s enactment. Aiding-and-abetting liability is deeply rooted in the law, and it was well established in both civil and criminal actions by 1934.[FN7] Significantly, aiding-and-***11** abetting liability had been applied by that time in securities fraud and related cases both under state "blue sky" statutes and under the common law.[FN8] In enacting the Exchange Act, Congress intended to expand, not restrict, investor protections under existing law. *Herman & MacLean*, 459 U.S. at 389. It is thus reasonable to conclude that, by selecting the expansive language of Section 10(b), Congress intended to include within its scope the well-established theory of aiding-and-abetting liability. Excluding aiders and abettors from liability would frustrate that intent.

FN7. See, *e.g.*, Restatement of Torts § 876(b) (1939); *Prosser and Keeton on the Law Of Torts* § 46 & nn.8-9 (W. Keeton 5th ed. 1984) (citing pre-1934 civil cases); *Lincoln v. Claflin*, 74 U.S. (7 Wall.) 132, 138 (1869) (civil fraud); Act of Mar. 4, 1909, ch. 321, § 332, 35 Stat. 1152 (now codified at 18 U.S.C. 2) (criminal liability); *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938) (Learned Hand, J.) (criminal case discussing English sources of aiding-and-abetting doctrine dating back to fourteenth century).

FN8. *E.g.*, *Randall v. California Land Buyers' Syndicate*, 20 P.2d 331, 333 (Cal. 1933) (directors who aid and assist issuance of stock in violation of blue sky statute civilly liable to purchaser of stock); *Noll v. Woods*, 203 N.W. 848, 849-850 (Mich. 1925) (investment company president involved in sale of stock liable to purchaser under blue sky statute that referred only to "investment companies" and "dealers"); *Board of Trade v. Price*, 213 F. 336, 337 (8th Cir. 1914) (one who "aids" and "assists" purloining of market quotations may be enjoined in civil action). By early 1933, the blue sky laws of 11 states and the Territory of Hawaii had created private rights of action that expressly imposed liability on aiders and abettors. See Abrams, *The Scope Of Liability Under Section 12 of the Securities Act of 1933: "Participation" and the Pertinent Legislative Materials*, 15 Fordham Urb. L. J. 877, 945 (1987) (citing authorities).

C. Congress Has Declined To Disturb The Courts' Long-standing Interpretation That Aiders And Abettors May Be Included As Defendants In Private Actions Under Rule 10b-5

The right of private plaintiffs to proceed against aiders and abettors under Rule 10b-5 has been widely established in the lower courts for more than 25 years. All 11 of the federal courts of appeals to address this issue have permitted such claims.[FN9] Congress may fairly be presumed *12 to be aware of such an important and widespread judicial interpretation of a statute, and to adopt that interpretation when it comprehensively reenacts or amends the statute without relevant change. *Lorillard v. Pons*, 434 U.S. 575, 580-581 (1978); *Cannon v. University of Chicago*, 441 U.S. 677, 698-699 (1979).

FN9. See the cases cited in notes 10-11 of the government's brief at the petition stage (U.S. Amicus Br. 9-10). The only court of appeals not to address the issue has permitted Rule 10b-5 claims against aiders and abettors in Commission actions. *Dirks v. SEC*, 681 F.2d 824, 844 (D.C. Cir. 1982), rev'd on other grounds, 463 U.S. 646 (1983). See also *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35-36 (D.C. Cir. 1987) (dismissing claim on facts but acknowledging elements of aider-and-abettor liability recognized by other courts of appeals). Commentators have likewise recognized aiding-and-abetting liability under the Rule 10b-5 private action. See Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. Pa. L. Rev. 597, 632-633, 638, 645-646 (1972); 5B A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 40.02 (2d ed. 1993).

In *Herman & MacLean*, the Court unanimously confirmed the cumulative nature of the Rule 10b-5 implied private right of action, rejecting the argument that the plaintiff was limited to express rights. The Court noted that, in 1975, Congress comprehensively amended the Securities Exchange Act, undertaking the "most substantial and significant revision of this country's Federal securities laws since the passage of the Securities Exchange Act in 1934." 459 U.S. at 384-85 (citations omitted). Congress did so without overturning the prevalent judicial interpretation treating the Section 10(b) private right of action as cumulative. "In light of this well-established judicial interpretation, Congress' decision to leave Section 10(b) intact suggests that Congress ratified the cumulative nature of the § 10(b) action."[FN10] 459 U.S. at 385-386.

FN10. Similarly, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. at 376, the Court found that by the time Congress "comprehensively reexamined and strengthened" the Commodity Exchange Act in 1974, federal courts had consistently recognized an implied private right of action under that statute. Accordingly, the implied right was part of the "contemporary legal context," and the fact that the 1974 amendments "left intact the statutory provisions under which the federal courts had implied a cause of action * * * evidence[d] that Congress affirmatively intended to preserve that remedy." *Id.* at 381-382.

*13 That principle applies with even greater force to private aiding and abetting liability under Section 10(b). When Congress comprehensively amended the Exchange Act in 1975, it specifically focused on the private action, overturning court decisions involving Section 10(b) private rights of action with which it disagreed.[FN11] It did not, however, disturb the by then widespread recognition by the federal courts that aiders and abettors could be sued in such actions,[FN12] although it plainly knew how to do so had it desired such a result.

FN11. See Section 21(g) of the Exchange Act, 15 U.S.C. 78u(g) (prohibiting consolidation of Commission injunctive actions with private actions in the absence of Commission consent); S. Rep. No. 75, 94th Cong., 1st Sess. 75-77 (1975) (citing decisions disapproved by Congress).

FN12. For some ten years prior to 1975 a large and growing body of courts, including five federal courts of appeals, had embraced aiding and abetting liability in Rule 10b-5 private actions. See, *e.g.*, *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680-681 (N.D. Ind. 1966); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.), cert. denied, 396 U.S. 838 (1969); *Landy v. FDIC*, 486 F.2d 139, 162-163 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); *Kerbs*, 502 F.2d at 740; *Zabriskie v. Lewis*, 507 F.2d 546, 554 (10th Cir. 1974); *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1278 (2d Cir. 1973) (en banc) (dictum); *Green v. Jonhop, Inc.*, 358 F. Supp. 413, 419 (D. Or. 1973); *Anderson v. Francis I. DuPont & Co.*, 291 F. Supp. 705, 709 (D. Minn. 1968); *Fischer v. Kletz*, 266 F. Supp. 180, 190 (S.D.N.Y. 1967); *Pettit v. American Stock Exchange*, 217 F. Supp. 21, 28 (S.D.N.Y. 1963). See also Ruder, *supra*, 120 U. Pa. L. Rev. at 599. As petitioner concedes (Br. 29), no court has held to the contrary.

Later Exchange Act amendments also reflect congressional approval both of implied private actions and of aiding and abetting liability. In 1977, Congress enacted the Foreign Corrupt Practices Act, Pub. L. No. 95-213, 91 Stat. 1494, which among other things, amended the Exchange Act. The House Committee explicitly approved existing Exchange Act implied private rights of action, ***14** expressing its intent that "the courts shall recognize a private cause of action based on this legislation, as they have in cases involving other provisions of the Securities Exchange Act, on behalf of persons who suffer injury as a result of prohibited [practices]." H.R. Rep. No. 640, 95th Cong., 1st Sess. 10 (1977). Likewise, in 1984 Congress passed the Insider Trading Sanctions Act, Pub. L. No. 98-376, § 2, 98 Stat. 1264, which added a treble civil penalty provision applicable in Commission enforcement actions to tippers who aid or abet insider trading violations. 15 U.S.C. 78u(d)(2)(A) (Supp. V 1987). The House Report particularly "endorse[d] the judicial application of the concept of aiding and abetting liability to achieve the remedial purposes of the securities laws." H.R. Rep. No. 355, 98th Cong., 2d Sess. 10 (1983). In addition to a Commission case, the report cited *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978), a leading Second Circuit decision that held an aider and abettor liable in a private action under Rule 10b-5.

Even more recently, Congress amended the Exchange Act in the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 5, 102 Stat. 4680 That Act added Exchange Act Section 20A, which provides an express action to contemporaneous traders for insider trading violations, and states that "[n]othing in this section shall be construed to limit or condition * * * the availability of any cause of action implied from a provision of this title." 15 U.S.C. 78t-1(d); see also H.R. Rep. No. 910, 100th Cong., 2d Sess. 27 n.23 (1988) (1988 Act would not "affect the availability of any other theories of liability, such as aiding and abetting[,] * * * in appropriate circumstances"). Last term this Court construed the enactment of Section 20A as a congressional "acknowledgement" of the existence of the private action under Rule 10b-5, and of judicial authority "to shape, within ***15** limits, the 10b-5 cause of action." *Musick, Peeler*, 113 S. Ct. at 2089.[FN13]

FN13. The history of the 1988 legislation likewise acknowledges the existence of the implied private right under Rule 10b-5. See, *e.g.*, 134 Cong. Rec. 17,218, 17,220 (1988) (remarks of Senator Garn).

In the face of this recent evidence of congressional approval, petitioner (Br. 20-22 & n.15) and its amici (AICPA Br. 12 n.7; SIA Br. 15-16) assert to the contrary that Congress's "rejection" of amendments proposed in 1957, 1959 and 1960 demonstrates an intent to exclude aiders and abettors from liability. That argument mischaracterizes the legislative history. The proposal in question, originally part of a proposed comprehensive revision of the federal securities laws, would have amended Exchange Act Section 20(b), and was intended to confirm the Commission's right (then established in the courts) to proceed against aiders and abettors. It was not intended to address private rights of action. See *Hearings on Senate Bills 1178-1182 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 86th Cong., 1st Sess. 335 (1959) (Commission statement). Moreover, the proposal was not "rejected." In 1960, the responsible House committee reported favorably on the original legislation, and the Senate passed a modified version, which would have amended the Commission's express right to seek injunctive relief under Exchange Act Section 21 (referred to incorrectly in the Senate report as Section 20(b)). See H.R. Rep. No. 2177, 86th Cong., 2d Sess. (1960); S. Rep. No. 1757, 86th Cong., 2d Sess. (1960); 106 Cong. Rec. 15,613, 16,457-16,458 (1960). Further consideration of the proposal was postponed, however, "due to the lack of time remaining in the term," L. Loss & J. Seligman, *Securities Regulation* 205-206 & n.80 (2d ed. 1961) (quoting 106 Cong. Rec. 15,611-15,612 (1960)); see also *Brennan*, 259 F. Supp. at 677-680, and it was not revived in subsequent Congresses. In any event, the more recent legislative record, developed at a time when the courts had uniformly ***16** approved aiding and abetting liability under 10(b), provides far more compelling evidence of congressional intent.

D. Policy Considerations Support The Inclusion Of Aiders And Abettors As Defendants

As this Court has noted, the Commission has only limited resources to detect or investigate federal securities law violations, and private actions accordingly serve as "a necessary supplement to Commission action." *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964); *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988). In the Commission's own actions under Rule 10b-5, the established right to proceed against aiders and abettors is critical to effective enforcement. See note 15, *infra*. The private right of action's effectiveness as a supplement to Commission enforcement would be severely undercut if it did not also reach aiders and abettors.

