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Supreme Court Review Granted Following Recent Appellate Court Differences Over the Scope of Primary "Scheme" Liability Under Section 10(b)

By Andrew B. Weissman and Jesse T. Travis

Andrew B. Weissman is a partner and Jesse T. Travis an associate in the Securities Litigation and Enforcement Group in the Washington, D.C. office of Wilmer Cutler Pickering Hale and Dorr LLP. Contact: andrew.weissman@wilmerhale.com.

On March 26, 2007, following several recent disparate appellate decisions, the Supreme Court granted review in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[1] to address the concept of primary "scheme" liability under section 10(b) of the Securities Exchange Act of 1934. The Court will consider whether a party engaging with a public company in a transaction that is alleged to "have no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements" has primary liability under section 10(b), even where that party made no public statements concerning the transactions.[2] The Court's decision will have a major impact on future securities litigation against parties who were not affiliated with the issuer and did not make any alleged misrepresentations. The importance of this issue was highlighted days before certiorari was granted when the Fifth Circuit overturned class certification in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, a case involving section 10(b) claims against non-issuer defendants involved in financial transactions with Enron Corp.[3] The Fifth Circuit's ruling on certification turned on its rejection of plaintiff's theory that "scheme" liability extended the scope of section 10(b) to include these non-issuer defendants as primary violators. The court declined to accept that conduct that did not violate a duty to disclose but was allegedly part of a "scheme to defraud" constituted "deception" encompassed by section 10(b).[4] The conflict in the lower courts on the scope of section 10(b) emphasizes the need for a "certain and predictab[le] rule" for determining the scope of primary liability under section 10(b),[5] and the grant of certiorari in *Stoneridge* suggests a likely near-term resolution of this important issue.

"Scheme" Liability and the Ninth Circuit's Decision in *Simpson v. AOL Time Warner*

The saga began with the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, rejecting the then-commonly held view that private actions under section 10(b) extended to claims against alleged aiders and abettors of a primary securities fraud violation.[6] The Court wrote: "the statute prohibits

only the making of a material misstatement (or omission) or the commission of a manipulative act… . We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute."[7] The Court also, however, left open the prospect that persons often sued as aiders and abettors, *e.g.*, lawyers, accountants, lenders, or the like, could still have primary liability under the statute:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. 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.[8]

Since then, the lower courts have struggled to determine where primary liability ends and secondary liability begins.

In recent securities fraud cases, the appellate courts have begun to consider plaintiffs' attempts to assert primary liability under section 10(b) for secondary actors – such as accountants, banks, and business partners – who are not themselves responsible for the issuer's alleged misrepresentations or omissions and owed no disclosure duty to the issuer's shareholders.[9] Plaintiffs assert these parties are liable for securities fraud because by engaging in a business transaction with a public company that made material misstatements about the transaction or the impact of the transaction on its financial condition they joined in that company's "scheme to defraud" and are liable to the same extent as the maker of the misstatement. To support their argument, these plaintiffs invoke the "directly or indirectly" language in section 10(b), as well as the language in subsections (a) and (c) of SEC Rule 10b-5 prohibiting the employment of "any device, scheme, or artifice to defraud," or engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit."[10] Because section 10(b) prohibits the use of any "manipulative or deceptive device," and because subsections (a) and (c) of Rule 10b-5 are independent of subsection 10b-5(b)'s express prohibition on misstatements and omissions, plaintiffs contend they may bring securities fraud claims against defendants who did not themselves make misrepresentations, or owe a disclosure duty to shareholders, if they enabled a reporting company to make materially misleading disclosures to its shareholders by entering into questionable transactions with that company.[11]

Several district courts, and one court of appeals, have accepted the proposition that primary liability under section 10(b) extends to such actors.[12] Most notably, in *Simpson v. AOL Time Warner Inc.*, the Ninth Circuit recently considered securities fraud claims against AOL Time Warner, Cendant Corp., and advertising firm L90, Inc. based on their involvement in transactions with Homestore.com that enabled Homestore to misreport its financial condition. Homestore later restated its financial statements, decreasing its revenues by more than $170 million.[13] Plaintiff alleged that:

