Supreme Court Issues Decision Analyzing Whether Misrepresentation is "in Connection with" Purchase or Sale of Covered Security

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On February 26, 2014, in *Chadbourne & Parke LLP v. Troice et al.*,[1] the Supreme Court narrowed the definition of "in connection with" as that term is used in the Securities Litigation Uniform Standards Act of 1998 (SLUSA). SLUSA bars state law class actions in which the plaintiff alleges a misrepresentation or omission "in connection with the purchase or sale of a covered security." The plaintiffs in a state law class action had alleged that they purchased certificates of deposit (uncovered securities) based on the misrepresentations that the certificates of deposit were backed by purchases and sales of covered securities. The Supreme Court held that a material misrepresentation is "in connection with" the purchase or sale of a covered security only if it makes a significant difference to someone's (other than the fraudster's) decision to purchase or sell a covered security.[2]

Because the certificates of deposit purchased by the class were not "covered securities," the 7-2 majority concluded that there was not a sufficient "connection" between the misrepresentations (which related to the *fraudster's* purported purchase or sale of securities) and any purchase or sale of covered securities by the *aggrieved investors*.[3] As a result, SLUSA did not bar the state class action from continuing.

Although the Court interpreted the "in connection with" requirement of SLUSA, the same "in connection with" language appears in the key antifraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Accordingly, the decision will have implications for both application of the restrictions imposed by SLUSA and the reach of the antifraud provisions of the 1934 Act.

The Decision

At issue in *Chadbourne* were four consolidated class actions involving plaintiffs who purchased certificates of deposit in the Stanford International Bank as part of former financier and cricket magnate Allen Stanford's multibillion-dollar Ponzi scheme.[4] These certificates of deposit were not traded on a national exchange or issued by an investment company. The plaintiffs alleged they were told that Stanford International Bank backed the certificates of deposit with nationally traded securities, making the certificates of deposit more secure.[5] The four class actions alleged that the defendants (investment advisers, insurers, and law firms) helped Stanford carry out or conceal the fraud from regulators.[6]

SLUSA is a federal statute that precludes state law class actions alleging (1) misrepresentation or omission of material fact in connection with the purchase or sale of a covered security; or (2) use of any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.[7] Covered securities are limited to those traded on a national exchange or issued by an investment company.[8] The Court evaluated whether SLUSA precluded a state law class action based on misrepresentations relating to covered securities where the victims purchased certificates of deposit, but did not themselves directly purchase covered securities.[9]

The Court, in a 7-2 decision, narrowly interpreted the "in connection with" requirement in SLUSA, holding that "[a] fraudulent misrepresentation or omission is not made 'in connection with' such a 'purchase or sale of a covered security' unless it is material to a decision by one or more individuals (other than the fraudster) to buy or sell a 'covered security.'"[10] The misrepresentations at issue concerned *Stanford International Bank's* purchase or sale of covered securities—the victims did not purchase or sell covered securities. Consequently, there was not a sufficient "connection" between the misrepresentations and the purchase or sale of covered securities.[11] Justice Breyer, writing for the majority, gave several reasons for the decision:

- the focus of SLUSA is on transactions involving covered securities;[12]
- a natural reading of SLUSA reveals that preclusion applies only when a misrepresentation is material to a decision to purchase or sell a covered, as opposed to uncovered, security;[13]
- prior cases alleging fraud in connection with purchase or sale of a security have all involved victims "who maintained *an ownership interest* in financial instruments that fall within the relevant statutory definition";[14]
- such a limit is consistent with the underlying statutes, the Securities Act of 1933 and the Securities Exchange Act of 1934, which evince a focus on "transactions involving the statutorily relevant securities";[15] and
- a broader interpretation of the connection would interfere with and limit a state's ability to address violations of state law frauds.[16]

Implications

As Justice Kennedy observed in the dissent, this new approach may restrict the Securities and Exchange Commission (SEC) and civil litigants in their ability to use the antifraud provisions of the federal securities laws, as well as expose defendants to costly state law litigation. The new "ownership" rule, for instance, may pose challenges to the SEC where the vehicle in which victims invest is not itself a security under the federal securities laws, though that vehicle invests in securities.[17] And though the facts presented by the Stanford matter were unusual—investors purchasing "uncovered securities" based on misrepresentations regarding "covered securities"—the dissent notes that fraudulent practices "constantly vary,"[18] and that it is difficult to predict how this narrowing may frustrate enforcement efforts in the future.

Additionally, Chadbourne arguably represents a departure from prior Supreme Court jurisprudence. In decisions such as *SEC v. Zandford*,[19]*Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*,[20] and *U.S. v. O'Hagan*,[21] the Court focused the "in connection" inquiry on whether the misrepresentation or omission "coincided" with a purchase or sale. *Chadbourne* requires, in addition, that the misrepresentation or omission cause someone *other than the fraudster* to purchase or sell a security. As the dissent observes, it is difficult to reconcile this new requirement with precedent such as *O'Hagan*, in which the entity "defrauded" was not the other party to the trade, but the fraudster's principal from whom confidential information was misappropriated.[22] It will be interesting to see whether *Chadbourne* cabins the SEC in future insider trading cases, particularly where it might seek to expand the reach of the misappropriation theory.

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[1]*Chadbourne & Parke LLP v. Troice et al.*, Nos. 12-79, 12-86, 12-88, slip op. (U.S. Feb. 26, 2014), *available at* http://www.supremecourt.gov/opinions/13pdf/12-79_h3ci.pdf. The companion cases are *Willis of Colorado Inc. et al. v. Troice et al.* and *Proskauer Rose LLP v. Troice et al.*

[2]*Id*. at 8-9.

[3]*Id*. at 18-19.

[4]*Id*. at 5.

[5]*Id*. at 7, 18.

[6]*Id*. at 6-7.

[7] 15 U.S.C. § 78bb(f).

[8] 15 U.S.C. § 78bb(f)(5)(E).

[9]*Chadbourne*, slip op., at 8.

[10]*Id*.

[11]*Id*. at 18-19.

[12]*Id*. at 9.

[13]*Id*.

[14]*Id*. at 9-10 (emphasis in original).

[15]*Id*. at 11.

[16]*Id*. at 12-13.

[17]*Chadbourne*, slip op., at 16-17 (Kennedy, J. dissenting).

[18]*Id*. at 11.

[19] 535 U.S. 813, 820 (2002).

[20] 547 U.S. 71, 85 (2006).

[21] 521 U.S. 643, 658 (1997).

[22]*Chadbourne*, slip op., at 9-12 (Kennedy, J. dissenting).

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