Private actions also serve the compensatory purposes of the securities laws. Although the Commission may seek certain monetary relief, its remedies are designed primarily to deter violations by making them unprofitable, rather than to make investors whole. See *SEC v. Coven*, 581 F.2d 1020, 1027-1028 (2d Cir. 1978), cert. denied, 440 U.S. 950 (1979). Accordingly, the primary means of compensating injured investors remains the private action, and all participants in a fraud should be liable in order to ensure full recovery.

Amicus AICPA asserts (Br. 17-20) that aiding and abetting liability sweeps too broadly and that it is too easy for a plaintiff to allege that routine business functions aid and abet violations of the securities laws. It is possible, of course, for any private right of action under the securities laws to give rise to some unfounded or vexatious claims. The proper response to such problems, however, is not to jettison a whole class of defendants or substantive theory of liability (such as aiding and abetting), but rather to ***17** fashion safeguards to reduce frivolous claims against both primary violators and aiders and abettors.[FN14]

FN14. The AICPA also asserts (Br. 17-19), as a policy reason for eliminating aiding and abetting liability, that an "explosion" of litigation against accountants has led to their "virtually limitless liability." If so, however, then the "explosion" is taking place within the overall bounds of existing litigation: the number of district court securities laws cases appears not to have increased during the last two decades. See *Concerning Private Litigation Under the Federal Securities Laws: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 103d Cong., 1st Sess. 8-11 (1993) (testimony of William R. McLucas, Director of the Commission's Division of Enforcement). In addition, much of the asserted increase in liability may be based on state law negligence claims, and hence would not be affected by changes in the federal securities laws or private rights of action under them. *Ibid.*

Finally, as noted above, it has long been settled in the lower courts that private plaintiffs may sue aiders and abettors under Rule 10b-5. Many hundreds of reported cases reflect this uniformity. A decision by this Court dispensing with aiding and abetting liability in private actions would unquestionably have a major impact on the well-established law governing such actions. The Court should thus give considerable weight to the lower courts' longstanding acceptance of the aiding and abetting principle of liability. See *Musick, Peeler,* 113 S. Ct. 2091; *Blue Chip Stamps,* 421 U.S. at 733; see also *Curran,* 456 U.S. at 376. Indeed, in discussing the implied private right of action under Rule 10b-5, this Court has acknowledged that a rule of law consistently applied for several decades may become established "beyond peradventure." *Herman & MacLean,* 459 U.S. at 380. Particularly in light of the evidence of congressional approval discussed above, any decision to reverse direction and reject aider and abettor liability under Rule 10b-5 would, at this late date, be better left to Congress.[FN15]

FN15. Commission actions under Exchange Act Section 21(d), while not involved here, also routinely seek relief against aiders and abettors. For decades, the courts have uniformly permitted the Commission to include such defendants in Rule 10b-5 cases. *E.g., SEC v. Coffey,* 493 F.2d 1304, 1316 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975); *SEC v. Timetrust, Inc.,* 28 F. Supp. 34, 43 (N.D. Cal. 1939) (action under Securities Act Section 17(a)). In fiscal 1992, more than 15% of the Rule 10b-5 cases brought by the Commission included an assertion of liability for aiding and abetting. Elimination of such liability would sharply diminish the effectiveness of Commission actions. Moreover, because Commission cases are brought by a government agency, are prophylactic in nature, and seek equitable relief, the rationale for permitting aiding and abetting liability in those actions is somewhat different from (and even stronger than) the rationale in private damages actions. Accordingly, whatever the result for private actions, the Court's decision should preserve the availability of aiding and abetting liability in Commission actions.

*18 II. RECKLESSNESS SATISFIES THE SCIENTER REQUIREMENT FOR AIDING-AND-ABETTING LIABILITY UNDER SECTION 10(B) AND RULE 10B-5

A. A Recklessness Standard For Aiding-And-Abetting Liability Comports With The Language And Purposes Of Section 10(b) And Rule 10b-5, While A Conscious Intent Standard Would Frustrate The Purposes Of The Statute And The Rule

The precise formulation for establishing aiding and abetting liability varies among the circuits, but in general a plaintiff must prove: (1) a Rule 10b-5 violation by another; (2) substantial assistance by the defendant in achieving the violation; and (3) scienter on the part of the defendant.[FN16] This case concerns only the last element of the test. In our view, the court of appeals correctly adopted a recklessness standard for aiding-and-abetting liability under Rule 10b-5 where the defendant's affirmative acts *19 assisted another's violation of the Rule.[FN17] Recklessness satisfies the scienter requirement for primary violations of Rule 10b-5, and the rationale used in that setting applies equally to aiding and abetting.[FN18]

FN16. See U.S. Cert. Br. 10 n.11 (collecting cases). The Seventh Circuit's test is more restrictive, requiring that the aider and abettor "(1) commit one of the 'manipulative or deceptive' acts prohibited under section 10(b) and rule 10b-5 (2) with the same degree of scienter that primary liability requires." *Robin v. Arthur Young & Co.,* 915 F.2d 1120, 1123 (7th Cir. 1990), cert. denied, 111 S. Ct. 1317 (1991).

FN17. The Tenth Circuit, like most courts of appeals (see U.S. Cert. Br. 11 n.13), follows the Seventh Circuit's definition of recklessness, under which a reckless action would be "a highly unreasonable [action], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.) (citation omitted), cert. denied, 434 U.S. 875 (1977).

FN18. One possible exception involves an alleged aider and abettor who has no independent duty to disclose or act, and whose only substantial assistance consists of silence and inaction. Under those circumstances, courts of appeals have indicated that conscious intent to aid the fraudulent scheme is or may be required. See, *e.g.*, Pet. App. A17-A18 (citing cases). This case, however, raises no such question, and we take no position on that issue. (We also take no position on the question, not raised here, whether petitioner in fact owed respondents any independent duty of disclosure.) We agree with the court of appeals, *id.* at A6-A8, A23, that petitioner's conduct constituted affirmative action. Petitioner's retraction of its demand for an independent appraisal is unlike conduct that the courts have held to consist of mere silence and inaction. See, *e.g.*, *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 776-779 (1st Cir. 1983) (persons named as directors in offering memorandum without their knowledge or consent, and who had taken no actions and made no representations); see also Pet. App. A16-A19 (finding genuine factual dispute over whether another defendant in this case substantially assisted the alleged fraud through silence and inaction).

1. *The recklessness standard applies to primary*

. In *Ernst & Ernst v. Hochfelder*, this Court examined the language of Section 10(b) and evidence of congressional intent, and concluded that the statute requires "some element of scienter and cannot be read to impose liability for negligent conduct alone," 425 U.S. at 201, for "wholly faultless conduct," *id.* at 198, or for acts performed "in good faith," *id.* at 206. A recklessness standard does not, of course, impose liability for negligent, ***20** faultless or good faith conduct. In analyzing the culpability standard under Section 10(b), the Court in *Ernst & Ernst* considered the express civil remedies in favor of purchasers or sellers of securities under the Securities Act and the Exchange Act. *Id.* at 206-208. For purposes of this case, it is significant that recklessness is sufficient to satisfy the culpability requirements under those sections.[FN19]

FN19. See Securities Act §§ 11 (strict liability and negligence), 12(2) (negligence) and 15 (negligence), 15 U.S.C. 77k, 77*l*(2) and 77*o*; Exchange Act §§ 9(e) ("willfully," a term this Court has interpreted in other contexts to include reckless disregard, see *Hazen Paper Co. v. Biggins*, 113 S. Ct. 1701, 1708-1709 (1993)), 18 ("good faith" defense), and 20 ("good faith" defense), 15 U.S.C. 78i, 78r and 78t.

Moreover, the Court recognized in *Ernst & Ernst* that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct," and indicated, without deciding, that recklessness could satisfy the scienter requirement.[FN20] 404 U.S. at 194 n.12. The *Ernst & Ernst* Court likely had common law fraud in mind as one area of law where recklessness is considered to be a form of intentional conduct. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d at 45 (common law as source of securities law concepts); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976) (common law deceit and misrepresentation relevant in interpreting Rule 10b-5); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979) (useful, after *Ernst & Ernst*, to analogize between common law ***21** fraud and Rule 10b-5).[FN21] For purposes of common law fraud, recklessness is considered to be a form of intentional conduct, and satisfies the scienter requirement for primary liability.[FN22] One who acts with reckless disregard of potentially harmful consequences is just as culpable as one who acts with actual knowledge of such consequences.[FN23]

FN20. Petitioner erroneously suggests that the Court viewed Section 10(b) as requiring "conscious intent." Pet. Br. 36; see also AICPA Br. 23; SIA Br. 18-21. The Court, however, stated only that scienter "refers to a mental state embracing intent to * * * defraud," and that the statute proscribes "knowing or intentional misconduct," *Ernst & Ernst,* 425 U.S. at 194 n.12, 197, and it explicitly noted that recklessness might be considered "a form of intentional conduct" for these purposes. *Id.* at 194 n.12. Moreover, "'[k]nowing' is a word laden with common law connotations: at common law, reckless conduct is viewed as a form of knowing conduct." *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d at 45.

FN21. Petitioner (Br. 36) and amicus SIA (Br. 21) incorrectly suggest that criminal law is the proper source to determine the scienter required for aiding and abetting liability. In fact, the courts have properly looked to common law fraud for guidance with respect to scienter under Rule 10b-5. See, *e.g., Rolf,* 570 F.2d at 46; AICPA Br. 22; Johnson, *Liability for Reckless Misrepresentations and Omissions under Section 10(b) of the Securities Exchange Act of 1934,* 59 U. Cin. L. Rev. 667, 696 (1991) (cited by both SIA and AICPA). The decisions of this Court cited by the SIA (Br. 21 n.21) stand only for the proposition that courts should evaluate whether relevant market conditions or other circumstances are so different from those under which the common law developed that a particular common law rule may not furnish complete or appropriate guidance for modern securities law. See *Basic Inc. v. Levinson,* 485 U.S. at 243-244; *Herman & MacLean,* 459 U.S. at 388-389; *Blue Chip Stamps,* 421 U.S. at 744-745. Such an evaluation in this case reveals no difference in circumstances pertinent to the degree of culpability that should be required to impose liability for aiding and abetting a fraud. Moreover, both *Basic Inc.* and *Herman & MacLean* rejected common law analogies that would have tended to thwart the Exchange Act's protective purposes; here, in contrast, reliance on the common law would *avoid* a restrictive scienter requirement that would conflict with those purposes. See Johnson, *supra,* 50 U. Cin. L. Rev. at 710.

FN22. See Restatement (Second) of Torts § 526(b), comment e (1977); *Prosser & Keeton, supra,* § 107, at 741-742.

FN23. *Derry v. Peek,* 14 App. Cas. 337 (H.L. 1889) ("a person making a false statement [who] had shut his eyes to the facts, or purposely abstained from inquiring into them, * * * [is] just as fraudulent as if he had knowingly stated that which was false"); *State Street Trust Co. v. Ernst,* 15 N.E.2d 416, 418-419 (N.Y. 1938) (accountant's "refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud"; "heedlessness and reckless disregard of consequence may take the place of deliberate intention"). See also *Lehigh Zinc & Iron Co. v. Bamford,* 150 U.S. 665, 673 (1893) (one who makes representations of material facts, when he is conscious that he has no knowledge of the existence of such facts, is as much responsible for the injurious consequences as if he actually knew them to be false).