- Homestore purchased services it did not need from third parties, contingent on those parties purchasing a similar amount of advertising from AOL. AOL took a commission and returned the remainder to Homestore under a legitimate advertising reseller agreement. AOL developed and supervised the transactions and agreed to documentation obscuring the transactions.
- L90 engaged in similar triangular transactions, and confirmed revenue from them for Homestore's 10-Q filing.
- Cendant sold Homestore a website for more than it was worth, contingent on Cendant's returning some of the payment by creating a separate corporate entity to buy products and services from Homestore.[14]

The Ninth Circuit acknowledged *Central Bank*'s holding that section 10(b) "does not allow recovery for aiding and abetting liability,"[15] but rejected the contention that "*Central Bank* limited primary liability under § 10(b) to defendants who personally made a public misstatement, violated a duty to disclose or engaged in manipulative trading activity, and not to those engaged in a broader scheme to defraud."[16] The court relied on *Central Bank*'s caveat that secondary actors may still be liable as primary violators, and on language in past Supreme Court opinions that it viewed as mandating a broad construction of "device," and of section 10(b) in general, to reach "schemes to defraud."[17]

To determine "what conduct constitutes a manipulative or deceptive act in the furtherance of a scheme to defraud sufficient to render the defendant a 'primary violator' of § 10(b)," the *Simpson* court adopted, with one caveat, a formulation proposed by the Securities and Exchange Commission as *amicus curiae*.[18] The SEC proposed that primary liability extend to "any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud," with "deceptive act" defined as "engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues."[19] The Ninth Circuit clarified that the defendant's *own conduct*, not merely the transaction, must have a "deceptive purpose and effect."[20] According to the court, this focus on the deceptive nature of the defendant's own conduct ensures that "only primary violators (that is, only those defendants who use or employ a manipulative or deceptive device) are held liable under the Act."[21] In general, conduct that does not have a "principal legitimate business purpose…may have a principal purpose of creating a false appearance" and would support liability, while "[c]onduct that is consistent with the defendants' normal course of business" would not.[22]

Applying its new formulation of "scheme" liability, the Ninth Circuit concluded that plaintiff failed to allege grounds for holding defendants primarily liable under section 10(b):

- Plaintiff did not allege the AOL transactions "were completely illegitimate or in themselves created a false appearance." Although plaintiff did allege the transactions between Homestore and the third parties were shams, it did not allege that the third parties did not buy "actual advertisements" from AOL. Allegations that AOL's employees created and supervised the transactions amounted to no more than aiding and abetting liability. Nor was AOL's acceptance of less descriptive documentation sufficient to support primary liability for AOL, because "any misrepresentation in the transactions involving AOL resulted from the additional agreements between Homestore and the Third Party Vendors and the misreporting of the income by Homestore."[23]
- The allegations against L90 were insufficient for the same reason—it was not alleged to have "acted with the purpose and effect of creating a false appearance in these transactions." As for L90's allegedly false confirmation of the revenues, it was not "used or employed in connection with the purchase or sale of securities" because it was never introduced into the market.[24]
- Similarly, the complaint did not indicate how Cendant's transaction "created a false appearance, independent from Homestore's misreporting of the income from these transactions as unrelated to any previous transaction." Cendant's press release in fact acknowledged that its subsequent purchases "were planned in conjunction with Homestore's acquisition of Cendant's websites."[25]

The court remanded and granted plaintiff an opportunity to seek leave to amend its complaint.[26] On remand, the district court denied plaintiff's motion for leave to amend on the ground it would be futile, except with respect to defendant L90, and dismissed the other defendants.[27]

The Eighth Circuit Rejects "Scheme" Liability in *In re Charter Communications, Inc.*

Two months earlier, the Eighth Circuit rejected an attempt to state a section 10(b) claim against defendants who engaged in a business transaction that a public company reported improperly, but who themselves made no misstatements or omissions and had no disclosure duty to that company's shareholders. In *In re Charter Communications, Inc. Securities Litigation*,[28] Charter, a cable company, purchased set-top boxes for its customers' TV sets from third parties. Despite having firm contracts, Charter agreed to pay the third parties an additional $20 per set-top box in exchange for a return payment to Charter as advertising fees. Plaintiffs alleged these were "sham or wash transactions with no economic substance…but did not allege that the Vendors played any role in preparing or disseminating the fraudulent financial statements and press releases through which Charter published its deception."[29] The court concluded that "deceptive" conduct prohibited by section 10(b) "involves either a misstatement or a failure to disclose by one who has a duty to disclose."[30] Accordingly, "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5."[31]

The Eighth Circuit, like the Ninth, relied on *Central Bank*, and on the earlier Supreme Court cases *Central Bank* cited, to support its construction of section 10(b). In particular, the court noted the Supreme Court "categorical[ly] declar[ed] that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).'"[32] It also concluded the High Court's precedents stand for the principle that "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose."[33] Because neither defendant in the case before it "issue[d] any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information," the court held that the district court properly dismissed the claims against the vendors as no more than aiding and abetting claims, which are barred by *Central Bank*.[34] The court was particularly concerned about the "potentially far-reaching duties and uncertainties" that would arise from imposing liability on "one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors."[35]

The Fifth Circuit Reaches the Same Result in *Regents v. Credit Suisse First Boston*

Just days before the Supreme Court granted certiorari in *Charter Communications*, the Fifth Circuit decided *Regents of the University of California v. Credit Suisse First Boston (USA)*, which endorsed the Eighth Circuit's holding that a disclosure-based section 10(b) claim must be premised on a misstatement or a failure to disclose by one who has a duty to disclose.[36] The context and consequences of the court's decision—decertification of a class of investors seeking $40 billion in damages following Enron's collapse, and the circuit split it emphasizes—highlighted the need for a definitive resolution by the Supreme Court of the scope of primary liability under section 10(b).

In the district court, plaintiffs alleged the defendant banks entered partnerships and transactions that "allowed Enron to misstate its financial condition" but, as in other cases in which plaintiffs have asserted "scheme" liability, plaintiffs did not allege the banks themselves made misstatements or omissions or owed the plaintiff shareholders a duty to disclose.[37] Rather, they alleged the banks knew that Enron was artificially inflating its stock price and were helping Enron misrepresent its financial health.[38] The district court granted class certification, in part because it concluded that presumptions of reliance endorsed by the Supreme Court in *Affiliated Ute Citizens of Utah v. United States* (for material

omissions where there was a duty to disclose),[39] and *Basic Inc. v. Levinson* (that stock price in an efficient securities market reflects accurate information about the issuer),[40] made reliance an issue common to the class.[41] Regarding the *Affiliated Ute* presumption, the district court thought the relevant duty in a case brought under Rule 10b-5(a) and (c) is not a disclosure duty to the issuer's shareholders, but rather "the duty not to engage in a fraudulent 'scheme' or 'course of conduct' that could be based primarily on an omission"—a duty that is owed to the investing public generally.[42] Because plaintiffs alleged the banks' "concealed, material conduct in a scheme to defraud" created a false picture of Enron's financial health – an allegation based primarily on omissions—the *Affiliated Ute* classwide presumption of reliance applied.[43] Regarding *Basic*, the district court believed the Fifth Circuit did not limit the fraud on the market presumption of reliance to misrepresentations or omissions that make a defendant's statement misleading.[44] Instead, it had "at times intermingled the two presumptions," such that the fraud on the market presumption can also apply to "defendants' primarily undisclosed conduct in a scheme or course of conduct to defraud securities investors."[45] Finally, in its discussion of "scheme" liability, the district court adopted the SEC's "principal purpose and effect" formulation to support its conclusion that the allegations regarding the banks' nonrepresentational conduct were sufficient to plead a primary violation of section 10(b).[46] A motions panel of the Fifth Circuit granted defendants leave to appeal the class certification order, and the court *sua sponte* expedited the appeal.[47]