***22** One underlying rationale for this rule is, of course, to discourage deliberate ignorance of facts indicating fraud. See, *e.g., State Street Co. v. Ernst,* 15 N.E.2d 416, 418-419 (N.Y. 1938). The rule also prevents a defendant from escaping liability simply by denying, falsely, any conscious intent to defraud. Proving such intent can be a daunting task, particularly when (as is frequently the case) the evidence is entirely circumstantial. In the face of these difficulties, the Commission and private parties routinely rely on proof of recklessness in complex Rule 10b-5 fraud cases. Insistence on a conscious intent standard would permit much deliberately wrongful conduct to escape liability, and "would for all intents and purposes disembowel the private cause of action under [Section] 10(b)." *Rolf*, 570 F.2d at 47.[FN24]

FN24. See also *Mansbach*, 598 F.2d at 1025; *Hackbart v. Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982); *G. A. Thompson & Co. v. Partridge*, 636 F.2d 945, 961 n.32 (5th Cir. 1981); cf. *Herman & MacLean*, 459 U.S. at 390-391 n.30 ("If anything, the difficulty of proving the defendant's state of mind supports a lower standard of proof."). Petitioner and its amici offer no response to this weighty consideration, even though the authorities they cite view it as a reason why the recklessness standard is appropriate. See Ruder, *supra*, 120 U. Pa. L. Rev. at 634-636; Johnson, *supra*, 59 U. Cin. L. Rev. at 679.

A recklessness standard is therefore a practical necessity for the effectiveness of aiding and abetting liability-both in private actions such as this one and, importantly, in the Commission's own enforcement program. Scienter is required under Rule 10b-5 in both types of action (see *Aaron v. SEC*, 446 U.S. 680 (1980)), and the same standard will presumably be applied in both. Since *Ernst & Ernst*, every court of appeals that has considered whether recklessness suffices for primary *23 liability under Rule 10b-5 has held that it does,[FN25] and this Court should now confirm that conclusion.

FN25. See U.S. Cert. Br. 11 n.13, Several courts of appeals have expressly relied on the common law. See *id.* at 13 n.16. The courts have also generally relied both on the difficulties of proving conscious intent and on the broad remedial purposes of Section 10(b). See *Mansbach*, 598 F.2d at 1024-1025; *Hackbart*, 675 F.2d at 1117; *Sundstrand*, 553 F.2d at 1044. Prior to *Ernst & Ernst*, many courts that required scienter had held that recklessness sufficed. See, *e.g.*, *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc); *Coffey*, 493 F.2d at 1314. Recklessness also satisfies scienter under the American Law Institute's proposed Federal Securities Code. ALI, *Federal Securities Code* §§ 202(147), 202(86) & comment 8 (1980).

2. *The rationale for the recklessness standard applies to aiding and abetting liability.* The reasons for adopting the recklessness standard for primary liability under Rule 10b-5 apply equally to aiding and abetting. The language of Section 10(b) considered by the Court in *Ernst & Ernst* is, of course, the same in both cases. Moreover, courts in fraud cases have recognized that recklessness satisfies the scienter requirement for common law aiding and abetting. See generally Restatement (Second) of Torts, *supra*, § 876(b); see, *e.g.*, *FDIC v. First Interstate Bank, N.A.*, 885 F.2d 423, 431 (8th Cir. 1989) (actual knowledge not required for aiding and abetting common law fraud). Requiring conscious intent would encourage aiders and abettors, as it would primary violators, to deliberately ignore facts indicating fraud. And proving conscious intent to defraud is equally difficult whether the case involves primary liability or aiding and abetting. See Kuehnle, *Secondary Liability Under the Federal Securities Laws*, 14 J. Corp. L. 313, 324, 327 (1988). Since *Ernst & Ernst*, every court of appeals that has considered whether recklessness satisfies the scienter requirement for aiding and abetting under Rule 10b-5 has held that it does in at least some circumstances.[FN26]

FN26. See U.S. Cert. Br. 12 n.14. As with primary liability, many courts requiring scienter for Rule 10b-5 aiding and abetting prior to *Ernst & Ernst* also held that recklessness sufficed. See, *e.g.*, *Rochez Bros. v. Rhoades*, 527 F.2d 880, 886 (3d Cir. 1975); *SEC v. First Securities Co.*, 463 F.2d 981, 987 (7th Cir.), cert. denied, 409 U.S. 880 (1972); *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541 (2d Cir. 1973). See also *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (en banc) (Friendly, J., concurring) (acknowledging that recklessness may be a form of scienter), cert.

denied, 394 U.S. 976 (1969).

*24 Furthermore, a recklessness standard for aiding and abetting comports with the purposes of Section 10(b). See Ruder, *supra*, 120 U. Pa. L. Rev. at 645-646. This Court has long noted that Section 10(b) serves broad remedial purposes, and has stated that the securities laws should be liberally construed to effectuate those purposes. See, *e.g.*, *Herman & MacLean*, 459 U.S. at 386-387. By facilitating enforcement of Rule 10b-5, the recklessness standard promotes the congressional policy embodied in the 1934 Act. See *Basic Inc.*, 485 U.S. at 245. The higher conscious intent standard, by contrast, would impede both Commission and private enforcement of the Act, thereby impairing the securities laws' function of protecting investors.[FN27]

FN27. Petitioner's reliance (Br. 41, 48; SIA Br. 8, 27-28) on *Chiarella v. United States*, 445 U.S. 222 (1980) in determining scienter for aiding-and-abetting liability is misplaced. *Chiarella* dealt with an alleged primary violator who was silent and had no duty to speak. Petitioner does not dispute that the primary violators in this case were not silent, but made affirmative misrepresentations. The *Chiarella* duty analysis simply does not apply to such misrepresentations. Moreover, *Chiarella* did not discuss what constitutes scienter. Amicus SIA's reliance (Br. 27-28) on *Dirks v. SEC*, 463 U.S. 646 (1983), is also misplaced. The Court expressly stated in *Dirks* that the issue in the case was not scienter, but only whether the alleged primary violator had engaged in wrongful conduct. 463 U.S. at 663 n.23.

B. The Recklessness Standard Is Flexible, Predictable, And Preferable To Other Approaches

In addition to the approach adopted by the court of appeals here-applying a recklessness standard where the aider and abettor's conduct consisted of affirmative *25 action[FN28]-the lower courts have used two other main approaches in analyzing the scienter requirement for aiding-and-abetting liability under Rule 10b-5: the "duty" approach and the "sliding scale" approach.

FN28. The approach in this case is essentially the same as that taken by the Ninth Circuit in *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1484-1485 & nn.4-5 (9th Cir. 1991), and is consistent with those decisions that have suggested that recklessness would satisfy the scienter requirement in *all* Rule 10b-5 aiding-and-abetting cases. See *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981); *DCD Programs, Ltd. v. Leighton*, 833 F.2d 183, 188-189 (9th Cir. 1987).

Applying the former approach, some courts have held that recklessness does not suffice for Rule 10b-5 aiding-and-abetting liability absent breach of a duty to disclose or act. See U.S. Cert. Br. 15-16 & nn.20-21. Absent such a breach, a plaintiff must always prove conscious intent to defraud, even if the defendant's substantial assistance consisted of affirmative action. See, *e.g.*, *Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990); *Schatz v. Rosenberg*, 943 F.2d 485, 496 (4th Cir. 1991).

Several other courts have applied the "sliding scale" approach, under which the scienter standard depends both on the nature of the conduct and on whether the defendant had a duty to disclose.[FN29] A defendant who affirmatively acts to assist a fraudulent scheme but who has no duty to disclose is liable for aiding and abetting only if the plaintiff can prove "conscious intent [,] unless * * * the assistance is unusual, * * * in which case recklessness will suffice." *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 531 (5th Cir. 1992).

FN29. See, *e.g.*, *Woodward v. Metro Bank*, 522 F.2d 84, 95-97 (5th Cir. 1975); *Metge v. Baehler*, 762 F.2d 621, 624-625 (8th Cir. 1985), certs. denied, 474 U.S. 1057 and 474 U.S. 1072 (1986); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480-1481 (11th Cir. 1988), cert. denied, 490 U.S. 1091 (1989). Petitioner uses the term "sliding scale" differently (Br. 38-40), combining the "duty" and "sliding scale" approaches discussed here to produce a "majority rule sliding scale" approach.

*26 In contrast to those approaches, the standard we urge focuses on recklessness-that is, an extreme departure from ordinary care (see note 17, *supra*). It requires a state of mind closer to conscious intent than to gross negligence. In our view, it combines flexibility and predictability more effectively than either the "duty" or the "sliding scale" approach. What is a "highly unreasonable" omission or an "extreme" departure from "standards of ordinary care" turns on the facts of each case. That focus accords with the judicial view that aiding-and-abetting liability should be determined flexibly, based on particular circumstances. See, *e.g., Camp v. Dema*, 948 F.2d 455, 459 (8th Cir. 1991); *Woodward*, 522 F.2d at 94; *FDIC v. First Interstate Bank, N.A.*, 885 F.2d 423, 429 (8th Cir. 1989).

The "duty" approach lacks this flexibility and places too severe a limit on Rule 10b-5 aiding and abetting liability based on a defendant's affirmative acts. The source of the idea that scienter for aiding and abetting liability should turn on a duty to disclose or act is unclear. Where aiding and abetting consists of silence and inaction, requiring a breach of duty before imposing liability is arguably consistent with the common law precept that mere bystanders are not liable if they have no duty to speak or act.[FN30] Where the defendant takes affirmative action, however, the rationale for such protection does not exist.[FN31] To engraft a duty requirement on Rule 10b-5 aiding and ***27** abetting liability in the latter circumstances would serve no useful purpose, and would only pointlessly hinder both Commission and private enforcement of the securities laws.

FN30. See *Prosser & Keeton, supra*, § 56, at 373-377 (citing cases); *Louisville & N. R.R. v. Scruggs & Echols*. 49 So. 399, 400 (Ala. 1909) ("law imposes no duty on one man to aid another"). See also Restatement (Second) of Torts, *supra*, § 551(2)(a). Petitioner claims (Br. 47) that a rule distinguishing action from inaction is unworkable. That distinction, however, is fundamental in the law, including in traditional determinations of "bystander" liability.

FN31. See *Prosser & Keeton, supra*, § 56, at 378-382 (citing cases); *Black v. New York, N.H. & H. R.R.*, 79 N.E. 797, 798 (Mass. 1907) (once aid is undertaken, actor must use ordinary care); *Zelenko v. Gimbel Bros.*, 287 N.Y.S. 134, 135 (Sup. Ct. 1935) aff'd, 287 N.Y.S. 136 (App. Div. 1936) (same).

While flexible, the recklessness standard sets a high level of culpability: a form of intent, and a standard clearly distinguishable from negligence.[FN32] Fears of unwarranted liability are thus exaggerated. See Ruder, *supra*, 120 U. Pa. L. Rev. at 632-633, 638.[FN33] Experience suggests that courts have not hesitated, in appropriate circumstances, to find defendants (either primary violators or aiders and abetters) in Rule 10b-5 actions not liable under a recklessness standard.[FN34] Indeed, if the Court upholds ***28** application of that standard in this case, petitioner will have every opportunity to demonstrate at trial that its actions were in fact routine and reasonable, or otherwise not reckless. Thus, although some courts have expressed concern that participants in routine business transactions should not be liable for aiding and abetting absent conscious intent,[FN35] such concern is not warranted. The recklessness standard accommodates distinctions among varying types of assistance, as well as differences in the level, remoteness, and routineness of the conduct.[FN36]

FN32. The Court recognized this distinction in *Ernst & Ernst*, 425 U.S. at 193-194 n.12, 197, 199, 201. See also *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977), cert. denied, 450 U.S. 1005 (1981) (recklessness should be regarded as a "lesser form of intent" rather than "merely a greater degree of ordinary negligence"). The *Sundstrand* standard (see note 17, *supra*) is generally considered to impose a relatively high level of culpability. See, *e.g., Broad v. Rockewell Int'l Corp.*, 642 F.2d 929, 961-962 (5th Cir.), cert. denied, 454 U.S. 965 (1981); *G.A. Thompson & Co.*, 636 F.2d at 945; *White v. Sanders*, 689 F.2d 1366, 1367 n.4 (11th Cir. 1982). Historically, moreover, the recklessness standard developed in contradistinction to negligence. At common law, recklessness, like conscious intent, involves a culpable mental state, while negligence does not. See *Prosser & Keeton, supra* § 107; Restatement (Second) of Torts, *supra*, §§ 552 comment a, 526(b) comment e. Cf. *Hazen Paper Co. v. Biggins*, 113 S. Ct. 1701, 1708-1710 (1993) ("willfulness" equated to "knowledge or reckless disregard").

FN33. In relying (Pet. Br. 49) on the statement that "[k]nowledge of wrongful purpose thus becomes a crucial element in aiding and abetting" cases, 120 U. Pa. L. Rev. at 630-631, petitioner overlooks Ruder's elaboration that recklessness satisfies that requirement. *Id.* at 636, 638.

FN34. See, *e.g., Marbury Management, Inc. v. Kohn*, 470 F. Supp. 509 (S.D.N.Y. 1979) (alleged aiders and abettors); *Lingenfelter v. Title Ins. Co.*, 442 F. Supp. 981 (D. Neb. 1977) (same); *Hoffman v. Estabrook & Co.*, 587 F.2d 509 (1st Cir. 1978) (alleged primary violators); *Cook v. Avien, Inc.*, 573 F.2d 685 (1st Cir. 1978) (same); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111 (2d Cir. 1982) (same); *State Teacher's Retirement Board v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981) (same); *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979) (same); *Coleco Industries, Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977), cert. denied, 439 U.S. 830 (1978) (same); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929 (5th Cir.), cert. denied, 454 U.S. 965 (1981) (same); *Croy v. Campbell*, 624 F.2d 709 (5th Cir. 1980) (same); *Sanders v. John Nuveen & Co.* 554 F.2d 790 (7th Cir. 1977), cert. denied, 450 U.S. 1091 (1989) (same).

FN35. See, *e.g., Camp*, 948 F.2d at 459-464; *Woods, v. Barnett Bank* 765 F.2d 1004, 1009-1010 (11th Cir. 1985); *Woodward*, 522 F.2d at 97, 100.

FN36. The recklessness standard is nonetheless more restrained in its flexibility than is the "sliding scale" approach. Recklessness, for example, must take current standards of conduct applicable to the defendant's profession or position. The "sliding scale" approach has no similar reference to provide guidance.

The recklessness standard is also predictable. A potential aider and abettor knows that his affirmative conduct will be judged under a recklessness standard according to objective standards applicable to the particular situation. The "sliding scale" approach lacks this predictability; indeed, the need to categorize varying fact patterns simply in order to determine the applicable standard of scienter complicates the analysis and increases the possibility of conflicting results. Finally, to the extent that the "sliding scale" approach ultimately imposes a conscious intent standard, it adversely affects enforcement of the securities laws.[FN37]

FN37. Petitioner argues (Br. 43-44) that this Court should adopt the Seventh Circuit's approach (see note 16, *supra*). Even the authority petitioner cites (Br. 38, 40) acknowledges, however, that that court has effectively abolished Rule 10b-5 aiding-and-abetting liability, in a striking departure from the consensus among the other courts of appeals. Feldman, *The Breakdown of Securities Fraud Aiding and Abetting Liability: Can A Uniform Standard Be Resurrected?*, 19 Sec. Reg. L.J. 45, 59-64, 66-67, 69, 71 (1990).

***29** The AICPA and SIA argue that a recklessness standard is arbitrary and virtually indistinguishable from negligence. SIA Br. 22-26; AICPA Br. 27-28. But the primary authority cited for that proposition in fact disagrees with their view that the recklessness standard should be abandoned, concluding instead that it should satisfy Rule 10b-5's scienter requirement and that its rejection would mark a radical departure from settled common law. Johnson, *supra*, 59 U. Cin. L. Rev. at 695-696, 705-706, 710. For the most part, amici's criticism is directed not to the prevailing *Sundstrand* standard of recklessness (see note 17, *supra*), but rather to standards never used, or now abandoned, in Rule 10b-5 cases.[FN38] Nor has the Commission criticized the *Sundstrand* standard, properly construed, as being unworkable or indistinguishable from negligence.[FN39]

Compare SIA Br. 23.

FN38. *Smith v. Wade*, 461 U.S. 30 (1983), from which the SIA quotes only the dissent (SIA Br. 22), involved neither fraud nor securities. Moreover, the majority there was "*not* persuaded that a recklessness standard is too vague to be fair or useful." 461 U.S. at 49 (emphasis added).

FN39. The Commission has taken the position that recklessness should be defined as a "conscious indifference to the truth." See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), cert. denied, 499 U.S. 976 (1991), SEC Br. Re Rehearing 13-14. That definition, however, is derived from common law deceit and fraudulent misrepresentation-not, as the SIA erroneously suggests (SIA Br. 24), from concepts of negligence.

In sum, the scienter standard for aiding and abetting liability under Rule 10b-5 should be neither so low that liability exposure is excessive, nor so high that unlawful activity will escape deterrence and remediation. The recklessness standard avoids both liability for good faith or merely negligent conduct, and the undue weakening of ***30** the securities laws that would result from insistence on often elusive proof of conscious intent.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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Securities and Exchange Commission

SEPTEMBER 1993

CENTRAL BANK OF DENVER, N.A., Petitioner, v.
FIRST INTERSTATE BANK OF DENVER, N.A., and
Jack K. Naber.
1993 WL 13006275 (U.S.) (Appellate Brief)

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H

United States District Court,
S.D. New York.
In re **REFCO**, INC. SECURITIES LITIGATION.
No. 05 Civ. 8626(GEL).

March 17, 2009.

Background: In putative securities fraud class action arising from the collapse of international brokerage firm, firm's outside counsel moved to dismiss claims brought against them.

Holding: The District Court, Gerard E. Lynch, J., held that allegations failed to state securities fraud claims against outside counsel as primary violator of antifraud provisions of federal securities laws.

Motion granted.

West Headnotes

[1] Securities Regulation 349B ⟹60.51(1)

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.50 Pleading
349Bk60.51 In General
349Bk60.51(1) k. In General. Most Cited Cases

In cases where it is not a statement or omission that is alleged, but rather, a fraudulent scheme to affect the price of stocks, it is sufficient under Private Securities Litigation Reform Act (PSLRA) to specify what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the securities at issue. Private Securities Litigation Reform Act of 1995, § 101(b)(1), 15 U.S.C.A. § 78u-4(b)(1).

[2] Securities Regulation 349B ⟹60.18

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.18 k. In General. Most Cited Cases

In order for a securities fraud defendant to be held liable for a claim brought under Rule 10b-5, a plaintiff must allege that the defendant made a false or misleading statement or omission that investors attributed to him or her, or that the defendant participated in a fraudulent scheme or other activity proscribed by the securities laws. 17 C.F.R. § 240.10b-5.

[3] Securities Regulation 349B ⟹60.30

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.30 k. Conduct of Accountants, Attorneys or Other Professionals. Most Cited Cases

Investors' allegations that issuer's outside counsel was involved in the preparation and review of allegedly fraudulent the offering documents were insufficient to allege that outside counsel "made" the alleged material misstatements and omissions upon which investors relied, and therefore investors failed to state securities fraud claims against outside counsel as primary violator of antifraud provisions of federal securities laws; even if outside counsel played a substantial role in drafting the offering documents, investors failed to allege that they reasonably understood outside counsel to be speaking through the documents at the time of their release. 17 C.F.R. § 240.10b-5(b).

[4] Securities Regulation 349B ⚷60.30

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.30 k. Conduct of Accountants, Attorneys or Other Professionals. Most Cited Cases

A lawyer who makes a material misstatement or omission on which a purchaser or seller of securities relies may be liable as a primary violator of antifraud provisions of federal securities laws. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

[5] Securities Regulation 349B ⚷60.40

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.39 Persons Liable
349Bk60.40 k. In General; Control Persons. Most Cited Cases

A secondary actor cannot incur primary liability for securities fraud for a statement not attributed to the actor at the time of its dissemination. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

[6] Securities Regulation 349B ⚷60.18

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.18 k. In General. Most Cited Cases

Allegations that a defendant committed a deceptive act, even one in furtherance of a scheme to defraud investors, are insufficient to state a claim for "scheme liability" under Rule 10b-5. 17 C.F.R. § 240.10b-5(a, c).

[7] Securities Regulation 349B ⚷60.30

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.30 k. Conduct of Accountants, Attorneys or Other Professionals. Most Cited Cases

Allegations that issuer's outside counsel designed and implemented sham transactions used by issuer to fraudulently transfer uncollectible debt and designed and participated in blatantly fraudulent sham loan transactions were insufficient to state a claim against outside counsel for "scheme liability" under Rule 10b-5 where investors had no knowledge of counsel's conduct that facilitated the fraudulent transactions; such allegations, if proven true, were adequate to establish liability for aiding and abetting securities fraud, but were not enough to establish civil liability as a primary actor. 17 C.F.R. § 240.10b-5(a, c).

[8] Securities Regulation 349B ⚷60.48(2)

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance
349Bk60.48(2) k. Nondisclosure. Most Cited Cases

Securities Regulation 349B ⚿60.48(3)

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance
349Bk60.48(3) k. Fraud on the Market. Most Cited Cases

For purposes of investors' securities fraud claims, presumption of reliance did not arise from issuer's outside counsel's alleged conduct in assisting issuer in its scheme to defraud investors by hiding true state of its finances; outside counsel owed no duty of disclosure to issuer's investors, counsel's deceptive acts were not communicated to the public so as to give rise to a fraud on the market, and there were no allegations that allegations fell far short of alleging that issuer's stock could not have been sold at any price. 17 C.F.R. § 240.10b-5(a, c).