Taking up the banks' appeal, the Fifth Circuit first set forth its rationale for reaching the merits issue of the scope of primary liability under section 10(b) in an appeal of a class certification order. It determined that, although it was not permitted to conduct "an independent inquiry into the legal or factual merit of the case," it could "address arguments that implicate the merits of plaintiffs' cause of action insofar as those arguments also implicate the merits of the class certification decision."[48] Because the issue of individual reliance would predominate in the absence of a classwide presumption of reliance, a review of the district court's grounds for finding such a presumption was necessary. The court went on to find that the district court's application of the fraud on the market presumption of classwide reliance was premised on an overbroad understanding of what constitutes a "deceptive act" under section 10(b), and that the district court misapplied the *Affiliated Ute* presumption. That led to the conclusion that reliance by class members on the banks' conduct could not be presumed and would be an individual issue that would predominate, precluding class certification.[49]

The appeals court rejected the district court's application of *Affiliated Ute* because that presumption of reliance applies only where the allegations reflect (i) claims founded primarily on omissions, and (ii) that the defendant owed plaintiff a duty of disclosure.[50] Focusing on the second element, the court disagreed with the district court that Fifth Circuit case law supports application of the presumption based on violation of a general duty not to engage in a fraudulent scheme.[51] It found that because "deception" within section 10(b) "requires that a defendant fail to satisfy a duty to disclose material information to a plaintiff," and the banks had no such duty to plaintiffs in this case, plaintiffs were not entitled to the *Affiliated Ute* presumption of reliance.[52]

Turning to the district court's application of the presumption of reliance on the market, the court found the lower court's broad definition of "deceptive act" caused it to conclude erroneously that the banks' actions were "misrepresentations" to which the fraud on the market presumption could apply.[53] It held that to qualify for the presumption, a plaintiff must allege public material misrepresentations made by the defendant, which plaintiffs did not allege for the defendant banks.[54]

The Fifth Circuit's analysis is notable for its emphatic demarcation of section 10(b)'s term "deceptive" to include only misstatements, misleading omissions of a material fact or breaches of a duty of disclosure.[55] To support its conclusion, the court relied on the Supreme Court's statement in *Central Bank* that section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[56] Decisions interpreting the text of section 10(b) establish that conduct (including a "scheme") "is not 'deceptive' under section 10(b) unless it involves breach of some duty of candid disclosure."[57] For example, the Supreme Court in *Chiarella v. United States* (cited on multiple occasions in the *Central Bank* opinion) held that "[w]hen an allegation of fraud is based upon non-disclosure, there can be no fraud absent a duty to speak."[58] Similarly, in *United States v. O'Hagan*, the Court stated that "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."[59] The Fifth Circuit determined that this limit on the meaning of "deceptive" circumscribes the range of "devices" that are prohibited by both section 10(b) and Rule 10b-5. It also undercuts any "interpretation of 'indirectly' that contradicts the accepted meaning of 'deception.'"[60] The court concluded that, because the banks had no duty to disclose information to Enron's shareholders, the transactions in which they engaged "at most aided and abetted Enron's deceit by making its misrepresentations more plausible" and therefore did not give rise to primary liability under section 10(b).[61]

After joining the Eighth Circuit and rejecting both the Ninth Circuit's reasoning in *Simpson* and the SEC's proposed formulation for "scheme" liability in its *amicus* brief to that court, the Fifth Circuit considered the policy implications of its decision. Although the banks were "escap[ing] liability for alleged conduct that was hardly praiseworthy," the court's strict construction established "the type of certainty that the Court sought in *Central Bank*."[62] Indeed, the difficulty of defining an endpoint for liability beyond the categories of misrepresentation and omission or violation of a duty to disclose raises the same policy concerns mentioned in

Central Bank and weighs against engrafting this or any other conspiracy-like concept onto section 10(b).[63] That courts and market participants could determine with any certainty whether involvement in a business transaction gives rise to primary liability or constitutes merely aiding and abetting is not apparent from the cases that have applied the "scheme" liability theory thus far. As the Fifth Circuit noted in comparing the outcomes of *Simpson* and *Charter*: "If there is a distinct difference between the culpability of defendants' action based on the pleadings in those two cases, it is not apparent to us and is likely beyond the understanding of good-faith financial professionals who are attempting to avoid liability."[64] It remains to be seen what kind of line the Supreme Court will draw when it takes up the issue in *Stoneridge*.