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John K. Villa, George A. Borden, Thomas G. Ward, Williams & Connolly LLP, Washington, D.C., for Defendant Mayer Brown.

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OPINION AND ORDER

GERARD E. **LYNCH**, District Judge.

In yet another chapter of this putative class action for securities fraud arising from the collapse of Refco Inc. and its affiliated companies ("Refco"), Joseph P. Collins ("Collins") and Mayer Brown LLP ("Mayer Brown") (the "Mayer Brown Defendants")-move for dismissal of the Second Amended Consolidated Class Action Complaint ("the Complaint") as to them.[FN1] The core issue before the Court is whether ***306** the plaintiff-investors [FN2] can hold Refco's outside counsel liable for their injury pursuant to §§ 10(b) and 20(a) of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78j(b), 78t(a). Although the Complaint alleges facts that, if true, would make the Mayer Brown Defendants guilty of aiding and abetting the securities fraud that harmed the plaintiffs, the Supreme Court and Congress have declined to provide a private right of action for victims of securities fraud against those who merely-if otherwise substantially and culpably-aid a fraud that is executed by others. Accordingly, the motions to dismiss must be granted.

FN1. The Complaint added Mayer Brown and Collins as defendants and incorporated the allegations made in a separate complaint filed in this Court on October 1, 2007, under the caption *RH Capital Associates LLC, et al. v. Mayer Brown LLP, et al.*

FN2. In an order dated February 8, 2006 (Doc. # 63), the Court appointed RH Capital Associates LLC ("RH Capital") and Pacific Investment Management Company LLC ("PIMCO") as lead plaintiffs pursuant to 15 U.S.C. § 78u-4(a)(3)(B) and 15 U.S.C. § 77z-1(a)(3).

BACKGROUND

The factual background of the fraudulent scheme to deceive investors and others about the true financial circumstances of the international brokerage firm

Refco Inc. and its affiliated companies is set forth in detail in the Court's prior opinion in *In re Refco, Inc. Sec. Litig.*, 503 F.Supp.2d 611, 618-20 (S.D.N.Y.2007), and in any number of additional opinions,[FN3] but the details will be repeated here to the extent that they are relevant. In reviewing a dismissal pursuant to Fed.R.Civ.P. 12(b)(6), plaintiffs' allegations are assumed to be true for purposes of deciding the motion. *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 151 (2d Cir.2007).

FN3. *See, e.g., Thomas H. Lee Equity Fund V, L.P. v. Grant Thornton LLP*, 586 F.Supp.2d 119, 121-23 (S.D.N.Y.2008); *In re Refco Capital Markets, Ltd. Brokerage Customer Sec. Litig.*, No. 06 Civ. 643, 2007 WL 2694469, at *4 (S.D.N.Y. Sept. 13, 2007); *American Financial Int'l Group-Asia, L.L.C. v. Bennett*, No. 05 Civ. 8988, 2007 WL 1732427, at *1 (S.D.N.Y. June 14, 2007).

I. *The Alleged Fraudulent Scheme*

Prior to Refco's spectacular collapse, it was among the world's largest providers of brokerage and clearing services in the international derivatives, currency, and futures markets. Refco's business model involved extending credit to its customers so that they could trade on margin and leverage their capital into larger trades, for which Refco could again extend credit. (Compl. ¶ 2.) These trades generated substantial commissions, revenues, and profits for Refco, but over time Refco began making loans without adequately assessing customers' credit-worthiness or the risks associated with their trading activities. (Compl.¶¶ 428-30.) These lapses began to have consequences in the late nineties, when several global financial crises caused a number of customers to suffer massive trading losses. (Compl.¶¶ 3, 431-35.) The loans now became "uncollectible receivables" that Refco's customers were unwilling or unable to repay.

Rather than write off or disclose these uncollectible receivables-the revelation of which would have had dire financial consequences for the company (Compl.¶¶ 426, 579-80)-Refco's management allegedly devised a scheme to conceal them from the public and Refco's investors. (Compl.¶ 3.) First, they transferred the loans onto the books of Refco Group Holdings, Inc. ("RGHI"), an entity owned and controlled by Phillip R. Bennett ("Bennett"), Refco's President, CEO, and Chairman. (Compl.¶¶ 3, 33.) As a result of these transfers, RGHI owed hundreds of millions of dollars to Refco, but RGHI had no liquid assets and no operational functions (Compl.¶¶ 31, 638), and thus it had no conceivable***307** means of repaying the "loans." (Compl.¶ 3.)

Next, to avoid the disclosure of large "related-party" receivables-the sum of which dwarfed Refco's net income-a series of fraudulent transactions were arranged by which the RGHI receivables were periodically made to disappear from Refco's books through so-called "round-trip loans" in which the receivables owed to Refco from RGHI were replaced with receivables purportedly owed by a third-party customer. (Compl.¶¶ 3, 450-51, 627.)

These loans, which straddled the end of each fiscal year from 2000 through 2005 and at the end of several fiscal quarters as well, all worked in essentially the same way. (Compl.¶ 451.) First, several days before Refco closed its books for each financial period, Refco Capital Markets Ltd. ("RCM"), a Refco subsidiary, would loan hundreds of millions of dollars to a third-party customer who then, through its account at Refco, simultaneously loaned the same amount to RGHI. (*Id.*) The loan agreements between the third party and RCM-which were done on a book basis (the principal never changed hands)-were meticulously structured so that they were essentially risk-free to the third-party customers; the customers' loans to RGHI were guaranteed by Refco and the customers profited for their participation in the "loans" through interest earned on their loans to RGHI, which by design exceeded the interest they were charged by RCM.[FN4] (Compl.¶¶ 451, 633.) RGHI, in turn, used the loans from the customers to pay down the money it owed to Refco for its uncollectible receivables. (*Id.*) The net effect of these transactions was that at the close of each reporting period, Refco's books would show "loans" to third-party customers and the RGHI receivables would be gone. Then, just days after the financial period closed, the transactions were unwound-the "loans" repaid, and the uncollectible receivables from RGHI were returned to Refco's books. Thus, these transactions enabled Refco to lend money to itself, through third parties, to conceal its grim, multi-hundred million dollar losses from the public and from its investors. (Compl.¶¶ 579-80.)

FN4. Although the third parties purportedly earned interest from RGHI the payment of the difference in interest was made by RCM. (Compl.¶ 451, 632.) In effect, RCM paid the interest on a loan extended by a customer to a purportedly separate entity, RGHI. (Compl.¶ 632.) This payment to the third-party customer was the only occasion on which funds actually changed hands in these "round-trip" transactions.

II. *The Mayer Brown Defendants' Participation in the Alleged Scheme*

From 1994 until Refco's collapse, Mayer Brown was Refco's outside counsel and was Collins's largest client.[FN5] (Compl. ¶¶ 76-78.) Mayer Brown and Collins-the partner-in-charge of the Refco account-had a close working relationship with Refco, in which the firm provided the company with a broad range of legal services and through which Mayer Brown collected approximately $5 million per annum in legal fees. (*Id.*) Accordingly, Mayer Brown was familiar with Refco's operations and finances and participated in seventeen rounds of the round-trip loan transactions between 2000 and 2005 by which Refco's uncollectible receivable were concealed. (Compl.¶¶ 79, 451-52.) Specifically, the role of the Mayer Brown Defendants was to explain the structure and terms of the transactions to potential third-party participants, negotiate the loans, draft and revise***308** the documentation for the transactions including the relevant loan agreements, promissory notes, guarantees and indemnification letters, transmit documents to the participants, distribute executed copies of the documents, and mark the third-party customers' promissory notes to RCM as "paid in full" when the transaction was unwound. (Compl.¶¶ 451-52, 457-60, 471, 476, 482, 488, 494, 500, 506, 512, 514, 550-58, 564-65, 567, 569-72, 574.) Collins supervised all of these activities, approved bills for the work, personally negotiated and revised some of the loan documents, sent drafts of loan documents to Refco, and discussed the enforceability of the loans with Refco management. (Compl.¶¶ 550, 556, 560, 567, 571-72, 574.)[FN6]

FN5. Mayer Brown began representing Refco in 1994 when Collins moved to Mayer Brown from Schiff Hardin & Waite and brought Refco with him as a client. (Compl.¶ 77.)

FN6. Plaintiffs' opposition papers incorporate the criminal indictment of Collins (Sabella Decl. Ex. 1) into their allegations, arguing that it "confirms in detail Collins' and Mayer Brown's indispensable role in conceiving and effectuating [Refco's] fraudulent scheme." (Pl. Opp. Mem. at 4, n.3.) Whatever its substance, the Court can take judicial notice of the indictment, "not for the truth of the matters asserted in the other litigation, but rather to establish the fact of such litigation and related filings." *Liberty Mut. Ins. Co. v. Rotches Pork Packers, Inc.*, 969 F.2d 1384, 1388(2d Cir.1992).

III. *The Mayer Brown Defendants' Participation in Statements that Refco Used to Issue Securities to Investors*

While the round-trip loans concealed the trouble at Refco, certain Refco insiders began to consider cashing out of the company. Their plans began to unfold in 2004 when Refco issued $600 million in bonds (the "Bonds") to public investors in connection with a leveraged buy-out ("LBO"), and came to fruition approximately one year later when Refco conducted a $670 million initial public offering ("IPO"), during which Refco sold approximately one-fifth of its shares to the plaintiff class.[FN7] (Compl.¶¶ 6-7, 195.) Both the LBO and the IPO yielded tens of millions of dollars in cash payouts to Bennett and other executives. (*Id.*)

FN7. Two months later, on October 10, 2005, Refco announced that it bad discovered the RGHI receivable and that, accordingly, investors could no longer rely on its financial statements for the preceding four years. (Compl.¶¶ 233-34.) On October 17, 2005, Refco filed for Chapter 11 bankruptcy protection. (Compl.¶ 244.)

The Mayer Brown Defendants participated in drafting the documents that were filed with the Securities and Exchange Commission ("SEC") in order to induce investors to purchase Refco's Bonds and, later, to effectuate the IPO. (Compl.¶ ¶ 116, 127-28, 133, 135, 149-50, 152-53.) Specifically, with respect to the LBO, the Mayer Brown Defendants were involved, as were others,[FN8] in drafting and disseminating the Offering Memorandum to investors. (Compl.¶¶ 115, 117.) The Offering Memorandum, which stated that Mayer Brown represented Refco in connection with the offering, concerned the creation of unregistered bonds that, through an underwriting by certain financial institutions, were purchased and immediately resold to certain institutional investors, including some of the plaintiffs. (Compl.¶¶ 114, 116, 118.) The portions of the memorandum drafted by the Mayer Brown Defendants included the Management's Discussion & Analysis ("MD & A") and Risk Factors portions, which discussed Refco's business and financial condition in a way that, given Mayer Brown's involvement in the round-trip loan transactions and knowledge of the RGHI receivables, the Mayer Brown Defendants***309** knew to be false. (Compl.¶¶ 116-17.)

FN8. Participants included, inter alia, Credit Suisse Securities (USA), Banc of America Securities LLC, Deutche Bank, Bennett, Robert C Trosten, Scott L. Jaeckel, and the so-called THL Partners. (Compl.¶ 115.) All of these parties are defendants in this action.

The Offering Memorandum, in turn, was used as the foundation for preparing the Bond Registration Statement whereby the Bonds issued in 2004 were exchanged for registered securities. (Compl.¶ 165.) With respect to the Bond Registration Statement, the Mayer Brown Defendants, together with banks underwriting the Bonds received and reviewed SEC comment letters and participated in drafting sessions for amendments to the statement.[FN9] (Compl.¶ 170.) Like the Offering Memorandum, the Bond Registration Statement contained untrue statements and omissions of material fact because it failed to disclose the existence and full extent of the related-party transactions and the related-party indebtedness between Refco and RGHI. (Compl.¶¶ 181-94).

FN9. Specifically, Refco filed a Form S-4 Registration Statement with the SEC on October 12, 2004, which was subsequently amended through numerous Form S-4/A

> filings in late 2004 and early 2005 (collectively, the "Bond Registration Statement"). (Compl.¶ 165.) The Bond Registration Statement became effective, and registered bonds were issued pursuant thereto, on or about April 13, 2005. (Compl.¶ 166.)

Similarly, the Mayer Brown Defendants played a significant role in drafting and reviewing the IPO Registration Statement, which was prepared at the same time as the Bond Registration Statement. The IPO Registration Statement also specifically identified Mayer Brown as counsel to Refco. (Compl.¶¶ 116, 201.) In that capacity, the Mayer Brown Defendants received and presumably reviewed the SEC's comments. (Compl.¶ 204.) Both the IPO and Bond Registration Statements were materially false and misleading for the same reasons as the Offering Memorandum-they misrepresented Refco's financial condition and failed to disclose multi-hundred million dollar receivable that were concealed through the round-trip loans that the Mayer Brown Defendants helped facilitate. (Compl.¶¶ 181, 186, 203.)

IV. *Plaintiffs' Claims*

As a result of Refco's collapse, the value of plaintiff-investors' interests in Refco plummeted, allegedly causing them millions of dollars in losses. (Compl.¶¶ 17-19.) Plaintiffs allege that the Mayer Brown Defendants knew, or were reckless in not discovering, that Refco's statements made in the Offering Memorandum, the Bond Registration Statement, and the IPO Registration Statement were false or materially misleading and that, accordingly, defendants should be held primarily liable for those statements under Section 10(b), either because they participated in drafting the documents and were identified as counsel for Refco in two of the three offering documents, or because they documented the round-trip loans that enabled Refco to issue false and misleading financial statements. Plaintiffs also contend that control person liability under Section 20(a) is sufficiently alleged. The Mayer Brown Defendants move to dismiss all claims pursuant to Fed.R.Civ.P. 12(b)(6). The motion will be granted.

DISCUSSION

I. *Motions to Dismiss*

On a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure, the Court must accept as true all of the factual allegations in the Complaint and draw all reasonable inferences in plaintiffs' favor. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir.2007). Nonetheless, "[f]actual allegations must be enough to raise a right of ***310** relief above the speculative level." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S.Ct. 1955, 1965, 167 L.Ed.2d 929 (2007). Ultimately, the plaintiffs must allege "enough facts to state a claim to relief that is plausible on its face." *Id.* at 1974. This "flexible 'plausibility standard,' ... obliges a pleader to amplify a claim with some factual allegations in those contexts where such amplification is needed to render the claim *plausible.*" *Iqbal v. Hasty*, 490 F.3d 143, 157-58 (2d Cir.2007), quoting *Twombly*, 127 S.Ct. at 1968 (emphasis in original). If plaintiffs "have not nudged their claims across the line from conceivable to plausible, their complaint must be dismissed." *Twombly*, 127 S.Ct. at 1974.

While the rules of pleading in federal court usually require only "a short and plain statement" of the plaintiff's claim for relief, Fed.R.Civ.P. 8, averments of fraud must be "stated with particularity," Fed.R.Civ.P. 9(b). To comply with Rule 9(b), a plaintiff must: "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *Rombach v. Chang*, 355 F.3d

164, 170 (2d Cir.2004) (internal quotation marks omitted). Accordingly, where the fraud is based on alleged misrepresentations, the complaint must "specify the statements it claims were false or misleading, give particulars as to the respect in which plaintiff contends the statements were fraudulent, state when and where the statements were made, and identify those responsible for the statements." *Suez Equity Investors, L.P. v. Toronto-Dominion Bank,* 250 F.3d 87, 95 (2d Cir.2001), quoting *Cosmas v. Hassett,* 886 F.2d 8, 11 (2d Cir.1989). A plaintiff pleading fraud based on deceptive conduct "must specify what deceptive or manipulative acts were performed, which defendants performed them, when the acts were performed, and the effect the scheme had on investors in the securities at issue." *In re Parmalat Secs. Litig.,* 383 F.Supp.2d 616, 622 (S.D.N.Y.2005).

II. *Pleading a Violation of Section 10(b) and Rule 10b-5*

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful "for any person, directly or indirectly ... [t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance" in violation of the rules set forth by the Securities and Exchange Commission for the protection of investors. 15 U.S.C. § 78j. Pursuant to SEC Rule 10b-5, promulgated thereunder, it is unlawful:

(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.

17 C.F.R. § 240.10b-5.

The Supreme Court recently articulated the elements necessary to sustain a private cause of action for securities fraud under § 10(b) and Rule 10b-5:

In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

***311** *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. 148, 128 S.Ct. 761, 768, 169 L.Ed.2d 627 (2008), citing *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005); *see also, e.g., Jay Dees Inc. v. Def. Tech. Sys., Inc.,* No. 05 Civ. 6954, 2008 WL 4501652, at *4 (S.D.N.Y. Sept. 30, 2008) (reciting this articulation of the elements from *Stoneridge*).[FN10]

FN10. The Second Circuit has recognized a largely indistinguishable set of elements necessary to state a claim for relief under § 10(b) and Rule 10b-5, which requires that a plaintiff prove that defendants " '(1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs relied; and (5) that plaintiffs' reliance was the proximate cause of their injury.' " *Lattanzio v. Deloitte & Touche LLP,* 476 F.3d 147 (2d Cir.2007), quoting *In re IBM Sec. Litig.,* 163 F.3d 102, 106 (2d Cir.1998).

[1][2] In the context of securities fraud complaints, the Private Securities Litigation Reform Act of 1995 ("PSLRA") has expanded on Rule 9(b)'s pleading requirements. *See*15 U.S.C. § 78u-4(b).

The PSLRA provides that, where misleading statements or omissions under Section 10(b) are alleged, a plaintiff must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1); *see also Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S.Ct. 2499, 2509-10, 168 L.Ed.2d 179 (2007). In cases where it is not a statement or omission that is alleged, but rather, a fraudulent scheme to affect the price of stocks, it is sufficient to specify "what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the securities at issue." *In re Global Crossing, Ltd. Sec. Litig.*, 322 F.Supp.2d 319, 329 (S.D.N.Y.2004), quoting *In re Blech Sec. Litig.*, 961 F.Supp. 569, 580 (S.D.N.Y.1997). Thus, in order for a defendant to be held liable for a claim brought under Rule 10b-5, a plaintiff must allege that the defendant made a false or misleading statement or omission that investors attributed to him or her, or that the defendant "participated in [a] fraudulent scheme or other activity proscribed by the securities laws." *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 111 (2d Cir.1998) (citations omitted).

III. *Sufficiency of the Rule 10b-5(b) Claim*

[3] In Count Nine of their Complaint, plaintiffs allege that the Mayer Brown Defendants violated § 10(b) and Rule 10b-5(b) when they drafted, reviewed, and revised portions of the Offering Memorandum and the IPO Registration Statement, which contained false and misleading statements and in which-at the conclusion of each document-Mayer Brown was identified as counsel for Refco. The Mayer Brown Defendants argue that Count Nine should be dismissed because none of the alleged misstatements were actually made by, or otherwise attributed to, Mayer Brown.

The starting point for this analysis is *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), which held that § 10(b) imposes liability only on a person who makes a material misstatement or omission, and that there is no liability for aiding and abetting fraudulent conduct. *Id.* at 177, 114 S.Ct. 1439. In *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir.1997), the Second Circuit, observed that "[i]f *Central Bank* is to have any real meaning, a defendant must actually make ***312** a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting *...no matter how substantial that aid may be....*" *Id.* at 720 (emphasis added). This requirement draws a "bright line" between the conduct of a secondary actor and that of a primary violator. *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir.1998). To rise to the level of a primary violation, the secondary actor must not only make a material misstatement or omission, but "the misrepresentation must be attributed to the specific actor at the time of public dissemination," such as in advance of the investment decision, so as not to undermine the element of reliance required for § 10(b) liability. *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 153 (2d Cir.2007), quoting *Wright*, 152 F.3d at 175. "Allegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms ... all fall within the prohibitive bar of *Central Bank.*" *Shapiro*, 123 F.3d at 720.

Nor can silence or mere association be construed as nonetheless conveying an actor's "imprimatur." *Lattanzio*, 476 F.3d at 155.

> Public understanding that [a secondary actor] is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the [secondary actor]. Unless the public's understanding is based on [that actor's] articulated statement, the source for that

> understanding-whether it be a regulation, an accounting practice, or something else-does not matter.

Id. (holding that a securities regulation requiring that the company's accountant review the quarterly unaudited financial statements did not "associate" the accountant with those statements to such a degree that, without more, those statements became the accountant's statements). Here, the decisive question is whether the allegations against the Mayer Brown Defendants are sufficient to show that they "made" the alleged material misstatements and omissions such that plaintiffs relied on the *defendants'* misrepresentation. Plaintiffs have not made such a showing.

Lattanzio explains that only an "articulated statement" of attribution to a secondary actor is sufficient. *Id.; accord, United States v. Finnerty,* 533 F.3d 143 (2d Cir.2008); *see also In re Alstom SA,* 454 F.Supp.2d 187, 204 (S.D.N.Y.2006) (noting that the attribution requirement is "of particular concern" when plaintiffs seek to hold outside secondary actors like accountants and auditors liable for a corporation's misleading statements). The Offering Memorandum and the IPO Registration Statement each mention Mayer Brown only once in their nearly two-hundred pages-at the coda, and under the subheading "legal matters," in which counsel for Refco and counsel for the purchasers are identified. (Borden Decl. Ex. A "Offering Memorandum" at 172; *id.* Ex. C "IPO Registration Statement" at 125.) Throughout these documents, where outside entities did supply content, the source of that content is identified. At no point, however, do these documents attribute any of their contents to Mayer Brown, including with respect to the portions of the documents that the Mayer Brown defendants participated in drafting, such as the "Management's Discussion and Analysis" portion of the Offering Memorandum which attributes its analysis solely to Refco's *management* (Borden Decl. Ex. A "Offering Memorandum" at 50), and the Risk Factors section of the IPO Registration Statement which clearly states that, "[p]resented below are all the risks that *management* deems material ...." (*id.* Ex. C "IPO Registration Statement" at 11) (emphasis added). This, without more, is not an "articulated statement" by the Mayer Brown Defendants.