All Three Appellate Courts Agree that Misleading Disclosures Are Not "Manipulation"

In the course of their efforts to justify finding a cause of action based on "scheme" liability, some district courts appear to be open to expanding the definition of a "manipulative…device."[65] However, the one area of agreement among these three recent appellate decisions is that the manipulation concept in section 10(b) is not so malleable. All of these courts— including the concurring judge in *Regents*—agreed that "manipulation" under section 10(b) is limited to the types of artificial securities trading activity the Supreme Court described in *Santa Fe Industries v. Green*: "[m]anipulation is virtually a term of art when used in connection with securities markets" and "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[66] Thus, the courts of appeals are resisting pressure from plaintiffs to expand the section 10(b) prohibition on a "manipulative…device" to cover the various "schemes" plaintiffs allege, requiring instead that plaintiffs alleging "manipulation" plead facts showing that the defendant affected the market directly by engaging in artificial transactions in the underlying securities, not indirectly through means such as misleading disclosures or omissions.

The courts in both *Charter Communications* and *Regents* endorsed the language of then-district judge Higginbotham that manipulation under section 10(b) is limited to "'transactions in the [securities] marketplace, the effects of which were to prevent the market price from accurately reflecting the market's unimpeded judgment of the stock's value.'"[67] The *Regents* court provided what could be a useful gloss on the *Santa Fe* language when it stated unequivocally: "Manipulation requires that a defendant act directly in the market for the relevant security."[68]

Notes

1. 2007 WL 879583 (U.S. Mar. 26, 2007). Chief Justice John G. Roberts and Justice Stephen Breyer took no part in the consideration or decision of the petition for a writ of certiorari.
2. *See* Pet. for Writ of Cert., *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 2006 WL 1909677, at *i (2007) (No. 06-43).
3. 2007 WL 816518 (5th Cir. Mar. 19, 2007).
4. *See id*. at *8-14.
5. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994).
6. Central Bank served as indenture trustee for two bond issues. The bonds were secured by liens on land. The bond covenants required that the land be worth at least 160% of the bonds' outstanding principal and interest and required the developer to report annually to Central Bank with evidence that the requirement was met. In the January 1988 report, the developer provided an appraisal that showed land values almost unchanged from the appraisal of two years before. Even though both an underwriter and Central Bank's appraiser expressed concern that the land was no longer worth the required amount, the Bank, after consulting with the developer, agreed to delay an independent review of the appraisal. In the interim, the issuer defaulted. *See id*. at 167-69.
7. *Id*. at 177-78.
8. *Id*. at 191 (emphasis in original).
9. *See generally* Daniel A. McLaughlin, *Liability Under Rules 10b-5(a) & (c)*, 31 Del. J. Corp. L. 631 (2006); Gregory A. Markel & Gregory G. Ballard, *The Evolution of "Scheme" Liability Under Section 10(b)*, Practicing Law Institute/Corporate Law and Practice Course Handbook Series (Nov. 2006); Matthew L. Mustokoff, "*Scheme Liability Under Rule 10b-5: The New Battleground in Securities Fraud Litigation*, Federal Lawyer (June 2006).
10. Section 10(b) states, in relevant part:

    It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— . . .

    (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe as necessary or appropriate in the public interest or for the protection of investors.