***313** Plaintiffs seem to concede as much, arguing-citing this Court's opinion in *Global Crossing*-that it is not the mere mention of Mayer Brown as counsel-of-record that imputes the statements to the defendants, but rather that "investors [were] sufficiently aware of defendant's participation that they may be found to have relied [on the statement] ... as if the statement had been attributed to [Mayer Brown]." 322 F.Supp.2d at 332-33. Even if, after *Lattanzio, Global Crossing* remains good law,[FN11] plaintiffs have neither alleged any facts showing that at the time of their investment they or other members of the investing public "almost certainly understood [Mayer Brown] to be the speakers," *In re Converium Holding AG Sec. Litig.,* No. 04 Civ. 7897, 2006 WL 3804619, at *12 (S.D.N.Y. Dec. 28, 2006), nor alleged the rather extraordinary awareness found sufficient in *Global Crossing,* in which this Court observed that

> FN11. *Lattanzio* does not discuss *Global Crossing* and the Mayer Brown Defendants question whether *Global Crossing* and the cases that follow it can be reconciled with *Lattanzio* 's renewed endorsement of *Wright* and its prohibition against relying on "public understanding" to attribute statements to actors for purposes of Rule 10b-5 liability. It is not necessary, however, to reach that issue, since plaintiffs have not pleaded facts that would meet even this "relax[ed]" version of the *Wright* standard. *Global Crossing,* 322 F.Supp.2d at 331.

it is undisputed, as a matter of public record, that

> Andersen's audit reports were included in all of GC's registration statements and annual reports from 1998 to 2000, and that they were widely available to shareholders during the class period. Andersen's role as GC's auditor was thus well known to investors, who could easily have relied on the accounting firm's involvement in making any public financial reports, even where a particular statement was not publicly attributed to it. Moreover, Andersen's aggressive marketing of the novel accounting strategies promoted in the White Paper, which allegedly "became a 'must-read' in the telecom industry," raises an inference that sophisticated investors would have known of Andersen's role in creating the reporting practices behind GC's false statements. These allegations are sufficient to raise a reasonable inference not only that Andersen was one of the 'makers' of the statements, but also that investors viewed it as such.

Global Crossing, 322 F.Supp.2d at 334 (distinguishing these extraordinary allegations from those insufficient to transcend the proscribed category of aiding and abetting liability).

Here, plaintiffs allege that Mayer Brown's involvement in the drafting process "provides more than a sufficient basis for 'attributing' the false statements therein to Mayer Brown." (Pl. Opp. Mem. at 15.) FN12 Even if the Mayer Brown Defendants***314** played a substantial role in drafting the statements at issue, however, the relevant inquiry is not simply the extent of their involvement viewed in hindsight, but whether, at the time, plaintiffs reasonably understood Mayer Brown to be speaking through the release. *Global Crossing,* 322 F.Supp.2d at 332-33; *see also In re Converium,* 2006 WL 3804619, at *12. To that end, plaintiffs' meager allegation-that the mention in the Offering Memorandum and the IPO Registration Statement that Mayer Brown was Refco's primary outside counsel, and that accordingly investors expected that "Mayer Brown was involved in the preparation and review of those documents" (Compl.¶ 749)-is plainly insufficient to establish a primary violation by *Global Crossing* 's own terms. *See id.* at 333 (finding no liability where an accountant "merely reviewed and approved" unaudited statements or was "instrumental in helping" the company prepare the statements at issue).

> FN12. At one point, plaintiffs also argue that the fact that the Mayer Brown Defendants "devised and perpetrated a fraudulent scheme to falsify the issuer's financial statements" provides a basis for attributing the misstatements in the financial statements to Mayer Brown. (Pl. Opp. Mem. at 17.) This argument improperly conflates the distinct elements of a claim for false statements under subsection (b) of Rule 10b-5, which requires a misrepresentation or omission, with those of a claim for engaging in a fraudulent scheme under subsections (a) or (c). *See*17 C.F.R. § 240.10b-5; *Affiliated Ute Citizens of Utah v. United States,* 406 U.S. 128, 152-53, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972) (drawing a distinction between the two kinds of claims); *cf. Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 177-78 (2d Cir.2005) (finding that "where the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a [fraudulent scheme] claim under Rule 10b-5(a) and (c)"). Plaintiffs' allegation that Mayer Brown was behind the scenes papering the loans that concealed the RGHI receivables is not relevant to the issue of what investors understood Mayer Brown's role to be at the time plaintiffs made their investment. Accordingly, plaintiffs cannot offer their fraudulent scheme claim as proof for their fraudulent misstatement claim.

Further, unlike in *Global Crossing,* where the plaintiffs pleaded facts that raised a reasonable inference that *investors knew* that Andersen had masterminded the misleading accounting behind the issuer's false statements, here plaintiffs have offered no reason why the Mayer Brown Defendants' status as counsel for Refco would be understood by investors as an endorsement of the accuracy of Refco's assertions about its financial condition. Nor is such an inference self-evident. Indeed, it is implausible that the mere fact that the issuer's law firm was identified in the offering documents would, without a great deal more, be perceived as an articulation by that law firm of the accuracy of the statements made in those documents.

[4][5] Although it is well settled that a lawyer who makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under § 10(b) and Rule 10b-5(b), *Central Bank,* 511 U.S. at 191, 114 S.Ct. 1439, it is equally well settled that "a secondary actor cannot incur primary liability ... for a statement not attributed to the actor at the time of its dissemination" precisely because "[s]uch a holding would circumvent the reliance requirements of the Act." *Wright,* 152 F.3d at 175; *Lattanzio,* 476 F.3d at 154-55. Accordingly, Count Nine of the Complaint as to the Mayer Brown Defendants must be dismissed.

IV. *Sufficiency of the Rule 10b-5(a) and (c) Claim*

In addition to liability for its statements in the offering documents, plaintiffs posit an alternative theory of liability, commonly known as "scheme liability," for Mayer Brown's role in the fraud alleged: subsections (a) and (c) of Rule 10b-5, which prohibit "employ[ing] any device, scheme or artifice to defraud," or "engag[ing] in any act, practice or course of business which operates ... as a fraud or deceit upon any person" in connection with the sale of securities. 17 C.F.R. § 240.10b-5(a), (c). Plaintiffs allege that the Mayer Brown Defendants "design[ed] and implement[ed] sham transactions used by Refco to fraudulently transfer uncollectible debt and design[ed] and participat [ed] in blatantly fraudulent sham loan transactions." (Compl.¶ 766.) The Mayer Brown Defendants seek dismissal of this claim, inter alia, on the ground that the Supreme Court's decision in *Stoneridge* forecloses this theory of liability. They are correct.

[6] In *Stoneridge,* the Court examined the issue of "when, if ever, an injured investor may rely upon § 10(b) to recover ***315** from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b)." 128 S.Ct. at 767. Specifically, the Court considered whether two vendors of a cable operator that entered into various sham transactions with the cable operator to artificially increase the cable operator's publically reported revenues could be held liable for violating § 10(b). The vendors were not alleged to have made any misstatements directly to the public, but instead were alleged to have knowingly participated in the scheme with the purpose of creating a false appearance about the cable operator's revenues. While finding that "[c]onduct itself can be deceptive," the Court ultimately concluded that the vendors could not be held liable because the vendors' "deceptive acts, which were not disclosed to the investing public [were] too remote to satisfy the requirement of reliance ... except in an indirect chain ... too remote for liability." *Id.* at 769-70. Precisely because "[t]he conduct of the secondary actor must satisfy each of the elements or preconditions for liability," a mere allegation of " 'scheme liability' ... does not answer the objection that petitioner did not in fact rely upon [the defendants'] own deceptive conduct." *Id.* at 770. Accordingly, allegations that a defendant committed a deceptive act, even one in furtherance of a scheme to defraud investors, are insufficient. *Id.* at 771; *see id.* at 770 (rejecting this interpretation of reliance because the implied cause of action would then "reach the whole marketplace in which the issuing

company does business; and there is no authority for this rule").

[7] Here, there is no dispute that plaintiffs had no knowledge of the Mayer Brown Defendants' conduct that facilitated the fraudulent transactions. Plaintiffs' Complaint specifically alleges that "[p]laintiffs ... purchased Refco securities" "[i]n ignorance of the fraudulent conduct of Collins, Mayer Brown" and others. (Compl.¶ 771.) Accordingly, the Mayer Brown Defendants contend that no liability can attach because plaintiffs could not have relied on their conduct, just as the plaintiffs in *Stoneridge* did not know of, and thus could not have relied on, the transactions in that case. *See Stoneridge,* 128 S.Ct. at 769.

Plaintiffs nevertheless attempt to distinguish *Stoneridge,* arguing that the Mayer Brown Defendants were not unrelated suppliers or customers such that they were "remote" from the issuer and that Mayer Brown's conduct "made it necessary or inevitable for [the issuer] to record the transactions as it did." *Id.* at 769-70. This line of argument is unavailing. The nub of plaintiffs' contention is that as Refco's primary counsel, the Mayer Brown defendants could not be "remote" within the meaning of *Stoneridge,* because they were directly involved in creating and executing the fraudulent scheme, including the drafting of misleading communications to Refco investors. (Pl. Opp. Mem. at 23-24.) Plaintiffs' reading of "remote" is myopic. The issue is not the distance between the issuer and the defendant, but rather the distance between the defendant's conduct and the investor.

As in *Stoneridge,* plaintiffs admittedly did not know of, and thus did not rely on, any of Mayer Brown's work on the fraudulent loan transactions. Nor can plaintiffs salvage their claim by arguing that the "inevitable consequence" of the transactions on which Mayer Brown worked were the misstatements on which investors relied. In *Stoneridge* as well, the transaction at issue-participation by outside vendors in an issuer's patently fraudulent scheme to create fictitious documents and backdate contracts-had no other plausible purpose than to misstate the issuer's financial condition, but this fact was insufficient to establish liability, because irrespective ***316** of the obviousness of the fraudulent scheme to the participating defendants, or the importance of their participation to the execution of the scheme, the defendants' conduct was too remote from the investing public to satisfy the reliance element of § 10(b). *Id.* at 770-71, 128 S.Ct. 761 (finding that liability "does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way"). Here, the Mayer Brown Defendants were not even the counter-party to the fraudulent transactions; they merely participated in drafting the documents to effect those transactions.

As alleged in the Complaint, the Mayer Brown Defendants explained the structure and terms of the transactions to potential third-party participants; negotiated the loans; drafted and revised the documentation for the transactions including the relevant loan agreements, promissory notes, guarantees and indemnification letters; transmitted documents to the participants; distributed executed copies of the documents; and marked the third-party customers' promissory notes to RCM as "paid in full" when the transactior was unwound. (Compl.¶¶ 451-52, 457-60, 471, 476, 482, 488, 494, 500, 506, 512, 514, 550-58, 564-65, 567, 569-72, 574.)