    15 U.S.C. § 78j.

    Rule 10b-5 states:

    It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any national securities exchange,

    (a) To employ any device, scheme, or artifice to defraud,

    (b) To make any untrue statement of a material fact or to omit to state a material fact necessary 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.
11. A similar issue in attributing primary liability arises in misrepresentation cases as courts attempt to define when a defendant can be said to have "made" a false statement or misleading omission. Under the "bright-line" test, a person is liable only for statements publicly attributed to him. *See*, *e.g.*, *Wright v. Ernst & Young, LLP*, 152 F.3d 169 (2d Cir. 1998). Other courts take a more expansive approach, concluding that "substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements." *Simpson v. AOL Time Warner*, 452 F.3d 1040, 1048 (9th Cir. 2006) (citing *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000)); *see also In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d

319, 331-33 (S.D.N.Y. 2004) (expanding primary liability to include statements not publicly attributed to defendant so long as its participation was substantial and "investors are sufficiently aware of defendant's participation that they may be found to have *relied* on it as if the statement had been attributed to the defendant") (emphasis in original).

12. *See In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 492-93, 502-03 (S.D.N.Y. 2005) (relying on rule 10b-5(a) and (c) to find sufficient to state section 10(b) claim allegations that bank securitized allegedly worthless invoices for Parmalat, which Parmalat then misrepresented in its public filings); *Quaak v. Dexia*, 337 F. Supp. 2d 330, 332-41 (D. Mass. 2005) (relying on rule 10b-5(a) and (c) to find sufficient to state section 10(b) claim allegations that bank provided funding to company for purposes of maintaining sham entities engaged in illegitimate licensing agreements, which company then used to record artificial revenue). *But see In re Dynegy Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 819-20 (S.D. Tex. 2004) (rejecting primary liability under section 10(b) for a bank that allegedly structured, funded and executed transactions that company improperly reported).
13. 452 F.3d 1040, 1042 (9th Cir. 2006).
14. *Id.* at 1044-45.
15. *See id.* at 1043 (citing *Central Bank*, 511 U.S. at 177-78).
16. *Id.* at 1043.
17. *See id.* at 1047. The court cited *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 n.20 (1976), for its definition of "'device' as 'an invention; project; scheme; often, a scheme to deceive'"; *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10 n.7 (1971), for its statement: "We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception" (internal quotation omitted); and *SEC v. Zandford*, 535 U.S. 813, 821-22 (2002), which it construed to hold that "a non-speaker who engages in a 'scheme to defraud' has used or employed a deceptive device within the meaning of § 10(b)." *Zandford*, however, involved an omission when there was an affirmative duty to disclose. *See Zandford*, 535 U.S. at 820-21 (each transaction by broker was "deceptive because it was neither authorized by, *nor disclosed to*, [his clients]") (emphasis added); *id.* at 825 n.4 ("if the broker told his client he was stealing the client's assets, that breach of fiduciary duty might be in connection with a sale of securities, but it would not involve a deceptive device or fraud").
18. *Simpson*, 452 F.3d at 1048. Although Congress reaffirmed, in the Private Securities Litigation Reform Act of 1995, the SEC's authority to bring aiding and abetting actions under the Exchange Act, it did not do so under the Securities Act. *See* 15 U.S.C. § 78t(e). Accordingly, "assuming the *Central Bank* holding applies to the Commission," the SEC thought that resolution of *Simpson* "could have a bearing upon the Commission's authority to proceed against violators of the antifraud provisions of the Securities Act." *See* Brief of the Securities and Exchange Commission as Amicus Curiae in Support of Positions that Favor Appellant, *Simpson v. California State Teachers' Retirement Sys.* (No. 04-55665) (9th Cir. Oct. 2004).
19. *Id.* at 1048.
20. *Id.* at 1048.
21. *Id.* at 1049.
22. *Id.* at 1050. The court also concluded that "scheme" liability was consistent with the "in connection with the purchase or sale of securities" and "reliance" elements of a section 10(b) action. *Id.* at 1050-52.
23. *Id.* at 1052-53.
24. *Id.* at 1054.
25. *Id.* at 1053-54.
26. *Id.* at 1055.
27. *See* Brief in Opp. to Pet. for a Writ of Cert., *Stoneridge Inv. Partners*, 2007 WL 432471, at *11 (U.S. Feb. 7, 2007).
28. 443 F.3d 992 (8th Cir. 2006).
29. *Id.* at 989-990. Interestingly, despite plaintiffs' allegation that the *Charter* transactions were shams, the Ninth Circuit cited the case as an example of "participation in a legitimate transaction" that, under its formulation, would likewise not give rise to primary liability. *See Simpson*, 452 F.3d at 1050.
30. *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d at 990 (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 474-75 & n.15 (1977); *Affiliated Ute Citizens of the State of Utah v. United States*, 406 U.S. 128, 153-54 (1972); *United States v. O'Hagan*, 521 U.S. 642, 653-55 (1997)).
31. *Id.* at 992. *See infra* for a discussion of section 10(b)'s prohibition on "manipulation."
32. *Id.* at 992 (quoting *Central Bank*, 511 U.S. at 173).
33. *Id.* at 992 (citing *Santa Fe Indus.*, 430 U.S. at 474-75).
34. *Id.* at 992.
35. *Id.* at 992-93.
36. 2007 WL 816518, at *9-12.
37. *See id.* at *1.
38. *See id.* at *2.
39. 406 U.S. 128 (1972). In *Affiliated Ute*, the Supreme Court held that employees of a bank violated section 10(b) by inducing holders of stock to sell their shares "without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell." *Id.* at 153. Because the defendants were in essence acting as market makers, "they possessed the affirmative duty under [rule 10b-5] to disclose this fact" to the sellers. *See id.* Because rule 10b-5(a) and (c) are not restricted to misrepresentations and omissions to state a material fact, defendants' conduct, which involved "primarily a failure to disclose," was also covered by section 10(b). *See id.* In those circumstances, "positive proof of reliance is not a prerequisite to recovery." *Id.* at 153-154. As long as a reasonable investor would have considered the withheld information important to an investment decision – and defendants had a duty to disclose it – they could be liable under section 10(b). *See id.*
40. 485 U.S. 224 (1988). The fraud on the market theory allows a presumption of reliance on a misrepresentation made in an efficient market, on the theory that the price in such a market reflects all material public information and thus the investor may be presumed to rely upon its integrity.
41. *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 2006 WL 4381143, at *24-31 (S.D. Tex. June 5, 2006).
42. *See id.* at *27 (citing *Smith v. Ayres*, 845 F.2d 1360, 1363 & n.8 (5th Cir. 1988)).
43. *See id.*
44. *See id.* (citing *Shores v. Sklar*, 647 F.2d 462, 471 (5th Cir. 1981) and *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 359 (5th Cir. 1987)).
45. *See id.* at *27-30 & n.60 (citing *Finkel*, 817 F.2d at 359).
46. *See id.* at *38-44.
47. *See Regents*, 2007 WL 816518, at *3.
48. *See id.* at *4.
49. *See id.* at *6-7. The concurring judge criticized the majority for what he saw as its "leap to reach and resolve" the dispute about whether the banks were liable under section 10(b). *See id.* at *18-20 (Dennis, J., concurring in the judgment). In his view, regardless of whether section 10(b) covered the banks' conduct, their actions affected the market via Enron's public misrepresentations, which justified application of the fraud on the market presumption of reliance. *See id.* at *19. That the plaintiffs might not be able to

proceed against the banks at all was not, in his opinion, a reason to review class certification. *See id*. at *20.