Plaintiffs have clearly alleged facts, including the suspicious timing and the "risk-free" quality of the loans, that give rise to a strong inference of scienter, that is, that the Mayer Brown Defendants knew or acted in reckless disregard of Refco's intention to use the transactions to inflate its revenues, and knew or should have known that the resulting financial statements issued would be relied upon by research analysts and investors. Plaintiffs allege, moreover, that acting with such knowledge, the Mayer Brown Defendants engaged in conduct that materially aided Refco's fraud. Such allegations if proven true, are adequate to establish liability for aiding and abetting securities fraud, but are not enough to establish civil liability as a *primary* actor. As was the case in *Stoneridge,* it was Refco, not the Mayer Brown Defendants, "that ... filed fraudulent financial statements; nothing [the Mayer Brown Defendants] did made it necessary or inevitable for [Refco] to record the transactions as it did." 128 S.Ct. at 770.

The critical holding of *Central Bank*-that liability to investors under Rule 10b-5 does not extend to those who merely aid and abet violations by primary actors-is not limited to violations of Rule 10b-5(b). To establish liability under the other subsections of the Rule as well, a plaintiff must show that it was the defendant itself that "employ[ed]" the scheme to defraud or "engage[d] in the deceitful practice, and not merely that the defendants assisted another party in its fraudulent practices. Here the scheme to defraud was Refco's effort to hide from its investors the true state of its finances by concealing the uncollectible receivables and it was Refco that engaged in the deceitful practice of making the round-trip loans and reporting them in its financial statements as if they were bona fide loan transactions. However significant a role the Mayer Brown Defendants played in assisting Refco's management to engage in these transactions, and however culpable they may have been to do so with the knowledge that the transactions were ultimately designed as part of a scheme to defraud and practice a deceit upon Refco's shareholders-indeed even if the acts of Collins were, as the Government has charged, criminal-the liability that attaches to those acts is liability for aiding and abetting Refco's schemes and manipulation, not principal liability for executing schemes of the Mayer Brown Defendants' own.

Plaintiffs' attempts to argue to the contrary are unpersuasive because it was Refco's*317 decision how to account for the transactions at issue; plaintiffs have pleaded no facts that would support-nor could they-that the Mayer Brown Defendants were, in fact, "control[ing]" Recfo's misleading communications to investors. (*See* Pl. Opp. Mem. at 23-24.) Indeed, plaintiffs' allegations are substantially similar to those found insufficient by the Court in *Stoneridge* because the defendants ultimately merely facilitated the preparation of the fraudulent scheme rather than-as required-engaged in the fraudulent sale of securities pursuant to that scheme.

A thoughtful and highly-respected judge in this district has, following *Stoneridge,* and under similar circumstances, come to precisely this conclusion. *See In re Parmalat Sec. Litig.,* 570 F.Supp.2d 521 (S.D.N.Y.2008) (Kaplan, J.). In that case plaintiffs argued that the issuer's offering documents made the public aware of the underlying, allegedly deceptive transactions in which the defendant law firm was involved. *Id.* at 525. The court, having previously upheld on a motion to dismiss some but not all of plaintiffs scheme liability claims against the firm,[FN13] found this argument "unconvincing" and granted summary judgment in favor of the firm on the basis that "nothing about [the issuer's] disclosures describes any of [the law firm's] own conduct, much less conduct that was deceptive." *Id.* at 525-26; *see also In re DVI, Inc. Sec. Litig.,* 249 F.R.D. 196, 216-18 (E.D.Pa.2008) (refusing to certify a class against an issuer's law firm notwithstanding allegations of the law firm's "unique role in initiating and masterminding certain aspects of the overall scheme" because "the fact remains that none of this alleged conduct was publically disclosed such that it affected the market for [the issuer's] securities"). As in *In re Parmalat Sec. Litig.,*"even assuming the truth of plaintiffs' factual allegations and granting every reasonable inference therefrom, plaintiffs' evidence would establish only that investors relied on [Refco's] deceptive disclosures concerning transactions [in] which [the Mayer Brown Defendants] were [involved]." 570 F.Supp.2d at 526.

FN13. Plaintiffs contend that this decision, *see In re Parmalat Sec. Litig.*, 383 F.Supp.2d 616 (S.D.N.Y.2005), which predates *Stoneridge*, lends support to their position. (Pl. Opp. Mem. at 29-30.) This reliance is wholly undermined, however, both by Judge Kaplan's recent decision following *Stoneridge* and by the fact that in his earlier decision Judge Kaplan had summarily dismissed a number of plaintiffs' allegations quite similar to those at bar and determined that the law firm could only be held liable when it became an active counterparty by-itself "creat[ing] and controll[ing] shell companies-in the transactions that effectuated the fraud." *See*, 383 F.Supp.2d at 624-26 & nn. 39 & 43.

[8] Finally, plaintiffs argue that they are nevertheless entitled to a presumption of reliance under three distinct theories. None of the presumptions applies here. First, plaintiffs invoke *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972), for the presumption that "if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance." *Stoneridge*, 128 S.Ct. at 769, citing *Affiliated Ute*, 406 U.S. at 153-154, 92 S.Ct. 1456. The Mayer Brown Defendants owed no duty of disclosure to Refco's investors. *See In re Parmalat Sec. Litig.*, 570 F.Supp.2d at 526 ("even assuming *arguendo* the applicability [of professional rules and a violation thereof] it would not follow that [the law firm] breached a legal duty *to the plaintiffs*") (emphasis in original); *see also Finnerty*, 533 F.3d at 149-50 (citing *Lattanzio* and rejecting criminal liability based on investors' "background assumption" of compliance with NYSE rules). Second, plaintiffs invoke the fraud-on-the-market doctrine as ***318** announced in *Basic Inc. v. Levinson*, 485 U.S. 224, 243, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988), in which reliance is presumed when the statements at issue become public. Here, it is undisputed the Mayer Brown's deceptive acts were not communicated to the public; as in *Stoneridge*,"no member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times." 128 S.Ct. at 769. Accordingly plaintiffs "cannot show reliance upon any of respondents' actions except in an indirect chain ... too remote for liability." *Id.*

Third and finally, plaintiffs invoke the so-called "fraud-created-the-market" presumption, where reliance may be presumed if the defendants' fraudulent activity is "so pervasive that it goes to the very existence of the [securities] and the validity of their presence on the market." *Ross v. Bank South, N.A.*, 885 F.2d 723, 729 (11th Cir.1989). This Circuit has never adopted this presumption and it has been criticized by at least two other Courts of Appeals. *See Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1159 (6th Cir.1994); *Eckstein v. Balcor Film Investors*, 8 F.3d 1121 (7th Cir.1993) (rejecting the presumption). Whatever its merit's (and those merit's appear to be in grave doubt after *Stoneridge*), courts that apply the presumption appear to agree that the touchstone of this standard is "unmarketability." Such "unmarketability" must mean either economic unmarketability, which occurs when a security is patently worthless, or legal unmarketability, which occurs when a regulatory or municipal agency would have been required by law to prevent or forbid the issuance of the security. *Joseph v. Wiles*, 223 F.3d 1155, 1163-66 (10th Cir.2000) (citing cases). Plaintiffs' allegations here fall far short of alleging that Refco stock could not have been sold at any price or that Refco bonds could not have been offered at any combination of price and interest rate. *See Ross*, 885 F.2d at 729-30. Nor are there any allegations that the issuer was prohibited from issuing the securities as a matter of law. *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1333 (10th Cir.1983).[FN14]

FN14. Although plaintiffs point to a single paragraph in the Complaint, which alleges that had investors known about the Refco fraud "there would have been no market for the Bonds." (Compl.¶ 733), plaintiffs have pleaded no facts to support that conclusion, and the vast weight of the Complaint establishes only that "had Refco's true financial picture been disclosed to investors at the time of the Bond Offering, investors would have known that the credit risk associated with the Bonds was substantially greater than they otherwise believed," (Compl.¶ 733). Specifically, in both Counts Nine and Eleven of the Complaint, plaintiffs allege only that as a result of the Mayer Brown Defendants' conduct, they "purchased Refco securities at artificially inflated prices." (Compl.¶¶ 753, 771.) Under these circumstances, plaintiffs cannot rely on a "fraud-created-the-market" presumption as a stand-in for reliance on defendants' "own deceptive conduct." *Stoneridge*, 128 S.Ct. at 770.

In sum, even if the Mayer Brown Defendants' conduct helped Refco to carry out their scheme to defraud investors, under *Stoneridge* plaintiff-investors have no claim under the federal securities laws against the Mayer Brown Defendants.[FN15] ***319** At most, the Mayer Brown Defendants were culpable aiders and abettors. Accordingly, Count Eleven of the Complaint as to the Mayer Brown Defendants will be dismissed.

FN15. It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. However, as the Court noted in *Stoneridge*, the fact that the plaintiff-investors have no claim is the result of a policy choice by Congress. 128 S.Ct. at 769. In 1995, in reaction to the Supreme Court's decision in *Central Bank*, Congress authorized the SEC-but not private parties-to bring enforcement actions against those who "knowingly provide [ ] substantial assistance to another person" in violation of the federal securities laws. *See* PSLRA, Pub.L. No. 104-67, § 104, 109 Stat. 737, 757, codified in 15 U.S.C. § 78t(f). This choice may be ripe for legislative re examination. While the impulse to protect professionals and other marginal actors who may too easily be drawn into securities litigation may well be sound, a bright line between principals and accomplices may not be appropriate. There are accomplices and there are accomplices: after all, in the criminal context when the Godfather orders a hit, he is only an accomplice to murder-one who "counsels, commands, induces or procures" but he is nonetheless liable as a principal for the commission of the crime. 18 U.S.C. § 2(a). Likewise, some civil accomplices are deeply and indispensably implicated in wrongful conduct. Perhaps a provision authorizing the SEC not only to bring actions in its own right but also to permit private plaintiffs to proceed against accomplices after some form of agency review would provide the necessary flexibility without involving the courts in standardless and difficult-to-administer line-drawing exercises.

V. *Section 20(a)-Control Person Liability*

As plaintiffs have failed to plead Section 10(b) claims against the Mayer Brown Defendants, plaintiffs' Section 20(a) claims, 15 U.S.C. § 78t(a), in which they seek to impose control person liability for alleged Section 10(b) and Rule 10b-5 violations by former Mayer Brown partner Collins, fail as a matter of law because plaintiffs have not made out a prima facie case of any such violations by any of those defendants. *See In re Pfizer, Inc. Sec. Litig.*, 538 F.Supp.2d 621, 637 (S.D.N.Y.2008) ("Section 20(a) claims are necessarily predicated on a primary violation of securities law ...."), citing *Rombach,* 355 F.3d at 177-78. Accordingly Count Fifteen of the Complaint as to Mayer Brown is dismissed.

CONCLUSION

For the reasons stated above, the Second Amended Consolidated Class Action Complaint is dismissed in its entirety as to the Mayer Brown Defendants. As this ruling disposes of all claims against Joseph P. Collins and Mayer Brown LLP and there is no just reason for delay, the Clerk is directed, pursuant to Fed.R.Civ.P. 54(b), to enter final judgment with respect to those defendants.

SO ORDERED.

S.D.N.Y.,2009.
In re Refco, Inc. Securities Litigation
609 F.Supp.2d 304

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