50. *See id*. at *7.
51. *See id*. at *8. The authority on which the district court relied, *Smith v. Ayres*, 845 F.2d at 1363 & n.8, related to the first element of the test, and stood merely for "the straightforward proposition that a case brought under rule 10b-5(a) or (c) is more likely to be based primarily on omission than is a case under rule 10b-5(b), which requires that a defendant affirmatively make a misleading representation." *See Regents*, 2007 WL 816518, at *8.
52. *See id*. at *8. The concurring judge "d[id] not disagree with the majority's conclusion that the *Affiliated Ute* presumption does not apply in this case." *See id*. at *17 n.3.
53. *See id*. at *9. The court said it was addressing only the district court's definition of "deceptive act," on which the application of the fraud on the market presumption was founded, and not its application of "scheme" liability. *See id*. at *6, 16. Nevertheless, the court rejected the SEC's and the Ninth Circuit's "principal purpose and effect" formulation for "scheme" liability, and it reached the same conclusion as the Eighth Circuit about what constitutes "deceptive" conduct under section 10(b) – *i.e.*, only a misstatement or a failure to disclose by one who has a duty to disclose.
54. *See id*. at *9.
55. *See*, *e.g.*, *id*. at *10 ("Decisions interpreting the statutory text place a limit on the possible definitions that can be ascribed to the words contained in the SEC's rule promulgated thereunder. It is by losing sight of the limits that the statute places on the rule, and by ascribing, natural, dictionary definitions to the words of the rule, that the district court and likeminded courts have gone awry.").
56. *See id*. at *9 & n.23 (citing *Central Bank*, 511 U.S. at 177).
57. *See id*. at *12 & n.30 (citing *Chiarella v. United States*, 445 U.S. 222, 235 (1980) and *United States v. O'Hagan*, 521 U.S. 642, 644 (1997)).
58. *See id*. at *12 n.30 (citing *Chiarella*, 445 U.S. at 235).
59. *See id*. at *12 n.30 (citing *O'Hagan*, 521 U.S. at 644). In agreeing with the Eighth Circuit's analysis in *Charter*, the court also noted that decision was supported by cases applying the "bright line" test to refuse to extend primary liability to secondary actors in non-transactional scenarios, *see supra* note 11. *See Regents*, 2007 WL 816518, at *12 n.29.
60. *See id*. at *12 (citing *Central Bank*, 511 U.S. at 173, for principle that rule 10b-5 may not exceed scope of section 10(b)). The concurring judge criticized what it called the majority's "strict, narrow reading" of the word "deceptive" in section 10(b). *See id*. at *22. While he recognized that statements in *Chiarella* and *O'Hagan* could be read to support the majority's position, he reasoned that those cases "dealt only with insider trading …[n]either of those cases involved allegations of a multi-party scheme to defraud," and nothing in them "forecloses the conclusion that Section 10(b) can reach 'deceptive' conduct that is not in the form of a misrepresentation or omission in cases, like this one, that involve large-scale schemes to defraud." *See id*. at *21.
61. *See id*. at *12. The court also disagreed with the district court that Fifth Circuit precedent extends the fraud on the market presumption to a "scheme to defraud." *See id*. at *14 & n.35-38 (holding that *Shores* did not apply presumption to conduct like that at issue here and concluding that *Shores*' imposition of liability on lawyers and other secondary actors was overruled by *Central Bank*).
62. *See id*. at *14.
63. *See Central Bank*, 511 U.S. at 188-190 (noting that unclear rule in "an area that demands certainty and predictability…leads to the undesirable result of decisions made on an ad hoc basis, offering little predictive value to those who provide services to participants in the securities business," and that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general") (internal quotations and citations omitted).
64. *See Regents*, 2007 WL 816518, at *14.
65. *See In re Parmalat*, 376 F. Supp. 2d at 492-93; *In re Global Crossing, Ltd*., 322 F. Supp. 2d at 336-37.
66. 430 U.S. at 476 (internal citations and quotations omitted); *Charter*, 443 F.2d at 992 n.2; *Regents*, 2007 WL 816518, at *13; *id*. at *21 n.7 (Dennis J., concurring in the judgment); *Simpson*, 452 F.3d at 1047 n.2 (citing *Santa Fe*, 430 U.S. at 476).
67. *Charter*, 443 F.2d at 992 n.2; *Regents*, 2007 WL 816518 at *13 (both citing *Hundahl v. United Benefit Life Ins. Co*., 465 F. Supp. 1349, 1360 (N.D. Tex. 1979)).
68. *Regents*, 2007 WL 816518, at *13.